

Structuring a Securitized *Shari'a*-Compliant Real Estate Acquisition Financing: A South Korean Case Study

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INTRODUCTION

Securitization in Islamic finance is becoming a reality, as evidenced by the recent *sukuk* offerings by national governments and Islamic investment banks and the *sukuk* offerings presently being structured for municipalities, regional governmental entities, and private commercial entities. The primary foci of *sukuk* structures implemented to date have been on pooled lease (*ijara*) securitizations and securitizations of pools of *murabaha* payment obligations. The conventional wisdom in the Islamic finance field has been that there cannot be a securitization of obligations, in compliance with the principles and precepts of Islamic *shari'a* (the “*shari'a*”), in transactions where the financing for the transaction is primarily conventional interest-based debt and there is no *shari'a*-compliant lease or similar *shari'a*-compliant obligation.

¹ Partner, King & Spalding LLP. The author is resident in the firm’s New York and London offices. All intellectual property rights, including copyright, are retained by Michael J. T. McMillen. The author expresses his gratitude to the *shari'a* scholars who considered the many complicated aspects of the South Korean transaction that forms the basis of this case study and to the entities involved in that transaction. Confidentiality considerations prevent the identification of those scholars and entities, but do not diminish the author’s gratitude. The author also expresses his gratitude to other *shari'a* scholars who consulted on many of the complicated *shari'a* questions and issues raised by the structuring of this transaction, most notably Mohammed Ali Elgari, Sheikh Nizam Yaquby, and Sheikh Yusuf Talal DeLorenzo. For the same confidentiality reasons, the author could not describe to these scholars all aspects of the South Korean transaction, nor could he identify the transaction or the participants in the transaction to these scholars, when discussing aspects of the transaction with them. Nevertheless, as always, these gentlemen were generous with their thoughts, their wisdom, their criticism, their humor, their time, and their creative suggestions.

This essay is intended to focus discussion on the basis for that conventional wisdom by examining, through a case study, the fundamental conception of securitization in Islamic finance. It is intended to challenge the widespread assertions that the presence of conventional interest-bearing debt in a transaction necessarily prohibits the application of the securitization model to that transaction. It is also intended to illustrate how careful and creative transactional structuring can be used to develop a *shari'a*-compliant transaction that opens new markets to Muslim investors.

Thus, this essay will focus on the fundamental nature of structuring an individual transaction involving primarily conventional interest-based debt financing, and no *shari'a*-compliant *ijara* or *murabaha* obligation, so as to permit securitization of that transaction in compliance with the *shari'a*. The focus is on the individual transaction:² a case study of a single real estate acquisition financing transaction in South Korea where financing is mandatorily subject to the South Korean securitization laws and is thus comprised of conventional interest-bearing debt (the “Securitized Acquisition Financing Transaction”).³ The critical inquiry is whether a transaction such as this can be structured so that it can be securitized in a manner that is compliant with the *shari'a*.⁴

A GENERIC OVERVIEW OF SECURITIZATION

Before examining the Securitized Acquisition Financing Transaction, it is essential to have a framework understanding of the general nature and process of securitization. The New Basel Capital Accord of the Basel Committee on Banking Supervision of the Bank for International Settlements broadly defines securitization as follows:⁵

² This essay will not focus directly on asset-based securitizations of the type evidenced by the recent *sukuk* issuances. Nor will this essay focus on the pooling and related statistical concepts that underpin the predictability concepts that are essential to securitization.

³ The description of the transactional case study set forth in this essay departs from the actual facts of the South Korean transaction in various particulars. Those departures are intended to highlight certain issues pertaining to *shari'a* compliance as well as to protect client confidences.

⁴ Any departures from compliance with the *shari'a* that may be perceived, asserted, or identified by any reader are the sole responsibility of the author, whether resulting from the author's understanding (or lack thereof), characterization, or interpretation of the relevant *shari'a* principle or precept, and are in no way attributable to any of the *shari'a* scholars mentioned in footnote 1 of this essay.

⁵ Bank for International Settlements 2003: sections 502 and 503. Securitization is to be distinguished from factoring (although the differences may be slight in sophisticated securitization transactions). In a factoring transaction, the factor purchases receivables from the originator at a discount and the factor thereafter

502. A *traditional securitization* is a structure where the cash flow from an underlying pool of exposures is used to service at least two different stratified risk positions or tranches reflecting different degrees of credit risk. Payments to the investors depend upon the performance of the specified underlying exposures, as opposed to being derived from an obligation of the entity originating those exposures. The stratified/tranched structures that characterize securitizations differ from ordinary senior/subordinated debt instruments in that junior securitization tranches can absorb losses without interrupting contractual payments to more senior tranches, whereas subordination in a senior/subordinated debt structure is a matter of priority of rights to the proceeds of a liquidation.

503. A *synthetic securitization* is a structure with at least two different stratified risk positions or tranches that reflect different degrees of credit risk where credit risk of an underlying pool of exposures is transferred, [in] whole or in part, through the use of funded (e.g. credit-linked notes) or unfunded (e.g. credit default swaps) credit derivatives or guarantees that serve to hedge the credit risk of the portfolio. Accordingly, the investors' potential risk is dependent upon the performance of the underlying pool.

As a general matter,⁶ any securitization begins by identifying assets that can be used to raise funds. In the typical case, these assets are receivables that represent rights to payments at future dates. The types of receivables, and other cash flows, that have been and are being securitized is extensive and constantly expanding and includes residential mortgage loans, commercial mortgage loans, aircraft leases, rolling stock leases, automobile leases, other equipment leases, credit card receivables, patent

collects on the receivable. In a securitization transaction, a "Special Purpose Vehicle" is established and that Special Purpose Vehicle purchases the receivables and issues asset-backed securities based upon the receivables. The Special Purpose Vehicle relies upon the quality of the receivables (and the statistical construction of the pool of receivables, among other factors) to reduce risk, rather than on its ability to collect on those receivables.

⁶ This essay provides only a general description of some of the more important and generic aspects of securitization. The securitization markets are now highly developed and sophisticated markets and there are a myriad of structures used for different types of securitizations. None of those more sophisticated structures is discussed in this essay. Similarly, this essay does not consider many of the essential features and considerations relating to even a relatively simple securitization, such as overcapitalization of the conduit special purpose entities, credit and liquidity enhancements, capitalization, or tax and accounting rules applicable to different types of single-seller conduit and multiple seller conduit securitizations. For an interesting comparison of the earliest securitizations with more recent securitization trends, compare *The Handbook of Mortgage-Backed Securities*, Frank J. Fabozzi, ed. (1985) (hereafter "Fabozzi 1985"), with the revised version of *The Handbook of Mortgage-Backed Securities*, Frank J. Fabozzi, ed. (2001).

payments, other intellectual property royalties, licensing fees and other payments, student loans, and virtually any other payment obligation.

In the securitization process, the owner of these rights to payments (the “Originator”) transfers these assets to a newly-formed special purpose entity (for example, a corporation, trust, or other legal entity) (the “Special Purpose Vehicle”). This transfer must constitute a “true sale” under relevant bankruptcy laws, meaning that the sale is sufficient under those bankruptcy laws to remove the receivables from the bankruptcy estate of the Originator, and that the transaction does not constitute a secured loan from the Special Purpose Vehicle to the Originator.⁷ This true sale has the important effect of separating the receivables, and the risks associated with payment on those receivables, from the risks associated with the Originator.

The Special Purpose Vehicle raises the funds to purchase the receivables by issuing securities (the “SPV Securities”) in the capital markets. In transactions that are not compliant with the *shari’a*, these securities are usually debt or debt-like instruments, although some transactions involve equity instruments.⁸ In the case of a *shari’a*-compliant transaction, there is issuance of a *sukuk* as a type of participation in the ownership of the assets that are the subject of the underlying *ijara* or other *shari’a*-compliant obligation.⁹ The interest rate or payment rate on the SPV Securities is less than the cost of funds that would be applicable to securities issued by the Originator due to elimination from the transaction of risks associated with the Originator (including the risk of the bankruptcy of the Originator).¹⁰ Payments in respect of the SPV Securities are made

⁷ See, e.g., 11 U.S.C. § 541 with respect to the bankruptcy laws of the United States of America.

⁸ In contemporary sophisticated securitization transactions, the range of the different types of SPV Securities is broad and covers short-term, medium-term, and long-term instruments, including commercial paper and a broad range of different types of notes, as well as equity instruments.

⁹ A *sukuk* has many similarities to a “pass through certificate” in the non-Islamic capital markets, although most pass through certificates do not represent interests in *shari’a*-compliant assets or receivables pertaining to *shari’a*-compliant assets. See, e.g., Fabozzi 1985, pages 101-147 discussing mortgage pass through certificates in the early years of securitizations.

¹⁰ Unless otherwise noted, this essay assumes (a) that the SPV Securities will not be “pass through certificates” or similar securities that are structured so that the holder of the SPV Securities owns a fractional undivided interest in the individual or pooled receivables and all of the payments in respect of the receivables are passed through to the holder of the SPV Securities, and (b) that the yield on the SPV Securities is established as a designated rate of interest or profit. The pass through structure, and variations on that structure, are akin to *sukuk* structures in which the holder of the *sukuk* owns a fractional undivided interest in the assets which have been leased to end users pursuant to different *ijara* arrangements that provide the receivable for payment of the *sukuk*.

exclusively from the cash flows of the receivables that are the subject of the transaction.¹¹

The Special Purpose Vehicle must be structured to be “bankruptcy remote,” particularly if the securities issued by the Special Purpose Vehicle are to be rated by any of the primary “rating agencies.”¹² Bankruptcy remoteness in this context means that the Special Purpose Vehicle is unlikely to be adversely affected by a bankruptcy of the Originator. Bankruptcy remoteness is achieved by (a) strictly limiting the permitted business activities of the Special Purpose Vehicle, (b) isolating the management and operations of the Special Purpose Vehicle from those of other entities (particularly the Originator), (c) requiring the Special Purpose Vehicle to observe third party formalities with entities with whom it conducts business (particularly the Originator), and (d) otherwise maintaining operational and management independence. The foregoing types of provisions reduce the risk that the bankrupt Originator will cause the Special Purpose Vehicle to file for bankruptcy and the risk that a bankruptcy court, in the exercise of its equitable powers, will substantively consolidate the assets and liabilities of the Special Purpose Vehicle with those of the Originator.

THE SOUTH KOREAN SECURITIZATION CASE STUDY

Facts, Overall Transaction, Compulsory Considerations, Assumptions

The reason for considering the Securitized Acquisition Financing Transaction is that an investor (the “*Shari'a*-Compliant Investor”) desires to participate in the Securitized Acquisition Financing Transaction and desires that its participation be compliant with the *shari'a*. It is assumed for purposes of this essay that the *Shari'a*-Compliant Investor desires to achieve a specific internal rate of return (the “Target IRR”) on its investment and is willing to participate at a level of risk that is generally associated with equity capital investments. It is further assumed that the *Shari'a*-Compliant Investor is willing to forgo returns in excess of the Target IRR.¹³

¹¹ Note, however, that SPV Securities may bear credit enhancements, such as guarantees and insurance, and payments might then be made from the proceeds of the credit enhancement device.

¹² The most well-known “rating agencies” are Standard & Poor’s Ratings Group, Moody’s Investors Services, Inc., Duff and Phelps, and Fitch Investors Service, Inc.

¹³ These assumptions regarding the Target IRR and returns in excess of the Target IRR are consistent with the position of the actual *Shari'a*-Compliant Investor in the transaction that forms the basis for the case study discussed in this essay. However,

The Securitized Acquisition Finance Transaction involves the acquisition by a South Korean special purpose entity (the “Project Owner”)¹⁴ of a commercial office property in South Korea, including a large tract of land and multiple office buildings (the “Project”). The acquisition occurs pursuant to a property sale and purchase agreement (the “Property Sale Agreement”) between the Project Owner and the seller of the Project (the “Seller”). Pursuant to the Property Sale Agreement, the Seller conveys its fee interest in the Project to the Project Owner and the Project Owner pays the Seller the agreed price for the Project (the “Acquisition Price”).

At the time of the acquisition of the Project, the Project is leased to a number of different commercial enterprises (the “End User Tenants”), which occupy the buildings pursuant to end user tenant leases of various terms, including long-term end user tenant leases (the “End User Leases”). A significant number of the End User Tenants do not conduct business in compliance with the *shari’a*. These include a conventional insurance company and a capital company that makes interest-bearing loans. The acquisition of the Project is made subject to the End User Leases. Periodic rents under the End User Leases (the “Rent”) are payable by the End User Tenants to the Project Owner.

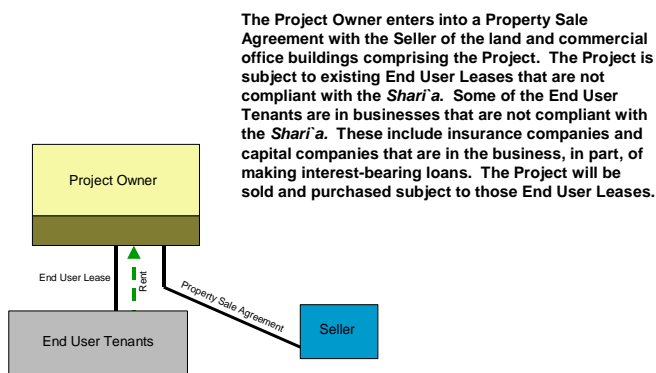


Figure 4. Purchase of the Project Subject to Non-Conforming End User Leases

that actual *Shari’a*-Compliant Investor was also willing to invest on a “pure equity” basis, with all attendant equity risks and rewards, including entitlement to returns in excess of the Target IRR. The structure that was developed for the transaction and that is discussed in this essay allowed for either type of participation by the *Shari’a*-Compliant Investor.

¹⁴ The special purpose entity will have no assets other than the Project.

The primary source of financing for acquisition of the Project in the Securitized Acquisition Financing Transaction is (and must be) conventional interest-bearing debt in accordance with the South Korean securitization laws. In summary, the relevant provisions of the South Korean securitization laws require a bond financing structure comprised of two tranches of bonds: senior secured bonds and junior bonds. The senior secured bonds (the “Senior Bonds”) are issued to the banks and other financial institutions providing interest-based acquisition financing for the transaction (collectively, the “Senior Bond Holder”). The Senior Bond Holder provides an amount of financing (say, 70 percent of the purchase price of the Project) as agreed between the Senior Bond Holder and the other parties on negotiated terms that are customary for a transaction of this type (the “Senior Bond Amount”). Those terms include a first mortgage on the Project to secure amounts payable under the Senior Bonds.¹⁵ The Senior Bonds bear interest at either a fixed rate or a variable rate and are otherwise on customary terms for transactions of this type that are not compliant with the *shari'a*.

The second tranche of bonds that must be issued pursuant to the South Korean securitization laws are the junior bonds (the “Junior Bonds”), which are issued to the entity providing the junior financing amount (the “Residual Interest Purchaser”). The Junior Bonds issued to the Residual Interest Purchaser are “subordinated” bonds and are issued in an amount that is approximately equal to the excess of the purchase price of the Project over the Senior Bond Amount (the “Junior Bond Amount”).¹⁶ There is some flexibility as to the structuring of the payments on the Junior Bonds. Basically, however, the payments on the Junior Bonds are equal to all amounts of the Rent remaining after payment of operating costs in respect of the Project, funding of appropriate reserves (such as maintenance, capital improvement, working capital, tax, insurance, and debt service reserves),

¹⁵ The mortgage and other security documents securing the Senior Bonds are not discussed in this essay and are not shown on the accompanying slides.

¹⁶ The Junior Bond Amount will usually be greater than the amount of the excess of the Acquisition Price over the Senior Bond Amount so as to provide for other deposits, payments, and reserves. Such other deposits, payments, and reserves may include (a) payment of transaction costs, (b) provision of working capital, (c) initial funding of reserves (such as maintenance reserves, capital improvement reserves, tax reserves, insurance reserves, and debt service reserves), and (d) provision for certain other identifiable future payments. These deposits, payments, and reserves will be determined and negotiated on a case-by-case, transaction-by-transaction basis. In addition, the structuring of the transaction in accordance with applicable laws, particularly applicable tax laws in a number of different jurisdictions, may have the effect of reducing the Junior Bond Amount. *See* the section of this essay entitled “Economics and Pricing.”

and payment of the Senior Bonds.¹⁷ The “subordination” is such that failure to pay the Junior Bonds will not result in a default and the Junior Bonds will not have a liquidation preference for a specified sum. The Junior Bonds bear interest at a fixed rate or a variable rate, although payment of principal and interest on the Junior Bonds will be made only after payment of scheduled principal and interest on the Senior Bonds, and payments on the Junior Bonds will be made only out of free cash flow after other required payments, including payments on the Senior Bonds. The Junior Bonds may be secured by a subordinate mortgage on the Project.¹⁸

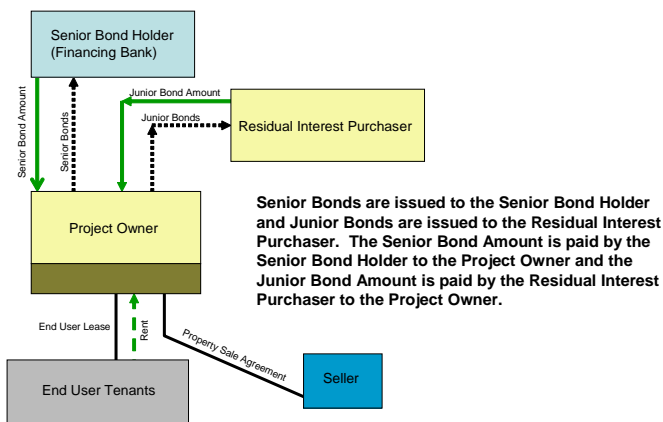


Figure 5. South Korean Securitization Requirements of Senior Bonds and Junior Bonds

The Senior Bond Holder pays the Senior Bond Amount to the Project Owner and receives the Senior Bonds from the Project Owner. The Residual Interest Purchaser pays the Junior Bond Amount to the Project Owner and receives the Junior Bonds from the Project Owner. The sum of

¹⁷ As an example of a structural variation, there may be an equity entity, in addition to the Senior Bond Holder and the Residual Interest Purchaser, that receives pure equity payments after the making of all payments in respect of the Senior Bonds and the Junior Bonds. That variation is not presented in this essay. This essay assumes that the Residual Interest Purchaser, as the holder of the Junior Bonds, will receive all amounts remaining in the Project Owner after payment of the Senior Bonds (and after payment of operating costs and funding of reserves). Thus, the Junior Bonds effectively constitute pure equity for purposes of this transaction. These assumptions are in accordance with the structure of the actual transaction that forms the basis of this case study.

¹⁸ The mortgage and other security documents securing the Junior Bonds are not discussed in this essay.

the Senior Bond Amount and the Junior Bond Amount¹⁹ is paid by the Project Owner to the Seller as the Acquisition Price, and the ownership of the Project will be transferred by the Seller to the Project Owner.²⁰

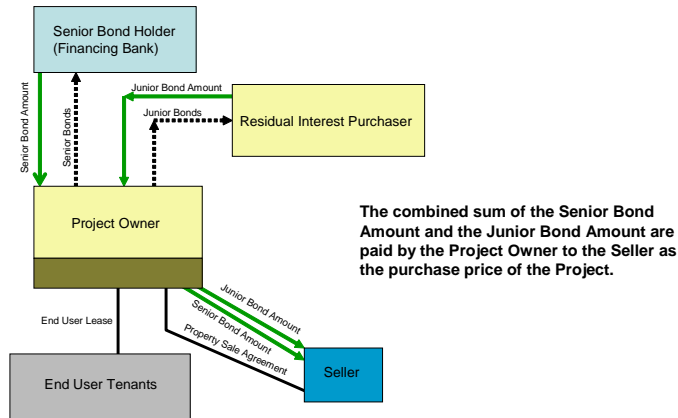


Figure 6. Payment of the Purchase Price for the Project

Upon receipt of the Rent, the Project Owner (a) pays operating expenses in respect of the Project, (b) funds appropriate reserves in respect of the Project, (c) makes periodic payments to the Senior Bond Holder in respect of the Senior Bonds, and (d) makes payments to the Residual Interest Purchaser in respect of the Junior Bonds. Customarily, payments are made in the order set forth in the preceding sentence. In all cases, payment in full of scheduled principal and interest is made on the Senior Bonds prior to the making of any payments in respect of the Junior Bonds.²¹

¹⁹ Less the amounts referred to in footnotes 15 and 21.

²⁰ *But see* the section of this essay entitled “Economics and Pricing.”

²¹ The nature of the operating payments, deposits, and reserves, and the order in which each is made or funded, varies from transaction to transaction and is heavily negotiated in every transaction. For example, there may be maintenance reserves, capital improvement reserves, working capital reserves, tax reserves, insurance reserves, debt service reserves in respect of the Senior Bonds, and a wide range of other reserve accounts and categories. The parties will negotiate the amount and timing of deposits to each of the reserve accounts. Similarly, the parties will negotiate the order in which operating expense payments are made and the order, relative to all other deposits and payments, in which payments are made in respect of the Senior Bonds. These parameters, including the amounts and order of deposit and payment, will be set forth in the documents in a series of provisions (collectively often referred to as the “cashcade” or “waterfall”) that may vary

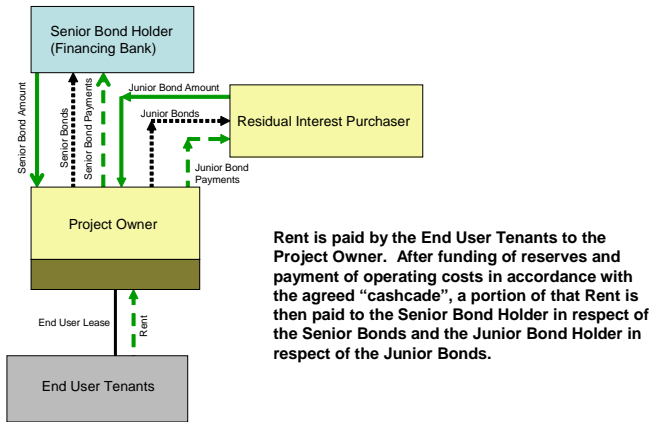


Figure 7. Payment of Senior Bonds and Junior Bonds

For purposes of this essay, except as otherwise noted, it is assumed that the equity in the Project Company is held by the Residual Interest Purchaser and that the equity in the Residual Interest Purchaser is held by a third party that is unrelated to the *Shari'a*-Compliant Investor (the “Ultimate Tax Owner”).²²

This essay also assumes that the End User Lease is a “true lease” and that the tax benefits of ownership of the Project flow through the ownership chain from the Project Company to the Residual Interest Purchaser to the Ultimate Tax Owner. Although the tax ownership and true lease laws and regulations vary from country to country, for convenience this essay assumes that true lease characterization is obtained based upon criteria that are applicable in the United States of America under Revenue Procedure 75-21 and related revenue rulings and revenue procedures²³ and that

depending upon the financial strength of the Project and the absence or existence of an event of default (as well as other factors).

²² The Ultimate Tax Owner is not shown on the diagrams included in this essay. Although not discussed in this essay, the structure that was developed for the Securitized Acquisition Financing Transaction can also be used where this ownership assumption is not true and there is either joint ownership of the Project Company by another third party entity as well as the Residual Interest Purchaser or exclusive ownership by such a third party; in each such case there will be modifications to the economics and pricing of the Junior Bonds, the purchase of the residual interest, and the sale of the shares in the Investor Entity.

²³ Revenue Procedure 75-21 (1975), Internal Revenue Service of the United States of America Department of the Treasury (“Rev. Proc. 75-21”). See also Revenue Procedure 75-28, which elaborated on the guidelines set forth in Rev. Proc. 75-21

allowable depreciation is substantially the same as that permitted under applicable laws and regulations of the United States of America.²⁴ Thus, for example, it is assumed that (a) the Project Company, as the lessor, will maintain a 20 percent minimum at-risk equity investment throughout the lease term of the End User Lease, (b) the residual value of the Project (comprising the value of the residual interest) at the end of the term of the End User Lease will be at least equal to 20 percent of the original cost of the Project, without regard to inflation or deflation, and (c) the remaining useful life of the Project at the end of the term of the End User Lease will be at least 20 percent of the estimated useful life of the Project.²⁵ These assumptions, which are substantially in accord with the facts of the South Korean transaction, are critical to, and essential constraints upon, structuring the economics and pricing arrangements of, and contractual arrangements for, the structure that was developed to allow participation by a *Shari'a*-Compliant Investor.

and certain filing information requirements, Revenue Procedure 76-30 (1976), which addressed the definition of “limited use property,” and Revenue Procedure 79-48, which addresses certain lessee-funded improvements to leased property. Revenue Ruling 55-540 (1955-2 Cumulative Bulletin 39), although superseded in substantial part by Rev. Proc. 75-21, is useful for an historical understanding of factors that may indicate that a transaction is a conditional sale rather than a true lease.

²⁴ For example, the essay assumes that, for depreciation purposes, the buildings constituting real property will be depreciable over 30 years on a straight-line basis and that certain other property constituting portions of the Project will be depreciable over other, sometimes much shorter, periods on different accelerated depreciation formulas. This essay assumes that a qualified consultant will determine the applicable depreciation class and methodology for each asset constituting a part of the Project, as is customarily done in transactions of this type.

²⁵ Rev. Proc. 75-21 and related Revenue Procedures address a number of other factors, of less importance to this essay, that relate to true lease characterization, including: (1) the definition of the term of the lease (here, the End User Lease) for purposes of determinations of true lease status; (2) fair market value lease renewal terms; (3) provision of the cost of the property by the lessee (the End User Tenant) and related parties; (4) prohibitions on the provision of debt financing by the lessee (the End User Tenant) and related parties to the lessor (the Project Company); (5) demonstrations of the likelihood of profit on the leasing transaction apart from tax benefits, including profits in respect of the residual interest or residual value of the property; (6) uneven rent considerations; (7) prohibitions on the inclusion of “limited use property” in true leases; (8) lessee financing of improvements; (9) residual interest or residual value sharing arrangements; and (9) the payment of transaction costs for true lease transactions.

Some Relevant Principles of Property, Property Interests, and Sales

Before considering the structure that will allow the *Shari'a*-Compliant Investor to make an investment in the Project in compliance with the *shari'a*, it is useful to examine a few secular and *shari'a* principles and precepts that underlie the structure that was developed for the Securitized Acquisition Financing Transaction and then to summarize the application of those principles to the facts of the Securitized Acquisition Financing Transaction. Consideration is given to some principles applicable to the nature of property generally and then to the types of property interests affecting the sale and purchase transaction that is the basis for the Securitized Acquisition Financing Transaction and, thereafter, to the primary principles applicable to sales of property interests.

1. Property interests

Property of any type consists of the assets comprising the property (here, the land and the buildings). But that is not the end of the matter. The interests in that property must also be considered. There are “current interests” in property (such as current title to the property, leasehold interests in the property, easement interests in the property, and license interests in the property), and there are “residual interests” in property, or interests in property that relate to the future (such as title interests in the residual value or residual interest in the property that arise after the expiration of current interests in the property).

For purposes of the Securitized Acquisition Financing Transaction and this essay, ownership of property commences with only a current interest in existence. However, property rights are divisible and differentiable. Thus, the property rights may be differentiated into a current interest and a residual interest. Upon any such differentiation and thereafter until the current interest and the residual interest are again merged, there are two current property ownership interests in the Project: the “current interest,” which is defined by reference to a then-current point in time, and the “residual interest,” which is defined by reference to either a set of conditions or a specified point in time. At any given time, one person or entity may own the current use, while another person or entity may own the residual interest, or a single person or entity may own both the current interest and the residual interest. At such time as the residual interest commences, the current interest and the residual interest are merged and there is again only a current interest until such time as the property interests are again differentiated.

Distinct from then-current ownership rights in the Project at any specific date are rights to use the Project at that date and at various future dates. These interests of use may also be variable, with respect to any one person or entity, in each of the current interest and the residual interest. Thus, for example, prior to commencement of the residual interest period the owner of the residual interest may have certain limited current use rights relating to the land. These may include, for example, rights to protect the residual interest, such as the right to enter upon the property and inspect the same, and correct waste by the current user during the current interest period. But these would not include any other rights in respect of the land and buildings until such time as the residual interest period shall commence (and thus be merged with the then-current current interest). Thus, for example, prior to commencement of the residual interest period, the owner of the residual interest would not be entitled to till the land, or build upon the land, or modify the improvements, or destroy the buildings on the land, all of which rights will be exercisable only by the owner of the current interest until commencement of the residual interest period, whereupon the owner of the current interest prior to such commencement will lose the ability to exercise any such rights with respect to the land without further act or deed and the owner of the residual interest will acquire the exclusive ability to exercise all such rights without further act or deed.

At any time after the disassociation of the property interests into the “current interest” and the “residual interest” but prior to the time when the current interest is merged with the residual interest (*i.e.*, prior to the satisfaction of the conditions that render the residual interest current and thus cause commencement of the residual interest term), both the “current interest” and the “residual interest” are existent interests in property that can be separately owned and sold. A person or entity can irrevocably own and sell a current property interest that relates only to the future (*i.e.*, the residual interest). The disassociation of the current interest and the residual interest is accomplished pursuant to contract.

2. Secular legal principles

Secular legal principles take cognizance of the differentiation of current interests from residual interests in a wide range of contexts. One of the most familiar examples pertains to the residual value or remainder interest in equipment upon termination of an equipment lease. Similar examples with respect to land and other property interests include the recognition by tax law and other laws of residual interests in land or other property and the recognition of “charitable remainder” and similar “remainder” trusts and conveyances, including those upon which educational and other charitable institutions focus and depend. Another

example relates to expropriation and condemnation. If there is total condemnation of property after the disassociation of the current interest from the residual interest prior to the merger and reassociation of those interests, the owner of the current interest and the owner of the residual interest would each be entitled to a portion of the condemnation award based upon the relative values of their interests.

As another example, contracts are often fashioned to allow a present conveyance and transfer of the current ownership of a future use of a property to a third party, with current rights of ownership and use being retained in a different party (say, for the life of the conveying party or for a term of years). There can be a present irrevocable sale and delivery (transfer and conveyance) of current ownership of future rights and interests in that property.²⁶ That is, the seller and the purchaser are permitted to enter into a valid and binding contract that is presently effective for the sale and purchase of property (such as real property) whereby the purchaser will have a present ownership interest in and of the residual interest in the property, and certain attendant rights, but will not be entitled to exercise all rights in respect of use of the property until a future date. The applicable contract may or may not contain a wide range of terms and conditions pertaining to, for example, (1) the present possession and use of the subject property, (2) allocations of obligations and liabilities in respect of the subject property, particularly upon the occurrence of different specified events and conditions (for example, environmental liabilities arising prior to the transfer of possession to the residual owner), and (3) adjustments to the pricing or other terms and conditions of the sale and transfer upon the occurrence of specified events (for example, a partial or total condemnation or other taking by a governmental authority prior to such transfer of possession to the residual owner).

The object of a sale and purchase (*bay'*) is to transfer ownership of the property being sold and purchased to the purchaser and to transfer ownership of the purchase price to the seller. And rights of use may be differentiated from rights of ownership. The critical considerations for purposes of this essay relate to (a) the transfer of ownership of the relevant property and property right (the residual interest in the Project) to the purchaser at the time of entering into the contract with the ability to exercise the right to use the Project not being exercisable by the purchaser until some future time, and (b) the payment of the purchase price on an installment basis.

²⁶ Any such sale, transfer, and conveyance must meet applicable legal requirements pertaining to the validity of the transaction and the applicable contract. Thus, for example, the transaction and related contract cannot be in violation of public policy and must comply with requisite formalities. It is assumed for purposes of this essay that all such requirements are met and that the transaction is legally permissible. A discussion of those requirements and formalities is beyond the scope of this essay.

3. *Shari'a* principles

A brief overview of some of the *shari'a* principles and precepts²⁷ applicable to sales of the types contemplated by this essay provides context for the discussion of the development of the structure for the Securitized Acquisition Financing Transaction. In order to have a valid sale and purchase under the *shari'a*, the property must be in existence, be capable of delivery (*taslim*), have specific value, be known to the purchaser, and be precisely described and defined.²⁸ Sales may be made subject to conditions, and those conditions may be established by the parties at the time of the making of the contract of sale.²⁹

While the *Majelle* does not specifically address the sale of a residual interest (at least in those terms), it does express address the sale (and resale) of fractional undivided interests in real property³⁰ and it does address the sale of easements, rights of way and rights relating to the use of land and assets on or under real property (such as water).³¹ In the case of the sale and purchase of real property, the purchaser can sell such real property to

²⁷ While it does not constitute definitive substantive law and does not take into account variations among the different schools of Islamic jurisprudence with respect to any specific principle or precept, for convenience this essay makes reference to the English language translation of the *Majallat Al-Akham Al-'Adliyya* made by Judge C. A. Hooper, *The Civil Law of Palestine and Trans-Jordan*, Volumes I & II (1933), reprinted in 4 *Arab Law Quarterly* (August 1986) (the "*Majelle*"), as illustrative of applicable *shari'a* principles and precepts. Reference is also made to *Financial Transactions in Islamic Jurisprudence*, Wahban Al-Zuhayli's *Al-Fiqh Al-Islami wa 'Adillatuh* (Islamic Jurisprudence and its Proofs), translated by Mahmoud A. El-Gammal (2003) ("*Al-Zuhayli – El-Gamal*"), which is a translation of Volume 5 of *Al-Fiqh Al-Islami wa 'Adillatuh*, fourth edition (Damascus 1997) and appears in two volumes.

²⁸ *Mejelle*, Articles 197 – 200, 205, 209, 221 and 363; Al-Zuhayli – El-Gamal, Volume I, Chapters 1 – 4, pages 5–163. *See, also*, *Majelle*, Articles 230 – 236 in respect of appurtenances, fixtures, and items of property, including fruits of, or increases in, the property prior to delivery of the property.

²⁹ *Mejelle*, Articles 186 – 189.

³⁰ *Majelle*, Articles 214 and 215. Article 214 indicates that the "sale of an ascertained, jointly owned undivided share in a piece of real property owned in absolute ownership prior to division, ... is valid." Article 215 provides that a person "may sell his undivided jointly owned share to some other person without obtaining the permission of his partner," although various *shari'a* scholars, in discussions with the author, have indicated that contractual provisions may be used to introduce the concept of partner consent to this type of arrangement.

³¹ *Majelle*, Article 216, which states: "The sale of a right of way, and the right of taking water and of a right of flow attached to land and of water attached to canals[,] is valid."

another person or entity before taking possession of such real property (although the same rule is not applicable to movable property).³²

The price for the property to be sold and purchased must be established at the time of the making of the contract of sale and must be ascertained.³³ A valid sale may be concluded in which payment of the price is deferred and is made in installments and, in such a case, the period of installment payment must be definitely ascertained and fixed.³⁴ Unless the parties otherwise agree, and the parties may otherwise agree (as in an installment sale transaction), the purchaser must deliver the purchase price to the seller before the seller is obligated to deliver the property to the purchaser.³⁵ A seller of property has the right to dispose of the purchase price for such property prior to receiving the same, as where the purchase price is assigned to a creditor.³⁶ A concomitant, and broader, principle is that the taking of delivery of the purchased property is not an essential condition of sale.³⁷

In many instances, the seller of property has a right of retention of the property until receipt of payment in full where the sale is structured to be for immediate payment in full.³⁸ There is no right of retention in the seller if the transaction is a sale on credit, in which case the property subject to the sale must be delivered immediately to the purchaser.³⁹ Notably, however, there is no right of the seller to withhold or retain where payment of the purchase price is agreed to be on an installment sale basis as the seller in such a transaction has voluntarily agreed otherwise, and the right to

³² *Majelle*, Article 253; Al-Zuhayli – El-Gamal, Volume 1, § 3.2.2, at pages 56 and 60-61 (noting also that not all *shari'a* scholars are in agreement that the real property may be sold by the purchaser before receipt).

³³ *Majelle*, Articles 237 and 238.

³⁴ *Majelle*, Articles 245 – 250; Al-Zuhayli – El-Gamal, Volume 1, § 3.2.1, at page 53, § 3.2.2, at page 63 (citing Al-Sarakhsi (1st edition) ((Hanafi), vol. 13, p. 192), Al-Kasani (Hanafi), vol. 5, p. 244, 'Ibn Al-Humam ((Hanafi), vol. 5, p. 109), and 'Ibn 'Abidin ((Hanafi), vol. 4, p. 43 onwards, and noting that the seller has voluntarily forfeited its right to withhold in an agreed installment sale transaction), and § 4.3.9, at pages 119-120 (noting that all four major schools of Islamic jurisprudence consider the installment sale a valid sale arrangement).

³⁵ Al-Zuhayli – El-Gamal, Volume 1, § 3.2.2, at page 57.

³⁶ *Majelle*, Article 252; Al-Zuhayli – El-Gamal, Volume 1, § 3.2.2, at pages 56 and 61-62.

³⁷ *Majelle*, Article 262.

³⁸ *Majelle*, Article 278, which states the rule for transactions of sale for immediate payment. The right of retention may be lost in various circumstances, including where the seller gives delivery without having received the purchase price or where the seller postpones payment of the price after having sold for immediate payment. See, e.g., *Majelle*, Articles 281 and 284, respectively. See, also, Al-Zuhayli – El-Gamal, Volume 1, § 3.2.2, at pages 64-66.

³⁹ *Majelle*, Article 284; Al-Zuhayli – El-Gamal, Volume 1, § 3.2.2.

withhold or retain is voided by the deferral of the payment of the purchase price.⁴⁰

Various types of options (*khiyarat*) are permitted under the *shari'a*, and these options may allow cancellation or ratification of the relevant contract and related transaction.⁴¹ These include, among others, options in respect of: (1) misdescriptions,⁴² (2) selection of property,⁴³ (3) inspection (*al-ru'ya*),⁴⁴ (4) defects,⁴⁵ and (5) payment (including installment payments).⁴⁶

Agreements in respect of sales for immediate payment are concluded by offer and acceptance in the same manner as other agreements for sales, and require that there be a statement as to a determinable quality and quantity.⁴⁷ An essential element to the validity of such a sale agreement is that there be immediate payment at the time of the making of such agreement.⁴⁸

Delivery, for purposes of the *shari'a*, relates to the removal of obstacles by the seller between the purchaser and the object of the sale (the property), allowing the purchaser to take ownership and control of the object.⁴⁹ As a general matter, the purchaser must have full access to or possession of the property with the full permission of the seller under applicable Hanafi, Maliki, and Shafi'i rules, while the Hanbali school is of

⁴⁰ Al-Zuhayli – El-Gamal, Volume 1, § 3.2.2, at page 64, noting that the Hanbali school is of the position that the seller must deliver the property prior to receipt of the purchase price in all cases, including installment sale transactions.

⁴¹ *Majelle*, Article 300; Al-Zuhayli – El-Gamal, Volume 1, chapter 5, at pages 165-231, which discusses the various types of options recognized by each of the four major schools of Islamic jurisprudence (seventeen by the Hanafis, two by the Malikis, sixteen by the Shafi'is, and eight by the Hanbalis). The options must be exercised within a defined time period. *See, Majelle*, Articles 301 – 309.

⁴² *Majelle*, Articles 310 – 312. *See, also, Majelle*, Articles 356 – 360 in respect of misrepresentation and deceit.

⁴³ *Majelle*, Articles 316 – 317.

⁴⁴ *Majelle*, Articles 320 – 335.

⁴⁵ *Majelle*, Articles 336 – 355.

⁴⁶ *Majelle*, Articles 313 – 315.

⁴⁷ *Majelle*, Articles 380 – 387.

⁴⁸ *Majelle*, Article 387.

⁴⁹ Al-Zuhayli – El-Gamal, Volume 1, § 3.2.2, at pages 66-70. This discussion notes that “if a person purchases wheat in a house, and the seller gives him the key to the house saying: ‘I have given you full access and permission to take the object of sale’, then the buyer would have received the object of sale” (pages 66-67), and, in footnote 44, noting that giving full access and permission to the buyer is receipt by the buyer even if the buyer did not literally receive the property. This discussion notes a similar position by the Malikis and the Shafi'is with respect to access and permission, stating that delivery of the keys would constitute access and permission. The Hanbali position, as summarized in that same work, is that possession is determined by the nature of the property. With respect to the Hanbali position in the Kingdom of Saudi Arabia, see McMillen 2001.

the position that the taking of possession is determined in accordance with the nature of the property being sold and purchased.

Residual Interests and *Shari'a* Determinations in the Case Study

In the Securitized Acquisition Financing Transaction, the set of conditions, and time, at which the residual interest becomes the current interest is defined as (a) the payment in full of the Senior Bonds, (b) the payment in full of the Junior Bonds, and (c) the termination of the End User Lease (the date on which such occupational use may commence, the “Commencement of Residual Use”).⁵⁰

The deed of transfer is executed (and recorded) at the present, thus effecting the transfer at the present time, although use is delayed until a specified further time. In the South Korean transaction, as in most transactions, there is significant value to the residual interest: the land is located in a desirable prime location and the End User Lease will terminate in all cases prior to the last day of the useful life of the buildings (and certainly prior to the end of the useful life of the land).

Considering the relevant *shari'a* principles and precepts, the object of the sale (the Project, consisting of the land and buildings) is currently in existence and will be in existence at the Commencement of Residual Use, it has determinable value, it is known to the purchaser, and it otherwise meets the relevant *shari'a* requirements for a valid contract of sale and purchase.⁵¹

⁵⁰ The residual interest itself exists at the time the contract of purchase and sale is made and at the time of the transfer of the ownership of the residual interest; it has value at the time of the making of such contract and thereafter. Thus, at the time of “delivery” (see the further discussion in this section) of the residual interest to the purchaser (which is in the present, at the time of the making of the contract and the execution of the related deed) and thereafter, all benefits appertaining to the residual interest will be for the account of the purchaser.

⁵¹ Absent a total condemnation and taking, which is addressed in the relevant contracts, the land will be in existence at the Commencement of Residual Use. The building may not be in existence, or may be in existence in modified form at the Commencement of Residual Use. If the relevant contract of sale and purchase is otherwise drafted in accordance with the *shari'a* (for example, with respect to maintenance requirements, delineation of property elements constituting the Project and allocation of price to each of such elements, and adjustments to be made to the purchase price in respect of loss, damage, and destruction depending upon causation, compensation, and other relevant factors), the purchase price in an installment sale would be appropriately adjusted in accordance with the assets in existence, and the condition of such assets, at the time of Commencement of Residual Use. The parties would agree on the relevant risk allocation provisions, consistent with the *shari'a*, in the contract of sale and purchase.

Shari'a scholars who were consulted in connection with the Securitized Acquisition Financing Transaction, and other *shari'a* scholars with whom the author has discussed this transaction and other transactions of this type, have indicated that *shari'a* principles applicable to undivided interests and divisible rights in real property would be applicable to the concept of a residual interest in real property and that the concept of a “residual interest” is valid under the *shari'a*. Those scholars have also indicated that *shari'a* principles and precepts applicable to sales generally would be applicable to permit a binding present sale of the entirety of the Project (land and buildings) with delivery of possession and use at a future date.

Delivery of the present residual interest in the Project occurs at the time of the execution of the contract of sale and purchase and the related deed. The purchaser will then have full possession and use of the residual interest, although the purchaser will not have the right to occupational use of the Project until Commencement of Residual Use. The purchaser will be entitled to all value appertaining to the residual interest, and benefits therefrom, and will have all discretionary rights and all burdens with respect to the residual interest from the time of execution of the contract of sale and purchase and the conveyance of the deed. Thus, for *shari'a* purposes (as well as secular purposes) the “key” to the residual interest in the Project will have been delivered at the time of conveyance of the deed even though occupational use will be delayed until Commencement of Residual Use. Thus, for example, if there were a permanent condemnation or taking of the Project after the date of the contract or sale and purchase but prior to the Commencement of Residual Use, the seller would be entitled to compensation for the value of the Project prior to the Commencement of Residual Use, and the purchaser would be entitled to compensation for the value of the Project on and after the Commencement of Residual Use. Similarly, by way of another example, absent contractual limitations the purchaser would be entitled to use the residual interest as collateral for a financing or other obligations and would be exclusively entitled to grant a *rahn* (mortgage or pledge) on the residual interest.

The price for the purchase and sale is established at the time of the execution of the contract for purchase and sale of the Project and is payable in periodic installments during the period from the making of the contract to and including the Commencement of Residual Use. The seller is entitled to use the purchase price payments in its discretion in accordance with the *shari'a*. The payment provisions are structured in accordance with the *shari'a*, including with respect to individualization of the descriptions of the assets comprising the Project, allocation of the purchase price to the various assets, and adjustments to the purchase price in respect of various types of loss, damage, and destruction to those assets. There are also terms with respect to use of the Project during the period prior to the Commencement of Residual Use, including maintenance provisions.

Purchase of the Residual Interest

Returning to a description of the Securitized Acquisition Financing Transaction, the *Shari'a*-Compliant Investor desires to make an investment in the Project. For purposes of the transaction, the *Shari'a*-Compliant Investor will establish a wholly-owned special purpose entity (the “Intermediate Investor Entity”) which, in turn, will own all of the equity in another special purpose entity (the “Investor Entity”).⁵² Pursuant to a residual interest sale and purchase agreement and related agreements, documents, and instruments, including a deed (the “Residual Interest Purchase Agreement”), the Investor Entity acquires all of the residual interest in the Project (the “Residual Interest”) from the Project Owner for an agreed purchase price (the “Residual Interest Purchase Price”). The Residual Interest Purchase Price will be established on the basis of the current value of the Residual Interest.⁵³

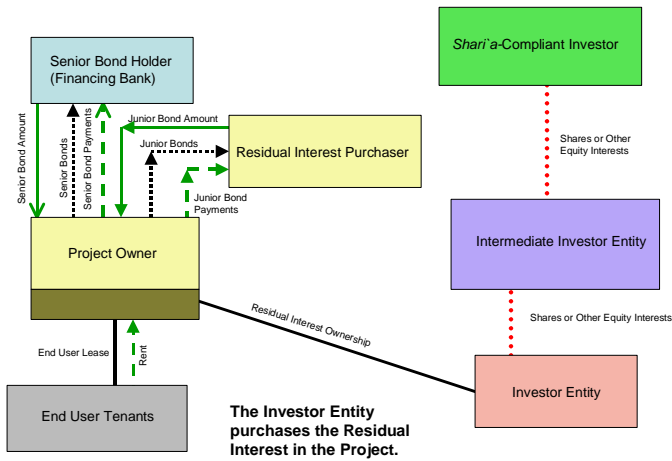


Figure 8. Purchase of the Residual Interest

⁵² The use of both the Intermediate Investor Entity and the Investor Entity is frequently necessitated by applicable real estate laws (including laws pertaining to foreign ownership of real property in a given country), tax laws (including those pertaining to taxation of interests in real property, those pertaining to taxation of sales of stock, and those pertaining to the ability to make payments to offshore entities with the minimum amount of taxation), and other applicable laws.

⁵³ See the section of this essay entitled “Economics and Pricing.”

Sale of Shares in the Investor Entity

After the Investor Entity has acquired the Residual Interest, the Intermediate Investor Entity enters into an equity interest sale and purchase agreement with the Residual Interest Purchaser (the “Equity Interest Sale Agreement”). Pursuant to the Equity Interest Sale Agreement, all of the shares (*hissas*) representing ownership in the Investor Entity are sold to the Residual Interest Purchaser on a deferred purchase basis. The purchase price for these shares (the “Hissa Purchase Price”) is determined by reference to the anticipated value of the Residual Interest.⁵⁴

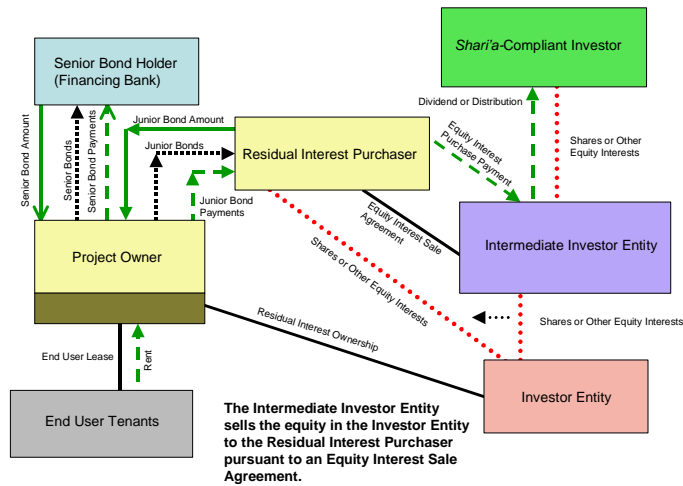


Figure 9. Sale of Residual Interest

Economics and Pricing

The foregoing structural elements allow the *Shari'a*-Compliant Investor to achieve participation in the Project by virtue of the purchase and sale of the residual interest. The exact manner in which the economics and pricing of the component transactions are achieved for the *Shari'a*-Compliant Investor will depend upon many factors and varies from jurisdiction to jurisdiction, and from transaction to transaction, and is subject to complicated economic and pricing determinations based upon the existing facts. Matters in respect of the primary component transactions that

⁵⁴ Ibid.

are subject to economic and pricing factors are: (a) establishing the absolute amount of the Junior Amount at the inception of the transaction; (b) establishing the structure, terms, and tenor of the Junior Bonds, including the interest rates payable on the Junior Bonds; (c) establishing the purchase price for the residual interest at the time the residual interest is purchased by the Investor Entity from the Project Company; and (d) establishing the purchase price of the shares in the Investor Entity at the time that those shares are sold by the Intermediate Investor Entity to the Residual Interest Purchaser.⁵⁵

A few examples of the factors affecting the economics and pricing of the component transactions will illustrate the complexity of structuring a transaction of this type.

In certain jurisdictions as a matter of law, and in certain transactions as a matter of business and political considerations, real estate interests (such as the residual interest) can be owned and held only by local (here, South Korean) entities and not by foreign entities. In any such circumstance, both the Investor Entity and the Residual Interest Purchaser will have to be established as local entities. Similarly, securitization, tax, collateral security, and other laws may require that the holder of Junior Bonds must be a local entity rather than a foreign entity.

Tax laws will affect the structuring at various points. Taxation and recordation requirements pertaining to interests in real property (such as the residual interests in the Project), particularly where those interests are held by a local (South Korean) entity may have a greater or lesser burden on the economics of the transaction from the vantage of the *Shari'a*-Compliant Investor than sales of shares in a local entity (such as the Investor Entity), particularly where the sale of the shares is made offshore. Other legal, business, and political considerations may make it more palatable to sell shares in the Investor Entity offshore rather than attempting to have an offshore entity purchase real estate interests (the residual interests in the Project). Tax (and other) laws applicable to offshore share sales to an onshore entity must be compared with tax (and other) laws applicable to purchases of onshore real estate interests by offshore entities and to sales of onshore real estate interests by an offshore entity to an onshore entity.

One of the most difficult aspects of a transaction such as the South Korean case study involves the determinations of (a) the economic

⁵⁵ There are other similar matters in respect of the component transactions that relate to “closing out” the overall transaction (*e.g.*, the sale of the residual interest, the shares in the Investor Entity, or the shares of the Project Company after the Commencement of Residual Use). *See* “Closing Out the Transaction.” However, the structure was designed to ensure flexibility at the time of Commencement of Residual Use so that determinations and allocations made at the commencement of the financing transaction would not unduly restrict available alternatives at the time of Commencement of Residual Use. Thus, this essay does not focus on the economics and pricing of these “closing out” transactions.

contributions to be made by the Residual Interest Purchaser in respect of the Junior Amount, (b) the pricing of the sale and purchase by the residual interest in the Project by the Investor Entity, and (c) the pricing and sale of the shares by the Intermediate Investor Entity to the Residual Interest Purchaser. The sum total of the Junior Amount and the purchase price of the residual interest in the Project (the “Investor Total Contribution”) is the total investment by the *Shari'a*-Compliant Investor.⁵⁶

If the Senior Amount is a specified percentage of the purchase price for the Project that is paid to the Seller (say, 70 percent), there is a mandatory requirement as to the minimum amount of the Investor Total Contribution at the inception of the Project (*i.e.*, 30 percent). The *Shari'a*-Compliant Investor will be resistant to payment of more than the required minimum amount of the Total Investor Contribution as it will not desire to have excess capital in the transaction and an attendant diminution in the efficiency of the deployment of its capital. On the other hand, the concept of, and requirements pertaining to, the Junior Bonds will exert pressure on the structure to maximize the portion of the Investor Total Contribution that is contributed to the transaction through the Residual Interest Purchaser as a portion of the Junior Amount.

In a jurisdiction where it is possible to structure the Junior Bonds as an equity equivalent (*i.e.*, the Junior Bond payments are truly the excess of rent over (a) operating costs, (b) reserve fundings, and (c) Senior Bond payments), the pressure to contribute through the Residual Interest Holder as part of the Junior Amount is considerably alleviated. Further alleviation of the pressure to contribute through the Residual Interest Purchaser as part of the Junior Amount results from the fact that the Ultimate Tax Owner is entitled to depreciation, certain available tax credits, and possibly other tax incentives (collectively, “Depreciation and Tax Benefits”). To the extent that the Ultimate Tax Owner realizes depreciation and tax benefits, particularly in the early periods of the overall transaction, there is a greater amount of cash available to the Residual Interest Purchaser for payments in respect of the Share Sale Price.

Each of these considerations, in turn, allows significantly greater flexibility in structuring the transaction (1) to increase the amount paid by the Investor Entity in respect of the Residual Interest and (2) to increase the

⁵⁶ The *Shari'a*-Compliant Investor will have to fund the Junior Amount by getting money, directly or indirectly, into the Residual Interest Purchaser. The *Shari'a*-Compliant Investor may not hold an equity interest in the Residual Interest Purchaser because the Junior Bonds will bear a rate of interest and because the Residual Interest Purchaser will hold an actual or constructive equity interest in the Project Owner (the Project Owner will have non-conforming obligations on the Senior Bonds as well as the Junior Bonds and the Project Owner will be a party to a non-compliant End User Lease with an End User Tenant in a non-conforming business). A *qard hassan*, non-interest-bearing loan, from the *Shari'a*-Compliant Investor or the Intermediate Investor Entity is one alternative solution to this issue.

amount of the Share Sale Price payable by the Residual Interest Purchaser to the Intermediate Investor Entity in respect of the sale and purchase of the Investor Entity Shares. That increased flexibility, in turn, allows the transaction to be structured more precisely in accordance with the most beneficial interpretation and use of tax laws (including differentials between tax laws applicable to real estate and share sales) and other applicable laws.

Closing Out the Transaction

As final steps in the overall transaction, the structure must consider how the transaction might proceed on and after the Commencement of Residual Use. At such time, by definition, the Senior Bonds will have been paid in full, the End User Leases with the non-conforming End User Tenants will have terminated, and, if the Junior Bonds are not pure equity for *shari'a* purposes, the Junior Bonds will have been paid in full. The structure of the Securitized Acquisition Financing Transaction allows for a number of alternatives on and after Commencement of Residual Use. First, the End User Leases can be structured as leases that conform with the *shari'a* and End User Tenants that operate in accordance with the *shari'a* can be obtained. This will allow for restructuring of the transaction to allow direct ownership of the Project Owner by or on behalf of the *Shari'a*-Compliant Investor. If the *Shari'a*-Compliant Investor desires to own and hold the Project, the Residual Interest can be sold directly to the *Shari'a*-Compliant Investor (directly or indirectly by sale to the Intermediate Investor Entity or the Investor Entity). Alternatively, various share ownership transfers are available for consideration, including a transfer of the shares in the Investor Entity to the *Shari'a*-Compliant Investor or one or more of its affiliates. The various possibilities can be structured into the relevant documentation at the beginning of the transaction, allowing the *Shari'a*-Compliant Investor, directly or indirectly, to choose that alternative or set of alternatives that is most advantageous (including in respect of taxation) at the time of effectuation of the various transfers.

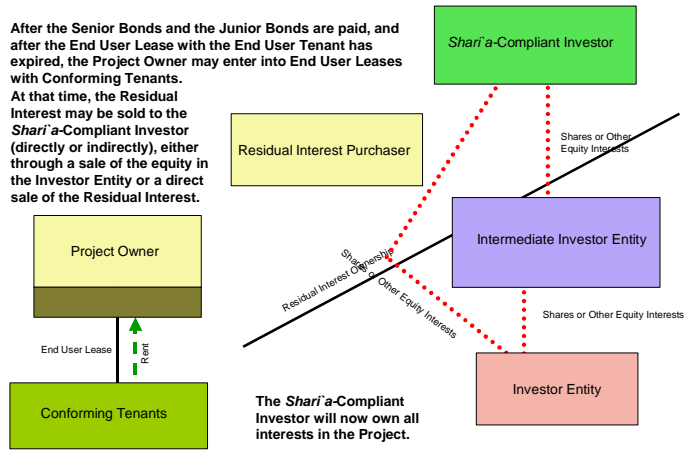


Figure 10. Conforming Tenant and Sale of the Project

STRUCTURING FROM FIRST PRINCIPLES

To the date of this essay, the application of securitization concepts in Islamic finance has been through the use of *sukuk* structures. As noted in this essay, the *sukuk* structures are akin to “pass through” asset-backed securities in the conventional markets in that they focus on fractional undivided ownership of assets and current cash flows relating to the use of those assets. That focus seems to preclude *shari'a*-compliant securitizations in transactions involving interest-based financing. The great bulk of financings in the world, be they of real estate, equipment, intellectual property, or other assets, involve interest-based financing. The result may be that the Islamic financing industry will not be able to participate in the great bulk of financings in the world. And that is the proper result if participation in those financings cannot be effected in compliance with the *shari'a*.

Developments in thinking of *shari'a*-compliant uses of the *sukuk* have been gratifying and highly creative, even as embodied in the initial and elementary structures used to date. These developments give a glimpse of a bright future. Further thinking about the use of the *sukuk* structure will undoubtedly result in greater refinements and sophistication, coverage of a wider range of assets, and significant advances in the range of *shari'a*-compliant products. The *sukuk* structure should be, and will be, a primary focus of efforts in the Islamic finance industry for years to come.

But is the *sukuk* structure the only structure to be considered for approaching the concept of securitization? This essay takes the position that the *sukuk* is not the only structure to be considered in thinking about securitization.

This essay takes the position that the Islamic finance industry should reconsider the entirety of Islamic jurisprudence and the *shari'a* in considering the development of an Islamic economy constituted by a truly diversified range of product offerings. It is important to note what the term “reconsider” does not mean, as well as what it means. Reconsideration does not reject the traditional learning or experience or seek to modify that learning or experience. It means consider again, examine again, and entails a return to the historical learning rather than a rejection of that learning. It means that examination should proceed from well-established traditional and conventional *shari'a* principles, precepts, and concepts. It means a return in order to achieve a thorough understanding in the context of present circumstances. The examination should be based upon first principles that have long been accepted in Islamic jurisprudence and scholarship. Creative structuring should be based upon a sound historical and jurisprudential base. The scholarship and wisdom of our forefathers should weigh heavily in the analysis and the creative efforts of the present.

In the context of *shari'a*-compliant securitizations, this essay focuses on one small aspect of the broad spectrum of principles, precepts, and concepts that should be reconsidered, namely the nature and components of “property” and “assets.” It challenges the Islamic finance industry to start with the basic questions relating to the nature of property and assets: What is “property”? What is an “asset”? How can the essential elements of property be reconfigured in the context of a sophisticated modern financing? How can the nominated contracts be applied to these traditional concepts in new ways?

Further, this essay is intended to challenge the conventional wisdom that it is not possible to effect *shari'a*-compliant securitizations if interest-based financing is present somewhere in the transaction. Careful structuring of *shari'a*-compliant transactions in other contexts has demonstrated that the presence of interest-based financing is not itself preclusive of involvement of devout Muslim investors.⁵⁷ Careful structuring of transactions in the securitization realm should make the development of

⁵⁷ See, for example, the discussions of current transactions at Michael J. T. McMillen, “Shari'a-Compliant Finance Structures and the Development of an Islamic Economy,” *The Proceedings of the Fifth Harvard University Forum on Islamic Finance: Islamic Finance: Dynamics and Development* (2003), 89–102; McMillen 2001; and Michael J. T. McMillen, “Islamic Shari'a-Compliant Project Finance: Collateral Security and Financing Structure Case Studies,” *The Proceedings of the Third Harvard University Forum on Islamic Finance: Local Challenges, Global Opportunities* (2000), 111-131.

shari'a-compliant securitization structures equally tenable despite the presence of interest-based financing in the broader transaction.

This essay considers a case study, the Securitized Acquisition Financing Transaction, in which a structure was developed in the context of interest-based financing as required by secular South Korean securitization laws in a transaction in which the End User Leases were not compliant with the *shari'a* and the End User Tenants were in businesses that are not *shari'a*-compliant (non-mutual insurance and interest-based lending). The structure that was developed focuses on the essential nature of “property” under both the *shari'a* and secular law. The development of the structure began with basic concepts of property that are considered by first year law students and sought to make use of those concepts in a modern transactional context. The structure that was developed allows the cash flows from a single rent stream to be structured to service “at least two different stratified risk positions or tranches reflecting different degrees of risk” with payments to investors depending “upon the performance of the specified underlying exposures, as opposed to being derived from an obligation of the entity originating those exposures.”⁵⁸ While the Securitized Acquisition Financing Transaction involved “securitization” of the cash flows from a single property and asset, the transaction was also considered and structured with cognizance of methods of pooling that are used to provide for risk diversification, and the transaction was structured so as to be compatible with pooling securitizations.

The particulars of the structure presented for the Securitized Acquisition Financing Transaction are not presented for their own sake, they are not presented to provide a roadmap for effecting a transaction, although it is the author’s hope that the particulars are of assistance to practitioners in the Islamic financing industry in thinking about creative approaches to *shari'a*-compliant securitizations.

The case study is presented to illustrate the concept, and the importance, of reconsideration and application of first principles, to illustrate that the wisdom and experience of the past is pertinent to the present and the future, and to challenge the Islamic finance industry to study and understand the body of knowledge that is the inheritance of the entire industry. The Islamic finance industry continues to develop into new and more challenging areas. The product base of *shari'a*-compliant products continues to expand, and the products continue to deeper and more complex levels of sophistication. The pace of development is increasing. The form of the Islamic economy is evolving and achieving greater penetration in financial markets throughout the world. The industry must remain firmly rooted in its base even as it becomes more creative and the debate intensifies with respect to what is appropriate in any given transactional

⁵⁸ Basel II Accord, section 502.

context. Hopefully, this essay will contribute to the debate, even initiate further debate.