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Shifting Title and Risk: Islamic Project Finance with Western Partners

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STUDENT NOTE

SHIFTING TITLE AND RISK: ISLAMIC PROJECT FINANCE WITH WESTERN PARTNERS

Alan J. Alexander*

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INTRODUCTION

A. Background to Islamic Project Finance

Project finance exemplifies modern globalized business transactions in that a single project can bring together numerous participants from across the world, and in that sense it is a truly international undertaking.¹ A general definition of project finance is “the financing of an economic unit in which the lenders look initially to the cash flows from operation of that economic unit for repayment of the project loan and to those cash flows and other assets comprising the economic unit as collateral for the loan.”² The “economic unit” is often referred to as a Special Project Vehicle (SPV).³ Project finance is commonly used to finance large-scale infrastructure projects such as toll roads, power plants, airports, and desalination plants, as well as natural resource exploitation projects such as hydroelectric dams, mining projects, oil and gas assets, and paper mills.⁴ These types of projects often require larger amounts of capital than one company alone can raise, or entail greater amounts of risk than one company alone can bear.⁵ Thus, project finance enables companies to pool capital and spread risk.⁶ Moreover, because the project is its own economic unit, it is “off-balance sheet”⁷ from the vantage point of the sponsor companies, thus further insulating the sponsors from the project’s liabilities.⁸ Also, governments will sometimes look to project finance to undertake projects that would be difficult for the government to finance through its own resources, or because the host country and its government lack the expertise to domestically construct and operate the

1. See generally JOHN M. NIEHUSS, INTERNATIONAL PROJECT FINANCE IN A NUTSHELL (2010) (explaining that international project finance contains a cross-border dimension where participants from many different countries can take part in a transaction).

2. Michael J.T. McMillen, *Islamic Shari’ah-Compliant Project Finance: Collateral Security and Finance Structure Case Studies*, 24 FORDHAM INT’L L.J. 1184, 1186 (2001).

3. See NIEHUSS, *supra* note 1, at 4.

4. See McMillen, *supra* note 2, at 1186.

5. See E.R. YESCOMBE, PRINCIPLES OF PROJECT FINANCE § 2.5.1, at 16 (2002); see also McMillen, *supra* note 2, at 1187 (noting the aversion of project sponsors to guaranteeing project loans or incurring balance sheet liability from a project).

6. See YESCOMBE, *supra* note 5, § 2.5.1, at 15–16; see also McMillen, *supra* note 2, at 1185–87 (describing briefly how project finance operates).

7. “Off-balance sheet” means the Special Project Vehicle’s (SPV) debt does not appear on the sponsoring companies’ balance sheets. This avoids any formal restrictions on additional borrowing that may be part of the sponsoring companies’ existing debt obligations. See NIEHUSS, *supra* note 1, at 21. Off-balance sheet financing also insulates the assets of the sponsoring companies in the event the project defaults. See *id.* at 4–5.

8. See YESCOMBE, *supra* note 5, § 2.5.1, at 16; see also McMillen, *supra* note 2, at 1187.

project.⁹ In sum, project finance is common in both the public and private sector, and has been since the mid 1970s.¹⁰

Indeed, there are very few countries and economic systems in the world where project finance techniques have not been used to undertake the construction and operation of a project.¹¹ Countries in which Islam is the predominant religion (the Islamic world)¹² and financiers from such countries have perhaps been the most recent entrants to the world of project finance. As such, project financing in and from the Islamic world picked up steam only in the last ten years.¹³ This late arrival is due in large part to conflicts between many fundamental principles of Western project financing and certain Islamic principles.¹⁴ Despite these obstacles, growth in project finance in the Islamic world is due in large part to surges in the price of oil and the resulting pools of excess cash that governments in the Islamic world have accumulated and invested in infrastructure.¹⁵

9. See YESCOMBE, *supra* note 5, § 2.5.2, at 17–19.

10. See BENJAMIN C. ESTY, MODERN PROJECT FINANCE: A CASEBOOK 26–29 (2004); see also M. FOUZUL KABIR KHAN & ROBERT J. PARRA, FINANCING LARGE PROJECTS: USING PROJECT FINANCE TECHNIQUES AND PRACTICES 38–91 (2003) (discussing the history of project finance from the time of the Code of Hammurabi to modern times).

11. One curious case is China. Project finance has not been used as extensively in China as the size of its economy would indicate. See YESCOMBE, *supra* note 5, § 3.1.1, at 23 (noting that project finance lending in China has tapered off since 1998).

12. In terms of geography, the Islamic world could be said to constitute a belt around the globe from Morocco and Cote d'Ivoire in West Africa to Indonesia and Malaysia in South-east Asia, with most of the countries in between possessing predominantly Muslim populations, such as Saudi Arabia and Somalia, or a large minority population of Muslims, such as in India and China. See Fuaad A. Qureshi & Mathew M. Millet, *Introduction to Islamic Finance*, at 1, 8 (Harvard Business School, Ser. No. 9-200-002). For the purposes of this Note “the Islamic world” is understood to mean countries in which Muslims constitute the majority of the population, and in which Islamic law, *Shari'ah*, governs either formally or informally to some extent.

13. See John Inglis & Nadim Khan, *Must Try Harder*, PROJECT FIN., Oct. 2004, at 30, 30 (“Islamic finance has been a source of funds for many years, but it is only in the last few years that a product range has been developed that allows it to be applied in the Middle Eastern project finance market.”); see also Mohammed El Qorchi, *Islamic Finance Gears Up*, FIN. & DEV., Dec. 2005, at 46, 46 (noting that the number of Islamic financial institutions in the world has grown from one in 1975 to over 300 in 2005).

14. See, e.g., McMillen, *supra* note 2, at 1186 (“A significant limiting factor relates to the conflict of certain Islamic principles with the fundamental debt-leverage principle of Western project financing . . .”).

15. See Michael Marray, *Deeper Pockets*, PROJECT FIN., Apr. 2005, at 33, 35 (noting that some governments in the Middle East “are currently awash in oil Dollars [sic]” and will do some projects on balance sheet, but will tap into “Islamic lease” structures for other larger projects); see also El Qorchi, *supra* note 13, at 46 (noting that the growth in Islamic finance is due to (1) demand for *Shari'ah*-compliant financial services from a large number of immigrant and non-immigrant Muslims, (2) growing oil wealth, and (3) the competitiveness of the products to both Muslim and non-Muslim investors).

For Muslims, Islam governs and prescribes rules for all aspects of human life, including the economic aspects of banking and finance.¹⁶ The body of law that guides the life and conduct of the Muslim is known as *Shari'ah*. Rather than a codified body of law, *Shari'ah* is a continual interpretation of religious law.¹⁷ In Islamic finance, *Shari'ah* first provides for two general principles: risk sharing and the promotion of social and economic welfare.¹⁸ From these two general principles derive five specific rules of Islamic finance: (1) *riba*, which is interest, making money from money, or unlawful gain, is prohibited; (2) *gharar*, which is speculation, uncertainty, or excessive risk taking, is prohibited; (3) the lender must share in the profits or losses that arise out of the activity for which money is lent; (4) money has no intrinsic value, or time value, such that transactions must be asset-backed; and (5) investments should only support activities that are not themselves forbidden, such as the production of pork, alcohol, or tobacco.¹⁹

B. Potential for Islamic Project Finance

These five principles have caused difficulty for Western project financiers who would like to undertake projects in the Islamic world, as well as for project financiers from the Islamic world that would like to invest their capital in projects in other parts of the world. Yet these barriers belie the tremendous potential for Islamic project financing,²⁰ both within and outside of the Islamic world. Within the Islamic world, there are numerous possibilities for project financing related to all phases of oil and gas production, from upstream projects associated with the extraction of hydrocarbons, such as the development and operation of oil fields, to downstream projects associated with oil and gas activities that take place after the oil and gas is removed from the ground, such as transportation, refining, and developing petrochemical plants.²¹ In addition, project financing within the Islamic world has been used outside of

16. See ZAMIR IQBAL & ABBAS MIRAKHOR, AN INTRODUCTION TO ISLAMIC FINANCE: THEORY AND PRACTICE 1–2 (2007).

17. See Qureshi & Millet, *supra* note 12, at 2.

18. Ali Adnan Ibrahim, *The Rise of Customary Businesses in International Financial Markets: An Introduction to Islamic Finance and the Challenges of International Integration*, 23 AM. U. INT'L L. REV. 661, 664 (2008).

19. See Scheherazade S. Rehman, *Globalization of Islamic Finance Law*, 25 WIS. INT'L L.J. 625, 630–31 (2008); Kelly Holden, Note, *Islamic Finance: "Legal Hypocrisy" Moot Point, Problematic Future Bigger Concern*, 25 B.U. INT'L L.J. 341, 346–47 (2007).

20. As used in this Note, "Islamic project financing" or "Islamic project finance" means project financing in which at least some of the sources of financing for the project are compliant with the tenants of *Shari'ah*. See *supra* text accompanying notes 18–19.

21. See Christopher F. Richardson, *Islamic Finance Opportunities in the Oil and Gas Sector: An Introduction to an Emerging Field*, 42 TEX. INT'L L.J. 119, 120 & nn. 1 & 4 (2006).

the oil and gas industry for the construction of desalination plants,²² aluminum smelters,²³ power projects,²⁴ and the construction and operation of toll roads.²⁵ The breadth, scope, and variety of these projects should come as no surprise considering that the Islamic world stretches from Morocco to Indonesia and Muslims comprise almost a fourth of the world's population.²⁶

There is also great potential for Islamic project finance outside of the Islamic world, as many Muslims and governments in the Islamic world are beginning to look for *Shari'ah*-compliant investment possibilities outside of their home countries.²⁷ Investing in project finance opportunities represent one such possibility. Given the experience and familiarity of the countries in the Middle East with the oil and gas industry, projects in this sector outside of the Islamic world would be attractive to Islamic investors. In fact, Islamic project financing has already supported one such project in the Gulf of Mexico for the drilling and operating of oil wells, thus showing the potential for future such projects.²⁸ In addition, commercial real estate projects are another possibility for Islamic project finance in the United States, and Islamic project financing has already contributed to several such projects.²⁹ Although outside of the traditional scope of project finance, it is worth noting the inroads that Islamic banking practices are making outside of the Islamic world.³⁰ These projects and trends show that despite decades of misunderstanding and uncertainty, Islamic financial practices are becoming better known and accepted throughout the world. As the general level of knowledge about Islamic finance and banking increases, its use in project finance will likely increase as well.

This potential for successful Islamic project finance highlights the importance of Islamic finance law and the unique concerns that it presents. Some of these concerns include: the unpredictable nature of *Shari'ah* advisory board decisions, conflicts relating to the Islamic lender's need to retain title in the project assets and the Western lender's need for a security interest, the Islamic lender's need to share in the

22. See, e.g., Abu Dhabi Islamic Bank, *Gulf Grower*, PROJECT FIN., Sept. 2002, at 40, 40.

23. See, e.g., *infra* Part IV.A.3.

24. See, e.g., *infra* Part IV.A.2.

25. See, e.g., Dominic Jones, *Cheap and Deep*, PROJECT FIN., May 2001, at 47, 49.

26. See *supra* note 12.

27. See *supra* note 15.

28. See *infra* Part IV.B.2.

29. See *infra* Part IV.B.1.

30. See, e.g., Samuel G. Freedman, *A Hometown Bank Heeds a Call to Serve Its Islamic Clients*, N.Y. TIMES, Mar. 6, 2009, at A9 (discussing how University Bank, a small, regional bank in Ann Arbor, Michigan, developed *Shari'ah*-compliant financial products for its Muslim consumer banking clientele).

project risk in the face of risk aversion on the part of Western lenders, and the variability in regulatory structures throughout the Islamic world.³¹ Understanding both the *Shari'ah*-compliant financing tools and the problems that they present will allow increased participation by Western investors in projects in the Islamic world as well as increased participation by Islamic investors in the West. This is desirable because it allows Islamic governments and companies to diversify their investment activities and avails Western investors of a new source of capital at a time when traditional credit markets are less able to lend than in years past.

This Note will survey Islamic finance and banking practices to show that the main consideration for structuring *Shari'ah*-compliant project financing is to ensure that the Islamic financier retains title in the project's operating assets. Structuring projects to accommodate this requirement allows for traditional Western financing to cooperate in project finance with Islamic financing, and overcomes most *Shari'ah* prohibitions. Title retention for the Islamic participants not only facilitates the participation of Western interests in projects in the Islamic world, but also allows for the participation of *Shari'ah*-compliant financing in countries outside of the Middle East, including the United States.

Part I of this Note will provide a general background to *Shari'ah*, its economic principles, and its application to project finance. Part II will address potential problem areas that are idiosyncratic to participation in Islamic project finance, including the need for the Islamic participants to retain title in the underlying project assets. Part III will describe Islamic financing tools and how those tools have been applied to project finance to facilitate title retention. Part IV will examine some past project financings that used Islamic financing tools with both Islamic and Western participants in order to demonstrate how allowing for some form of title retention on the part of the Islamic participants helps assure *Shari'ah* compliance. Finally, this Note will conclude by reemphasizing the importance of the retention of title in some or all of the project assets for the Islamic financiers, and discussing the benefits to project finance from the sources of wealth and resources in the Islamic world. In the end, learning how to facilitate the retention of title for the Islamic financier makes it possible to overcome most of the *Shari'ah* restrictions as well as many of the potential problem areas associated with Islamic project finance.

31. See *infra* Part II.

I. *Shari'ah* AND ITS APPLICATION TO PROJECT FINANCE

A. *The Sources of Shari'ah and the Islamic Economic System*

"[I]n the West . . . theology does not directly regulate commercial endeavors and remains generally divorced from the marketplace, [but] *Shari'ah* is intended to dictate all behavior undertaken by Muslims, including business affairs."³² Finance and banking are not exceptions; thus, it is important to gain an understanding of *Shari'ah* law and how it applies to project finance. Unlike a codified body of law, *Shari'ah* is not centralized, collected, and conveniently published. Instead, it is an ever-expanding body of law that, similar to the common law, is based on the interpretation of jurists.³³

Shari'ah is comprised of two primary and two secondary sources of legal authority.³⁴ The first, and most important, is the *Quran*.³⁵ Muslims believe the *Quran* to be the word of God communicated through the Prophet Muhammad.³⁶ Legal injunctions in the *Quran* are scattered throughout its verses, and it is frequently necessary to consult several verses in order to derive meaning from the *Quran*.³⁷ Often times, the *Quran* is nevertheless ambiguous about certain topics, especially those involving social conditions that have changed drastically since the *Quran* was written during the period of years spanning 610 through 632 C.E.³⁸ The *Quran* declared that the prophetic traditions, or the *Sunnah*, were to be followed, thus when the *Quran* is ambiguous, investigation should proceed to the *Sunnah*.³⁹

The *Sunnah* comprises the Prophet Muhammad's acts, sayings, and anything he tacitly approved, all of which were, according to the *Quran*, divinely inspired.⁴⁰ Most of these prophetic traditions were compiled and written down after his lifetime, which helps explain why there are several competing compilations of these traditions.⁴¹ These prophetic traditions are considered the second most authoritative source and either

32. Ayman H. Abdel-Khaleq & Christopher F. Richardson, *New Horizons for Islamic Securities: Emerging Trends in Sukuk Offerings*, 7 CHI. J. INT'L L. 409, 411 (2007).

33. See Ibrahim, *supra* note 18, at 673–85.

34. See *id.* at 675–76.

35. *Id.* at 675.

36. *Id.*

37. *Id.* at 676–77.

38. See *id.*

39. See *id.* at 677–78.

40. *Id.* at 675–76.

41. See *id.* at 678–79.

confirm the *Quran*, explain it, clarify it, or “comprise independent rulings that cannot be traced back to the *Quran*.”⁴²

After these two primary sources, *Shari’ah* begins to resemble the classic common law,⁴³ and the sources that follow are known as *fiqh* or “human comprehension of *Shari’ah*, the divine law.”⁴⁴ If the *Quran* and the *Sunnah* offer no guidance, the third source of *Shari’ah* is the “unanimous consensus of juristic opinion,” or the *ijma*.⁴⁵ Thus, once there is widespread opinion among Islamic jurists on an issue, that consensus becomes binding authority itself such that its reliance on primary authority is no longer necessary.⁴⁶ As universal consensus on an issue is extremely difficult to achieve, there are few instances of the true *ijma*.⁴⁷ Nonetheless, it has aided in the development of standardized legal theory in *Shari’ah*.⁴⁸

The final source of *Shari’ah* is juristic and analogical reasoning, *ijti-had* and *qiyas*, respectively.⁴⁹ The scope of juristic reasoning, *ijti-had*, is to infer meaning from the unclear text of the *Quran* and the *Sunnah* and apply that meaning to problems that *Shari’ah* has not previously addressed.⁵⁰ Similarly, analogical reasoning, *qiyas*, “is one of the main avenues of evolution for *Shari’ah*” and involves the extension of a legal injunction from its original case to an analogous situation in a new case.⁵¹

In the context of finance and banking, *fiqh* is the most important source of *Shari’ah*. Most Islamic financial institutions, as well as many Western institutions that do business in the Islamic world, will have *Shari’ah* supervisory boards comprised of one or more Islamic scholars that possess expertise in a certain field or type of financial transaction.⁵² After examining a transaction, if the board finds the transaction to be *Shari’ah*-compliant it will issue a legal opinion, or *fatwa*, as to the project’s compliance with *Shari’ah*.⁵³ Many, if not all, Islamic investors and finan-

42. *Id.* at 678.

43. *See id.* at 682–83.

44. McMillen, *supra* note 2, at 1190.

45. Ibrahim, *supra* note 18, at 679.

46. *See id.*

47. *See id.* at 680.

48. Qureshi & Millet, *supra* note 12, at 2.

49. Ibrahim, *supra* note 18, at 680–82.

50. *Id.* at 680–81.

51. Qureshi & Millet, *supra* note 12, at 2; Ibrahim, *supra* note 18, at 681.

52. McMillen, *supra* note 2, at 1190.

53. *See* Ibrahim, *supra* note 18, at 685–87. According to Islamic law, advisory boards should not receive remuneration, other than administrative costs, from the company seeking the *fatwa*; however, this is often not the case in modern practice. *See id.* at 687. Moreover, financial and transactional teams seeking a *fatwa* often do not disclose all the relevant information to the advisory board, resulting in “opinions based on limited information.” *Id.* at 688.

cial institutions will not proceed with a project or transaction until a *fatwa* is issued.⁵⁴ *Fatwas* are generally announced publicly, so like the common law, they allow for the replication of the product design or project structure for which they were issued.⁵⁵ Yet, as will be discussed below in greater detail, *Shari'ah* boards do not always follow precedent from previous *fatwas*, and will sometimes issue opinions that question or disapprove of previously approved practices.⁵⁶

Shari'ah raises unique issues as applied to finance and banking.⁵⁷ Broadly speaking, Islamic economic systems should: (1) seek to balance economic growth with economic justice, (2) promote prosperity and job creation, and (3) lead to the further adoption of Islamic economic and financial practices.⁵⁸ As noted in the first point, "Islamic finance is based on an understanding of economic justice."⁵⁹ For example, prohibitions against interest are in part based on a belief that lending money should be a charitable act.⁶⁰ In like manner, prohibitions against excessive levels of risk and uncertainty come from beliefs that excessive risk taking diverts attention away from productive occupations, and that the focus should be on the social relationships inherent in a monetary transaction rather than on the objects of those transactions themselves.⁶¹ These

Scholars and experts have yet to reach a consensus on how to resolve these and other ethical issues in Islamic finance. *See id.*

54. *See* McMillen, *supra* note 2, at 1190–91.

55. *See* Ibrahim, *supra* note 18, at 688–89.

56. Robin Wigglesworth, Special Report, *Sharia Compliance Rulings Reverse Trend*, FIN. TIMES, Dec. 8, 2009, at 3.

57. *See* Cole Beyer Richins, Comment, *Shari'ah Compliant Securities: American Lawyers Meet Islamic Finance*, 33 J. LEGAL PROF. 135, 140–42 (2008).

58. *See* Rehman, *supra* note 19, at 629. From these three general goals are extracted fifteen specific principles of the Islamic economic system:

- (1) Equal economic opportunities for all members of society; (2) Economic equity;
- (3) Economic freedom; (4) Personal property rights and sanctity of contracts; (5) Job creation for all that can and want to work and equal availability of employment;
- (6) Equal availability of education; (7) General economic prosperity; (8) Poverty prevention and reduction; (9) Basic needs fulfillment of food, shelter, clothing and rest; (10) Alms giving to charity; (11) Taxation to meet the unfulfilled needs of society and to address social issues generally; (12) Appropriate management of natural and depletable resources to benefit all members of current and future generations; (13) Abolition of corrupt practices; (14) Establishment of a supportive financial system and financial practices that include the abolition of interest; (15) The effectiveness of the state in achieving the above.

Id. at 630.

59. Bjorn Sorenson, *Ethical Money: Financial Growth in the Muslim World*, 23 AM. U. INT'L L. REV. 647, 649 (2008).

60. *See* Ibrahim, *supra* note 18, at 701.

61. *See* Sorenson, *supra* note 59, at 650 ("Though Islamic financial instruments do not allow for the spectacular gains and collapses that regularly churn through the capitalist economy, they do excel morally by integrating ethics into the financial system. Where capitalism

examples show that Islamic notions of economic justice influence the determination of permitted as well as prohibited Islamic financial practices. While these economic tenants and prohibitions apply to Islamic banking and finance in general, it is important to understand not only what they are, but also, their implications for project finance.⁶²

B. *The Fundamental Principles of Islamic Finance*

As mentioned in the Introduction, there are five major rules in Islamic finance that affect project financing: (1) *riba*, or interest, is prohibited; (2) *gharar*, or excessive risk taking, is prohibited; (3) profits or losses of the transaction must be shared; (4) transactions must be asset-backed because money has no intrinsic value; and (5) investments should only support activities that are not themselves forbidden.⁶³ These rules obviously have profound implications for the traditional structure of project finance activities, thus necessitating the examination of each rule in further detail.

“*Riba* literally means increase,” and in the context of a loan transaction it implies “a gain from a debt which merely arises through the passage of time by reference to the use of money itself.”⁶⁴ Sometimes it is divided into two similar concepts of “making money from money” and “any predetermined payment over and above the actual amount of prin-

rewards a risk-taking individual, Islamic finance . . . limits risk for the betterment of society as a whole.”).

62. See Richins, *supra* note 57, at 138–39 (noting the lawyer’s ethical duty to understand *Shari’ah* when working with clients in the Middle East).

63. See *supra* note 19 and accompanying text; see also MUHAMMAD TAQI USMANI, AN INTRODUCTION TO ISLAMIC FINANCE, at xiii–xviii (2002) (describing some of the principles and precepts of Islamic finance and also some of the main differences between Islamic finance and Western banking and financial practices). The concept of asset-backed financing as it relates to Western notions of finance and banking is summed up with the following:

One of the most important characteristics of Islamic financing is that it is an asset-backed financing. The conventional/capitalist concept of financing is that the banks and financial institutions deal in money and monetary papers only. That is why they are forbidden, in most countries, from trading in goods and making inventories. Islam, on the other hand, does not recognize money as a subject-matter of trade, except in some special cases. Money has no intrinsic utility; it is only a medium of exchange; each unit of money is 100 per cent equal to another unit of the same denomination, therefore, there is no room for making profit through the exchange of these units *inter se*. Profit is generated when something having intrinsic utility is sold for money or when different currencies are exchanged one for another. The profit earned through dealing in money (of the same currency) or the papers representing them is interest, hence prohibited. Therefore, unlike conventional financial institutions, *financing in Islam is always based on non-liquid assets which creates real assets and inventories*.

Id. at xiv–xv (emphasis added).

64. DENTON WILDE SAPTE LLP, ISLAMIC FINANCE 2 (2009) (on file with author).

cipal.”⁶⁵ *Shari’ah* scholars consider either the paying or receiving of interest as usury. Islam considers *riba* to be unjust because it allows the lender to gain without assuming any of the risks associated with the transaction.⁶⁶ In the traditional notion of project finance, lenders lend to the SPV, which in turn uses the funds to purchase the project assets to generate a revenue stream and pay back the loan with interest.⁶⁷ The ability to receive interest payments on loans is especially important in project finance where there may pass a considerable amount of time before the SPV is able to service its debt.⁶⁸ Although Islamic finance has developed tools that are functional equivalents of interest payments, the strict prohibition against interest-bearing debt is central to Islamic finance, and is a major obstacle for project finance.⁶⁹

Whereas the prohibition on *riba* is relatively easy to interpret and understand, the prohibition against *gharar*, or speculation, uncertainty, or excessive risk taking, is a much grayer concept. Under the prohibition against *gharar*, a contract is viewed as lacking mutual consent of the parties if the “existence, price, quantity or characteristics of the goods for sale are unknown or unspecified.”⁷⁰ Moreover, contracts that have vague obligations based on conditions relating to events outside the control of the parties would likely be disallowed.⁷¹ Every contract contains a certain degree of uncertainty, and it will be up to *Shari’ah* supervisory boards to determine what amount of uncertainty is acceptable.⁷² An example of a type of project that would likely be acceptable would include a power project in which the host government or corporation agrees in an off-take agreement⁷³ to purchase a specific amount of electricity over a defined period of time at a previously agreed upon price.⁷⁴ Yet, an unacceptable project would be a commercial farm where future years’ crops are sold with forward contracts on pricing terms based upon the future spot price. Such a project would entail the sale of goods that are not yet

65. Rehman, *supra* note 19, at 631.

66. See DENTON WILDE SAPTE LLP, *supra* note 64, at 2.

67. See Mansoor H. Khan, *Designing an Islamic Model for Project Finance*, 16 INT’L FIN. L. REV. 13, 14 (1997).

68. See *id.*

69. See Haider Ala Hamoudi, *The Muezzin’s Call and the Dow Jones Bell: On the Necessity of Realism in the Study of Islamic Law*, 56 AM. J. COMP. L. 423, 447–48 (2008).

70. DENTON WILDE SAPTE LLP, *supra* note 64, at 2.

71. *Id.*

72. See *id.*

73. See NIEHUSS, *supra* note 1, at 92–98 (discussing off-take contracts). “There are two main ways that a project generates income: selling output under a purchase contract or charging for the use of project facilities under a user contract. For convenience, these two types of contracts are often combined and considered together under the generic name of offtake [sic] contract.” *Id.* at 92.

74. See Khan, *supra* note 67, at 14–16.

in existence at undetermined prices; thus, it might be deemed to entail a prohibited level of *gharar*.⁷⁵

Gharar is also problematic in project finance because it is generally interpreted to prohibit derivative contracts, Western-style security interests, and insurance.⁷⁶ With respect to derivative contracts, this limits a SPV's ability to insulate itself from various risks in the form of price volatility on both the production/input side of the project, as well as on the off-take/sale side of the project.⁷⁷ Moreover, the Islamic financiers are completely exposed to default risk if they do not have an adequate security interest,⁷⁸ and without insurance, they are exposed to the potential to suffer total loss from natural disasters.⁷⁹ All of these instruments are *gharar* due to the fact that they are deemed to entail a large amount of uncertainty because, although their price "[is] certain, . . . the benefit to be derived from them [is] not."⁸⁰ There are forms of *Shari'ah*-compliant collateral security structures,⁸¹ as well as insurance contracts,⁸² but with the exception of some very limited forms of forward-sale contracts,⁸³ derivatives, such as swaps and options, are generally prohib-

75. See DENTON WILDE SAPTE LLP, *supra* note 64, at 17–18 (describing how *salam* contracts enable the forward sale of goods not yet in existence, but that the purchase price must be paid immediately upon contracting, thus precluding the possibility of a price based on future benchmarks).

76. See Ibrahim, *supra* note 18, at 702–03. But see Michael J.T. McMillen, Richard Fagerer & Michael E. Pikiel, The 2010 Tahawwut Master Agreement: Paving the Way for *Shari'ah*-Compliant Hedging Products 6–16 (Aug. 21, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1670118 (discussing the 2010 Tahawwut Master Agreement as a standardized form that could allow for certain kinds of *Shari'ah*-compliant swaps and derivative contracts).

77. See YESCOMBE, *supra* note 5, § 6.1.1, at 70–71, § 8.8.1, at 161, § 8.8.3, at 163, § 8.9, at 170–74 (describing input supply risks, off-take risks, and the use of derivatives to hedge against those risks).

78. See *id.* § 13.7, at 308 (discussing the use of security interests in project finance). “There is seldom any substantial disagreement between Sponsors [sic] and lenders about the latter’s right to take security over all physical assets . . . which the [SPV] has.” *Id.* § 13.7.1, at 309. In the event of default in project finance, lenders do not expect to recoup their investment from the sale of the SPV assets. Investments in project finance are made on the expected cash flows from the operation of the SPV, not on the value of the SPV’s assets themselves. However, security over the project assets remains important for other reasons, including ensuring that lenders are involved in the early stages of the project if things begin to go wrong, and preventing the SPV assets from being sold without the lenders’ consent. *Id.* § 13.7, at 308.

79. See *id.* § 7.6.1, at 127–29, § 8.10.1, at 175–76 (discussing the role of insurance in project finance to cover the risk of a catastrophic loss).

80. Ibrahim, *supra* note 18, at 702.

81. See *infra* text accompanying notes 135–138, Part IV.A.1 (discussing a project utilizing the *rahn-adl* collateral security structure).

82. See Ibrahim, *supra* note 18, at 715–16 (discussing *takaful*, or *Shari'ah*-compliant insurance).

83. See Richardson, *supra* note 21, at 127; see also DENTON WILDE SAPTE LLP, *supra* note 64, at 17–18 (discussing a form of *Shari'ah*-compliant forward contract known as a *salam*).

ited.⁸⁴ Thus, the ability to use derivatives to hedge risk is limited in Islamic project finance.

For the purposes of project finance, the rules that the lender must share in the profit and loss of the transaction and that all transactions must be asset-backed are inherently linked in a manner that highlights the importance of retention of title on the part of the Islamic financiers. Given the view of lending money as a charitable act and the prohibition on the charging of interest as an exploitative activity,⁸⁵ the asset underlying the transaction will be the central focus of the transaction, and the Islamic lender will be subject to the risks of the asset through the retention of its title in some form or another.⁸⁶ Many Islamic transactions therefore are derived from a basic form in which the lender takes title to or purchases the asset in the transaction, and then leases it back to the purchaser who will acquire title to the asset after a specified number of lease periods.⁸⁷ This makes the project asset-backed from the perspective of the Islamic lenders rather than the SPV. If the SPV does not generate profit for the project sponsors, the Islamic lenders will also not receive lease payments from the lease of the project assets to the SPV.⁸⁸ In this way, the transaction forces the Islamic lenders to bear the risk of the project's failure.⁸⁹

Finally, *Shari'ah* explicitly forbids some activities as *haram*, meaning that they are harmful and socially offensive.⁹⁰ Such goods or activities include pork-related products, tobacco, alcohol, pornography, casinos, and gambling.⁹¹ Any project aiming to directly produce such products or to indirectly facilitate the production of such products or activities would likely be prohibited under *Shari'ah*.⁹² This requirement can become an issue in the construction and operation of commercial real estate if, for example, a restaurant in a hotel wants to serve alcohol or food with pork

84. Richardson, *supra* note 21, at 127. But see McMillen, Fagerer & Pikiel, *supra* note 76, at 6–16 (discussing the possibility for some kinds of *Shari'ah*-compliant swaps and derivative contracts through the use of the 2010 Tahawutt Master Agreement).

85. Ibrahim, *supra* note 18, at 701.

86. See Rehman, *supra* note 19, at 631–32 (describing the necessity of Islamic investors to share in the risk of a venture in order to realize a return and discussing the importance of asset-backed financing in Islamic finance); see also Holden, *supra* note 19, at 346–48 (describing Islamic transactions as “Profit-Loss sharing” and providing examples of how Islamic banks would finance certain activities).

87. See Rehman, *supra* note 19, at 634–37.

88. See Rahail Ali & Rustum Shah, *Square Peg Can Fit a Round Hole*, PROJECT FIN., Dec. 2004/Jan. 2005, at 2, 4.

89. See *id.*

90. DENTON WILDE SAPTE LLP, *supra* note 64, at 3.

91. *Id.*

92. *Id.*

in it.⁹³ Yet typically, as long as such noncompliance is *de minimis*, as in the case of one restaurant that serves alcohol in a large commercial real estate project, the noncompliant activity will be overlooked or allowed.⁹⁴ In other cases, *Shari'ah* boards will find that noncompliant projects are susceptible to "cleansing." For example, if an Islamic lender is entitled to interest payments from late rental payments from a tenant, the lender could "cleanse" or "purify" the transaction by refusing the interest income or by accepting it and donating it to charity.⁹⁵

In sum, *Shari'ah* dictates a number of economic precepts and principles for Islamic financiers and Western lenders who undertake projects in the Islamic world. These economic principles, together with the common law-like evolution of *Shari'ah*, leave five rules of Islamic finance that are applicable to project finance. However, these rules create a number of potential problem areas for Islamic project finance, some of which are unique to Islamic finance. While these problem areas may present unique considerations for Islamic project finance, they are not insurmountable, especially if the project financing structure accommodates the Islamic participants' need to retain some degree of title in the project assets.

II. POTENTIAL PROBLEM AREAS IN ISLAMIC FINANCE

Islamic project finance is an emerging field with unsolved problems that become more pronounced when the needs of Islamic lenders conflict with those of Western lenders. When undertaking *Shari'ah*-compliant projects that attempt to fit Western debt tranches along side of Islamic debt tranches, there are at least four potential sources of problems:⁹⁶ (1) uncertainty regarding the somewhat unpredictable and

93. See, e.g., Michael J.T. McMillen, *Asset Securitization Sukuk and Islamic Capital Markets: Structural Issues in These Formative Years*, 25 WIS. INT'L L.J. 703, 724 (2008).

94. See *id.* at 727–28.

95. See *id.* at 725.

96. In addition to the four potential problem areas discussed in this Section, there are at least two other potential sources of problems for Western participants in Islamic project finance. The first is the possibility of civil liability and criminal exposure that could result for Western participants. See David Yerushalmi, *Shari'ah's "Black Box": Civil Liability and Criminal Exposure Surrounding Shari'ah-Compliant Finance*, 2008 UTAH L. REV. 1019, 1062–1105 (2008). In short, if a public company, or a private company that later goes public, is involved in *Shari'ah*-compliant project financing, they will want to err on the side of caution in determining what facts related to the project are material for Securities and Exchange Commission (SEC) disclosure purposes. See *id.* at 1084–87. Otherwise the corporation could face civil liability for failure to disclose material facts under SEC rules, while the corporate officers, executives, and counsel could also face both criminal and civil liability. See *id.* at 1048–50.

subjective nature of the decisions of *Shari'ah* boards,⁹⁷ (2) the lack of an overarching regulatory body for Islamic banking and finance,⁹⁸ (3) the Islamic need to retain title in the project assets and the Western lender's need for a security interest in those same assets,⁹⁹ and, (4) the Islamic requirement that the lender bear some of the project risk compared to the Western lender's risk aversion.¹⁰⁰

While the issue of retention of title on the part of the Islamic financiers does not bear on most of these issues, it is itself a potential source of problems in Islamic projects with Western participants. It inhibits Western lenders from taking an effective security interest in the project assets.¹⁰¹ This, in turn, increases the risk from the perspective of Western lenders because it hinders their recourse in the event of default.¹⁰² An understanding of the problems that could arise from title retention and the other potential sources of problems will lessen the probability that an otherwise well-financed and bankable project will fall victim to an unforeseen and misfortunate contingency.¹⁰³

Another potential source of problems stems from the inapplicability of *Shari'ah* in a choice of law clause. See generally Michael J.T. McMillen, *Contractual Enforceability Issues: Sukuk and Capital Markets Development*, 7 CHI. J. INT'L L. 427, 441–47 (2007). In the English case *Shamil Bank of Bahrain EC v. Beximco Pharmaceuticals Ltd.*, the dispute in question revolved around a series of *ijara* agreements in which the governing law provision in each agreement stated, "Subject to the principles of Glorious *Sharia'a*, this Agreement shall be governed by and construed in accordance with the laws of England." *Shamil Bank of Bahrain EC v. Beximco Pharm. Ltd.*, [2004] EWCA (Civ) 19, [1], [2004] 4 All E.R. 1072 at 1074 (Eng.). In dealing with the governing law issue, the court concluded that only one body of law can govern the contract, that only the law of a country can be chosen, and that simply referencing the "Glorious *Sharia'a*" was not referencing the laws of a nation. See *id.* ¶¶ 40–48, 54–55. Thus, it is not clear that *Shari'ah* is applicable as a choice of law to govern an agreement. Cf. *The Inv. Dar Co. v. Blom Dev. Bank, SAL*, [2009] EWHC (Ch) 3545, [16] (Eng.) (concurring with the trial court that The Investment Dar Company's (TID) contention that the agreement was not *Shari'ah*-compliant and therefore void was "an arguable case"). See generally Robin Wigglesworth, *Court Concession Raises Islamic Finance Risk*, FIN. TIMES, Mar. 25, 2010, <http://www.ft.com/cms/s/0/aa3dd5c4-382d-11df-8420-00144feabdc0.html> (noting that the uncertainty created by the decision in the TID case raises the *Shari'ah* risk for dealing with Islamic institutions).

97. See Wigglesworth, *supra* note 56, at 3.

98. See Holden, *supra* note 19, at 362–65.

99. See McMillen, *supra* note 2, at 1205–06.

100. See Rehman, *supra* note 19, at 631; Holden, *supra* note 19, at 346–49.

101. See YESCOMBE, *supra* note 5, § 13.7.1, at 309–11 (discussing how problems could arise for lenders who wish to take an effective security interest in the project assets if the SPV does not actually own those assets).

102. Cf. *id.* at 309 (noting that if lenders cannot take an effective security interest, they can rely on contract assignments); McMillen, *supra* note 2, at 1206 (describing how a sound security structure decreases transactional risks and financing costs).

103. See generally Richins, *supra* note 57, at 135–47.

A. Potential Regulatory Issues in Islamic Finance

The first two potential problem areas are related, and deal with the centrality of *Shari'ah*-compliance boards and the lack of an overarching regulatory structure in Islamic finance. These two problems could loosely be referred to as "regulatory issues." In the first instance, despite some similarity between the evolution of both *Shari'ah* and the common law, there is no doctrine of *stare decisis* with respect to *Shari'ah* board decisions.¹⁰⁴ When a *Shari'ah* board in one government or corporation issues a *fatwa*, it is only valid for the specific instance for which it was issued.¹⁰⁵ In approving transactions, a *Shari'ah* board will consider similar transactions for which *fatwas* were issued, but prior approval of a similar transaction is no guarantee of approval for the transaction in question.¹⁰⁶ Moreover, the opinions of prominent scholars in the field of Islamic finance can have a profound effect on the decisions of *Shari'ah* advisory boards. In late 2007 and early 2008, Sheikh Taqi Usmani, then chairman of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and one of the most respected scholars in the field of Islamic finance, issued statements claiming that as many as eighty-five percent of *sukuk*¹⁰⁷ were probably not *Shari'ah*-compliant because they contained repurchase agreements.¹⁰⁸ This contributed to a slowdown in the Islamic debt market as "the sudden disapproval of previously accepted structures . . . sparked uncertainty."¹⁰⁹ Compounding the problem is the fact that growth in the Islamic finance industry has led to a growth in the number of *Shari'ah* boards with often differing opinions as to the permissibility of some practices.¹¹⁰ Yet the industry lacks a single pan-Islamic forum in which *Shari'ah* scholars and financial regulators can discuss and reach consensus on these issues.¹¹¹

This lack of a forum for reaching consensus is part of the second problem with Islamic finance: the lack of a cohesive regulatory body.¹¹² In addition to the regulation of capital market products and financing structures, areas of regulation could include *Shari'ah* certification, the establishment of *Shari'ah* boards, qualifications for *Shari'ah* advisors,

104. See McMillen, *supra* note 2, at 1184.

105. See *id.* at 1190–91.

106. See Wigglesworth, *supra* note 56, at 3.

107. Loosely defined, a *sukuk* is a *Shari'ah*-compliant bond. See *infra* Part III.A.3.

108. See Jason Benham, *Islamic Bond Market "Wrecked" by Critical Remarks*, ARABIANBUSINESS.COM, Oct. 29, 2008, <http://www.arabianbusiness.com/536401-islamic-bond-market-wrecked-by-critical-remarks>.

109. Wigglesworth, *supra* note 56, at 3.

110. See *id.*

111. See Holden, *supra* note 19, at 362; Wigglesworth, *supra* note 56, at 3.

112. See Wigglesworth, *supra* note 56, at 3.

and disclosure issues.¹¹³ The lack of regulation in these areas “could inhibit the development and expansion of uniform Islamic financial services by limiting cross-border flows and could encourage fractionalization among interpretation and region.”¹¹⁴ Arguably then, the lack of regulation could make Islamic finance more country-specific or even *Shari’ah* board-specific, which would limit the potential sources of capital within the Islamic world from which one project could draw.

Some regions of the Islamic world have supervisory and regulatory systems in place. For example, the AAOIFI, based in Bahrain, publishes the widely followed *Shari’ah Standards*, and the Islamic Financial Services Board publishes various technical standards for financial institutions.¹¹⁵ Other institutions include the International Islamic Financial Market, the Liquidity Management Center, and the International Islamic Rating Agency.¹¹⁶ “Though many agencies are interested in facilitating the future of Islamic financing by providing regulatory framework[s], there still is no universal set of rules to abide by.”¹¹⁷ Regulating the financial industry is complicated enough when the main players are various national governments,¹¹⁸ central bankers, and the private sector, but the task is further complicated by the need to reach consensus among religious advisors from divergent backgrounds.¹¹⁹ In this vacuum, a narrow class of credible scholars, such as Sheikh Taqi Usmani, holds considerable sway.¹²⁰ Yet reliance upon scholars leads to the uncertainty noted above when dealing with *Shari’ah* advisory boards; it is simply hard to predict whether a transaction will be approved or whether one particular type of instrument will remain viable over the long term.¹²¹ Commentators have urged the need for uniform standards, with one proposing a Model Islamic Acts,¹²² but until there is

113. See Sorenson, *supra* note 59, at 655 (quoting Islamic Capital Market Task Force of the International Organization of Securities Commissions, *ISLAMIC CAPITAL MARKET FACT FINDING REPORT* 72–73 (2004), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD170.pdf>).

114. *Id.*

115. See Holden, *supra* note 19, at 362–63.

116. See *id.* at 365.

117. *Id.*

118. The interpretation of *Shari’ah* also varies on a national level, with some countries like Malaysia considered more lax in their interpretation, while other countries such as Pakistan and Iran are considered to prefer a more strict interpretation of *Shari’ah*. See Holden, *supra* note 19, at 352–57.

119. See Robert R. Bianchi, *The Revolution in Islamic Finance*, 7 *CHI. J. INT’L L.* 569, 575 (2007).

120. See *id.*

121. See *supra* text accompanying notes 104–114.

122. See McMillen, *supra* note 96, at 458–60.

such a uniform standard, regulatory uncertainty and *Shari'ah*-compliance risk will be present in Islamic project finance.

B. Retention of Title and Risk Aversion

The concepts of retention of title and risk aversion will also be points of conflict between Islamic financing tranches and Western debt tranches. These problem areas are related in the sense that an Islamic financier's need to retain title to the assets underlying the transaction stems from the *Shari'ah* requirement that the financier share in the profits and losses (i.e., the risks) that arise out of transaction.¹²³ Conversely, Western lending practices do not call for retention of title of the SPV assets, and Western lenders evaluate the projected cash flows from the project to determine the likelihood of repayment.¹²⁴ Instead of retaining title, Western lenders will take a security interest in the project assets to protect against the default risk from the SPV.¹²⁵ In project finance, a security interest is a right of a lender "to possess and/or sell" the SPV's project assets in order to satisfy the SPV's debt to the lender in the event of default.¹²⁶ While no one expects that the security interest in the project assets will completely cover the loan the lender made to the SPV, the security interest does provide one layer of protection in the event of default.¹²⁷ If the SPV defaults or goes bankrupt, the Western lenders' security interest provides them with a claim to the SPV assets that takes precedence over other unsecured lenders' claims.¹²⁸

123. See Inglis & Khan, *supra* note 13, at 31 ("[S]ince the assets are owned by the Islamic financier it should assume the risk of total loss."); Rehman, *supra* note 19, at 630–31 (describing the necessity of Islamic investors to share in the risk of a venture in order to realize a return); Holden, *supra* note 19, at 346–48 (describing Islamic transactions as "Profit-Loss Sharing" and providing examples of how Islamic banks would finance certain activities); see also DENTON WILDE SAPTE LLP, *supra* note 64, at 16 ("Another important issue which is often overlooked is the Islamic financier can only agree to sell a building to the customer if it has some legal right to the land on which the building is to be constructed."); McMillen, *supra* note 2, at 1205–06 (comparing the need for physical possession in order to perfect a security interest under *Shari'ah*, with the English and American need for recordation in order to perfect the security interest). In this way, the Islamic financiers share the risk of the project and collect rents as opposed to interest payments. From a structural perspective, this assures *Shari'ah* compliance. It will then only be necessary to ensure that the activity is not overly speculative (*gharar*) and that the project activity is not forbidden (*haram*). See *supra* Part I.B.

124. See Khan, *supra* note 67, at 14–16.

125. See NIEHUSS, *supra* note 1, at 136–37.

126. *Id.*

127. See YESCOMBE, *supra* note 5, § 2.2, at 7, § 13.7, at 308, § 13.7.1, at 309.

128. See NIEHUSS, *supra* note 1, at 136–37; see also JAMES J. WHITE & ROBERT S. SUMMERS, PRINCIPLES OF SECURED TRANSACTIONS § 3-1, at 117–18 (2007) (describing the preference that a secured creditor takes in bankruptcy compared to an unsecured creditor).

By comparison, in Islamic project finance, the lender will need to take title to the SPV assets instead of a security interest.¹²⁹ If the SPV defaults, the Islamic lender will already have title to the SPV's project assets that the Islamic funds helped purchase. In this situation, the Islamic lenders can likely dispose of the assets to partially or completely satisfy the SPV's outstanding debt obligations.¹³⁰ Thus, from the lender's perspective, a Western security interest and Islamic title retention function similarly if the SPV defaults. Nonetheless, in project finance, it is unlikely that there will be one lender and one tranche of debt.¹³¹

In a project financed both through Islamic finance and Western finance, the *Shari'ah* requirement for retention of title will conflict with the Western lender's ability to obtain a security interest in the same assets financed through the lending transactions.¹³² Sometimes the nature of the project provides avenues to overcome this problem. For example, in aluminum projects, Islamic tranches have funded and retained title to specific smelters or production lines while Western debt funded the rest of the project.¹³³ Similarly, in an oil and gas transaction in the United States, the Islamic financiers retained a royalty interest that represented a certain percentage of the mineral estate.¹³⁴ Islamic financial practices also allow for the *rahn-adl*, which is a type of mortgage (*rahn*) arrangement in which title to the asset is placed with a special type of agent (*adl*) who would owe fiduciary duties to both the Islamic financier and the Western lender.¹³⁵ The *rahn-adl* agreements typically only allow for dispositions of the asset if both parties agree to such.¹³⁶ In the case of default, the agreement will specify the rights to the assets that each party will possess.¹³⁷ Thus, *rahn-adl* agreements allow for the Islamic lender to meet the requirement of retention of title, albeit through an agent, while also providing a security interest for the Western lenders.¹³⁸

129. See *supra* note 123 and accompanying text.

130. Cf. Inglis & Khan, *supra* note 13 (describing how in the event of a total loss, Islamic financiers own the assets and therefore assume the risk of total loss).

131. See NIEHUSS, *supra* note 1, at 112–21 (stating that it is common that international project financings in emerging markets will have a mix of debt sources, and describing some of the different sources of debt, including Islamic finance).

132. See McMillen, *supra* note 2, at 1205–06.

133. See Susan Traill, *Blending Islam*, PROJECT FIN., Sept. 2005, at 29, 30 (discussing projects funded by both *Shari'ah*-compliant financing and Western financing).

134. See Richardson, *supra* note 21, at 149–52.

135. See McMillen, *supra* note 2, at 1203–05, 1215–16; cf. YESCOMBE, *supra* note 5, § 13.7.1, at 309 (noting that problems can arise for lenders in taking an effective security interest in the project assets if the SPV does not own the project assets).

136. See McMillen, *supra* note 2, at 1215–16.

137. See *id.* at 1216 (discussing the use of grants to the *adl* in mortgage agreements that allow for the *adl* to take action with respect to the property in the event of a default).

138. See *id.* at 1205–06.

Yet, while the nature of the project, a *rahn-adl* agreement, or one of the Islamic financing structures discussed in Part III can solve the retention of title problem for Islamic financiers, Western lenders will remain risk averse, thus presenting additional challenges.¹³⁹ Advance rental payments are one example of how Western lenders' risk aversion can affect an Islamic project finance venture. Advance rental payments are problematic under *Shari'ah* because a return on an investment cannot derive from an asset that is not yet in existence.¹⁴⁰ However, Western lenders want to receive payments on their loans before the project assets are completed, and forcing them to wait an extended period to receive payment makes the project less attractive.¹⁴¹ Nonetheless, some *Shari'ah* advisory boards allow for advance rental payments to be credited against the lease payment once the lease term begins, either in a lump sum amount or a *pro rata* amount over the whole term of the lease.¹⁴² Thus, there could be solutions to the problem posed by the prohibition on advance rental payments.

Also, in retaining title to the SPV assets, the Islamic financiers retain the risk of total loss.¹⁴³ Yet, because they retain title, the Islamic financiers will often have primary recourse to the insurance policies in place for the project asset.¹⁴⁴ This could give rise to inter-creditor issues by forcing the Western lenders to also bear the risk of total loss because they have limited or no recourse to the insurance policies.¹⁴⁵ A common *Shari'ah*-compliant solution is for the Islamic financiers to assign the insurance proceeds to the SPV, and to require the SPV to use those insurance proceeds to replace all or some of the project assets in the event of a total loss.¹⁴⁶ In theory, this solution would minimize interruption to both the Islamic and the Western financing packages.¹⁴⁷

Thus these examples reiterate that it is possible for Western lenders to mitigate the increased risk inherent in *Shari'ah*-compliant project financing.¹⁴⁸ The fact that *Shari'ah* does not allow for advance rental payments, and that retaining title places the risk of total loss on the Islamic financier all increase the amount of project risk from the Western lender's perspective.¹⁴⁹ Nonetheless, despite the tendency toward risk

139. See Inglis & Khan, *supra* note 13, at 30.

140. See *id.*

141. See *id.*

142. *Id.* at 30–31.

143. See *id.* at 31.

144. See *id.*

145. See *id.*

146. See *id.*

147. See *id.*

148. See *id.*

149. See *id.*

aversion on the part of Western lenders, the need for Islamic financiers to retain some degree and form of title in the project assets has been resolved in various forms that do not require Western lenders to assume prohibitive levels of risk. These forms include various structures that place the physical asset at the center of the transaction, and thus facilitate the retention of title.

III. ISLAMIC FINANCING TOOLS IN PROJECT FINANCE

A project utilizing Islamic financing will likely also have Western financing, and thus, will be a dual-tranche or multi-tranche project.¹⁵⁰ It is possible for there to be projects financed completely through Islamic financing, but given the preference for shorter-term investments in the Islamic world, most such projects would likely be smaller in scale.¹⁵¹ Due to the capital needs in a typical large-scale infrastructure project, there could be numerous tranches of debt, some Islamic and some Western.¹⁵² Nonetheless, the assumption in this Note is that of a dual-tranche project in which Islamic finance and Western finance cooperate. The next step is therefore to understand the structures Islamic finance can take, and the adaptation of those structures to the specific needs of project finance.¹⁵³ These structural combinations enable the retention of title in all or part of the project assets on the part of the Islamic project partners, and thus do much to help overcome all of the *Shari'ah* prohibitions except for the prohibitions against activities that are considered *haram*, or socially offensive.

A. Islamic Financing Tools

Islamic finance has developed a diverse array of tools and structures to accommodate the requirements of *Shari'ah*, and in turn, facilitate the retention of title for the project's Islamic lenders. As mentioned above, most of these tools involve some form of cost-plus purchasing in which the lending institution or financier actually purchases the asset or goods in question, takes title (and in some cases possession), and then resells them at a markup or leases them back to the original "purchaser" or

150. See McMillen, *supra* note 93, at 719 (discussing a split project structure in which one portion is *Shari'ah*-compliant, and one portion is not); see also Traill, *supra* note 133, at 29 (discussing projects funded by both *Shari'ah*-compliant financing and Western financing).

151. See Traill, *supra* note 133, at 29.

152. See, e.g., *id.* (discussing the success of several larger projects, including a power project and a water desalination plant upgrade in the United Arab Emirates along with an expansion of an aluminum plant in Bahrain, in which Islamic tranches fit along side conventional debt).

153. See Richins, *supra* note 57, at 142–44.

“borrower.”¹⁵⁴ Few of these structures are without criticism by more conservative Muslims for being too similar to Western lending practices.¹⁵⁵ While it is true that many of these structures resemble traditional interest-bearing transactions, these structures would not exist were it not for the need to address the unique requirements of Islamic finance.¹⁵⁶ Moreover, a focus on their resemblance to interest-bearing transactions ignores the need for the lender to retain title to the asset underlying the transaction, which starkly conflicts with the Western lender’s desire for a security interest in the same asset.¹⁵⁷ To facilitate understanding, this Section will first classify Islamic financing tools as similar to either debt financing structures or equity financing structures, and discuss each accordingly.¹⁵⁸ In addition, this Section will also explain Islamic asset-backed securitization as this practice has grown in popularity in recent years.¹⁵⁹ Lastly, the final portion of this Section will discuss how these structures have been adapted and combined to address the unique circumstances of project finance to help facilitate the retention of title for the Islamic financiers.¹⁶⁰

1. Islamic Debt-Like Instruments

The first Islamic financing tool is a *murabaha* contract in which a financial institution purchases the asset in question, takes title to it, and then resells it to the customer at a certain profit added to the cost.¹⁶¹ This profit is not prohibited interest because the financial institution assumes the risk of purchasing and retaining title, and the customer is under no obligation to subsequently buy the asset from the financial institution.¹⁶² Thus, the profits from the *murabaha* derive from the risk that the customer will not purchase the asset from the financial institution.¹⁶³ Such agreements are common for commodities purchases in which a commodity broker or end user lacks sufficient working capital,¹⁶⁴ although there are reports of *murabaha* financings for equity purchases and li-

154. Rehman, *supra* note 19, at 634–35.

155. *See id.* at 636.

156. *See* Qureshi & Millet, *supra* note 12, at 3–4.

157. *See* McMillen, *supra* note 2, at 1205–06 (comparing the need for physical possession in order to perfect a security interest under *Shari’ah*, with the English and American need for recordation in order to perfect the security interest).

158. *See* Qureshi & Millet, *supra* note 12, at 4–5; *infra* Part III.A.1–2.

159. *See* Michael Marray, *Sukuk and See*, PROJECT FIN., Dec. 2003/Jan. 2004, at 24, 24; *infra* Part III.A.3.

160. *See generally*, McMillen, *supra* note 2.

161. *See* Holden, *supra* note 19, at 349–50.

162. Qureshi & Millet, *supra* note 12, at 5.

163. *Id.*

164. *See* DENTON WILDE SAPTE LLP, *supra* note 64, at 10–12.

censing agreements in the telecom sector in the Middle East.¹⁶⁵ As such, it may be possible to use *murabaha* in project finance to purchase expensive capital equipment or to finance the purchase of raw materials such as coal or bauxite.¹⁶⁶ Yet, Islamic institutions tend to prefer to enter into *murabaha* agreements with familiar and trusted individuals, which could limit their application to large projects.¹⁶⁷

Similar to Western lease financing, an *ijara* agreement is a leasing arrangement in which a financial institution purchases an asset, retains title, and then leases it to its client.¹⁶⁸ The lease rate is marked up from the purchase price and is also periodically reviewed and adjusted.¹⁶⁹ The markup and adjustments are justified because the financial institution owns the asset in question throughout the lease term and retains the risk associated with its performance.¹⁷⁰ Moreover, in contrast with Western lease financing, the lessee is not liable for the full rent if the asset is destroyed.¹⁷¹ Also, the lease term begins when the lessee receives the asset, and not when the contract is signed.¹⁷² Thus, there are differences with Western lease financing. Finally, options to purchase the asset at the end of the lease term are typically prohibited for excessive levels of uncertainty, but *ijara* contracts do allow for upfront agreements in which the client agrees to purchase the asset at the end of the lease term.¹⁷³ As discussed below, *ijara* financing is commonly used in combination with *istisna'a* financing to finance the operation and construction, respectively, of the project assets.¹⁷⁴

Istisna'a contracts involve an Islamic bank, a client, and a third party that can create the commodity that the client wishes to purchase. These agreements are common in project finance, and are typically found in contracts between financial institutions and construction contractors whereby the Islamic financial institution orders the construction contractor to construct the project assets either for the SPV or the project sponsors.¹⁷⁵ In project finance, the construction phase is a period of high risk, yet under an *istisna'a* this risk is perhaps even greater because the purchase price must be fixed when the parties enter into the contract, and

165. See Traill, *supra* note 133, at 29.

166. See, e.g., DENTON WILDE SAPTE LLP, *supra* note 64, at 12 (discussing the use of *murabaha* to purchase copper).

167. See Holden, *supra* note 19, at 349.

168. See *id.* at 350.

169. See *id.*; Qureshi & Millet, *supra* note 12, at 5.

170. Holden, *supra* note 19, at 350.

171. *Id.*

172. *Id.*

173. See Qureshi & Millet, *supra* note 12, at 5.

174. See DENTON WILDE SAPTE LLP, *supra* note 64, at 13–15.

175. See Holden, *supra* note 19, at 352.

variable rates of return are not allowed.¹⁷⁶ In this way, the Islamic financial institution bears both the completion risk and the cost-of-funds risk, although payments on the contract can be made on a deferred basis, either at completion or following a predetermined set of construction milestones.¹⁷⁷ Upon completion of the construction of the asset and transfer of title to the Islamic financial institution, it will usually enter into a parallel *istisna'a* or *ijara* at a markup with the SPV, who will purchase or lease the commissioned asset from the Islamic financial institution once its construction is completed.¹⁷⁸ Thus, the *istisna'a* highlights the emphasis in Islamic finance on ensuring that the financial institution retains title in the assets underlying the transaction in order to subsequently sell it or lease it back to the SPV client.¹⁷⁹

Salam contracts are similar to *istisna'a* contracts except that a *salam* deals with fungible goods, and the purchase price must be paid in full when the parties enter into the contract.¹⁸⁰ Thus, a *salam* is like a *mura-baha* in that it typically deals with commodities, and it is like an *istisna'a* in that when the contract is formed, the goods do not exist.¹⁸¹ Essentially, a *salam* is a forward purchase agreement in which the parties agree to future delivery of a fungible good for a price paid in advance.¹⁸² *Salam* contracts are *Shari'ah*-compliant because the bank shares the transaction's risk. There is a possibility that the bank will ultimately possess goods in the future for which there is not a ready market.¹⁸³ The financial institution will typically take the goods and resell them to a customer in a back-to-back *salam*, but the date of delivery from the bank to the final customer must be after the date of delivery from the manufacturer to the bank.¹⁸⁴ Finally, to avoid *gharar*, a *salam* contract cannot describe the specific source of the goods, but it must describe them in enough detail to enable the seller or the reselling financial institution to perform their obligations; thus details as to "specification, quality, quantity and other relevant details" will be important.¹⁸⁵ For example, in project finance, an SPV power plant could use a *salam* contract to purchase coal. To do so, it would want to specify the amount of coal,

176. DENTON WILDE SAPTE LLP, *supra* note 64, at 15–16.

177. See Qureshi & Millet, *supra* note 12, at 5.

178. See DENTON WILDE SAPTE LLP, *supra* note 64, at 15–16.

179. See *id.* at 16 ("Another important issue which is often overlooked is the Islamic financier can only agree to sell a building to the customer if it has some legal right to the land on which the building is to be constructed.").

180. *Id.* at 15.

181. *Id.* at 17.

182. See Ibrahim, *supra* note 18, at 714.

183. See Qureshi & Millet, *supra* note 12, at 5.

184. See DENTON WILDE SAPTE LLP, *supra* note 64, at 17–18.

185. *Id.* at 17.

delivery date, and average degree of purity, but it would want to avoid stipulating that the supplier must supply the coal from a specific mine.¹⁸⁶

2. Islamic Equity-Like Instruments

Since the payment of dividends is not permitted under *Shari'ah*, Islamic equity-like structures resemble Western partnership agreements.¹⁸⁷ Thus, the retention of title in the project assets is inherent in the ownership interest that the partners take in the venture. The first such agreement is a *mudaraba* agreement, which is analogous to a Western trust financing agreement,¹⁸⁸ or a venture capital agreement.¹⁸⁹ In a *mudaraba*, a financial institution will enter into an agreement with an entrepreneur in which the bank will provide the capital and the entrepreneur will provide the management skills.¹⁹⁰ Profits are distributed according to a pre-negotiated proportion, but only after first settling all liabilities.¹⁹¹ The financial institution bears the risk of losing the capital invested and the entrepreneur bears the opportunity cost of his efforts.¹⁹² Due to the risks involved, Islamic financial institutions are very selective in working with clients in a *mudaraba* agreement, and such agreements therefore represent less than five percent of banking operations within the Islamic world.¹⁹³ Nonetheless, it is a scheme that would be amenable to project finance where an Islamic corporate conglomerate wishes to undertake a project off-balance sheet, or where a financial institution wishes to take an equity position in a project.¹⁹⁴ To this end, "[t]he Islamic Development Bank recently launched a 'US \$1.5 billion infrastructure fund' accessible via *mudaraba* transactions," thus showing the potential for such transactions in the field of project finance.¹⁹⁵

The other principal form of Islamic equity-like financing is the *mu-sharaka*, and it is very similar to the *mudaraba*, except that the financial institution and the entrepreneur are not confined to distinct roles of capital provider and manager.¹⁹⁶ The financial institution will typically provide some of the capital for the venture and the manager will provide

186. See *id.*

187. See Qureshi & Millet, *supra* note 12, at 5.

188. See *id.*

189. See Holden, *supra* note 19, at 351.

190. See Ibrahim, *supra* note 18, at 709–10.

191. See *id.*

192. See *id.* at 709.

193. See Holden, *supra* note 19, at 351.

194. See, e.g., McMillen, *supra* note 2, at 1232–36 (describing a project in which three financial institutions formed a partnership with a power utility in order to fund a power project through equity investments in the SPV assets).

195. Holden, *supra* note 19, at 351 (quoting Gohar Bilal, *Islamic Finance: Alternatives to the Western Model*, 23 FLETCHER F. WORLD AFF. 145, 156 (1999)).

196. See Qureshi & Millet, *supra* note 12, at 5.

the remaining capital and the management expertise.¹⁹⁷ The parties then will enter into to a profit-sharing agreement created at the formation of the *musharaka*, and will share losses to the extent of their capital investment.¹⁹⁸ Given that the financial institution will have an interest in the partnership and in any assets that the partnership purchases, as well as the fact that the financial institution bears risk to the extent of its capital investment,¹⁹⁹ *musharaka* agreements are typically *Shari'ah*-compliant unless the purpose of the partnership is to engage in some sort of forbidden activity.²⁰⁰ *Musharaka* agreements have potential for use in Islamic project finance because they would permit the financial institution to retain complete or partial title in the SPV or its assets.²⁰¹ This would facilitate an ownership interest similar to a tenancy in common,²⁰² and over time the SPV or the project sponsors could purchase the financial institution's interest in the *musharaka*.²⁰³ In this way, the SPV would repay the funds that the financial institution contributed to the project.²⁰⁴

3. *Sukuk*: Islamic Asset-Backed Securities²⁰⁵

Sukuk are sometimes referred to as Islamic bonds, yet there are significant differences between a *sukuk* and a traditional bond.²⁰⁶ These Islamic securities may come in two forms: asset-based and asset-backed.²⁰⁷ First, given the prohibition against *riba*, a *sukuk* should be

197. See Holden, *supra* note 19, at 351.

198. See Ibrahim, *supra* note 18, at 711.

199. See Rehman, *supra* note 19, at 631; Holden, *supra* note 19, at 346–47.

200. See McMillen, *supra* note 93, at 729.

201. See, e.g., McMillen, *supra* note 2, at 1234–36 (describing a project that utilized a partnership structure in which banks took a partnership interest in an entity that owned the project assets).

202. See DENTON WILDE SAPTE LLP, *supra* note 64, at 7.

203. *Id.* at 8 (describing the “diminishing *musharaka*”).

204. See, e.g., McMillen, *supra* note 2, at 1236.

205. An adequate discussion of *Sukuk* structures is worthy of a separate article unto itself.

206. See DENTON WILDE SAPTE LLP, *supra* note 64, at 19; see also McMillen, *supra* note 96, at 427–28 (2007) (discussing two types of *sukuk*).

207. See DENTON WILDE SAPTE LLP, *supra* note 64, at 19; see also McMillen, *supra* note 96, at 428 (“Securitizations involve asset transfers from an originator into a trust or similar special purpose vehicle (‘SPV’) with *sukuk* issuance by that SPV and payments on the *sukuk* derived from the payments received in respect of those transferred assets.”) (emphasis added). The difference between the idea of asset-based and asset-backed *sukuk* is described as the following:

A true, asset-backed *sukuk* should be similar to a conventional securitization with the investors’ only recourse being to the assets. However, in most *sukuk* to date, the investors have primarily focused on a purchase undertaking from the originator to buy back the assets on either a scheduled or early redemption. . . .

backed by an underlying asset and represent a beneficial interest in that asset.²⁰⁸ Nonetheless, most *sukuk* are in fact asset-based, such as when a government guarantees the borrowed proceeds and uses those proceeds to purchase assets.²⁰⁹ Asset-based *sukuk* resemble traditional bonds in that a government or a government entity issues them in order to finance the purchase of an asset or to help finance a project. While the asset underlies the transaction, it is the creditworthiness of the government issuer that makes these issuances bankable. Thus, asset-based *sukuk* focus on the purchasing entity as opposed to the assets purchased.²¹⁰

Another type of *sukuk* resembles an asset-backed security issued by an Islamic finance institution, although it is less common.²¹¹ Asset-backed “[s]ecuritizations involve asset transfers from an originator into a trust or similar [SPV] with *sukuk* issuance by that SPV and payments on the *sukuk* derived from the payments received in respect of those transferred assets.”²¹² This means that the asset-backed *sukuk* holders actually hold “a proportional or fractional undivided ownership interest in an asset or pool of assets.”²¹³ In a sense, the asset-backed *sukuk* is a form of partial title in the underlying asset. This form of *sukuk* includes project financing that securitizes the project assets without a guarantee of repayment from the project’s government sponsor, corporate sponsor, or other equity sponsor.²¹⁴

This approach has, therefore, meant that most *sukuk* have been asset based [sic] and not asset backed [sic]. [Asset-backed] [s]ukuk should arguably be structured so that they are in effect the same as a conventional securitization in that the investors (who own the assets under the *sukuk*) should only be looking to those assets to obtain their financial returns and the recovery of their initial investments.

DENTON WILDE SAPTE LLP, *supra* note 64, at 19. Despite the similarity that an asset-backed *sukuk* may bear to the mortgage-backed securities that led to the current economic crisis in much of the world, it is unlikely that once a *sukuk* is issued, it would be permissible under *Shari’ah* to repackage and resell the *sukuk* in a manner similar to the repackaging of mortgages. The reason for this is that under *Shari’ah* “[p]rofit is generated when something having intrinsic utility is sold for money . . .” USMANI, *supra* note 63, at xv. Thus, it would likely violate *Shari’ah* to derive profit from a non-liquid asset lacking in intrinsic utility, such as a repackaged mortgage-backed security. *See id.*

208. See Ibrahim, *supra* note 18, at 719–20; *supra* note 207; see also DENTON WILDE SAPTE LLP, *supra* note 64, at 19 (“The investors should own a pool of assets supporting the *sukuk* issue and not just the right to a debt or revenue stream divorced from ownership of the revenue producing assets.”).

209. See Marray, *supra* note 159, at 24 (discussing a *sukuk* issuance that “[was] more similar to covered bonds” because the investor would look to the borrower for repayment of the loan rather than the financed asset); *supra* note 207.

210. See USMANI, *supra* note 63, at xiv–xv; McMillen, *supra* note 96, at 428; *supra* note 207.

211. See McMillen, *supra* note 96, at 428.

212. *Id.*

213. *Id.*

214. See *supra* note 207.

As will be discussed below, for the purposes of project finance, *sukuk* issuances are often used to securitize the assets that are obtained from another type of Islamic financing structure, such as an *ijara*, a *murabah*, or a *musharaka*.²¹⁵ *Sukuk* issuances have the greatest potential to spur the expansion of Islamic project finance both within and outside of the Islamic world. For example, a *sukuk* issuance raised \$700 million in Qatar in 2003, partly for the construction of a medical facility,²¹⁶ and in 2006, the first *sukuk*-financed project in the United States helped raise \$165.7 million for the construction and operation of oil and gas assets in the Gulf of Mexico.²¹⁷

Some of the tools and financing structures discussed in this Section have direct application to project finance. Yet, in most cases these Islamic financing mechanisms have been adapted to address the specific needs of a project. In other cases, project finance has innovated tools specific to the needs of Islamic project finance, including the transfer to and retention of title by the project's Islamic lenders. As the field of Islamic project finance continues to grow, further innovation within the confines of these basic Islamic financing tools is likely.²¹⁸

B. The Application of Islamic Financing Tools to Project Finance

Combinations of the Islamic financing structures are common in order to adapt Islamic finance to the needs of large projects.²¹⁹ In recent years, *sukuk* combinations with other structures have become common given the ability of a *sukuk* issuance to raise large amounts of capital over a numerous and diverse pool of investors.²²⁰ Yet, *sukuk* is not the only option for project finance. Commissioned manufacturing in combination with lease agreements during the operational period are common in the form of a dual *istisna'a-ijara* arrangement.²²¹ Similarly, use of one of the partnership arrangements in combination with a *murabaha* agreement would enlarge the capital pool for the funding of projects on a cost-plus basis.²²² These combinations help address the capital requirements of

215. See McMillen, *supra* note 96, at 429.

216. See Marray, *supra* note 159, at 24.

217. See Richardson, *supra* note 21, at 149–52.

218. There are other Islamic financing tools in existence, some of which could play a role in project financing, but they are probably not the vehicles for funding and operating the SPV and the project assets. Such instruments include the *wakalah*, *takaful*, *damanah*, and *urban*, which are, respectively, *Shari'ah*-compliant agency contracts, insurance policies, third-party guarantees, and partial advance payments. See Ibrahim, *supra* note 18, at 715–17.

219. See Traill, *supra* note 133, at 29.

220. See McMillen, *supra* note 96, at 430–31.

221. See McMillen, *supra* note 2, at 1237–39.

222. See *id.* at 1232–36.

project finance, while also facilitating retention of title and enabling the Islamic lenders to comply with *Shari'ah*.

Under the *istisna'a-ijara* structure, the *istisna'a* agreement is actually the first of the two agreements to take effect, with the *ijara* going into effect upon the completion of the construction of the asset.²²³ If this structure were to be categorized as debt-like or equity-like, it would be debt-like since there is no partnership agreement in the transaction, and a single financier or lending institution takes title to the asset that it subsequently leases.²²⁴ Under an *istisna'a* agreement, the Islamic financier will commission the construction of the SPV assets. During the construction, the Islamic financier will typically remain liable for the construction of the assets, thus bearing the risk of the project.²²⁵ Upon completion of the project, the Islamic financier retains title to the SPV assets, and enters into an *ijara* agreement with the SPV whereby the SPV makes periodic lease payments to the Islamic financier, typically in an amount greater than the construction cost of the assets.²²⁶ Upon completion of the lease term, the SPV can either purchase the assets and take title to them from the Islamic financier or enter into another *ijara* agreement at renegotiated payment rates.²²⁷ This structure is used extensively in commercial real estate projects, and has even been used to fund such projects in the United States.²²⁸

One of the partnership agreements, either a *musharaka* or a *mudaraba*, can be used in combination with a *murabaha* agreement to achieve a structure very similar to equity financing of the SPV.²²⁹ Under this arrangement, Islamic financial institutions would enter into one of the two partnership agreements with the SPV. If the SPV does not provide any capital, the structure will be a *mudaraba* agreement in which the banks provide the capital and the SPV provides the management experience. Conversely, if the SPV is to provide some capital, a *musharaka* would be the preferred partnership structure.²³⁰ Each of the capital contributors receives shares (*hissas*) in the partnership in proportion to its contribution.²³¹ In this way, the banks fund the SPV, and although the partnership would probably retain title to the project assets, the banks'

223. See *id.* at 1239.

224. See Qureshi & Millet, *supra* note 12, at 5.

225. See *supra* text accompanying notes 175–179.

226. See McMillen, *supra* note 2, at 1239. ("The rent will commence immediately upon execution of the *ijara* if the [SPV assets have] sufficient economic value and substance at that time, meaning that it can be, and is, put to the use for which it was intended.").

227. See *id.*

228. See, e.g., *id.* at 1237–47; *infra* Part IV.B.1.

229. See, e.g., McMillen, *supra* note 2, at 1232–36.

230. See *supra* Part III.A.2.

231. See, e.g., McMillen, *supra* note 2, at 1234–35.

partnership *hissas* would represent their interest in those assets. Once the SPV begins operation, the *murabaha* portion of the agreement will take effect. Under the *murabaha* agreement, the SPV will purchase shares from the partners at cost plus profit.²³² These repurchases can either be made in accordance with a predetermined purchase schedule, or in a lump sum purchase after a specified period.²³³ In this way, the SPV eventually repurchases all of the shares and the partnership is dissolved, leaving the SPV with title to the project assets.²³⁴ Arrangements similar to this have been used in Saudi Arabia to fund a utility power project.²³⁵

The final, and perhaps most diverse, set of possibilities for Islamic project finance involves the use of *sukuk* issuances to securitize the assets of a project held and operated under any one of the structures mentioned in Part III.²³⁶ As mentioned above, an asset-backed *sukuk* issuance would avail the investors to a form of partial title in the underlying project assets.²³⁷ In 2004 the AAOIFI issued the *Standard for Investment Sukuk* that provided for fourteen eligible asset classes, including *ijara* agreements, *istisna'a* agreements to fund construction, *murabaha* agreements to fund the acquisition of assets on a cost-plus basis, and *musharaka* or *mudaraba* agreements to fund participation in a business or investment activity.²³⁸ Although the AAOIFI is not an industry-wide body with regulatory authority, this pronouncement does give an indication of the likely permissibility of the various *sukuk* structures.²³⁹ It would be an exhaustive process to examine all the possible permutations of *sukuk* securitizations of Islamic financing structures. Nonetheless, it is sufficient to say that the ability of any of these Islamic financing structures to securitize and transfer partial title to assets creates a much wider capital base for each such structure.²⁴⁰ The result has been an increase in project financings in the Islamic world, as well as expanded participation in project financing outside of the Islamic world.²⁴¹

These tools at first may seem counterintuitive, but if there is one takeaway, it is that all of these financing structures focus on the necessity of the Islamic lender to retain some degree of title in the underlying pro-

232. See, e.g., *id.* at 1236.

233. See, e.g., *id.*

234. See, e.g., *id.* at 1233.

235. See, e.g., *id.* at 1232–36; see *infra* Part IV.A.2.

236. See McMillen, *supra* note 96, at 429.

237. See *supra* Part III.A.3.

238. See McMillen, *supra* note 96, at 428–29 (citing ACCOUNTING & AUDITING ORG. FOR ISLAMIC FIN. INST., SHARI'A STANDARDS 296 (2004)).

239. See DENTON WILDE SAPTE LLP, *supra* note 64, at 19–20 (describing the Accounting and Auditing Organization for Islamic Financial Institutions).

240. See McMillen, *supra* note 96, at 429–30.

241. See El Qorchi, *supra* note 13, at 46; Marray, *supra* note 15, at 33.

ject asset. In the *istisna'a-ijara* structure, the financier commissions the construction of the project asset, takes title to it when it is complete, and then retains title to it while leasing it back to the SPV. With the partnership-*murabaha* combination, the partnership likely retains title to the assets, but the financiers' *hissas* in the partnership afford them an interest in the project assets until the partnership dissolves and title shifts to the SPV. Finally, any of the Islamic financing structures in combination with an asset-backed *sukuk* could securitize the project assets and thus allow the financiers to take partial title to those assets. Thus, at the heart of these Islamic financing structures is the retention of title in the project assets. Projects that utilize these structures illustrate the feasibility of using Islamic project finance for projects that span a diverse set of industries in both the Islamic world and the United States.

IV. CASE STUDIES

This Section will discuss in more detail five projects that demonstrate the application of Islamic project finance: three in the Islamic World and two in the United States. These cases highlight the central theme of *Shari'ah*-compliant project finance in that they all show that the main requirement for *Shari'ah* compliance is to ensure that the Islamic financiers retain title to the SPV assets.²⁴² The first case will discuss a project that used the *rahn-adl* collateral security structure, and the rest of the cases will demonstrate, in the context of project finance, the tools of Islamic finance that were discussed in Part III. As these cases show, *Shari'ah* compliance is complex, but it should not be a deterrent to undertaking potentially lucrative projects.

A. Projects in the Islamic World

The first three cases will demonstrate some of the principles of Islamic project finance in projects that have taken place in the Islamic world. Two of the projects demonstrate dual-tranche project financing with Islamic and Western lenders and illustrate how to address both collateral security issues and issues related to the Islamic lender's need for some degree of title in the financed assets.²⁴³ The third project, although financed through purely Islamic lenders, demonstrates the mechanics of a hybrid between partnership and cost-plus financing structures.²⁴⁴ This structure would also work with a mixed group of Islamic and Western

242. See *supra* note 123 and accompanying text.

243. See *infra* Parts IV.A.1, IV.A.3.

244. See *infra* Part IV.A.2.

investors who wished to form a partnership or as a means to finance an Islamic tranche in a dual-tranche project. These projects not only show that the retention of title to the financed assets is a key consideration for *Shari'ah* compliance, but also illustrate the adaptability of the Islamic financing structures to projects in various industries.

1. Saudi Chevron Petrochemical Project: The *Rahn-Adl* Collateral Security Structure

The Saudi Chevron petrochemical project was a project in Saudi Arabia in which the sponsors were a Chevron Corporation affiliate and the Saudi Industrial Venture Capital Group.²⁴⁵ It was the first limited recourse project in Saudi Arabia, and thus involved interest-bearing loans as opposed to a *Shari'ah*-compliant structure.²⁴⁶ Nonetheless, because the project involved the perfection of security interests for a syndicate of Western and Islamic lenders, it illustrates that the *rahn-adl* structure would likely also function to establish a security interest in a dual-tranche project involving interest-bearing debt and Islamic finance.²⁴⁷

The Western lenders in the syndicate wanted a first prior perfected security interest to cover all of the SPV assets, yet the local (Saudi) lenders considered that retention of title to the SPV assets was required to perfect a security interest.²⁴⁸ The solution was to deposit the *rahn*, or mortgage, with a form of mutually agreed upon trustee known as an *adl*.²⁴⁹ This would satisfy the *Shari'ah* requirement to retain title, and would satisfy the Western lender's desire for a security interest without having to surrender full title in the assets to the Islamic lenders.²⁵⁰ Detailed agreements specified the powers of the *adl*, such as the inability to sell or surrender the title to the SPV assets without the consent of both parties.²⁵¹ The agreements specifying the powers of the *adl* essentially made it the agent of the syndicate of lenders to manage the SPV assets until the loaned funds had been repaid or the project defaulted.²⁵² The agreements also specified the term of the *adl* as a period of years beyond the term of the debt in order to allow for enforcement in the event of de-

245. See McMillen, *supra* note 2, at 1203.

246. See *id.* at 1204 n.27.

247. Further, in lieu of an adequate recording system, some countries may require physical possession to perfect a security interest, much in a manner similar to *rahn-adl*. See *id.* at 1205–06.

248. See *id.*

249. See *id.* at 1214–16.

250. See *id.* at 1211–16.

251. See *id.* at 1216–17.

252. See *id.* at 1218.

fault, but an earlier termination was required if all the obligations of the SPV to the syndicate of lenders were paid and fully performed.²⁵³

The *rahn-adl* collateral security structure in the Saudi Chevron petrochemical project is noteworthy for another reason. It shows the potential for Islamic finance if Western lenders and Islamic lenders are willing to compromise. The Islamic lenders were willing to forgo strict adherence to the requirement to retain title in the SPV assets and instead, substituted another *Shari'ah*-compliant tool that would allow the project to go forward.²⁵⁴ Conversely, the Western lenders showed a willingness to address the needs of their Islamic counterparts through an agreement allowing for the deposit of title on the mortgaged assets with an agent.²⁵⁵ Compromise and ingenuity in the project structure enabled the project to go forward.²⁵⁶

2. Utility Power Project in Saudi Arabia: *Mudaraba-Murabaha* Financing

A utility power project in Saudi Arabia demonstrates the possibilities of combining an Islamic “equity-like” structure with a “debt-like” structure.²⁵⁷ This project also used the *rahn-adl* collateral security structure to provide a security interest, but it did so in combination with Islamic financing tools.²⁵⁸ The project included five parties: an engineering, procurement, and construction contractor; three banks; and the utility company.²⁵⁹ The three banks and the utility company formed a type of *mudaraba* agreement, in which the banks capitalized the *mudaraba* initially, and then continued to capitalize it periodically according to construction completion milestones.²⁶⁰ Upon the formation of the *mudaraba*, each of the members received shares, or *hissas*, in the venture.²⁶¹ A controversial aspect of this project was that during the capitalization of the project, “the banks were not entitled to any profits [from the

253. See *id.* at 1219.

254. See *id.* at 1260–61.

255. See *id.* at 1206, 1211, 1260–61.

256. See generally McKean James Evans, Note, *The Future of Conflict Between Islamic and Western Financial Systems: Profit, Principle and Pragmatism*, 71 U. PITT. L. REV. 819 (2010) (arguing that Western and Islamic financial systems will need to compromise in the areas where the two systems come into conflict).

257. The project actually used a *sharikat mahassa* structure, which under Saudi Arabian law is a form of joint venture. Essentially, it is a form of partnership like a *musharaka* or a *mudaraba*. The utility power project discussed here would be a *mudaraba* since the parties initially had distinct roles in the partnership: the utility company was the technical manager and the banks provided capital. See McMillen, *supra* note 2, at 1235; *supra* Part III.A.2.

258. See McMillen, *supra* note 2, at 1234.

259. *Id.*

260. See *id.* at 1235.

261. See *id.*

mudaraba], nor were they liable for any of its losses or liabilities.²⁶² *Shari'ah* advisory boards were not in agreement on the permissibility of this structure.²⁶³ The *murabaha* portion of the structure involved the banks reselling their *hissas* to the utility. This was effected through a five-year repayment schedule for the financing on a cost-plus basis.²⁶⁴ In this way, the utility repaid the funds the banks committed to the project.²⁶⁵

This *mudaraba-murabaha* structure also highlights the importance of retaining title so that the Islamic lenders achieve *Shari'ah* compliance. To finance the utility project, the banks bought an interest in the *mudaraba*, which held title to the project assets. Through the banks' interest in the *mudaraba*, the banks had title in the project assets.²⁶⁶ Thus, the financiers through their share ownership in the *mudaraba* retained title in the assets underlying the transaction.²⁶⁷ The utility later repurchased these shares pursuant to the *murabaha* agreement, and eventually repaid the capital that the banks provided. Title in the project assets then shifted to the utility.²⁶⁸ The shifting of title facilitated the *mudaraba-murabaha* financing structure.

3. Sohar Aluminum, Oman: *Istisna'a-Ijara* Financing

The Sohar Aluminum smelter project in Oman closed in December of 2005, and was the first greenfield aluminum smelter to be built in the Middle East in the last twenty-five years.²⁶⁹ The project sponsors were Oman Oil Company, Abu Dhabi Water and Electricity Authority, and Alcan.²⁷⁰ The project funding involved \$1.545 billion in debt, \$1.2 billion of which was commercial debt, but \$260 million of it was financed through an Islamic financing tranche.²⁷¹ The Islamic tranche used an *is-*

262. See *id.*

263. See *id.*

264. See *id.* at 1236.

265. It was also a subject of debate as to whether the utility could repurchase the *hissas* before the project was completed and operational, or upon the completion of certain milestones. The same questions were raised regarding the *murabaha* agreement and whether or not the parties should wait until completion of the project to enter into a resale agreement. A final issue that the *Shari'ah* advisory boards debated was whether the *hissas* should be resold at their net asset value or at fair market value. See *id.*

266. See *id.* at 1235.

267. See *supra* text accompanying notes 187–195.

268. See McMillen, *supra* note 2, at 1236; see also *supra* text accompanying notes 187–195.

269. Sohar Aluminium: No Clubbing, PROJECT FIN., Feb. 2006, at 27, 27.

270. *Id.*

271. *Id.*

tisna'a-ijara financing structure.²⁷² Pursuant to the *istisna'a* agreement, the Sohar Aluminum Project Company commissioned the construction of the Islamic-financed assets on behalf of the Islamic lenders.²⁷³ When the assets were complete, they were delivered to the Sohar Aluminum Project Company, but title to the assets passed to the Islamic lenders.²⁷⁴ Under the *istisna'a*, the Islamic lenders paid the Sohar Aluminum Project Company for procurement of the assets via "phase payments."²⁷⁵ Concurrently upon entering into the *istisna'a* agreement, the Sohar Aluminum Project Company entered into an *ijara* agreement with the Islamic lenders for the operational phase of the project.²⁷⁶ Under the *ijara* lease agreement, Sohar Aluminum Project Company leased the financed assets from the Islamic lenders and made lease payments that were closely equivalent to the principal and interest payments made under the commercial bank tranche.²⁷⁷

The *istisna'a-ijara* structure again highlights the importance of title retention for the purposes of *Shari'ah* compliance. In sum, the Islamic lenders financed the purchase of some of the project assets for the Sohar Aluminum Project Company under the *istisna'a* agreement, and received title to those assets.²⁷⁸ The Islamic lenders then received payment on this financing via the *ijara* agreement and upon completion of the lease term, would transfer title to the assets back to the Sohar Aluminum Project Company.²⁷⁹ As with other Islamic financing structures, retaining title in the project assets underlying the transaction facilitated the *Shari'ah*-compliant financing structure.

B. Projects in the United States

Islamic finance has proven its ability to finance projects outside of the Islamic world as well. In the two projects discussed in this Section, one implemented the *istisna'a-ijara* structure in commercial real estate projects in Texas and Maryland,²⁸⁰ and the other helped finance oil and gas production activities in the Gulf of Mexico for a Texas-based

272. See Craig Nethercott & Nick Collins, *Sohar Aluminum Smelter Project Islamic Finance Facility*, PROJECT FIN. NEWS, Jan. 8, 2008 at 36, available at <http://www.islamicfinancenews.com/HanbookPDF/36.Sohar.pdf>.

273. See *id.*

274. See *id.*

275. *Id.*

276. *Id.* at 37. Under the *ijara* the operational phase was the period following delivery of the Islamic financed assets until the final maturity date under the commercial bank tranche. *Id.*

277. See *id.*

278. See *id.* at 36.

279. See *id.* at 37.

280. See *infra* Part IV.B.1.

company through a *sukuk* offering.²⁸¹ As these examples will show, *Shari'ah*-compliant project financing is obtainable in the United States through facilitating the retention of title in the project assets for the Islamic lenders. On a broader level, Islamic project financing in the United States "provide[s] an alternative to traditional borrowing, and allow[s] the] . . . issuer to take advantage of a largely untapped resource: liquidity in the [Islamic] world."²⁸²

1. Truman Park & Maconda Park Apartments: *Istisna'a-Ijara* Financing

The Maconda Park Project in Austin, Texas, and the Truman Park Project in Largo, Maryland involved residential housing transactions financed with an *istisna'a-ijara* financing structure. They were implemented in June of 2000 and April of 2001, respectively.²⁸³ In these deals, Islamic investors wished to use a *Shari'ah*-compliant structure to finance the construction and purchase of residential housing developments.²⁸⁴ In both projects, the Islamic investors formed special purpose project companies (a limited partnership in the Maconda project and a limited liability company in the Truman project) in order to implement the financing arrangements.²⁸⁵ The Islamic investors made equity contributions to the special purpose project companies in order to purchase the premises on which the construction would take place.²⁸⁶ The lead bank for the transactions was Key Bank, who formed separate entities called "owners." The owners would then enter into an *istisna'a* agreement to construct the structures on these premises. Following construction, the owners would enter into an *ijara* agreement with the Islamic investors through their special purpose project companies.²⁸⁷

For issues relating to *Shari'ah* compliance, the owners could only commission the *istisna'a* agreement for construction of the buildings if they had some kind of legal right to the land on which the buildings would be constructed. For this reason, the Islamic investors, who had previously purchased the land on which the construction would take place, leased these sites to the owners.²⁸⁸ The owners then commissioned

281. See *infra* Part IV.B.2.

282. Abdel-Khaleq & Richardson, *supra* note 32, at 423.

283. McMillen, *supra* note 2, at 1237.

284. See *id.* at 1238–40.

285. See *id.* at 1242.

286. *Id.* at 1244–45.

287. *Id.* at 1242.

288. See DENTON WILDE SAPTE LLP, *supra* note 64, at 16 ("Another important issue which is often overlooked is the Islamic financier can only agree to sell a building to the customer if it has some legal right to the land on which the building is to be constructed."); see

the construction of the residences with an *istisna'a* agreement.²⁸⁹ Once the residences were completed, the owners had title to the residences and were leasing the land upon which they were constructed.²⁹⁰ At this time the owners entered into an *ijara* agreement with the Islamic investors through their respective special purpose project companies for the residences themselves, and also entered into a sublease back to the Islamic investors of the land.²⁹¹ The *ijara* lease agreements were the primary financing documents by which the Islamic investors repaid the funds that Key Bank disbursed to undertake the construction of the project.²⁹² The Islamic investors also entered into call option agreements that would allow them to purchase the residences from the owners at the end of the *ijara* term.²⁹³

The Maconda Park Project and the Truman Park Project again highlight the importance of retaining title in the project assets for the purpose of *Shari'ah*-compliance. Key Bank formed "owners" for the purposes of first commissioning the construction of the residences through an *istisna'a* agreement, and then for the purposes of retaining title and leasing these residences back to the Islamic investors through an *ijara* agreement.²⁹⁴ Without the ability of the owners to retain title in the residences themselves, the *istisna'a-ijara* structures would not have been possible.²⁹⁵ Moreover, the Islamic investors retained ownership in the premises on which the residences were constructed, and entered into lease agreements for these premises with the owners to ensure validity of the *istisna'a* agreement.²⁹⁶

In addition to facilitating title retention, the Islamic investors' ownership of the land also aided in other aspects of *Shari'ah*-compliance. The Islamic investor must share in the risk of the project, and ownership of the project site meant that under U.S. law the Islamic investors retained responsibility for environmental liability, condition of the sites themselves, and tax payments.²⁹⁷ This left the Islamic investors exposed to a necessary amount of risk throughout the project.²⁹⁸ In short, the Maconda Park Project and the Truman Park Project show that

also McMillen, *supra* note 2, at 1247 (discussing in general terms the use of site leases in the projects to lease the property owned by the Islamic investors to the owners).

289. See McMillen, *supra* note 2, at 1243.

290. *Id.* at 1246.

291. See *id.* at 1252.

292. *Id.* at 1249.

293. See *id.* at 1246.

294. See *id.* at 1242, 1244–46.

295. See *id.* at 1237–41.

296. See *supra* note 288 and accompanying text.

297. McMillen, *supra* note 2, at 1247.

298. *Id.*

Shari'ah-compliant project financing in the commercial real estate sector through an *istisna'a-ijara* structure is quite feasible in the United States.

2. East Cameron Gas Company: *Sukuk* Offering

Sukuk offerings are very popular in the Islamic world, especially the Middle East, but most offerings are of the asset-based variety meaning that "investors have primarily focused on a purchase undertaking from the originator to buy back the assets on either a scheduled or early redemption."²⁹⁹ Asset-based *sukuk*, therefore, depend on the credit of the issuer.³⁰⁰ In the Islamic world, true asset securitizations have been rare in part due to the inability to obtain ratings from the major international rating firms, although some sovereign issuances have been rated based on the rating of the sovereign credit.³⁰¹ Yet, in the United States, it is much easier to obtain a credit rating for the issuer, thus overcoming one of the major obstacles to *sukuk* issuances in the Islamic world.

To this effect, the first asset-backed *sukuk* offering in the United States occurred in July of 2006. The East Cameron Gas Company, a Texas-based company, raised \$165.7 million through a *sukuk* offering to finance capital and operating costs associated with drilling and operating wells in the Gulf of Mexico.³⁰² To avoid potential issues due to an association with *riba*, the funds raised were also used to eliminate almost all of East Cameron's outstanding conventional debt.³⁰³ Although a modest-sized deal for the oil and gas industry, it could be replicated on a much larger scale, assuming there is sufficient interest on the part of investors.³⁰⁴ Both Muslim and non-Muslim investors subscribed to the issuance.³⁰⁵ Banks in London and Beirut provided the underwriting, with legal counsel in both Houston and Dubai.³⁰⁶

Louisiana law governed the property underlying the *sukuk* given that the project was located in the Gulf of Mexico off the coast of Louisiana.³⁰⁷ Nonetheless, oil and gas law in Louisiana, Texas, and other states in the United States provide a framework that seamlessly accommodates *Shari'ah*-compliance. In Louisiana, Texas, and other states, the minerals in the ground are often a separate and severable estate from the surface

299. DENTON WILDE SAPTE LLP, *supra* note 64, at 19.

300. See McMillen, *supra* note 96, at 428; *supra* notes 63, 208–210 and accompanying text.

301. See McMillen, *supra* note 96, at 428.

302. Richardson, *supra* note 21, at 149; see also Abdel-Khaleq & Richardson, *supra* note 32, at 422.

303. Abdel-Khaleq & Richardson, *supra* note 32, at 423.

304. See Richardson, *supra* note 21, at 152.

305. *Id.* at 150.

306. Abdel-Khaleq & Richardson, *supra* note 32, at 422–23.

307. See *id.* at 423.

estate.³⁰⁸ The rights to the minerals in the mineral estate are subject to joint ownership in numerous forms, but one of the most popular forms is a royalty interest.³⁰⁹ A royalty is “an economic interest . . . defined as ‘a share of production free of the costs of production, when and if there is oil and gas production on the property.’”³¹⁰ East Cameron sold a royalty interest in its federal offshore oil and gas leases to an SPV, which in turn issued the *sukuk* as a private placement offering.³¹¹ Subsequently, East Cameron received the funds from the *sukuk* to finance the operation activities of its production facilities.³¹² In short, the asset underlying the *sukuk* was the royalty interest in the oil and gas that East Cameron would produce as a result of the transaction,³¹³ and the *sukuk* themselves represented a beneficial ownership interest in the royalty.³¹⁴

If East Cameron produced enough oil and gas to generate a profit, this royalty interest would entitle the SPV to a percentage of the profit,³¹⁵ which the SPV would then distribute to the *sukuk* holders.³¹⁶ The SPV takes no part in the drilling or production activities. It only holds a “non-working interest that entitles it to a portion of the stream of income generated by the sale of production.”³¹⁷ Moreover, the *sukuk* offering was non-recourse to East Cameron, meaning that if the royalty could not generate sufficient funds, East Cameron would not be obligated to pay the *sukuk* holders.³¹⁸ Thus, the Islamic investors bore risk associated with insufficient oil and gas reserves to support the *sukuk* issuance, a natural disaster that could impact production, or price risk.³¹⁹

The *sukuk* offering was *Shari'ah*-compliant due to the risk sharing on the part of the *sukuk* holders, and the characterization under Louisiana law of a royalty interest as real property, of which the *sukuk* holders held undivided beneficial ownership.³²⁰ This undivided beneficial ownership could be considered a form of partial title in the royalty interest. The financial institutions structuring the transaction retained the services of two renowned Islamic scholars, one in Bahrain and one in the United

308. See Richardson, *supra* note 21, at 134–36.

309. See *id.* at 136–37.

310. *Id.* at 137 (quoting JOHN S. LOWE, OIL AND GAS LAW IN A NUTSHELL 43 (3d ed. 1995)).

311. See Abdel-Khaleq & Richardson, *supra* note 32, at 422–23; Richardson, *supra* note 21, at 149–50.

312. See Richardson, *supra* note 21, at 149–50.

313. See Abdel-Khaleq & Richardson, *supra* note 32, at 423.

314. See Richardson, *supra* note 21, at 150.

315. See *id.* at 150–51.

316. See Abdel-Khaleq & Richardson, *supra* note 32, at 423–24.

317. *Id.* at 423.

318. See *id.* at 424.

319. See *id.*

320. See Richardson, *supra* note 21, at 151.

States.³²¹ These Islamic scholars were consulted throughout the process of structuring the project, and ultimately issued a *fatwa* approving of the deal.³²² In the end, *Shari'ah* compliance again focused on the retention of title in some of the assets underlying the project.³²³ Once this was achieved, the investors shared in the project risks, and received rentals on the project's production, as opposed to interest payments.³²⁴

Sukuk offerings are perhaps the most malleable of the Islamic financing structures. Any project structure that generates or contributes to the generation of a revenue stream is subject to securitization for the purposes of a *sukuk* offering.³²⁵ Although East Cameron was a high-risk project with a CCC+ credit rating that ultimately defaulted,³²⁶ its experience shows that *sukuk* offerings are a potential source of funds for project finance in the United States. Notwithstanding the current economic downturn and the effect it has had on securitization, it is clear that *sukuk* offerings in the oil and gas industry in the United States hold tremendous long-term potential given the enthusiasm for the East Cameron deal on the part of both Islamic and non-Islamic investors.³²⁷

As was highlighted throughout the discussions of these cases, structuring the project in a manner that allows the Islamic lenders to retain title to some of the project's assets, or a portion of the project's assets, will do much to ensure that the project is *Shari'ah*-compliant. The *rahn-adl* arrangement can satisfy the dual purpose of allowing for the retention of title in the project assets with Islamic lenders while also enabling Western lenders to have a security interest in the financed assets. The *mudaraba-murabaha* arrangement demonstrates how Islamic lenders can retain title through shared ownership in a type of partnership arrangement. *Istisna'a-ijara* can work on its own or alongside Western tranches of debt, and allows for the Islamic lender to commission construction, retain title, and lease the assets back to the SPV or the project's owners. A true asset-backed *sukuk* is functionally a portion of the title in the assets under it, and as such, it enables a form of partial retention of title for the Islamic financiers. These projects show that retention of title on the part of the Islamic financiers is at the heart of *Shari'ah*-compliant financing, and is also a workable model alongside projects with Western financing sources.

321. See Abdel-Khaleq & Richardson, *supra* note 32, at 424.

322. Richardson, *supra* note 21, at 151.

323. See, e.g., *id.* at 150–51.

324. See *id.* at 151.

325. See *supra* text accompanying notes 215–217, 236–241.

326. *Sukuk it up*, *ECONOMIST*, Apr. 17, 2010, at 82.

327. See Richardson, *supra* note 21, at 149.

CONCLUSION

The key to *Shari'ah* compliance is to facilitate the retention of title on the part of the Islamic lenders in the project assets underlying the financing transaction.³²⁸ Once the lender has title to these assets, he is subject to the risks of the project and any return on the investment will be in the form of rents on the assets, and not *riba*.³²⁹ Moreover, *Shari'ah*-compliant financing is well-suited for project finance due to the nature of the projects typically undertaken in project finance transactions. Such projects tend to be large industrial or infrastructure projects whose cash flows can be projected to some extent, which avoids the prohibition on *gharar*.³³⁰ Finally, as long as the project is not or does not facilitate an activity that is *haram*, the project should be *Shari'ah*-compliant.³³¹ Islamic project finance conflicts with Western project finance practices in ways that create problem areas and potential issues.³³² Yet, as the case studies show, these problem areas and issues are surmountable through the use of the many combinations of structures unique to Islamic finance.³³³

Much of the Islamic world consists of countries where a substantial portion of the economy has traditionally depended on fossil fuels. As the prices of these commodities rise, these countries will accumulate cash, which they will look to invest.³³⁴ Project finance presents opportunities to invest this cash in many diverse industries outside of the realm of natural resource exploitation.³³⁵ Moreover, the liquidity in the Islamic world represents an opportunity for Westerners who undertake project finance activities.³³⁶ This is even more true in light of the recent financial troubles of many Western governments and financial systems.³³⁷ Thus, the liquidity of the Islamic world is potentially a very large source of capital for Western project finance investors and could provide them with

328. See *supra* note 123 and accompanying text.

329. See *supra* notes 63–69, 123 and accompanying text.

330. See *supra* notes 4, 70–84 and accompanying text; see also *supra* Part IV (providing examples of *Shari'ah*-compliant projects).

331. See *supra* notes 90–95 and accompanying text.

332. See *supra* Part II.

333. See *supra* Part IV.

334. See *supra* note 15 and accompanying text.

335. See *supra* Part IV.

336. See *supra* note 15 and accompanying text.

337. See Kevin Brown, Special Report, *Wider Appeal Battles with Signs of Inefficiency*, FIN. TIMES, Dec. 8, 2009, at 5.

investment opportunities they may not otherwise have if their only sources of financing are Western financial markets.³³⁸

For the Islamic world, project finance is an avenue not only for investment, but also for infrastructure development and economic diversification.³³⁹ Western project finance partners are likely to bring knowledge and technical expertise to the Islamic world about industries that may not be fully developed locally. *Shari'ah*-compliant project finance has proven its ability to function outside of the Islamic world as well.³⁴⁰ Nonetheless, competition for access to the liquidity of the Islamic world could be fierce, and those project finance investors that show the most understanding and willingness to work with *Shari'ah*-compliant finance practices will possess an advantage in accessing Islamic sources of capital.

338. See Richardson, *supra* note 21, at 152 ("With the potential for liquidity in the Middle East to continue indefinitely as oil prices remain at near-record highs, there should be significant sources of funds for U.S. projects in the foreseeable future.").

339. Cf. Khan, *supra* note 67, at 13–14.

340. See *supra* Part IV.B.