

# Islamic structured finance: legal due diligence

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**For several years, the Islamic Sukuk industry has experienced significant growth and has garnered unprecedented attention both in traditional Islamic jurisdictions and in non-Islamic jurisdictions. With this expansion, Islamic structured products are becoming increasingly innovative as a result of the growing sophistication of the investor base and investment in new pools of assets in un-chartered territories. The industry is now poised to experience additional growth despite, and arguably as a result of, the credit crunch.**

This chapter briefly highlights a number of key legal and regulatory considerations, of various levels of complexity, pertinent to structuring Islamic Sukuk products backed by pools of assets in both Islamic and non-Islamic jurisdictions. Such considerations arise as a result of various elements including the nature of the assets, the Islamic structure being utilised, the eligibility of the investors and more generally the legal, regulatory and judicial limitations. The authors will argue that the credit crunch, caused by the collapse in the sub-prime mortgage market, may indirectly contribute to the growth of the Sukuk industry.

## Nature of the assets

As a threshold matter, the pool of assets backing the Islamic Sukuk must themselves be Shari'ah-compliant for a Sukuk issue to withstand Shari'ah scrutiny. Moreover, Islamic investors may only invest in activities which are in strict compliance with Shari'ah precepts, which means that investments in such sectors and industries as the manufacture, packaging or distribution of alcohol, tobacco or pork products; entertainment; conventional financial services; or the manufacture and sale of weapons, is impermissible.

With the above in mind, the focus of most Sukuk offerings has historically been on real estate development projects and, generally, on acquiring real properties. However, there has been a trend towards new sectors such as energy (both oil and gas) and, to a lesser extent, renewable energy. In fact, we have advised on, and seen, multiple energy-based Sukuk offerings that involved assets located in non-Islamic jurisdictions, particularly Western jurisdictions. Interestingly, the reasoning behind such occurrences probably has less to do with the abundance of the relevant energy resources in such jurisdictions (at least as compared to the Middle East), and more to do with the fact that such jurisdictions offer a legal and regulatory environment

that is more amenable to private sector investment, as evidenced by a proven track record of successful conventional offerings of securities that are backed by energy rights.

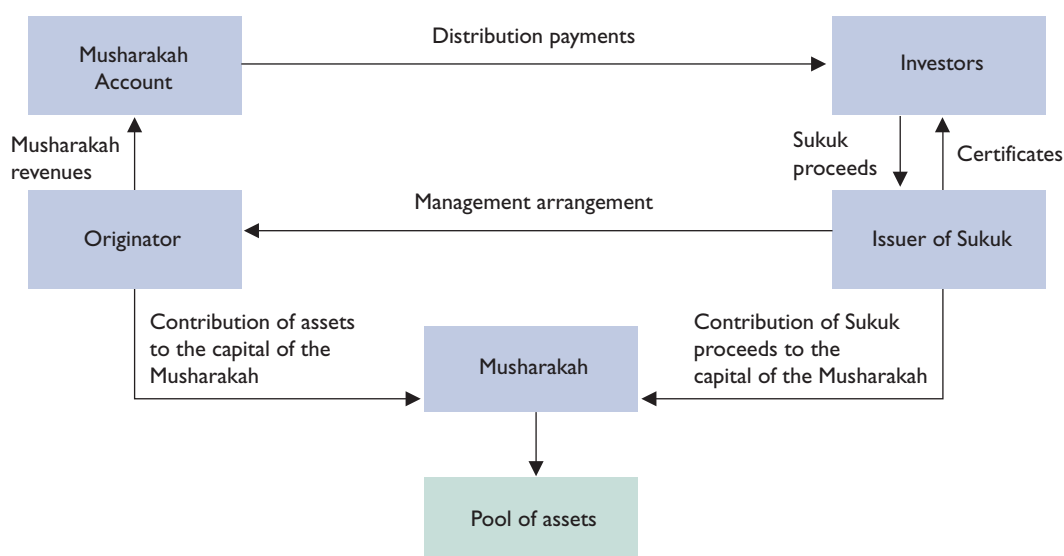
Despite the foregoing, Sukuk offerings backed by real property assets have continued to evolve. Recent offerings have been issued based on income streams generated by rental proceeds from commercial and residential real property that have essentially been securitised through the Sukuk offering. In one such offering that we recently advised on, the proceeds of the Sukuk offering provided the originator, or the offering, with an infusion of capital to be used both in expanding its existing business and in acquiring new business. Given the success of Islamic Sukuk products based on such securitised income streams, Islamic securitisation of income streams has gained momentum in the market and the prospects of new issues of Islamic securities based on this type of asset have garnered considerable interest.

## Structures

While encouraging risk sharing, Shari'ah investment guidelines restrict the manner in which Islamic private equity investments can be structured and operated. Such guidelines include prohibiting investing in certain industries, and imposing financial ratio requirements and rules.

Many of the recent Sukuk offerings have utilised Ijarah-based (lease) structures due primarily to the flexible nature of the rules governing Ijarah. In fact, Ijarah rules under Shari'ah are similar in many ways to conventional approaches to leasing. Typically, Ijarah finance arrangements are structured as lease transactions, ending in ownership (Ijarah Muntahia Bittamleek). Most of the early Sukuk offerings utilised a sale-lease-back structure, whereby the Sukuk issuer acquires the assets from the originator and leases it back to the originator. One

**Figure 1: Typical Musharakah structure**



Source: Vinson & Elkins LLP

improvement to such structure is for the Sukuk issuer to acquire the assets from one entity while leasing it to another, even if the originator and the lessee are associated companies.<sup>2</sup>

Another variation to plain vanilla Ijarah structures is to supplement an Ijarah agreement with an Istisna'a (construction) agreement for the construction and development of the underlying project, with the Ijarah agreement coming into force once such project, or a portion thereof, is constructed.

The various types of Ijarah raise a number of interesting legal issues. One such issue is whether there is a true sale by the originator of the assets in question to the Sukuk issuer. While being straightforward on the surface, a combination of foreign ownership limitations and high ownership transfer taxes may hinder the true sale of the underlying asset to the Sukuk issuer. For example, legislation in some jurisdictions requires, in connection with the conveyance of title in real estate or property transactions, that the sale contract and the resulting title transfer be recorded in a real estate register and that a transfer of title fee or tax be paid.

A complication that arises in Islamic Ijarah transactions has been that the structure exposes the Sukuk issuer to double taxation; first, when it purchases the underlying real estate or property from the seller and, again, when the seller (now a lessee) exercises the option to repurchase such real estate or property. While Shari'ah does not require that such registration process be undertaken and

completed for the transfer of title to be rendered valid and enforceable, legislation in some jurisdictions requires otherwise. This creates an additional level of analysis which would impact the structuring process, the choice of jurisdiction and the interactions with, and expectations from, the relevant regulators.

Some Western jurisdictions have recognised this issue. The UK for example, introduced legislation in the form of the Finance Act 2005 that removes the double taxation of any alternative finance arrangements (essentially, an Islamic financed product) and provides additional tax incentives to encourage Islamic finance structures to the UK.

Another issue which is derived from the true sale analysis is whether, in a jurisdiction in which a foreign Sukuk issuer is not permitted to acquire a certain asset, such as real estate, a trustee may be appointed to hold the relevant assets in trust. Most Middle Eastern jurisdictions do not have trust regulations although in Saudi Arabia, for example, the notion of an Adl (a quasi-fiduciary) would provide a Shari'ah-compliant alternative to the common law trust. Another mechanism for replicating a trust that has been employed is the appointment of an agent (Wakeel) to act on behalf of the Sukuk issuer, pursuant to contractual terms and conditions intended to mirror the duties customarily assumed by a trustee in jurisdictions having trust regulations.

Another Shari'ah structure that seems to be attracting increasing popularity and which emphasises the notion of risk sharing, is the diminishing or declining Musharakah (partnership)

structure. In a typical Musharakah, the Sukuk issuer makes a cash contribution, often from the proceeds of the Sukuk issuance, with the originator making an in-kind contribution. In order for this structure to work, the Musharakah entity appoints the originator as the manager of both the pool of assets contributed by the originator and other assets acquired by the Musharakah entity through the utilisation of the issuer's cash contribution. Both the Sukuk issuer and the originator own undivided rights in the Musharakah assets. As and when the proceeds generated from the management and operations of the assets are paid into the Musharakah account, and the issuer collects the periodic distributions to which it is entitled, the units or shares in the Musharakah that the Sukuk issuer holds decrease or diminish<sup>3</sup> (hence the name) and those of the originator increase until such time as, on the final distribution date, the originator owns 100% of the units or shares and the Musharakah dissolves. The Musharakah may be contractual, in that the rights and obligations of the two parties are provided in a Musharakah agreement, or formal, in that the Musharakah takes the form of a registered company in which the rights and obligations of the parties are provided in the constitutive documents and, possibly, a shareholders agreement.

A key legal issue is identifying the rights and obligations of the Musharakah, particularly if it is not registered as a company, towards third parties. This factor is of added significance in jurisdictions in which the civil code governs civil companies and the companies' regulations govern commercial companies. In many ways, a Musharakah arrangement may qualify as a *Sharikat Al-Mahassah* (joint venture) in some Islamic jurisdictions that have promulgated a civil code, and as such the arrangement would be governed not only by the Musharakah agreement, but also by the relevant provisions of the civil code.<sup>4</sup> By the same token, *Mudarabah* partnerships (partnership arrangements in which one partner contributes sweat capital), while being one of the more popular forms of risk sharing under Shari'ah, are also governed in the UAE by the UAE civil code.<sup>5</sup>

One recent development is that purchase undertakings will be subject to added scrutiny with a view to bringing them in line with Shari'ah's profit and loss principles. This is primarily due to recent views expressed by a number of prominent Shari'ah advisers. Purchase undertakings are usually issued by obligors to support their repayment obligations under a Sukuk offering's documentation. *Ijarah* mechanisms seem to be back in the spotlight and may well restore the levels of interest seen during the early days of the Sukuk industry.

## Jurisdictional analysis

As the previous sections of this chapter indicate, the jurisdiction of the assets that will back-up a Sukuk offering plays an important role in shaping the arrangers' views as to the marketability of the relevant Sukuk product. Legal practitioners who are involved in the Islamic finance and investment industry will be hard-pressed to define what constitutes an Islamic jurisdiction. While at least on the surface those jurisdictions with a predominantly Muslim population (or to be more objective, members of the Islamic Development Bank or the Organization of Islamic States) would qualify as being Islamic, our preference, at least for purposes of this chapter, is to base any analysis on whether the legal system itself is Shari'ah-based.

If one is to apply the nature of the legal system criterion, a number of interesting distinctions and observations can be made even in jurisdictions that may be deemed Islamic. For example, in structuring a Sukuk product involving assets in an Arab and Muslim country like Egypt and Jordan, the influence of the Napoleonic code and the Ottoman *Majalat Al-Ahkam Al-Adiyah* results in the need to adapt the structure of the Sukuk to the provisions of, amongst other laws and regulations, the civil code. While the ultimate product will still need to comply with Shari'ah, opinions of local counsel are more likely to focus on the effectiveness and validity of the transaction documents under the civil code and other relevant regulations, as opposed to compliance with Shari'ah. This is not the case in Saudi Arabia, for example, where opinions of local counsel would focus on the transaction documents' compliance with Shari'ah, as it is the basic law of the land.

As another example of varying interpretation among Islamic jurisdictions, a commonly acceptable view amongst Shari'ah scholars in a number of Islamic jurisdictions is that *Murabahah* debt cannot be securitised because the sale of a document representing money is akin to the trading of monies, which is prohibited under the rules of *Riba* (prohibition of interest). However, the Malaysian view is that if the underlying receivable is connected to a true trade transaction or to a commercial transfer of a non-monetary interest, then the receivable can be traded freely for purposes of Shari'ah.<sup>6</sup>

Another observation is that structuring a Sukuk product involving assets in, for example, a Western jurisdiction is not necessarily much more demanding and complex than it would be to structure a similar Sukuk product in an Islamic jurisdiction just by virtue of the jurisdiction of the assets being non-Islamic. While such a statement defies conventional

wisdom and hence is likely to trigger conflicting views from Islamic banking practitioners, a possible starting point for consensus is to acknowledge that Sukuk products are highly structured by nature, regardless of the jurisdiction of the assets. Having said this, Shari'ah structures, in their own right, have consistently proven to be capable of adaptation to different legal regimes, but it is the interplay between Shari'ah precepts and such aspects as tax and bankruptcy regimes that pose the biggest challenge. For example, in a sale-lease-back structure involving assets in the US, legal and tax opinions would focus, among other things, on whether the underlying sale-lease-back agreements qualify as a finance lease. In structuring a similar product in, for example, Kuwait, transfer of title considerations would take centre stage.

Finally, the credit crunch may generate an abundance of new investment opportunities for Islamic investors. Although the credit crunch is negatively impacting the international finance industry, its negative effects appear to be off-set in the Gulf Cooperation Council countries and some other Islamic jurisdictions by high oil and commodities prices. The assets in backing this new wave of Islamic investment are likely to be based in non-Islamic jurisdictions, particularly those that have been hardest hit by the troubled credit market (including the US and European Union). A disproportionate increase in legal activity and analysis focused on the Islamic banking industry would likely accompany such an increase in Islamic banking. This is due to expansion into jurisdictions that are more rigorously regulated and new offerings backed by assets that require specialised knowledge and expertise. Consequently, the scope of legal and regulatory preparation necessary for such new investments will expand significantly.

## Bankruptcy considerations

While virtually irrelevant up to this point, the insolvency laws of Western jurisdictions, particularly of the US, may soon intersect with the legal and Shari'ah regimes currently shaping the Islamic finance industry. Conditions in Western jurisdictions experiencing the current credit crunch create new opportunities for Islamic banking. Whether Islamic investment is used to fill the capital void created by the tightening of conventional sources of capital, or assets from such jurisdictions are used to back Islamic investment products, investors in Islamic finance structures are likely to be affected by the increase in bankruptcy activity that typically accompanies downturns in the economies subject to Western insolvency laws. This potential exposure to

insolvency laws will influence both how Islamic finance transactions will be structured and how they will be documented.

## Judicial and conflict of laws considerations

In addition to the above legal concerns, specialised legal advice should be sought in order to identify other issues that may be relevant in choosing the law the relevant fund documentation will be subject to and the forum for resolving disputes. Legal advice would reveal, for example, court decisions which may impact a choice of legal decision. For example, the English High Court, presented with a choice of legal dispute, decided that English law would take precedence notwithstanding a choice of law provision in a Murabahah agreement which provided that the governing law of the contract is English law 'subject to the principles of glorious Shari'ah'.

Other instances involve cases in which courts in a number of Gulf countries have ruled that trading in futures or derivatives qualifies as gambling, with the result that the underlying transaction is not Islamic-compliant.

In jurisdictions where Shari'ah is applicable, but where certain codifications have been adopted to facilitate specific transactions, an internal conflict of laws can arise. For example, under Shari'ah, contracting parties are strictly bound by the terms of the contract, but applicable statutes in some jurisdictions may impose additional requirements to those provided in the contract. For example, and as discussed, the transfer of title over real estate must be recorded with the appropriate government authority for the transfer to be valid.

Finally, regulators in Islamic and non-Islamic jurisdictions are attempting to facilitate Sukuk issues, but the extent to which they are willing to go is a reflection of governments' policies at that time. Singapore, for example, is currently bullish about attracting Islamic banking and finance institutions to cement its status as an international banking hub. Turkey is attempting to attract Islamic investors without affecting its strict secular regulations. In addition, the focus of the Sukuk industry in countries with a long Sukuk tradition, such as Malaysia and Bahrain, seems to have expanded to encompass both sovereign and corporate issues.

## Conclusion

The Islamic Sukuk industry will continue to evolve as promoters and their professional advisers work together to meet the regulatory, legal and judicial challenges that will arise as a result of operating in

an increasing number of jurisdictions and legal environments. While significant progress has been made, promoters will undoubtedly appreciate that offering Islamic private equity funds and products requires substantial structural and documentary changes to what have conventionally been perceived as the norm in the securities industry, and that legal, judicial and compliance considerations be thoroughly examined and addressed. Regardless of the nature of the progress, the Sukuk industry has captured the attention of regulators in a growing number of jurisdictions. This has translated, and will continue to translate, into the coming into force of Sukuk-friendly regulations in Islamic and non-Islamic jurisdictions.

#### Notes:

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- <sup>2</sup> This is intended to avoid the appearance of Bai Al-Aeena, whereby a person buys an asset on credit then immediately sells at a discounted price to the same seller.

<sup>3</sup> This type of Musharakah is also referred to as a 'declining balance' Musharakah. See *Equity Finance Vehicles: mudarabah and musharakah*, Abdulkader Thomas and M. Ikram Thofeek, an article published in *Structuring Islamic Finance Transactions*, p.56, Euromoney Books, 2005.

<sup>4</sup> For example, the Jordan Civil Code No. 43 of 1976; Articles 611 to 618.

<sup>5</sup> The UAE Federal Law No. 5 of 1985; Articles 693 to 707.

<sup>6</sup> *The Murabahah and Simple Sales Transactions*, Abdulkader Thomas, Bryan Kraty and others; an article published in *Structuring Islamic Finance Transactions*, p.69, Euromoney Books, 2005.

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