Legal issues arising in Islamic finance transactions in the United States

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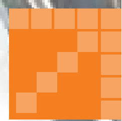

Introduction

Islamic finance in the United States has developed along two distinct paths during the past 15 years. The first is the development of retail Islamic finance and investment products by conventional US financial institutions and several Shariah compliant non-bank financiers, and the marketing of those products to consumers and small businesses. The second is equity investment by non-US Islamic institutions (and their clients) in US assets, in particular property, companies and leased equipment. While there is some overlap on certain issues, in general the legal issues that have impacted these two lines of activity are quite different.

The development and marketing of Islamic financial products to consumers in the US has required the sponsors of those products to obtain approvals from US or state banking regulators, as well as tax rulings from local tax authorities. The regulatory approval process has focused on the legal and economic substance of those products and how they do or do not fit into a regulatory framework that is based on interest-based products or conventional financing structures. In addition, sponsors have had to consider the application to their products of the various federal and state laws that are intended to protect consumers in their financial and investment dealings.

In contrast, the making of equity investments in US assets and, in particular, the financing of those investments by US financial institutions raise a number of legal issues of a non-regulatory nature that are typically

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addressed by the parties in the structuring of the proposed transaction or in the transaction documentation.

This section will provide an overview of some of the key legal issues associated with the offering of Shariah compliant financing and investment products to US consumers, and the financing of wholesale equity investments in the United States. Although several Islamic structures are used for these financing arrangements, the principal Islamic structures in use are Murabaha, Ijarah and Ijarah Wa'iqtinah, and our discussion will be limited to those structures.

Retail financing products

Regulatory considerations. The groundwork for the approval of Shariah compliant retail financing products in the United States was established with the approval by the Board of Governors of the Federal Reserve (Federal Reserve) of the offering of such products by the foreign subsidiaries and branches of US banks. During the 1985 to 1997 period, the Federal Reserve authorised some of the leading US financial institutions to offer Murabaha and Ijarah products in countries, such as Pakistan and the Sudan that had mandated that all financing activities in those countries be provided on an Islamic basis. During this same period, the Federal Reserve also approved the offering of such products by the foreign subsidiaries and branches of certain US banks in countries in which the offering of such products was not legally mandated, but in which there existed strong and increasing demand.

Implicit in the granting of these approvals was a determination by the Federal Reserve that the risks associated with offering the specified Murabaha and Ijarah products were substantively no different than the risks associated with comparable conventional financial instruments. In a Murabaha transaction, the financial institution will first purchase the goods that have been specified by its customer and then, once ownership has been transferred to the financial institution, resell those goods to the customer on a cost plus profit basis, usually with payment to be made at an agreed future date. As a result of this arrangement, the financial institution will take title to the goods for a short period of time before reselling the goods to its customer. In an Ijarah or Ijarah Wa'iqtinah structure, the financial institution will hold title to the leased assets until the end of the lease term. Taking title to goods and then reselling those goods is not a typical activity for a US financial institution. Nevertheless, in its approvals the Federal Reserve chose to look to the substance of the transactions rather than the form and in doing so reached the conclusion that the risks posed to the US financial institutions were essentially credit risks of the type regularly managed by those institutions in their traditional banking operations.

This focus on the substance of the proposed financing transaction rather than its form was essential to the regulatory approvals that were next granted by the Office of the Comptroller of the Currency (OCC) in the 1997 to 2001 period. During that period, the OCC approved on a case-by-case basis the offering of Murabaha and Ijarah Wa'iqtinah arrangements to finance home purchases. Not only did the OCC conclude that the transactions were essentially credit transactions, and that the applicant US financial institutions had the expertise to identify and manage those credit risks, but the OCC also addressed the restrictions placed on ownership of real estate by US financial institutions. US banks are not permitted to own real estate, other than to house the operations of the bank, or real estate acquired as a result of a foreclosure. The purpose of these restrictions is to prevent banks from engaging in speculative real estate investment activities. In its approvals, the OCC again took a substantive view of the transactions in question and determined that the risks associated with the ownership of real estate in these situations were credit risks rather than the types of risks intended to be prevented by the regulatory restrictions. Its approvals were granted that basis. The New York State Banking Department also approved similar home mortgage financing products during the same period.

Tax considerations. Although regulatory approval of Murabaha and Ijarah financing products is a precondition for such products to be offered by regulated US banks, those approvals do not address all of the legal issues faced by US banks in offering such

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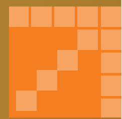

products to consumers seeking to finance home purchases on a Shariah compliant basis. As with many Islamic financing products, their viability may depend on the tax treatment of the financing product. For example, state property transfer taxes need to be taken into consideration in any home finance product that is based on a Murabaha or Ijarah Wa'iqtinah structure. Most states have property transfer taxes that will impose a tax on each transfer of real estate or each recording of a deed. If a Murabaha or Ijarah Wa'iqtinah structure is used, the initial purchase of the home by the bank will be subject to a transfer tax, the payment of which will typically shifted to the consumer or built into the resale price or the lease rental payments. When the Murabaha or lease payments have been fully made and the property is to be transferred to the consumer, as second real estate tax is likely to be payable, thus imposing an additional tax burden on an Islamic financing transaction that is not applicable in a conventional mortgage financing. The tax authorities in New York have recognised the inequity of imposing a second tax payment on a Shariah compliant structure when the substance of the transaction is the equivalent of a conventional financing, and rulings have been issued on a case-by-case basis to eliminate this double tax burden.

Ownership risks. Regardless of whether a Murabaha or an Ijarah Wa'iqtinah structure is used to finance the purchase of real property, a financial institution will have become part of the "chain of title" of the property even if, in a Murabaha structure, only for a moment. US law imposes various responsibilities and liabilities on the current and prior owners of real property, and a bank participating in financing structured in a Shariah compliant manner will need to recognise and mitigate those risks. If, for example, a property is found to have environmental issues, the current and prior owners may be legally obligated to pay the cost of any

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required clean-up of the property. These are risks that are generally not applicable to banks providing conventional mortgage finance. These risks can be mitigated by having environmental experts conduct thorough diligence prior to undertaking the transaction. Indemnities from the bank's customer may also be sought, but such indemnities may be insufficient. Structurally, the bank's other assets can be protected from these risks by using a separate subsidiary for each financing transaction, but the creation and maintenance of a new entity for each transaction will drive up the cost of the transaction and may put the financing product at a competitive disadvantage in comparison with a conventional mortgage financing product.

The ownership of property also carries with it the risk of liability for injuries occurring on the property. A financial institution financing the acquisition of property through an Ijarah Wa'iqtinah structure needs to be mindful of those risks and should obtain an indemnification undertaking from its customer, which is the party that occupying the property, or insurance protecting it against the risks associated with its ownership of the property. Other risks. Murabaha and Ijarah Wa'iqtinah structures can be used by US financial institutions to finance the purchase or goods or equipment in addition to real estate. When these structures are used to finance the purchase of goods or equipment, the financial institution will seek to address some of the risks unique to those transactions.

A customer in a Murabaha transaction will want to have the benefit of the supplier's express and implied warranties relating to the goods or equipment, and the financial institution will want to be sure that its customer is looking to the supplier, rather than to the financial institution, should the customer seek to make claims under those warranties. It is generally possible to transfer contractually the benefit of the supplier's warranties from the financial institution to the customer, and this issue should be addressed during the customer's preliminary dealings with the supplier, and in the purchase contract that is eventually signed between the financial institution and the supplier, otherwise the warranties will end up benefitting only the financial institution.

Similarly, the financial institution will seek to eliminate any warranty claims that might be made against it by its customer. Although it is generally possible to disclaim warranties, such disclaimers, especially in a consumer context, are generally not favoured and would probably be strictly construed against the financial institution. In most states, any disclaimer of warranties must be conspicuous and the language used must clearly call the customer's attention to the exclusion. In addition, the disclaimer of certain implied warranties, such as merchantability and fitness for a particular purpose requires specific language to be enforceable. Warranty disclaimers that fail to meet those requirements may be held to be invalid.

The nature of a Murabaha transaction is such that the purchase price to be paid by the customer does not change if the customer is required to make early payment, for example in a default situation, or if the customer seeks to prepay the purchase price voluntarily. This feature of a Murabaha transaction can create problems under US laws that aim to protect consumers by limiting the interest or finance charges that

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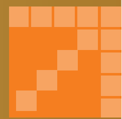

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may be imposed in a consumer transaction, that impose a limit on penalties resulting from mandatory or voluntary prepayments or that require full disclosure of all interest and finance charges applicable in a consumer transaction. Under US laws, the profit element of a Murabaha purchase price would be treated as interest. The general practice of Islamic financial institutions in voluntary prepayment situations is to provide the customer with a compensatory payment that is intended to offset the financial institution's receipt of the portion of the profit embedded in the Murabaha price that is "unearned" as a result of the early payment. This approach is not documented, and the Islamic financial institution has no legally enforceable obligation to make such compensatory payment to its customer. Nevertheless, making such compensatory payments is generally expected by participants in Murabaha transactions.

Such an approach, however, does not work in the regulated field of consumer finance in the United States. What we have seen in this situation in which US legal requirements and Shariah requirements come into conflict is that the Shariah scholars, recognising the utility of providing Shariah compliant financing products to the Muslim community, have permitted the financial institutions providing such financial products to rebate the "unearned" profit back to the customer so that the financial institution may avoid violating US laws concerning the receipt of usurious interest charges or what might be considered to be impermissible prepayment penalties.

Retail investment products

The offering of retail investment products to US consumers is still a work in progress. Investment accounts of the type offered by Islamic institutions in the Middle East are not yet available in the United States. Those investment accounts are based on a sharing in the profits and losses of the depository bank, an arrangement that puts the invested amount at risk. The notion that an amount placed on deposit by a consumer with a US bank could be at risk is inconsistent with the US regulatory framework, which does not permit the invested amount to be at risk, and backs that arrangement with federal deposit insurance up to specified limits. The United Kingdom, which has a regulatory approach that is similar to the approach taken by the United States, has responded to that difference by continuing the guaranty of the investment amount but permitting the bank's customer to waive the benefit of the guaranty if the depository institution suffers a loss that would otherwise have been shared by the customer. US regulators have not yet been asked to approve such an arrangement. The depository arrangements currently targeted to the Muslim community in the US permit the customer to share in the profits of the depository bank, but not in any of the bank's losses. This arrangement, while financially beneficial to the customer, is not in full compliance with Shariah principles because the customer is not required to share in the bank's loss. It remains to be seen whether a US financial institution will seek regulatory approval of a deposit product that would pass on the financial institution's losses to the depositor under a UK-style waiver approach or some other arrangement that has the same substantive effect. In considering a solution to this problem, one approach that has been suggested would be to treat a profit and loss sharing deposit as an investment product regulated by the Securities and Exchange Commission, rather than a banking product regulated by the federal and state banking regulators.

Wholesale equity investment

Acquisition and financing structure. Regulatory issues are generally not relevant to Shariah compliant equity investment in properties,

companies and leased equipment in the United States. Such investments, undertaken on a wholesale basis by Islamic financial institutions typically for syndication to their clients, have their own legal issues, but those issues are addressed in the transaction documentation and generally do not involve regulatory authorities. The structure that appears to be most frequently used for the acquisition and financing of US assets on a Shariah compliant basis is an Ijarah Wa'iqtinah, or a lease-purchase arrangement. We will use that structure in the context of an investment in a portfolio of stabilised commercial and residential properties to illustrate some of the key legal issues.

In an Ijarah Wa'iqtinah, the property is held by a special purpose entity (SPE) that is usually owned by a corporate services company. The property being acquired from the third party seller is transferred directly to the SPE. At the time of acquisition, the SPE will enter into an Ijarah Wa'iqtinah lease of the property with an entity (InvestorCo) established for that purpose by the Islamic financial institution sponsoring the investment. The Ijarah Wa'iqtinah documentation will require InvestorCo to make an initial payment to SPE, which payment may be treated as an initial rent payment, but in substance it represents the equity investment made by InvestorCo in the property. SPE will enter into a conventional financing arrangement with a US bank or other lender (Lender), and the proceeds of that financing together with the initial payment made by InvestorCo will be used by SPE to pay the purchase price of the property. InvestorCo, as master lessee of the property from SPE, will become the landlord in relation to the tenants physically occupying the property. InvestorCo will secure its obligations under the Ijarah Wa'iqtinah documentation by assigning to SPE its rights under the tenant leases as collateral and by granting a security interest in any other assets of InvestorCo. The SPE will, in turn, secure its obligations under the mortgage loan from Lender with an assignment of its rights under the Ijarah Wa'iqtinah documentation with InvestorCo, and with a collateral assignment of the collateral received from InvestorCo. Rent payments by InvestorCo under the Ijarah Wa'iqtinah are substantially equivalent to the debt service obligations of SPE under the mortgage loan documentation with Lender. As a result, any payment default by InvestorCo is likely to result in a payment default under SPE's mortgage loan documentation with Lender. Moreover, the mortgage loan documentation is likely to have an explicit cross default to defaults by InvestorCo under the Ijarah Wa'iqtinah documentation (a corresponding cross default in the Ijarah Wa'iqtinah documentation to a default under the mortgage loan documentation is typically not agreed because of Shariah considerations).
In conjunction with the Ijarah Wa'iqtinah documentation, SPE would typically grant to InvestorCo a "call" right to purchase the property at any time or at certain specified times for an acquisition cost specified in the Ijarah Wa'iqtinah documentation. InvestorCo would, in turn, typically grant to SPE a "put" right to require InvestorCo to purchase the property upon an event of default for an amount equal to the acquisition cost. The Ijarah Wa'iqtinah documentation will require that certain tasks associated with ownership of the property be handled by SPE. SPE will typically seek to retain InvestorCo (or an affiliate of InvestorCo) under a separate supplemental agreement to handle the performance of those responsibilities on behalf of SPE. The amount required to be paid by SPE to InvestorCo under this supplemental agreement would be factored into the rent payment obligations of InvestorCo under the Ijarah Wa'iqtinah documentation. The last document comprising the Ijarah Wa'iqtinah documentation would typically be a tax matters agreement in which

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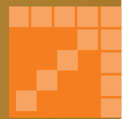

InvestorCo and SPE would agree on the US tax treatment of the overall transaction. This type of structure can also be used in connection with a corporate acquisition or an acquisition of leased assets, and the key legal issues that arise in such arrangements tend to be the same.

Structural legal issues. Two key legal issues are presented in the above-described acquisition and financing structure. InvestorCo (and the investors who have capitalised InvestorCo) will seek to be treated as the owners of the property to obtain the US federal tax benefits of property ownership. To achieve that tax treatment, all of the benefits and burdens of ownership of the property must rest with InvestorCo, notwithstanding that InvestorCo is the lessee of the property and not the title holder. Achieving that tax treatment while respecting Shariah principles can be challenging but it is achievable. The other key legal issue relates to Lender's recognition that, while its mortgage loan is to SPE, which is the title owner of the property, its true "borrower" is InvestorCo, which is leasing the property from SPE. Lender will want to be certain that this structure – in which an SPE is interposed between it and its true borrower – will not negatively impact Lender's rights or the enforcement of its remedies. These broader issues end up being addressed in the mortgage loan documentation between Lender and SPE and in the Ijarah Wa'iqtinah documentation between SPE and InvestorCo.

Tax ownership of the property. To pass Shariah scrutiny, a lease must provide that certain responsibilities that are generally thought of as being attributable to property ownership be retained by the property lessor. The consensus among Shariah scholars is that the property owner should retain the obligation to make major or structural repairs to the property and to maintain casualty insurance on the property. As a consequence, the Ijarah agreement that forms a part of the Ijarah Wa'iqtinah documentation in our example must provide that such responsibilities are the obligation of SPE. That allocation of responsibilities, however, is inconsistent with the tax perspective, which takes the view that these burdens allocated to SPE should instead be the responsibility of InvestorCo if InvestorCo seeks to be treated as tax owner of the property. This conflict is resolved through the supplemental agreement by which SPE retains InvestorCo to undertaken on behalf of SPE the responsibilities for major repairs and property insurance allocated to SPE under the lease document.

Another point of conflict pertains to the consequences of a casualty resulting in a total loss. Under Shariah principles, one cannot lease an asset that no longer exists, so if a total loss of the property occurs as a result of a casualty, the lease must terminate. As

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the lease essentially represents the extension of the financing provided by Lender to SPE and from SPE on to InvestorCo, one can see how such a result would not be acceptable to Lender, plus the result would be inconsistent with the tax position that all risks and rewards of property ownership must fall on InvestorCo if it is seeking to be treated as the owner of the property for federal tax purposes. This conflict is also typically resolved in the supplemental agreement, which may provide that InvestorCo (as the contractor under the supplemental agreement) is responsible for maintaining insurance that upon a casualty resulting in a total loss of the property will pay out insurance proceeds equal to the outstanding obligations under the Ijarah Wa'iqtinah documentation (those obligations being substantively identical to the obligations of SPE under the mortgage loan). The consequence of this arrangement is to reallocate back to InvestorCo the risks associated with a total loss arising from casualty.

Bankruptcy. If the property investment performs poorly and defaults occur, Lender will want to be certain that the Ijarah Wa'iqtinah structure and the holding of title to the property by SPE will not put it in a worse position than if it had provided financing directly to the substantive owner. This structural issue could be mitigated by InvestorCo entering into a direct agreement with Lender under which it acknowledges that its lease is subordinate to Lender's mortgage on the property, and that such lease may be terminated upon a foreclosure of the mortgage by Lender. Most Shariah compliant investors, however, are not prepared to have direct contractual dealings with Lender, and the resulting solution has been to place the requested subordination provisions directly in the Ijarah agreement between SPE and InvestorCo. These self-executing provisions provide for an acknowledgement by InvestorCo that the Ijarah agreement is subordinate to the mortgage of Lender and may be terminated by Lender upon a foreclosure of the mortgage. While the mortgage foreclosure procedure may be a little more complicated because of the loan-to-lease arrangement, the foreclosure process should not be materially more complicated than foreclosing on a conventional mortgage financing structure.

Governing law. Although the Ijarah Wa'iqtinah documentation is intended to comply with Shariah principles, the agreements are generally stated to be governed by New York law (except for the mortgage and related security documentation, which are typically governed by the law in which the property is located). The occasional suggestion that the documentation should be governed by Shariah principles (in addition to the local secular law) has been generally resisted on the basis that such provisions conflict with the selection of the local law as being the governing law of the transaction and are likely to create confusion in an enforcement scenario. Instead, the goal should be to have the legal effects of the documents be consistent with Shariah principles, while looking to the local secular law to achieve such effects in a predictable manner.

In summary, a number of the regulatory and legal issues associated with the introduction of Islamic financing and investment products in the United States, and the making of wholesale equity investments in the United States, have been identified and addressed, but there remain a number of issues, especially on the regulatory front, that will no doubt be explored and resolved in the coming years as Islamic finance makes inroads into the United States.

Isam Salah *heads up the Middle East & Islamic Finance practice at King & Spalding, and is based in the firm's New York City and Dubai offices.*

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