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## Separating the Good from the Bad: Developments in Islamic Acquisition Financing

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# SEPARATING THE GOOD FROM THE BAD: DEVELOPMENTS IN ISLAMIC ACQUISITION FINANCING

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## INTRODUCTION

Fairness and compassion, hallmarks of the religion of Islam,<sup>1</sup> are among the fundamental moral principles underlying Islamic law.<sup>2</sup>

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1. For an introduction to the religion of Islam, see ROGER DUPASQUIER, *UNVEILING ISLAM* (T.J. Winter trans., 1992).

2. See e.g., Umar Faruq Abd-Allah, *Mercy the Stamp of Creation*, available at <http://www.nawawi.org/downloads/article1.pdf>. For an introduction to Islamic law and jurisprudence, see BERNARD WEISS, *THE SPIRIT OF ISLAMIC LAW* (1998); MOHAMMAD HASHIM KAMALI, *SHARI'AH LAW: AN INTRODUCTION* (2008).

With varying degrees of success, contemporary Islamic transactions endure a variety of challenges to these fundamental principles. Notwithstanding these pressures, Islamic banking and finance has seen tremendous growth and success in a short amount of time. However, room for further quantitative, and more importantly, qualitative improvement, remains.

Private equity has also come to see record growth recently, both in funds raised and in transaction size, so much so that various debates, such as whether private equity should be taxed additionally, are well underway. Perhaps a more important debate, however, is whether private equity investments and acquisitions are good for their targets, particularly with the use of leverage and features such as liquidation preference and mandatory redemption. During this same time, the Islamic finance industry has seen the establishment and growth of an Islamic private equity, and even more recently, an Islamic venture capital.<sup>3</sup> Islamic equity financings, and indeed Islamic finance

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The Shari'ah—frequently, but incompletely, translated as “Islamic law”—constitutes the interaction of beliefs, values, and legal guidelines designed to maintain a proper balance between the spiritual and temporal components of existence in this world and the Hereafter. The primary sources of the Shari'ah are the Qur'an [the book of God] and the *Sunnah* [Prophetic precedent] and the rules contained therein. Detailed practical laws are derived by the application of *usul al-fiqh*: the methods of reasoning and rules of interpretation applied to the texts of the Shari'ah. The result of this interpretive process is known as *fiqh*, a term the author has chosen to translate as “Islamic law.” Jurists acknowledge that although the sources of Islamic law are divine, their derivation and application is a construct of the human intellect. . . . The goals and objectives of the Shari'ah are known in Arabic as *maqasid al-Shari'ah*. Securing benefit and preventing harm in this life and in connection with the Hereafter are the most important considerations (*maslahah*) of Islamic law. In order for any rule of Islamic law to be valid and applicable, it must not, among other things, violate the ultimate intent and purpose of the Shari'ah.

Umar F. Moghul, *No Pain, No Gain: The State of the Industry in Light of an American Islamic Private Equity Transaction*, 7 CHI. J. INT'L L. 469, 476-77 (2007) [hereinafter Moghul, *No Pain, No Gain*]. For an introduction to the *Qur'an*, see M. M. AL-AZAMI, *THE HISTORY OF THE QUR'ANIC TEXT FROM REVELATION TO COMPILATION* (2003). For an introduction to the *Sunnah*, see MOHAMMAD HASHIM KAMALI, *PRINCIPLES OF ISLAMIC JURISPRUDENCE* 58-116 (The Islamic Texts Society 2003) (1989).

3. See e.g., Badr El Din A. Ibrahim, *Nothing Ventured Nothing Gained*, 5 ISLAMIC BANKING & FIN. 23 (Winter 2007). To our knowledge, Islamic leveraged buyouts in the private equity context began in the United States in the mid or late 1990s.

generally, have come to challenge the paradigm of the dominant financial order, with an increased focus on the welfare of stakeholders, employees, and the environment, among other concerns. From perhaps a more technical perspective, Islamic finance expects a faithful adherence to its legal underpinnings, including its prohibition on liquidation preference, the use of redemption pricing reflective of market value,<sup>4</sup> and particularly with its risk assessment and risk allocation and sharing schematic.

This Article focuses on a particular leveraged buyout transaction (the “Subject Transaction”) in which the author served as legal counsel to the sponsor and ultimate buyer, an Islamic investment bank, of a U.S. technology-manufacturing business.<sup>5</sup> This Article presents a number of the key legal issues that arose through the course of the Subject Transaction, particularly with respect to the structure of the leverage, to demonstrate and advocate for the use of more efficient, simpler structures with a view towards increasing compliance with a greater portion of Islam’s substantive legal-financial concepts.<sup>6</sup> In the course of analyzing these legal structures, this Article shows the impact of Islamic principles on private equity

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4. See Moghul, *No Pain, No Gain*, *supra* note 2, at 490-93 (discussing liquidation preference and fixed returns).

5. The sponsor is established and licensed as such pursuant to the laws of its jurisdiction of formation. Not all Muslim countries, it should be noted, have such a regulatory scheme.

6. By substantive, I refer to the ‘*ilal* (effective causes), *hikam* (rationale), and purposes of the law (*maqasid al-Shari’ah*). See e.g., MUHAMMAD MUSTAFA AL-SHALABI, TA’LIL AL-AHKAM [THE RATIOCINATION OF LEGAL RULINGS] (1981); see also Umar F. Moghul, *Approximating Certainty in Ratiocination: How to Ascertain the ‘Illah (Effective Cause) in the Islamic Legal System and How to Determine the Ratio Decidendi in the Anglo-American Common Law*, 4 J. ISLAMIC LAW 125 (1999).

Matters of contract and finance fall in the realm of *mu’amalat*: the realm of Islamic law that is mutable and dynamic, and thus consistent with the temporal and material aspects of human existence and life in this world. This is of special significance to contemporary Islamic finance since classical Islamic legal theories envision the necessity of applying Islamic principles to newly arisen contexts and provide for mechanisms to create new laws. At a particular level, the “substance” of Islamic law—important for constructing new law—might be said to be found in the preservation of the ‘*illah* and *hikmah*, as well as in the purposes of the law (*maqasid al-Shari’ah*). Moghul, *No Pain, No Gain*, *supra* note 2, at 474 n.18; see also AHMAD AL-RAYSUNI, IMAM AL-SHATIBI’S THEORY OF HIGHER OBJECTIVES AND INTENTS OF ISLAMIC LAW, at xxv–xxx (Nancy Roberts trans., 2005).

transactions and highlights some similarities and differences between contemporary Islamic financial practice and classical Islamic jurisprudence.<sup>7</sup>

## I. THE SUBJECT TRANSACTION: THE EQUITY SIDE

One does not normally encounter significant structuring difficulties when structuring or documenting an Islamic equity investment transaction, or, in this case, the equity side of a leveraged buyout transaction. That was the case with the Subject Transaction, and for that reason this Article spends little time exploring the course of the acquisition itself. There are, however, at least some interesting points to note in this regard from an Islamic finance perspective.

### A. PURCHASE PRICE

Among the most conspicuous features of Islamic financial law, apart from its prohibition of *riba*,<sup>8</sup> is its prohibition of *gharar*. This concept, simply translated as an aleatory sale, is perhaps best understood as trading in risk and extends to the ignorance of the material terms of a transaction.<sup>9</sup> Of course, most every transaction involves some degree of risk, but Islamic law concerns itself with a heightened degree, or certain type, of risk. If the *gharar* is trivial, does not sufficiently impact the material transaction terms, and the

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7. Readers are encouraged not to assume that if there is a difference between contemporary (conventional or Islamic) financial practice and classical Islamic law, such a difference is necessarily inappropriate or somehow un-Islamic.

8. A detailed explanation of *riba* is beyond the purview of this Article. For present purposes, we may understand *riba* as interest or other consideration (in perhaps whatever other form), payable or receivable, directly or indirectly, in a loan transaction. This is of course not to say that *riba* occurs only in loan transactions. Muslim jurists are also concerned with the use of sale transactions (which, for Islamic legal purposes, also interestingly include leases as the sale of usufruct) containing *riba*. See MUHAMMAD TAQI USMANI, THE TEXT OF THE HISTORIC JUDGMENT ON RIBA (2001); see also WAHBAH AL-ZUHAYLI, 1 FINANCIAL TRANSACTIONS IN ISLAMIC JURISPRUDENCE 309-11 (Muhammad S. Eissa ed., Mahmoud A. El-Gamal trans., 2007).

9. See MOHAMMAD HASHIM KAMALI, ISLAMIC COMMERCIAL LAW: AN ANALYSIS OF FUTURES AND OPTIONS 84-98 (2000) [hereinafter KAMALI, ISLAMIC COMMERCIAL LAW] (expounding upon *gharar*).

people are in need of the type of transaction at hand, the concern for *gharar* can be mitigated.<sup>10</sup>

The purchase price in the Subject Transaction constituted a combination of cash as well as common stock in the buyer<sup>11</sup> and was payable to the seller in exchange for substantially all of the seller's assets as well as some of its liabilities.<sup>12</sup> As with many equity transactions, the Subject Transaction involved a net working capital calculation and review process as well as a clawback to either the buyer or seller in the event certain specified performance targets were achieved or missed, respectively.

Traditionally, net working capital adjustments and such clawbacks are articulated as an adjustment to the purchase price. Under Islamic principles, to avoid (excessive) *gharar*, the purchase price must be known by the buyer and seller and definitively stated at contract. This is especially true at the time of closing, which is understood by Islamic contract law to be the moment at which title to the purchase price and title to the assets exchange hands.<sup>13</sup> From the vantage point of Islamic law, as interpreted by the sponsor's *Shari'ah* department,<sup>14</sup>

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10. See AL-RAYSUNI, *supra* note 6, at 48.

11. The buyer constituted a U.S. corporation established (though not directly owned) by the sponsor, and constituted the new business post-acquisition. This Article refers to the buyer as the "company" or the "lessee" from time to time.

12. As with acquisitions generally, the buyer was careful not to assume certain liabilities and to limit its liability for certain others.

13. Under most interpretations, Islamic law does not consider binding those agreements where delivery of both countervalues is delayed. See FRANK E. VOGEL & SAMUEL HAYES, III, *ISLAMIC LAW AND FINANCE: RELIGION, RISK, AND RETURN* 114-16 (1998).

14. See generally Michael J. T. McMillen & Abradat Kamalpour, *An Innovation in Financing—Islamic CMBS*, in *COMMERCIAL MORTGAGE-BACKED SECURITIZATION: DEVELOPMENTS IN THE EUROPEAN CMBS MARKET* 382, 385-87 (Andrew V. Petersen ed., 2006) (discussing the composition and role of *Shari'ah* boards). Islamic legal assistance and advice are provided in contemporary Islamic transactions through the construct of *Shari'ah* boards or committees retained by Islamic investors, funds, institutions and even family offices. Such boards or committees are comprised of Muslim jurists who assist in the structuring and documentation of offerings, financings, investments and any other transactions. They also audit and oversee the operations of Islamic businesses as well. If their approval is finally obtained, it is set forth in the form of a *fatwa*, or non-binding legal opinion. See MOHAMMAD AKRAM NADWI, *MADRASAH LIFE* 59 (2007) ("In the past, it was customary to use as few words in a *fatwa* as possible. But this is not the right way. Rather, arguments drawn from the Qur'an, *sunnah* and common

the purchase price in the Subject Transaction was insufficiently specified because the net working capital adjustment and clawback provisions could lead to an increase or decrease in the purchase price by an uncertain amount at a time following close. Moreover, the sponsor's *Shari'ah* board noted that the risk of the business' performance should be borne by the buyer, its new owner. Both challenges were overcome with explanatory discussions with the *Shari'ah* board and by restructuring the possible purchase price adjustments as additional payments made subsequent to the purchase price payment at closing.<sup>15</sup>

The Subject Transaction involved the buyer paying some amount of cash itself, while the balance of the purchase price was financed by way of two sale-leaseback transactions.<sup>16</sup> The capital obtained through these sale-leaseback transactions involved a sale by the buyer of the assets that were acquired from the seller to a third-party-owned special purpose vehicle (the "SPE"), which was formed to function as a counterparty in multiple components of the Subject Transaction.<sup>17</sup> Therefore, at the very moment in time the buyer acquired the assets from the seller, the buyer owned only its cash contribution to the purchase price payable to the seller. The buyer would not yet acquire the capital made available through the sale-leasebacks until after it acquired the assets from the seller (since such capital was receivable as the purchase price payable for this subsequent sale by the buyer). Thus, at the time of purchase from the seller, the buyer could only state that it would pay its cash contribution. The balance of the purchase price (excluding the sale-leaseback financing) was thus stated to be paid by way of a non-

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sense should be presented in order to convince those seeking a ruling, as it will increase their knowledge.").

15. Under a conventional transaction, if some component of the purchase price is being paid in cash, the purchase agreement simply states it to be payable in cash. Conventionally, and arguably inaccurately, the borrowing and purchase transactions are viewed as occurring simultaneously. On this point, however, the *Shari'ah* department (and others in the author's experience) disagrees with customary conventional parlance.

16. See *infra* Part III (discussing the two component sale-leaseback transactions).

17. More specifically, as discussed below, the SPE, a corporation, serves as the borrower under the loan component, and buyer and lessor in the sale-leaseback components, of the financing. It is owned by a third-party corporate services company.

interest-bearing demand note made by the buyer to the order of the seller. Such a note could not bear interest because of the prohibition of *riba* and, for the same reason, typical default or penalty provisions were also problematic. It was of course important for the seller to be comfortable with this arrangement. Continued dialogue and education were important in this regard, as is the practical reality of the Subject Transaction—namely, that each of its components are occurring at about the same time at the same closing.<sup>18</sup>

## B. ESCROW

Escrow arrangements are often used in equity transactions for the purpose, among others, of ensuring the availability of capital in the event of a representation or warranty breach or an indemnity claim. Typically, a bank is selected as an escrow agent in exchange for a fee.<sup>19</sup> The bank, as escrow agent, accepts instructions from a particular party regarding investment of the escrow property. Such instructions are typically set forth in an escrow agreement as a list of what are often termed permitted investments. These are interest-bearing, fixed income instruments, such as money market accounts, certificates of deposits of larger financial institutions, and U.S. government-issued or guaranteed obligations.

Fundamentally, such an arrangement is not problematic from an Islamic legal perspective. The trustee (*amin*) under Islamic laws is generally not deemed liable for losses or damages to the property in trust absent its negligence, willful misconduct, or breach of

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18. It is important to note that a sale with a deferred and higher purchase price was possible under Islamic laws though, as noted above, would have been overly cumbersome in light of the practical realities of the transaction mechanics and timing. *Cf. Moghul, No Pain, No Gain, supra* note 2, at 489-91 (discussing the critical role of education in Islamic finance in the context of an Islamic growth equity transaction).

19. Many Islamic financial institutions utilize escrow arrangements in the United States without expressly authorizing or specifying any investment instruments for the escrow property and without earning any returns resulting from any investment thereof. They are not charged a fee by the escrow agent. To our knowledge, only one institution in the United States offers any Islamic deposit product, yet the scale of the institution or its product are probably not appropriate in the eyes of larger Islamic investors. For those institutions where the escrow property may be held offshore to the United States, more relevant Islamic products are available in our experience.



obligations to the property owner.<sup>20</sup> These limits to liability generally parallel what is usually found in conventional escrow agreements. On the other hand, the list of permitted investments commonly found in such agreements was problematic; this was identified at the outset by counsel prior to *Shari'ah* department review.

The prohibition of *riba* extends to the receipt of interest on investments of the type typically permitted in escrow agreements as well as the investment in companies having *riba*-based income.<sup>21</sup> As an entity operating per Islamic norms, the buyer could not agree to the permissibility of such typically permitted investments neither for itself, nor for its counterparty, the seller.<sup>22</sup> The parties did, however, agree that the escrow property would belong to the seller,<sup>23</sup> and, as can be expected, the seller sought to invest its property in the manner it deemed fit. The conclusion that the escrow property would belong to the seller certainly made structuring an alternative escrow

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20. VOGEL & HAYES, *supra* note 13, at 112-13 (mentioning that Islamic fiduciary law generally favors the trustee because the owner selected the trustee). This principle is the inverse of Anglo-American common law governing fiduciary conduct. *See id.* at 113 n.41.

21. In 1998, the Dow Jones Islamic Market Indexes' *Shari'ah* board issued a *fatwa* setting forth a series of tests to determine the basis on which a publicly traded company was not impermissible as the target of an investment. Among other things, this *fatwa* applied the prohibition of *riba* with some discretion to arrive at certain tolerance threshold of the presence of *riba* as well as other impermissibilities. *See* GUIDE TO THE DOW JONES ISLAMIC MARKET INDEXES, DOW JONES INDEXES (2007), available at <http://www.djindexes.com/mdsidx/index>. This *fatwa* has opened the door to a similar series of filters in the private company context and in other financings as well. *See* Moghul, *No Pain, No Gain*, *supra* note 2, at 486-88. Though not relevant to the Subject Transaction, the prohibition of *riba* is also relevant to the prohibition of liquidation preference. *See id.* at 491-92.

22. Readers are cautioned from the understanding that Islamic law is wholly applicable to persons of faiths other than Islam as this is certainly not the case. *See, e.g.,* Najwa Al-Qattan, *Dhimmi in the Muslim Court Legal Autonomy and Religious Discrimination*, 31 INT'L J. MIDDLE E. STUD. 429, 430 (1999) (finding that many non-Muslim litigants preferred Islamic courts and Islamic law because of its advantages to them). It is often asserted that the prohibition of *riba* is found within the Jewish and Christian faiths, however, and thus is applicable to their respective members. *See, e.g.,* Mervyn Lewis, *Comparing Islamic and Christian Attitudes to Usury*, in HANDBOOK OF ISLAMIC BANKING (M. Kabir Hassan & Mervyn Lewis eds., 2007); Daniel Klein, Comment, *The Islamic and Jewish Laws of Usury: A Bridge to Commercial Growth and Peace in the Middle East*, 23 DENV. J. INT'L L. & POL'Y 535 (1995).

23. This has important U.S. tax implications that are not discussed in this Article.

agreement all the easier from an Islamic legal perspective. The buyer was primarily concerned that the types of permitted investments be suitable for the purposes of the escrow. The escrow property had to be kept intact to the maximum extent possible and be liquid and readily available in the event the buyer was to make a claim for it. Ultimately, the parties agreed on these conditions as the required investment parameters. It must be mentioned that such an unconventional escrow arrangement required a flexible bank as escrow agent with an appreciation of the long-term potential of the growing Islamic investments market.<sup>24</sup>

### C. OTHER EQUITY RELATED ISSUES

Following close of the Subject Transaction, the buyer, a corporation, constituted the new business.<sup>25</sup> The sponsor, together with certain other shareholders, may be said to have entered into a partnership, by way of written contracts, crystallized in the form of a conventional business entity.<sup>26</sup> The Islamic nominate contract form most relevant to this constitution is the *sharikah al-mal*<sup>27</sup> in which the buyer, seller, and seller's management contributed, or were deemed to have contributed, capital for their shares in the buyer.<sup>28</sup> As

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24. See, e.g., Joanna Slater, *When Hedge Funds Meet Islamic Finance*, WALL ST. J., Aug. 9, 2007, at A1 (discussing how funds in the United States are seeking to develop new products to market to investors seeking Islamic instruments).

25. Contemporary Islamic finance seems to have little criticism regarding the limitations of liability of modern business forms. *But see* IMRAN AHSAN KHAN NYAZEE, *ISLAMIC LAW OF BUSINESS ORGANIZATION: PARTNERSHIPS* (1999); IMRAN AHSAN KHAN NYAZEE, *ISLAMIC LAW OF BUSINESS ORGANIZATIONS: CORPORATIONS* (1998).

26. Moghul, *No Pain, No Gain*, *supra* note 2, at 489 ("The notion that a legal entity serves as the *sharikah* is a departure from classical formulations of Islamic law."). These contracts address the underlying contractual basis of a *sharikah*. The shareholders agreement, for instance, addresses much of the substance of the contracts of *amanah* and *wakalah* that underlie the *sharikah*. *Id.* at 488-89.

27. Contemporary Islamic finance uses the Arabic term *musharakah* instead of *sharikah*. See generally AL-ZUHAYLI, *supra* note 8, at 445-522; Muhammad Taqi Usmani, *The Concept of Musharakah and Its Application As an Islamic Method of Financing*, 14 ARAB L. Q. 203, 204 (1999) ("Islam has not presented a specific form or procedure for *musharakah*. Rather, it has set some broad principles which can accommodate numerous forms and procedures.").

28. As noted earlier, common stock of the buyer issued to the seller was a component of the purchase price paid for the seller's assets.

shareholders, these parties' agreement was set forth in a shareholders agreement.

As is customary, the shareholders carefully negotiated a set of responsibilities and rights with respect to one another and their respective stock ownership. These included limitations on transfer with customary carve-outs, a right of the minority holders to appoint a director, rights of first refusal granted to the owner in the event the minority shareholders proposed a third party sale, a right of the minority shareholders in the event new securities were issued, as well as co-sale and drag along rights. No substantial issues were raised by the *Shari'ah* department in connection with this shareholders agreement, and this is consistent with past experience.<sup>29</sup>

## II. THE SUBJECT TRANSACTION: THE FINANCING SIDE

While we have discussed some of the impact of the prohibition of *riba* on equity transactions, the prohibition of *riba* impacts debt financings in a much more pronounced manner. The Subject Transaction involved financing for the purpose of the acquisition itself as well as the working capital requirements of the new business. The acquisition financing was broken into three tranches. The first two tranches involved two secured sale-leaseback financings with one effectively subordinated to the other. The third tranche was an unsecured financing provided by the seller.

### A. FIRST AND SECOND SALE-LEASEBACKS

The vast majority of contemporary jurists have interpreted commercial interest-bearing loans as prohibited because of the presence of *riba*. As such, Islamic finance has sought structure financings by identifying assets (which are themselves lawful) to be utilized in some form of sale (which includes leasing transactions as the sale of usufruct). Past Islamic leveraged buyout transactions in the United States have combined a conventional loan with a finance

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29. This Article does not address regulatory aspects of the Subject Transaction, such as the required filing under the Hart-Scott Rodino Act or filings made pursuant to federal and state securities laws. Other common, important aspects of an equity transaction include employment agreements and stock options. Neither, in our experience, has presented any significant issue from a *Shari'ah* board.

lease to create an Islamically acceptable financing transaction.<sup>30</sup> The Subject Transaction in part follows that precedent.

Such transactions have usually involved one or more lenders (often, but not always banks), lending to a special purpose entity. In the United States, regulatory guidance has been issued regarding Islamic finance and the ability of U.S.-regulated banks to participate therein.<sup>31</sup> As banks, these lenders are bound by certain regulatory constraints that arguably have a very direct impact on their ability to engage in Islamic transactions. Such regulatory guidance has focused on the nature and substance of the risk borne by banks to ensure that

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30. Given the prohibition of commercial interest-bearing loans, as mentioned earlier, one seems forced to conclude that such transactions would not normally be deemed acceptable, but rather there must be some concession granted. By “normal”, I refer to an *‘azimah* ruling. See IMRAN AHSAN KHAN NYAZEE, ISLAMIC JURISPRUDENCE 77 (2000) (explaining *‘azimah* as “[a] rule initially applied as a comprehensive general principle to which exceptions or provisions are provided by the law later” but that new exemptions cannot be obtained by way of analogy based on an exemption). “The special and exceptional commands which allow to act against the regular injunctions are called *rukhas* (pl. of *rukhsah*). . . . For instance, journey, disease, duress and necessity are causes of dispensation (*rukhsah*) . . . .” AHMAD HASAN, I THE PRINCIPLES OF ISLAMIC JURISPRUDENCE: THE COMMAND OF THE *SHARI’AH* AND JURIDICAL NORM 154-55 (1993).

31. See Letter from Jonathan H. Rushdoony, Dist. Counsel, Comptroller of the Currency [OCC], to Steven T. Thomas, Gen. Manager, United Bank of Kuwait, Interpretive Letter No. 806 (Oct. 17, 1997), available at <http://www.occ.treas.gov/interp/dec97/int806.pdf> (authorizing a U.S.-regulated branch of the United Bank of Kuwait (“UBK”) to provide a product whereby UBK’s Muslim clients would purchase residential real estate with the aid of UBK by entering into a lease agreement and purchase agreement, which together amounted under U.S. law as a financing, rather than a leasing, transaction); see also Letter from Jonathan H. Rushdoony, Dist. Counsel, OCC, OCC Interpretive Letter No. 867 (June 1, 1999), available at <http://www.occ.treas.gov/interp/nov99/int867.pdf> (authorizing a “riskless principal” purchase of property on behalf of Muslim clients, whereby a bank would “acquire the property on behalf of the customer and then resell the property to the customer at a mark up on an installment basis”). The “*Murabaha* financing facility” is essentially a “riskless principal” transaction from the point of view of the bank. There could appear to be a contradiction, if not a tension, between the prescribed risk profile of banks under applicable U.S. laws, as exemplified in these two advisory letters, that render more substantive Islamic financing challenging. Nevertheless, these letters are part of a broader effort by U.S. regulators to open the doors to Islamic finance in the United States. See Abdi Shayesteh, *Analysis: Bullish on U.S. Islamic Banking*, NEW HORIZON, Jan. 1, 2008 (Issue No. 166, Oct.-Dec. 2007), available at [http://www.newhorizon-islamicbanking.com/index.cfm?action=view&id=10564&section=features&return=latest&return\\_action=view&return\\_id=77](http://www.newhorizon-islamicbanking.com/index.cfm?action=view&id=10564&section=features&return=latest&return_action=view&return_id=77) (highlighting the many initiatives of U.S. regulations with respect to Islamic finance).

they remain within the business of banking when financing on an Islamic basis. This risk allocation strikes against the risks demanded by financiers under Islamic laws insofar as such guidance demands that the banks take only a credit risk.<sup>32</sup> Non-bank lenders are at least not limited by such regulations though some, in our experience, tend to operate as if they were banks with regard to their expectations and parameters. Nevertheless, it is non-banks that offer the potential to move away from the presence of loans towards further compliance with Islamic principles. Perhaps on account of the limitations imposed by U.S. banking regulations, *Shari'ah* boards have conditionally permitted the presence of an interest-bearing loan transaction in leveraged acquisitions, including the Subject Transaction.

The Subject Transaction involved a syndicate of bank and non-bank lenders, lending to the SPE, which is owned by a corporate services company and played no other role in the transaction. For Islamic reasons, the lenders have no direct contractual privity with the buyer; no written contract exists between any lender and the Islamic investor and its affiliates.<sup>33</sup> This independent ownership (and the absence of ownership by the Islamic party) is critical because it appears to be an important basis on which *Shari'ah* boards permit the use of the loan within the overall otherwise Islamic, financing mechanism. Such permission is probably granted on a conditional basis or with the view towards gradually implementing Islamic laws.

The credit agreement and promissory notes evidencing the loans contained customary provisions, accounting for the fact that the borrower is a special purpose entity. The SPE borrower utilized the proceeds of the above-described loan to acquire certain assets from the buyer that the buyer had only moments before acquired from the seller. These assets were then leased back to the buyer. The SPE thus

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32. See Moghul, *No Pain, No Gain*, *supra* note 2, at 478 (discussing the Islamic legal maxim, '*al-kharaj bi al-damani*', which may be translated as "[Entitlement to] profit must be accompanied by a liability for loss"). A mere credit risk is insufficient. *Id.*

33. It is interesting to note that the commitment letter in this transaction was also between the agent for the lenders and the borrowing special purpose vehicle. A second commitment letter was established between the latter and the buyer-lessee, covering the sale-leaseback, as more fully discussed below. See *infra* Part III.B.

also serves as the seller and owner-lessor in each of the sale-leaseback transactions.

As briefly noted above, leases are viewed as sales by Islamic laws, and thus generally follow the laws relating thereto. Perhaps second only to *murabahah* transactions in frequency, *ijarah*, or lease-based, transactions are a significant segment of the current Islamic banking and finance market.<sup>34</sup> Contemporary Islamic finance, as will be shown in the case of the Subject Transaction below, often combines a lease with the ultimate purchase of the asset by the lessee. With each rent payment, the lessee effectively increases its ownership in the leased assets, though title thereto is held throughout the term by the lessor, which role was performed by the SPE in the Subject Transaction. Primary Islamic legal issues relate to the obligations that Islamic law requires of the lessee and lessor, respectively. Islamic legal issues also arise with respect to the rental if and when the assets decrease in value or are destroyed altogether. These issues and certain other relevant ones are discussed below.

The finance lease agreement contained a host of representations and warranties as well as affirmative and negative covenants that were carefully drafted to mirror the representations, warranties, and covenants in the loan documentation. Obligations and rights might thus be said to effectively flow through between the loan and lease sides of the transaction.<sup>35</sup> It is important to note that rent is articulated in a manner that enables the lessor to meet its obligations to the lenders. *Shari'ah* committees have generally permitted the calculation of rent in the manner the parties have agreed upon; the pricing of rent in a manner linked to interest rates, such as LIBOR in the case of the Subject Transaction, appears to be reluctantly tolerated.<sup>36</sup>

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34. See generally AL-ZUHAYLI, *supra* note 8, at 381-434. For our immediate purposes, the following information should suffice: In addition to the requirements of a valid contract, such as offer and acceptance, there must be a valid leased object, the usufruct must be deliverable and of benefit to the lessee (and not the lessor), and both the lease term and price must be clearly articulated. See *id.* Other relevant rules and their contemporary application are discussed below. See *infra* Parts III.C.-E.

35. Again, however, no direct privity or written agreement exists between the lenders and the Islamic lessee-operating company.

36. As can be the case in some Islamic retail financing products, the *Shari'ah* board (similar to others in our experience) here did not require a "floor" or

As owner of the leased assets, the SPE granted, as is customary in such Islamic facilities, an option to acquire some or all of the assets upon specified conditions. Such an option, often called a call option or promise to sell, effectively replicates the concept of partial and total prepayments in conventional loans. The notion of prepayments, and the consequent reductions in principal, are somewhat alien to the notion of an acquisition or sale in which a single purchase price is payable.<sup>37</sup> Such an option is, therefore, articulated and structured as a sale for the purpose of not characterizing the transaction as a loan. The call option in this case set forth limitations as to the timing and amounts of any early acquisitions and also listed conditions precedent to such acquisitions that are economically or financially similar to those placed in conventional financing arrangements.

Moreover, the financier or lessee or both seek to have the ownership of the assets pass into the hands of the lessee. Having the lease of the assets conditioned on their sale is prohibited by contemporary *Shari'ah* committees, however. Consequently, the finance lease agreement is not to contain a condition of sale or other transfer of the assets' ownership, and the call option is set forth in a separate written instrument.<sup>38</sup> Many *Shari'ah* boards view this option as a unilateral promise and, as such, the sale of the assets is neither a condition to their being leased nor is it binding on the optionee.<sup>39</sup> In

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“ceiling” to the rental amount. Others might characterize pricing without the same as having *gharar*. See, e.g., Irshad Abdal-Haqq, *A Model of Islamic Banking and Finance in the West: IslamiQ*, 6 J. ISLAMIC L. & CULTURE 101, 126-28 (2001).

37. There is a Prophetic statement (*hadith*) to support the notion of a reduction in amount when payment is hastened. Its authenticity is disputed. See, e.g., MUHAMMAD TAQI USMANI, AN INTRODUCTION TO ISLAMIC FINANCE 61 (2002) (stating that, in light of the dispute regarding the authenticity of this *hadith*, “the majority of the jurists hold that if the earlier payment is conditioned with discount, it is not permissible. However, if this is not taken to be a condition for earlier payment, and the creditor gives a rebate voluntarily on his own, it is permissible”).

38. Note that under Islamic contract law, a contract is deemed to be formed at the time of the parties' mutual assent; the written form is the memorialization of that contract. See generally HUSSAIN HAMID HASSAN, AN INTRODUCTION TO THE STUDY OF ISLAMIC LAW 251-66 (Ahmad Hasan trans., 1997).

39. Many classified Muslim jurists viewed such promises as not legally (*qada'an*) binding but others, particularly of the Maliki school, did not where the promise has a financial motivation and is relied upon by the promisee. See VOGEL & HAYES, *supra* note 13, at 125-28 (recognizing that under Islamic law, contracts become binding only after one party has performed, giving rise to a general rule that unilateral promises cannot be binding). Contemporary Muslim jurists have

the Subject Transaction, as with other U.S. Islamic financial transactions with which the author is familiar, both instruments are executed and delivered at closing.

Many newcomers to Islamic financial transactions will seek to draft such instruments as bilateral agreements either by having both the grantor and grantee execute it or by weaving more of its terms into the terms of the finance lease agreement. Some *Shari'ah* boards, as can be expected, stringently resist such efforts, and others appear to allow such drafting. Nevertheless, local law may very well interpret the call option together with the other lease documentation and hold the provisions of the call option to be bilateral.

In turn, the buyer, as lessee of the leased assets, grants the SPE an option to require the buyer to acquire the assets upon the occurrence of specified events. This option—often titled a promise to purchase or put option—is often similarly viewed as a unilateral promise on the part of the grantor for the reasons discussed above regarding the call option. The triggering events to this option principally include the occurrence of a default under the finance lease and can address their total and partial loss as well. In addition, the put option in the Subject Transaction permitted its holder to put to the buyer-lessee some specified amount of the assets in the event the buyer-lessee (i) raised capital in the form of debt or equity, (ii) sold assets above a certain dollar threshold, or (iii) if and when operations resulted in excess cash flow.

In the case of both this put option and the foregoing call option, pricing is clearly specified and calculated so as to enable the SPE to meet its requirements under the conventional lending documentation. Again, careful attention is paid to separate the loan and lease side of the financing from one another at least with respect to the manner in which lease-related provisions are articulated. This is typically among the most challenging and time consuming tasks of legal counsel.

Islamic rules relating to risk and the entitlement to profit require owners to bear risk and responsibility for obligations that might be

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issued *fatwas* suggesting that Islamic law should abandon this rule. *See id.* at 142. That such promises are deemed binding legally now seems to be the prevailing rule among contemporary Muslim jurists active in Islamic finance. This is an important example of the growth and development of Islamic law and jurisprudence.



viewed as correlative to ownership. Here, we speak primarily of the structural maintenance of the leased assets and their insurance. Customarily, such obligations are placed upon the shoulders of the lessees or the borrowers or both, but to do so would conflict with Islamic principles.<sup>40</sup> The owner-lessor, however, can, under Islamic laws, appoint a person to perform these tasks. Such matters were thus addressed in supplemental documentation whereby the lessee was appointed by the owner-lessor as the agent of the lessor to carry out these types of duties.

Among the more controversial documents in the usual Islamic lease facility is the owner's and lessee's agreement as to the tax treatment of the transaction. As one might expect, the parties seek to avail themselves of favorable tax treatment, such as asset depreciation and interest deductions. In a tax matters agreement, the parties agree as to the treatment of the transaction for tax purposes as a single transaction constituting a mere interest-bearing financing. This agreement sets forth the parties' agreement that the lessee is the true owner of the assets for such purposes. Despite their familiarity with such agreements, *Shari'ah* boards, including the one reviewing the Subject Transaction, remain quite uncomfortable with statements that negate the tenor and structure of the overall financing. Approval of the foregoing was very reluctantly obtained in the Subject Transaction.

#### B. ACQUISITION FINANCING: SECOND FINANCING TRANCHE

Similar to the first tranche of financing, the second financing tranche also involved a sale-leaseback transaction. Except as discussed below, the second sale-leaseback was documented in a manner substantially similar to the first sale-leaseback. The credit markets turbulence of the summer of 2007 (and beyond) imposed pressure upon, and created a host of difficulties *vis-à-vis* the lender syndicate. Additional financing to enable the acquisition became

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40. See Babback Sabahi, Note, *Islamic Financial Structures as Alternatives to International Loan Agreements: Challenges for U.S. Financial Institutions*, 24 ANN. REV. BANKING & FIN. L. 487, 501 (2005) (noting the use of a lessor appointing the lessee as the former's agent to carry out structural maintenance and procure and maintain certain insurance). Contemporary Islamic finance appears to continue to struggle in practice with burdening owner-lessors with this responsibility. See *id.* at 502.

necessary.<sup>41</sup> Ultimately, an Islamic bank provided the requisite funds. The resulting financing structure, interestingly arising as a result of significant market pressures, is probably the most novel feature of the Subject Transaction.

The primary question faced by legal counsel to the sponsor was how to structure this financing.<sup>42</sup> As mentioned earlier, the prohibition of *riba* prevents Islamic financial institutions from making interest-bearing loans, and thus practically speaking assets are sought to be used in some form of sale transaction to generate a financing mechanism. The Islamic financier could not, therefore, be placed among the conventional lenders or make a loan. The Islamic financier, moreover, required that any financing it provided be tradable. The conventional lenders preferred that a mechanism distinct and apart from the first sale-leaseback be utilized, and this was also of some comfort from an Islamic perspective since it furthered the distance from such banks and their loan transaction.

Ultimately, legal counsel utilized concepts from the contract of *musharakah* as well as *sukuk* financings. The former has been addressed above in relevant detail, but it is sufficient to state here that the key principle relied upon from the rules of a *musharakah* is that joint owners of property are entitled to revenues derived from the jointly owned assets in the manner agreed upon.<sup>43</sup>

The latter, *sukuk* financings, are akin to asset-backed certificates (sometimes incorrectly analogized to bonds) that have been used for

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41. While not discussed in detail, the financing documentation allowed for the possibility of a dividend recapitalization to account for this unexpected, additional financing amount.

42. From a legal perspective, Islamic investors—perhaps like any investor—must consider the terms and conditions of financing facilities in light of business operations, needs, and goals. Adequate provision must be made for the proper and efficient operation of the business so that the financing contributes to, and does not impede, the growth and success of the venture. Carve-outs to the flow of funds may be appropriate to the extent the investor seeks the flexibility to pay dividends and management fees, among other items. A certain flexibility may also be required for future equity issuances or financings and for using the company as a platform for further strategic acquisitions. Our experience has shown that such business terms rarely if ever raise *Shari'ah* concerns.

43. This is the position taken by a sizeable number of Muslim jurists. See Moghul, *No Pain, No Gain*, *supra* note 2, at 486.

financings and can be used for securitizations as well.<sup>44</sup> Holders of these certificates contribute capital to acquire their ownership share and are, as such, entitled to some portion of the revenue generated from the assets or business, as the case may be. *Sukuk* have come of age rather recently and are generally used in project financings and other large-scale industrial contexts. Such financings are generally coupled with some other Islamic nominate contract-based financing mechanism, such as a *musharakah* or *ijarah*, which itself is used to generate revenue for the *sukuk* holders. To our knowledge, their use in private equity financings in the United States has been nonexistent.

Counsel proposed that the SPE and an affiliate of the Islamic financier share in the ownership of certain assets. As a joint owner, the Islamic financier affiliate would be entitled to revenues derived from the assets in the manner agreed upon. Assets acquired from the seller and to be subsequently sold to the SPE were thus split into two tranches upon agreement of the parties. Each set of assets was separately sold by the buyer to the SPE and then separately leased back, all under separate written documentation. In turn, assets leased under the second lease agreement were subdivided into two: a set of assets which corresponded to the Islamic financier's purchase/participation financing and a set of assets that enabled certain actions to take place with respect to the seller financing, which is discussed below.

As mentioned earlier, proceeds from the loan enabled the SPE to acquire the first tranche of assets, while capital contributed by the Islamic financier enabled the second tranche of assets to be purchased by the SPE. The purchase price contributed by the Islamic financier was paid in exchange for an ownership share in the second tranche assets pursuant to a purchase agreement which also entitled the purchaser to share in income generated from the assets (by lease and, as discussed below, otherwise).

Similar to the first tranche, the second sale-leaseback documentation encompassed a put option and a call option, as well as

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44. See Ayman H. Abdel-Khaleq & Christopher F. Richardson, *New Horizons for Islamic Securities: Emerging Trends in Sukuk Offerings*, 7 CHI. J. INT'L L. 409, 411-15 (2007) (discussing *sukuk* and the *sukuk* market); see also McMillen & Kamalpour, *supra* note 14, at 400-12.

a tax matters agreement and supplemental agreement (relating to responsibilities incident to ownership). Both the call and put options covered the same matters as the first tranche call option and first tranche put option, but did so with respect to the purchase/participation financing.

The ownership of the Islamic bank in the second tranche assets was evidenced by a certificate, as is the case with *sukuk* financings generally, which, together with the aforementioned purchase agreement, set forth many of the principal terms, conditions, entitlements, and obligations of the certificate holder. The certificate speaks to matters of formalities, such as transfers and replacements of the certificates, lists events of default, and expresses the terms on which the certificate holder would participate in revenue derived from the leased assets.

First, as is perhaps obvious, the certificate holder was entitled to participate in the rental payable under the second finance lease. Revenue with respect to the assets could also be generated in the event the assets were sold to the company (whether under the call option or under the put option relating to the second finance lease). For instance, assets could be sold in the event of a desired early acquisition or upon default, asset sale, equity issuance, or the incurrence of additional financing obligations. Revenue received by the SPE, as asset owner and certificate issuer, in these scenarios would be passed to the certificate holder on the agreed upon terms and conditions set forth in the certificate.

Initially, there was only one Islamic financier and one certificate holder. However, as mentioned previously, the certificates were required by the Islamic financier to be tradable. Most *Shari'ah* boards, including the one opining on the Subject Transaction, generally prohibit the sale of debt alone.<sup>45</sup> When the stream of money

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45. The Islamic legal maxim prohibiting *al-kali' bi al-kali'*, "meaning literally the exchange of two things both 'delayed,'" is often cited in support of the prohibition on such debt sales. See VOGEL & HAYES, *supra* note 13, at 115. This extrapolation is not "unanimously agreed upon by scholars, although such an agreement is often claimed." See *id.* at 115, n.47. From this maxim, many Muslim jurists have derived a prohibition on exchanges where the contract specifies delay terms, not just for transfer of titles, but also for actual payment or delivery of the two countervalues—for example, wheat to be delivered later for money to be paid later. *Id.* at 116. "Thus the maxim excludes the purely executory or future sale—

is coupled with an ownership of the assets underlying the financing or those assets generating that revenue stream, however, the sale can be rendered permissible.<sup>46</sup> Because of the nature of the purchase/participation financing, namely the transfer of asset ownership, the *Shari'ah* department concluded that the certificates could be traded in whole or in part. The Islamic financier was accordingly named as an administrative agent under the purchase/participation financing in anticipation of a multiplicity of certificate holders and to comfort the administrative agent of the first tranche financing that it would not have to deal with a host of subsequent buyers.

This purchase/participation agreement, together with the certificate, was linked to the second sale-leaseback in much the same way as the loan was linked to the first lease. However, this purchase and participation was fundamentally Islamic, unlike the loan. As such, a linking of the two documentation sets could be accomplished more simply and explicitly. Moreover, and more importantly, the absence of the loan made the second tranche of acquisition financing more substantively compliant with Islamic principles than the first tranche and made the second tranche financing structure more efficient and simpler from the standpoint of documentation.

### C. SELLER FINANCING

The purchase price paid by the SPE to acquire the second tranche of assets included, in addition to cash, an assumption in part of the

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perhaps the most common contract of sale today—i.e., a contract in which the parties exchange only promises or obligations, with the actual sale occurring only when these obligations are satisfied.” *Id.* Furthermore, the maxim “prohibits the exchange of abstract property for abstract property . . . even when one or both of the two *dayns* [obligations] is due presently. Thus, it is forbidden to sell a *dayn*, whether due now or later, for another *dayn* due now or later.” *Id.* The foregoing relates to instances in which both countervalues are delayed, not those instances in which only one is delayed. The ordinary credit sale is therefore lawful. *Id.* at 118. *But see* KAMALI, ISLAMIC COMMERCIAL LAW, *supra* note 9, at 125-30 (concluding that the *bay' al-dayn* of the type incurred in futures transactions is in the nature of the fulfillment of an obligation and the repayment of a debt by the debtor). “This is in line with the basic Qur’amic norm (5:1) in respect of the fulfillment of contracts.” *Id.*

46. *See* Sabahi, *supra* note 40, at 495 (discussing the principle under certain Islamic nominate contract forms that ownership in assets in otherwise purely financial transactions, entitles the owner to profit).

non-interest bearing note made by the buyer in favor of the seller. The amount of this assumption corresponded directly to the amount of the seller financing, which itself was also to some extent unexpected. Such a need probably could have been accommodated within the structure of the primary asset sale (from the seller to the buyer) given that seller financing and deferred purchase price payments generally were permissible in the view of the sponsor's *Shari'ah* board.<sup>47</sup> However, this financing was a matter that arose as closing approached.

The seller agreed to accept a promissory note from the SPE, but, as one might expect, demanded that it be paid interest on this amount. The terms and conditions of this note were agreed upon in writing by seller and the SPE, though as a special purpose entity one might contend such an agreement was concluded by the SPE more as a formality.<sup>48</sup> Since payments under such note were essentially deferred for a number of years, it contemplated certain minimum payments to the seller from time to time to enable the seller to make tax payments on income deemed gained under this note.<sup>49</sup> Further, this note contemplated the possibility of prepayments following termination of the first and second tranches of financing.

To accommodate these features of the seller financing, the second tranche put option thus included a right exercisable by the SPE to put to the company some amount of assets in order for the SPE to fulfill its obligations under the seller note relating to the permitted tax payments. The second tranche call option was also drafted to account for the possibility of voluntary prepayments under the seller financing whereby the buyer could acquire some amount of the assets from the SPE earlier than expected.

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47. *See id.* at 131-45 (discussing deferred sales and noting that such arrangements are most clearly approved when the contract provides a clearly defined deferment period and thus, in this regard, precludes *gharar*).

48. I do not mean to imply or infer that form is unimportant especially since it is a probabilistic indicator that the substance or rationale of the related legal rulings has been achieved. But, as most Islamic legal rulings are probabilistically known (*zanni*), there is room, both theoretically and practically, for the possibility of a disconnect between form and practice at times. *See WEISS, supra* note 2, at 88-112.

49. Payments under this note were not necessarily to be paid in cash until maturity, but could be made in kind by increasing the principal amount.

## D. WORKING CAPITAL

Financing facilities for the purpose of a company's working capital needs are frequently put in place at the same time as the acquisition financing. In fact, many acquisition financiers consider such a facility critical in ensuring the company can properly conduct its business and pay its debts. The Subject Transaction was no different in this regard.

The prohibition of *riba* and the search for assets to construct Islamic financings are again relevant in the case of working capital facilities. But, the absence of appropriate or saleable assets for many companies like the target in the Subject Transaction creates a significant difficulty in constructing sales. Contemporary Islamic finance has consequently introduced assets, namely certain metals, and in the case of the Subject Transaction, aluminum into the context, utilizing a *murabahah*-based metals transaction to create a working capital facility. Such structures are fairly common and now reasonably well-known.

Simply speaking, a *murabahah* contract is one in which the seller's price is its cost associated with its acquisition of the sale item, plus a specified and fully disclosed mark-up.<sup>50</sup> Contemporarily, *murabahah* transactions have come to include the order of the sale item by the customer of a financial institution.<sup>51</sup> A large majority of Islamic financial transactions today take place with this nominate contract form, and it has come under increasing criticism, including by Muslim jurists.<sup>52</sup> Such criticism has largely centered upon the

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50. See AL-ZUHAYLI, *supra* note 8, at 354-61.

51. See, e.g., Umar F. Moghul & Arshad A. Ahmed, *Contractual Forms in Islamic Finance Law and Islamic Inv. Co. of the Gulf (Bahamas) Ltd. v. Symphony Gems N.V. & Ors.: A First Impression of Islamic Finance*, 27 *FORDHAM INT'L L.J.* 150, 155-56 (2003).

52. See USMANI, *supra* note 37, at 41-42 (“[O]riginally, *murabahah* was not a mode of financing. It was only a device to escape interest and not the ideal instrument for carrying out the real economic objectives of Islam. Therefore, this instrument should be used as a transitory step taken in the process of the Islamization of the economy, and its use should be restricted . . . .”); see also MOHAMMAD HASHIM KAMALI, *EQUITY AND FAIRNESS IN ISLAM* 103-04 (2005) (stating that “[t]his focus on short term trade financing is a cause for concern for two main reasons: [ ] It is likely to relegate the Islamic banks to the periphery of the financial system. It will attract only a certain type of clientele, much like finance companies in hire-purchase financing or savings and loans for home

infinitesimal non-credit risk borne by the financial institution with respect to its ownership of the sale items, whether the financial institution is thus lawfully entitled to profit from the transaction; and whether such transactions too closely approximate loans.

Such financings often involve the presence of a conventional loan transaction though they need not in all cases. In the Subject Transaction, the SPE would be informed by the company of the latter's requirement for a certain amount of working capital. Subsequently, the SPE borrows the requisite amount of capital under the terms of the credit agreement. Using the proceeds of this borrowing, it acquires aluminum from a supplier in a spot sale. Immediately after acquiring these metals (in an amount corresponding to the amount of desired capital), the company acquires them on a deferred payment basis from the SPE. Once acquired by the company, the metals are sold on a spot basis. Some similar Islamic transactions permit this final sale to the previously mentioned metals supplier, but the *Shari'ah* department in this case preferred that it be made to a party other than the one that made the initial sale to the special SPE—perhaps to decrease the formalism of the structure. At the end of this series of transactions, the company is left with a deferred payment obligation to the SPE, which in turn is also left with the same to its lenders.

The nature of Islamic financing facilities generally requires significant education and dialogue with lenders, sellers and other counterparties. This is perhaps more so with Islamic working capital facilities than with Islamic acquisition financings where parties can rely on the significant presence of, and jurisprudence relating to, sale-leaseback transactions generally within the conventional marketplace. On the other hand, the commonality of Islamic working capital facilities within Islamic finance means that there are minimal *Shari'ah* issues (from the point of view of executing such a transaction), especially if legal counsel has prior relevant

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mortgages. Without taking the centre stage, Islamic banks run the risk of being marginalized. Second, short-term trade financing is largely concerned with the financing of goods already produced, and not with the creation or increase of production capital, or with facilities like factories and plants, infrastructure etc. Yet it is investment in such facilities that encourages real economic growth. Hence the current emphasis of Islamic banks on short-term financing is not congruent either with the long term objective of the banks or with their social welfare agenda").



experience.<sup>53</sup> The prevalence of such transactions has also led to metals suppliers and offtakers being readily available and comfortable in participating in these financings. From a business standpoint, the sponsor thus focused on business issues.<sup>54</sup>

#### E. SECURITY AND PRIORITY

A broadly articulated pledge by the buyer of its assets, including receivables, supported each of the two lease financing tranches as well as the working capital facility.<sup>55</sup> In addition, the buyer's stockholders pledged their stock (in the buyer) to support the same. The majority stockholder, an affiliate of the sponsor, was also required to provide two guaranties—one in support of each lease. However, for Islamic legal reasons, the foregoing collateral package was provided to support the two leasing transactions and not the loan transaction. Accordingly, such pledges and guaranties were made to the SPE, as the lessor, and not to the lender syndicate. In turn, the SPE pledged the leased assets to which it held title and assigned the foregoing collateral package to the lender syndicate to support the loan. It also made a separate, similar pledge to the Islamic financier to support the purchase/participation financing.

The sponsor's *Shari'ah* department informed the parties that assets jointly owned by the SPE and Islamic financier under the purchase/participation financing could not be pledged to support the loan given the Islamic party's ownership thereof. Having some assets carved out of the pledge created some level of discomfort for the lenders because they are accustomed to what we might term, loosely speaking, unrestricted security. Ultimately, the matter was resolved by persuading the banks to forego their usual, broader security interest and to permit the assets owned in part by the Islamic financier to be excluded from the security package made to support the loan.

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53. See generally MAHMOUD A. EL-GAMAL, *ISLAMIC FINANCE: LAW, ECONOMICS, AND PRACTICE* 69-73 (2006) (identifying Islamic legal and economic issues with such transactions as well as objections posed to such transactions classically and currently).

54. These business issues included the number and amount of sales which the buyer could enter into in a given period of time. The sponsor had also to be sure that the conditions precedent to the financings were reasonable.

55. The seller financing, as stated previously, was unsecured.

The question of multiple financing tranches triggers the question of priority. As one might expect, the conventional financiers providing the first tranche of financing sought a priority over the Islamic financier's second tranche. The notion of such a priority or preference raises considerable concern from an Islamic legal perspective.<sup>56</sup>

Discussions with the sponsor's *Shari'ah* department began with it taking the position that both the first tranche holder and second tranche holder were sharing in the pledged collateral and, therefore, as "partners," they were to share on a pro rata basis without any preference, particularly because the context was one of bankruptcy, or loss generally. The *Shari'ah* department did not, however, seek to overturn any result that might come about by operation of applicable local laws (namely, by a party perfecting its security interest first in time). Typical intercreditor agreements where such matters are addressed, however, go beyond such cases to protect first lien holders in seemingly all instances, even those in which they have failed to properly protect their own interest through no fault of other lien holders. Needless to say, these conversations with the *Shari'ah* board troubled the lenders, who are used to showing little flexibility in this realm.

Ultimately, the sponsor and its local counsel cited Standard 4/2 published by the Accounting and Auditing Organization for Islamic Financial Institutions ("AAOIFI"). In relevant part, this standard, entitled "Conditions Relating to Pledged Asset," reads:

[I]t is permissible to grant more than one pledge on the same property, on the condition that the subsequent pledge should be aware of the previous pledges, in which case such pledges would rank equally if all were registered on the same date. In this case, the recovery of their debts from the value of the pledge make take place on a pro rata basis. But if the pledges were registered at different dates, then their priority to recover the

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56. See Michael J. T. McMillen, *Islamic Shari'ah-Compliant Project Finance: Collateral Security and Financing Structure Case Studies*, 24 FORDHAM INT'L L.J. 1184, 1222-24 (2001) (noting the distinction and prioritization under Islamic law amongst creditors and recognizing the creation of priorities or preferences is in tension with Islamic principles).

amount of their debts would be determined according to the date of registration.<sup>57</sup>

This authoritative standard demonstrated the viability of an interpretation of *Shari'ah* that allowed priority in the context of the Subject Transaction financing.<sup>58</sup> This standard's recognition of priority, resulting from different registration of perfection timings, proved dispositive and persuasive to the *Shari'ah* board. Nevertheless, some careful drafting with regard to the intercreditor agreements was still necessary *vis-à-vis* the *Shari'ah* board as well as the conventional financiers, who were forced to show some degree of flexibility as some conventional provisions were rewritten or removed. At the very least, this required the parties to strengthen their knowledge of the fundamental legal principles underlying such agreements.

## CONCLUSION

While Islamically leveraged transactions have been used many times previously, including here in the United States over the past decade or so, they are fraught with complexity and inefficiency, among other things; yet they continue as a response to increasing demand. These concerns, in our opinion, ought to be tempered with the many realities of contemporary Islamic finance, which stands still in the initial phases of development. The innovation which took place in the course of developing and documenting the second financing tranche of the Subject Transaction is an important example and a step in the search to address these concerns and to develop structures that are more substantively Islamic in nature.

To the extent banks under the present regulatory regime continue to be involved in Islamic finance, tensions will likely continue to remain in implementing more of the causes and rationale underlying Islamic laws, as interpreted by many *Shari'ah* boards and other contemporary Muslim jurists. In the short term, any new, perhaps

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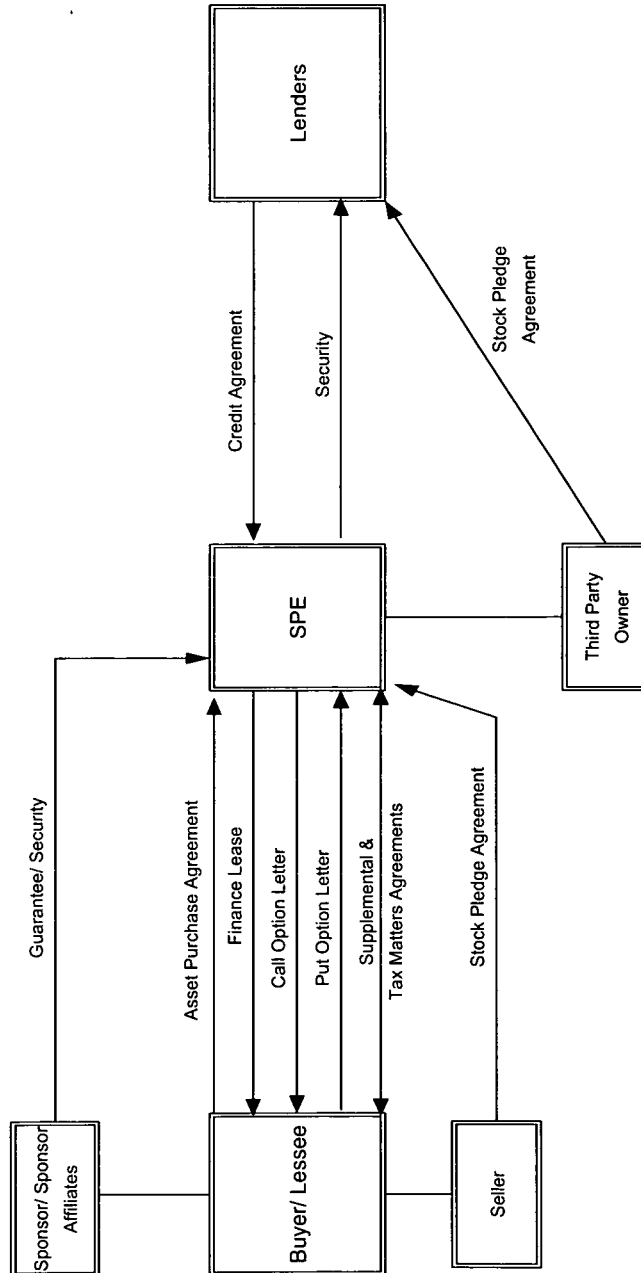
57. See ACCOUNTING, AUDITING AND GOVERNANCE STANDARDS FOR ISLAMIC FINANCIAL INSTITUTIONS (AAOIFI 2003).

58. See Ida Madieha Azmi & Engku Rabiah Adawiyah Engku Ali, *Legal Impediments to the Collateralization of Intellectual Property in the Malaysian Dual Banking System*, 2 ASIAN J. COMP. L. 1, 8-15 (2007) (discussing the different views among Muslim jurists regarding the division of asset ownership).

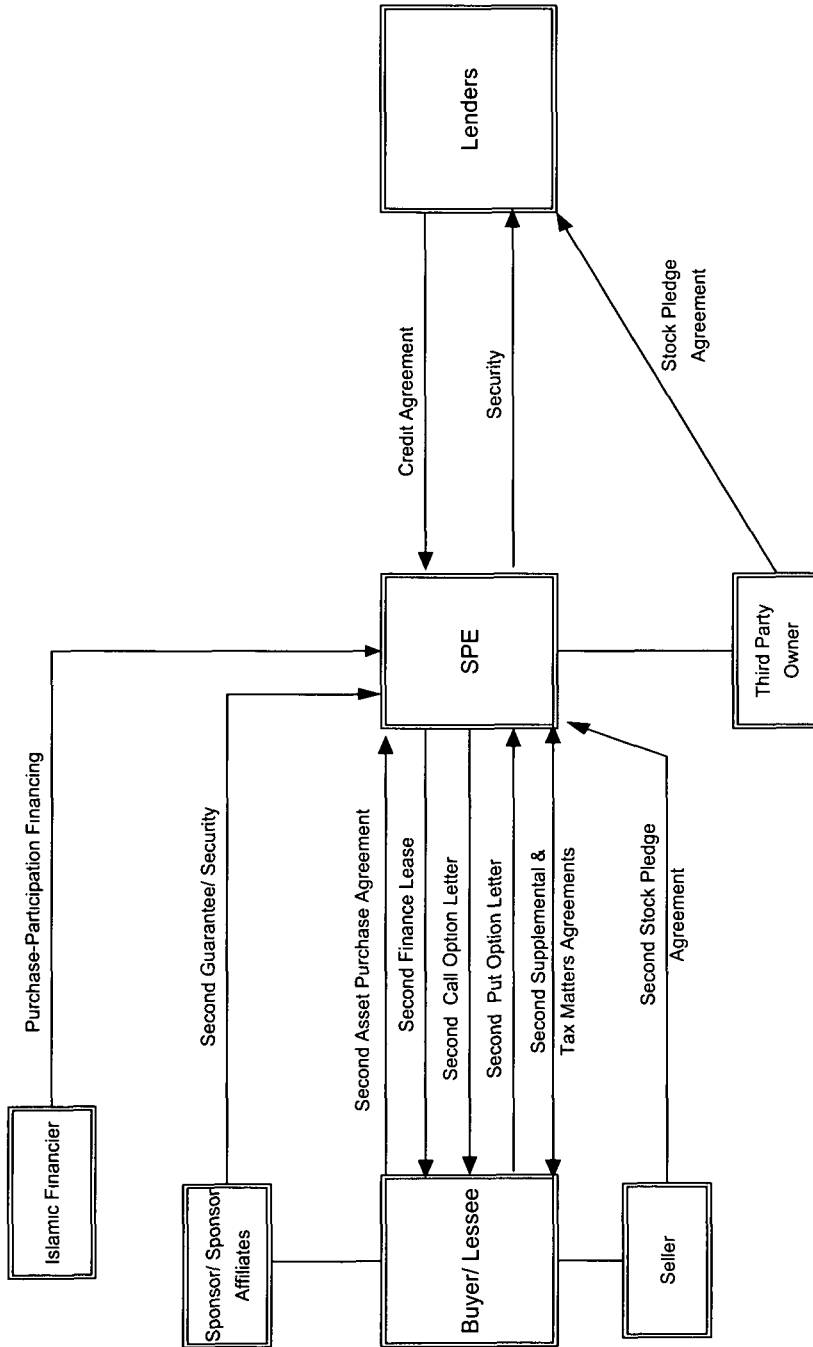
interim, structures will probably acquiesce to these regulations. More simplified, streamlined methods are, however, under investigation and will likely be found considering that alternative, more flexible sources of financing are identified and regulations which are more responsive to Islamic finance are legislated. It is hoped that the innovation that took place within the second tranche of acquisition financing will contribute to this important effort.

# APPENDIX

## FIRST TRANCHE ACQUISITION FINANCING



SECOND TRANCHE ACQUISITION FINANCING



REVOLVING *MURABAHAH* FACILITY

