CHAPTER 4

Islamic financial products under US Law

4.1 Introduction

The United States is not sufficiently recognized for its openness to Islamic financial products and investments. Part of that openness is derived from a legal and regulatory framework that generally takes a substantive and flexible approach to issues and developments, rather than an approach that is tied to labels and formalities. The regulatory authorities, in recognition of constitutional protections, have also sought to treat financial products and instruments that are based on Islamic principles in a manner that would not discriminate on the basis of religion. The traditional willingness of the U.S. business community to undertake new transactions is also a positive factor.

Two important trends have characterized the growth of Islamic finance in the United States. The first has been the development of consumer Islamic financing and investment products and the regulatory approvals required for the introduction of such products. Those regulatory approvals have come from federal and state bank regulators and have included the rulings of local tax authorities. The focus of the approval process has been on determining how closely the legal and economic substance of the proposed products, satisfy the criteria designed with interest-based products in mind. In addition to obtaining required regulatory approvals, applicants have also had to consider the application of consumer protection and disclosure laws. Those laws often force a characterization of Shari'a-compliant transactions in a manner that is often inconsistent with the Islamic view of such transactions.

The second important trend has been the significant level of equity investment, structured and financed on a Shari'a-compliant basis, which has flowed into the United States from the GCC since the mid-1990s. This wholesale investment flow has been led by GCC-based financial institutions and investment companies that have made investments in property, companies and leased equipment, often using fund or fund-type structures. The equity capital for such investments has generally come from the local, high net worth clients of those institutions. Most of the legal issues arising in such investments have related to the way in which they have been financed. These issues have been resolved by the parties in the manner in which they have structured the ownership and financing of such investments and have not required the involvement of regulatory authorities.

This chapter will provide an overview of some of the key legal issues that arise in the financing of wholesale equity investments in the United States and with the offering of Shari'a-compliant financing and investment products to U.S. consumers. The focus will be on the key structures that are used in these transactions-those being murabaha, ijara and ijara wa'iqtina.

4.2 Equity investment

4.2.1 Acquisition and financing structure

The structure most commonly used to finance property or corporate acquisitions in the United States on a Shari'a-compliant basis is an ijara wa'iqtina, which is a lease and purchase arrangement. The structure is popular because it provides financing flexibility and it is similar to other conventional financing structures regularly used in the United States.

To structure an ijara wa'iqtina, it is necessary to create a special purpose company (SPC). The purpose of the SPC would be to hold title to the property and to lease it to the Shari'a-compliant investor entity (Investor). The SPC would be established and maintained by a corporate service company that would maintain the company in good standing, supply the directors and officers of the SPC, maintain the books and records of the SPC, and file the SPC's tax returns. The corporate service company would be paid a nominal annual fee for performing these services. The use of an SPC is necessary in the United States if the ultimate finance provider is a bank, because banks are generally prohibited from owning real property. Even if that regulatory prohibition did not exist, most conventional banks would probably be reluctant to own real property assets directly because of the potential liabilities that flow from such assets.

The contract under which the property is to be acquired (the purchase contract) is generally entered into by one of the investment sponsors prior to the establishment of the various entities, including the SPC and the Investor, that will be used in the acquisition and financing structure. The purchase contract needs to provide the buyer with flexibility either to assign the purchase contract to the SPC or to direct that the property be conveyed directly to the SPC. The approach that is taken to convey title to the property to the SPC should be carefully analyzed to make sure that it does not result in the double application of any local property transfer tax - for example, once for the deemed conveyance of the property to the buyer and a second time for the deemed conveyance from the buyer to the SPC.

The SPC will generally be obligated to pay the purchase price of the property at the closing. The SPC will fund its payment of the purchase price from two sources -the proceeds of a conventional loan from a financial institution and an initial payment from the Investor under the ijara wa'iqtina documentation that is entered into on the closing date. This payment by the Investor under the ijara wa'iqtina documentation may be identified as an initial payment of rent, but it represents the equity investment made by the Investor in the property. Under the ijara wa'iqtina documentation, the Investor will lease the property from the SPC, and the SPC will assign to it any existing tenant leases. As a result of this assignment, the Investor will become the landlord in relation to the end user tenants of the property. The rent payments to be made by the Investor to the SPC will be substantially equal to the debt service payments to be made by the SPC to the financial institution, and the method of computation and dates of payment will be matched. Any default by the Investor under the ijara wa'iqtina will result in a default under the lease documentation: first, because the terms of the ijara wa'iqtina are substantially the same as the terms of the conventional financing provided by the financial institution to the SPC and, second, because the conventional financing will typically contain a cross default provision linking to defaults by the Investor under the ijara wa'iqtina documentation. A corresponding cross default in the ijara wa'iqtina documentation to a default under the mortgage loan documentation is typically not acceptable, however, because it requires an explicit recognition of the existence of the conventional financing being obtained by the SPC.

As part of the ijara wa'iqtina documentation, the Investor would grant to the SPC, the right to "put" the property to the Investor and require the Investor to purchase the property and pay the unpaid "acquisition cost" of the property; the acquisition cost corresponds to the unpaid principal amount of the loan provided by the financial institution to the SPC. The put option would be exercisable upon an event of default and it is intended to provide an equivalent acceleration mechanism under the ijara wa'iqtina documentation. The ijara wa'iqtina documentation would also provide for the SPC to grant to the Investor a "call" right to purchase the property for an amount equal to the acquisition cost. The dates on which the call right may be exercised would correspond to the dates under the conventional financing on which the SPC may prepay that financing.

To satisfy Shari'a considerations relating to the sharing of risk, it will be necessary for the lease document to assign to the SPC, as the owner of the property, certain major responsibilities relating to the property. The SPC will then typically seek to retain the Investor (or an affiliate of the Investor) under a separate supplemental agreement to handle the performance of those responsibilities on behalf of the SPC. An amount equal to the amount required to be paid by the SPC to the Investor (or its affiliate) under the supplemental agreement would be included as part of the rent calculation, with the result that these two amounts are offset against each other. The final document comprising the ijara wa'iqtina documentation would typically be a tax agreement in which the SPC and the Investor would agree that for U.S. federal income tax purposes, the ijara wa'iqtina is to be treated as a financing, that the Investor is to be treated as the owner of the property for U.S. tax purposes (notwithstanding that title to the property is held by the SPC), and that the SPC and the Investor are to prepare and file their tax returns in a manner consistent with this treatment. As noted above, this type of structure, with minor modifications, can be used to finance corporate acquisitions in addition to property acquisitions.

4.2.2 Key legal issues relating to transaction structure

There are several key legal issues inherent in the ownership and financing structure described above. The Investor, including its equity owners, will want to be treated as the owners of the property to obtain the U.S. federal tax benefits of property ownership. To achieve that tax treatment, the Investor must be entitled to all of the benefits, and must suffer all of the burdens, of property ownership, notwithstanding that the Investor is the lessee of the property and not the title holder. As will be discussed below, achieving that tax treatment while respecting Shari'a principles can be challenging, but is achievable, through the inter-play of the ijara wa'iqtina documentation. Another key legal issue relates to the Lender's recognition that, while its mortgage loan is to the SPC, which is the title owner of the property, its true "borrower" is the Investor, which is leasing the property from the SPC. The Lender will want to be certain that this structure -in which a special purpose company is interposed between it and its true borrower -will not negatively impact the Lender's rights or the enforcement of its remedies. Although all of the rights of the Lender should flow from its mortgage loan documentation, through the SPC and reach the Investor through the ijara wa'iqtina documentation, there can be occasional gaps in the structure if the documentation is not properly drafted or structured.

The use of the SPC presents the additional issue of control. Although the property is generally controlled through the ijara wa'iqtina documentation, representatives of the corporate service company will be serving as directors of the SPC, and those individuals will be obligated to respect their director fiduciary obligations to the SPC, when they are called on to make decisions. For example, if a default has occurred and a foreclosure action is being threatened, the Investor may seek to have the SPC file for bankruptcy as a defensive measure to force the lender to negotiate a restructuring of the financing. In such circumstances, directors of the SPC may take a more conservative approach to the question of a bankruptcy filing than would directors who are employees of the Investor.

4.2.3 Tax issues and property ownership

To pass Shari'a scrutiny, the lease that is part of the ijara wa'iqtina documentation 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 Shari'a scholars is that the property owner should retain the obligation to make major or structural repairs to the property and to maintain damage insurance on the property. As a consequence, the lease agreement must provide that such responsibilities are the obligation of the SPC. This allocation of responsibilities, however, is inconsistent with the tax approach which requires that these burdens, which are correctly attributable to ownership, be the responsibility of the Investor if the Investor is seeking to be treated as tax owner of the property. This conflict is resolved through the supplemental agreement by which the SPC retains the Investor, or a consolidated affiliate of the Investor, to undertake on behalf of the SPC the responsibilities for major repairs and property insurance allocated to the SPC under the lease document. The payment by the SPC to the Investor under the supplemental agreement and a corresponding rent payment by the Investor to the SPC under the lease, are in practice netted off against each other.

Another point of conflict pertains to the consequences of damage resulting in a total loss. Under Shari'a principles, once an asset has been destroyed and can no longer be used, it cannot be the subject of a lease; and any existing lease of that asset must terminate. As the lease essentially represents the continuation of the financing provided by Lender to the SPC and from the SPC on to the Investor, one can appreciate that, from the Lender's perspective, it would be unacceptable for a borrower to be relieved of its payment obligation under a loan upon the destruction of the collateral for the loan. Moreover, such a result would be inconsistent with the tax position that all risks and rewards of property ownership must fall on the Investor if it is seeking to be treated as the owner of the property for federal tax purposes. This conflict is also typically resolved in a supplemental agreement, which may provide that the Investor (as the contractor under the supplemental agreement) is responsible for maintaining insurance and that upon damage resulting in a total loss of the property, will pay out insurance proceeds equal to the outstanding obligations under the ijara wa'iqtina documentation (those obligations being substantively identical to the obligations of the SPC under the mortgage loan). The consequence of this arrangement is to reallocate back to the Investor the risks associated with a total loss arising from damage, thereby preserving the tax treatment of the ijara wa'iqtina transaction as a financing.

4.2.4 Foreclosure and subordination

Before entering into a property financing transaction using an ijara wa'iqtina structure, the lender will want to determine that if a default occurs there will be no material impediment to the exercise of its remedies, in particular foreclosure.. In addition, the lender will want to be assured that it will be able to sell the property free of the Investor's rights under the ijara wa'iqtina documentation. We are not aware of court decisions dealing specifically with ijara structures of the type described above, but we would expect that the lender would be able to consolidate the foreclosure proceeding under the mortgage loan documentation with the foreclosure proceeding under the ijara wa'iqtina transaction so that both foreclosures proceed together in one consolidated proceeding. We would also expect that if a foreclosure proceeding is initiated by the lender against the SPC, but the Investor is not included in that proceeding, it should be possible for the Investor, as the party in interest, to intervene in that foreclosure proceeding.

The termination of the ijara wa'iqtina documentation requires that such arrangement be subordinate to the mortgage granted by the SPC to the Lender. Subordination may be achieved through a direct agreement between the Lender and the Investor, but most Shari'a scholars are reluctant to permit the investor to enter into a direct contractual arrangement with the lender. The solution most commonly used has been to place the requested subordination provisions directly in the ijara wa'iqtina documentation between the SPC and the Investor. In these unilateral provisions, the Investor acknowledges that the ijara wa'iqtina documentation is subordinate to the mortgage of the Lender and may be terminated by the Lender upon the completion of a foreclosure of the mortgage (and not merely upon a default under the mortgage loan).

4.2.5 Governing law

Although the ijara wa'iqtina documentation is intended to comply with Shari'a 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 Shari'a principles (in addition to the local secular law), has been generally resisted on the basis that such provisions conflict with the selection of local law as 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 Shari'a principles, while looking to the local secular law to achieve such effects in a predictable manner.

The issue of governing law has recently received special attention as a result of legislative initiatives that would prohibit judges from applying Shari'a law in court decisions. These initiatives are partially in response to a misguided court decision that sought to apply principles of Shari'a in a family law context; and perhaps influenced by the anti-Islam agenda of some. Legislation in the State of Oklahoma that would prohibit judges from applying Shari'a law or international law in their decisions was passed in a voter referendum, but its application was enjoined by a federal judge. In the State of Georgia, recently introduced legislation did not single out Shari'a law, but instead prohibited the application of foreign law by judges in Georgia courts if to do so would deprive litigants of their constitutional protections. These initiatives are all the more reason to approach Shari'a-compliant transactions with the objective of implementing a structure that will be enforceable under a designated local secular law.

4.3 Consumer investment products

The offering of retail investment products to U.S. consumers is still in its early stages. The United States bank regulatory framework does not contemplate investment accounts of the type offered by Islamic institutions in the Middle East, because those investment accounts require a sharing of profits and losses between the depository bank and the consumer. Such losses are not limited to the loss of profits, but also to a loss of all or part of the amount deposited with the bank. A loss of the amount deposited by a consumer with a bank is inconsistent with the U.S. 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's approach to the same issue might indicate a possible course of action for U.S. regulatory authorities that would enable them to reconcile the requirements for Shari'a-compliance with the principles of the U.S. regulatory system. The UK's FSA, which follows a regulatory approach similar to the approach taken by the United States, has required the continuation of the guarantee of the investment amount, but has permitted the bank's customer to waive the guarantee and its benefit if the depository institution suffers a loss that would otherwise have been shared by the customer U.S. regulators have not yet been asked to approve such an arrangement, and there has been no indication whether such an approach would be acceptable. The depository arrangements currently targeted to the Muslim community in the U.S. permit the customer to share in the profits of the depository bank, but not in any of the bank's losses. Although this arrangement protects the customer against the bank's losses, it is not in compliance with Shari'a principles, because the customer is not required to share in the bank's loss. It remains to be seen whether a U.S. 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.

4.4 Consumer financing products

4.4.1 Regulatory issues

U.S. regulatory authorities began to address the issues relating to Shari'a-compliant consumer products in the mid-1980s. The regulator that took these initial steps was the Board of Governors of the Federal Reserve (Federal Reserve). During this period and continuing until the late 1990s, the Federal Reserve approved the offering of Shari'a-compliant consumer financing products by the foreign subsidiaries and branches of U.S. banks. The initial approvals permitted some of the leading U.S. financial institutions to offer murabaha and ijara 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. The Federal Reserve next expanded this authority by permitting foreign subsidiaries of certain U.S. banks to offer such products in countries that had a strong and increasing demand for Shari'a-compliant products, even though such products were not legally mandated in those countries.

Embedded in these approvals was the Federal Reserve's implicit determination that the risks associated with offering the specified murabaha and ijara products - in particular taking title to the product for a short period of time (as in a murabaha transaction) or for an extended period of time (as in an ijara transaction) were substantively no different than the risks associated with comparable conventional financial instruments. One of the keys to a murabaha transaction is that the financial institution must take title to the goods in question before they are resold to the financial institution's client, with such resale at cost plus an agreed profit and with payment typically at an agreed future date or dates. In an ijara or ijara wa'iqtina 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 or generally permitted activity for a U.S. financial institution. Nevertheless, in its approvals the Federal Reserve chose to look to the substance of the transactions rather than the form. In doing so, the Federal Reserve reached the conclusion that the risks posed to U.S. financial institutions engaged in such transactions were essentially credit risks of the type regularly managed by those institutions in their traditional banking operations. This flexible approach of the Federal Reserve -to look to the substance of the transaction in making a regulatory determination- is one of the strengths of the U.S. regulatory system and will benefit the Islamic finance industry as it submits additional products for review and approval.

This focus on the substance of the proposed financing transaction rather than its form was also essential to the regulatory approvals that were next granted from 1997 to 2001, but this time by the Office of the Comptroller of the Currency (OCC), which is the federal bank licensing authority. During this period, the OCC approved the offering of ijara wa'iqtina and murabaha financing products on a case-by-case basis to finance consumer home purchases. As part of its approval, the OCC concluded that the transactions were essentially credit transactions that could be effectively identified and managed by U.S. financial institutions, and that the applicant U.S. financial institutions did have the appropriate expertise to identify and manage those credit risks.

In addition, the OCC addressed the restrictions placed on ownership of real estate by U.S. financial institutions. U.S. 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. These depression-era restrictions were intended 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 on that basis. The New York State Banking Department, which has taken an active interest in the regulatory issues posed by Islamic financial products and issues, also approved similar home mortgage financing products during the same period.

4.4.2 Tax issues

The regulatory approval of ijara and murabaha financing products was a significant step forward, but it did resolve all of the legal issues associated with the use of such products to provide consumer finance in the United States. A key issue with almost every Shari'a-compliant product in the United States is its tax treatment, both on a federal and on a state and local level. For example, most states have property transfer taxes that apply to every transfer of real estate or every recording of a real estate deed. These taxes can be significant in some jurisdictions and can materially affect the profitability of a transaction. If the Shari'a-compliant product proposed by the bank is a murabaha financing of real estate, a tax could potentially be payable on the sale of the home from the seller to the bank and again on the resale of the home by the bank to its customer. The same result would apply in an ijara financing, except that the second tax would be payable when title to the property is transferred to the bank's customer at the end of the lease term. This double taxation of common home finance products would make such products disadvantageous in comparison with conventional home finance products. The tax authorities in New York State have recognized the inequity of imposing a second tax payment on a Shari'a-compliant structure when the substance of the transaction has equivalence to conventional financing. Rulings have been issued on a case-by-case basis to eliminate this double tax burden.

In addition to transfer tax issues, Islamic consumer finance products also present potential federal tax issues. For example, under current U.S. tax law, an individual tax payer is permitted to deduct mortgage interest payments in determining the tax payer's total taxable income. As the Shari'a-compliant structures are substantially equivalent to the conventional structure, these embedded finance (or "interest") charges should also be deductible. The financial institution that developed the Islamic financial product may have obtained such approval to facilitate the marketing of such product, but if it did not, the consumer would be left with the choice of either not deducting the embedded financing charges or deducting such charges and defending its position if challenged by the tax authorities.

4.4.3 Risks of property ownership

U.S. law imposes various responsibilities and liabilities on the current and prior owners of real property. If a bank provides financing to a consumer with a Shari'a-compliant product, it will generally take title to the property for only a moment (in a murabaha financing) or for an extended period of time (in an ijara wa'iqtina financing). The mere fact that the bank entered the chain of title (even if, in the case of a murabaha transaction, for only a brief moment) is sufficient to make the bank potentially liable for risks associated with the property. Risks of this type are generally not applicable to banks providing conventional mortgage finance, so a bank providing a Shari'a-compliant financial product will need to understand and take steps to mitigate such risks. If, for example, environmental problems are identified at a property that is currently or was previously owned by the bank, that bank would potentially have the obligation to bear the expense of any environmental remediation that may ensue. Risks of this type can be mitigated by having environmental experts conduct thorough due 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 ijara wa'iqtina structure needs to be mindful of those risks and should obtain an indemnification undertaking from its customer, which is the party that is occupying the property, or insurance, protecting it against the risks associated with its ownership of the property.

4.4.4 Other risks

Murabaha and ijara wa'iqtina structures can be used by U.S. 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 U.S. laws that aim to protect consumers by limiting the interest or finance charges that 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 U.S. laws, the profit element of a murabaha purchase price would be treated as interest. The general practice of IFIs 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 IFI 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 U.S. legal requirements and Shari'a requirements come into conflict is that the Shari'a scholars, recognizing the utility of providing Shari'a-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 U.S. laws concerning the receipt of usurious interest charges or what might be considered to be impermissible prepayment penalties.

4.5 Conclusion

The United States maintains an open attitude to Shari'a-compliant equity investments and financial products, and the regulators have demonstrated their willingness to address the issues raised by such consumer products in a constructive manner. A number of issues have yet to be addressed, however, and that will not occur until we begin to witness more robust entry of IFIs into the United States.