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# *Sukuk* (Islamic Bonds and Securitizations): Toward A Viable Capital (Including Secondary) Market

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One of the most active areas of Islamic finance involves the issuance of *sukuk* (Islamic bonds and securitizations). These issuances not only form the base for the development of a *shari'a*-compliant capital market, but also, potentially, the base for the development of secondary markets for *shari'a*-compliant instruments. Most *sukuk* issuances to date constitute Islamic bonds, rather than true asset securitizations. The credit base for these issuances is not an asset pool, as would be the case in a true securitization. Rather, it is the credit of an operating entity (most frequently a sovereign). In order to achieve success in the development of capital markets and secondary markets, and benefits of asset securitizations, *sukuk* issuances will need to be structured as true asset securitizations that are broadly distributed across both Islamic finance and the conventional finance markets. While governmental and government-sponsored entities perform critical functions in the establishment and growth of capital markets and secondary markets, they are far from sufficient. Achieving the desired results is dependent upon broad and sustained private sector involvement that in turn is dependent upon the ability to obtain ratings for the *sukuk* issuances from the most prominent rating agencies.

This essay first surveys some of the generic *sukuk* structures now in use or being contemplated for use in the near future. The essay then considers a case study implementing features from these generic structures, the Bahrain Financial Harbour *Sukuk*. The essay then turns to a consideration of some of the factors that impede or inhibit the growth of

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Islamic capital markets (including secondary markets). Various market-related factors are noted. Thereafter, legal factors are considered, including systemic, structural, and operational function factors and factors pertaining to the enforcement of the *shari'a* in both purely secular jurisdictions that do not incorporate the *shari'a* to any extent in the secular law of the nation, and jurisdictions that do incorporate the *shari'a* to some extent in the secular law. With respect to the former jurisdictions, the essay considers the implications of the English appellate case, *Shamil Bank v. Beximco*. With respect to the latter jurisdictions, the essay focuses on structural, systemic, and legal opinion issues, including those of particular relevance to asset securitization *sukuk* such as (1) true sale, (2) non-consolidation, (3) bankruptcy remoteness, (4) the necessary collateral security structure, (5) enforceability of agreements, (6) choice of law, and (7) enforcement of judgments and awards.

## *SUKUK* (ISLAMIC BONDS AND SECURITIZATIONS)

### Introduction to *Sukuk* Structures

*Sukuk* issuance currently is one of the fastest growing areas of Islamic finance.[2] *Sukuk* are frequently referred to as "Islamic bonds." A more

[2] As an indication, during 2006 Dow Jones and Citigroup recently launched the "Dow Jones Citigroup Sukuk Index." *Sakk* (plural: *sukuk*) means, in ancient Arabic, "to strike" or "to hit," as in to strike or imprint one's mark on a document or tablet. As a derived term it means "minting coins." While the *sukuk* concept has deep roots in the history of Islamic finance, the current structural formulations are a product of the "jurisprudence of transformation and adaptation" of modern Islamic finance that has emerged since the 1980s wherein the classical system of nominate contracts (*'uqud masammat*) is viewed as a set of building blocks rather than as complete and immutably static transactional formulations and structures in and of themselves (with evolutionary effects on the classical system of transactions (*mu'amalat*)). See Yusuf Talal DeLorenzo and Michael J. T. McMillen, "Law and Islamic Finance: An Interactive Analysis," in *Islamic Finance: The Regulatory Challenge*, ed. Rifaat Abdel Karim and Simon Archer (John Wiley & Sons, 2007) (hereafter cited as DeLorenzo and McMillen, "Law and Islamic Finance"). Other examples of the reconfiguration of the nominate contracts in recent times can be found in Abdulkader Thomas, et al., *Structuring Islamic Finance Transactions* (Berlin: de Gruyter Recht, 2005). For more detailed discussions of issues relating to the implementation of *sukuk* as capital markets instruments, see Michael J. T. McMillen, "Contractual Enforceability Issues: *Sukuk* and Capital Markets Developments," *Chicago Journal of International Law* 7 (2007): 1-41 (hereafter cited as McMillen, "Contractual Enforceability"); McMillen, "Islamic Capital Markets: Developments and Issues," *Capital Markets Law Journal* 1 (2006): 136-172 (hereafter cited as McMillen, "Islamic Capital Markets"); and DeLorenzo and McMillen, *Law and Islamic Finance*, 154-187.

accurate descriptive analogy, from conventional securitization finance and taking cognizance of ownership attributes, would be "pass-through certificates" [3] or "investment certificates." [4] Thus, a *sakk* represents a proportional or fractional undivided ownership interest in an asset or pool of assets or an investment venture or operating venture.

*Sukuk* are of two general types: Islamic bonds and Islamic asset securitizations. Islamic bonds are based upon the credit of an entity that is

[3] Descriptions of various conventional securitization structures are contained in Frank J. Fabozzi, ed., *The Handbook of Mortgage-Backed Securities* (New York: McGraw-Hill, 2001). For an interesting comparison of the earliest securitizations with more recent securitization trends, compare the 2001 revised edition with the 1985 version of the same title.

For literature analyzing the benefits of asset securitization, see Joseph C. Shenker and Anthony J. Colletta, "Asset Securitization: Evolution, Current Issues and New Frontiers," *Texas Law Review* 69 (1990-1991): 1383-1405 (hereafter cited as Shenker & Colletta, "Asset Securitization"); James A. Rosenthal and Juan M. Ocampo, "Analyzing the Economic Benefits of Securitized Credit," *Journal of Applied Corporate Finance* 1 (1992): 32 (hereafter cited as Rosenthal & Ocampo, "Securitization Benefits"); Steven L. Schwarcz, "The Alchemy of Asset Securitization," *Stanford Journal of Law, Business & Finance* 1 (1994-1995): 133 (hereafter cited as Schwarcz, "Alchemy of Securitization"); and Robert Dean Ellis, "Securitization Vehicles, Fiduciary Duties, and Bondholder's Rights," *Journal of Corporate Law* 24 (1998-1999): 295. The foregoing, and Schwarcz, "The Universal Language of International Asset Securitizations," *Duke Journal of International & Comparative Law* 12 (2002): 285 (hereafter cited as Schwarcz, "International Securitization"), provide readable introductions to securitization concepts, structures, and issues. See also Schwarcz, "Securitization Post-Enron," *Cardozo Law Review* 25 (2003-2004): 1539. Although limited to commercial mortgage-backed securitizations, the U.S. CMBS Legal and Structured Finance Criteria of Standard & Poor's (2003, with updates) (hereafter cited as *S&P Rating Criteria*) provides a comprehensive and detailed presentation of the many issues that must be considered and resolved if asset securitization *sukuk* are to be posited as a backbone of an Islamic capital market. For a good overview of a wide range of conventional securitization issues and current European practice in the commercial mortgage-backed securities markets, see Andre V. Petersen, ed., *Commercial Mortgage-Backed Securitization: Developments in the European Market* (Sweet & Maxwell, 2006) (hereafter cited as Petersen, *CMBS*).

Examples of the literature pertaining to specific types of securitizations include Patrick D. Dolan, "Lender's Guide to Securitization of Commercial Mortgage Loans," *Banking Law Journal* 115 (1998): 597; Dolan, "Securitization of Equipment Leases," *New York Law Journal* (August 11, 1999): 1; Dolan, "Lender's Guide to the Securitization of State Lottery Winnings and Litigation Settlement Payments," *Banking Law Journal* 115 (1998): 710; and Charles E. Harrell, et al., "Securitization of Oil, Gas, and Other Natural Resource Assets: Emerging Financing Techniques," *Business Lawyer* 52 (1996-1997): 885.

[4] See Rodney Wilson, "Overview of the *sukuk* market," in *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk*, eds. Nathif J. Adam and Abdulkader Thomas (Euromoney Books, 2004), 3.

participating in the transaction (the issuer, guarantor, or other credit support provider) rather than on specific assets and cash flows derived from those assets. Asset securitizations involve asset transfers from an originator into a trust or similar special purpose vehicle with *sukuk* issuance by that trust or vehicle and payments on the *sukuk* derived from the payments received with respect to those transferred assets. Most *sukuk* offerings to date have been of the bond type, and the ultimate credit in most of those bond offerings has been a sovereign entity. There have been very few true securitizations, largely because of the inability to obtain ratings from major international ratings firms for securitization *sukuk* issuances (ratings have been obtained for the sovereign bond issuances based upon the rating of the sovereign credit).

In 2003, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) issued the Standard for Investment *Sukuk* ("AAOIFI *Sukuk* Standard").[5] It defines *sukuk* as certificates of equal value put to use as common shares and rights in tangible assets, usufructs, and services, or as equity in a project or investment activity. The AAOIFI *Sukuk* Standard carefully distinguishes *sukuk* from equity, notes, and bonds. It emphasizes that *sukuk* are not debts of the issuer; they are fractional or proportional interests in underlying assets, usufructs, services, projects, or investment activities. *Sukuk* may not be issued on a pool of receivables. Further, the underlying business or activity, and the underlying transactional structures (such as the underlying leases), must be *shari'a*-compliant (the business or activity cannot engage in prohibited business activities, for example).

The AAOIFI *Sukuk* Standard provides for 14 eligible assets classes. In summary, there are securitizations: (1) of an existing or to-be-acquired tangible asset (*ijara* – lease); (2) of an existing or to-be-acquired leasehold estate (*ijara*); (3) of presales of services (*ijara*); (4) of presales of production of goods or commodities at a future date (*salam* – forward sale); (5) to fund construction (*istisna'a* – construction contract); (6) to fund the acquisition of goods for future sale (*murabaha* – sale at a mark-up); (7) to fund capital participation in a business or investment activity (*mudaraba* and *musharaka* – types of joint ventures); and (8) to fund various asset acquisition and agency management (*wakala* – agency), agricultural land cultivation, land management, and orchard management activities.

Some of the foregoing types of *sukuk* bear predetermined returns; others allow for the sharing of profit and, in some instances, loss. To date,

[5] *Shari'a* Standard No. 17 in *Shari'a Standards: The Full Text of Shari'a Standards as at Rabi' 1425H – May 2004* (Accounting and Auditing Organization for Islamic Financial Institutions, 2004).

most issued *sukuk* have been *sukuk al-ijara* bearing predetermined rates of return. The *sukuk al-musharaka* and the *sukuk al-mudaraba* are examples of profit- and loss-sharing *sukuk*.

Market participants desire to issue asset securitization *sukuk* in the near future.[6] A major challenge in implementing that desire is the ability to obtain ratings from major international ratings agencies on transactions that are dependent, at any level, upon laws in jurisdictions within the Organization of the Islamic Conference (OIC) and other jurisdictions and economies that desire to use *shari'a*-compliant financing techniques as their primary economic form (the *Islamic Economic Sphere*—jurisdictions and economies that use primarily interest-based financing techniques as their primary economic form are referred to as the *Western Economic Sphere*). The main impediments are discussed later in this essay and relate to characteristics of the relevant legal systems and the inability to obtain satisfactory legal opinions with respect to a range of enforceability issues, including true sales of assets and various bankruptcy law matters. Considerable legal reform is necessary in many jurisdictions to ensure sufficient certainty, predictability, consistency, and transparency in order to allow market and transactional participants to make risk assessments with comfort and confidence and to allow lawyers to render the necessary legal opinions. Absent the ability to make such assessments and obtain such opinions, the asset securitization *sukuk* market, and Islamic capital markets generally, will remain severely constrained.

Implementation of legal reform is a slow process (and, as a result, the movement toward securitization *sukuk* is likely to be a gradual process). However, there are organized efforts to define the necessary legal reforms. For example, the Islamic Financial Services Board (IFSB) is undertaking a broad survey of trust laws, securities laws, capital markets laws, and bankruptcy laws in an effort to identify and suggest necessary legal reforms so as to facilitate the development and growth of capital markets, including *sukuk* issuances and secondary trading. Efforts of this type hold the potential to ease constraints on the issuance of securitization *sukuk* in the Islamic Economic Sphere.

It seems probable that the initial asset securitization *sukuk* issuances will emanate from United States and European jurisdictions. These are likely to be securitizations of assets in those jurisdictions, rather than assets located in jurisdictions within the Islamic Economic Sphere.[7] The reasons

[6] For a discussion of the benefits of asset securitizations, see Rosenthal & Ocampo, "Securitization Benefits," and Schwarcz, "Alchemy of Securitization." See also Michael S. Gambro, "Selected Legal Issues Affecting Securitization," *North Carolina Banking Institute* 1 (1997): 131, and McMillen, "Contractual Enforceability,": 3-4.

[7] Prohibitions on *riba* (roughly translated as "interest") and on the sale of instruments that do not represent fractional undivided ownership interests in tangible assets present

for this are: (1) increased involvement in Islamic finance by international banks and investment banks; (2) those institutions have substantial *shari'a*-compliant assets (such as leased equipment and real estate) that are desirable investments for *shari'a*-compliant investors; (3) those institutions have significant securitization experience; and (4) importantly, those institutions can obtain the necessary ratings because the transactions can be structured entirely within jurisdictions where necessary legal opinions are readily obtainable. Unrated securitization *sukuk* may involve assets in jurisdictions within the Islamic Economic Sphere, but the issuers of those *sukuk* are likely to be located outside such jurisdictions in order to minimize true sale, bankruptcy and other enforceability issues. However, the market for unrated *sukuk* is likely to be dwarfed by the market for rated *sukuk* in the medium to long term.

In anticipation of the development of securitization *sukuk* (including whole business securitizations), this essay undertakes a general survey of the generic structures that will be used, or adapted for use.

## Generic *Sukuk al-Ijara* Structures

The most widely used *shari'a*-compliant structure in real estate, equipment, and private equity finance is the *ijara* structure depicted in Figure 1 below.[8] In an asset acquisition, the Funding Company will

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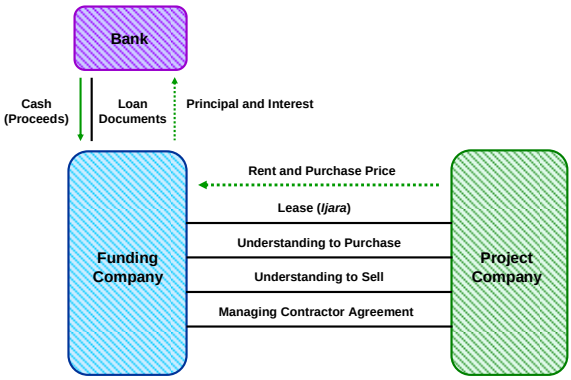
a seemingly insurmountable problem for securitization of many categories of conventional receivables, such as conventional mortgages and credit card receivables. Many of these receivables will never be made *shari'a*-compliant in and of themselves, but it seems likely that bifurcated structures will be developed to securitize these assets (just as conventional interest-based financing is now used in most international *shari'a*-compliant real estate and private equity financings).

[8] See McMillen, "Islamic Shari'ah-Compliant Project Finance: Collateral Security and Financing Structure Case Studies," *Fordham International Law Journal* 24 (2000-2001): 1184 at 1237-63 (hereafter cited as McMillen, "Fordham Project Finance Structures"); McMillen, "Islamic Shari'ah-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* (Cambridge: Harvard Islamic Finance Information Program, 2000), 111-31 (hereafter cited as McMillen, "Harvard Project Finance Structures"); and McMillen and Abradat Kamalpour, "An Innovation in Islamic Financing—Islamic CMBS" in Petersen, *CMBS*, 382-412 (hereafter cited as McMillen and Kamalpour, "Islamic CMBS"). McMillen, "Fordham Project Finance Structures" and McMillen, "Harvard Project Finance Structures," discuss the standard *ijara* structure in its earliest incarnations. McMillen and Kamalpour, "Islamic CMBS," focuses on basic *sukuk* structures using *ijara*, *murabaha* (sale at a mark-up), *mudaraba*, and *musharaka* structures. Many variations on this structure have been used, with particular adaptations as a result of tax and real estate regimes in different countries.

acquire the asset (usually from a third party) with conventional loan funds and equity from the Project Company (in which the *shari'a*-compliant investors make an investment). In a private equity transaction, the loan proceeds will allow the Funding Company to purchase some assets (usually much less than all of the operating assets) from the Project Company. In any case, the Funding Company will then lease the assets it holds to the Project Company pursuant to the Lease (*Ijara*). Pursuant to the Understanding to Purchase, the Funding Company (at the direction of the Bank) will be entitled to cause the Project Company to purchase the assets in certain circumstances (such as defaults). Pursuant to the Understanding to Sell, the Project Company will be entitled to purchase the assets in certain circumstances (voluntary retirements of the *sukuk* or sale of the asset to third parties). The purchase price under the Understanding to Purchase and the Understanding to Sell will be equal to the outstanding principal amount of the loan from time to time.

**Figure 1: Generic *Ijara***

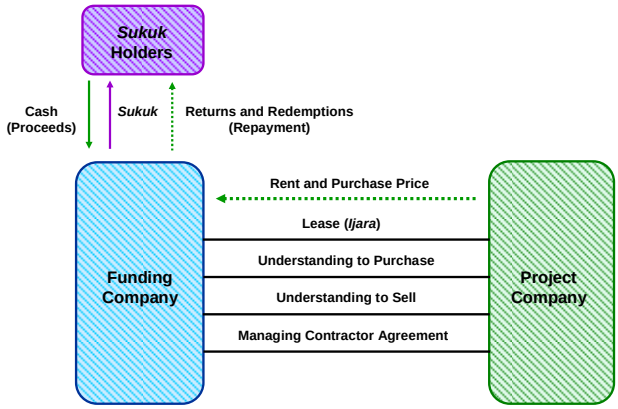



This structure can easily be converted to a number of different securitization structures. Figure 2 depicts a generic *ijara sukuk* in which the conventional interest-bearing loan by the Bank to the Funding Company is replaced by having the Funding Company engage in a *sukuk* issuance.[9] Rent from the Lease (*Ijara*) will provide periodic payments on the *Sukuk* and the payment of the purchase price under the Understanding

[9] Bankruptcy and other considerations may necessitate the insertion of a special-purpose issuance vehicle between the Funding Company and the *Sukuk* Holders; this modification is not illustrated. Throughout this essay, capitalized terms used in discussing specific structures and not otherwise defined are defined by reference to the Figure.

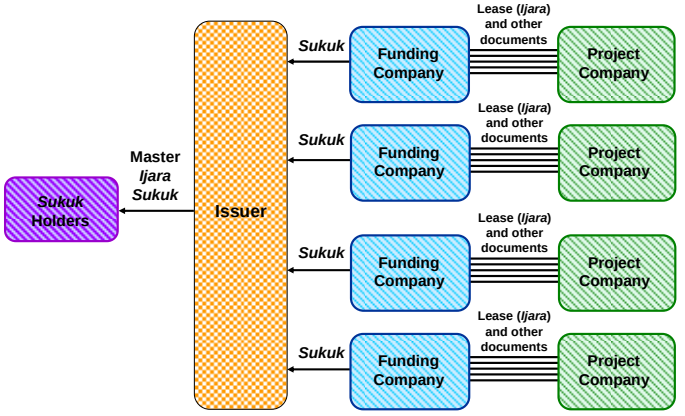
to Purchase or Understanding to Sell will be used to make payment of the outstanding principal amount of the *Sukuk* in mandatory or elective retirements of the *Sukuk* or a sale of the asset to a third party.

**Figure 2: Generic *Ijara Sukuk***




Pooling opportunities are also afforded by this structure, as illustrated in Figure 3. For example, each Funding Company could issue a *Sukuk* to the Issuer, who would then issue a different Master *Ijara Sukuk* to the *Sukuk* Holders.

**Figure 3: Generic Pooled *Ijara Sukuk***



In each of these structures, the rental stream from the various Leases (*Ijara*) can be structured to produce a precise cash flow on the *Sukuk* (and Master *Ijara Sukuk*), fixed or variable, based upon an amortization schedule or a bullet repayment. Another common adaptation allows creation of *sukuk* that have economic qualities similar to standard bonds, and these structures are currently common in the market. The structures are amenable to modification to achieve different accounting and tax results (such as ownership by either the Funding Company or the Project Company, as desired). As a general statement, trading in debt above or below par is an impermissible violation of *riba* precepts (being interest). On the other hand, the ability to trade freely in capital market instruments is critical for the creation of liquidity. The resolution of the apparent *riba* issue lies in the fact that an *ijara sukuk* represents a fractional undivided ownership interest in the underlying tangible assets rather than pure debt. Therefore, those *sukuk* can be traded above or below par as tangible asset trades.

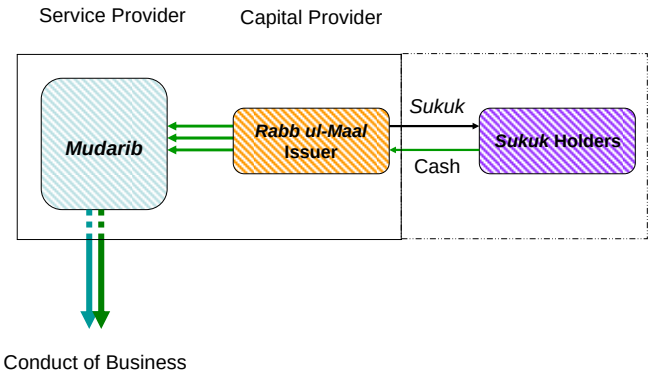
There are some limitations to the use of the *ijara sukuk*. For example, many originators do not own appropriate underlying assets that are subject to *shari'a*-compliant leases or can be made available for such leases during the *sukuk* term, and in many jurisdictions, there are significant adverse tax consequences (such as transfer taxes) associated with the introduction of the assets into a *sukuk* structure.

*Ijara sukuk* transactions to date have not been true pooled securitizations. They have used a limited number of discrete assets and are rated, not on the basis of pooled asset performance, but on the basis of the ultimate credit, the lessee, and the ultimate purchaser of the asset at maturity or default. Thus, most transactions to date are akin to bond financings.

### Generic *Sukuk al-Mudaraba* Structures

The *mudaraba* structure may also be incorporated into a *sukuk* offering in a number of different variants of the *sukuk al-mudaraba*. A generalized generic form of a *sukuk al-mudaraba* is set forth in Figure 4.

**Figure 4: Generic *Sukuk al-Mudaraba***



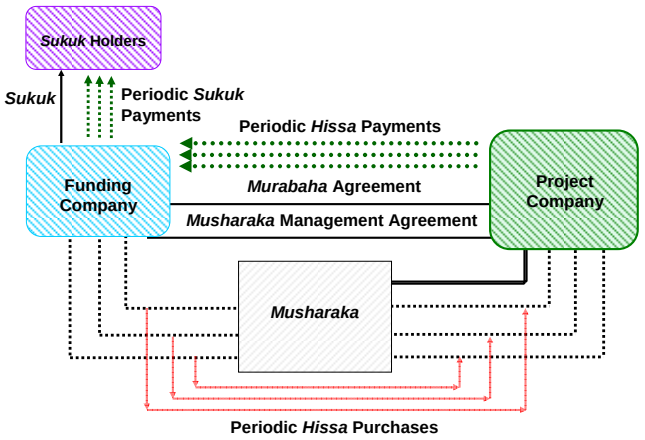

In the standard *mudaraba* structure, the *Mudarib* provides services and the *Rabb al-Mal* provides capital. In the *sukuk al-mudaraba*, the capital-contributing *Rabb al-Mal* Issuer obtains the capital by issuing a *Sukuk* to the *Sukuk* Holders. This is similar to a limited partnership or limited liability company. However, the *shari'a* principles applicable to allocations and distributions of profits and losses and the permissibility of capital contributions by the *Mudarib* will be quite different from secular limited partnerships or limited liability companies. Despite such differences, with careful tax structuring there are opportunities to allow the *Sukuk* Holders to achieve partnership tax treatment in this type of structure in some jurisdictions.

In investment funds, this *mudaraba* may constitute the entirety of the fund. In operating businesses, this may also be the only entity necessary for the conduct of the relevant business. In more complex project financings, this *mudaraba* will likely enter into joint venture and/or other contractual arrangements with other parties, such as project sponsors and other project participants. In current practice, however, the *sukuk al-mudaraba* is infrequently encountered. Some of the reasons relate to the fact that this is a partnership arrangement and institutional financiers tend to retain the view that their financing should be preferentially paid rather than being subject to the vagaries of successful operation of the enterprise, particularly where the venture is controlled by the client (*mudarib*) rather than by the financing institution. And this perception has not been limited to Western interest-based financing institutions. The successful use of the *sukuk al-musharaka* may change this perception on a broader basis.

## Generic *Sukuk al-Musharaka* Structures

The Funding Company and the Project Company may form a *musharaka* joint venture to undertake a business venture. The *musharaka* may attain the advantages of *sukuk* financing by including the issuance of a *sukuk al-musharaka* in this structure. Each party may contribute capital to the *musharaka*. Each of the partners receives "units" or "*hissas*" in the *musharaka* in accordance with their respective capital contributions. The Funding Company's capital contribution is in cash and equals the proceeds of the *sukuk* issuance. The contribution of the Project Company may be in kind and in cash. A generic *musharaka* structure is depicted in Figure 5.

**Figure 5: Generic *Sukuk al-Musharaka***




The *Musharaka* will be managed by the Project Company pursuant to the *Musharaka* Management Agreement. The parties will also enter into a *Murabaha* Agreement (or other purchase agreement) pursuant to which the Project Company will purchase *hissas* owned and held by the Funding Company from time to time on specified dates during the term of the *sukuk*. The Funding Company will receive profit distributions from the *musharaka* and the proceeds from sales of the *hissas* to the Project Company, which are distributed to the *Sukuk* Holders in accordance with agreed formulas.

One of the earliest transactions of this type was a 1997 Saudi transaction with respect to electric generation and transmission assets.[10] Three banks contributed both fixed and variable rate financing for the

[10] See McMillen, "Fordham Project Finance Structures," 1184-1236.

construction of the assets by purchasing *hissas* in an undisclosed *sharikat mahassa* (the *musharaka*) as construction milestones were completed. One bank acted as the administrative and finance manager of the *sharika*, and the electric utility acted as the technical manager of the *musharaka*. At defined times, in accordance with a financing amortization schedule, *hissas* were sold by the banks to the utility pursuant to a *murabaha* agreement in order to effect repayment of the financing.

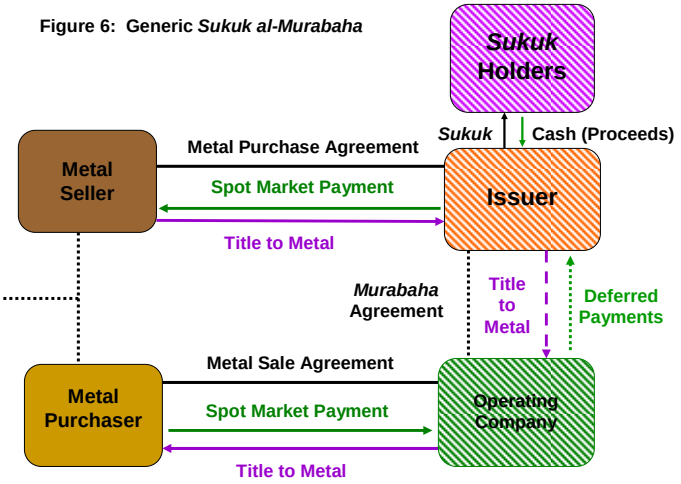
The *musharaka* structure has not been unanimously accepted by *shari'a* scholars. One area of discussion among the scholars relates to the pricing of the *hissas* being sold to the Project Company. Some scholars take the position that the price of the *hissas* must be established at the time of the sale to the Project Company and cannot be established at the inception of the *Murabaha* Agreement for a serial purchase arrangement. The reasoning is that a sale price that is in excess of the market price would represent a disproportionate share of the *musharaka* profit. Another line of discussion focuses on the compulsory nature of the *hissa* purchase and sale. A selling partner would be obligated to sell if the buying partner (the Project Company) elects to purchase, but the buying partner cannot be compelled to purchase. Some *shari'a* scholars have required that a series of *murabaha* agreements be executed, one at the time of each *hissa* sale and purchase. A further point of discussion relates to the provisions of the Musharaka Management Agreement that restrict profit entitlements and limit loss allocations to the bank partners (or the *sukuk* holders).

Careful structuring with respect to the matters addressed in the preceding paragraph, and the acceptance of existing *musharaka sukuk* structures by some of the more influential *shari'a* scholars, will ensure that the *musharaka sukuk* will remain a securitization vehicle in Islamic finance.

### Generic *Sukuk al-Murabaha* Structures

There have been a number of *sukuk* issuances based upon *murabaha* transactions. As a general matter, these are of three types: (1) an Operating Company purchases an asset using the proceeds of a *sukuk* issuance and retains ownership of that asset; (2) the *Sukuk* Holders are participating in a *murabaha* transaction itself (akin to a bond); and (3) a number of deferred *murabaha* payment obligations constitute the pool upon which the *sukuk* is issued (akin to a true securitization). Figure 6 illustrates a bond-type *sukuk*.

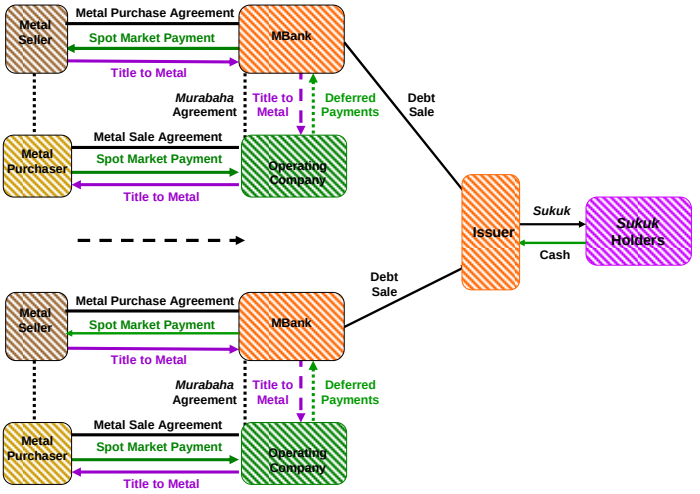
Figure 6: Generic *Sukuk al-Murabaha*




The *sukuk al-murabaha* is issued to the *Sukuk* Holders by the Issuer. The *Sukuk* represents a "participation interest" in the underlying *murabaha* transaction. The issuance proceeds are used to purchase metal on the spot market. The metal is then sold to Operating Company on a deferred-payment basis, and Operating Company sells the metal to the Metal Purchaser on the spot market. The net result is that the Operating Company holds cash equal to the spot market price of the metal which it can use in its operations, and the Operating Company has a deferred-payment obligation on the *Murabaha* Agreement that is used to service the *Sukuk*. Periodic issuances are possible.

Figure 7 illustrates a *murabaha sukuk* in which the deferred *murabaha* payment obligations under a pool of *murabaha* transactions are pooled, and the Issuer sells a *sukuk* off of that pool.

**Figure 7: Generic Pooled *Sukuk al-Murabaha***




It is clear from a review of the two *murabaha sukuk* structures that the party needing financing (Operating Company) obtains cash only by selling the tangible asset (the metal or other asset). Thus, on an on-going basis, this *sukuk* does not represent an ownership interest in a tangible asset—the asset has been sold. Only the deferred debt obligation remains after sale of the asset. *Ijara sukuk* are tradable above and below par because they are structured to represent fractional undivided ownership interests in tangible assets. The issue is significantly more difficult for a securitization or pooled *murabaha sukuk.*

Some scholars have taken the position that *murabaha* debt is not tradable unless it continues to be backed by assets. Other scholars have taken the position that a *murabaha sukuk* that is not backed by assets is tradable at par, but not at a premium or discount to par. Other scholars, mostly in Southeast Asia, have taken the position that the deferred debt obligation arose in and through a *shari'a*-compliant transaction, and may thereafter be the basis for a tradable *sukuk*, including at a premium or discount. The purchase of the *murabaha* debt (the "Debt Sale" element in Figure 7) can therefore be problematic from a *shari'a* point of view. This issue is particularly acute if the debt needs to be sold at a discount (as is the case in many conventional securitizations) in order to achieve credit enhancement of the underlying pool of *murabaha* debt that will ultimately back the *sukuk* for ratings purposes.

The 2003 Solidarity Trust Services Limited trust certificates issuance of the Islamic Development Bank (IDB), a seminal *sukuk* issuance, addressed some of these issues. The pool of assets underlying the *sukuk*

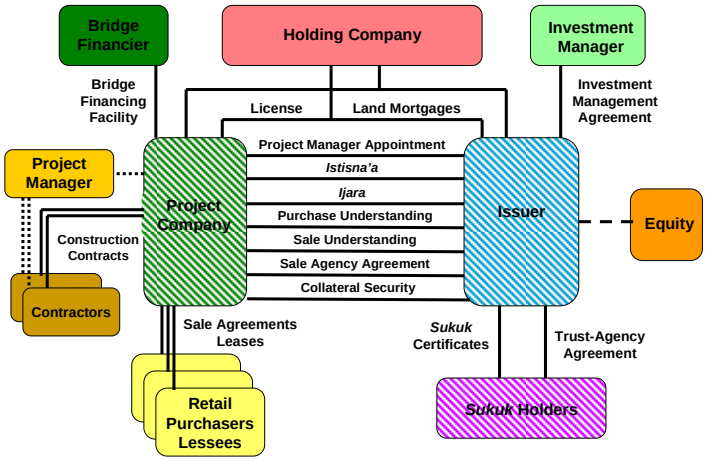
were *ijara*, *murabaha*, and *istisna'* (construction contract) payment obligations. In order for the *sukuk* to be tradable, including at a premium over or discount to par, the *Shari'a* Board required that not less than one-third of the obligations in the pool must be *ijara* obligations on tangible assets owned and leased in a *shari'a*-compliant manner. Although this structure involved the pooling of various *shari'a*-compliant obligations, it was not a true rated asset securitization. The IDB guaranteed pool performance to the Issuer, and this guarantee was the basis for the rating. The issue thus resembled an IDB bond issue. An important feature of the structure was the ability to replace *shari'a*-compliant obligations constituting part of the pool with other compliant obligations. This feature provides the basis for developing *shari'a*-compliant structures akin to conventional collateralized debt obligations (CDOs) and collateralized loan obligations (CLOs).

## Bahrain Financial Harbour *Sukuk*

The July 2005 Bahrain Financial Harbour *Sukuk* provides an example of a *shari'a*-compliant financing that combines a number of the structural elements described in this essay, most notably the *istisna'* and the *ijara*. The structure also includes a *shari'a*-compliant interim investment mechanism and a *shari'a*-compliant bridge financing facility. Figure 8 provides a graphic summary of the overall documentary structure of the financing transaction.

The Project is comprised of the development and construction of the "Financial Centre Development Phase" of the Bahrain Financial Harbour Project (i.e., the Dual Towers (East and West), the Financial Mall, and the Harbour House Facilities) located in Manama, Kingdom of Bahrain. The financing of the development and construction of the Project is provided by the issuance of the *Sukuk* Certificates and limited equity investments in the Project. As construction payments are periodic throughout the construction period, the proceeds of the *sukuk* issuance are invested in certain *shari'a*-compliant investments pursuant to the Investment Management Agreement until drawn with respect to those construction payments.

Figure 8: Overall Transaction: Documentation




The *Sukuk* Certificates were registered, certificated, and transferable. [11] Each certificate represents an undivided beneficial ownership interest in the Trust Assets (as hereinafter defined), and the sole recourse of *Sukuk* Holders is to the Trust Assets. The certificates provide for periodic distributions on a quarterly basis in an amount equal to LIBOR plus 2.5 percent per annum. The redemption price is equal to 100 percent of the face value of the *Sukuk* Certificates (each in an amount of US $10,000). Early redemptions are payable from excess funds. Dissolution events include events of default, total loss events, and certain other events. There will be total redemption of the certificates upon a total loss of the project.

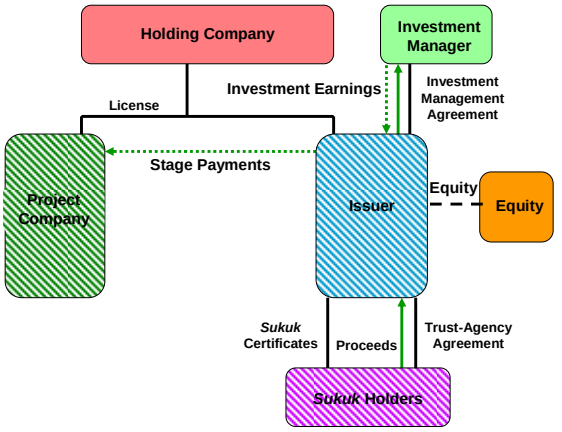
The "Trust Assets" include (1) completed "Project Segments" and all interests in the "Project Land," (2) the rights of Al Marfa'a Al Mali Sukuk Company B.S.C. (the "Issuer") under the "Transaction Documents," including the "Security Documents," (3) the rights of the Issuer to amounts

[11] A number of issues arise during the early stages of construction with respect to rent payments on the *ijara* where physical assets have not yet been constructed to the point of "economic sufficiency" so as to enable the payment of rent. In the context of a *sukuk*, there is a similar set of issues pertaining to the ability to trade the *sukuk* above or below par value prior to construction of the physical assets to the state of required economic sufficiency. Many *shari'a* scholars, if not most, take the position that trading of *sukuk* certificates is not permissible prior to that time. This issue was addressed in the Bahrain Financial Harbour *Sukuk* offering by noting the issue and leaving the *shari'a* determination to the individual certificate holder.

(including earnings) in its bank accounts, (4) any proceeds of the sale or lease of Project Segments, (5) certain "Eligible Investments," including those pursuant to the Investment Management Agreement, (6) all insurance proceeds received by the Issuer, and (7) all insurance proceeds relating to the Project Land.

Figure 9 provides a graphic illustration of the initial entity formation, the equity and *sukuk* proceeds infusion, and the general nature of the Stage Payments with respect to the completion of construction milestones.

**Figure 9: Entity Formation, *Sukuk* Sale, General Payment Mechanism**



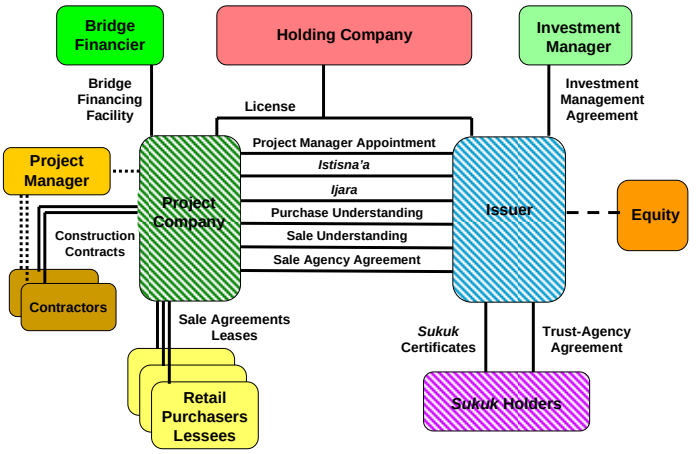

Before summarizing the cash infusion, it is essential to note that the Holding Company holds all legal and beneficial title to the "Land," which includes the Project Land and a broader parcel of land. The Holding Company grants a License to the Issuer and the Project Company giving the Issuer the rights and permissions to develop and carry out all necessary work to construct the Project on the Project Land. The Holding Company will subdivide the Land, and in connection therewith, transfer the legal and beneficial title to the Project Land to the Project Company. The Project Company is deemed to have made the same grant to the Issuer after acquisition of title to the Project Land as the Holding Company made at the inception of the transaction.

To allow issuance of the *Sukuk* Certificates, the Trust and Agency Agreement is entered into, and the Issuer acts as both trustee and agent on behalf of the *Sukuk* Holders. The equity investment and the proceeds from issuance of the *Sukuk* Certificates are deposited with the Issuer. The Issuer then transfers those proceeds to the Investment Manager for investment pursuant to the Investment Management Agreement. As and when Stage

Payments are required from time to time with respect to the construction of the Project, funds are drawn from the Investment Manager and paid over to the Project Company. The Project Company will ultimately pay these Stage Payments to the various construction subcontractors.

The elements of the transaction that are necessary to effect construction and repayment of the *Sukuk* Certificates are summarized in Figure 10.

**Figure 10: Structural Elements for Construction and *Sukuk* Repayment**




To effect construction of the Project, the Issuer and the Project Company appoint a Project Manager to oversee construction. The Issuer and the Project Company also enter into the *Istisna'* pursuant to which the Project Company will cause the construction of the Project pursuant to Construction Contracts overseen by the Project Manager.

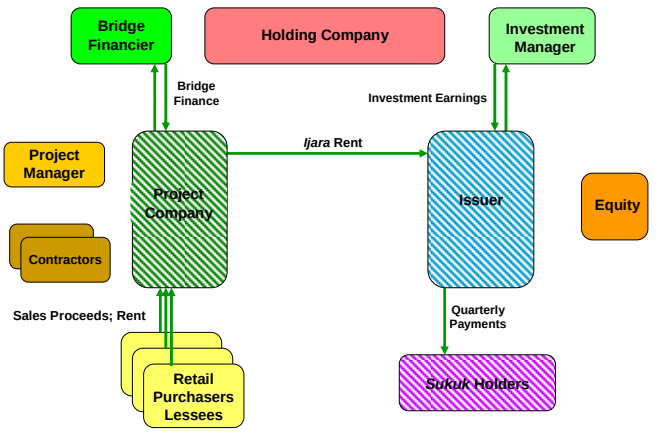
The Issuer leases the Project Land to the Project Company pursuant to a forward *Ijara*. Advance rentals are paid with respect to each uncompleted Project Segment and rentals are paid with respect to each completed Project Segment. Ancillary Lease Letter Agreements (not shown in Figure 10) relate to the specific lease terms applicable to each Project Segment. The Purchase Undertaking and the Sale Undertaking are executed between the Issuer and the Project Company. Under the Purchase Undertaking, the Project Company will purchase the Project upon the election of the Issuer in certain circumstances (such as defaults). Similarly, under the Sale Undertaking, the Issuer will sell the Project Segments upon the election of the Project Company in certain circumstances (such as the sale of Project Segments, or portions thereof, to third parties). The

Purchase Undertaking and the Sale Undertaking are essentially the same as the Understanding to Purchase and the Understanding to Sell in the standard *ijara* structure used for acquisition financings and construction and development financings.[12] The Issuer and the Project Company also enter into the Sale Agency Agreement. Like the Managing Contractor Agreement in such a standard *ijara* structure, the Project Company agrees to perform certain maintenance and insurance obligations for the Issuer and agrees to sell or rent various aspects of the Project to Retail Purchasers and Lessees. The funds from such sales and rentals are an important element of the cash flows that will be available for repayment of the *Sukuk* Certificates.

Finally, the Project Company obtains a *shari'a*-compliant revolving Bridge Financing Facility from the Bridge Financier. This facility is primarily for the payment of rent shortfalls under the *Ijara*. The Issuer is not a party to this Bridge Financing Facility and cannot initiate remedies under the Bridge Financing Facility. However, the Issuer does benefit from certain representations and warranties provided under the Bridge Financing Facility. The Issuer can also initiate certain drawings under the Bridge Financing Facility, and is entitled to default notices under the Bridge Financing Facility.

The structural elements for repayment of the *Sukuk* Certificates being in place, the cash flows for their repayment are summarized in Figure 11.

**Figure 11: *Sukuk* Payment**

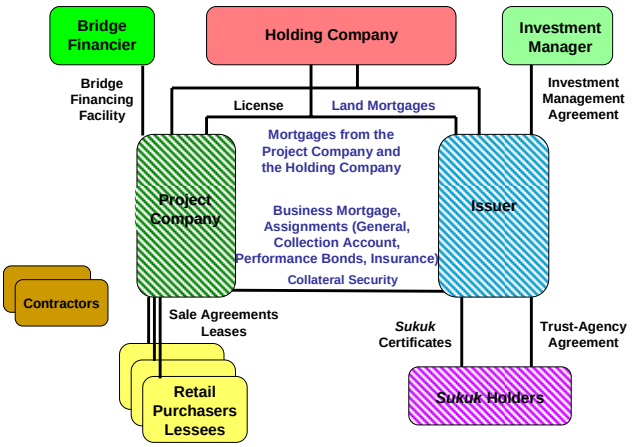



[12] See McMillen, "Fordham Project Finance Structures," 1237-1263, and McMillen, "Harvard Project Finance Structures," 111-131. The Understanding to Purchase, Understanding to Sell, and Managing Contractor agreements are discussed in these articles.

The primary sources of funds for repayment are the proceeds from sales by the Project Company of Project Segments, or portions thereof, and rentals obtained by the Project Company for the rental of Project Segments. Shortfalls in any given period may be covered by drawings on the Bridge Finance Facility. These are paid by the Project Company to the Issuer as *Ijara* Rent and then to the *Sukuk* Holders with respect to quarterly payments. It is also possible to draw upon the investment earnings and amounts invested with the Investment Manager to cover other shortfalls in the quarterly payments.

The final aspect of the structure that should be considered is the collateral security package that is made available for the benefit of the *Sukuk* Holders. This collateral security package is graphically summarized in Figure 12.

**Figure 12: Collateral Security**




The first element of the collateral security package consists of the Land Mortgages. These consist of a present Land Mortgage over the Land (including the Project Land) from the Holding Company to the Issuer. There is also a Land Mortgage Side Letter pursuant to which the Holding Company agrees to subdivide the Land and transfer legal and beneficial ownership in the Project Land to the Project Company. Upon such transfer, the Project Company will also grant a Land Mortgage to the Issuer.

The second element of the collateral security package is comprised of a group of security documents from the Project Company to the Issuer. The primary security documents are (1) a Business Mortgage pursuant to which the Project Company grants a security interest in all of its assets, including uncompleted Project Segments, (2) a General Assignment

pursuant to which the Project Company grants a security interest in all of its contractual rights, licenses, benefits, and receipts in relation to the Project, (3) a Collection Account Assignment pursuant to which the Project Company grants a security interest in all proceeds from time to time in the Collection Account (being all amounts received from sales and rentals of Project Segments), (4) a Performance Bond Assignment pursuant to which the Project Company grants a security interest in all of its rights and benefits under performance bonds and advance payment guarantees, and (5) an Insurance Assignment pursuant to which the Project Company grants a security interest in certain insurance proceeds.

## *SUKUK*: CAPITAL MARKETS AND SECONDARY MARKETS

Bond and securitization issuances and secondary market trading in these issuances are primary structural elements of capital markets—particularly secondary markets—in global finance. Bond issuances focus on the economic viability of the issuing entity as an operational entirety, whether it is a governmental or private sector entity. The primary economic focus in an asset securitization is a discrete pool of assets. The entity focus in such a securitization is of relevance as a secondary structural matter; the focus on the entity is designed to ensure that the entity does not interfere with the realization of benefits on the underlying assets.

While both bonds and pooled securitization vehicles are essential elements for the functioning of vibrant capital markets, securitizations have particular benefits for the market participants. They both allow and require broad asset diversification, and thus broad risk diversification. They allow asset originators to manage their balance sheets by transferring assets off those balance sheets to a larger, more diversified investor base. The originator receives immediate cash payments for the transferred assets, which can be used to generate more assets, without disrupting the deferred payment mechanism afforded to the asset user or the financing investor in those assets. The securitization process also allows greater risk management and liquidity management for all market participants. The securitization vehicle results in reduced financing costs for the originator of the assets.[13]

As noted above, the two different types of *sukuk* are equivalent to bond and securitization issuances, and their effective structuring and use should allow Islamic finance to integrate seamlessly into the global capital markets at both the primary and secondary levels. Most *sukuk* issuances to date have been of tradable certificates in the nature of bonds (rather than

[13] For literature on the benefits of securitization, see note 3 above.

asset securitizations). Yet there has been very little actual trading of these certificates. In part this is due to the quality of most of those issuances. However, it is also due to the lack of capital market access and the absence of secondary markets in the field of Islamic finance.

The questions that come to the fore relate to the factors that have inhibited or impeded the growth of Islamic capital markets. These factors can be summarized into two general categories: (1) institutional market factors and (2) legal enforceability factors. The latter category can be subdivided into (a) general systemic factors and (b) factors specific to asset securitizations and similar transactions.

## Market Factors

The primary market-related inhibitors and impediments affecting Islamic capital markets and secondary markets may be summarized as:

(1) the lack of market volume and the absence of program issuers at all levels, particularly the absence of government sponsored entities that have been critical to the development of capital markets in other jurisdictions;[14]
(2) the degree of market fragmentation, including with respect to: (a) countries, (b) currencies, (c) the state of legal and regulatory development, (d) the degree of elucidation of, and agreement on,

[14] Historically, governmental institutions and government sponsored entities have been critical to the development of securitization markets and related secondary markets. In the United States, institutions such as the Federal National Mortgage Association (FNMA or Fannie Mae), the Federal Home Loan Mortgage Association (Freddie Mac), the Government National Mortgage Association (GNMA or Ginnie Mae), and the Student Loan Marketing Association (SLMA or Sallie Mae), among others, have been particularly effective in helping to establish broad secondary markets and in otherwise realizing the benefits of securitization. For example, participation of these entities in the securitization markets has helped develop the relevant legal and regulatory framework, fostered and overseen the development of standards and standardized documentation, and helped generate volume and depth of the markets. Governments and quasi-governmental agencies have acted as regulators, enablers, issuers, and purchasers of securitized instruments and related securities, with profound effects on the capital and secondary markets and the effectuation of monetary policy. See Richard D. Jones, *Commercial Mortgage Backed Securities—The Emergence of CMBS*, in Petersen, *CMBS*, 1-17; Shenker & Colletta, "Asset Securitization," 1373-1420; and "Comment: An Overview of Commercial Mortgage Backed Securitizations: The Devil Is in the Details," *North Carolina Banking Institute* 1, 288 at 291-296, for concise histories of the development of mortgage-backed securities, including the involvement of government-sponsored entities.

applicable *shari'a* standards, (e) the degree of incorporation of the *shari'a* into applicable secular laws, and (f) disjuncture resulting from the operation of both Islamic and conventional interest-based markets in the same realms;
(3) underdevelopment of markets;
(4) market illiquidity;
(5) excessive concentration of risks;
(6) the absence of agreed-upon market standards for risk allocation among market participants, and the correlative absence of implementing standards and standardization with respect to transactional documentation, participant roles, and market procedures, practices, and guidelines;
(7) the lack of *shari'a*-compliant currency swaps, rate swaps, and other hedging mechanisms;[15]
(8) inconsistencies and uncertainties with respect to enforcement of agreed-upon risk allocations;
(9) the absence or underdevelopment of necessary and appropriate legal infrastructure;
(10) lack of specialization; and
(11) human resource scarcities, including with respect to qualified *shari'a* scholars and experienced financial, legal, accounting, and other professionals of all types.

**Enforceability Factors**

Certainty, predictability, consistency, and transparency are critical elements of any effective legal and financial system. They are critical to achieving risk minimization, systemically and transactionally, and are thus a focus of governments, regulators, market participants, and transaction participants. However, of equal (if not greater) importance is the degree of certainty that an agreed-upon set of risk allocations (whether or not minimized) will be given effect by the legal and financial system. This is equally true whether the commercial and financial activity is predicated on interest-based principles or *shari'a* principles.

Consideration must be given to both the general structure and the operation of the legal and financial system, and to its operation with respect to specific capital markets transactions, in this case *shari'a*-

[15] There are initiatives to develop standardized *shari'a*-compliant hedging mechanisms, including an initiative of the International Swaps and Derivatives Association (ISDA). However, given the *shari'a* requirements that tradable instruments represent an ownership interest in tangible assets, and the prohibitions on the sale and purchase of debt and similar instruments, this is a particularly challenging area in Islamic finance.

compliant asset securitizations utilizing *sukuk* structures.[16] For the purposes of this essay, these considerations are distilled to a focus on whether the risk allocations that are agreed upon among the market participants will be enforced. Those risk allocations are embodied in (1) the structure and operation of the relevant legal system, (2) the substantive and procedural laws of the relevant jurisdictions, (3) contracts and specific transactional requirements,[17] and (4) relevant market and institutional practices and procedures, including the obtaining of ratings from prominent rating agencies.[18] The opinions of qualified lawyers will be provided as to each of these matters, sometimes as a general market matter, and at other times in the course of product structuring and as a

[16] More detailed discussions of the issues addressed in this section are found in DeLorenzo and McMillen, "Law and Islamic Finance," 154-186; McMillen, "Contractual Enforceability," 8-40; and McMillen "Islamic Capital Markets," 153-166.

[17] For some provocative thoughts on the origins and similarities of Islamic law and Anglo-American common law, see John A. Makdisi, "The Islamic Origins of the Common Law," *North Carolina Law Review* 77 (1998-1999): 1635. For thoughts on the similarities between Islamic law and Anglo-American law with respect to the concept of contracts and obligations, see Frank E. Vogel and Samuel L. Hayes III, "Law and Islamic Finance: Risk, Religion and Return," *Kluwer Law International* (1998): 66-68; E. Allan Farnsworth, "Parables and Promises: Religious Ethics and Contract Enforceability," *Fordham Law Review* 71 (2002-2003): 695; and Abdul Jalil Al-Rawi, "Principles of the Islamic Law of Contracts," *George Washington Law Review* 22 (1953-1954): 32. Vogel, Hayes, and Farnsworth each discuss specific Qura'nic covenants and injunctions with respect to the enforceability of promises and obligations, as well as commentary on those covenants and injunctions.

With respect to contracts and liquidity as important elements of risk reduction, see Peter L. Bernstein, *Against the Gods: The Remarkable Story of Risk* (New York: John Wiley & Sons, 1996). In summarizing the explanation developed by Kenneth Arrow and Frank Hahn on the relationship between money, contracts, and uncertainty, he states: "In business, we seal a deal by signing a contract or by shaking hands. These formalities prescribe our future behavior even if conditions change in such a way that we wish we had made different arrangements. At the same time, they protect us from being harmed by the people on the other side of the deal. . . . [T]he past and the future are to the economy what woof and warp are to a fabric. We make no decision without reference to a past that we understand with some degree of certainty and to a future about which we have no certain knowledge. Contracts and liquidity protect us from unwelcome consequences, even when we are coping with Arrow's clouds of vagueness" (205). The essence of these explanations and arguments as to the importance of contracts is predicated on a series of presumptions as to the stability and predictability of the enforcement of those contracts.

[18] On ratings criteria in respect of European commercial mortgage-backed securities, see Judith O'Driscoll, "Standard & Poor's Rating of European CMBS: Legal and Structural Considerations," in Petersen, *CMBS*, 60-72. With respect to United States commercial mortgage-backed securities, see *S&P Rating Criteria*, particularly, "Section Four: Special-Purpose Bankruptcy-Remote Entities," 89-98 and "Section Five: Legal Opinions," 99-114 for a thorough discussion of the major requirements.

precondition to closing of individual transactions. Examples include the necessity of obtaining legal opinions of qualified lawyers (x) as a critical element of the ratings process where the absence of satisfactory legal opinions will preclude the issuance of a rating for a particular *sukuk* issuance, and (y) as a precondition to the financial closing of any individual transaction. The remainder of this essay considers various existing legal inhibitors and impediments to the development and growth of Islamic capital markets (including secondary markets), with a particular focus at the transactional level on *sukuk* issuances.

## STRUCTURE AND OPERATION OF THE LEGAL SYSTEM

At the most general level, the structure and operation of the relevant legal system must be considered.[19] Considerations at this level include: (1) whether the relevant legal system is based upon a system of binding precedents; (2) whether legal and arbitral decisions, and the rationale for those decisions, are published and widely available; (3) whether the judicial structure is responsive to continuity, consistency, and transparency in the application of judicial precedents; and (4) the timeframe for enforcement of remedies within the system.

As a general matter, there are significant systemic impediments with respect to many (if not all) of the foregoing matters in most of the jurisdictions within the Islamic Economic Sphere. The concept of binding precedent is often totally absent. Decisions are rarely published. In many jurisdictions, each case is considered *de novo* and without regard to other decisions rendered in similar cases. Judges and other adjudicators are afforded wide and unfettered discretion in determining cases. The time-frame for enforcement is frequently so long that it precludes effective remedies, particularly in fast-moving markets such as the capital markets. The old saw that "justice delayed is justice denied" is too frequently a comment on reality in many jurisdictions.

Each of these factors is frequently cited by international securitization and capital markets institutions as a reason for their reluctance to engage in capital markets initiatives in the Islamic Economic Sphere. Each of these factors is also cited as an exception to legal opinions that must be rendered in capital markets transactions (or a factor precluding the issuance of any legal opinion). And each of these factors is cited by major international ratings agencies as problematic and among the primary reasons that asset

[19] On matters addressed in this subsection, see DeLorenzo and McMillen, "Law and Islamic Finance," 154-186; McMillen, "Contractual Enforceability," 8-40; and McMillen, "Islamic Capital Markets," 153-166.

securitization *sukuk* involving these jurisdictions have not yet been rated. These are substantial impediments to growth of the securitization markets (and thus the capital markets, including secondary markets) in these jurisdictions, and there should be immediate focus on the removal, or a satisfactory alleviation, of these impediments.

## SUBSTANTIVE AND PROCEDURAL LAWS

Capital markets transactions, including *sukuk* transactions, involve a wide range of both Islamic and conventional multinational banks and financial institutions as participants, and participation by both *shari'a*-compliant and conventional participants. They also conform to both the *shari'a* and at least one body of secular law.[20] A critical inquiry focuses on the issue of whether the principles and precepts of the *shari'a* will be legally enforced in any given circumstance, with respect to any given structure, product, or transaction, and to any given jurisdiction, which in turn gives rise to consideration of a wide range of related questions.[21]

By way of context, consider first the degree to which the *shari'a* is or is not incorporated into the law of any given jurisdiction. At one end of the spectrum are jurisdictions, such as the United States, the United Kingdom,

[20] With respect to the matters addressed in this subsection, see DeLorenzo and McMillen, "Law and Islamic Finance, 164-165. The Bahrain Financial Harbour *Sukuk* transaction discussed in this essay is illustrative of the range of participants. Examples of other *shari'a*-compliant transactions involving a range of participants and jurisdictions are discussed in McMillen, "Fordham Project Finance Structures," 1237-1263; McMillen, "Harvard Project Finance Structures," 111-131 (see note 8 above); McMillen, "*Shari'a*-Compliant Finance Structures and the Development of an Islamic Economy," in *The Proceedings of the Fifth Harvard University Forum on Islamic Finance: Islamic Finance: Dynamics and Development* (2003), 89-102; McMillen, "Islamic Finance Review 2005/2006: A Year of Globalization and Integration" and McMillen, "Raising the Game of Compliance: People and Organizations," both in *Euromoney Islamic Finance Year in Review 2005/2006* (2006): 1-12 and 70-75; McMillen, "Shari'a-compliant real estate finance in Europe," in *Euromoney 2006 Guide to Opportunities and Trends in Islamic Finance* (2006): 10-13; McMillen, "Structuring Shari'ah-Compliant Transactions Involving Non-Compliant Elements: Use of the Nominate Contracts" (a paper presented at the Islamic Financial Services Board conference, Islamic Financial Services Industry and the Global Regulatory Environment Summit 2004, May 18-19, 2004, in London); and McMillen, "Special Report U.S. Briefing: Islamic Finance: Breaking the Mould," *Middle East Economic Digest (MEED)* 38 (September 22, 2000): 28-29, describing some of the earliest *shari'a*-compliant transactions in the United States involving Middle Eastern investors.

[21] Consider, in this regard, DeLorenzo and McMillen, "Law and Islamic Finance" 161-162.

Japan, South Korea, and most Western jurisdictions, in which the secular law does not incorporate any element of the *shari'a* (*Purely Secular Jurisdictions*). At the other end of the spectrum are jurisdictions in which the *shari'a* comprises the entirety of the secular law. Most jurisdictions within the Islamic Economic Sphere incorporate the *shari'a* into the secular law to some greater or lesser extent (and are referred to as *Shari'a-Incorporated Jurisdictions*).

While the *shari'a* is not incorporated into the secular law in Purely Secular Jurisdictions, enforcement of the *shari'a* is still obtainable in these jurisdictions. In current practice, this is accomplished by structuring the relevant contracts in such a manner that they are compliant with the *shari'a* in the opinion of the *shari'a* scholars that pass on the specific transaction, albeit without mention of *shari'a* in those contracts. Western lawyers will then render legal opinions that those contracts are "valid and binding agreements, enforceable in accordance with their terms," which is the standard opinion language of remedies or enforceability opinions.

The more difficult and uncertain situation in Purely Secular Jurisdictions is whether the relevant contracts will be enforceable if and to the extent that those contracts are made subject to the *shari'a* as a governing law concept applicable to those contracts, or incorporate *shari'a* principles and precepts as contractual terms. The most recent relevant appellate court decision is the English case, *Shamil Bank of Bahrain E.C. (Islamic Bankers) v. Beximco Pharmaceuticals Ltd. and Others* ("*Shamil Bank v. Beximco*").[22] This case focused on the governing law provisions of the relevant legal contracts in a *shari'a*-compliant financing (and refinancing) arrangement. The contracts contained the following language: "Subject to the principle of the Glorious *Shari'a*, this Agreement shall be governed by and construed in accordance with the laws of England." In summary, the appellate court, like the lower court, determined that the governing law clause did not require consideration of the *shari'a*.

The court determined that only one law can govern enforceability of the contractual provisions, in this case the law of England, not both English law and the *shari'a*. This is in accord with principles of national

[22] *Shamil Bank of Bahrain E.C. (Islamic Bankers) v. Beximco Pharmaceuticals Ltd. and Others*, [2004] EWCA Civ 19, [2004] All ER (D) 280 (Jan), 28 January 2004. This case is analyzed in further detail, with respect to the matters addressed in this subsection, in DeLorenzo and McMillen, "Law and Islamic Finance," 166-172; McMillen, "Contractual Enforceability," 15-21; Andreas Junius, "Islamic Finance—Issues Surrounding Islamic Law as a Choice of Law under German Conflict of Laws Principles," *Chicago Journal of International Law* 7 (2007): 537; and Kilian Bälz, "Islamic Financing Transactions in European Courts," in *Islamic Finance: Current Legal and Regulatory Issues*, ed. S. Nazim Ali (Cambridge, MA: Islamic Finance Project, Harvard Law School, 2005).

sovereignty. The parties are entitled to choose the applicable law of the contract,[23] but the law so chosen must be the law of a country,[24] which precludes the choice of the *shari'a* which is a set of "Islamic religious principles"[25] and "religious and moral codes,"[26] rather than the law of a nation. The court next noted that, acknowledging English law as the governing law, the contract may incorporate provisions of another foreign law or a set of rules as terms of the contract whose enforceability is to be determined by such national law.[27] The court determined that, in the instant case, the references to the *shari'a* were insufficiently specific and precise to be effective under these doctrines.[28]

While the decision leaves many questions unaddressed and unanswered, it does provide a basis for the argument that the *shari'a* may be enforced by virtue of its incorporation into a contract that is enforceable under the laws of England or New York or another Purely Secular Jurisdiction—if the relevant *shari'a* principles and precepts being incorporated are sufficiently specific and other aspects of relevant choice of law or conflicts of laws principles are satisfied. There is an implication from the opinion that incorporation in those circumstances might be considered to be analogous to incorporation of provisions of the French Civil Code, the Hague Rules, or the Harter Act. In any such incorporation, of course, the relevant *shari'a* principles and precepts being incorporated would have to be sufficiently specific and the incorporation would have to be in compliance with other applicable legal doctrines. Customary limitations would apply. These include, by way of example, (1) limitations pertaining to illegal acts or acts contrary to public policy, which cannot be the subject of a valid and enforceable contract, (2) limitations relating to contractual contravention of a paramount law, such as a constitution or, in certain *Shari'a*-Incorporated Jurisdictions, the *shari'a* itself, and (3) limitations pertaining to unwaivable and mandatory legal provisions (which most frequently apply to matters where the sophistication and

[23] *Shamil Bank v. Beximco*, at paragraph 48, citing Article 3.1 of the Rome Convention ("a contract shall be governed by the law chosen by the parties"). Paragraph 40 summarizes the similar finding of the lower court.
[24] *Shamil Bank v. Beximco*, at paragraph 48, citing Article 1.1 of the Rome Convention ("the rules of this Convention shall apply to contractual obligations in any situation involving a choice between the laws of different countries"). Paragraphs 40, 42, and 43 summarize the lower court's similar finding on this issue of interpretation.
[25] *Shamil Bank v. Beximco*, at paragraph 54. See also paragraph 40 with respect to the characterization of this matter by the lower court.
[26] *Shamil Bank v. Beximco*, at paragraph 55. See also paragraph 40 with respect to the characterization of this matter by the lower court.
[27] *Shamil Bank v. Beximco*, at paragraphs 50–52, citing Dicey & Morris, *The Conflict of Laws*, 13th ed. Vol 2, 32-086 and 32-087.
[28] *Shamil Bank v. Beximco*, at paragraph 52.

bargaining power of the parties are disparate). The (preclusive) difficulty at present is that an adequate degree of specificity may be difficult to achieve given the absence of compilations of *shari'a* principles and precepts. Development of "model laws" for each of the main nominate contracts and transactional structures would address the incorporation issue in terms of specificity.[29]

Turning to *Shari'a*-Incorporated Jurisdictions, the degree to which the *shari'a* is incorporated in the secular law of the land varies considerably from jurisdiction to jurisdiction.[30] In some jurisdictions, the *shari'a* is described as "a" source of law, to be considered at some level of the hierarchy of judicial analysis. In other jurisdictions, the *shari'a* is described as "the" paramount law or source of law. In most jurisdictions, portions of the *shari'a* are incorporated, either legislatively or judicially, into codes that are otherwise purely secular and not necessarily *shari'a* compliant. Whatever the degree of incorporation of the *shari'a*, different schools of Islamic jurisprudence will be applied in different jurisdictions. Enforcement bodies and procedures, which vary markedly from jurisdiction to jurisdiction, may have a significant impact on whether and to what extent incorporated *shari'a* principles and precepts are given effect.[31] Given that the *shari'a* is itself not incorporated in a comprehensive writing, and given the factors noted in this essay under the heading, "Enforceability Factors: Structure and Operation of the Legal

[29] For a more detailed discussion of the structure and implementation of such model laws, see McMillen, "'Enforceable In Accordance With Its Terms': A Proposal Pertaining to Islamic *Shari'a*," Fourth Meeting of the Council and Second Meeting of the General Assembly of the Islamic Financial Services Board, Bali, Indonesia, 2 Raby' al-awal 1425 H.E., April 2, 2004 (hereafter cited as McMillen, "Enforceability Proposal").

[30] For a review of the extent to which the laws of various Middle Eastern nations have been and are comprised of the *shari'a*, and the extent to which other legal principles are incorporated in the laws of such nations, see Ann Elizabeth Mayer, "Islam and the State," *Cardozo Law Review* 12 (1990-1991): 1015; Nayla Comair-Obeid, *The Law of Business Contracts in the Arab Middle East* (Boston: Kluwer Law International, 1996), particularly chapter 3; and David Bonderman, "Modernization and Changing Perceptions of Islamic Law," *Harvard Law Review* 81 (1967-1968): 1169. The discussion in this section, to the extent that it addresses the integration of the *shari'a* into the law of various nations, is based in part upon these sources. See also Majid Khadduri, "Islam and the Modern Law of Nations," *American Journal of International Law* 50 (1956): 358, and Noel J. Coulson, *Commercial Law in the Gulf States* (London: Graham and Trotman, 1984). See also Noel J. Coulson, *A History of Islamic Law* (Edinburgh, 1964) and Joseph Schacht, *An Introduction to Islamic Law* (Oxford, 1964), as general histories of Islamic law.

[31] Consider, for example, the discussion in McMillen, "Fordham Project Finance Structures," 1193-1203, with respect to enforcement entities in the Kingdom of Saudi Arabia.

System," it is difficult to determine with certainty, predictability, and consistency, whether and to what extent a given contractual set of risk allocations will be enforced in many jurisdictions within the Islamic Economic Sphere, an obvious impediment to the growth of capital markets.

## LEGAL OPINIONS IN FINANCING (INCLUDING *SUKUK*) TRANSACTIONS GENERALLY

In virtually all transactions, including *shari'a*-compliant transactions, and in both Purely Secular Jurisdictions and *Shari'a*-Incorporated Jurisdictions, the parties will require that their counsel or opposing counsel provide a series of legal opinions. Two sets of opinions are usually required. One set (the "entity authority" opinions) will address the due formation and valid existence of the participating entities under relevant applicable law. The second (the "enforceability" or "remedies" opinions) will address the validity and binding effect, and enforceability, of the relevant documents.[32]

"A remedies opinion deals with the question of whether the provisions of an agreement will be given effect by the courts."[33] The essence of the enforceability or remedies opinion is that each of the "undertakings"[34] in the contracts to which the client is a party are enforceable under the designated law governing the contracts, and the

[32] See, with respect to the matters addressed in this subsection, DeLorenzo and McMillen, "Law and Islamic Finance," 174-195, and McMillen, "IFSB *Shari'a* Enforceability Proposal."

[33] "Third Party 'Closing' Opinions: A Report of the TriBar Opinion Committee," *Business Lawyer* 53 (1998): 592 (hereafter referred to as "TriBar Report"), at page 619. See also "Special Report by the TriBar Opinion Committee: Use of the ABA Legal Opinion Accord in Specialized Financing Transactions," *Business Lawyer* 47 (1992): 1720 (the "TriBar Specialized Financing Report"). See also "Third-Party Legal Opinion Report, including the Legal Opinion Accord, of the Section of Business Law, American Bar Association," *Business Lawyer* 47 (1991): 167 at Section 10, "The Remedies Opinion," and the definition of "Remedies Opinion" in the Glossary thereof.

[34] The TriBar Report notes that *all* undertakings in the agreements with respect to which the enforceability opinion relates are covered by the opinion. See "TriBar Report," 621. The TriBar Report, at footnote 69, notes that coverage of all undertakings is based upon New York custom and practice, and that not all jurisdictions so interpret opinions. The variance noted in footnote 69 is that of the "1989 Report of the Committee on Corporations of the Business Law Section of the State of California Regarding Legal Opinions in Business Transactions," *Business Lawyer* 45 (1990): 2169. That report endorses a narrower definition of the scope of the enforceability opinion, limiting the coverage of the opinion to only "material" provisions of the agreements that are the subject of the enforceability opinion. It is important to be familiar with the scope of the enforceability opinion in the governing law jurisdiction.

standard formulation is that "the agreements are valid and binding obligations of the Company, enforceable against the Company in accordance with their terms."[35] This opinion is customarily delivered at the closing of the transaction, and its delivery is usually a precondition to the closing of that transaction. Under customary practice,[36] the remedies opinion covers three distinct, but related, matters: (1) it confirms that an agreement has been formed; (2) it confirms that the remedies provided in the agreement will be given effect by the courts; and (3) it describes the extent to which the courts will enforce the provisions of the agreement that are unrelated to the concept of breach.

One of the more significant impediments to the growth of Islamic capital markets relates to the exceptions and exclusions that have been taken with respect to the enforceability opinion summarized above. Exceptions and exclusions to the opinion are set forth in the opinion itself. Customary exceptions and exclusions that are acceptable to transactional parties (and rating agencies) include certain defined circumstances where, under applicable law, the opinion recipient will not have a remedy for a breach of any "undertaking" by the other party to the agreement, or a remedy specified in the agreement (such as specific enforcement) will not be given effect by the courts under the circumstances contemplated.[37] For example, virtually every matter noted under the heading "Enforceability Factors: Structure and Operation of the Legal System" in this essay has been taken as an exception or exclusion to legal opinions rendered in connection with *sukuk* or other *shari'a*-compliant transactions. Thus, for example, exceptions and exclusions have been taken for (1) the absence of binding precedent concepts, exacerbating uncertainties noted below with respect to the *shari'a*, (2) the fact that laws are not always published or widely available, (3) the absence of published decisions and determinations, (4) the effect of lengthy judicial procedures on the practical realization of transactional benefits, (5) the fact that the *shari'a* is comprised of general principles, rather than specific legal requirements, making application in a specific transaction difficult to determine,[38] (6) the fact that different schools of Islamic jurisprudence interpret relevant *shari'a* principles and precepts differently and inconsistently, resulting in similar uncertainties as to application in any given transaction, (7) the lack

[35] See the relevant opinion language in DeLorenzo & McMillen, "Law and Islamic Finance," 187-195 (see Appendix 1).
[36] "TriBar Report," 620.
[37] Exceptions and exclusions are discussed in greater detail in DeLorenzo & McMillen, "Law and Islamic Finance," 174-195.
[38] Consider, for example, the section entitled "Substantive and Procedural Laws" above and the *Shamil Bank v. Beximco* case discussed in that section with respect to exceptions.

of uniform statements of relevant *shari'a* principles and precepts,[39] (8) the great degree of discretion in a court in these jurisdictions, (9) the uncertainty of remedies within these jurisdictions, and (10) the fact that many of these jurisdictions will not enforce foreign judgments and, even where they will enforce foreign arbitral awards, may infuse the *shari'a* into a review of that award pursuant to public policy doctrines.[40]

Other exceptions and exclusions have been taken with respect to specific organizational, procedural, or substantive matters that are particular to a specific country or judicial or other dispute resolution authority. For example, one set of exceptions and exclusions in a Middle Eastern jurisdiction relates to an exclusion from the jurisdictional authority of a dispute resolution authority that prohibits an award of interest or lost earnings after the day of filing of the action, no matter what the duration of the action before that authority.

Focusing on *sukuk* transactions, there are a number of critical opinion issues. To date, law firms have had difficulty rendering opinions on each of these critical matters. As a result, rating agencies have declined to rate *sukuk* issues (other than bond-type *sukuk* that are based upon a sovereign credit and *sukuk* focused on assets located in the United States).[41]

As a generic matter, and in its simplest form, a securitization involves (1) an originator of assets, (2) an issuer of the *sukuk* or other instrument, which is a trust or SPV, (3) a parent of the issuer, (4) a payer or payers with respect to the assets being securitized, and (5) a purchaser-holder of the *sukuk* or other security. By sale, the originator of the assets transfers the assets to be securitized into the issuer. The issuer sells a *sukuk* to the purchaser and uses the proceeds of that sale to pay the originator for the transferred assets. Over time, the payer or payers make payments to the issuer who then transfers those payments to the *sukuk* purchaser as the holder of the *sukuk*. The issuer provides collateral security over the assets to the *sukuk* holders to secure the payment of the *sukuk*.[42]

The critical inquiries, for opinion purposes,[43] relate to, among other things, transfer and bankruptcy issues.[44] For example, the securitized

[39] See McMillen, "IFSB Enforceability Proposal."

[40] See the discussion of enforcement of foreign judgments and awards in McMillen, "Fordham Project Finance Structures," 1199-1203.

[41] Other areas of the legal infrastructure are not considered in this essay, largely because of the tremendous diversity over different jurisdictions. These include tax law, real estate law, competition law, and corporate law, among many other areas of applicable law.

[42] For further summaries of standard transactional securitizations, see sources in notes 3 and 44 above.

[43] Rating agencies consider a range of other factors pertaining to credit matters. See, for example, *S&P Rating Criteria* (see note 2 above).

assets must be isolated for the benefit of the *sukuk* holders. In the simplest case, the critical elements are that: (1) all right, title, interest, and estate in and to the securitized assets are transferred by the originator to a bankruptcy remote special purpose issuer vehicle, and (2) that issuer must grant a first priority perfected (or perfectible) security interest over those assets to secure payments on the *sukuk* and other claims of the *sukuk* holders. This, in turn, focuses inquiry on (a) the transfer of the assets from the originator to the issuer and (b) the priority, perfection, and enforceability of the security interests granted in the securitized assets provided as collateral for the benefit of the *sukuk* holders. The concomitant examination is made through review of the documentation and through the obtaining of a legal opinion that addresses all of the transactional issues. Looking to the primary substantive legal opinions,[45] the following are the primary areas addressed by the legal opinions:[46]

(1) True sale of the securitized assets to the issuer by the originator such that the transfer will not be re-characterized as a secured loan or otherwise avoided in the bankruptcy of the originator;
(2) The nature of title in the issuer such that the transfer is either perfected or perfectible at the election of the issuer;[47]

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[44] See *S&P Rating Criteria*, 99-114 and 89-98. The literature on bankruptcy-related issues in securitizations is extensive. Examples include Schwarcz, "Alchemy of Securitization"; Schwarcz, "International Securitization"; "Note: Asset Securitization: How Remote Is Bankruptcy Remote?," *Hofstra Law Review* 26 (1997-1998): 929; Christopher W. Frost, "Asset Securitization and Corporate Risk Allocation," *Tulane Law Review* 72 (1997-1998): 101; Thomas J. Gordon, "Securitization and Executory Future Flows as Bankruptcy-Remote True Sales," *University of Chicago Law Review* 67 (2000): 1317; Lois R. Lupica, "Asset Securitization: The Unsecured Creditor's Perspective," *Texas Law Review* 76 (1998): 595; and Lupica, "Comment: Transplanting Asset Securitization: Is the Grass Green Enough on the Other Side?," *Houston Law Review* 38 (2001-2002): 541. With respect to… {ed: something missing here; ask author?} and the Convention on the Assignment of Receivables in International Trade, Appendix to the Report of the United Nations Commission on International Trade Law ("UNCITRAL") on its 34th Session (2002) GAOR supp. no. 17 (A/56/17), and www.uncitral.org, see Harry C. Sigman and Edwin E. Smith, "Toward Facilitating Cross-Border Secured Financing and Securitization: An Analysis of the United Nations Convention on the Assignment of Receivables for International Trade," *Business Lawyer* 57 (2001-2002): 727.

[45] Entity organization opinions are critical, and are obtained, but are not discussed in this essay. These opinions address formation of relevant entities, due authorization of the transaction by all entities, and due execution of all documentation.

[46] Other categories that must be covered by legal opinions in asset securitization transactions include tax matters, corporate matters, and transaction-specific matters.

[47] Historically, *shari'a* scholars have had differing views on the permissibility of separation of legal and equitable title to assets (which occurs in a perfectible asset

(3) Whether the assets are transferred to the issuer free of liens;
(4) Non-consolidation of the assets of the issuer in a bankruptcy of the originator or the parent of the originator;
(5) Bankruptcy remoteness of the issuer itself to ensure that (a) the issuer conducts only a specified business and (b) the issuer's assets are distributed in accordance with the agreed-upon financing structure rather than according to a different legally imposed paradigm;
(6) The collateral security structure for the benefit of the *sukuk* holders, and whether the same are first prior perfected or perfectible interests, including in bankruptcy scenarios;
(7) Enforceability of the transactional documents, as discussed above;
(8) Whether the documentary choice of law will be given effect in each of the respective jurisdictions involved in the transaction; and
(9) Whether judgments and awards in the various jurisdictions involved in the transaction will be enforced in the other jurisdictions of relevance.

Suffice it to say that exceptions and exclusions have been taken in *sukuk* transaction legal opinions with respect to each and every one of the foregoing matters, and those exceptions and exclusions have been of sufficient gravity as to significantly impede the growth of Islamic capital markets. For example, as applied to *sukuk* and other financing structures, the laws applicable to title transfers, liens, consolidation and other bankruptcy matters, collateral security (especially perfection), and choice of governing law are quite unclear and uncertain, and the application of those laws is neither transparent nor predictable. As another example, the enforcement of foreign judgments and awards—although the subject of more experience—is problematic.[48] Some countries will not enforce foreign judgments and arbitral awards. Some will enforce foreign arbitral awards, but not foreign judgments. In some jurisdictions, the extent and degree of enforcement of foreign judgments and awards is not entirely clear, particularly in *shari'a*-compliant transactions where it is arguable that the *shari'a* is a matter of public policy in certain of the enforcing jurisdictions (and thus raises public policy exception issues in virtually every such jurisdiction).[49]

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transfer). If separation of legal and equitable title is not permissible, legal title would have to be transferred in a manner that satisfies all of the applicable perfection requirements (including notification of the payer).

[48] See McMillen, "Fordham Project Finance Structures," 1195-1203.

[49] See McMillen, "Fordham Project Finance Structures," 1195-1203, for a discussion of enforcement mechanisms in the Kingdom of Saudi Arabia.

## CONCLUSION

One of the most exciting developments in Islamic finance is the emergence of the *sukuk* as a viable *shari'a*-compliant "debt side" alternative. AAOIFI has laid the groundwork for expansive use of the *sukuk* vehicle and a range of *sukuk* structures have been developed. Some of those structures are summarized in this essay. The lead has been taken by various sovereigns that have issued bond-type *sukuk* that are, at some level, dependent upon the sovereign credit. Realization of the benefits of asset securitization is widely anticipated and broadly sought, through implementation of asset securitization *sukuk* issuances. Whether those instruments will serve as the backbone of a debt-side Islamic capital market and become the nidus for growth of secondary trading in the Islamic economy depends in large part upon the will of governments as well as industry participants and industry organizations to address a range of market and legal inhibitors and impediments. This essay has surveyed some of those impediments and inhibitors, and focused on two general categories: those that are market-related, and those that relate to the legal system. Many of the market factors are being resolved as a function of the growth and increasing sophistication of the Islamic finance markets themselves. Many of these impediments and inhibitors will be removed and resolved just by virtue of the continued growth of the markets in these capital market areas.

The more daunting impediments and inhibitors are those arising from the structure and operation of the relevant legal systems, and the substantive and procedural elements of those legal systems. Short-term adaptive solutions are available (many are now being used; others will undoubtedly be devised). Long-term resolution of these matters, however, will entail not only effort within the Islamic finance industry by industry participants, but also the involvement of governments in a process of fundamental legal reform and clarification, with an eye to coordinated international integration of Islamic finance and markets with conventional interest-based markets. Failure to remove and resolve the legal impediments and inhibitors will constrain capital market growth, thereby limiting the growth of the entire Islamic finance industry, while also limiting the ability of the markets to resolve existing market inhibitors.

Thus, what is needed is a movement to coordinated action, broad-based industry and government involvement in the process, encouragement for the involvement of a broader range of professionals from both the Islamic finance and the conventional finance sectors (private and governmental), and support for reform and clarification undertakings, including those now in process. This essay attempts to join those calling for further consideration of the necessary legal reforms and clarifications, and in identifying impediments and inhibitors, this essay attempts to refine

the focus of reform and clarification efforts in certain legal areas. The spirit of this essay is one of optimism based upon all that has been addressed and achieved in the field of Islamic finance in the last decades, and with a view toward a future in which there is a true Islamic capital market.