

ASSET SECURITIZATION *SUKUK* AND ISLAMIC CAPITAL MARKETS: STRUCTURAL ISSUES IN THESE FORMATIVE YEARS

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I. INTRODUCTION

In the late 1990s, and particularly in the earliest years of the twenty-first century, Islamic finance (finance in accordance with the principles and precepts of Islamic *shari'ah* (the “*Shari'ah*”¹), took root in

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¹ The *Shari'ah* is the perfect, immutable, divine law as revealed in the text of the *Qur'an* and the *sunna*. *Fiqh* (“understanding,” from *faqaha*, “to understand”) is the sum of human comprehension of that divine law and is given effect in the practical rules of the *Shari'ah* as determined by the *Shari'ah* scholars. The primary methodology used in this determinative effort is *ijtihad* (literally, “effort”), or legal reasoning, using, as the primary sources, the “roots of the law” (*uṣūl al-fiqh*). The primary sources of law, in Islamic orthodoxy, are: (a) the *Qur'an* (the divine word of Allāh); (b) the *sunna* (the practices, examples, dicta, and decisions of the Prophet Mohammed); (c) *ijmā'* (consensus, most particularly the consensus of the community of scholars); and (d) *qiyās* (analogical deductions and reasoning). *Hadīth* are the textual records of the Prophet's *sunna*, as determined by skilled juristic scholars. See Zafar Ishaq Ansari, *Islamic Juristic Terminology Before Ṣāfī: A Semantic Analysis with Special Reference to the Kūfā*, in *THE FORMATION OF ISLAMIC LAW* 211, 215-38 (Wael B. Hallaq ed., 2004) (an interesting and helpful etymological and historical review of the development of the term “*sunna*” as an element of *fiqh*). Ansari notes the etymological root (“SNN”) as originally referring to the “flow and continuity of a thing with ease and smoothness,” such as the manner in which water flowed easily away when poured on a person's face. *Id.* The sense of a “way” or “course” that was easily tread and traversed arose from this usage and “derivatives of SNN were employed with reference to the course across which winds blew or along which water flowed.” *Id.* at 215. The connotations of ease and facility then gave rise to usage, most notably in ancient Arabic poetry, in reference to admirable aspects of the human face, particularly brightness and polish, smoothness and shape. See *id.* Thereafter, there was an extension to human behavior: “*Sunna* began to mean, therefore, ‘a way, course, rule, mode, or manner, of acting or conduct of life, and became an equivalent of *sīra*,’ while still retaining the concepts of ease and smoothness. *Id.* at 216-17. “*Sunna* therefore signified, *inter alia*, a mode of behaviour which a person could adopt without difficulty. This seems to be the background in which the term *sunna* developed a nuance of moral appropriateness and normativeness.” *Id.* at 217. Ansari observes that there are sixteen references to *sunna* in the *Qur'an*, most of which are references to the *sunna* of Allāh (which he notes to be literary innovation of the *Qur'an*) and none of which are references to the

the United States.² Investments were made in a limited number of areas,

sunna of the Messenger of Allāh. *Id.* However, the *Qur'ān* is clear that the conduct of the Prophet is conduct *par excellence*, thus supporting the concept of the *sunna* of the Prophet in the early years of Islām. *Id.*

For a range of accessible introductions to the history and methodology of Islamic jurisprudence, see S.G. Vesey-Fitzgerald, *Nature and Sources of the Shari'a*, in *LAW IN THE MIDDLE EAST* 85 (Majid Khadduri & Herbert J. Liebesny eds., 1955); NOEL J. COULSON, *A HISTORY OF ISLAMIC LAW* (1964); JOSEPH SCHACHT, *THE ORIGINS OF MUHAMMADAN JURISPRUDENCE* (1950); JOSEPH SCHACHT, *AN INTRODUCTION TO ISLAMIC LAW* (1964); FRANK E. VOGEL & SAMUEL L. HAYES III, *ISLAMIC LAW AND FINANCE: RELIGION, RISK AND RETURN* 23-70 (1998); WAEEL B. HALLAQ, *THE ORIGINS AND EVOLUTION OF ISLAMIC LAW* (2005); WAEEL B. HALLAQ, *A HISTORY OF ISLAMIC LEGAL THEORIES: AN INTRODUCTION TO SUNNĪ UṢŪL AL-FIQH* (1997); JOHN ALDEN WILLIAMS, *THE WORD OF ISLAM* (1994); MOHAMMED HASHIM KAMALI, *PRINCIPLES OF ISLAMIC JURISPRUDENCE*, (3d ed. 2003); MUHAMMAD TAQI USMANI, *AN INTRODUCTION TO ISLAMIC FINANCE* (1988); Irshad Abdal-Haqq, *Islamic Law: An Overview of Its Origin and Elements*, 1 J. ISLAMIC L. 1 (1996); Christopher Melchert, *Islamic Law*, 23 OKLA. CITY U. L. REV. 901 (1998); Wael B. Hallaq, *Legal Reasoning in Islamic Law and the Common Law: Logic and Method*, 34 CLEV. ST. L. REV. 79 (1985); Bernard Weiss, *Interpretation in Islamic Law: The Theory of Ijtihād*, 26 AM. J. C. L. 199 (1978); P. Nicholas Kourides, *Traditionalism and Modernism in Islamic Law: A Review*, 11 COLUM. J. TRANSNAT'L LAW 484 (1972); Ahmed Souaiaia, *On The Sources of Islamic Law And Practices*, 20 J. LAW & RELIGION 123 (2004). Asifa Quraishi presents an interesting discussion of the "schools" of jurisprudence and their bases and modes of analysis of the *Qur'ān* and the United States Constitution. Asifa Quraishi, *Interpreting the Qur'an and the Constitution: Similarities in the Use of Text, Tradition and Reason in Islamic and American Jurisprudence*, 28 CARDOZO LAW REV. 67 (2006). In so doing, she provides elegant summaries of how the different schools of jurisprudence endeavor upon *ijtihād*. *Id.* See also Azizah Y. al-Hibri, *Islamic and American Constitutional Law: Borrowing Possibilities or a History of Borrowing*, 1 U. PA. J. CONST. LAW 492 (1998).

² See Yusuf Talal DeLorenzo & Michael J.T. McMillen, *Law and Islamic Finance: An Interactive Analysis* in *ISLAMIC FINANCE: THE REGULATORY CHALLENGE* 132-97 (Simon Archer & Rifaat Ahmed Abdel Karim, eds., 2007) (providing a short history of modern Islamic finance focusing on the interaction between financial and legal elements from the 1970s to the present). See also, Rodney Wilson, *The Evolution of the Islamic Financial System*, in *Islamic Finance: Innovation and Growth* (2002) (Simon Archer and Rifaat Ahmed Abdel Karim, eds.), at 29-41, and Mohammad Nejatullah Siddiqi, *Islamic Banking and Finance*, UCLA International Institute, located at <http://www.international.ucla.edu/article.asp?parentid=15056> (2001) (last visited on June 1, 2008). For a particularly interesting snapshot of perceptions as to the relevance and appropriateness (more often, the perceived irrelevance and inappropriateness) of the *Shari'ah* in 1987 and speculation as to its potential application in commercial realm see, W M Ballantyne, *The Shari'a: A Speech to the IBA Conference in Cairo, on Arab Comparative and Commercial Law*, 15-18 February 1987, 2 Arab Law Quarterly 12, 12-13, 15-17, 27-28 (1987). Consider also, A.A.A. Fyze, *The Relevance of Muhammadan Law in the Twentieth Century*, 1963 Cambridge Law Journal 261 (1963) and *The Politics of Islamic Finance* (2004) (Clement M. Henry & Rodney Wilson, eds.) (includes numerous essays addressing different elements of the origin and growth of modern Islamic finance, including Samer Soliman, *The Rise and Decline of the Islamic Banking Model in Egypt*, at 265-86, which challenges some conventional positions). Compare, Walid S. Hegazy, *Contemporary Islamic Finance: From Socioeconomic Idealism to Pure Legalism*, 7 CHICAGO J. INT'L L. 581, 581-603 (2007), Haider Ala Hamoudi, *Judicial Schizophrenia in Islamic Finance*, 7 Chicago Journal of International Law 605 (2006-2007), and Haider Ala Hamoudi, *Muhammad's Social Justice or Muslim Cant?: Langdellianism and the Failures of Islamic Finance*, 40 Cornell International Law Journal 89 (2007). As discussed in

particularly real estate and private equity. These areas of investment were chosen because of market opportunities and the particular expertise and preferences of Middle Eastern investors. In addition, investments in these areas minimized the *Shari'ah* issues that had to be addressed by investors and *Shari'ah* scholars in an industry that, at the time, had limited experience in applying the *Shari'ah* to complex investment and financing transactions—particularly in jurisdictions that took no cognizance, economically or legally, of the *Shari'ah*. Matters were difficult enough just trying to develop and implement structures that were compliant with two quite divergent bodies of law: (1) the secular laws of the United States, and (2) the religious, moral, and ethical law that is the *Shari'ah*. As experience was acquired—and the acquisition was rapid—investments became increasingly complex, in terms of the legal structure and the *Shari'ah* considerations that had to be addressed, in most instances for the first time. In approximately 2003, *Shari'ah*-compliant real estate investments began to be made on a significant scale in Europe. The European structures were, and remain, based upon those developed in the United States, although local considerations, including, most importantly, real estate and tax laws, have required structural modifications. All of these early investment transactions were financed privately by commercial banks in the United States and Europe. Initially, the financings were on a transaction-by-transaction basis. As pooled investment vehicles were created (usually off-shore investment funds) and transactional volume expanded dramatically, cross-collateralized private commercial loans were utilized. None of these transactions (or the related investment funds) were financed through the debt or equity capital markets. Conventional Western capital markets were unavailable, largely because of lack of familiarity with *Shari'ah*-compliant financing techniques. There were no Islamic capital markets: debt or equity. Constraints were such that *Shari'ah*-compliant investors could not even invest in the equity securities of entities listed on the major stock exchanges of the world, with some rare exceptions. *Shari'ah*-compliant capital market participation was impractical or impossible prior to the late 1990s. In 1998, however, a monumental *fatwā* was issued by a prominent *Shari'ah* supervisory board.³ With the

this article, introduction of *Shari'ah*-compliant transactions into the West in modern Islamic finance began in the United States and subsequently occurred in Europe.

³ A *fatwā* (*fatāwā* is the plural) is an opinion on *Shari'ah* matters issued by a *Shari'ah* scholar in response to a difficult question pertaining to the interpretation of the *Shari'ah*. It is an opinion providing clarification; it is not legislative or of binding judicial effect. The word is derived

issuance of that *fatwā*, the world changed in numerous particulars. That *fatwā* established a series of tests to determine whether a *Shari'ah*-compliant investor could make an investment in an equity security of a company that was not totally in compliance with the *Shari'ah*. Of course, most companies in the world are not in compliance with the *Shari'ah* (some are engaged in prohibited businesses or activities; most either pay interest on indebtedness or receive interest from deposits or investments). That *fatwā* opened the equity capital markets to *Shari'ah*-compliant investors despite the lack of purity in compliance; it also had profound effects on private equity investment as scholars began to develop rules for direct equity investment in entities that were not purely *Shari'ah* compliant.⁴

Shari'ah-compliant access to the “debt” capital markets was a more difficult accomplishment, not occurring until between 2001 and 2003. In 2001 and 2003, there were seminal *Shari'ah*-compliant *sukuk* offerings.⁵ *Sukuk* are defined, in common parlance, as Islamic bonds and

from the Arabic language root term *fata*, whose meaning relates to a strong and vital youth. As the elements of strength and vitality combine metaphorically to signify clarity, the verb *afta* came to mean to clarify or explain.

⁴ Absolute purity, in terms of *Shari'ah* compliance, at the inception would preclude many transactions, thus restricting the growth of the Islamic finance industry. These tests acknowledged, and sanctioned (on a conditional basis) a degree of impurity. Recognition of permissible impurity, at least as a temporary matter, led to the development of various “cleansing” or “purification” mechanisms. These mechanisms were, and are, operative after the occurrence of a transaction, activity, or development that is impermissible under the *Shari'ah* and are designed to allow the occurrence, but address the impure consequences of that occurrence. Thus, for example, if some interest were obtained in violation of *ribā* doctrines, that interest could be donated to charity to purify the transaction. In the years after 1998, and continuing through the present, the permissible impurity or permissible variance principles of the 1998 *fatwā* have evolved and been applied in other areas, such as *Shari'ah*-compliant real estate finance. Thus, for example, it is now permissible in certain limited and carefully-analyzed situations, and on a case-by-case basis, to have tenants that are in non-compliant businesses where a property is the subject of a *Shari'ah*-compliant investment. This progression, and numerous examples, are discussed in section II of this article. The 1998 *fatwā* is discussed in, Rushdi Siddiqui, *Islamic indexes: the DJIM framework*, in *Islamic Asset Management: Forming the Future for Shari'a-Compliant Investment Strategies* (2004), Sohail Jaffer, ed., at 46-58; Rushdi Siddiqui, *Shari'ah Compliance, Performance and Conversion: The Case of the Dow Jones Islamic Market IndexSM*, 7 *Chicago Journal of International Law* 495 (2007); Haider Ala Hamoudi, *The Muezzin's Call and the Dow Jones Bell: Necessity of Realism in the Study of Islamic Law*, Legal Studies Research Paper Series, Working Paper No. 2007-08, September 2007, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1014670 (last visited on June 19, 2008); and Michael J.T. McMillen, *Islamic Project Finance: An Introduction to Principles and Structures* (2008; in printing) [hereinafter *McMillen Islamic Project Finance*].

⁵ *Sukuk* had been issued prior to 2001, but on an isolated and inconsistent basis. See Nathif J. Adam & Abdulkader Thomas, *Islamic Fixed-Income Securities: Sukuk*, in *ISLAMIC ASSET MANAGEMENT: FORMING THE FUTURE FOR SHARI'A-COMPLIANT INVESTMENT STRATEGIES* 72-

securitizations. The early *sukuk* issuances, and all but a few of the *sukuk* issuances to the date of this writing, are bond structures (rather than asset securitization structures), and the overwhelming percentage of the issuances involve sovereign credits. At the same time, another monumental *fatwā* was issued, by the *Shari'ah* board of the Accounting and Auditing Organization for Islamic Financial Institutions (“AAOIFI”), the preeminent accounting and auditing authority for the Islamic finance industry. This *fatwā* approved standards for *sukuk*, including both bond and securitization structures.

Since 2003, bond structure *sukuk* issuance has accelerated. With this acceleration in issuances, and as more sophisticated issuances were attempted, it became clear that the legal infrastructure of many jurisdictions within the Organization of the Islamic Conference (“OIC”), most immediately Middle Eastern countries, was an impediment to the growth of the capital markets. Lawyers were unable to opine on critical legal matters. As a result, international rating agencies were unwilling to rate issuances that did not involve, ultimately, a sovereign credit.

Realizing the potential for *sukuk* to form the backbone of an Islamic capital market, the Islamic Financial Services Board (“IFSB”) began to focus on capital markets and the legal infrastructure issues. The IFSB had previously directed its efforts in respect of standard-setting for the Islamic finance industry to the implementation of Basle II, capital adequacy matters, prudential standards, and related matters. In 2006, with initial reports made in 2007, the IFSB focused on the development of an effective legal framework for Islamic finance, with special emphasis on those elements of the legal infrastructure that relate to *sukuk* issuances.

While the volume of bond structure *sukuk* issuances (and a limited number of corporate *sukuk* issuances) increased, securitization *sukuk* have not been issued (with only the rarest of exceptions). This has been due to a range of factors including critical legal issues, the inability to obtain satisfactory legal opinions, and the resulting inability to obtain ratings from major rating agencies. But the winds of change are starting to be felt. In 2006, a rated securitization structure *sukuk* was issued. The asset base for this *sukuk* was oil and gas royalties in the Gulf of Mexico. Because the transactional and contractual structure was governed by U.S. law, the legal issues that precluded the issuance of asset-backed

81 (Sohail Jaffer ed., 2004); ISLAMIC BONDS: YOUR GUIDE TO ISSUING, STRUCTURING AND INVESTING IN *SUKUK* 11-16 (Nathif J. Adam & Abdulkader Thomas eds., 2004).

securitization *sukuk* were avoided. The Islamic finance industry began to glimpse the future of securitization *sukuk*. And in July of 2007, an international rating agency announced that two asset-backed securities (“ABS”) issuances from the Middle East would be rated, and both have since been issued. Both involved real estate in Dubai, United Arab Emirates. One was a *Shari’ah*-compliant residential mortgage-backed securities (“RMBS”) *sukuk*. The other was a conventional commercial mortgage-backed security (“CMBS”) backed by a single office building.

This article covers the foregoing developments, and takes the discussion, ultimately, to a sampling of *sukuk* structures of relevance to ABS *sukuk*. An overview of the *Shari’ah* and, in general terms applicable to modern Islamic finance, some of its essential elements are presented by way of background. The article then surveys the development of two areas of Islamic finance in the West: real estate investments, and the standards for investment in equity securities. The article then turns to the primary area of consideration—securitization. After providing an overview of relevant elements of conventional securitization, *sukuk* standards and categories, and the essential elements of *sukuk*, are discussed. The discussion then turns three primary ABS *sukuk* structures: the *ijāra* [lease] and *sukuk al-ijāra*; *mudāraba* [service-investor partnerships] and *sukuk al-mudāraba*; and *mushāraka* [capital-capital partnerships] and *sukuk al-mushāraka*.

A. THE *SHARI’AH* AND ISLAMIC FINANCE

The Islamic finance industry was young in the late 1990s and early years of the 21st century, and was struggling with fundamental, threshold issues. One of those issues, the most fundamental, was how to apply the principles and precepts of the *Shari’ah* to complex financial transactions. The essence of Islamic finance, of course, is compliance with the *Shari’ah*, in all circumstances and in all jurisdictions. Investment in the United States (and later Europe) involved significantly more complex permutations of these issues, in part because its component jurisdictions took no cognizance of the *Shari’ah* in commercial, financial, or legal practices; the *Shari’ah* was not (and is not) a constituent legal element in the United States (or the relevant European jurisdiction).⁶

⁶ A discussion of the continuum of incorporation—non-incorporation of the *Shari’ah* in the secular law of the land—as well as issues pertaining to enforcement of *Shari’ah*-compliant contractual arrangements, including legal opinion issues, with particular focus on *sukuk* (Islamic

The word “*shari’ah*,” in its early usages, referred to the path by which camels were taken to water, the source and fundamental sustaining factor of life. In later, and current times, it refers to “the way” or “the path” by which a Muslim is to conduct his or her life, in every aspect. Thus, the *Shari’ah* is comprised of, and embodies, religion, ethics, morality, and behavioral admonitions, as well as those that are more customarily recognized as legal requirements it is:

[T]he “Whole Duty of Man[;]” [m]oral and pastoral theology and ethics; high spiritual aspiration and the detailed ritualistic and formal observance which to some minds is a vehicle for such aspiration and to others a substitute for it; all aspects of law; public and private hygiene; and even courtesy and good manners.⁷

It is, in part, divine revelation, human example, and, human understanding, ratiocination, and reason.⁸ And it is, in part, law as that

bond and asset securitization) transactions is set forth in DeLorenzo & McMillen, *supra* note 2, at 150-87. See also Michael J.T. McMillen, *Contractual Enforceability Issues: Sukuk and Capital Markets Development*, 7 CHICAGO J. INT’L L. 427, 434-472; Michael J.T. McMillen, *Islamic Capital Markets: Developments and Issues*, 1 CAPITAL MARKETS L.J. 136, 153-66; Michael J.T. McMillen, *Securities Laws, Enforceability and Sukuk*, in *Islamic Finance: Surveys on Global Legal Issues and Challenges* (2008) (Rifaat Ahmed Abdel Karim and Madzlan Mohamad Hussein, eds.), at 117-213 (which is a portion of the IFSB study of Islamic capital markets) [hereafter McMillen *Securities Laws, Enforceability and Sukuk*].

⁷ Vesey-Fitzgerald, *supra* note 1, at 85-86.

⁸ See Ansari, *supra* note 1. While the *Shari’ah* is the subject of voluminous scholarship, the *Shari’ah* as applied in Islamic finance is largely oral, although there is a growing body of literature and *fatāwā*. See, e.g., DeLorenzo & McMillen, *supra* note 2, at 136-50. An exception to the predominance of oral formulations as they pertain to financial matters is the *Majelle* (*Majalat al-Akham al-Adliyah*), an unfinished digest of principles and rules of the *Shari’ah* under the Hanafi *madhab* as applied in civil law transactions (*mu’āmalāt*). It was prepared by a committee of Ottoman Hanafi scholars during the period from 1869 to 1888, was published between 1870 and 1877, and was codified as law in the Ottoman empire as applicable to matters outside the commercial code. See, e.g., *The Mejella*, 1 ARAB L. Q. 363 (1986) (The ARAB L. Q. reprinted a series of English language translations of *Majalat Al-Ahkam Al-Adliyah* originally prepared by Judge C.A. Hooper as THE CIVIL LAW OF PALESTINE AND TRANS-JORDAN, VOLUMES I AND II (1933)) [hereinafter Hooper, *Majella*]; and THE MAJELLE: BEING AN ENGLISH TRANSLATION OF MAJRALLAH EL-AHKAM-ADLIYA AND A COMPLETE CODE ON ISLAMIC CIVIL LAW (C. R. Tyser et al., trans., 2001). See S.S. Onar, *The Majalla*, in LAW IN THE MIDDLE EAST 292, 292-308 (Majid Khadduri & Herbert J.Liebesny, eds., 1955); and see Herbert J. Liebesny, *Impact of Western Law in the Countries of the Near East*, 22 George Washington Law Review 127 (1953-1954), at 130-32. A summary of some provisions of the *Shari’ah* as applied in commerce and finance is contained in Wahbah Al-Zuhayli, *Al-Fiqh Al-Islami wa-Adillatuh* (Islamic Jurisprudence and its Proofs), Wahbah al-Zuhayli, *Financial Transactions in Islamic Jurisprudence*, which is a translation of Volume 5 of *Al-Fiqh Al-Islami wa ‘Adillatuh*, fourth edition (1997) and appears in two volumes (Mahmoud El-Gamal, translator, and Muhammad S. Eisaa, revisor). The most modern formulations of the *Shari’ah*, and those having the greatest influence on modern Islamic finance, are the various *Shari’ah* standards promulgated by the Accounting and Auditing Organization for Islamic Financial Institutions (“AAOIFI”), which are set forth in *Shari’a Standards 1425-6 H/2004-5* (Accounting and Auditing Organization for

term may be understood more broadly and conventionally (although, at least in the United States and the United Kingdom where the *Shari'ah* is not incorporated into the secular law, it is a body of commands that are not sanctioned by the state unless such commands are incorporated into the secular law in some permissible manner, such as by incorporation in a contract that is enforceable under secular law).⁹

Being a religious, moral, and ethical code, and a compilation of exhortations, both positive and negative, in respect of all such matters, it is fulsome in providing the observant Muslim with guidelines along the path.¹⁰ Among the prohibitions are some that are now broadly familiar. Thus, for example, under the *Shari'ah* it is impermissible to engage in the manufacture, distribution, or consumption of alcohol or pork. Pornography is prohibited, which leads to prohibitions on various types of entertainment (such as cinema and music as well as other pornographic materials). Gambling is also prohibited, with correlative prohibitions on casinos and the manufacture of instruments of gambling. *Ribā*, or what is commonly (and somewhat inaccurately) known as the payment or receipt of interest, is impermissible.¹¹ It is impermissible to

Islamic Financial Institutions 2004) [hereinafter AAOIFI *Shari'ah* Standards]. General summary textbooks of Islamic law are Asaf A.A. Fyzee, ed., *Outlines of Muhammadan Jurisprudence* (1949), and Asaf A.A. Fyzee, *Outlines of Muhammadan Jurisprudence* (2008) (Tahir Mahmood Fyzee, ed.).

⁹ See McMillen, *Contractual Enforceability Issues*, *supra* note 6, at 434-67; McMillen, *Islamic Capital Markets*, *supra* note 6, at 151-66. Reluctantly, this article will use the terms “conventional” and “Western” as correlatives, in reference to jurisdictions, practices, methodologies, and techniques that are interest-based, rather than *Shari'ah*-compliant, to any significant or primary extent.

¹⁰ Yusuf Talal DeLorenzo, *Shari'ah Supervision of Islamic Mutual Funds*, available at <http://www.djindexes.com/mdsidx/index.cfm?event=showIslamicArticles>.

¹¹ *Ribā* concepts relate to any excess paid or received on principal, or an increase in price or return, particularly an increase that is in some manner a function of time. The literature on *ribā* is extensive, and it remains a topic that is widely and vigorously debated. Noel Coulson provided a formulation that included “the illegality of all forms of gain or profit which were unearned in the sense that they resulted from speculative or risky transactions and could not be precisely calculated in advance by the contracting parties.” Noel J. Coulson, *COMMERCIAL LAW IN THE GULF STATES: THE ISLAMIC LEGAL TRADITION* 11 (1984). As to different the types of *ribā*, consider *ribā al-fadl* (relating to unequal spot trades in specified commodities), *ribā nasa' nasa'a* (relating to credit transactions in specified commodities), *ribā al-jahiliyya* (relating to deferment and increase of price), and *da/ wa ta/ajjal* (relating to discounting upon prepayment). See Mohammad H. Fadel, *Riba, Efficiency and Prudential Regulation: Preliminary Thoughts*, 25 *WIS. INT'L L.J.* 654; *The Text of the Historic Judgment on Interest Given by the Supreme Court of Pakistan*, http://www.albalagh.net/Islamic_economics/riba_judgement.shtml (last visited on July 17, 2008) (including a comprehensive treatment of *ribā* in the legal opinion of Justice Muhammed Taqi Usmani). The court concluded that:

For the detailed reasons recorded in the three separate judgments authored by Khalil-ur-Rehman Khan, J., Wajihuddin Ahmed, J., and Muhammad Taqi Usmani, J., it is

engage in or obtain the benefit of interest-based banking and non-mutual

hereby held that any amount, big or small, over the principal, in a contract of loan or debt is "riba" prohibited by the Holy Quran, regardless of whether the loan is taken for the purpose of consumption or for some production activity. The Holy Prophet (PBUH) has also termed the following transactions as riba:

- i) A transaction of money for money of the same denomination where the quality on both sides is not equal, either in a spot transaction or in a transaction based on deferred payment.
- ii) A barter transaction between two weighable or measurable commodities of the same kind, where the quantity on both sides is not equal, or where the delivery from any one side is deferred.
- iii) A barter transaction between two different weighable or measurable commodities where delivery from one side is deferred.

These three categories are termed in the Islamic jurisprudence as riba-al-sunnah because their prohibition is established by the Sunnah of the Holy Prophet (PBUH). Along with the riba-al-Quran, are four types of transactions termed as 'riba' in the literature of Islamic fiqh based on the Holy Quran and Sunnah.

Order of the Supreme Court's Appellate Branch in Riba Case, available at <http://www.financeislam.com/article/11/1/435>. See also Vogel & Hayes, *supra* note 1, at 71-95; NABIL A. SALEH, UNLAWFUL GAIN AND LEGITIMATE PROFIT IN ISLAMIC LAW 11-43 (2d ed. 1992); NAYLA COMAIR-OBEID, THE LAW OF BUSINESS CONTRACTS IN THE ARAB MIDDLE EAST 43-57 (1996); Latifa M. Algaoud and Mervyn K. Lewis, *Islamic Critique of Conventional Financing*, in HANDBOOK OF ISLAMIC BANKING 38-48 (M. Kabir Hassan & Mervyn K. Lewis eds., 2007); Barbara L. Seniawski, *Riba Today: Social Equity, the Economy, and Doing Business Under Islamic Law*, 39 COLUM. J. TRANSNAT'L L. 701 (2001); Hesham M. Sharawy, *Understanding the Islamic Prohibition of Interest: A Guide to Aid Economic Cooperation Between the Islamic and Western Worlds*, 29 GA. J. INT'L & COMP. L. 153 (2000); M A Ansari-pour, *Interest in International Transactions under Shiite Jurisprudence*, 9 ARAB L.Q. 158 (1994); M A Ansari-pour, *The Illegality of Taking Interest From Muslim Countries*, 11 ARAB L.Q. 281 (1996); Talib Siraaj Abdus-Shahid, *Interest, Usury and the Islamic Development Bank: Alternative, Non-Interest Financing*, 16 LAW & POL'Y INT'L BUS. 1095 (1984); Usama Uthman, *A Short Outline of the Foundations of Islamic Economics*, in The Proceedings of the Second Harvard University Forum on Islamic Finance: Islamic Finance Into The 21st Century (1998) [hereinafter Second Harvard Forum], at 83-91; and Taha J. al-Awani and Waleed El-Ensary, *Linking Ethics and Economics: The Role of Ijtihad in the Regulation and Correction of Capital Markets*, in Second Harvard Forum (1998), at 99-126. And consider, Mahmoud A. El-Gamal, *An Economic Explication of the Prohibitions of Riba in Classical Islamic Jurisprudence*, in The Proceedings of The Third Harvard University Forum on Islamic Finance: Local Challenges, Global Opportunities (2000), at 29-40. For histories of usury, including comparative histories see, J.T. NOONAN, SCHOLASTIC ANALYSIS OF USURY (1957); 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); and Mervyn K. Lewis, *Comparing Islamic and Christian attitudes to usury*, in Hassan & Lewis, *supra*, at 64-81. These histories provide an interesting perspective on the Islamic concept of *ribā*. In connection with an analysis of put-call parity as applied to the avoidance of usury by synthesizing a loan, Michael S. Knoll reviews certain *ribā* concepts and presents an analysis of some of the economic, tax and legal issues relating to the dominant *Shari'ah*-compliant financing mechanisms for home purchases. Michael S. Knoll, *The Ancient Roots of Modern Financial Innovation: The Early History of Regulatory Arbitrage* (U. Penn. Paper No. 49, 2004), available at <http://lsr.nellco.org/cgi/viewcontent.cgi?article=1053&context=upenn/wps>.

insurance. These are but some of the prohibited activities or businesses; there are others.¹² But these have special relevance in the commercial, financial and legal realms, where, in their expanded and fulsome form, they must be applied and interpreted.

The *Shari'ah*, being applicable to all aspects of human endeavor and existence, by definition is applicable to commercial and financial matters. Being comprehensive, it constitutes a code that is applicable to all aspects of commercial and financial matters. Thus, it will (and does) address sales [*bay*], leasing [*ijāra*], options, suretyship, transfer of obligations [*hawala*], mortgages and pledges [*rahn*], deposits for safekeeping [*emanet*], loans, gifts [*hiba*], joint ownership and joint ventures [*sharikat*, *mushāraka*, and *mudāraba*], guarantees, and virtually every other aspect of law as anyone familiar with the common law or the civil law will know the law.¹³ And like any other mature body of law, the principles are detailed and complex.¹⁴

¹² Tobacco and weapons are examples of items that are not expressly prohibited by the *Shari'ah*. However, many Muslims and *Shari'ah* scholars look askance at these items and they are frequently excluded from *Shari'ah*-compliant funds and equity indices. See, e.g., <http://www.djindexes.com/mdsidx/index.cfm?event=showIslamicOverView#board> (last visited on June 13, 2008) (with respect to the exclusions from the Dow Jones Islamic Market Indexes).

¹³ See, e.g., Hooper, *Majella*, *supra* note 8; THE MAJELLE: BEING AN ENGLISH TRANSLATION, *supra* note 8. But see Onar, *supra* note 8.

¹⁴ Given its breadth and complexity, comprehending the nuance of *Shari'ah* is frequently difficult for the lay person. Additionally, compliance is a matter of individual conscience. As such, different *madhahib* or “schools” of Islamic jurisprudence have arisen over the course of history. The four main Sunnī schools, and those having the greatest impact on modern Islamic finance, are referred to as Hanafī, Hanbalī, Mālikī and Shāfi'ī. Each *madhhab* (meaning “path” or “road to go”) is a body of juristic opinions and a related methodology of how to use text, tradition, and reason to understand pure *Shari'ah*. Historically, the different *madhahib* frequently interpreted and applied the *Shari'ah* differently to different factual or structural situations, and there have been variations even within individual schools. Thus, scholars that have specialized in the study of the *Shari'ah* play a prominent role in the interpretation and application of the *Shari'ah*, particularly in the field of Islamic finance. Islamic banks and financial institutions, some higher net worth families and individuals, and, increasingly, sponsors and developers of *Shari'ah*-compliant funds and investment products have retained one or more *Shari'ah* scholars (comprising a *Shari'ah* board) to assist in making the relevant determinations. The boards oversee the complete range of investment practices, and the principles, methodology and operational activities, of the entity or individual that has retained that particular board. Each board will certify, pursuant to *fatāwā*, *Shari'ah* compliance of a given fund, structure or instrument, usually on a confidential basis on behalf of the retaining party or entity. As a result, Islamic finance tends to develop in a rather disjointed fashion, without coordination across markets or *madhahib*. A different trend is exemplified by the existence and prestige of *Shari'ah* boards of institutions such as AAOIFI, the Fiqh Academy (*Majma' Al-Fiqh Al-Islami*) of the OIC (*Munazammat Al-Mu'tamar Al-Islami*), the Islamic Jurisprudence Institute (*Al-Majma' Al-Fihi Al-Islami*) of the Islamic League (*Rabitat Al-'Alam Al-Islami*), the Islamic Development Bank, Bank Negara Malaysia, and Suruhanjaya Sekuriti, Securities Commission of Malaysia, among others. The precise role of a *Shari'ah* board varies from entity to entity; it is a function of

Islamic finance is premised quite differently than conventional Western finance. The *Shari'ah*, when considered as a body of law, is also premised quite differently than secular law in the West, be it common law or civil law. These differences are of more than academic interest to the practitioner desiring to affect a *Shari'ah*-compliant transaction in a Western jurisdiction: the differences must be addressed and divergence must give way to harmony. Generally stated, finance in the conventional Western system is premised on an interest-based debtor-creditor model and the related risk-reward structure. Money is viewed not only as a medium of exchange and a measured store of value, but as a commodity in and of itself—an asset that can itself earn money. A central element of the conventional model is interest, the accretive earnings on money with the passage of time, or additional amounts in excess of the principal (i.e., *ribā*). That risk-reward structure, including the centrality of interest, finds further voice in contractual and legal terms with respect to financial realization on investments and collateral, including matters of payment preference.

Illustrative of the pervasiveness of these principles in Western finance are the following examples. When an individual places money with a bank for safekeeping and some return, the return on that “deposit” is specified as an amount of interest (a return that is guaranteed as a function of rate and time and not as a function of success or failure in the investment of that deposit). Providers of debt financing (lenders, bond

the unique relationship between each *Shari'ah* Board and its related retaining entity. As a general matter it can be said that a *Shari'ah* board will perform a number of different roles, typically including the following: (a) participation in product development and structuring activities; (b) review and approval of the fund or entity structure and its objectives, criteria and guidelines, and issuance of a *fatwā* in respect thereof; (c) review and approval of disclosure and offering documents, and issuance of a *fatwā* in respect thereof; (d) review, approval and oversight of investment and business operational structures and methodology, and issuance of a *fatwā* in respect thereof; (e) on-going review, oversight and approval of transactional or operational variances or applications to unique or changing circumstances; and (f) annual audits of the operations of the fund or entity and issuance of an annual certification of *Shari'ah* compliance. See DeLorenzo & McMillen, *supra* note 2, at 139-47; McMillen, *Islamic Capital Markets*, *supra* note 6, at 138-43; Michael J.T. McMillen & Abradat Kamalpour, *An Innovation in Financing—Islamic CMBS*, in *COMMERCIAL MORTGAGE-BACKED SECURITISATION: DEVELOPMENTS IN THE EUROPEAN MARKET* (Andrew V. Petersen ed., 2006); Nizam Yaquby, *Trading in Equities: A Shari'a Perspective*, available at <http://www.djindexes.com/mdsidx/index.cfm?event=showIslamicArticles>; Yusuf Talal DeLorenzo, *Shari'a Supervision of Islamic Funds*, in Jaffer: Asset Management, *supra* note 6, at 12-34; Yusuf Talal DeLorenzo, *Shari'ah Supervision in Modern Islamic Finance*, available at http://www.guidancefinancial.com/pdf/Shari'ah_Supervision_in_Modern_Islamic_Finance.pdf; Yusuf Talal DeLorenzo, *Shari'ah Supervision of Islamic Mutual Funds*, available at <http://www.djindexes.com/mdsidx/index.cfm?event=showIslamicArticles>.

holders, note holders, etc.) in conventional financial transactions are similarly compensated. Further, those providers are assured of repayment of interest and principal on their debt with priority over payments in respect of equity investments and to varying degrees relative to other debt providers. In most financing transactions, interest must be repaid in full before application of proceeds to principal. Interest compounding concepts operate to ensure that money earned on money (unpaid interest) generates further return. This fundamental assumption (and reality) is pervasive throughout the entire conventional Western economic system. Witness the pricing differentials (rate of return or cost of funds differentials) on debt versus equity. And those priority conceptions are served by a collateral security (security interests) structure and its system of realization priorities. Lenders, bondholders, and many other debt-side security holders, for example, insist on a first prior perfected security interest to ensure their preferential realization on collateral as against that of competing creditors.¹⁵

Shari'ah-compliant finance (Islamic finance) is premised quite differently, principally because of a different conception of risk and reward. Probably no single concept defines the difference between Islamic finance and Western interest-based finance better than the differences in the fundamental principles of how risk is allocated and rewarded in these different systems. The core premises in Islam look more to profit and loss sharing; thus, trading and partnership or joint venture arrangements are more appropriate risk-reward paradigms. Rewards without commensurate risk, and preferential rewards, are not permitted. *Ribā* is impermissible under the *Shari'ah*; it is both a reward without commensurate risk and a preferential reward to one party (a debt provider). The interest-based debtor-creditor paradigm is rejected, although debtor-creditor constructs are acceptable (if arising as a result of compliant arrangements).¹⁶ For the most part, predetermined fixed returns are not permissible. Guarantees or assurances of return of capital

¹⁵ This is not to say that every element of the Western economic system is tied to the interest-based debtor-creditor premise, as that is not the case. Nor is this to say that preference as applied to security interests of different types is undesirable. Rather, it is only to say that it is a central premise in the Western system and that the application of the security system is used, in substantial part, to support a preferential risk-reward construct. In fact, as discussed subsequently in this article, preferences in respect of security interests can themselves be compliant with the *Shari'ah* (consider the *rahn* and related concepts) and will be embodied in *Shari'ah*-compliant financing structures.

¹⁶ V. Sundararajan et al., *Monetary Operations and Government Debt Management* (IMF, Working Paper WP/98/144, Sept. 1998), available at <http://www.imf.org/external/pubs/ft/wp/wp98144.pdf>.

and return on capital are not permissible. Further, the use of money as a commodity is not acceptable under the *Shari'ah*. Money is not an asset that can itself earn money. It is a measured store of value and a medium of exchange. Every financial transaction must involve a tangible asset (leaving aside certain exceptions, such as intellectual property). Application of these principles precludes the sale and purchase (at least at a premium or discount) of pure financial instruments that do not represent interests in tangible assets, such as mortgage loans (which also include *ribā* elements), debts (including receivables, which frequently include *ribā* elements) that have been divorced from underlying assets, and derivatives.¹⁷

The methodology and historical tradition of Islamic jurisprudence are also factors that have no counterpart in conventional finance. They have resulted in the development of a system of “nominate contracts” that form the base, and provide structural constraints, for the development of *Shari'ah*-compliant products and instruments.¹⁸ The nominate contracts are defined contracts or structures (such as different *ijāra* structures, the *istisna'a*, the *mudāraba*, different *sharikat/mushāraka* structures, the *salam*, etc.), and they are defined with relative rigidity. While it is no longer imperative to adhere to the precise historical form of the relevant nominate contract, it now being permissible to combine different nominate contracts as “building blocks” in composite structures, the historical forms continue to work as significant constraints on the nature and structure of *Shari'ah*-compliant structures and instruments.¹⁹

Consider the *mudāraba* as an example of a long-accepted *Shari'ah*-compliant investment partnership or joint venture.²⁰ This type

¹⁷ Derivatives are a particularly vexing, and strenuously debated, issue in the field of Islamic finance. Practitioners in the field of Islamic finance are currently focused on the development of *Shari'ah*-compliant structures to achieve some of the economic benefits of derivatives, as well as to allow transactional integration with conventional Western derivatives markets. Human ingenuity being irresistible, bifurcated structures are being developed with respect to debts, receivables, derivatives, and similar “assets” to allow separation of the debt, receivable, or derivative from a *Shari'ah*-compliant transaction or instrument that allows realization of the benefits of the debt, receivable, or derivative.

¹⁸ See generally Coulson, *supra* note 12; DeLorenzo & McMillen, *supra* note 2, at 132-50.

¹⁹ Onar, *supra* note 13, at 299.

²⁰ The *mudāraba* and *sukuk al-mudāraba* are further discussed later in this article. See also Michael J.T. McMillen, *Shari'ah-compliant infrastructure and project finance*, in *Infrastructure Finance: Trends and Techniques* (2008) (Henry A. Davis, ed.), at 374-99. While the discussions here are highly generalized, *Shari'ah* principles and precepts are complex and pertain to all aspects of the joint venture arrangements, including the type and nature of contributions, the mechanisms for making contributions, determinations as to profits and losses (including *tandeed*

of joint venture is frequently used for Islamic banking and for *Shari'ah*-compliant investment funds. The managing partner [the *mudārib*, functioning as the bank or the fund manager] provides services to the partnership, but no capital in cash or in kind. The investors [*rabb ul-maal* or capital providers] provide investment capital, in cash or in kind.²¹ Should the *mudāraba* suffer financial losses, the entire burden of those financial losses will be borne by the *rabb ul-maal*, based upon the theory that the *mudārib* has lost the services it provided, lost its efforts.

The difference between the conventional Western paradigm and the Islamic paradigm that is illustrated by the foregoing example comes to the forefront in connection with the establishment of Islamic banks in Western jurisdictions where banking has, as a fundamental premise (and for admirable reasons—the protection of the investor), the requirement of deposit preservation through “deposit insurance” or “guaranteed deposits.”²² The participants in an Islamic bank view the arrangement as a *mudāraba* where return on invested funds is not, and cannot be, guaranteed. Government regulators insist on guarantees of deposits (at least with respect to some minimum level) and assured returns on those deposits (in the form of interest).²³ In the context of funds and other collective investment schemes, the governance rules embodied in the *mudāraba* as a *Shari'ah*-compliant institution will also have to be

(valuation) concepts), the permissibility of distributions in different circumstances, the procedures for making distributions, operational matters, the conduct of the venture, and governance matters.

²¹ The bank *mudāraba* may also itself constitute the *rabb ul-maal* in another investment *mudāraba*.

²² See Luca Errico & Mitra Farahbaksh, *Islamic Banking: Issues in Prudential Regulations and Supervision* (IMF, Working Paper WP/98/30, Mar. 1998), available at <http://www.imf.org/external/pubs/ft/wp/wp9830.pdf> (highlighting the differences between Islamic finance generally and conventional finance, particularly with respect to the *mudāraba* construct and the concepts of disclosure and entity governance). See also V. Sundararajan & Luca Errico, *Islamic Financial Institutions and Products in the Global Financial System: Key Issues in Risk Management and Challenges Ahead* (IMF, Working Paper WP/02/192, Nov. 2002), available at <http://www.imf.org/external/pubs/ft/wp/2002/wp02192.pdf>; V. Sundararajan et al., *Monetary Operations and Government Debt Management* (IMF, Working Paper WP/98/144, Sept. 1998), available at <http://www.imf.org/external/pubs/ft/wp/wp98144.pdf>; Nadeem Ul Haque & Abbas Mirakhor, *The Design of Instruments for Government Finance in an Islamic Economy* (IMF, Working Paper WP/98/54, Apr. 1998), available at <http://www.imf.org/external/pubs/ft/wp/wp9854.pdf>.

²³ In the case of the Islamic Bank of Britain, this issue was resolved by maintaining the mandatory deposit and return structure. This structure included mandatory assurances of protection of the deposit while allowing the Muslim investor to reject acceptance of payments if those payments were provided in circumstances where applicable *Shari'ah* rules would not have resulted in equivalent payments to the investor-depositor.

considered in developing and implementing a legal framework for Islamic finance.

Returning to some of the principles noted above, consider the prospect of *Shari'ah*-compliant asset securitization *sukuk*. The assets being securitized may not bear interest. The *sukuk* must itself bear a relationship to tangible assets.

II. EARLY INVESTMENT STRUCTURES AND THE *SHARI'AH*

Given all the differences (and only a few are here summarized), how is one to begin to make *Shari'ah*-compliant investments in the United States (or a European jurisdiction) where the economic and legal system is so fundamentally premised on interest-based financing and where the legal system knows nothing of the *Shari'ah* in form or in substance? That was the challenge in those early years and it remains a primary challenge now.

Commensurate with the interests and particular expertise of its Middle Eastern investor base, Islamic finance in the United States in the early years focused first on real estate, a favored asset for this investor base, and a market then ripe with opportunities. A second area of investment involved private equity investment in U.S. companies. In each case, financing arrangements for these transactions were provided by commercial banks in the United States, who syndicated or participated their loans in the normal course. The capital markets were not a source of funding for these early real estate and private equity transactions. Nor could they be a source of funding until the Islamic finance industry, including the *Shari'ah* scholars, addressed a broad range of issues regarding capital market investments on both the equity and the debt sides. Milestones in the development of the Islamic capital markets commenced in 1998 and include the years 2001, 2003, 2006, and 2007. Issuance of *fatāwā* in 1998 and 2003, the promulgation of *sukuk* standards in 2003 (with a significant clarification in 2008), *sukuk* issuances from 2003 to the present, and ABS *sukuk* issuances in 2006 and 2007 are among the most prominent milestones.

A. REAL ESTATE INVESTMENTS

After determining an asset class, the focus turned to structuring the investment transactions.²⁴ The issues were many; they were complex and unique. Analysis was made of market, institutional, legal, regulatory, and tax (among other) imperatives, sensitivities, and considerations. The transactions would have to be compliant with the *Shari'ah*, by definition. They would have to be consistent with the investment parameters of Middle Eastern investors at the time, which is to say the tenor of the investment would have to be in the range of two to five years. If leverage were to be used, the leverage would have to be provided by: (1) existing United States banks that knew and controlled the markets for financing of real estate projects, but knew relatively little, if anything, about *Shari'ah*-compliant leveraging techniques (and had little, if any, comfort regarding the use of such techniques in the applicable regulatory environments); (2) foreign institutions that were knowledgeable about *Shari'ah*-compliant leveraging techniques, but had essentially no understanding of real estate and financing issues in the United States (and would have to navigate a host of regulatory and tax hurdles in order to provide that financing); or (3) the capital markets, which, in the case of conventional markets, then knew nothing of *Shari'ah*-compliant instruments and structures and, in the case of Islamic markets, were essentially non-existent. The investments would have to be tax efficient, for all parties involved. Collateral security would have to be made available that was commensurate with existing market, underwriting, risk, legal, regulatory, and tax requirements and practices (which took no cognizance of *Shari'ah* and its imperatives). The documentation for these transactions, although *Shari'ah*-compliant, would have to be enforceable under the secular laws of the relevant U.S. jurisdictions and legal opinions, satisfactory to the financiers and other transactional participants, and would have to be obtained from prominent qualified law firms in the relevant U.S. jurisdictions.

A critical initial determination was that leverage was necessary and that the leverage would have to be provided by existing U.S. banks. The reasons for this decision included: the position of knowledge and experience of these banks; the absence of Islamic banks in the United States; the fact that provision of financing by knowledgeable foreign

²⁴ 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, 1203-36 (2000).

entities would have entailed excessive regulatory and tax burdens; the unfamiliarity of *Shari'ah*-compliant structures to conventional capital markets participants; and the absence of Islamic capital markets. The probability of U.S. banks providing direct *Shari'ah*-compliant financing, rather than interest-based financing, was determined to approach zero due to regulatory, underwriting, tax, and knowledge issues, among others. These, and related, determinations meant that conventional interest-bearing financing would comprise a component of the *Shari'ah*-compliant structure, however at odds that might seem to be in light of *ribā* prohibitions against the payment of interest.

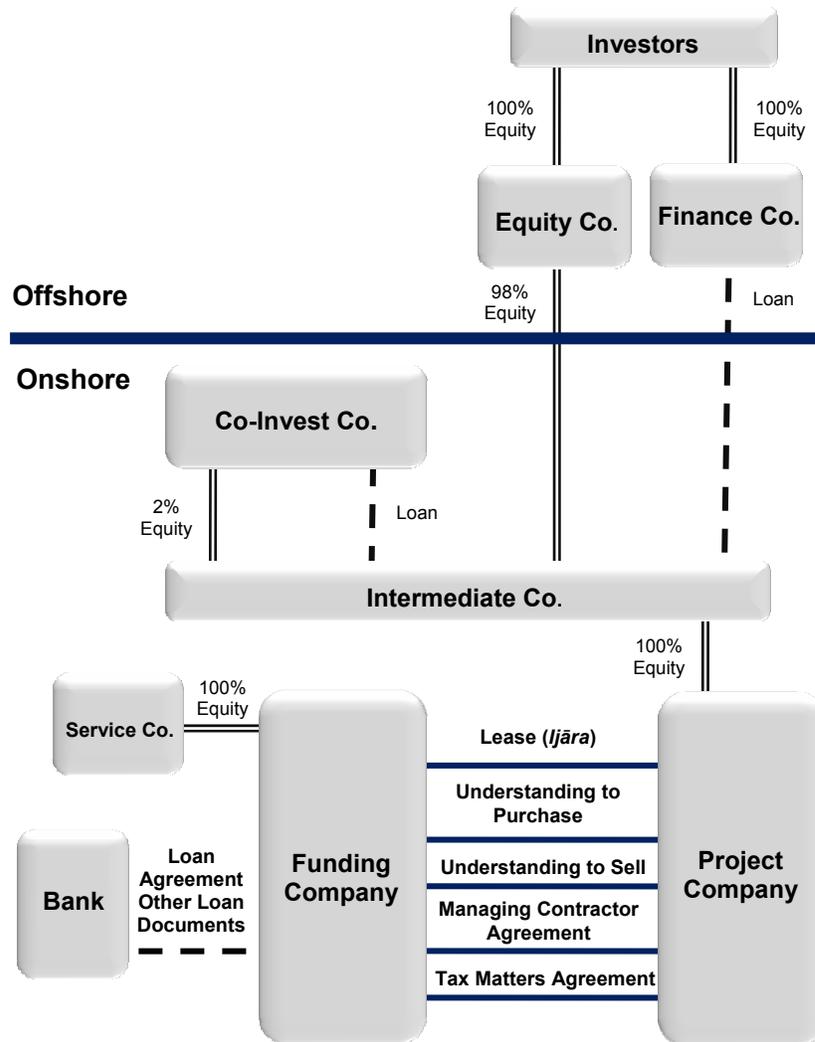
A fundamental principle of structuring international Islamic finance transactions that involve jurisdictions that do not incorporate the *Shari'ah* into their secular law, including transactions with non-compliant transactional parties, is that all matters in which the compliant investor is directly involved must be compliant with the *Shari'ah*. That imperative, however, does not apply to transactional parties with whom the *Shari'ah*-compliant investor is conducting business; non-Muslim transactional parties need not comply with the *Shari'ah*. A Muslim is not obligated to conduct business only with compliant Muslims. A Muslim consumer is not obligated to purchase goods only from compliant Muslims, although the compliant Muslim is required to purchase from the non-Muslim pursuant to a *Shari'ah*-compliant contract. The fact that a non-Muslim vendor financed the purchase of the goods with interest-bearing debt does not preclude the Muslim from purchasing those goods, although the purchase by the compliant Muslim is required to itself be compliant with the *Shari'ah*. A compliant Muslim is not required to lease property only from compliant Muslims, although the compliant lessee is required to lease from the non-Muslim only pursuant to a lease [*ijāra*] that is *Shari'ah*-compliant. In crude summary, all matters in which the *Shari'ah*-compliant investor was engaged would have to be compliant with the *Shari'ah*, although other aspects of the transaction, not directly involving the *Shari'ah*-compliant investor, may not be compliant with the *Shari'ah*.²⁵ Based upon these lines of thought, a solution emerged. It entailed the creation of a bifurcated structure, one portion of which was *Shari'ah*-compliant, and one portion of which was not.

²⁵ See El-Gamal, *supra* note 11; Hegazy, *supra* note 2.

Reference is made to Figure 1, which depicts a generic *ijāra* structure for acquisition financings.²⁶ A *Shari'ah*-compliant investor (the "Investor"), desiring to invest in a real estate project (the "Property"), would establish a tax-efficient structure to invest in a U.S. company (the "Project Company") that would have an interest in (ideally, ownership of) the Property. The Project Company would then sublease the Project to end user tenants (the "Occupational Tenants") (the sublease is not shown on figure 1). All direct dealings of the Investor and his or her related entities, including the Project Company, and all contractual relationships of those entities, would be *Shari'ah*-compliant. The discussion assumes seventy-five percent conventional interest-based financing and twenty-five percent contribution by the Investors; however, these percentages will vary with each transaction.

²⁶ A structure was also developed for construction and development projects, which is fundamentally the same as the acquisition financing structure with the addition of an *istisna'a* (construction) arrangement. The *istisna'a* arrangement includes the addition of a second special purpose vehicle, also owned by the Services Co., which is referred to as the "Construction Arranger." In summary, the Funding Company enters into an *istisna'a* agreement with the Construction Arranger whereby the Construction Arranger agrees to build the property. The Construction Arranger then enters into construction agreements with a general contractor (or a series of contractors). An early version of this *istisna'a - ijāra* structure is described in detail in McMillen, *supra* note 24, at 1237-60. That structure was widely used to implement the *Shari'ah*-compliant residential real estate investment transactions described in this article (and continues to be so used). That earlier structure has now been significantly refined and simplified. In addition, a "quadratic partnership" structure, treated as four *Shari'ah*-compliant contracts (including *istisna'a* and *salam* (forward sale contracts), has also been developed and is now used on many construction and development projects, residential and commercial, throughout the world.

Figure 1 Ijāra Structure



The investment of the Investors in the Project Company is, for tax reasons, usually made indirectly.²⁷ For example, that investment is

²⁷ Figure 1 shows a generalized fund structure using two offshore entities that together constitute the offshore investment fund. In some cases, a single offshore entity is used; in others, as many as eleven offshore entities have been used. The primary tax considerations relate to portfolio interest mechanisms that are used in offshore investment transactions, although earnings

usually made through an offshore investment “fund” (collectively denoted “Equity Co.” and “Finance Co.” in figure 1) and one or more intermediate entities (the “Intermediate Co.”). Co-investors, pro rata with Equity Co. and Finance Co., contribute equity and make loans to Intermediate Co. (although, in some cases, the Co-Investment Co. equity contributions and loans are contributed and made at the Project Company level, instead of the Intermediate Co. level). A special purpose vehicle, the “Funding Company,” is established to acquire and hold title to the Property. The Funding Company is owned by a corporate service company unrelated to the Investors (“Service Co.”). The Project Company contributes its investment (say, twenty-five percent of the acquisition price, which is one hundred percent of the amount contributed by the Investors) to the Funding Company. A conventional interest-bearing loan is made by the “Bank” to the Funding Company (equal to, say, seventy-five percent of the acquisition price). This loan is made on a basis that is consistent with the existing practices of that banking institution in respect of underwriting, credit matters, risk analysis, collateral security, and other matters. The Funding Company then acquires the Property from the Seller.

Thereafter, the Funding Company enters into an *ijāra* with the Project Company, as lessee. The rent payable under the *ijāra* is identical to the debt service on the conventional loan from the Bank and provides the funds to pay that debt service.²⁸ Future rents cannot be accelerated under a *Shari’ah*-compliant lease, including in default scenarios. Given that the outstanding principal is paid through the *ijāra*, an acceleration mechanism is necessary outside the *ijāra* itself. The Understanding to Purchase serves that function (while also mirroring all mandatory prepayment provisions of the Bank loan). The Bank, through the Funding Company, “puts” the Property to the Project Company at a strike price equal to the outstanding principal (and other outstanding and unpaid amounts).

The Project Company may also want to sell the Property (or a portion thereof, such as a single condominium or single family home) during the period that the loan is outstanding. The Understanding to Sell

stripping considerations may also be of relevance. See I.R.C. §§ 871(h) and 881(c) and related provisions.

²⁸ In European transactions, the rent is sometimes not equal to the debt service and structural modifications need to be made to ensure that the Funding Company (which is not a “disregarded entity” in most European transactions) does not have taxable income resulting in excess tax leakage for the overall transaction.

provides the mechanism (and also mirrors the voluntary prepayment provisions of the Bank loan).

Under the *Shari'ah* precepts noted above, and others, a lessor cannot pass structural maintenance and casualty insurance obligations to a lessee; however, in a building block analysis (relative to the nominate contracts noted above), a lessor can hire another entity to perform those functions. In this case, the Funding Company hires the Project Company to perform those activities pursuant to the Managing Contractor Agreement. The Managing Contractor Agreement also contains a second set of provisions that address decision-making by and on behalf of the Funding Company. The practical effect of that set of provisions is to remove the Funding Company from decision-making in the transaction.

Finally, the Tax Matters Agreement provides a road map for the relevant taxing authority, indicating, in U.S. transactions, that the Project Company is the tax owner of the Property; for income tax (and other) purposes, this is a loan from the Bank to the Project Company.²⁹ The Tax Matters Agreement delineates the correlative components as between the conventional loan documentation and the *Shari'ah*-compliant leasing documentation. In structuring and harmonizing the two transactions that are integrated into this single *ijāra* structure, it is important to reemphasize that the leasing transaction (between the Project Company and the Funding Company) must be completely independent from the conventional loan transaction (between the Bank and the Funding Company). Thus, for example, the lease transaction may not be cross-defaulted to the conventional loan transaction, although the conventional loan transaction may be cross-defaulted to the lease transaction. The result, in early structures, is a modular duplication, on an almost word-for-word basis, of the events of default, representations and warranties, covenants, and certain other provisions as between the conventional loan and the lease-related documents (although the latter were modified for lease-put-call applications, rather than loan applications). As another example, the assets of the Project Company (i.e., the Investors) may not be pledged to secure the conventional loan. Thus, the assets of the Project Company—most importantly the rent payable to the Project Company by the Occupational Tenants—are pledged to secure the obligations of the Project Company to the Funding Company under the Lease (*Ijāra*), the Understanding to Sell, and the

²⁹ In most European transactions, the Project Company will not be treated as the tax owner of the property and adjustments will be made to the structure, which will be described in the Tax Matters Agreement.

Understanding to Purchase. The Funding Company will collaterally assign its rights with respect to that collateral security package to secure the loan; however, that subsequent assignment will not affect the fact that the Project Company collateral security package will not be exercisable absent a default on the Lease (*Ijāra*), the Understanding to Sell, and the Understanding to Purchase. It is apparent that careful attention must be given to harmonization of the conventional loan and lease transactions. It also becomes apparent that this structure is quite similar to a standard, fractional, undivided interest leveraged lease transaction of the type used in project, aircraft, vessel, and equipment financings. The default, collateral security, remedies, and other structural elements are similar in most particulars, and are similarly harmonized.

The foregoing structure is used in essentially all *Shari'ah*-compliant real estate, including commercial real estate, private equity, and equipment finance transactions, in North America and Europe (with some relatively minor country variations as appropriate under relevant tax and real estate laws).³⁰ And, as noted below, it is easily modified to effect a *Shari'ah*-compliant securitisation. Many of the existing North American and European *Shari'ah*-compliant real estate funds have been structured, from their inception, to allow immediate conversion from private commercial bank financings to *sukuk* financings, although none of those funds have yet converted to capital market *sukuk* financing structures.

Having developed a workable structure and analytical focus (and the very practical focus of operating acquired properties), focus turned to the matter of the Occupational Tenants. Because the Property is subleased by the Project Company (i.e., the Investors), those Occupational Tenants must not be in prohibited businesses, such as interest-based banking, non-mutual insurance, or the provision or transportation of alcohol or pork for human consumption. This set of requirements drove the progression of *Shari'ah*-compliant real estate

³⁰ Private equity transactions use the same basic *ijāra* structure. However, in the normal transaction, not all of the Project Company assets are transferred to the Funding Company; only some of those assets are transferred to the Funding Company and then leased back to the Project Company. This is consistent with the financing of private equity transactions as operating companies. Financings of real estate transactions and project financings are financed on more of an asset basis. In addition, private equity transactions will involve working capital facilities. These are usually metals *murabaha* transactions in which a permissible metal (not gold or silver) is sold to the Project Company by a working capital provider on a deferred payment basis, the Project Company immediately selling the metal to a third party (often an affiliate of the original seller) on a spot market basis for immediate payment.

finance from the outset, not exclusively, but predominantly. Other important factors included the state of different real estate markets, the familiarity and expertise of Middle Eastern investors with real estate as an asset class, and the preference of Middle Eastern investors for investments having a tenor of two to three or three and one-half years.

In the earliest years (the late 1990s through approximately 2002), *Shari'ah*-compliant real estate focused on residential properties. This included multi-family housing developments, horizontal land development projects, gated communities, golf-course communities, single family home developments, and other residential real estate properties. An important reason for this residential focus was the fact that the prohibited business issues could be avoided entirely. This was critical at the time because the Islamic finance industry, and the *Shari'ah* scholars within that industry, were relatively absolute in their refusal to sanction transactions having any element, however small, of prohibited business activities.

As noted in the next section of this article, that position changed rather markedly after 1998. Suffice it to say, for the moment, that evolution proceeded rapidly in terms of the application of the *Shari'ah* to U.S. real estate investments. There were two major developments, from approximately 1998 onward, that catalyzed the growth of the industry in the field of real estate and many other areas. First, various devices were developed to allow potentially non-compliant transactions to proceed. Second, principles were developed to address degrees of impurity (i.e., degrees of *Shari'ah* non-compliance) that existed at the inception of investment transactions. Each is worthy of consideration and each is intimately related to developments with respect to equity investing that are discussed in the next section of this article.

With respect to potentially non-compliant transactions, various methods of “cleansing” and “purification” were developed that allowed some transactions to proceed at the inception of the transaction if devices were put in place to cleanse and purify the transaction of any subsequent violation of the *Shari'ah*. Thus, if an otherwise *Shari'ah*-compliant transaction (e.g. an *ijāra* transaction of the type noted in figure 1) were effected and, some time later in the transaction, interest was receivable by the Project Company from an Occupational Tenant under a sublease (e.g. late payment interest), the Project Company could either decline the interest or accept the interest and donate it to charity. Either method of proceeding would “cleansing” and “purify” the transaction. This example illustrates another development.

Changes with respect to consideration of transactions that were non-compliant at inception were the result of: (a) greater familiarity of the *Shari'ah* scholars and the industry as a whole with the United States (and other) markets, and recognition that pervasive and highly standard practices in those markets could not be readily changed (or could only be changed in a manner that would be so costly as to make the transaction uneconomic); and (b) a series of developments that resulted from the acceptance of equity investment principles that are discussed in the next section of this article. As one example of the evolving principles in respect to transactions that were somewhat non-compliant at inception, the scholars began to develop a series of principles of practical application to the effect of subleases to Occupational Tenants that were not *Shari'ah* compliant at the time of the acquisition of the Property (they are supposed to be *Shari'ah* compliant as the Project Company is a party) could be left in place despite their non-compliance. When those subleases came up for renewal, however, they had to be made *Shari'ah* compliant. This very practical decision obviously solved a problem of enormous magnitude to the growth of the Islamic finance industry.

However, the practical import of those at-inception principles was overshadowed by another similar development that occurred as *Shari'ah*-compliant real estate investment moved from a focus on residential real estate to commercial real estate. The early commercial real estate investments were primarily in single tenant, credit-leased office buildings. The reason for the preference for single tenant properties related, again, to attempts to minimize the application of the prohibited business precepts of the *Shari'ah*. The number of *Shari'ah*-compliant commercial office real estate investment transactions increased dramatically from 2002 on. The voracious appetite of the *Shari'ah*-compliant funds for these types of properties was matched by the appetite of conventional investors. *Shari'ah*-compliant investors were handicapped in this competition because they were limited to a much smaller tenant base. Initially, the *Shari'ah*-compliant investors moved to multi-tenant property investments in the commercial office sector. In 2003, these investors, as well as conventional investors, expanded to investments in the European markets. As investment in multi-tenant properties increased, and competition for commercial properties increased even more dramatically, *Shari'ah*-compliant investors found that the only available properties had some tenants that were in prohibited businesses, to some greater or lesser extent. As the *Shari'ah*-compliant investors looked longingly at investment in other

property sectors (such as retail, including malls, grocery stores, and big box retailers), the prohibited business rules loomed as a major hurdle.

Shari'ah-compliant investors turned to the *Shari'ah* scholars to find a practical solution. The argument was that the equity investment principles, the purification principles, and other aspects of the *Shari'ah* supported the position that investments should be acceptable where: (1) the degree of impurity was minimal, particularly if no *Shari'ah*-compliant alternatives to the impurity were available in the relevant market; and (2) efforts are subsequently made to achieve less and less impurity. For example, an investment in a large office building in a major urban location that has, as its only non-compliant tenant, an automatic teller machine ("ATM"), owned by an interest-based commercial bank, in the lobby. The ATM is *de minimus* in terms of rental revenue, square footage, and every other objective measure. Obviously, its presence is important to the residents of that building as the only source of ready cash and electronic banking; and there are no *Shari'ah*-compliant banking facilities available as an alternative. The *Shari'ah* scholars began to approve initial investment transactions in circumstances such as these. Sometimes the scholars required that the ATM be removed after a period of time; however, most of the time, in this type of situation, the practical necessities were deemed overriding and the ATM was allowed to remain. A degree of impurity or variance was permitted.

Starting around the year 2002, the application of these principles to the realities of real estate markets became one of the more rapidly-growing and relatively unpublicized areas of Islamic finance at the ground level. Consider only a few of the myriad possible permutations: (a) a restaurant in an isolated office complex in the middle of the country that serves alcohol; (b) a suburban office building in an isolated complex that has, as tenants, the back-office operations of a commercial bank, credit card company, or non-mutual insurance company; (c) a retail bank branch; (d) an automobile or consumer credit subsidiary of an automobile company; (e) a trans-shipment warehouse where pork or alcohol is present in some amount; or (f) grocery stores that sell pork and/or wine. The possibilities are infinite. The *Shari'ah* scholars continue to handle each and every one of these types of situations (there are many) on a case-by-case basis, in a highly practical manner that is consistent with the larger body of *Shari'ah* principles that is evolving concurrently with this area of investment practice. The *de minimus* concepts are being applied. But it must be emphasized that they have not

been applied to allow certain types of activities, no matter how *de minimus*. While the analysis is case-by-case and not entirely certain, the result is that *Shari'ah*-compliant real estate investment has expanded into almost all areas and types of real estate. Probably no single set of judgments has advanced the development of *Shari'ah*-compliant real estate investing as significantly as these. The essential determination that enabled such judgments to be made at all is illustrated by the determinations that were made in respect of equity investments.

B. EQUITY INVESTMENTS

Prior to 1998, the *Shari'ah*-compliant investor was precluded from making investments in all but a rare equity security, whether listed on a major exchange or over-the-counter. Prohibited business concepts were one of the reasons, and remain an important reason, for the prohibition of many equity investments. But the *ribā* doctrines were equally, if not more so, a preclusive factor; nearly every company has indebtedness and pays interest on that indebtedness or receives payments of interest in respect to its cash deposits or investments (both short-term and long-term). Strict application of the *Shari'ah* would prohibit any investment in these companies. The industry struggled with this fact for years—effectively, it was a total preclusion of equity capital market investment by Muslim investors. And then along came the Dow Jones Islamic Market Indexes (“DJIMI”).³¹

The DJIMI was established in 1999. Prior to establishing its first Islamic index (there are currently many), the DJIMI and its *Shari'ah* supervisory board had to address the equity investment prohibition.³² It did so in 1998, after years of consideration, in one of the more monumental *fatāwā* in the history of modern Islamic finance (the “DJIMI *Fatwā*”).³³ The DJIMI *Fatwā* establishes a series of “screens” to determine whether an investment in an equity security is permissible

³¹ See Dow Jones Islamic Market Indexes at <http://www.djindexes.com/mdsidx/?event=showIslamic> (last visited July 18, 2008) (overview of the nature and operations of the Dow Jones Islamic Indexes).

³² See Dow Jones Islamic Market Indexes, <http://www.djindexes.com/mdsidx/index.cfm?event=showIslamicOverView#board> (last visited July 18, 2008) (biographical descriptions of current members of the *Shari'ah* supervisory board of DJIMI).

³³ Dow Jones Islamic Market Indexes *Fatwā* (1998) (on file with author). A related paper, by one of the members of the DJIMI *Shari'ah* board that issued the DJIMI *Fatwā*, is Yaquby, *supra* note 14. The DJIMI *Fatwā* was amended by a subsequent *fatwā* in 2003. See also, *supra* note 4 and accompanying text.

under the *Shari'ah*. Three levels of screens were established. They relate to business activities, financial ratios, and ongoing monitoring.³⁴ Before considering those screens, it should be noted that the principle of “cleansing” or “purification” was acknowledged and accepted by the DJIMI *Fatwā*. Moreover, it was opined that a *Shari'ah*-compliant investor in an entity that has impure [*haram*] income is obligated to establish or estimate the amount of *haram* income and purify that income or cleanse their holdings of that income. This is an important underlying premise of the entire screening arrangement set forth in the DJIMI *Fatwā*.

The first level of screens is divided into two parts: (1) whether the security under consideration is itself a permissible security; and (2) whether the “primary or basic business” of the company whose securities are under consideration is a prohibited business. As to the first part of this screen, certain types of securities were determined to involve *ribā* elements, and thus were determined to be impermissible investments. These included fixed income securities, preferred shares, convertible notes, and similar securities where a predetermined rate of return was stipulated, and the principal is thus guaranteed.³⁵ If the security and business under consideration passed the level one screen, the level two screens were applied. Level two screening focused on certain financial ratios of the entity under consideration. The tests under the financial screens were whether: (a) the total interest-bearing debt of the entity exceeded thirty-three percent of the entity’s market capitalization; (b) the total accounts receivable of the entity exceeded forty-five percent of the total assets of the entity; and (c) cash and interest-bearing securities of the entity exceeded thirty-three percent of the market capitalization of the entity. The *Shari'ah* board was careful to note that these tests were established based upon information and techniques then available and that if more precise measurements, consistent with the principles set forth in the DJIMI *Fatwā*, were to become available with respect to all or any of the tests, the tests would need to be revised accordingly. As new information and techniques have become available, the tests have indeed been revised. For example, the increased availability of operating statements (rather than just balance sheets) has resulted in the

³⁴ Dow Jones Indexes, <http://www.djindexes.com/mdsidx?event=showIslamic> (last visited July 18, 2008).

³⁵ Since the issuance of the DJIMI *Fatwā*, some types of essentially fixed-income instruments, such as some *sukuk*, have been approved. With respect to some other prohibited instruments, *Shari'ah*-compliant structures have since been developed and approved.

development of new tests that focus on total interest income and expense relative to gross revenue (or other revenue measures), rather than just market capitalization. Market capitalization is a fickle measure, as the dot.com and volatile interest rate markets of the early years of the century have proven.³⁶ The third level of screening relates to on-going monitoring activities to ensure that the first and second level screens are adhered to as an on-going matter. For example, mergers and acquisitions should not result in a change in business purpose that would result in a failure, after the initial investment is made, in the business purpose screen. Similarly, incurrence of interest-bearing indebtedness, or investment in interest-bearing instruments or accounts, after passage of the initial financial screens, will not be permissible.³⁷ It is difficult to overestimate the importance of the DJIMI *Fatwā* in advancing the development of modern Islamic finance, both generally and specifically. The principles under-girding, as well as the specific tests included in, the DJIMI *Fatwā* were widely and penetratingly discussed with, and approved by, the members of the OIC Fiqh Academy.

What is most important, and what has been of greatest impact, are the principles underlying the DJIMI *Fatwā*. Some of those principles were expressly stated, such as the principle, stated as an opinion, that “an Islamic investor may own shares of companies or investment vehicles whose primary business is consistent with *Shari’ah* precepts, even when a small part of their revenues include, within certain limits, *haram* income.” The same principle is embodied in the portion of the first level screen dealing with prohibited businesses: the “primary, basic, or core business” of the entity under consideration may not be a prohibited business activity. The door is left open for consideration of investment in entities that have some non-compliant business activities.

³⁶ The author, in a professional capacity, has been involved with obtaining a number of *fatāwā* that implement standards relating to operating statement information, such as interest income and expense and gross revenue measures. The exact standards vary from one *Shari’ah* scholar and board to another, and no consensus has yet been reached on alternative tests.

³⁷ Failure to pass a screen on a subsequent basis may require divestiture of the security. In practice, the *Shari’ah* scholars have been deliberative and pragmatic in implementing these divestiture requirements. For example, they have been diligent in avoiding the imposition of a divestiture requirement where the result would be a “fire-sale” scenario. This is an especially sensitive and difficult area of the practice of Islamic finance, and one requiring mature and balanced judgment by everyone involved. Frequently, in establishing a *Shari’ah*-compliant fund, general parameters are set forth in the *fatwā* authorizing the fund and its structure. That *fatwā* may contain general principles with respect to issues such as divestiture, such as an outside time limit and some of the relevant considerations. In every case, however, on-going and candid discussion with the *Shari’ah* scholars will be necessary.

Establishment of the principle that total purity may not be obtainable, and that some degree of impurity or variance is acceptable in certain limited circumstances (including matters of degree and with obligations in respect of cleansing and purification), has had profound effects on all aspects of Islamic finance. It has facilitated the growth of *Shari'ah*-compliant real estate finance and led to the temporary acceptance of non-conforming Occupational Tenant subleases. It has allowed the industry to expand to investments in large, multi-tenant properties where some of the tenants are in non-compliant *haram* businesses to some greater or lesser extent. It has facilitated the expansion of the Islamic finance industry into a broad range of property types. It is one of the seminal *fatāwā* in modern Islamic finance. Its adoption was not without controversy, although a significant degree of consensus was achieved before its adoption; and its application is not without controversy. Its affects are broadly, if not unanimously, applauded. How these, and derivative or developed, principles will be applied in the *sukuk* field is only now beginning to be explored.

III. ASSET SECURITIZATIONS: *HARAM* AND *HALAL*

A. ASSET SECURITIZATIONS GENERALLY

As a historical matter, asset securitizations have been effective in providing the backbone for, and assisting in the development of, capital markets, including secondary markets.³⁸ Because of this, and other factors discussed below, *sukuk* have been chosen as the focus of the legal

³⁸ The securitization markets in the United States and Europe are primary examples. See McMillen, *Contractual Enforceability Issues*, *supra* note 6, at 429-31; McMillen *Securities Laws, Enforceability and Sukuk*, *supra* note 6; Michael J.T. McMillen, *Toward an Effective Legal Framework for Islamic Finance: Securities Laws, Trusts, Enforceability and Sukuk* (a report for the IFSB and the International Organization of Securities Commissions, April 19, 2007, Kuala Lumpur, Malaysia, that is part of the IFSB capital markets initiative hereinafter referenced) (on file with the author) [hereinafter *McMillen Effective Legal Framework*]. An earlier version of a portion of McMillen (2007-IFSB) addressing trust concepts was co-authored by Michael J.T. McMillen and Sheikh Yusuf Talal DeLorenzo in a report to the Asian Development Bank ("ADB") entitled *Toward an Effective Legal Framework for Islamic Finance: Trust Concepts and Sukuk*. This earlier report, in turn, was incorporated into a larger report to the ADB prepared by V. Sundararajan and Centennial Group Holdings, LLC, and entitled *TA-6182-REG: Development of International Prudential Standards for Islamic Financial Services, Final Report, March 2007*, and appears in full as Appendix 4 to that report.

infrastructure initiative of the IFSB. At inception, it is important to understand the structure and benefits of asset securitization.³⁹

Each asset originator, whatever their credit rating or grade, has a definable cost of obtaining funds from direct sources of funding (which is often expressed as the interest rate that the originator must pay on direct sources of funding). The principle and purpose of an asset securitization is to isolate certain assets initially owned by that originator in such a manner as will allow an investor in those assets to provide

³⁹ The literature analyzing the benefits of asset securitization is voluminous. *See, e.g.*, Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1383-1405 (1991); James A. Rosenthal & Juan M. Ocampo, *Analyzing the Economic Benefits of Securitized Credit*, 1 J. APPLIED CORP. FIN. 32 (1992); Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133 (1994-1995); Robert Dean Ellis, *Securitization Vehicles, Fiduciary Duties, and Bondholder's Rights*, 24 J. CORP. L. 295 (1998-1999); Steven L. Schwarcz, *The Universal Language of International Asset Securitizations*, 12 DUKE J. OF COMP. & INT'L LAW 285 (2002) (providing a readable introduction to securitization concepts, structures, and issues). *See also* Steven L. Schwarcz, *Securitization Post-Enron*, 25 CARDOZO L. REV. 1539 (2004); STANDARD & POOR'S U.S. CMBS LEGAL AND STRUCTURED FINANCE CRITERIA (2003) (a comprehensive and detailed presentation of the many issues that must be considered, and resolved, if asset securitization *sukuk* are to be posited as a backbone of an Islamic capital market, although it does not yet contain discussions or criteria relating specifically to *sukuk* and is limited to commercial mortgage-backed securitization). Examples of the literature pertaining to specific types of securitizations include Ara A. Babaian, *Striving for Perfection: The Reform Proposals for Copyright-Secured Financing*, 33 LOY. L.A. L. REV. 1205 (2000); Patrick D. Dolan, *Securitization of Equipment Leases*, N.Y. L.J., Aug. 11, 1999, at 1; Conor Downey, *Whole Business Securitization Comes of Age*, 18 INT'L FIN. L. REV. 8 (1999); Patrick D. Dolan, *Lender's Guide to the Securitization of State Lottery Winnings and Litigation Settlement Payments*, 115 BANKING L.J. 710 (1998); Patrick D. Dolan, *Lender's Guide to Securitization of Commercial Mortgage Loans*, 115 BANKING L.J. 597 (1998); Charles E. Harrell et al., *Securitization of Oil, Gas, and Other Natural Resource Assets: Emerging Financing Techniques*, 52 BUS. LAW. 885 (1997); Charles E. Harrell & Mark D. Folk, *Financing American Health Security: The Securitization of Healthcare Receivables*, 50 BUS. LAW. 47 (1994); Gregory R. Salathé, *Reducing Health Care Costs Through Hospital Accounts Receivable Securitization*, 80 VA. L. REV. 549 (1994); Jonathan Shann, *The Art of Securitizing Catastrophe Risk*, INT'L FIN. L. REV., Aug. 1999, at 26. While there is extensive literature on asset securitizations, two compilations, each structured as practitioner's guides, are particularly useful. PATRICK D. DOLAN AND C. VANLEER DAVIS III, *SECURITIZATIONS: LEGAL AND REGULATORY ISSUES* (2006), addresses the primary substantive bodies of law of relevance to securitizations (such as laws relating to securities, bankruptcy, tax, ERISA, security interests, and related issues) and the primary accounting rules. It also discusses various types of securitization transactions (such as commercial paper conduits, commercial mortgage backed securities, collateralized bond obligations, collateralized loan obligations, cross-border future flow securitizations, credit card receivables and auto loan securitizations, lottery receivables securitizations, stranded cost securitizations, structured settlement securitizations, home equity loan securitizations, insurance securitizations, derivatives securitizations, and rating agency issues and considerations). Other portions address legal issues in Mexico, the United Kingdom, Ireland, Italy, Germany, Australia, and France. JOHN ARNHOLZ & EDWARD E. GAINOR, *OFFERINGS OF ASSET-BACKED SECURITIES* (2007) focuses on the legal framework pertaining to the public offering and issuance of ABS, but also includes discussions of tax, ERISA and other legal issues, as well as accounting issues.

funding at a cost that is lower than that which would be payable on direct funding sources absent such an isolation (taking into account transaction costs). Most frequently, this involves accessing the capital markets. One working definition of securitization is thus:

[T]he sale of equity or debt instruments, representing ownership interests in, or secured by, a segregated, income producing asset or pool of assets, in a transaction structured to reduce or reallocate certain risks inherent in owning or lending against the underlying assets and to ensure that such interests are more readily marketable and, thus, more liquid than ownership interests in and loans against the underlying assets.⁴⁰

The “segregated, income producing asset or pools of assets” are assets, instruments, or obligations that involve some right to payment, such as a lease payment, a residential or commercial real estate loan receivable (commonly referred to as a mortgage-backed receivable), a receivable, or a royalty. As a general matter, some or all of the following parties are involved in an ABS transaction: (a) the initial owner of the asset, being the party that originated the asset; (b) the issuer of the security issued in respect of the securitized assets (the ABS, which are equity or debt instruments), usually a special purpose trust,⁴¹ corporation, or other entity (often referred to as the issuer “SPV”); (c) the investment bankers that assist in structuring the transaction and underwriting and placing the ABS; (d) the rating agencies, who assess the credit quality of the ABS and assign a credit rating to that security; (e) a credit enhancer, such as a mono-line insurer, surety company, bank, or other entity providing credit support through an insurance policy, letter of credit, guarantee, or other assurance to the effect that there will be a source of funds available for payments on the ABS as they become due; (f) a servicer who collects payments due on the underlying assets for a fee and remits those payments to the security holders or a trustee for the benefit

⁴⁰ Shenker & Colletta, *supra* note 39, at 1374-75.

⁴¹ Anglo-American common law trusts are a (if not the) primary vehicle for the SPV issuer in asset securitizations. Even where another entity form is used (such as a corporation), that entity is structured so as to ensure that it embodies the elements of a trust (for example, the fiduciary elements). The trust provides greater freedom and flexibility, particularly as regards governance, than the corporation, and thus is a preferred form. The trust also provides significant tax advantages over the corporate form in most jurisdictions. *See also*, Michael J.T. McMillen and Yusuf Talal DeLorenzo, *Trust Laws and Islamic Finance*, in Abdel Karim & Hussein, *supra* note 38, at 214-47; McMillen *Securities Laws, Enforceability and Sukuk*, *supra* note 6; and McMillen, *Effective Legal Framework*, *supra* note 38, at 93-121, focus on the nature of this trust vehicle and the question of whether and to what effect a *Shari'ah*-compliant trust vehicle can and should be incorporated into the legal framework of OIC jurisdictions.

of the security holders; (g) a trustee, who holds the assets for the benefit of the security holders and deals with the issuer, credit enhancer, and servicer; and (h) legal counsel, who assist in structuring the transaction and provide legal opinions to the ratings agencies and the transactional participants.

The assets to be securitized, which serve as the primary source of payment on the ABS, are first identified, evaluated, and valued. Evaluation and valuation will focus on the credit quality of those assets, particularly the likelihood that payments will be made as and when required pursuant to the terms of the documents relating to those assets. Evaluation, and the prediction of default risk in respect of the assets, is difficult if the focus is any particular asset; however, statistical methods, including those based upon the “law of large numbers,” or Bernouli’s Theorem, and related probability tools, can be applied to larger pools of assets resulting in a greater degree of confidence as to default predictions. After identifying the assets to be securitized, the originator of the securitized assets transfers those assets to the SPV that will hold the assets for the benefit of the ABS holders and issue the ABS to those holders. The purpose of this asset transfer is to separate the assets from the risks associated with the originator, including, importantly, the risks associated with the bankruptcy or insolvency of the originator, and place them in a vehicle that has a low likelihood of becoming involved in a bankruptcy or insolvency proceeding. Frequently, the asset transfer transaction will be structured to constitute a “true sale,” i.e., a sale that is sufficient under the bankruptcy and insolvency laws to remove the assets from the bankruptcy estate of the originator (thus being designated “bankruptcy remote”).⁴² The SPV will issue the ABS in the capital markets to raise funds to purchase the transferred assets. Because of the structure of the transaction (isolation of the underlying assets, often pursuant to a true sale, and bankruptcy remoteness), the rights and interests of the ABS holders will be limited to the assets and payments thereon (and to any credit enhancements). There will be relatively little concern about the financial condition or operations of the originator (except to the extent that the originator may have obligations to

⁴² To achieve this end, and thereby reduce the ability of the originator and third party creditors (other than the ABS holders) to institute bankruptcy proceedings against the SPV, the SPV is limited to a single business purpose (holding the assets and collecting and paying amounts in respect of those assets in a specified form) and must adhere to various formalities in the conduct of its business. See, e.g., McMillen, *Contractual Enforceability Issues*, *supra* note 6, at 25-32; McMillen, *Islamic Capital Markets*, *supra* note 6, at 164-66; McMillen *Effective Legal Framework*, *supra* note 38, at 204-10.

repurchase assets from the pool or provide other credit enhancement, and except to the extent that the practices of the originator affect the assets comprising the pool at its inception). The cost of funding through securitization will be determined by the interest rate on the ABS. That cost, in turn, will often be a function of the “rating” that is assigned to the ABS. Isolation of the underlying assets in the SPV will often allow a company to finance those assets at a higher rating, and lower cost, than would be incurred if the assets were not isolated and if the company sought entity-level funding (due to company-related credit matters unrelated to the specific assets).

Direct overall cost savings from securitization focus on the differential in two primary factors as compared with entity-level fundings: (1) interest rates or the direct cost of funds, and (2) transaction costs incurred in each type of funding transaction. Transaction costs are an important factor in analyzing whether a securitization will result in costs savings. Transaction costs will be markedly influenced by whether the transactions are “one-off” or in series, whether the transactions are private placements or public offerings, whether the asset pool is large or small, whether the issuance vehicles represent assets from one originator or many originators, the mix of assets comprising the pool, whether the issuance involves credit enhancement or resort only to the underlying assets, the rating assigned to the security, and a wide range of other factors.⁴³ Of particular importance for capital markets transactions are the higher transaction costs of public offerings of securities, which are reflective of factors such as the level of due diligence required to satisfy the disclosure requirements of securities laws as well as the time frames to consummate the securities offerings. Thus, the structure of the legal framework, particularly securities and other capital markets laws, will have a direct and significant impact on the securitization process and capital markets developments. Multi-seller conduit structures that allow various originators to contribute assets to a larger mixed pool may have the benefits of economies of scale with respect to transaction costs; thus expanding the universe of companies that can avail themselves of this funding device and access the capital markets at a lower cost of funds.

⁴³ Consider, for example, the discussion of these factors in Schwarcz, *supra* note 39, at 137-41. Modern securitizations involve the issuance of multiple classes of securities, each having different payment and risk characteristics, off a single pool of assets. This involves considerable mathematical engineering and is a far cry from the direct matched pass-through of payments on the underlying assets to the securitization securities.

There are also indirect overall costs savings from securitization.⁴⁴ For example, to achieve “true sale” treatment, “an originator must limit, if not forgo, its right to the residual value of the receivables [underlying assets] sold to the SPV.”⁴⁵ The amount of this residual value loss may be quite significant due to the necessity of “overcollateralization” of the SPV with excess underlying assets in order to assure investors, credit enhancers, liquidity providers, and rating agencies that losses will not be suffered as a result of delays or defaults in payments on the underlying assets. The excess assets over those necessary, in the perfect case, to assure payment of the ABS are real costs to the originator.⁴⁶

Securitizations provide a broad range of advantages to the originator and the investors in the ABS.⁴⁷ These advantages include:

- (a) decreased direct costs of funding;
- (b) lower weighted average costs of funding (especially where a senior/subordinated structure is used);
- (c) diversification of assets in the securitized pool and thus a degree of risk diversification;
- (d) facilitation of balance sheet and capital structure management by originating, as well as investing, entities, as newly generated assets are moved from the individual originator to the capital markets;
- (e) off-balance-sheet funding opportunities;
- (f) enhanced business expansion and asset regeneration for the originator of the transferred assets as those assets are moved from the originator to the capital markets;
- (g) greater risk and liquidity management for all market participants;
- (h) an expanded universe of credit enhancers;
- (i) innovation and flexibility in structuring techniques;
- (j) greater diversity of funding sources;

⁴⁴ See Schwarcz, *Alchemy of Securitization*, *supra* note 39, at 141-44.

⁴⁵ *Id.* at 142.

⁴⁶ See *id.* at 142-43 (regarding structures and techniques for minimizing this overcollateralization cost).

⁴⁷ Not all observers acclaim the benefits of securitizations. See Lois Lupica, *Asset Securitization: The Unsecured Creditor's Perspective*, 76 TEX. L. REV. 595 (1998); David Gray Carlson, *The Rotten Foundations of Securitizations*, 39 WM. & MARY L. REV. 1055 (1998); Christopher Frost, *Asset Securitization and Corporate Risk Allocation*, 72 TULANE L. REV. 101 (1997); Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 75 Washington University Law Quarterly 1061 (1996).

- (k) access to a deeper and wider investor base, and the promotion of participation of a greater proportion of the populace in market activities;
- (l) ability to access longer funding maturities;
- (m) capacity for increased transactional size;
- (n) ability for more strategic funding;
- (o) enhanced possibilities for regulatory arbitrage for investor institutions;
- (p) conduit funding arbitrage possibilities; and
- (q) for governments, an additional means of policy and monetary management as they participate in the securitization markets, as buyers and, through government sponsored entities (the "GSEs"),⁴⁸ as issuers.

In order to develop strong securitization capability and related secondary markets, significant market depth and breadth must be obtained. Program issuers are a critical component, and those issuers must generate considerable volumes on a constant basis. Program issuers should include governmental organizations, GSEs and, of course, primary financial institutions. As a historical matter, the role of GSEs in developing capital markets has been enormous. The GSEs have played a primary role in the development of the relevant legal and regulatory frameworks, have fostered and overseen the development of standards and standardized documentation, and have helped generate volume and depth of the markets. Governments and GSEs have acted as regulators, enablers, issuers, and purchasers of securitized instruments and related securities, with profound effects on the capital and secondary markets and the effectuation of monetary policy.

B. ABS SUKUK

Shari'ah-compliant capital markets activity began on the equity investment side of the markets. Only recently has there been a focus on

⁴⁸ GSEs played the primary issuance and market organization role in the United States, and continue to perform critical roles as issuers, buyers, standard setters. Some of the more prominent GSEs in the United States include the Federal National Market Association (FNMA or Fannie Mae), the Federal Home Loan Mortgage Association (Freddie Mac), the Government National Mortgage Association (GNMA or Ginnie Mae), and the Student Loan Marketing Association (SLMA or Sallie Mae). See Richard D. Jones, *The Emergence of CMBS, in COMMERCIAL MORTGAGE-BACKED SECURITISATION: DEVELOPMENTS IN THE EUROPEAN CMBS MARKET* 1-17 (Andrew V. Peterson ed., 2006).

the *Shari'ah*-compliant debt or financing side of these markets, with the *sukuk* coming to the fore as the instrument holding the greatest potential for developing the finance side of the market. *Sukuk* are often referred to as “Islamic bonds.”⁴⁹ That characterization is only partially accurate, and it is a product of the current state of the market. *Sukuk* are of two general types: Islamic bond structures and Islamic asset securitization structures.⁵⁰ In each case, there are ownership attributes that make these instruments more akin to “pass-through certificates”⁵¹ or “investment

⁴⁹ *Sakk* (singular) means, in classical Arabic, “to strike” or “to hit,” as in to strike or imprint one’s mark on a document or tablet, and, as a derived term means “minting coins.” Despite much earlier uses of the *sukuk* concept, the current structural formulations are a product of the “jurisprudence of transformation and adaptation” of modern Islamic finance that has emerged since the 1980s wherein the classical nominate contracts (*uqud musammata*) are viewed as a set of building blocks rather than as complete and immutably static transactional formulations and structures in and of themselves. See DeLorenzo & McMillen, *supra* note 2, at 136-201, for a survey of the history of modern Islamic finance. Mohamed Rafe Md. Haneef, *Recent Trends and Innovations in Islamic Debt Securities: Prospects for Islamic Profit and Loss Sharing Securities*, in ISLAMIC FINANCE: CURRENT LEGAL AND REGULATORY ISSUES 29-60 (S. Nazim Ali ed., 2005) [hereinafter FINANCIAL ISSUES] discusses *Shari'ah*-compliant debt-side instruments, including some *sukuk* structures.

⁵⁰ As noted later in this section, including note 72 *et seq.* and accompanying text, the AAOIFI *Shari'ah* Supervisory Board has recently expressed concern that the Islamic bond structures have become, in essence, conventional bonds and conventional bond structures, and, as a result, issued the AAOIFI *Sukuk* Clarification with respect to critical structural matters of bond-type structures. A sharp distinction should be drawn between “bonds,” as that term is used in Western finance, and “whole-business securitization structures,” which is more closely akin to the Islamic bond concept. In the “Islamic bonds” context, consider, for example, the differentiations as to bond *sukuk* and ABS *sukuk* that are recognized in some existing laws. See, e.g., SURUHANJAYA SEKURITI SECURITIES COMM’N, GUIDELINES ON THE OFFERING OF ISLAMIC SECURITIES, (2004), <http://www.sc.com.my/eng/html/resources/guidelines/Guidelines-Islamic%20Securities260704.pdf> (last visited on July 8, 2008). There are also various “Practice Notes” of the Securities Commission pertaining to Islamic securities (and most other laws, regulations and guidelines) at <http://www.sc.com.my> (follow “Guidelines, Codes and Practice Notes” hyperlink) (last visited July 8, 2008). Of particular interest in light of the desire of Malaysia to expand its role as an international Islamic finance hub are: SURUHANJAYA SEKURITI SEC. COMM’N, PRACTICE NOTE 1 ISSUED PURSUANT TO THE GUIDELINES ON THE OFFERING OF ISLAMIC SECURITIES, Revised Ed., Sept. 15 2005, <http://www.sc.com.my/eng/html/resources/guidelines/PN1-IS.pdf>; SURUHANJAYA SEKURITI SEC. COMM’N, PRACTICE NOTE 1A ISSUED PURSUANT TO THE GUIDELINES ON THE OFFERING OF ISLAMIC SECURITIES, Mar. 27 2007, [http://www.sc.com.my/eng/html/resources/guidelines/bondmkt/SC_PN1A\(IS%20GLs\)_270307.pdf](http://www.sc.com.my/eng/html/resources/guidelines/bondmkt/SC_PN1A(IS%20GLs)_270307.pdf); SURUHANJAYA SEKURITI SEC. COMM’N & BANK NEGARA MALAYSIA, JOINT INFORMATION NOTE ON THE ISSUANCE OF FOREIGN CURRENCY-DENOMINATED BONDS AND SUKUK IN MALAYSIA, Mar. 27, 2007, http://www.sc.com.my/eng/html/resources/guidelines/bondmkt/JointInfoNote_foreign%20currency%20bonds.pdf. See also Suruhanjaya Sekuriti Sec. Comm’n, *Malaysian Capital Markets According to Islamic Jurisprudence* 1 Q. BULL. MALAYSIAN ICM 1, 2 (2006), available at <http://www.sc.com.my/eng/html/icm/MsianICM.pdf>.

⁵¹ Consider the descriptions of various conventional securitization structures that are contained in Linda Lowell, *Mortgage Pass-Through Securities*, in THE HANDBOOK OF MORTGAGE-BACKED SECURITIES 25, 26-32, 38-39 (Frank J. Fabozzi ed., 2001). Particularly illuminating for students

certificates.⁵² As a general introductory statement, a *sakk* represents a proportional or undivided ownership interest in an asset or pool of assets.

Islamic bond structures are based, ultimately, upon the credit of an entity that is participating in the transaction (issuer, guarantor, or other credit enhancement provider), rather than on specific securitized assets and cash flows derived from those assets. Asset securitizations involve asset transfers from an originator into a trust or similar SPV, with *sukuk* issuance by that trust or SPV and payments on the *sukuk* derived from the payments received in respect of those transferred assets. Most *sukuk* offerings to date have been of the bond type, and the ultimate credit in most of those bond offerings has been a sovereign entity.⁵³ There have been very few true securitizations, largely because of the inability to obtain ratings from major international ratings firms for asset securitization *sukuk* issuances (ratings have been obtained for the sovereign bond issuances based upon the rating of the sovereign credit). Most *sukuk* to date have also been fixed income instruments, rather than participations in the operational profit or loss of on-going ventures.

In 2003, AAOIFI issued its *Shari'ah* standard for investment *sukuk* (the “AAOIFI Sukuk Standard”).⁵⁴ The AAOIFI *Sukuk* Standard defines *sukuk* as certificates of equal value put to use as rights in tangible assets, usufructs and services, or as equity in a project or investment activity. It distinguishes *sukuk* from equity, notes, and bonds. It

of Islamic finance is a comparison of that edition with an earlier edition, THE HANDBOOK OF MORTGAGE-BACKED SECURITIES, (Frank J. Fabozzi, ed., 1985). In 1985, the conventional securitization system was significantly more focused on the types of instruments that are the current focus of *sukuk* issuances.

⁵² See, e.g., Rodney Wilson, *Overview of the Sukuk market*, in ISLAMIC BONDS: YOUR GUIDE TO ISSUING, STRUCTURING AND INVESTING IN SUKUK 3 (Nathif J. Adam & Abdulkader Thomas eds., 2004).

⁵³ See Abdulkader Thomas, *Securitization in Islamic Finance*, in ISLAMIC FINANCE, *supra* note 2, at 259; McMillen, *Islamic Capital Markets*, *supra* note 6, at 163-72; McMillen, *Contractual Enforceability Issues*, *supra* note 6, at 1-8.

⁵⁴ AAOFI *Shari'ah Standard No. (17), Investment Sukuk*, SHARI'A STANDARDS 1425-6 H/2004-5 (Accounting and Auditing Organization for Islamic Financial Institutions, 2004) (on file with author). Additional information regarding the AAOFI available at <http://www.aaofi.com>. In March of 2008, after a considerable period of deliberation and numerous meetings, the *Shari'ah* Supervisory Board of AAOIFI released an issuance, styled as a “resolution” or “advisory,” with respect to the AAOIFI *Sukuk* Standard and practices in the Islamic finance markets since the issuance of the AAOIFI *Sukuk* Standard. That issuance, the “AAOIFI *Sukuk* Clarification,” is available under the “Latest News” section on the AAOIFI web site at <http://www.aaofi.com> (last visited on June 13, 2008) (on file with the author). It is discussed in this section of this article. The AAOIFI *Sukuk* Clarification, and some of its ramifications, are discussed in McMillen *Islamic Project Finance*, *supra* note 4, and in Michael J.T. McMillen, *Sukuk In Its Infancy: Some Missteps and Sequel*, 1 Dow Jones Islamic Indexes Quarterly Newsletter 3 (2008) (on file with the author).

emphasizes that *sukuk* are not debts of the issuer; they are fractional or proportional interests in underlying assets, usufructs, services, projects, or investment activities. *Sukuk* may not be issued on a pool of receivables that are not themselves *Shari'ah*-compliant. Further, the underlying business or activity, and the underlying transactional structures (such as the underlying leases), must be compliant with the *Shari'ah* (the business or activity cannot engage in prohibited business activities, for example).

The AAOIFI *Sukuk* Standard provides for fourteen eligible asset classes. In broad summary, they are securitizations: (a) of an existing or to be acquired tangible asset (*ijāra* [lease]); (b) of an existing or to be acquired leasehold estate (*ijāra*); (c) of presales of services (*ijāra*); (d) of presales of the production of goods or commodities at a future date (*salam* [forward sale]); (e) to fund construction (*istisna'a* [construction contract]); (f) to fund the acquisition of goods for future sale (*murabaha* [sale at a markup]); (g) to fund capital participation in a business of investment activity (*mudāraba* or *mushāraka* [types of joint ventures that are hereinafter discussed]); and (h) to fund various asset acquisition and agency management (*wakala* [agency]), agricultural land cultivation, land management, and orchard management activities. The parenthetical in each of the foregoing indicates the relevant *Shari'ah* structure.

In March of 2008, after a series of meetings on *sukuk* issues that have arisen since the issuance of the AAOIFI *Sukuk* Standard, the *Shari'ah* Board of AAOIFI issued the AAOIFI *Sukuk* Clarification.⁵⁵ The AAOIFI *Sukuk* Clarification applies to all *sukuk*, although it also addresses specific issues that have arisen with respect to specific types of *sukuk*. Its impact goes beyond *Shari'ah* principles and precepts to the interface between compliance of the *sukuk* structure and transaction with the *Shari'ah*, on the one hand, and secular tax, accounting, regulatory and legal requirements and practices, on the other hand. Practitioners working with entities or regulatory bodies that require reporting of operations and condition in accordance with generally accepted accounting principles ("GAAP") or international accounting principles ("IAP") are likely to confront a range of new issues that will require further clarification by *Shari'ah* Boards.

⁵⁵ See, the text of the AAOIFI *Sukuk* Clarification (on file with author); and McMillen Islamic Project Finance, *supra* note 4. This article uses "March 2008" as the issuance date because the AAOIFI *Sukuk* Clarification was posted on the AAOIFI web site on or about March 8, 2008. The last meeting at which the AAOIFI *Sukuk* Clarification was considered, before its issuance, was February 13-14, 2008 (8 Safar 1429 AH).

Issuance of the AAOIFI *Sukuk* Clarification was thought to be necessary because of a series of developments since 2003 in the structures of *sukuk*. Those structural developments had rendered many of those *sukuk* issuances to be essentially “conventional bonds” (rather than “entity securitizations” or “enterprise securitizations”) because: (a) they do not represent ownership in the commercial or industrial enterprises that issued them; (b) they generate regular payments determined as a percentage of capital rather than as a percentage of profit; and (c) through various mechanisms, they essentially guarantee a return of the principal at maturity.⁵⁶ Among the concerns relating to failure to represent ownership are the fact that many contemporary *sukuk* have been structured as entitlements to returns from entities rather than ownership of entities and others have included *murabaha* debt where there is no tangible asset to be owned. Concerns relating to the regular payment structures of contemporary *sukuk* focus on: (i) payments to the fund manager to the extent that returns are greater than amounts due on the *sukuk*,⁵⁷ and (ii) loans by fund managers to the *sukuk* holders or their proxies where returns are insufficient to pay fixed amounts on the *sukuk*. The issues pertaining to the guarantee of principal derive from the use of promises, by the issuer or fund manager or a similar party, to purchase the subject assets at an amount equal to the amount at which the assets were originally sold into the *sukuk* structure (i.e., at the principal amount of the *sukuk*).⁵⁸

The *sukuk* markets are among the most rapidly growing in the field of Islamic finance. Tradability of *sukuk* instruments is an important feature, particularly as the Islamic finance industry attempts to develop sustainable, coherent, finance-side capital markets. *Sukuk* issuances have been structured to include a range of different types of debt instruments, including residual debt from consummated *murabaha* transactions,

⁵⁶ See Muhammad Taqi Usmani, *Sukuk and Their Contemporary Applications* (undated, but prepared in 2007) [hereinafter *Usmani Sukuk*] (on file with author). Usmani *Sukuk* was prepared by Justice Usmani in his role as Chairman of the *Shari'ah* Supervisory Board of AAOIFI as part of the deliberative process that resulted in the issuance of the AAOIFI *Sukuk* Clarification. Notably, some of the repurchase obligations contained in contemporary *sukuk* also would be sufficient to disallow “true sale” characterization under a bankruptcy and/or tax analysis in jurisdictions such as the United States.

⁵⁷ This matter was not specifically in the AAOIFI *Sukuk* Clarification as issued. However, it was raised by Justice Usmani in his preparatory paper, *Usmani Sukuk*. His points are of particular relevance to investment fund structures incorporating *muḍārabah*, *mushārahah* and *sharikat* concepts.

⁵⁸ The AAOIFI *Sukuk* Clarification seems to refer to the outstanding principal amount of the *sukuk* as the “nominal” amount. See, e.g., AAOIFI *Sukuk* Clarification, clauses Fourth and Fifth.

which has raised significant *Shari'ah* issues that were then clarified in the AAOIFI *Sukuk* Standard. Thus, the AAOIFI *Sukuk* Clarification notes that tradable *sukuk* instruments must represent ownership (fractional undivided ownership) by the *sukuk* holders in actual assets that may be possessed and disposed of legally in accordance with the *Shari'ah*.⁵⁹ This reemphasizes that the *Shari'ah* principles and precepts applicable to possession and disposition of assets must be at the forefront in structuring any *sukuk* issuance or instrument. *Shari'ah*-compliant tangible assets are one such type of asset. So, also, are usufructs and services that may be compliantly possessed and sold, which reemphasizes recognition of the *sukuk al-ijāra* concept where appropriately comprised and structured.

Further, the AAOIFI *Sukuk* Clarification notes that the manager of the *sukuk* issuance bears the burden of establishing and certifying “the transfer of ownership of such assets in its (Sukuk) books, and must not keep them as his own assets.”⁶⁰ This aspect of the AAOIFI *Sukuk* Clarification will likely give rise to further issues. For example, the manager of the *sukuk* issuance will likely not be the originator of the underlying assets. Does the AAOIFI *Sukuk* Clarification require that there be an asset transfer for book purposes on the books of the originator as well as on the books of the manager?⁶¹ It is possible to structure transactions to allow a book ownership transfer at the manager level even where such a transfer does not occur at the asset originator level.⁶² And the transfer may be subject to different characterizations under AAOIFI accounting and auditing principles and either GAAP or IAP. This is an important area for further inquiry given that essentially all securities exchanges and secular regulators operate on a GAAP or IAP basis, and require disclosure and reporting to be in compliance with GAAP or IAP.

In some transactions, it may be desirable to avoid adverse tax consequences (such as transfer taxes) associated with a book transfer. In other transactions, there may be a transfer for one tax purpose, but not for another, and the necessity or desirability of book transfers will need to be considered in these transactional contexts. Thus, for example, transfers may be structured to ensure ownership transfer for some tax

⁵⁹ AAOIFI *Sukuk* Clarification, clause First.

⁶⁰ AAOIFI *Sukuk* Clarification, clause First.

⁶¹ Often, of course, a transfer on the books of the originator, and a true sale, will be desired.

⁶² Usmani *Sukuk*, *supra* note 56, implies a negative answer, although the AAOIFI *Sukuk* Clarification is silent on this point.

purposes (say, capital gains or profit realization) but not for other tax purposes. Here again, different issues are likely to arise in different jurisdictions.

The AAOIFI *Sukuk* Clarification requires that a tradable *sukuk* must not represent receivables or debt, except in the case of a trading or financial entity that is selling all of its assets, or a portfolio which includes a standing financial obligation such that debt was incurred indirectly, incidental to a physical asset or a usufruct in accordance with the guidelines mentioned in [AAOIFI Financial Paper Standard].⁶³ This requirement is directed at inclusion of *murabaha* debt in *sukuk* transactions, among other matters that remain to be clarified.

Numerous *sukuk* transactions have been structured to ensure, as a practical matter, a fixed income stream to the *sukuk* holder, even where the profits on or payments from the underlying obligations are variable or uncertain over time.⁶⁴ In many transactions, this was accomplished by having the manager of the *sukuk* (whether a *mudārib*, a *sharik* (partner) or a *wakil* (agent), undertake to offer and make (non-interest-bearing) loans to the *sukuk* holders at times when there were shortfalls in performance below the periodic payout on the *sukuk* instruments. These loans are repayable out of periodic excesses over the *sukuk* payments and/or out of the sale proceeds of the subject assets upon maturity of the *sukuk*.

The AAOIFI *Sukuk* Clarification makes clear that loans of this type are impermissible.⁶⁵ However, the clarification does permit the *sukuk* issuer to accumulate reserves out of profits or payments on the underlying obligation and the use of those reserves to make *sukuk* payments at times of such shortfalls.⁶⁶ This aspect of the clarification is also likely to raise some interesting tax issues where taxation is based upon current income prior to funding of the reserves. For example, in a tax pass-through entity (such as a partnership or limited liability company in some jurisdictions), this income would be attributable to each of the *sukuk* holders, pro rata, at the time it is earned, and it is likely that different tax rates will be applicable to each of such *sukuk* holders. Subsequent distribution of the reserves to different *sukuk* holders (or the same *sukuk* holder at a different time) may entail double taxation or (less

⁶³ AAOIFI *Sukuk* Clarification, clause Second.

⁶⁴ The practices in the *sukuk* field since 2003 are discussed in Usmani *Sukuk*, *supra* note 56.

⁶⁵ AAOIFI *Sukuk* Clarification, clause Third.

⁶⁶ AAOIFI *Sukuk* Clarification, clause Third.

likely given the diligence of taxing authorities) no taxation to some persons.

There has been discussion of the permissibility of periodic distributions to *sukuk* holders in anticipation of profitable operations and prior to *tandeed* and determination of actual profits and losses. The AAOIFI *Sukuk* Clarification does note that it is permissible to make distributions of expected earnings, on account, in accordance with AAOIF *Mudāraba* Standard, article (8/8), “or to obtaining project financing on the account of Sukuk holders.”⁶⁷ The quoted language is of direct relevance to project financing transactions. Presumably, the language is intended to legitimize periodic distributions, without actual or constructive *tandeed*, and without actual profit realization, so as to facilitate construction and development transactions. Further clarification of this aspect of the AAOIFI *Sukuk* Clarification will be eagerly awaited by the project finance community.

The obligation of a party (*mudārib*, *sharik*, or *wakil*) to purchase assets from the *sukuk* holders (or their ownership representative, such as a trust) at extinguishment of the *sukuk* was also addressed in the AAOIFI *Sukuk* Clarification.⁶⁸ The principles set forth in the clarification acknowledge that the assets may be purchased at the maturity of the *sukuk* for: (1) their net value; (2) their market value; (3) their fair market value; or (4) a price to be agreed at the time of their purchase in accordance with the AAOIFI *Shari’ah* standards pertaining to partnerships (AAOIFI *Mushāraka* Standard) and guarantees (AAOIFI Guarantees Standard). Differentiations between some of these pricing concepts is not entirely clear (for example, the difference between market value and fair market value) and remain for future clarification. Specific clarifications were made with respect to aspects of lease-related assets. First, if the assets of a *sukuk al-mushāraka*, a *sukuk al-mudāraba* or a *sukuk al-wakala* are of lessor value than assets leased by way of a lease ending in possession (*ijarah muntahiya bbi’t-tamlik*), the fund manager will be permitted to purchase those (leased?) assets upon extinguishment of the *sukuk* for the remaining lease payments on the assets, by considering these payments to be the net value of those assets.⁶⁹ Second, the lessee in a *sukuk al-ijāra* is permitted to agree to purchase the leased assets upon extinguishment of the *sukuk* for their

⁶⁷ AAOIFI *Sukuk* Clarification, clause Third.

⁶⁸ AAOIFI *Sukuk* Clarification, clauses Fourth and Fifth.

⁶⁹ AAOIFI *Sukuk* Clarification, clause Fourth.

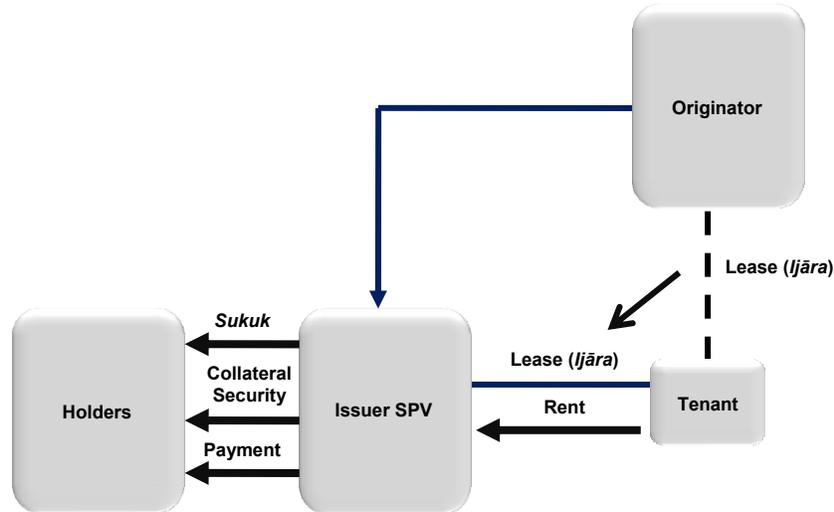
“nominal” value as long as the lessee is not also an investment partner, *mudārib* or agent.⁷⁰

To summarize the impact of the AAOIFI *Sukuk* Clarification: precedents from *sukuk* issuances since 2003 will have limited, if any, precedential value going forward, at least to the extent that they contain devices and structures referred to in the AAOIFI *Sukuk* Clarification. It is clear that the AAOIFI *Shari'ah* Board intends to scrutinize *sukuk* structures, to bring this rapidly expanding market device into greater harmony with the *Shari'ah*, and to frown upon mimicry of conventional bond structures, particularly where they do not serve the fundamental principles of Islamic finance. It is also clear that the AAOIFI *Shari'ah* Board intended to issue a bell-weather call for greater rigor, and greater and continuing oversight, in the industry, as evidenced by the final operative clause of the AAOIFI *Sukuk* Clarification:⁷¹

Shariah supervisory boards must not consider their responsibility to be over when they issue a fatwa on the structure of Sukuk. Rather, they must review all contracts and documentation related to the actual transaction, and then oversee the ways that these are implemented in order to be certain that the operation complies at every stage with Shariah guidelines and requirements as specified in the Shariah Standards, and that the investment of Sukuk proceeds and what those proceeds are converted to takes place in accordance with one [or another] of the approved Shariah methods of investment as stated in Shariah Standard (17) on the subject of Investment Sukuk, Article (5/1/8/5).

⁷⁰ AAOIFI *Sukuk* Clarification, clause Fifth. Presumably, the term “nominal value” here means “stated value,” which, based upon the financial structuring, would likely be equal to the remaining outstanding principal amount of the *sukuk* from time to time.

⁷¹ AAOIFI *Sukuk* Clarification, clause Sixth. The closing paragraph (which is not a numerically designated clause) of the AAOIFI *Sukuk* Clarification reads: “Furthermore, the Shari’ah Board advises Islamic Financial Institutions to decrease their involvements in debt-related operations and to increase true partnerships based on profit and loss sharing in order to achieve the objectives of the Shari’ah.”

Figure 2 Generic Sukuk Securitization Concepts

Before moving to a discussion of specific *sukuk* structures, and to ensure comprehension of the essential securitization mechanisms, it is advisable to look at a simple, and much generalized, *sukuk* transaction and hold this in mind as a reference point. Figure 2 is a diagrammatic summary of a generic *sukuk* transaction using an *ijāra* rent flow as the basis of *sukuk* cash flows.⁷²

The Originator acquires various *Shari'ah*-compliant assets (e.g., aircraft, vessels, equipment, or real estate), and leases them to the Tenant.⁷³ After accumulating a pool of those assets, the Originator desires to securitize them. An Issuer SPV is established to acquire the assets. The Issuer SPV issues *Sukuk* certificates to the Holders to obtain the funds necessary to acquire the assets from the Originator. The assets are then transferred to the Issuer SPV, which becomes the landlord on the various *ijāra*, against payment of the proceeds of issuance of the *Sukuk* certificates. Customarily, the Issuer SPV is a trust or an SPV with trust attributes and the beneficiaries of that arrangement are the Holders.

⁷² Examples of other structures are set forth in McMillen & Kamalpour, *supra* note 14. The AAOIFI *Shari'ah* standard applicable to *ijāra* is *Shari'a Standard No. (9), Ijarah and Ijarah Muntahia Bittamleek*, in AAOIFI *Shari'ah* Standards, *supra* note 4, at 135.

⁷³ For simplicity, the example chosen is an *ijāra*-based *sukuk*. The cash flows could be provided by any of the methods outlined in the AAOIFI *Sukuk* Standard.

Collateral security may be made available to the Issuer SPV to secure payments on, and repayment of, the *Sukuk* certificates. It is immediately apparent that asset securitization structures used in the conventional markets are structurally quite similar to asset securitization *sukuk* as a conceptual matter and in general structural characteristics.⁷⁴ And, *sukuk* offer the same benefits for the Islamic economy as securitizations provide for conventional Western economies, plus the additional benefits of *Shari'ah* compliance and a lack of reliance on excessive leverage. It is for this reason that the IFSB chose *sukuk* as the case study example for its initiative to develop an effective legal framework for Islamic finance, a capital markets initiative.

C. IFSB LEGAL FRAMEWORK—CAPITAL MARKETS INITIATIVE

Concurrently with market developments and in recognition of the some of the systemic impediments to the growth of Islamic capital markets, the IFSB, among others, initiated programs to rationalize the development of an effective legal framework for Islamic finance.⁷⁵ The IFSB,⁷⁶ an international standards setting organization whose ambit includes Islamic banking, capital markets and insurance, was inaugurated in 2002, opened in 2003, and has been granted the immunities and privileges of an international organization and diplomatic mission by the

⁷⁴ While the structural similarities are many, some of the applicable *Shari'ah* principles and precepts result in significant differences between conventional asset securitization instruments and asset securitization *sukuk*. See, e.g., McMillen & Kamalpour, *supra* note 14, at 400-12.

⁷⁵ Among the systemic legal issues are the underdevelopment of securities and capital markets laws and regulatory regimes, underdevelopment of bankruptcy and insolvency laws, underdevelopment (sometimes absence) of laws and systems pertaining to security interests, and a range of factors that result in uncertainties as to enforcement of contractual arrangements, particularly in jurisdictions (such as most countries within the OIC). See, e.g., McMillen *Securities Laws, Enforceability and Sukuk*, *supra* note 6, McMillen *Effective Legal Framework*, *supra* note 38, McMillen *Islamic Project Finance*, *supra* note 4; and DeLorenzo & McMillen, *supra* note 2 at 150-91, which consider the enforcement of the *Shari'ah* in both jurisdictions that do not incorporate the *Shari'ah* to any extent in the secular law of that jurisdiction and jurisdictions that do incorporate the *Shari'ah* to some extent in the secular law, legal enforceability opinion practice in *Shari'ah*-compliant financings, and specific enforceability issues pertaining to *Shari'ah*-compliant asset securitization *sukuk* issuances. Other examples, also focusing on enforceability issue in the *sukuk* context, include: McMillen, *Contractual Enforceability Issues*, *supra* note 6, at 434-472; McMillen, *Islamic Capital Markets*, *supra* note 6, at 153-66. Enforceability issues in the context of a project financing in Saudi Arabia utilizing a *Shari'ah*-compliant collateral security structure are discussed in McMillen, *Islamic Shari'ah-compliant Project Finance*, *supra* note 24, at 1203-36.

⁷⁶ See generally Islamic Financial Services Board Website, <http://www.ifsb.org> (last visited July 18, 2008).

government of Malaysia pursuant to the Financial Services Board Act of 2002.⁷⁷ The primary voting members of the IFSB consist of the regulatory and supervisory agencies of governments.⁷⁸ The objectives of the IFSB include the introduction and promotion of standards pertaining to the prudence and transparency of the Islamic financial services industry, the provision of guidance regarding effective supervision and regulation of institutions offering Islamic products, the maintenance of databases of relevance to the Islamic finance industry, and various cooperation, training and research projects related to the industry.⁷⁹

The IFSB's initiative is focused on an examination of elements deemed critical for the development of an effective legal framework for Islamic capital markets (both primary and secondary), particularly the debt side of those capital markets, which brings to the fore *sukuk* transactions, structures, and concepts. ABS *sukuk* were chosen as the paradigm for study. In that context, the legal framework initiative focuses on five aspects of Islamic capital markets: (a) securities and capital markets legal and regulatory frameworks; (b) the use of trusts in *sukuk* transactions; (c) enforceability of the *Shari'ah*; (d) bankruptcy and insolvency regimes; and (e) *Shari'ah* supervisory boards.⁸⁰

⁷⁷ See Islamic Financial Services Board Act 623 § 7 (2002) (Malay.), available at <http://www.ifsb.org/doc/Act623v2002.htm>.

⁷⁸ See Islamic Financial Services Board Website, <http://www.ifsb.org/index.php?ch=2&pg=4&ac=7> (last visited (Sept. 27, 2007)). There are three classes of membership in the IFSB. *Id.* Full voting members are lead financial supervisory authorities of sovereign countries having jurisdiction over Islamic finance matters. *Id.* There are currently 20 full voting members. *Id.* (follow Full Membership hyperlink). Associate members constitute the second class of membership. *Id.* Associate members are central banks, monetary authorities, financial supervisory organizations and international standard setting organizations. *Id.* Associate members do not have voting rights. *Id.* There are currently fourteen associate members. *Id.* (follow Associate Membership hyperlink.) The third category of membership is observer members, of which there are currently one hundred and one, including many of the most prominent banks and financial institutions in the Islamic finance field and at least one multi-country development bank. *Id.* (follow Observer Membership hyperlink.)

⁷⁹ Islamic Financial Services Website, <http://www.ifsb.or/index.php?ch=2&pg=2&ac=4> (last visited July 18, 2008). The IFSB has issued a series of standards for the Islamic finance industry, and it has proposed further standards that are now in the commitment stage. *Id.* (follow Standards and Publications hyperlink). Other Islamic development banks and infrastructure institutions that are contributing to the setting of standards for the Islamic finance industry include the Islamic Development Bank (<http://www.isdb.org>); the International Islamic Financial Market (<http://www.iifm.net>); the International Islamic Rating Agency, (<http://www.iirating.com>); and the General Council of Islamic Banks and Financial Institutions.

⁸⁰ The author had responsibility for the initial reports on securities and capital laws markets, trusts (including *waqf* and *irsad*), and enforceability of the *Shari'ah* and presented the initial report at the Third Seminar on Legal Issues in the Islamic Finance Industry: Surveys on Legal and *Shari'ah* Issues in the Islamic Finance Industry, organized by the IFSB and held on March 27-29, 2007, in Kuala Lumpur, Malaysia. McMillen *Effective Legal Framework*, *supra* note 38. See

D. SUKUK STRUCTURES: AN OVERVIEW

To understand Islamic securitisation instruments and envisage the future of Islamic securitisation, it is necessary to have some knowledge of the permissible securitization structures. Some of these structures relate to the assets, usufruct or services that are securitised. These are primarily the lease (*ijāra*) and sale (particularly *murabaha* and *salam*) structures.⁸¹ Two structures, the *mudāraba* and *mushāraka*, are joint venture structures. Each structure (other than the *murabaha* and *salam*) is briefly summarised in this section.⁸²

1. SUKUK AL-IJĀRA

a. Generic Structure

Sukuk al-ijāra based upon the basic *ijāra* structure previously discussed are permitted under the AAOIFI *Sukuk* Standard.⁸³ Figure 3 sets forth a generic *sukuk al-ijāra* structure based upon the *ijāra* structure

note 38 with respect to the earlier versions of the report. The portion addressing trusts in Islamic finance was excerpted and revised as McMillen & DeLorenzo, *supra* note 38. The March 28, 2007 version of the report was then further revised and was presented at the Seminar on Regulation of Islamic Capital Markets, hosted by Suruhanjaya Sekuriti, Securities Commission of Malaysia and organized by the International Organization of Securities Commissions and the IFSB and held on April 19, 2007 in Kuala Lumpur, Malaysia.

⁸¹ *Sukuk* based upon *murabaha* and *salam* transactions are not discussed in this article. Familiarity with *murabaha*-based *sukuk* is important given its widespread use and the debate they have engendered. The *murabaha*-based *sukuk* involve the purchase of a commodity on a deferred basis and the sale of that commodity on a spot market, immediate payment basis. Payments on the deferred payment obligation provide the basis for the *sukuk* payments. Sales and trading of the deferred indebtedness above and below par value have been determined to be permissible in some jurisdictions (Malaysia, for example), and to be impermissible in other jurisdictions (within the Middle East). The scholars in Malaysia allow the trading of the (deferred) indebtedness above and below par if the indebtedness was incurred in connection with a *Shari'ah*-compliant transaction. The Middle Eastern scholars opine that the indebtedness has been disconnected from, and no longer represents an interest in, the underlying asset, with the result that trading of such indebtedness above or below par value is impermissible. The ability to trade above or below par is of obvious critical importance in the *sukuk* context.

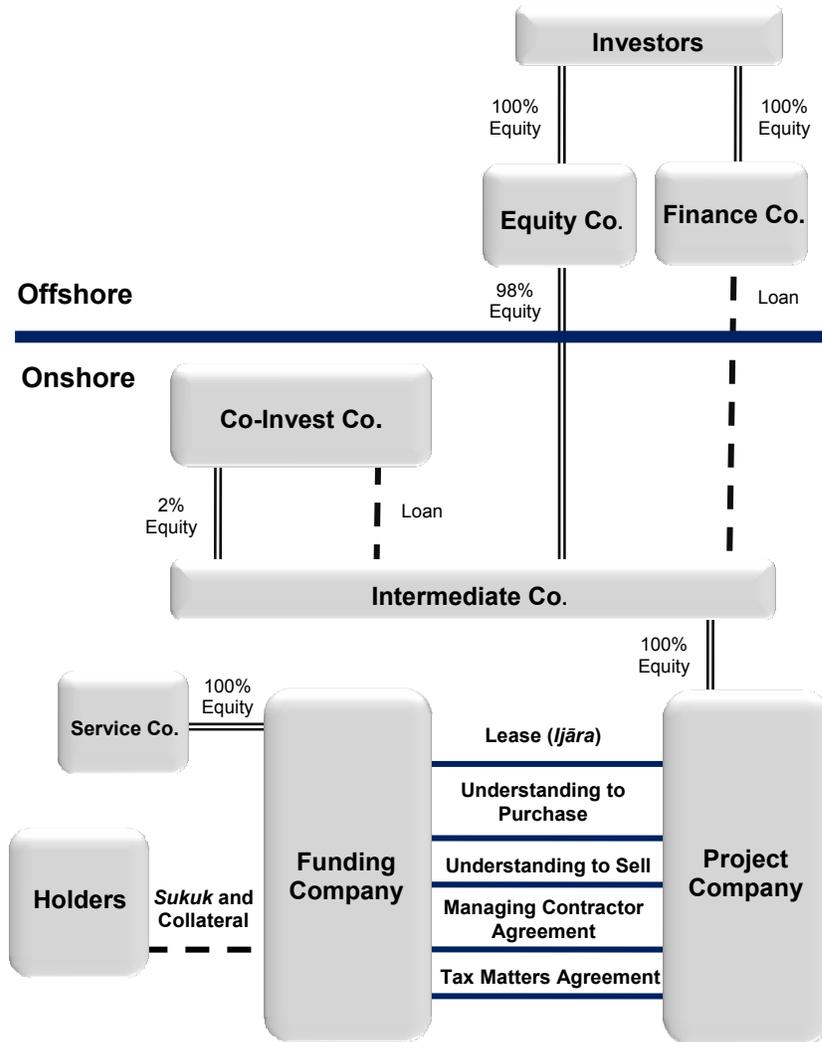
⁸² Michael J.T. McMillen, *Structuring a Securitized Shari'a-Compliant Real Estate Acquisition Financing: A South Korean Case Study*, in FINANCIAL ISSUES, *supra* note 49, at 77-104, addresses the structuring of a real estate acquisition financing in circumstances where the securitization laws of South Korea were mandatorily applicable. This involved a complicated residual interest sale, rather than a *sukuk*, but provides an indication of the types of issues that arise in structuring a *Shari'ah*-compliant transaction in the context of mandatorily applicable secular securitization laws.

⁸³ See, *supra* Figure 1 and related text.

described in figure 1. Issuances of *sukuk* have been contemplated in the implementation of the *ijāra* structure from its inception, in both residential and commercial real estate transactions, and, to a lesser extent, in private equity transactions.

Figure 3 illustrates direct issuance by the Funding Company, which could be structured to include necessary fiduciary elements. In the simplest generic structure, shown in figure 3, a *sukuk* issuance replaces the conventional bank loan; the Funding Company issues a *sukuk* to the Holders rather than utilizing conventional bank financing. Rent flows under the *ijāra* are structured to provide the payments on the *sukuk*. Tax considerations permitting (and they may well not so permit in jurisdictions such as the United States), at maturity the Project Company (or some other party) will usually have an obligation to purchase the leased assets at an amount equal to the outstanding principal amount of the loan. If multiple properties were to be included in the securitization, a trustee or similar issuer SPV would be interposed between the different Funding Companies (one for each property) and the Holders of the *sukuk*. The *sukuk al-ijāra* can be sold and traded above and below par because it represents a permissible fractional undivided ownership interest in a real property usufruct.

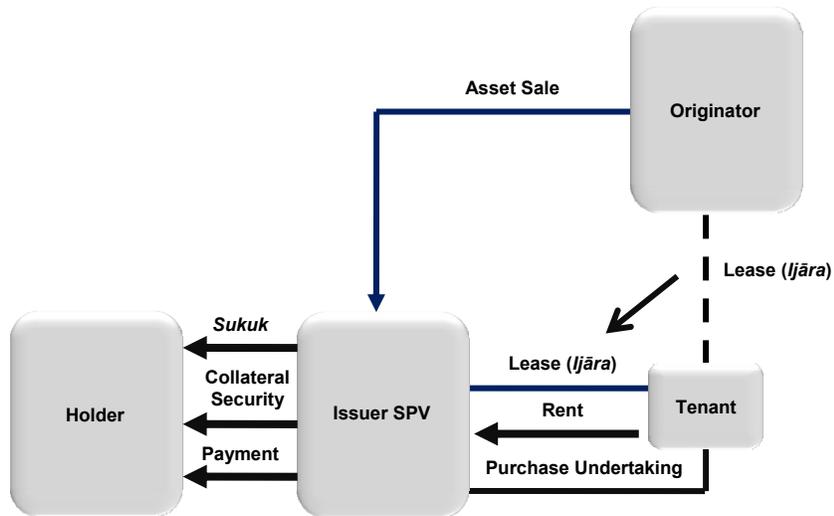
Figure 3 Generic Sukuk al- Ijāra



b. Malaysian 2002 Bond-Structure Sukuk

An early and important *sukuk* transaction using the *sukuk al-ijāra* was the Malaysian government's issue of Sukuk Trust Certificates in August 2002, a sovereign variable rate (LIBOR-based) bond structure. This issue was listed on the Luxembourg Stock Exchange and rated by both Standard & Poor's Corporation and Moody's Investors Services. Figure 4 presents a generalized illustration of that Malaysian *sukuk* issuance (compare figure 2).

Figure 4 Malaysian Sukuk al-Ijāra of 2002



The Issuer SPV was Malaysian Global Sukuk Inc. ("MGS"), which was owned by a Malaysian government entity and was incorporated in Labuan. MGS used the issuance proceeds to purchase parcels of land from another Malaysian state entity. MGS then leased those parcels to the Federation of Malaysia. Pursuant to the Purchase Undertaking, the Malaysian government agreed to purchase the parcels from MGS at the face value of the initial issue amount of the *sukuk*. This Malaysian *sukuk* utilizes a trust arrangement pursuant to which the land parcels are held by MGS in favour of the Holders of the *sukuk* certificates. The rent under the Lease (*Ijāra*) and the proceeds of the

purchase of the land parcels under the Purchase Undertaking are all made available to the Holders of the *sukuk* certificates. Identical bond payment cash flow structures were used for both the Lease (*Ijāra*) and the *Sukuk*.

2. ABS RESIDENTIAL *SUKUK* AND CONVENTIONAL CMBS OF 2007

Two ABSs on leases of assets located in Dubai, United Arab Emirates, have been rated by major international ratings agencies and were issued in July 2007. These are the first ABS *sukuk* on Middle Eastern assets to have received ratings. These transactions are particularly good examples of how transactional structuring can be used to address systemic legal infirmities and market constraints. In order to achieve those ratings, the transactions had to be structured so as to address the many inhibiting factors that have been identified.⁸⁴ Tamweel Residential ABS CI (1) Ltd is a *Shari'ah*-compliant residential mortgage-backed security ("RMBS") *sukuk al-ijāra* ("Tamweel RMBS"). UAE CMBS Vehicle No. 1 Limited ("TECOM Free Zone CMBS") is a commercial mortgage-backed security ("CMBS") backed by leases from a single commercial office building.

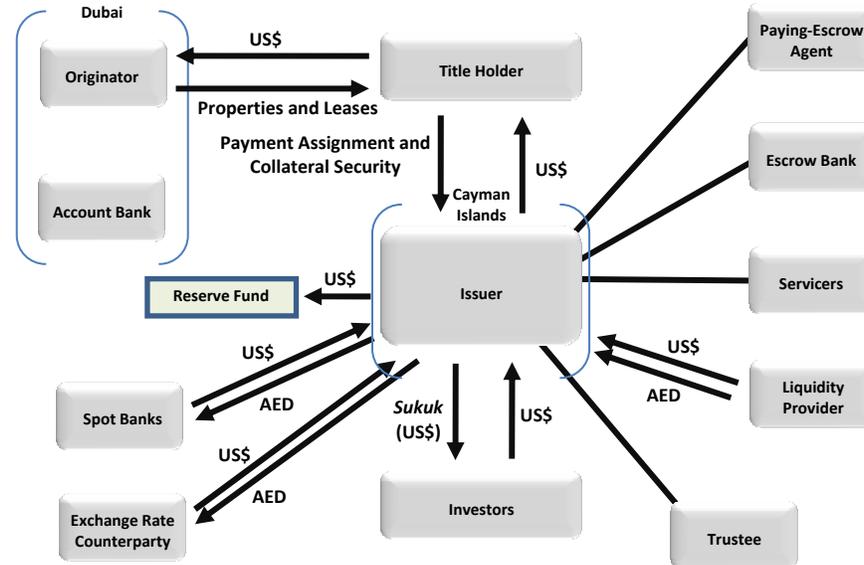
The Tamweel RMBS *sukuk* is a four class RMBS of relatively seasoned lease-to-buy *ijāra* relating to the purchase of residential properties, primarily villas, in Dubai.⁸⁵ The *ijāra* transactional structures are quite similar to the structure described in figure 1. The *ijāra* are both fixed and floating rate. The loan-to-value characteristics of the *ijāra* pool are low, in part due to high real estate inflation in Dubai as of 2007. Due to the lease-to-buy nature of the obligations, the sellers of the properties retain ownership of the properties until completion of all lease payments. The residential tenants are primarily employees in Dubai, with few non-residents, and only a small portion of the properties are investment properties. However, overwhelmingly, these residents are not nationals of the United Arab Emirates (i.e., they are ex-patriots). Payment of rent for most of the properties is by post-dated check, and post-dated checks have been received for a matter of years, but not the

⁸⁴ See McMillen, *Contractual Enforceability Issues*, *supra* note 6; McMillen, *Islamic Capital Markets*, *supra* note 6, at 6; and McMillen, *Effective Legal Framework*, *supra* note 80, for a discussion of legal issues relating to *sukuk* issuances in the Middle East, including enforceability issues.

⁸⁵ Certain information in respect of the Tamweel RMBS *sukuk* is from MOODY'S INVESTORS SERVICE INTERNATIONAL STRUCTURED FINANCE, TAMWEEL RESIDENTIAL ABS CL (1) LTD PRE-SALE REPORT, June 25, 2007.

entire lease term, on these properties. All of the properties are new, completed construction.

The asset compositional elements and the legal structure of the *sukuk* were designed to minimize significant existing uncertainties. Those uncertainties include: (a) very limited historical performance data in the newly-emerging UAE mortgage market; (b) significant uncertainties as to the interpretation, application and enforcement of relevant laws (most notably, recently-issued bankruptcy and collateral security laws that have not been the subject of judicial proceedings); (c) economic issues relating to retention of structural maintenance by the seller-lessor during the term of the *ijāra* resulting from *Shari'ah* imperatives; (d) bankruptcy exposures of the title holders to the properties; (e) incomplete title registrations in respect of the properties as a result of the implementation of a new title registration process at the newly-established registration authority (Dubai Land Development); (f) geographic concentration of the properties; (g) lack of synchronization of variable rate adjustments on the *ijāra* and the *sukuk*; (h) issues relating to transfers of the post-dated checks used for rent payments; (i) recent applicable legislation limiting rent increases (enacted in response to the high rates of inflation in the heated Dubai economy); and (j) issues pertaining to the obtaining of lessee consents to assignments of rent payments. Other legal structural issues pertain to the federal structure of the United Arab Emirates, where federal law may supersede Dubai law (and many of the issues regarding such supersession are untested and uncertain). Because of the multi-jurisdictional structure of the transaction, there are many issues relating to enforcement of foreign judgments and awards. A summary of the salient terms of the *sukuk* provides insight as to how each of the foregoing uncertainties will be addressed. A generalized schematic description of the Tamweel RMBS *sukuk* is set forth in figure 5.

Figure 5 Tamweel Residential Sukuk

Upon the closing of the sale of the *sukuk*, the Issuer will use the proceeds of the *sukuk* sale to purchase the rights of the Title Holder to payments under the pool of leases. Using the proceeds obtained from that sale, the Title Holder will acquire, from the Originator, the residential properties and related leases. The Servicer will receive all of the post-dated rent checks at closing and will deliver them to the Paying-Escrow Agent for deposit in a transaction account. The Title Holder will declare a trust over all acquired assets, primarily the properties and leases, for the benefit of the Investors (*sukuk* holders). The Title Holder will also create a first priority security interest, for the benefit of the Investors, in all of those acquired assets and over its present and future business. The Reserve Account will initially be funded by a related-party loan, and repayment of that loan will be subordinated to senior expenses, returns on the *sukuk* and the principal amount of the *sukuk*.

Not all of the properties and leases will be transferred at the closing of the *sukuk* issuance; some (just over half) will be transferred over a period of time upon registration of the title with the Dubai Land Department. Proceeds from the *sukuk* issuance applicable to properties and leases not transferred at the closing will be deposited in the escrow

account until applied. The Issuer will not have the right to receive rents and payments in respect of properties until the properties and leases are transferred to the Title Holder. Complexities relating to the delayed transfer schedule, and the resulting delayed rent receipt schedule, are not specifically discussed in this article, although some of the mechanisms can be inferred from figure 5. In accordance with the *Shari'ah*, lessees may not be compelled to make payments in respect of structural maintenance. If a lessee were to make such a payment, that lessee would be entitled to deduct the amount of the payment from period rent under the *ijāra*. A mechanism, to the same effect as the Managing Contractor Agreement referred to in figure 1, will be implemented to allow the Servicer, ultimately, to collect these amounts from the lessee.

Other aspects of the structure address currency issues, particularly the fact that the *ijāra* rent payments are designated in Arab Emirates Dirhams ("AED") while the *sukuk* payments are in U.S. dollars. While the AED is currently pegged to the U.S. dollar, there is a possibility that the peg may be removed in the future (some Middle Eastern countries, Oman and Kuwait, for example, have recently removed their U.S. dollar pegs). Currency hedges with the Spot Banks and Exchange Rate Counterparty will be effected to address various currency and exchange rate issues of this type.

Credit enhancement for the *sukuk* includes: (i) excess spreads between amounts received from the leases and amounts earned on liquid investments over the variable returns on the *sukuk* and ongoing senior costs, and the amount of such excess varies with the outstanding *sukuk* class mix, fluctuations in EIBOR as compared to U.S. dollar LIBOR, and the variation of rentals relative to the minimum margin requirements for the transaction; (ii) amounts from time to time credited to the non-amortizing Reserve Fund; and (iii) subordination of certain classes of the *sukuk* to other classes of the *sukuk*. The *sukuk* will also have various types of liquidity support to address delinquencies or interruptions in cash collections or servicing. One interesting aspect of the structure is the timing mismatch between the rate adjustments on the *ijāra* (24 months in arrears) and rate adjustments on the *sukuk* (monthly, in accordance with U.S. dollar LIBOR). Corrections and adjustments will be effected by rent increases for successive two-year periods.

Issuance of ABS *sukuk* (and conventional ABS) from Middle Eastern jurisdictions is difficult given the considerable legal and economic uncertainties. The Tamweel RMBS *sukuk* structure appears to have successfully mitigated some of these uncertainties, at least

sufficiently to induce a major international rating agency to (provisionally as of the date of this article) rate the transaction. Some of the mitigating factors relate to composition of the securitized pool, and some of those relate to factors that will not be available in future *sukuk* transactions from the same market. Others relate to choice of law, location of accounts and service functions, and other structural elements designed to minimize legal uncertainties. Among the more important mitigating factors relating to pool composition are the following. The pool contains a significant number of villa-related obligations. Villas, being in short supply in a rapidly growing real estate market with limited available expansion space and infrastructure, are thought to be more resistant to price volatility and depreciation (as compared with apartments, of which there are many more). Further, villa purchasers tend to be families, rather than more transient, single residents. This beneficial feature will be unavailable in future *sukuk* offerings given the limited supply of villas in a small, single-city market such as Dubai. Another beneficial structural element is the use of post-dated checks. To address the difficulties of realizing on collateral owned by non-local seller-lessors, the pool was constructed so that only a small portion of the pool are investment properties. As *sukuk* offerings from Dubai (and similar smaller markets) penetrate deeper into the market, future *sukuk* offerings will contain larger and larger percentages of investment properties. This, in turn, increases risks associated with realization on assets of non-local obligors; many of their assets will be located in difficult-to-reach foreign jurisdictions. Further, while the loan-to-value ratios are presently comfortable, some of that comfort has been obtained as a result of inflation and a particularly hot Dubai real estate market. Cooling of market conditions exposes *sukuk* issuances in these jurisdictions to volatility in respect of collateral coverage.

As implied by figure 5, many of the relevant contracts and accounts, and many of the currency and exchange rate adjustments, for the Tamweel RMBS *sukuk* are located outside of Dubai and are subject to English or other non-UAE law. This is intended to minimize uncertainties that have been identified with respect to local legal matters. The staggered purchase of properties is designed, in part, to take maximum advantage of the relatively new registration procedures under the Dubai property laws. To the credit of the Emirate of Dubai, they have been a leader in the implementation of necessary legal reforms, including registration procedures, new bankruptcy laws, and a range of laws and procedures to render greater certainty in respect of collateral

security rights; however, these implementations are very recent (in 2006, for example, in the case of the relevant property laws). They are untested, and, as a result of the lack of experience, including judicial consideration, they are undefined in many respects. These types of legal issues come into sharper focus when one examines the structure of the TECOM Free Zone CMBS.

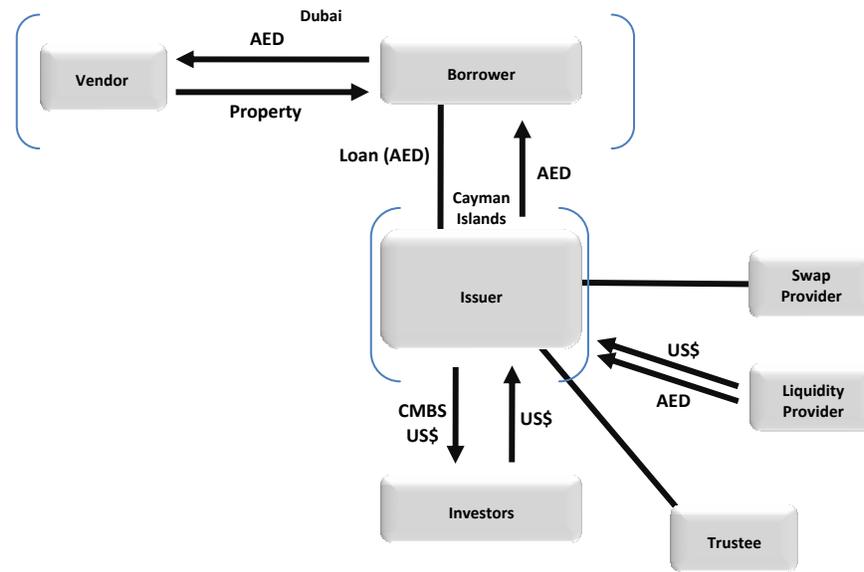
E. TECOM FREE ZONE CMBS

The second Middle Eastern securitization that received a provision rating in July of 2007 is the TECOM Free Zone CMBS.⁸⁶ This securitization relates to a single, newly-constructed commercial office building in the Technology and Media Free Zone of Dubai. This free zone has historically high occupancy rates, and the occupancy of the subject building is nearly total. Due to the industry specialization nature of free zone concepts in Dubai, the area has relatively little competition. Tenants of the building are predominantly multi-national companies and the tenant base is well diversified, although the industry diversification is quite limited. Rents in the building are well below current market values in the surrounding areas, thus providing reversionary potentials. Post-dated check arrangements are used for tenant rentals and rent payments are in advance. Tenant entitlement to lease is determined by a governmental free zone authority pursuant to a licensing procedure. The average lease term for tenants in the building is only one year. A government company provides a minimum annual rental guarantee in respect of the building. Other general market and legal uncertainties are the same as or quite similar to those noted in the discussion of the Tamweel RMBS *sukuk*. There are additional uncertainties in connection with the validity and enforceability of the security structure, in particular in respect of mortgages and security interests relative to the parallel debt structure (two debts being secured by a single mortgage). A security structure of this type has never been tested in a Dubai court. Further, despite the issuance of a title deed by the Dubai Land Department, rating agencies and lawyers involved in the transaction believe there is uncertainty as to confirmation and verification of ownership of the property because registration records are not open to public inspection and confirmation. Finally, the involvement of various governmental

⁸⁶ Certain information in respect of the TECOM Free Zone CMBS is from MOODY'S INVESTORS SERVICE INTERNATIONAL STRUCTURED FINANCE, UAE CMBS VEHICLE NO. 1 LTD PRE-SALE REPORT, June 25, 2007.

entities raises sovereign immunity issues. The structure of the transaction is graphically depicted in figure 6.

Figure 6 TECOM Free Zone CMBS



The Issuer will use the proceeds from issuance of a multi-class U.S. dollar CMBS to make an AED Loan to the Borrower. The Borrower will use the proceeds of that Loan to repay an AED bridge loan facility that was incurred in connection with the acquisition of the building from the Vendor.⁸⁷ The Loan will be structured such that payment obligations in respect of the Loan correspond to payment obligations in respect of the CMBS. The Issuer will grant a first priority security interest over all of its assets for the benefit of the Investors. The interests of the Issuer will include its rights under the first ranking mortgage over the property and various share and contractual rights assignments, in each case granted by the Borrower to secure the Loan from the Issuer. The Issuer will enter into a revolving liquidity facility which is designed to address CMBS payment irregularities, payments in respect of certain senior expenses, and certain payments in respect of

⁸⁷ The bridge loan is not shown in Figure 6.

hedging arrangements. In addition, the Issuer will enter into a combined fixed-floating interest rate and currency swap. This swap is structured to hedge certain mismatches between the fixed rate obligations under the Loan from the Issuer to the Borrower and the floating rate payment obligations on the CMBS, as well as currency exchange issues. The TECOM Free Zone CMBS transaction had to address many of the same legal issues that exist in the Tamweel RMBS transaction, including in respect of bankruptcy, collateral security, contractual enforcement, and enforcement of foreign judgments and awards. A trifurcated governing law structure is used for the TECOM Free Zone CMBS. The Issuer is sited in the Cayman Islands, and its organizational documentation is governed by Cayman Islands law. The Borrower is incorporated in Dubai. Its organizational documentation is governed by Dubai law, as are the property-related and Borrower-related documents. Most of the Issuer-related documents, the trust documents, and some of the collateral security documents are governed by English law. Cash receipts and account structures, and collateral security in respect of receipts and accounts, are divided between onshore elements (which are governed by Dubai law) and offshore elements (which are governed by English law). While the use of English law may resolve some enforceability issues, the use of such law does not render certainty because of continuing open issues with respect to the enforcement of foreign judgments and awards (including those rendered under or in respect of the English law documentation).

F. THE MUDĀRABA

1. SOME MUDĀRABA PRINCIPLES

A *mudāraba* is a profit-sharing joint venture (which may be a partnership), established by contract, wherein one party, the *rabb ul-maal*, provides capital and the other party, the *mudārib*, provides services, most frequently the management of the joint venture.⁸⁸ There

⁸⁸ With respect to the *Shari'ah* principles applicable to the *mudāraba*, see Hooper, *Majella*, *supra* note 8 at articles 1404-30; Tyser, *supra* note 8, at 233-36 (articles 1404-30); AL-ZUHAYLI, *supra* note 13, at 497-521; *Shari'a Standard No. (13), Mudaraba*, in AAOIFI *Shari'ah* Standards, *supra* note 4, at 227. See also Muhammad Taqi Usmani, *The Concept of Mushāraka and Its Application as an Islamic Method of Financing*, 14 ARAB L.Q. 203, 212-17 (1999). The *mudāraba* is quite similar to the Roman *commend* and may have been derived from the early Islamic version, the *qirād*. See Abraham L. Udovitch, *At the Origins of the Western Commenda*:

may be more than one *rabb ul-maal* and more than one *mudārib*. Usually, the *mudārib* does not (under classical formulations, could not) provide cash or other in-kind capital. The business of the *mudāraba* may be specifically limited or it may be unrestricted. Customary business practices guide the powers of the *mudārib* to the extent not otherwise specified in the *mudāraba* agreement.

Some *Shari'ah* boards still prohibit *mudārib* capital; all prohibit it without the consent of the other partner. The *rabb ul-maal* may provide capital in cash or in kind (the rules of the different *madhahib* differ with respect to the permissibility and effect of in-kind contributions). The *mudāraba* capital must be known and designated in a definite currency, although it may include debt for which a *mudārib* or another person is liable.⁸⁹ The agreement of the parties will govern the timing of, and conditions applicable to, the making of capital contributions; thus, capital infusions may be structured to be periodic (resembling, for example, lending structures for a construction financing).

A defining characteristic of the *mudāraba* is that losses from the operation of the *mudāraba* must be borne by the *rabb ul-maal* absent infringement, default, negligence, or breach of contract provisions by the *mudārib*. The *rabb ul-maal* suffers the loss of its capital, and the *mudārib* suffers the loss of its work and efforts. Profit allocations must be specified at the inception of the contract. It is permissible to provide for different percentages of profit distribution when the profit exceeds certain levels, thresholds, or amounts.⁹⁰ Importantly, there can be no predetermined or conclusive profit allocation to any of the parties and arrangements allocating all profit to a single party are impermissible. Consistent with this principle, guarantees may not be taken for the purpose of securing the *mudāraba* capital, return of capital may not be assured or guaranteed. However, guarantees may be taken by the *rabb ul-maal* to secure the ultimate repayment of the capital, minus losses plus profits, and/or to secure the *rabb ul-maal* against infringement, default, negligence, or breach by the *mudārib*. Obligations of the *mudārib* may

Islam, Israel, Byzantium?, reprinted in PRINCETON NEAR EAST PAPERS, NUMBERS 9 & 10 (1969).

⁸⁹ The debt might include, for example, debt owed by a third party to the *rabb ul-maal*, or it might be debt owed by the *mudārib* by the *rabb ul-maal*. Use of debt capital is not discussed in this article.

⁹⁰ These principles find application in many *Shari'ah*-compliant financings with non-Muslim Western investors where partnership and operating agreements include “hurdles” and preferences with varying rates and allocations between and among the joint venturers.

also be secured by a mortgage or pledge (*rahn*). Upon the termination of the *mudāraba*, the *mudārib* is obligated to return the *mudāraba* capital, plus profit and minus loss, to the *rabb ul-maal*. Failure to do so results in liability on the *mudārib*, including as a usurper. Any profits made by the *mudārib* through the use of assets after the capital should have been returned to the *rabb ul-maal* will be payable over to the *rabb ul-maal*.

The *mudārib* and the *rabb ul-maal* may agree upon methodologies for determinations as to the occurrence of infringement, default, negligence, or breach. Should any of those categories of behavior or status occur, the *mudārib* may be held liable for the return of the *mudāraba* capital. Default or breach by the *mudārib* of the provisions of the *mudāraba* agreement will result in liability for the *mudārib*.⁹¹ So also will exceeding of contractual authority by the *mudārib*. And, under the *Shari'ah*, usage and practice standards will apply to the activities of the *mudārib* and failure to carry out certain activities or exercise the requisite standard of care will result in liability to the *mudārib*. Profits may only be paid after the *rabb ul-maal* has received a return of its capital (including a retrieval of previous losses). Thus, any periodic distributions of profit during the period of the *mudāraba* are considered tentative and are subject to the final accounting upon liquidation of the *mudāraba*.⁹²

Profits and losses are determined by *tandeed*, or actual or constructive conversion of assets into cash. Profit is the amount of excess over the *mudāraba* capital provided by the *rabb ul-maal*. Loss (*wadee'ah*) is the amount by which the *mudāraba* capital is decreased or diminished. *Mudāraba* expenses are deducted from the *mudāraba* funds prior to distribution of profits. The presumption, as a *Shari'ah* matter, is that the *mudārib* is responsible for operational expenses, including the purchase, transportation, storage, sale, and collection activities of a business; however, some types of expenses may be allocable to the *mudāraba* itself. This is a matter that is usually determined in consultation with the *Shari'ah* board and the resulting determination will be embodied in the *mudāraba* agreement. The *mudāraba* agreement may also specify required reserves, which may be treated as expenses of

⁹¹ Consider the reports of the *mudāraba* agreements of Abbas Bin Abdul Muttaleb as an example: His agreements stipulated, with respect to travel, that the *mudārib* would not be permitted to “travel by sea, nor through valleys, nor by a riding animal” and violation would make the *mudārib* liable for repayment of the entire capital. See Mohamed Elgari et. al, *Shariah Standards for Islamic Free Banking*, available at <http://www.elgari.com/bookse1.htm>.

⁹² See, e.g., Mahmoud Nasreldin Ahmed Fadeel, *Legal Aspects of Islamic Finance*, in ISLAMIC FINANCE: INNOVATION AND GROWTH 98 (Simon Archer & Abdel Karim eds., 2002).

the *mudāraba*. Examples include reserves for taxes, insurance, and bad debts. The *mudārib* will be responsible for collecting the debts owed to the *mudāraba*, whether the *mudārib* realizes a profit or loss as a result of its activities.⁹³ Another general principle is that assets purchased by the *mudārib* in effecting the business of the *mudāraba* are deemed owned by the *rabb ul-maal*. Therefore, the *mudārib* is not entitled to a share of the profits until those goods are sold and profit is realized. More recently, *tandeed* concepts, actual and constructive, have been applied to allow determinations as to allocation of returns to both the *mudārib* and the *rabb ul-mall* upon termination of the joint venture, even if all assets have not been sold or disposed (based upon constructive sale concepts).

The *rabb ul-maal* generally may not participate in the management or service component. The contract establishing the *mudāraba* may, and usually does, specify in detail the terms under which the partnership will operate. The *mudāraba* may be free or limited; most are strictly limited. A *mudāraba* may be limited as to scope, time, activities, and other factors. The *mudāraba* agreement may specify those matters that require the consent of the *rabb ul-maal*. *Shari'ah* boards usually require *rabb ul-maal* if the *mudārib* desires to contribute money to the *mudāraba* and mix that money with the money of the *rabb ul-maal*. *Shari'ah* boards will usually allow *rabb ul-maal* consent rights that are akin to those provided to limited partners in limited partnership structures, such as those pertaining to changes in the fundamental business of the venture or the fundamental terms of the joint venture arrangement, sale of all or substantially all of the assets of the venture, bankruptcy declarations, and similar “minority shareholder” rights provisions. In publicly offered *sukuk al-mudāraba* transactions, the *sukuk* holders frequently have relatively limited consent rights; the consent rights closely resemble those afforded conventional bond or ABS holders, depending upon the nature of the transaction. Similarly, covenants in a *sukuk al-mudāraba* transaction are quite similar to those in an equivalent conventional transaction.⁹⁴ The *mudāraba* does not necessarily and need not correspond to an existing secular legal category

⁹³ The *Shari'ah* principles applicable to bad debts, valuation of debts, write-offs of bad debts, allocation of surplus upon collection of a debt formerly written off, and ultimate attribution of bad debts (to the *rabb ul-maal*) are not discussed in this article but will be a significant factor in drafting the documentation for a *mudāraba* transaction.

⁹⁴ While many, if not most, covenant requirements will be the same in a conventional and a *Shari'ah*-compliant transaction, there are many important differences as a result of applicable *Shari'ah* principles. For example, a *mudāraba* agreement would not be able to require return of capital or a specified return or amount of profit within a specified period.

(such as a partnership). This renders the *mudāraba* a particularly flexible business form, especially in multi-jurisdictional transactions. It may be established with respect to a defined group of assets, as distinct from the legal form of organization of a business. Thus, for example, the *mudāraba* may focus on a single production line rather than the entirety of the business (all production lines within the same company). Allocation of expenses and revenues will then be determined with respect to the single production line. Although it has not yet been so applied in the ABS realm, and secular law ramifications have not yet been fully examined, there seems to be potential for the use of the *mudāraba* concept with respect to ABS *sukuk* issuances involving multiple jurisdictions.

2. SUKUK AL-MUDĀRABA

The *mudāraba* structure may be incorporated into a *sukuk* offering in a number of different variants of the *sukuk al-mudāraba*. The *mudārib* will enter into a *mudāraba* agreement with an SPV issuer. The SPV issuer will obtain the funds that it will provide to the *mudāraba* by the issuance of a *sukuk al-mudāraba* to the investors. The *mudārib* will then conduct the business of the *mudāraba* in accordance with the *mudāraba* agreement. The *sukuk al-mudāraba* bears resemblance to the whole-business securitizations that have been used in Europe. The primary structural issues in contemporary Islamic finance transactions relate to: (a) structuring profit and loss allocations; and (b) the permissibility of capital contributions by the *mudārib*. This *mudāraba* may constitute the only entity necessary for the conduct of the relevant business. Or, as is more likely in a complex project or undertaking (and frequently in Islamic banking), this *mudāraba* may enter into joint venture and/or other contractual arrangements with other parties. For example, in a complex project financing, this *mudāraba* may enter into a further joint venture with a project sponsor in connection with the financing, construction, and operation of the project. To date, there have been few *sukuk al-mudāraba* issuances. Conventional Western financiers are reluctant to enter into partnership arrangements, and there are regulatory hurdles to this type of investment in some jurisdictions. Whole business securitizations are rare in the United States, although they have been used in Europe. Greater familiarity with the *sukuk al-mushāraka* may induce greater consideration of the use of the *sukuk al-mudāraba*.

G. THE MUSHĀRAKA

1. SOME MUSHĀRAKA PRINCIPLES

Al-sharika is a broad term which, based on its meaning of “sharing,” and in the commercial and financial realm encompasses various joint ownership arrangements (*sharikat ul-milk*) and partnerships for profit effected by mutual contract (*sharikat ul-'aqd*).⁹⁵ The latter category of partnerships is divided into: (a) partnerships in which all partners invest capital into a commercial enterprise (*sharikat ul-amwaal*); (b) partnerships in which the partners jointly undertake to provide services and distribute the fees in an agreed ratio (*sharikat ul-a'mal*); and (c) partnerships in which the partners, having made no capital investment, purchase an asset (usually a commodity) on a deferred basis and sell the asset on the spot market, with the profits distributed in an agreed ratio (*sharikat ul-'aqd*). *Mushāraka*, a term which has only recently come into use in the field of Islamic finance, is a subset of the *sharikat* referring, primarily, to *sharikat ul-amwaal* and, occasionally, to *sharikat ul-a'mal*. Management of the *mushāraka* is established in the *mushāraka* agreement, in accordance with the desires of the partners. This affords the partners considerable flexibility in allocating management responsibilities between and among partners; joint rights of management are frequent and usual. Historically, the presumption was that all partners would participate in the management of the *mushāraka*. If all partners participate in the management of the *mushāraka*, akin to

⁹⁵ With respect to the *Shari'ah* principles applicable to the *sharikat (mushāraka)*, see Hooper, *Mejella*, *supra* note 8, at 366; Tyser, *supra* note 8, at 166; AL-ZUHAYLI, *supra* note 13, at 447-81; *Shari'a Standard No. (12), Sharika (Musharaka) and Modern Corporations*, in AAOIFI *Shari'ah Standards*, *supra* note 4, at 197. The *mushāraka* and the various types of *sharikat* are discussed in Usmani, *supra* note 88, at 203-12. The general rules in respect of partnership profit and loss under Hanafī jurisprudence are summarized in Abraham L. Udovitch, *Credit as a Means of Investment in Medieval Islamic Trade*, reprinted in PRINCETON NEAR EAST PAPERS NUMBER 10 at 5: “To summarize: According to Hanafī law, liability in partnership corresponds to investment in all cases; profit follows any ratio stipulated in the contract, except in the case of credit partnership where it, too, follows the investment.” Udovitch’s discussion of the credit partnerships is particularly interesting. He discusses various long-accepted credit devices, such as *al-bay' bit-ta'khīr* (deferred payment for goods sold), *salam* (advances for future delivery), *hawala* (transfer of debt, novation), and *suftaja* (letters of credit). *See id.* He also speaks to the credit partnerships accepted by the Hanafī school of Islamic jurisprudence in which the capital of the partnership consists of only credit, not of cash or merchandise. *See id.* These partnerships are the *sharikat al-mafāls* (partnership of the penniless) and *sharikat al-wujūh* (partnership of those with good reputations).

general partnership concepts, each partner is treated as the agent of all other partners. Given the contractual basis of the *mushāraka* and the degree of latitude afforded the partners in agreeing as to operational matters, modern limited partnership agreements and operating agreements are useful models for structuring *mushāraka* arrangements.

There are significant differences between the *madhahib* regarding the rules applicable to capital contributions, especially as to the permissibility and effect of in-kind contributions. However, the schools all seem to agree that capital, once contributed, is the property of the *mushāraka* (rather than any individual partner) and inures to the benefit of all partners.⁹⁶ The *madhahib* are also unanimous on the view that a partner may not assume liability for the capital of another partner, including by way of guarantee. Guarantees may be taken by the partners to secure the ultimate repayment of the capital, minus losses plus profits, and/or to secure the partners against infringement, default, negligence, or breach by the managing partners. Absent agreement to the contrary in the *mushāraka* agreement, and again akin to general partnership concepts under the common law, the liability of each partner is unlimited. Profit and loss definitions are largely the same as with *mudāraba*, with some fundamental differences. As currently conceived, profit allocations may be in any ratio agreed by the partners. Profits may be allocated in accordance with a points system, and that points system may be structured to take cognisance of the amount of capital contributed and the period of participation. That position has long been accepted by the Hanbalī and Hanafī *madhahib*, although the Hanafī *madhab* modified the position if, pursuant to their agreement, one or more partners did not participate in management; in that case, participation of that partner in the profits of the *mushāraka* would be limited to the ratio of that partner's capital contribution to the *mushāraka*. The Mālikī and Shāfi'ī schools historically required that profit distributions be in accordance with ratios of contributed capital. Profit from a specific period or operation may not be allocated to a specified partner, nor may a lump sum be allocated to a specific partner. In the majority view, losses, up to the amount of a partner's capital contribution, must be distributed in accordance with the relative capital contributions of the partners. *Shari'ah* precepts applicable to purchases and sales of interests (*hissas*) from one partner to another (as well as *murabaha* precepts) form the

⁹⁶ Contrast the classical formulation on this point with respect to a *mudāraba* in which the property is deemed owned by the *rabb ul-maal*.

basis for securitisation transactions involving *mushāraka*—a key element of many *sukuk al-mushāraka* structures.

2. SUKUK AL-MUSHĀRAKA

Various current financings, including project financings, make use of the *sukuk al-mushāraka*. This structure, without the express use of a *sukuk*, was the basis of project financings in Saudi Arabia in the late 1990s.⁹⁷ An early version of this structure involved bank financiers, rather than capital market financing, by way of a *sukuk*. A joint venture (*mushāraka*) is formed among the banks providing the financing and the project sponsor that will operate the project. Thereafter, equity interests in the joint venture (*hissas*) are sold, periodically, by the banks to the project sponsor pursuant to a *murabaha* (sale at a markup, with deferred payments) in respect of those *hissas*.⁹⁸ The structure allows for participation by both Islamic banks and conventional Western banks. One of the benefits of this type of *mushāraka* is the simplicity of the structure and documentation (there are only two primary agreements: (a) the *mushāraka* agreement, and (b) the *murabaha* agreement.⁹⁹ In the *sukuk al-mushāraka* version that is currently used, a *sukuk* issuer is substituted for the banks.

Unanimity among the *Shari'ah* boards is lacking with respect to some critical *Shari'ah* issues, such as: (1) the breadth of the indemnity provided by the project sponsor in respect of operational matters; (2) permissible segmentation of the overall transaction to facilitate *hissa* purchases by the banks; (3) the nature of relevant events (such as construction milestones) and whether *hissa* purchases may be effected at those times or whether *hissa* purchases may only be effected at the completion of construction; (4) profit and loss allocations among the members of the *mushāraka*; (5) the times at which the *murabaha* agreement or agreements pertaining to the sale of the *hissas* by the banks

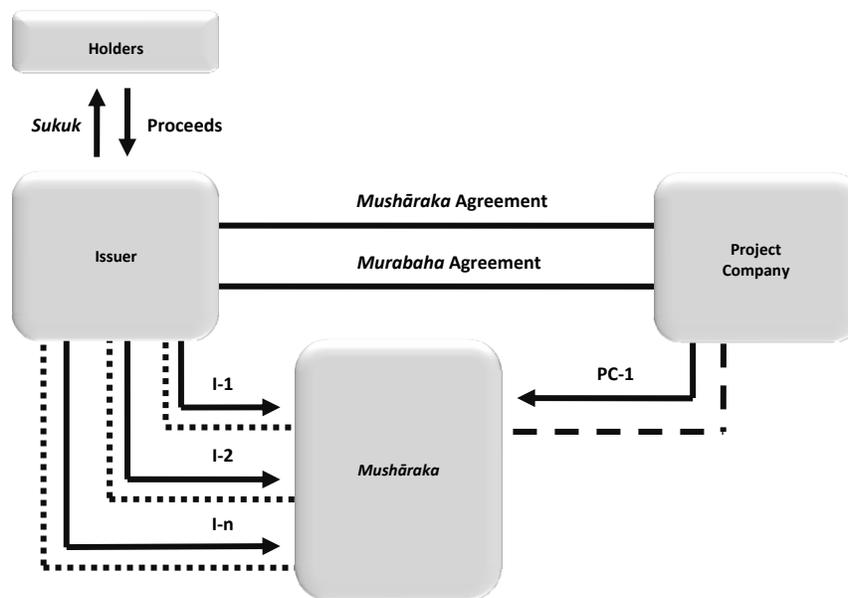
⁹⁷ See the discussion of the use of the structure, then referred to as a *sharikat mahassa* structure, for an electric utility financing in McMillen, *Islamic Shari'ah-Compliant Project Finance*, *supra* note 24, at 1232-36. The transaction involved electric generation and transmission assets of Saudi Consolidated Electric Company in the Central Region (now a part of Saudi Electric Company) in the Kingdom of Saudi Arabia in the late 1990s.

⁹⁸ As a general matter, the applicable *Shari'ah* principles with respect of a *sharikat* are set forth in the Hooper, *Mejella*, *supra* note 8, at 166-232; Tyson, *supra* note 8, at 166-232; AL-ZUHAYLI, *supra* note 13, at 447-81.

⁹⁹ There may also be a nondisclosure and indemnity agreement, particularly where the joint venture is an undisclosed *mushāraka*. Some *Shari'ah* boards allow the nondisclosure and indemnity arrangement to be incorporate in the *mushāraka* agreement.

to the project sponsor may occur; (6) the valuation of the *hissas* in connection with the *murabaha* sales; and (7) the matters previously discussed in connection with the AAOIFI *Sukuk* Clarification. Figure 7 sets forth a graphic depiction of the funding and formation of a generic *sukuk al-mushāraka* structure. This diagram depicts a project finance, construction or development arrangement in which multiple fundings are required. The same concepts are used in single-funding transaction.

Figure 7 Sukuk al-Mushāraka Formation and Funding



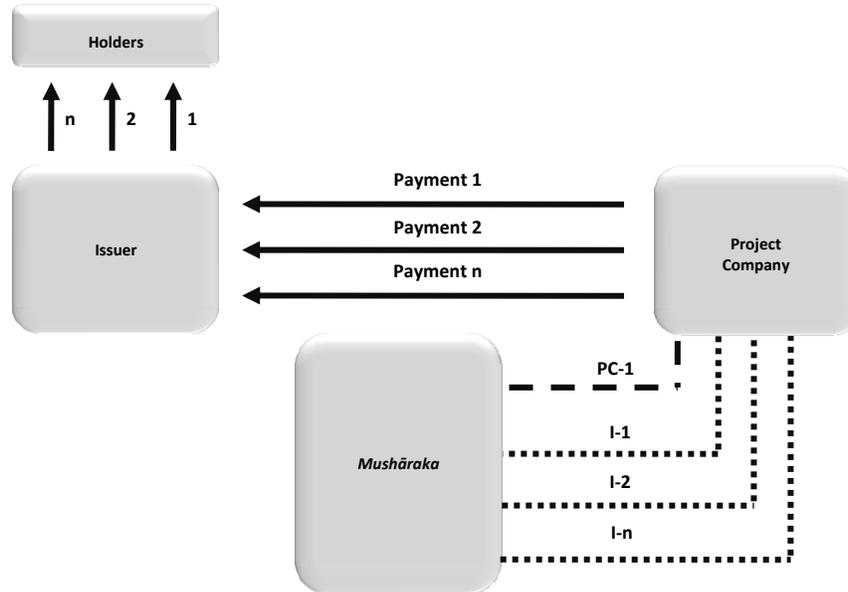
The Project Company (which may be an asset originator) will form the *Mushāraka* with an SPV Issuer pursuant to the *Mushāraka* Agreement. The *Mushāraka* will own the project or assets that are the subject of the transaction. Each of the Project Company and the Issuer will make initial capital contributions to the *Mushāraka* and receive a number *hissas* commensurate with the relative values of their capital contributions. The initial capital contributions are depicted in figure 7 as I-1 and PC-1 (with the dotted lines indicating *hissas* and the solid arrows depicting capital contributions). In the project finance context, the initial capital contribution by the Project Company may be in cash or in kind or

a combination of cash and property. For example, the Project Company may contribute land rights and contracts relating to the construction and development of the project. In other asset transactions, the initial capital contribution of the Project Company may be nominal or be structured in accordance with market co-investment practices. Often, the Project Company will make no further capital contributions (and that is the assumption of figure 7, although the transaction could be structured to include periodic Project Company capital contributions). In the example depicted in figure 7, the Issuer will make a series of future capital contributions (depicted as I-2 and I-n in figure 7), and will receive additional *hissas* commensurate with the amounts of each future capital contribution. Subsequent contributions may be staged with the completion of construction milestones to effect a construction financing. The capital contributions will then be used to make periodic construction payments.

The *Mushāraka* Agreement will allocate technical, administrative, financial, construction, and operational responsibilities. It will address profit and loss allocations and distributions. It will address payments of costs and expenses. Conventional partnership agreements provide good working models for these types of *mushāraka* agreements, although they obviously must be modified in respect of local laws and applicable *Shari'ah* principles and precepts. As an example of a *Shari'ah* issue, the profit and loss allocation rules applicable to a *mushāraka* may require profit allocations to the Issuer that are not harmonious with the *sukuk* payment structure. The effect will vary from transaction to transaction. For example, they may be of limited consequence in a construction project where there are no profits in the early periods while, in other types of transactions, they may result in *hissa* purchase price adjustments in the *murabaha* phase of the transaction. Further, loss allocations to the Issuer are problematic. Different *Shari'ah* boards have different positions on these matters.

Contemporaneously, the Project Company and the Issuer will enter into a *Murabaha* Agreement with respect to the *hissas* in the *Mushāraka* issued from time to time to the Issuer.¹⁰⁰ The *murabaha* phase of the transaction is depicted, generically, in figure 8.

¹⁰⁰ Depending upon the position of the relevant *Shari'ah* board, the structure may entail entering into a single *murabaha* agreement with respect to the initial purchase of *hissas* and an agreement to enter into a series of *murabaha* agreements relating to the future series of fundings effectuated by the future series of *hissa* purchases.

Figure 8 Sukuk al-Mushāraka Payment

In the *murabaha* phase, the Project Company will purchase *hissas* from the Issuer from time to time. The periodicity and amount of those purchases will be dovetailed with payments in respect of the *Sukuk*. The Issuer will use the *hissa* purchase payments to make payments on the *Sukuk*. Thus, in figure 8, Payment 1 from the Project Company to the Issuer will result in *hissas* I-1 being transferred to the Project Company and the Issuer will make the payment denoted “1” to the Holders. This series of transactions will repeat until the Project Company has acquired all *hissas* owned by the Issuer, and the *Sukuk* has been retired.

Shari’ah boards have differences of opinion with respect to one of the most important structural issues pertaining to the *murabaha* phase: whether all *hissa* purchases may be addressed in a single *Murabaha* Agreement, or whether a series of *Murabaha* Agreements must be executed (one for each *hissa* purchase), and, if a series of agreements must be executed, the timing of execution of those agreements. Some *Shari’ah* boards allow execution of a single *Murabaha* Agreement relating to all *hissas* sales and purchases at the inception of the transaction (i.e., at the time of formation of the *Murabaha*). This

presents difficult pricing issues, particularly where floating rate payments must be made in respect of the *Sukuk* payments. Other *Shari'ah* boards have taken the position that the *Murabaha* Agreement relating to all of such *hissas* must be executed at the time of completion of construction, in a project financing or development project. Yet another position is that a separate *Murabaha* Agreement with respect to each group of *hissas* may be executed at the time of each *hissa* sale and purchase in the series (some *Shari'ah* boards will allow execution at inception of an agreement to enter into the series of *Murabaha* Agreements). The purchase price for the *hissas* being sold pursuant to the *murabaha* transaction is another element of the transaction that generates considerable discussion with the relevant *Shari'ah* boards. A *Shari'ah* principle applicable to sales transactions, including *murabaha* transactions, is that the price must be specified and established at the time of entering into the agreement to sell and purchase. It is not possible to definitively establish the sales price at the inception of the transaction for a series of *hissa* sales and purchases that are tied to a variable rate *Sukuk*, although mechanisms have been developed to effect *hissa* purchase price adjustment to accommodate variable rate *sukuk* transactions. Some *Shari'ah* boards will also be concerned about the relationship of the *hissa* purchase price to the net asset value and/or fair market value of the assets in the *Mushāraka*. This issue is particularly acute in a construction transaction where the net asset value or fair market value accretion curve is not linear. Some boards opine that the *hissas* should be valued at the net asset value at the time of handover of the project, while others focus on fair market value measurements at the time of handover. In practice, most *Shari'ah* boards have allowed establishment of the *hissa* purchase price to be structured harmoniously with the periodic *sukuk* payments, even in variable rate transactions.

IV. CONCLUSION

While not commonplace, Islamic financing transactions are no longer a novelty in the United States or in Europe, as the brief summary in this article illustrates. Transactional volume and sophistication is increasing. Existing structures are being refined. New structures are being developed. The comfort level of sophisticated Western institutions is increasing. Most importantly, an increasing number of Western banks, investment banks, asset managers, and other commercial and financial

institutions are entering the field of Islamic finance. As they do so, new and different areas of commerce and finance are being avidly explored to determine if the application of Islamic financing principles will reveal new financial opportunities, both for *Shari'ah*-compliant participants and for Western participants. Among the areas of opportunity are the undeveloped Islamic capital markets.

Given the existing uncertainties and impediments to consummation of capital markets transactions in the OIC jurisdictions, and the extraordinary amount of available, sub-optimally utilized, investment capital in some of these jurisdictions (particularly the Middle East), Western financiers have an exceptional opportunity to sell Western assets to Middle Eastern investors. Realization of that opportunity will require acquisition of some level of understanding of the *Shari'ah* as it is applied to commercial and financial matters. Most obviously, they will have to learn to utilize some fundamental *sukuk* structures.

As the two recent Dubai securitization transactions make clear, however, this window of opportunity will narrow rather quickly. Despite all impediments, creative financiers and lawyers are developing structures that navigate the difficulties to allow access to both the Islamic and the conventional capital markets on the debt side. These are landmark developments. They will have a significant impact on opening new capital markets. A great deal of legal reform is still necessary. But as the institution of legal reforms in Dubai, Bahrain, and Qatar clearly indicate, legal reform will occur, and the window of opportunity will narrow a bit further. It will never close completely, if only because of the size of the available asset pool in Western countries and the stability and certainty afforded by legal regimes in these Western countries.

However, the early bird gets the worm, which will include not only immediate financial benefits, but also stronger long-term relationships and long-term benefits. The benefits of Western participation in *sukuk* issuances will be bilateral. Conventional Western securitization participants are highly skilled and highly experienced. Sensitive consideration of *sukuk* structuring by these individuals will contribute significantly to the development of *sukuk* technologies and, thereby, to the development of the Islamic capital markets in a manner that allows seamless integration with existing Western capital markets. That should redound to the benefit of all.