BASIC PRIMER ON SHARI'A-COMPLIANT FINANCE

KRISTEN A. BELL
ANN SAEGERT
HAYNES AND BOONE, LLP
2505 North Plano Road, Suite 4000
Richardson, Texas 75082
Kristen.bell@haynesboone.com
ann.saegert@haynesboone.com

Real Estate Probate and Trust Law Sections
of the State Bar of Texas
ADVANCED REAL ESTATE STRATEGIES 2007
October 17-19, 2007
San Diego, California

BASIC PRIMER ON SHARI'A COMPLIANT FINANCE

The payment and collection of interest has been a moral question for centuries. Both Christian and Islamic faiths include tenets that prohibit usurious conduct. The question whether interest on a loan of money was permitted as a matter of Christian doctrine remained a disputed issue well into the 1600s. In fact, Dante, in the *Divine Comedy*,[1] reserves the inner ring of the seventh circle of Hell for usurers, closer to Satan than even those who impose physical harm on people and property. Similarly, Muslim adherents have long struggled with the ability to collect and receive interest as part of their investment strategy in light of the tenets of their faith.

Shari'a law is a body of law derived from the Quran that prohibits the payment and collection of <u>any</u> interest (*riba*). Unlike the modern Christian tradition, compliance with *Shari'a* law is based on the premise that, not only is excessive interest prohibited, but any increase in the value of money that does not involve risk on both the borrower is lender is strictly prohibited. Recently, there has been a return of Muslim inherents to strictly follow the teachings of their faith, including *Shari'a* law. This increased adherence to Muslim principles, including the strict prohibition on the payment or collection of any interest, along with an increase in petrodollars in the Persian Gulf region, has left banks and other investment providers scrambling for a way to put *Shari'a* laws into practice to capture investors from the Persian Gulf nations.

This paper will outline the basics of building a *Shari'a*-compliant investment strategy. In addition, we will discuss the advantages and disadvantages for building *Shari'a*-compliant financial structures. Finally, we will discuss two examples of transactions that utilized *Shari'a*-compliant financing structures and took place in our own backyard, attracting both Muslim and non-Muslim investors.

I. The Building Blocks of *Shari'a* Finance

A. Prohibitions in *Shari'a* Law

There are three important factors to remember when discussing investment strategies in light of *Shari'a* law.

First, it is fundamental to recall that interest is strictly prohibited. Practically, this means that any investment must be asset-backed, so that any income or return based on the investment can be directly tied back to a quantifiable increase in value of the asset or a "rent" provided to the investor for another party's use of the asset. Because of this requirement, real estate is a popular vehicle for structuring *Shari'a*-compliant investments.

Second, speculation and gambling (*maser*) and uncertainty in a contract (*gharar*) are strictly prohibited. Because of the prohibitions on *maser* and *gharer*, it has generally been determined that the asset must be owned and certain at the time a transaction is entered into by

[1] *See* Dante Alighieri, *The Divine Comedy: The Inferno* (as translated by Henry Wordsworth Longfellow), Canto XVII.

the parties. These principles have limited *Shari'a* investors from investments involving short selling (common in hedge funds), derivatives and, even, conventional insurance. As we will discuss later in this paper, these prohibitions can affect the application of *Shari'a* law in project finance transactions, where the majority of the asset to be financed is acquired or constructed after the financing documents have been negotiated and executed.

Finally, *Shari'a* law strictly prohibits investments in activities that are unlawful (*haram*) according to *Shari'a* law. Examples of activities that are considered *haram* include the manufacturing of pork, alcohol, tobacco, and firearms; conventional banking; insurance or brokerage; and many entertainment services (hotels, gambling cinemas). In a real estate context, this may limit the ability of an investor to invest in real property that leases space to any entities engaged in any of the prohibited activities listed above.

In recent years, *Shari'a* law has allowed an investment portfolio to include up to 5% of impermissible income (i.e. income from interest or income from activities that are *haram* in nature). Generally, to maintain a *Shari'a*-compliant portfolio, the investment manager or individual investor would be expected to "purge" the prohibited income by donating that portion of the return to a charity.

B. Examples of Shari'a-Compliant Investment Strategies

The following transactions, similar to those that can be found in Western finance, act as the backbone for structuring *Shari'a*-compliant financing. As *Shari'a*-compliant investment strategies become more and more complex,. a combination of the strategies described below may be employed in an effort to allow historically high-yielding investment strategies to be available to *Shari'a* investors.

1. ***Murabaha*** (**Cost-Plus Financing**): In a *murabaha* transaction, a bank purchases an asset at the request of the client, and then the bank sells the asset back to the client on a deferred sale basis with a mark-up price that is determined before the purchase takes place and cannot be modified.

2. ***Ijara/Ijara wa-Iqtina*** (**Leasing Arrangements**): An *Ijara* transaction is similar to a Western lease (an asset is leased to a client for a specified period of time on agreed payment terms), and an *Ijara wa-Iqtina* is a lease in which the lessee has the right to own the asset at the end of the lease term. Triple net leases generally are prohibited.

3. ***Istinsa*** (**Commissioned Manufacture**): A bank is instrumental in the construction or manufacture of the underlying asset, sometimes directly and sometimes through a managing entity, and then sells the asset to a client at a reasonable profit. The profit paid to the lender is payment for the lender's taking on the risk to construct or manufacture the asset.

4. ***Mudaraba/Musharaka*** (**Limited Partnership/Joint Venture**): In both of these investment strategies, the lender and borrower work together to

finance/manage a project. A *mudaraba* transaction is similar to a Western limited partnership, whereby the investor contributes capital to a business and the borrowing party contributes labor and expertise. In a *mudaraba* transaction, the profit-sharing ratio must be agreed to prior to undertaking the project. A *musharaka* transaction is similar to a joint venture in that both parties provide capital and management to a project. Profits are shared based upon a pre-arranged ratio, but losses are distributed in proportion to equity participation.

5. ***Sukuk* (trust certificate equivalent to Western bond)**: The *sukuk* must be asset-backed, tradable and have a stable income (i.e. the share of a sukuk represents a sale of a share of the asset, unlike Western bonds which generally represent a sale of the debt), and payouts are derived from rents on leases, earned profits of a business or the sale of a tangible asset. It has been estimated that more than $20 billion in Islamic bonds are expected to be issued in 2007.[2]

6. ***Takaful* (Insurance)**: *Shari'a*-compliant insurance is based upon the principle of mutual support and a pooling of resources, so that the "insurance" company's role is that of a manager (to invest the contributions and manage the company's operations).

II. ADVANTAGES AND DISADVANTAGES OF SHARI'A-COMPLIANT INVESTMENT VEHICLES

The introduction of *Shari'a*-compliant financing into the marketplace has potential benefits for both Muslim and non-Muslim investors. There exists a strong argument that profit-sharing based on equal risk and reward and a quantifiable income stream creates a more efficient and stable investment market. In addition, offering *Shari'a*-compliant investment products can help to diversify an individual investor's portfolio and can increase the pool of potential investors for a given product, opening the door for both Muslim and non-Muslim investors. There are, however, some inherent limitations and restrictions that must be recognized when dealing with *Shari'a*-compliant finance structures.

A. Lack of Quality Assets

As a practical matter, it is important to recognize that each investment structure must be based on an asset that is quantifiable, certain and profitable. The sheer lack of quality assets in the marketplace limits the ability to apply *Shari'a* principles on a broader scale (although investors are constantly creating structures that broaden the applicability of *Shari'a* law to different investment assets). In addition, the prohibitions on speculation, gambling and uncertainty in a contract limit the ability of an investor to enter into contracts related to after-acquired assets. Many conventional investments in real estate and stock certificates are based on acquiring later-constructed or later-acquired assets, and creativity must be used to invest funds in such assets in a *Shari'a*-compliant manner.

---

[2] *See* Roane, Kit R. "Capitalism that Crosses Cultures", U.S. NEWS & WORLD REPORT, December 31, 2006.

B. Increased Lender Involvement

From a lender's perspective, *Shari'a*-compliant structures require lenders to be more involved, and as a result, bear increased risk in any given transaction. For example, many of the investment vehicles discussed above require the lender to take title to a certain asset (leasing the asset back to the borrower or selling the asset to the borrower on a deferred basis) in instances where the lender would normally procure only a security interest in the property. In the event the borrower becomes insolvent or fails to comply with the terms of the contract, the lender may be limited in its ability to engage normal foreclosure proceedings and could become liable under environmental laws as a 'mortgagee in possession'. Moreover, a lender who enters in a *mudaraba* (limited partnership) or *musharaka* (joint venture) may be deemed to be in "control" of the partnership or joint venture, and therefore, may be held liable in matters of corporate governance.

C. Lack of Uniformity Among Jurisdictions and *Shari'a* Scholars

A review of jurisdictional law is also important when structuring a *Shari'a*-compliant transaction, and in the case of *Shari'a* law, the jurisdictional question takes on a global scale. Several countries, in an effort to entice *Shari'a*-compliant investments, have created laws favoring such investments. In addition, different countries (and different financial entities) employ *Shari'a* boards to issue opinions on whether or not a transaction is compliant with *Shari'a* law. Because these opinions are not uniform, it is important to fully investigate both the law in the jurisdiction in which this transaction will be structured and the *fatwas* (opinions) issued by the applicable *Shari'a* board. If an investment structure is complex, it may be necessary to hire a *Shari'a* board to issue a *fatwa* stating that the structure is *Shari'a*-compliant.

D. Lack of Preparedness in Financial Markets for *Shari'a*-Compliant Transactions

Currently, the United States financial market is not structured in a manner conducive to complex *Shari'a*-compliant investments. An important factor limiting such investments is the lack of a rating system for *Shari'a*-compliant funds. This is slowly changing, an example of which can be seen in the East Cameron financing project discussed below. In addition, many financial transactions involve multiple transfers of the underlying asset to be compliant with *Shari'a* law and to insure the greatest profit. In states where a transfer tax would apply to each transfer of the asset, the taxes owed on the overall transaction can negatively affect the profitability of making the transaction *Shari'a*-compliant. In addition, as discussed above, legal mechanisms and precedent may not be present to protect lenders in complex *Shari'a*-compliant transactions.

III. TEXAS EXAMPLES OF *SHARI'A*-COMPLIANT FINANCING STRUCTURES

A. East Cameron Sukuk[3]

One of the most widely-discussed *Shari'a* finance transactions is the sukuk issued by East Cameron Partners. The popularity of this transaction is likely for two reasons: (1) it was hugely successful and (2) it was the first sukuk issued by an American company based on United States assets.

East Cameron Partners, a Texas oil and gas company, had an oil and gas reserve in the Gulf of Mexico, purchased from ConocoPhillips. In order to obtain conventional financing to explore the oil and gas reserve, East Cameron Partners' only option was to enter a financing agreement with a Western bank that acquired a significant equity piece in the exploration project. When East Cameron Partners discovered a valuable reserve, exploration and production allowed East Cameron Partners to quickly pay off the debt. Unfortunately, after the debt was paid, the bank continued to own a fifty percent working interest in the oil and gas reserve.

In order to buy out the bank's interest, East Cameron Partners (a non-Muslim company) investigated an unconventional approach to raising funds—the issuance of a sukuk. Because the value of the asset was secure and proved to be profitable (and the activity of drilling for oil is not *haram*), the oil and gas reserve was a prime candidate. Standard and Poor's issued a rating on the asset, and Muslim and non-Muslim investors raised $166 million in capital funds from the *Shari'a*-compliant sukuk issuance.

B. Maconda Park Apartment Project[4]

At first glance, the Maconda Park apartment project looks similar to a Western project finance transaction. A developer engages in debt and equity financing for the construction of an eight-building apartment project. In this transaction, however, the financing was provided by the developer and a group Islamic equity investors, who formed a special purpose entity to act as the investment entity (the "Shari'a Entity"), and a Western bank that provided debt-equivalent financing (the "Debt Entity"). The Shari'a Entity acted as owner and lessor of the project site and premises, while the Debt Entity acted as owner and lessor of the improvements. The Shari'a Entity, therefore, leased to the Debt Entity, the site and premises. In return, the Debt Entity leased to the Shari'a Entity the improvements through an *ijara* leasing structure. The *ijara* contained both a put and call option that allowed the Debt Entity to put the project to the Shari'a Entity at certain times and in certain circumstances, and allowed the Shari'a Entity to purchase the project at certain times and under certain circumstances. Therefore, the lease served as the primary financing document for the transaction. As owner and lessor of the improvements, the

---

[3] For more information related to the issuance of the East Cameron Sukuk and other Islamic bonds, please see *The East Cameron Gas Sukuk*, INVESTMENT BANKING, Issue 77, 36 (BME November 2007), and *Pushing Beyond the Boundaries*, EUROMONEY (February 2007), at www.euromoney.com.

[4] For more information related to the Maconda Park Apartment Project (and other project finance transactions), please see McMillen, Michael J.T., *Islamic Shari'ah-Compliant Project Finance: Collateral Security and Financing Structure Case Studies* (to be published in FORDHAM INTERNATIONAL LAW JOURNAL, vol. 48).

Debt Entity entered into a construction contract (*istisna'a*, or commissioned manufacture) with the general contractor, but the Debt Entity and Shari'a Entity also entered into a "Managing Contractor Agreement," in which the Shari'a Entity performed much of the construction oversight and management duties on behalf of the Debt Entity.

The above-described structure provides several solutions to some of the disadvantages of *Shari'a*-compliant financing. First, because the developers and Islamic investors, through the Shari'a Entity, held title in the property, they, and not the Debt Entity, remained liable for environmental issues and the payment of taxes. In addition, the lease was not fully effective, and the Shari'a Entity was not liable for payments of rent, until construction has been completed. Improvements were made subject to the lease, and rentals pursuant to the lease commenced, when each building was constructed and inspected by the Shari'a Entity.[5] If the lease was not fully effective by a specific date stated in the lease, the Debt Entity had the option to put the project to the Shari'a Entity. The basic rent stated in the lease included payments to be made to the general contractor and a profit built in for the Debt Entity.

IV. FINAL THOUGHTS

The presence of *Shari'a* financing in the global market cannot be overlooked. It is important, however, to remember the myriad of issues that arise when negotiating and constructing a *Shari'a*-compliant financing structure. Understanding the desired outcomes of the parties involved, the marketability of the product to non-Muslim investors, the legal parameters that affect the risk involved in such transactions and the impact of the *Shari'a* board's approval to the success of a transaction are all important factors in determining when and how to craft a transaction in a *Shari'a*-compliant manner. As shown above, it is likely that *Shari'a* transactions will become more and more common in international, and even local, transactions. Knowing the issues involved (and the complexity and expertise required in resolving these issues) is the best first step toward serving our clients as they navigate the world of *Shari'a* financing.

[5] These determinations will generally be made by a *Shari'a* board. Other approaches have been to allow the lease to become effective, except for the rental payments, which becomes effective at the point marketing and rental activities commence, or to require the parties to enter into separate leases for each portion (in this case, building) of the property so that each lease becomes effective when rental activity on the building that is the subject of that lease commences.