

# **Practical Legal and Tax Issues in Islamic Finance and Investment in the United States**

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## **ABSTRACT**

Several practical legal issues arise in the implementation of financing transactions structured to comply with the *Shari'ah*. Transactions involving an interest-based lender usually involve a special-purpose entity (SPE). *Shari'ah* committees have different views on some of the structural elements of SPE transactions. The cases in which the financing between the SPE and the investor is structured as a *murabaha* and *ijara* transaction are discussed, as are two cost issues in transactions involving SPEs. Although certain features of Islamic leases are unpalatable to conventional lenders, some *Shari'ah* committees allow a solution putting an Islamic lessor in the same economic position as a conventional lessor. When Islamic structured financing is viewed as being no different from its conventional counterpart, except that the finance recipient is trying to satisfy additional considerations, Islamic financing should seem no stranger than any other structured financing. Several regulatory developments should enable more widespread use of Islamic finance by conventional U.S. financial institutions.

## **I. INTRODUCTION**

This paper addresses the practical legal issues that arise in the implementation of financing transactions that are structured to comply with *Shari'ah* principles, and on some of the regulatory developments in the utilization of Islamic financing structures. Financing transactions in which the parties—that is, the finance provider and the finance recipient—must comply with the *Shari'ah* present fewer complications because the expectations of the parties on *Shari'ah*-sensitive issues should be consistent.

More issues arise in transactions that bring together interest-based lenders and Islamic finance recipients, and it is with these transactions that the author has had a greater degree of experience. The goal in financing transactions of this type is to reconcile the *Shari'ah* concerns of the finance recipient with the objectives and industry expectations of the interest-based lenders. In handling these transactions, King & Spalding has had the opportunity to represent both sides of the transaction and, therefore, to have gained an intimate appreciation of each side's objectives and concerns.

## **II. THE ROLE AND SHARI'AH VIEW OF SPECIAL-PURPOSE ENTITIES**

Transactions involving an interest-based lender generally involve the use of a special-purpose entity (SPE) that receives the interest-based financing, reformulates it, and passes it on to the ultimate finance recipient. Let us assume that an Islamic investor seeks to acquire an asset and requires financing to make that acquisition. In a typical transaction, a neutral SPE would be established to make the acquisition. By "neutral," it is meant that neither the interest-based lender nor the finance recipient owns or controls the SPE. Often the SPE is established in a tax-neutral jurisdiction, is owned by a charitable trust, and is set up to be remote from bankruptcy.

The SPE would acquire the asset from the seller and would pay for it with funds from two sources: an interest-based loan from the conventional lender and a down payment from the Islamic investor. The SPE would enter into a loan agreement with the lender that would evidence its obligation to repay the loan

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at maturity and to pay interest on the scheduled interest payment dates. The SPE would also enter a lease and purchase agreement with the Islamic investor, pursuant to which the SPE would lease the asset to the investor and would agree to sell the asset to the investor at the end of the lease term. Payments under the lease will equal that the payments be made by the SPE under the loan.

*Shari'ah* committees have different views on some of the structural elements of such transactions. Some of them require the initial amount paid by the investor to be characterized as an advance payment of rent rather than as a down payment against the subsequent purchase of the asset. Other *Shari'ah* committees prefer that the lease transaction be structured as a *murabaha*. Yet other committees stipulate that the asset purchase obligation be structured as an option that may be exercised by the investor rather than as a mandatory purchase obligation. Aside from these structural differences, these transactions present many of the same issues. Although many of these issues seem technical or relatively minor, they can stop a deal if not properly addressed.

### III. COST ISSUES

If a lender makes a loan with interest based on its prime rate, and the lender subsequently incurs an increased cost or expense as a result of a change in law or regulation, the lender would typically not have the right to receive compensation for such increased or additional cost or expense. The rationale is that the prime rate, a fluctuating rate, would eventually adjust to provide the lender with the additional compensation necessary to offset the cost or expense.

A conventional loan with interest based on the LIBOR operates differently. It entitles the lender to collect additional compensation from the borrower to offset such increased cost or expense. This difference arises because the LIBOR is set for the interest period and cannot be changed. The right to collect for the additional cost or expense allows the lender to protect its margin, which is the basis of LIBOR-based loans. Most lending is based on the LIBOR, so it becomes necessary to determine if any increased cost assessed by a lender on the SPE, which is its borrower, can be passed on to the investor.

We have thus far not seen a perfect solution to this problem. If the financing between the SPE and the investor is structured as a *murabaha* transaction, the nature of that transaction does not permit an adjustment in the purchase price to provide the SPE with the funds necessary to pay the increased cost assessed against it by the lender. Although increased cost provisions are rarely invoked, interest-based lenders and their credit committees expect to have those protections and will raise questions if they are not provided. One approach that offers some possibility with a flexible lender is to agree to increase the pricing by an agreed amount to compensate the lender against the remote risk that it will suffer an increased cost for which it will not be entitled to be compensated. If (as is likely) the increased costs never arise, the lender will have received some additional interest compensation for taking that risk. On the other hand, if significant increased costs are incurred, the lender may find that it has an unexpected shortfall. Lenders with an interest in participating in Islamic finance may be willing to consider such an approach.

If the financing between the SPE and the investor is structured as an *ijara*, some *Shari'ah* committees allow the use of an adjustable rent component. This flexibility allows the rent to be increased for subsequent interest periods if an increased cost is imposed on the SPE. Compensation would not be available for increased costs during the current interest period, but this adjustment mechanism may come close enough to satisfy a lender.

Another cost issue arises if the SPE is required to make a prepayment under the loan agreement and that prepayment is required to be made during, rather than at the end of, an interest period. The loan agreement will require that the SPE compensate the lender for any "breakage costs": costs or losses incurred by a lender as a result of its early receipt of funds. Breakage costs are most often incurred if interest rates have dropped since the beginning of the interest period, as any re-lending of funds will not produce the same return to the lender for the remaining duration of the interest period. As with increased costs, we are not aware of a perfect solution to this problem. The one solution that we have seen requires the Islamic finance recipient to pay the "LIBOR spread" for the duration of the rent period (which would correspond to the interest period under the loan agreement) if an early payment of rent were required at any time during that rent period. In effect, the Islamic finance recipient makes a payment (if any) that may or may not correspond to the actual breakage costs that the lender may incur. A solution of this type would, of course, require the lender to agree to a corresponding provision in the loan agreement.

An Islamic finance recipient would be reluctant to make a prepayment in a transaction structured as a *murabaha* because it would end up paying the full profit element over a shorter period of time. To avoid this uneconomic result, a prepayment obligation could be replaced with an obligation to post cash collateral that is pledged in favor of the SPE, which would in turn be pledged to the lender. Funds held in the cash collateral account could be invested in acceptable Islamic transactions so that the Islamic finance recipient would have some profit during the period of the cash collateral arrangement.

#### IV. LEASES IN ISLAMIC FINANCE

Lease arrangements used in Islamic financing often have several features that distinguish them from conventional finance leases. A conventional finance lease will be structured as a “net” arrangement, meaning that the lessee takes all risks and responsibilities arising from the leased equipment. In other words, the lessee must make all lease payments regardless of what happens to the equipment. An arrangement of this sort is generally unacceptable in a lease intended to comply with Islamic requirements. Most *Shari’ah* advisors will require that the lessor, as the owner of the property during the lease term, retain some of the major responsibilities of an owner. Often, a lessor under an Islamic lease will be required to retain the obligation to perform major maintenance and required alterations. In addition, *Shari’ah* advisors will generally require that the lease of the equipment terminate if the equipment is destroyed, and will not require the lessee to pay a stipulated termination value for the destroyed equipment unless the destruction arose from the negligence or misconduct of the lessee.

Limitations of this sort will not be acceptable to a conventional lender, but there is at least one solution to this problem. Although the lessor takes responsibility for certain maintenance/alterations and for the risk of loss to the leased equipment, some *Shari’ah* committees will allow the lessor, in a separate agreement, to appoint the lessee as its paid agent for the purpose of fulfilling those lessor responsibilities. The amount to be paid to the lessee, as an agent of the lessor, would be factored into the lease payments the lessee must make under the lease agreement, so the Islamic lessor ends up in the same economic position as a conventional lessor. These arrangements will then correspond with the loan terms between the SPE (lessor) and the lender.

The ownership and control of the SPE must be taken into consideration in financing using structures of this sort. The SPE will usually be established as a bankruptcy remote entity so that its introduction into the financing does not complicate the credit risks being taken by the parties (lender and Islamic finance recipient) that have an economic interest in the transaction. In addition, the parties will be interested in having the SPE controlled by a party neutral to the transaction.

We are often asked to include in the documentation a provision to the effect that disputes between the parties will be resolved in accordance with the *Shari’ah* or by arbitration proceedings conducted before agreed *Shari’ah* advisors. Thus far, we have resisted the inclusion of such provisions. In our view, the *Shari’ah* advisor should pass on a review of the transaction terms and documentation prior to closing of the transaction. Once the *Shari’ah* advisor is satisfied that the terms of the documentation comply with Islamic law, our objective is to have the documentation enforced according to its terms under the laws of a recognized commercial jurisdiction (New York or England). If the courts of those jurisdictions properly interpret the law, the documentation should be enforced according to its terms and the parties will obtain the results they bargained for. In addition, it is reasonable to expect that the commercial lender providing the loan financing to the SPE would not be prepared to rely on a lease agreement (which is its underlying credit document) that is governed by the *Shari’ah* because of the lender’s unfamiliarity with that body of law and the difficulty that could arise if it were required to prove that governing law if legal proceedings became necessary.

#### V. CONCLUSION

Financial institutions that seek to become involved in Islamic financial transactions must deal with the legal and practical issues, some of which are described above, that will be confronted in such transactions. They must also take a “long view” of the Islamic financial market and its long-term potential. When approaching lenders with a proposal that they engage in a transaction that is structured to satisfy Islamic requirements, we generally present the transaction as a structured financing utilizing an SPE. All lenders are familiar with structured financing and the use of special-purpose entities in such financing, as

such transactions are often undertaken to achieve tax or accounting objectives. An Islamic structured financing is no different, except that the finance recipient has additional considerations that it is trying to satisfy. Presented in this light, Islamic financing should seem no stranger or more foreign than any other structured financing. The presentation to a potential lender and the documentation should also not use foreign words, as new terminology can raise unnecessary concerns.

Some financial institutions in the United States are seeking to finance Islamic transactions directly rather than through loans made to SPEs. For example, the New York branch of the United Bank of Kuwait recently obtained regulatory approval for a home lease/purchase program. Obtaining this approval was significant because it represented an exception to the regulatory prohibition on a bank's ownership of real estate. Permission for the program was received in recognition that the transaction essentially represented a financing and that the risks of the program were comparable to the risks of conventionally structured financing. Another approval was given to Citibank, N.A. to engage in *murabaha* transactions. This approval was sought on the basis that such transactions constitute the economic equivalent of a financing and that such transactions are consistent with foreign banking practices. The approval was granted on the basis of the second rationale. These developments on the regulatory front should enable a more widespread utilization of Islamic financing structures by conventional U.S. financial institutions.