Fordham International Law Journal

Volume 24, *Issue* 4 2000 *Article* 6

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Abstract

This Essay addresses collateral security structures and project financing structures used in project financings where the structure of, and documentation for, the financing is compliant with the precepts of Islamic Shari'ah. The Essay first provides a brief summary of the sources and exposition of Shari'ah principles in financing transactions. It then surveys economic and financial trends in Saudi Arabia promoting and supporting the project financings discussed in the Essay. General legal considerations influencing development of the structure are then identified, including the absence of a statutory structure, the inapplicability of stare decisis, and the fact that many laws are not published. A critical factor in any project financing, particularly in a jurisdiction in which Islamic law is predominant, relates to the available enforcement entities and paradigms and the degree to which Islamic Shari'ah is the basis for interpretation and enforcement of agreements. This Essay examines the enforcement regimen of Saudi Arabia and then examines three project financing case studies.

ISLAMIC *SHARI'AH*-COMPLIANT PROJECT FINANCE: COLLATERAL SECURITY AND FINANCING STRUCTURE CASE STUDIES

*Michael J.T. McMillen**

This Essay addresses collateral security structures and project financing structures used in project financings where the structure of, and documentation for, the financing is compliant with the precepts of Islamic *Shari'ah*.[1] The Essay first provides a brief summary of the sources and exposition of *Shari'ah* principles in financing transactions. It then surveys economic and financial trends in Saudi Arabia promoting and supporting the project financings discussed in the Essay. General legal considerations influencing development of the structure are the identified, including the absence of a statutory structure, the inapplicability of *stare decisis*, and the fact that many laws are not published. A critical factor in any project financing, particularly in a jurisdiction in which Islamic law is predominant, relates to the available enforcement entities and paradigms and the degree to

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1. Portions of this Essay addressing the *rahn-adl* collateral security structure previously appeared in THE PROCEEDINGS OF THE THIRD HARVARD UNIVERSITY FORUM ON ISLAMIC FINANCE: LOCAL CHALLENGES, GLOBAL OPPORTUNITIES 111-31 (2000) [hereinafter THIRD HARVARD ISLAMIC FORUM]. A general description of the financing of the *rahn-adl* structure in the Saudi Chevron petrochemical project financing appeared in Michael J.T. McMillen, *Special Report, Saudi Arabia, Briefing: Project Finance, Reconciling New Funding with the Sharia*, 38 MIDDLE E. ECON. DIG., Sept. 18, 1999, at 36-39. A general description of the financing of the Maconda Park Project *istisna'a-ijara* transaction appeared in Michael J.T. McMillen, *Special Report U.S., Briefing: Islamic Finance: Breaking the Mould*, 38 MIDDLE E. ECON. DIG., Sept. 22, 2000, at 28-29.

which Islamic *Shari'ah* is the basis for interpretation and enforcement of agreements. This Essay examines the enforcement regimen of Saudi Arabia and then examines three project financing case studies. The first case study focuses on a *Shari'ah*-compliant collateral security that was developed for, and implemented in, the first limited recourse project financing in The Kingdom of Saudi Arabia, the Saudi Chevron Petrochemical Project. The structure is a *rahn-adl* (mortgage/pledge-"trustee-arbitrator") structure that is now used in the Middle East. The second case study focuses on a *sharikat mahassa–murabaha* (joint venture-bank purchase and sale) structure that was used in the financing of an expansion to a power project and related transmission equipment, in Saudi Arabia: the Utility Power Project. The final two case studies examine a *Shari'ah*-compliant *istisna'a–ijarai* (construction contract–lease) structure that was recently effected in the United States in the Maconda Park Apartments and the Truman Park Apartments Projects and which will be effected in various Islamic and non-Islamic jurisdictions. In each case, the transactional participants and documentary structure are considered in detail. In the case of the *rahn-adl* collateral security structure, the methodology of the development of the structure is also examined in order to provide an indication of the nature of structuring a transaction that bridges Western and Islamic financial systems and their divergent credit, economic, legal, and cultural parameters. The methodology is the opposite of that used in structuring project financings in other jurisdictions, commencing from the Islamic system and working to incorporate Western elements and, because it had not previously been undertaken, began with first principles under the *Shari'ah* and consideration of the nature of security interests in camels. Although the two Saudi Arabian transactions involved structures developed with primary sensitivity to the *Hanbali* School of Islamic jurisprudence, the Essay discusses variations for implementation of the structures in other jurisdictions where other schools of Islamic jurisprudence predominate.

INTRODUCTION

Commonly used definitions of "project financing" are focused on the productive capabilities of an economic unit (i.e., the project) and the needs and preferences of the debt partici-

pants in financing the construction and operation of such units, with the impact on the equity participants being implied by the debt structure. In general terms, a "project financing" 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 the other assets comprising the economic unit as collateral for the loan. It is an "off-balance sheet" method of financing from the vantage of the operator of the project.

Project financing techniques have become a primary means for financing a broad range of economic units throughout the world. The application of these techniques has been refined in most industrial categories and with respect to most types of assets. For example, they are used for the financing of power generation, transmission, and distribution assets; for upstream, midstream, and downstream assets in the oil and gas industries; for petrochemical, paper, and mining projects; and for the entire panoply of infrastructure projects, including roads, airports, and desalination plants. These techniques have been used for the financing of tankers and other vessels, aircraft, and virtually every type of manufacturing, transportation, computer, and telecommunications equipment.

And, with one major exception, project financing techniques have been used in most countries and economic systems in the world. The one major exception is that relatively little implementation has been made of those techniques in transactions that are compliant with the precepts of Islamic *Shari'ah*, be it in Islamic jurisdictions such as the Middle East, North Africa, Malaysia, Indonesia, or in other jurisdictions. A significant limiting factor relates to the conflict of certain Islamic principles with the fundamental debt-leverage principle of Western project financing, namely Islamic *Shari'ah* prohibitions on the payment or receipt of interest and other aspects of the doctrine of *riba*.[2]

2. *Riba* is traditionally translated as usury. However, jurists have a more expansive concept in Islamic jurisprudence, addressing not only prevention of the exploitation of those in a weak bargaining position, but also "the illegality of all forms of gain or profit which were unearned in the sense that they resulted from speculative or risky transactions and could not be precisely calculated in advance by the contracting parties." NOEL J. COULSON, COMMERCIAL LAW IN THE GULF STATES: THE ISLAMIC LEGAL TRADITION 11 (1984) [hereinafter COULSON, GULF STATES COMMERCIAL LAW]. *See* FRANK E. VOGEL & SAMUEL L. HAYES, III, ISLAMIC LAW AND FINANCE: RELIGION, RISK AND RETURN 71-95 (1998) [hereinafter VOGEL & HAYES]; NABIL A. SALEH, UNLAWFUL GAIN AND LEGITIMATE

The essential participants in any financing of a large scale industrial, infrastructure, real estate, or similar project are (a) one or more equity investors (often the sponsors of the project) and (b) the availability of debt financing or an Islamically acceptable alternative to the debt portion of the financing.[3] The determination by a bank or other financier as to whether to participate in a given project financing of this type centers on the project economics and, particularly, in a limited recourse project financings, the collateral package that is made available to secure the financing. Project sponsors and their affiliates have a strong aversion to guaranteeing a project loan or other financing and to otherwise incurring a balance sheet liability in respect of a project. This is particularly true of companies that may have to reflect the guarantee liability on, or consolidate project debt onto, a parent company balance sheet under generally accepted accounting principles. Thus, in addition to careful tax and ownership structuring, project sponsors and their parent companies also have a strong interest in providing the financiers with an acceptable collateral security package. And, to effectuate liability limitations and non-consolidation, sponsors and their parent companies want the collateral for the project to be, and to be limited to, the assets comprising the project and the cash flows from operation of the project.

This highlights a second group of limitations on the implementation of project financing techniques in transactions that are *Shari'ah*-compliant: the difficulty of obtaining a collateral security interest under the *Shari'ah* and the constraints inherent in the nature of a *rahn* (mortgage/pledge) under the *Shari'ah*.

PROFIT IN ISLAMIC LAW 11-43 (2d ed. 1992) [hereinafter SALEH]; NAYLA COMAIR-OBEID, THE LAW OF BUSINESS CONTRACTS IN THE ARAB MIDDLE EAST 43-57 (1996); Mahmoud A. El-Gamal, *An Economic Explication of the Prohibitions of Riba in Classical Islamic Jurisprudence*, *in* THIRD HARVARD ISLAMIC FORUM, *supra* note 1, at 29-40. *See generally* J.T. NOONAN, SCHOLASTIC ANALYSIS OF USURY (1957) (providing an interesting perspective on the Islamic concept of *riba* and a good history of usury in medieval Europe, including Canon Law positions at different periods).

See also Don Babai, *Islamic Project Finance: Problems and Promises*, *in* PROCEEDINGS OF THE SECOND HARVARD UNIVERSITY FORUM ON ISLAMIC FINANCE: ISLAMIC FINANCE INTO THE 21ST CENTURY (1999) [hereinafter SECOND HARVARD ISLAMIC FORUM] (noting other limitations); THIRD HARVARD ISLAMIC FORUM, *supra* note 1.

3. Two of the case studies set forth in this Essay describe such alternatives: the *sharikat mahassa-murabaha* structure used for the Utility Power Project and described in Section VI and the *istisna'a-ijara* structure used for the Maconda Park and Truman Park Projects and described in Section VII.

There is a pressing need for industrial, infrastructure, and real estate development in the entire range of Islamic jurisdictions. And, as noted below, there is a significant trend in Islamic jurisdictions to broaden the capital base within each country, draw upon funds from a world-wide financing base, and reduce reliance on local capital for all financing needs. However, there is a dearth of available financing structures that bridge Western financial systems[4] and Islamic systems. And there is a perception that the legal systems and principles of the Western systems and the Islamic systems are so diverse as to be unbridgeable.

This Essay focuses on two aspects of project financings in an Islamic jurisdiction: (i) the design and implementation of a collateral security structure under Islamic *Shari'ah* precepts and (ii) the design and implementation of *Shari'ah*-compliant financing structures so as to avoid, among other things, prohibitions on the payment and receipt of interest, and so as to comply with *Shari'ah* precepts applicable to the specific contractual arrangements used in those financings.[5]

To give structure to the discussion, four case studies are presented. Two of the case studies are of projects in Saudi Arabia, and the other two are of a *Shari'ah*-compliant structure recently implemented in the United States. The Saudi Arabian transactions were chosen (i) because of they were the first of their kind, (ii) because they involved both Western and Middle Eastern sources of financing (and thus had to comply with credit policies and legal requirements applicable in multiple divergent jurisdictions), and (iii) because of the lack of an applicable statutory framework in The Kingdom of Saudi Arabia, which forced direct consideration of *Shari'ah* principles and precepts. The United States transactions were chosen because they also were

4. References to "Western" systems are primarily to financing techniques and expectations that predominate in the United States of America, Europe, and Japan.

5. In addition to sources cited in this Essay (and other sources), many Islamic scholars, Islamic financiers, and Saudi Arabian legal practitioners have graciously provided invaluable assistance to the author in orally exploring *Shari'ah* principles and precepts, including those applicable to the structures discussed in this Essay. The author expresses particular gratitude to Dr. Mohamed Ali Elgari of the National Management Consultancy Center and of King Abdulaziz University in Jeddah, Saudi Arabia, Mr. Hafedh Maamouri, currently Senior Consultant with Islamic Finance Consultants in Manama, Bahrain, and previously Head of Islamic Banking for Saudi American Bank, and Hassan M.S. Mahassni, Esq. of the Law Office of Hassan Mahassni in association with White & Case LLP. Any errors in the statements of *Shari'ah* principles and precepts are the sole responsibility of the author.

the first of their kind and because they illustrates application of Islamic financings in a more complex regulatory environment without diminution in Islamic compliance or the ability to apply the structure in other jurisdictions.

An Islamically acceptable collateral security structure is discussed in the context of a case study for the first limited recourse project financing in Saudi Arabia, the Saudi Chevron petrochemical project in late 1998. In particular, it focuses on the development of the *rahn-adl* structure for that financing. This collateral security structure has been used as a model for, and has found a much broader implementation in, other secured financings throughout the Middle East. The first *Shari'ah*-compliant financing structure discussed in this Essay is a *sharikat mahassa–murabaha* (joint venture–share sale) structure that was used in the project financing of the expansion of a power plant and related transmission facilities in Saudi Arabia for an electric utility ("Utility") in 1998. The second *Shari'ah*-compliant financing structure was implemented (a) first in Austin, Texas, in June 2000, for the Maconda Park Apartments project and (b) second in Largo, Maryland, in April 2001, for the Truman Park Apartments project. Both the Maconda Park Project and the Truman Park Project (collectively, the "Projects") entail construction financing for residential housing developments. The Truman Park Project involved the take-out of a conventional construction loan using an Islamic structure. The Islamic structure in both transactions is an *istisna'a-ijara* (construction contract-lease) structure that involves bank construction and ownership of the project with a subsequent financing lease to the involved project company.

I. *SOURCES OF ISLAMIC SHARI'AH*

Islamic religious law as applied to commercial activities is comprised, for purposes of this Essay, of two parts: *Shari'ah* (literally, "the Way"), or perfect, immutable, divine law, as revealed in the *Qur'an* and the *sunna*; and *fiqh* (literally, "understanding"), or the sum of human comprehension of that divine law. While there is dispute among Islamic scholars as to the precise manner in which Islamic law is to be determined, those who determine Islamic law are religious scholars (*ulama*) that are skilled in interpreting the revealed sources of the *Shari'ah* and

the *fiqh* and in financial and economic disciplines. The primary methodology used in this determinative and interpretive effort is *ijtihad* (literally, "effort"), or legal reasoning. *Ijtihad* observes a particular methodology, called the "roots of the law" (*usual al-fiqh*).[6] The roots (*usul*) upon which Islamic jurisprudence is based are (a) the *Qur'an*, being the holy book of Islam, (b) the *sunna* of the Prophet Mohammed, which are the binding authority of his dicta and decisions, (c) the *ijma* or "consensus" of the community of scholars, and (d) the *qiyas*, or analogical deductions and reasoning.

In practice, Islamic *Shari'ah* is determined by *ulama*, acting individually or in groups. For purposes of this Essay, it is important to note that most significant Islamic financial institutions have *Shari'ah* supervisory boards, committees, and advisors ("*Shari'ah* Boards"), comprised of one or more Islamic scholars that have particular expertise in economic and financial transactions. These *Shari'ah* Boards will often examine in detail both the structure of a proposed transaction or financial product and the documentation giving effect to that transaction or product. In the course of structuring the transaction and documentation, there may well be multiple review sessions by the *Shari'ah* Board with modifications to the structure and the documentation after each review session, a process of continual refinement to give effect to the determinations of the *Shari'ah* Board with respect to the individual transaction or product. Given that *Shari'ah* Board determinations are *fiqh* (human comprehension of *Shari'ah*, the divine law), there can be variations in interpretation and implementation from one *Shari'ah* Board to another, with a multiplicity of views on a specific issue. These variations occur even though *Shari'ah* scholars in this period strive to achieve a consensus on difficult and novel issues, such as those involved in the development of new financial instruments and products.[7] Is-

6. *See generally* NOEL J. COULSON, A HISTORY OF ISLAMIC LAW (1964); JOSEPH SCHACHT, AN INTRODUCTION TO ISLAMIC LAW (1964). *See* VOGEL & HAYES, *supra* note 2; NICHOLAS DYLAN RAY, ARAB ISLAMIC BANKING AND THE RENEWAL OF ISLAMIC LAW (1995) [hereinafter RAY]; SALEH, *supra* note 2; COULSON, GULF STATES COMMERCIAL LAW, *supra* note 2; *see also* SECOND HARVARD ISLAMIC FORUM, *supra* note 2; THIRD HARVARD ISLAMIC FORUM, *supra* note 1 (containing articles covering current issues in Islamic finance).

While, as a precise matter, all discussion of Islamic jurisprudence is one of *fiqh*, this Essay, in keeping with convention, will refer to precepts and principles of *Shari'ah* without further reference to *fiqh*.

7. *See* Nizam Yaquby, *Islamic Finance in View of the Shari'ah*, *in* SECOND HARVARD

lamic investors, be they financial institutions or individual investors, rely heavily on the involvement of *Shari'ah* Boards in the structuring and documentation of a transaction or financial product and may request that the *Shari'ah* Board's *fatwa* of approval be provided before an investment is made.

II. *THE ECONOMIC AND FINANCING ENVIRONMENT IN SAUDI ARABIA*

The economic and financing environment in Saudi Arabia prior to, and at the time of consummation of, the financings of the Saudi Chevron petrochemical project and the Utility power project (the first two case studies) involved a focus on diversification of the industrial base in the Kingdom. There was a trend toward accessing a broader financing base, with greater involvement of Saudi Arabian investors as well as foreign investors, internationalization of the financing process, and the use of project financing techniques rather than personal and corporate guarantees. Concurrently, the government and local businesses were considering and attempting to implement methods of reducing the role of government in the provision of financing.

In the initial stages, industrial diversification proceeded most rapidly in the petrochemicals industry, particularly where affiliates of Saudi Arabian Basic Industries Corporation ("SABIC") were involved. Among the early petrochemical projects that obtained financing were expansions by Saudi Yanbu Petrochemical Company ("Yanpet"), a joint venture between SABIC and Mobil Yanbu Petrochemical Company, Saudi Petrochemical Company ("Sadaf"), United Jubail Fertilizer Company, a joint venture among SABIC and five SABIC companies, Al-Jubail Petrochemical Company ("Kemya"), and Eastern Petrochemical Company ("Sharq"). Notably, 1998 also saw the first international lending transaction in the electricity sector when Saudi Consolidated Electric Company in the Eastern Province executed a "dedicated receivables" financing for its Ghazlan II power project near Yanbu.

Financings by these, and other, companies involved some degree of recourse to the project sponsors or their affiliates. They also involved some element of collateral security for the

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ISLAMIC FORUM, *supra* note 2, at 159-61 (summarizing these and other responsibilities of modern *Shari'ah* Boards).

financiers of such projects. However, these projects did not fall within the "limited recourse project financing" concept that is being considered in this Essay and none of those projects involved the use of the *rahn-adl* collateral security, *sharikat mahassa-murabaha,* or *istisna'a-ijara* structures discussed in this Essay.

These early projects illustrate a broader involvement of Saudi Arabian investors. Each project involved significant or exclusively Saudi Arabian equity, and some involved joint stock companies that may eventually seek stock exchange listings. Foreign investors, such as Chevron, were allowed to participate in company ownership in Saudi Arabia, and there has been a significant advance in the encouragement of foreign investment in Saudi Arabia since the Saudi Chevron financing. In addition, Saudi Chevron and many SABIC projects, such as Yanpet, involve a combination of local, regional, and international lenders.

The health and liquidity of local and regional banks were significant factors in industrial and infrastructure finance in Saudi Arabia in that period. Local banks reported profits in each of the years preceding the financings of the Saudi Chevron petrochemical and Utility power projects. Those banks experienced substantial liquidity and low loan-to-asset ratios. Profits were based more on investment income than interest, and loan growth had been low. This encouraged banks to increase lending to all economic sectors. To spread risks and increase the borrowing base, banks sought to join regional and international lending groups, particularly for large projects such as Saudi Chevron, Ghazlan II, and Yanpet.

Governmental evaluations were ongoing regarding restructuring of the electricity sector, with initial consideration given to financing the Shoaiba project as an independent power project using a build-own-operate ("BOO") structure.[8] Privatization of the telecommunications sector, Saudi Arabian Airlines, and port operations, maintenance, and management were all being actively considered, and the privatization of the telecommunications sector did proceed. A public offering of SABIC shares was also being considered at the time. Regarding capital markets development, in April 1998, the Saudi Arabian Monetary Agency ("SAMA") issued a new binding draft of the Investment Business

8. The transaction was not completed as a build-own-operate structure at that time. Restructuring of the electricity system was undertaken and is in process.

Regulations, which regulate, among other things, the distribution of securities and the management of mutual funds. Accession to the World Trade Organization was also a frequently considered topic, together with its effects on brokerage, insurance, and commercial banking activities, as well as export/import markets.

Each of these developments, and others, worked to expand the capital markets, permitting greater access to foreign funds and a strengthening of the economy over the longer term. One goal was to free up Saudi Arabian capital, allowing it be spread over a broader risk base within the economy. It was believed that this, in turn, would have the effect of a reduced burden on government and an allocation of risks to those willing and most able to bear them. It was anticipated that increased foreign equity investment would result in further technology transfer into the industrial and infrastructure sectors. As completed financings illustrate, the time frame for implementation of individual projects was reduced as businessmen sought to avoid additional costs of delays and other inefficiencies in implementing their projects. Privatization, where determined appropriate, would allow governmental risk sharing with the private sector, cost reduction, and governmental management of the pace and depth of movement of functions to the private sector.

III. *THE SAUDI ARABIAN LEGAL ENVIRONMENT: GENERAL CONSIDERATIONS*

The fundamental and paramount body of law in The Kingdom of Saudi Arabia is the *Shari'ah*, as construed by the *Hanbali* School of Islamic jurisprudence.[9] The sources of the *Shari'ah*

9. The four major schools of Islamic jurisprudence are: (1) the *Hanafi* School, which is predominant in the countries of the former Ottoman Empire and emanated from the disciples of Abu Hanafi (d. 767 H.) in the Iraqi center of Kufa; (2) the *Hanbali* School, which is predominant in The Kingdom of Saudi Arabia and few other jurisdictions and was formed aby Ahmad bin Hangal (d. 855 H.); (3) the *Maliki* School, which emanated from the Arabian center in Medina through the followers of Malik bin Anas (d. 796 H.); and (4) the *Shafi'i* School formed by the followers of Shafi'i (d. 820 H.). The four major schools differ in many respects in their interpretation of certain *Shari'ah* precepts. Most scholars from medieval times until modern times aligned themselves with one of the four major schools of Islamic jurisprudence. However, in modern times many scholars do not believe it necessary to belong to any single school of Islamic jurisprudence. *See* VOGEL & HAYES, *supra* note 2, at 34-41 (describing methods of elaboration of law).

are the *Qur'an*, the *sunna*, *ijma*, and the *qiyas*. Certain matters are dealt with "statutorily," by Royal Decrees with respect to that matter. Where such a statutory body of law has been promulgated, such law is ultimately subject to, and may not conflict with, the provisions of the *Shari'ah*. Unlike other Middle Eastern countries, there is no statutory body of law in Saudi Arabia with respect to collateral security, mortgages and pledges, recordation of security interests, or related matters.[10] Nor is there a comprehensive statutory regime pertaining to sale (*istisna'a*) or lease (*ijara*) transactions. There are statutes pertaining to joint ventures and other types of business organizations and foreign investments in Saudi Arabia. However, considerations, hereinafter set forth below in this Section III, limit the predictability of those statutes in certain circumstances. Thus, financiers and legal practitioners must look directly to the *Shari'ah* in structuring and applying legal principles relating to collateral security matters, sales transactions, and leases. Financiers and legal practitioners must also look to the *Shari'ah* in implementing existing statutory provisions. These factors, in addition to those discussed immediately below, render it difficult to provide definitive advice as to how collateral security and financing arrangements similar to those implemented in the Saudi Chevron, Utility Power, Maconda Park, and Truman Park transactions can be effected or would be interpreted by adjudicative bodies in Saudi Arabia.[11] It is noteworthy, however, that under the *Shari'ah*, absent a prohibition in the *Shari'ah*, the agreement of the parties will control.

In addition, under the principles of law applicable in Saudi Arabia, previous decisions of Saudi Arabian courts and other adjudicative authorities are not considered to establish binding precedents for the decision of later cases, and the principle of *stare decisis* is not accepted in Saudi Arabia. Also, Royal Decrees,

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10. A unique exception in Saudi Arabia is in the area of ship mortgages, which is governed by the Commercial Court Regulations (Royal Decree No. M27 of 1931), the Ship Mortgage Regulations (which came into force on June 17, 1955), and the Regulations for Ports and Harbors (Royal Decree No. M27 of July 14, 1974), the Regulations for Ports, Harbors and Lighthouses dated 19/6/1394 (Resolution No. 934 of the Council of Ministers).

11. This realization had a profound impact on the "scientific method" and approach chosen for development of the *rahn-adl* collateral security structure. Predictability of outcome was a primary concern of the financing banks in the Saudi Chevron transaction.

ministerial decisions and resolutions, departmental circulars and other governmental pronouncements having the force of law, and the decisions of the various courts and adjudicatory authorities of Saudi Arabia are not generally or consistently collected in a central place and are not necessarily available to the public.

IV. *ENFORCEMENT OF AGREEMENTS IN SAUDI ARABIA*

A. *Jurisdiction of Enforcement Entities*

Considerations of choice of forum are critical in every financing and in every jurisdiction in the world. Different enforcement entities have different areas of expertise and different sensitivities to issues. Each enforcement entity has a different array of remedies that it can apply, particularly in a jurisdiction such as Saudi Arabia. Rights to appeal from each enforcement entity are different as are the procedural rules applicable to each enforcement entity. And, given varying dockets and procedures, the dispute resolution period can and does vary dramatically from one enforcement entity to another.

There are a number of different courts, committees, offices, and boards (collectively, "Enforcement Entities") that might have jurisdiction over a matter in Saudi Arabia in which a bank could be involved. Three of these Enforcement Entities were of particular relevance in the context of the financings of the Saudi Chevron Project and the Utility Power Project: the Banking Disputes Settlement Committee ("SAMA Committee") of the Saudi Arabian Monetary Agency ("SAMA"); the Office of the Settlement of Negotiable Instruments Disputes, also known as the Negotiable Instruments Offices ("NIO"), which are under the jurisdiction of the Ministry of Commerce;[12] and the Board of Grievances (*Qiwan Al-Mazal'im*) under The Board of Grievances Law ("Board of Grievances"). In summary:

(i) The SAMA Committee has jurisdiction over matters and disputes involving banks and their customers—that is, "settling" (mediating) disputes between banks and their customers "in accordance with the agreements concluded between them." Under the regulations constituting the SAMA Committee, all disputes between banks,

12. The NIO operates in practice like a court with hearings being held in a number of different circuit locations in Saudi Arabia. For ease of reference, references to the NIO will be in the singular.

including foreign banks, and their customers (other than those involving negotiable instruments) are to be referred in the first instance to the SAMA Committee.[13]

(ii) The NIO has jurisdiction over actions, matters, and disputes involving negotiable instruments (such as the promissory notes used in the financings discussed in this Essay), and in the context of such disputes, the NIO has jurisdiction superior to that of the SAMA Committee.[14]

(iii) The Board of Grievances has jurisdiction over commercial disputes (by implication, other than banking disputes and negotiable instruments disputes), including the enforcement of foreign judgments and bankruptcy matters.[15]

The jurisdiction of the various Enforcement Entities is, in certain respects, unclear and arguably overlapping. Numerous questions arise as to which Enforcement Entity would have jurisdiction in various matters involving one of the financing banks in the transactions discussed in this Essay. For example, although the Board of Grievances has jurisdiction with respect to enforcement of foreign judgments and awards generally, the SAMA Committee has jurisdiction with respect to all matters involving banks (other than in respect of negotiable instruments). Does this mean that the SAMA Committee should assert jurisdiction with respect to a foreign award obtained by a bank? Would this be true despite the express provisions of the various official pronouncements regarding enforcement of foreign awards, particularly those rendered in foreign arbitrations? In the bankruptcy context, although the Board of Grievances generally has jurisdiction, if a bank creditor has a claim, should the SAMA Committee take jurisdiction? Which Enforcement Entity has jurisdiction where the foreign judgment or award obtained by a bank is on a negotiable instrument? These are questions of first instance in Saudi Arabia that will be determined by each Enforcement Entity, and it is not possible to determine in advance the decision that will be made.

Given the foregoing situation and issues, among others, it

13. SAMA Committee decisions are final and not appealable.

14. NIO judgments may be appealed to the Legal Committee of the Ministry of Commerce.

15. Determinations of the Board of Grievances may be appealed to the Board of Grievances Scrutinization Committee.

was important to structure the Saudi Arabian transactions in a manner that would afford the banks initial access to, and an ultimate determination by, the Enforcement Entity of their choice in any given situation and the opportunity to raise these jurisdictional issues with the chosen Enforcement Entity.

B. *Examination of Underlying Documentation Under the Shari'ah*

Creditors involved in disputes to be resolved through the SAMA Committee or the NIO are afforded certain advantages over creditors who pursue their claims before the Board of Grievances. Although the SAMA Committee is in theory obliged to apply the *Shari'ah* and its precepts, including the prohibition on interest, to banking disputes, in practice the SAMA Committee has generally shown a willingness to force a recalcitrant debtor to honor the terms of the agreement creating the indebtedness, regardless of whether the agreement requires the payment of monies in the nature of interest or is otherwise variant from principles of Saudi Arabian law. The SAMA Committee does examine the various underlying documents and will make inquiry as to whether these arrangements are in accordance with Saudi Arabian law, but it makes all reasonable efforts to respect the agreement of the parties even in the face of conflicts with the *Shari'ah*.

It is noteworthy that review by the SAMA Committee is comprised of a legal review and an accounting review. The accountants of the SAMA Committee perform independent determinations based on their calculations of the amount of interest payable in respect of a given dispute. Interest is payable only to the date of commencement of the action with the SAMA Committee. Thus, no interest is payable in respect of periods after such date and no interest is payable in respect of overdue amounts. It is the author's understanding based upon discussions with Saudi Arabian lawyers and judges that in practice most actions before the SAMA Committee take from six months to one year.

Remedies available to the SAMA Committee include (i) prohibition of the debtor from leaving Saudi Arabia and (ii) putting the debtor on a "notice list" that is circulated to banks in Saudi Arabia. The second alternative can be a very effective remedy, as banks in Saudi Arabia will decline to conduct banking business with the debtor so listed.

Where the SAMA Committee, acting as a mediation body, is unable to bring about a settlement of a dispute, its implementing regulations require that the matter be submitted to the court of competent jurisdiction (i.e., the Board of Grievances) for a *de novo* hearing. Notwithstanding the express requirements of such implementing regulations, however, under present practice the Board of Grievances will generally decline to hear cases that fall under the jurisdiction of the SAMA Committee.[16]

In resolving actions, matters, and disputes within its jurisdiction, the NIO will generally enforce a debt obligation as evidenced by a negotiable instrument without looking to the substance of the transaction giving rise to such instrument, including whether such indebtedness includes amounts in the nature of interest.[17] The NIO will, however, consider general defenses such as whether or not a debt was actually incurred or a negotiable instrument properly formed. Thus, the NIO generally does not undertake an inquiry into whether the documents underlying a negotiable instrument comply with the *Shari'ah* and certain other principles of Saudi Arabian law.[18] Saudi Arabian legal practitioners have informed the author that actions before the NIO are resolved in less time that those before the SAMA Committee.

The Board of Grievances will undertake a fulsome examination of any matter presented to it, and this examination will include a rigorous inquiry into matters of public policy (including the compliance of all documentation with the *Shari'ah* and other principles of Saudi Arabian law). Thus, if a foreign judgment or award is obtained and enforcement is sought in Saudi Arabia, the Board of Grievances may examine the underlying documentation and make what is essentially a *de novo* determination as to whether the documentation underlying the judgment complies

16. The author has been informed that the Minister of the Interior has instructed the Civil Rights Department, the department of the Ministry of the Interior that is responsible for enforcing judgments of the SAMA Committee, that decisions of the SAMA Committee are to be enforced in the same manner as a decision of a court.

17. Many transactions are thus structured to provide separate notes for principal, interest, and other costs and expenses. These transactions frequently have a requirement for on-going provision of such notes.

18. A judgment issued by the NIO may be enforced through a presentation of the judgment to the Civil Rights Department of the Ministry of the Interior. Saudi Arabian legal practitioners have indicated that, unfortunately, the Civil Rights Department is often somewhat less than diligent in enforcing judgments.

with the *Shari'ah* and other Saudi Arabian law. In the context of considering the position of the Board of Grievances, it should be noted that the Board of Grievances generally does not recognize provisions of agreements with respect to choice of foreign law or submission to the jurisdiction of foreign courts. Actions before the Board of Grievances often take from two to ten years, although the author has been informed by Saudi Arabian legal practitioners that actions for enforcement of foreign judgments are likely to take approximately one year if the order or award, on its face, does not contravene the *Shari'ah* or Saudi Arabian law.

C. *Enforcement of Foreign Judgments and Awards; Arbitration*

As noted above, large industrial, infrastructure, real estate, and other projects are increasingly international in scope. Thus, they frequently involve the law of two or more countries. A critical set of legal and financial issues involve the enforcement of a foreign (e.g., American, English, or French) arbitral award or court judgment against the project company or its assets in the country in which the project is located (in this case, Saudi Arabia). The court with jurisdiction over applications seeking enforcement of foreign judgments is the Board of Grievances. There is an unresolved jurisdictional issue where the foreign judgment or arbitral award is obtained by a bank because of the jurisdiction of the SAMA Committee over disputes involving banks. The author is aware of only one case where a foreign bank has sought to enforce in Saudi Arabia a decision of a foreign court or arbitral body.[19]

There is little precedent for the recognition and enforcement of foreign judgments by the Saudi Arabian courts.[20] In-

19. It is likely that, on the basis of Council of Ministers Resolution No. 729/8 (which establishes the jurisdiction of the Board of Grievances to enforce foreign awards) and the animosity with which many Board of Grievances judges view non-Islamic banks, the Board of Grievances will refuse to exercise jurisdiction over the enforcement application submitted by a non-Islamic commercial bank. On the other hand, the Board of Grievances might decide that it is inappropriate for a decision of a foreign arbitral body or court to be referred to a non-judicial body (such as the SAMA Committee) for enforcement, particularly where jurisdiction over enforcement actions is specifically given to the Board of Grievances.

20. *See* A. Kritzalis, *Saudi Arabia, in* INTERNATIONAL EXECUTION AGAINST JUDGMENT DEBTORS (D. Campbell ed., 1993) (providing a comprehensive analysis of issues arising in respect of enforcement actions).

deed, other than a small number of 1989 cases involving judgments of courts in member states of the Arab League, the author is aware of no instance where the Board of Grievances has afforded final recognition to, and enforced, a judgment of a foreign court or a foreign arbitral award. The author has been informed of a single recent case in which a bank sought enforcement of a foreign judgment or award.[21] In that case, the Board of Grievances reportedly declined to exercise jurisdiction because of the involvement of a bank. Presumably, enforcement would be sought from the SAMA Committee in such an instance.[22]

Nevertheless, Saudi Arabian law does give the Board of Grievances the power to issue a judgment recognizing a foreign judgment for enforcement in Saudi Arabia if the state of origin would afford reciprocal recognition to the judgments of the Saudi Arabian courts and provided that nothing in the foreign judgment contravenes the *Shari'ah*.[23] In the only recent cases of which the author is aware that sought enforcement of decisions of the courts of England, the Board of Grievances declined to enforce the judgments because no showing had been made that the English courts would afford reciprocal treatment to a Saudi Arabian court decision.[24] As noted above, the Board of Grievances is said to have recently declined to exercise jurisdiction in

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21. The author is unaware of whether this is a foreign court judgment or a foreign arbitral award.

22. The author has been unable to determine at this time whether the party seeking enforcement of the foreign award has sought enforcement by the SAMA Committee in the referenced case.

23. Rules of Civil Procedure Before the Board of Grievances, Council of Ministers Resolution No. 190 dated 16/11/1409 A.H. (June 20, 1989), Article 6. Additional requirements for the enforcement of foreign judicial awards are set forth in Circular Number 7 of the President of the Board of Grievances, 15/8/1409 A.H. (May 5, 1985).

24. In these companion cases, the Board of Grievances initially issued a decision recognizing the three English High Court decisions. On appeal, however, the Board of Grievances found that there was no treaty between Saudi Arabia and the United Kingdom allowing for the reciprocal enforcement of judgments and that, on the evidence submitted, no law of the United Kingdom would provide for automatic recognition of a Saudi Arabian judgment. Rather, the Board of Grievances concluded that a judgment creditor seeking to enforce a Saudi Arabian court judgment in England would have to commence a common law action against the English judgment debtor in the English High Court to recover the debt evidenced by the Saudi Arabian judgment. In such new action, the English High Court could accept the Saudi Arabian judgment as proof of the debt. The Board of Grievances, therefore, held that the enforcement of the three High Court judgments should be denied.

the case of a foreign court judgment or arbitral award obtained by a bank.

In 1994, Saudi Arabia filed an instrument of accession to the New York Convention on the Recognition and Enforcement of Arbitral Awards of 1958 ("New York Convention"). The authorizing decree incorporates the requisite reciprocity requirement and specifies that jurisdiction over actions seeking enforcement of foreign arbitral awards shall lie with the Board of Grievances.[25]

To date, the Board of Grievances has not issued procedural rules for actions seeking enforcement of international arbitration awards. The author understands from Saudi Arabian legal practitioners who have consulted Board of Grievances officials that no such rules will be issued in the near future. This being the case, it appears that an application for the recognition of a foreign arbitral award would be submitted and would proceed in accordance with the procedures specified for applications in respect of the recognition of foreign judicial awards.

The author also understands that only one application seeking recognition of a foreign arbitral award under the New York Convention has been filed to date. In that case, the Board of Grievances declined to exercise jurisdiction because a bank obtained the foreign court judgment or award. Presumably, the bank must then make application to the SAMA Committee for enforcement of the judgment or award. Since any such application to the Board of Grievances would be quite rare at this point in time, it would be reasonable to anticipate that the Board of Grievances would consider such an application, as well as any objections filed with respect to the application, carefully and deliberately. *De novo* Board of Grievances proceedings normally last from two to ten years, with the long duration being in large

25. The structure for the Saudi Chevron transaction was designed to allow the banks, through the Onshore Security Agent, to attempt to enforce the foreign award through the SAMA Committee, rather than through the Board of Grievances. The structure of the Utility power project transaction was similarly structured. In each case, this should result in (i) substantially quicker resolution and enforcement and (ii) avoidance of a *de novo* review of the underlying documentation by the Board of Grievances in the enforcement action.

The respective jurisdictional ambits of the SAMA Committee and the Board of Grievances in this situation are unclear and, to the author's knowledge, except as noted in the text, no actions have been brought by a bank in either forum for enforcement of a foreign arbitral or judicial award to date.

part due to *Shari'ah* rules of procedure that allow a defendant considerable ability to delay the final resolution of the proceeding. The author understands from Saudi Arabian legal practitioners that a proceeding before the Board of Grievances to enforce an arbitral award, which on its face does not contravene the *Shari'ah* or other Saudi Arabian law, should take approximately one year.

However, officials of the Board of Grievances have also indicated that they will review arbitral awards brought for enforcement under the New York Convention to ensure compliance with the *Shari'ah* on public policy grounds. Although it is clear that decisions that are contrary to the *Shari'ah* will not be enforced on public policy grounds, it is unclear how broadly the Board of Grievances will review an award or the legal basis for the issuance of the award to ensure compliance with the *Shari'ah*. For example, it is possible that the Board of Grievances would decline to recognize an award if it is based upon underlying contractual commitments that would not be enforceable under the *Shari'ah*, such as where the underlying contractual commitment is prohibited, or *muharam*, under Islamic jurisprudence. Similarly, it is also possible that the Board of Grievances would decline to recognize an award of damages where the damages are of a type that would not be available under the *Shari'ah*[26] or where an element of an award would not be available under the *Shari'ah*. For example, generally speaking, in judicial proceedings in Saudi Arabia, the courts will only award actual, proven, out-of-pocket damages. Damages that are deemed by Saudi Arabian jurists to be speculative in nature, such as lost profits, are generally not available under the *Shari'ah* as interpreted in Saudi Arabia. Recognition of an award containing an element deemed to be speculative may therefore be declined.

From conversations with Saudi Arabian jurists, it is the author's understanding that the wording of the judgment or award may be critical. Many jurists believe that the Board of Grievances will not look beyond the face of the award, particularly in

26. Perhaps the clearest example of an element of an award that would be contrary to the *Shari'ah* would be where it contains an element of interest. Interest is considered to be a form of unearned gain, or *riba*, which is prohibited under the *Shari'ah* as construed in Saudi Arabia. The Board of Grievances will decline to enforce that part of any foreign award that constitutes an award of interest or amounts in the nature of interest. No pre-judgment interest on damages suffered is therefore recoverable.

the case of an arbitral award. If the award, on its face, does not contravene the *Shari'ah* or other Saudi Arabian law, it is felt that the Board of Grievances will not look beyond the award to substantive documentary provisions, although it will examine jurisdictional matters.

The fact that a foreign judicial decision contains an element that violates the *Shari'ah* may not necessarily be fatal to the enforcement of the decision, however. For example, the party seeking recognition of the decision in Saudi Arabia could, as a part of its recognition application, expressly disclaim any right to recovery based upon the contravening element. For example, the party could disclaim any right to recover the interest component of the award. Furthermore, in the event that the recognition of an English arbitral award or judicial decision in Saudi Arabia is the only means by which the financing banks could obtain satisfaction with respect to claims under the applicable loan or other financing agreement, it might be possible to fashion the claims, and thus hopefully the decision, in such a way as to maximize the probability of the decision being recognized by the Board of Grievances.

V. *COLLATERAL SECURITY: THE SAUDI CHEVRON RAHN-ADL STRUCTURE*

A. *Participants and General Structure*

The Saudi Chevron petrochemical project is a benzene and cyclohexane project located in Madinat Al-Jubail Al-Sinaiyah, The Kingdom of Saudi Arabia. The project company, which owns and operates the project, is Saudi Chevron Petrochemical Company, a Saudi Arabian limited liability company ("SC Project Company"). Equity in the SC Project Company is held by a Chevron Corporation affiliate ("Chevron") and Saudi Industrial Venture Capital Group ("SIVCG"). Loans for the project were made to the SC Project Company by a syndicated group of international, regional, and local banks ("SC Banks") led by Chase Investment Bank Limited, Gulf International Bank B.S.C., The Industrial Bank of Japan, Limited, United Saudi Bank, and The Saudi Investment Bank, as Arrangers. Additional loans, not governed by the agreements discussed in this Essay, were made to the SC Project Company by Saudi Industrial Development Fund

("SIDF").[27]

In summary, construction and long-term multi-tranche loans are made by the SC Banks to the SC Project Company pursuant to a Facilities Agreement ("SC Facilities Agreement") and certain related documents and are evidenced by promissory notes ("SC Notes") (collectively, " SC Financing Agreements"). Such loans are secured by essentially all the cash flows from the operation of the project, all the assets comprising the project,[28] and all assets owned or held by the SC Project Company pursuant to a mortgage (*rahn*) ("SC Mortgage (*Rahn*)") and numerous pledge (*rahn*) and assignment agreements ("SC Pledge (*Rahn*) Agreements") (collectively, "SC Security Documents"). The primary categories of assets of the SC Project Company include various contracts (including feedstock and other input and off-take agreements), the site lease for the land on which the project is built, other real property rights and interests, approvals and licenses, and intellectual property rights (including technology rights and licenses) (collectively, "SC Project Documents"), cash, bank accounts, accounts receivable, immovables, the assets comprising the project itself, computers, office equipment, and other personal property (collectively, with the SC Project Documents, "SC Collateral").

In addition, certain loans are made to the SC Project Company by SIDF pursuant to a loan agreement ("SIDF Loan Agreement"), and those documents are secured by a mortgage and pledge of certain assets of the SC Project Company pursuant to the "SIDF Mortgage and Pledge."[29]

Two entities act as *adlan* for the transaction, one for assets of the SC Project Company that are located outside Saudi Arabia ("Offshore Security Agent") and one for the assets of the SC Project Company that are located within Saudi Arabia ("Onshore

27. The Saudi Chevron project was the first limited recourse project financing in Saudi Arabia and involved conventional interest-bearing loans rather than an Islamic financing structure such as those discussed in this Essay. Therefore, the references to "debt" and the debt portion of financing are retained in this Essay.

28. As is customary in project financings, the SC Project Company is a single-purpose entity and has few assets other than such cash flows and the assets comprising the project itself.

29. Difficult issues arose in connection with the inter-creditor arrangements between the SC Banks and SIDF. These issues were successfully resolved, in some cases with unique arrangements and provisions. Those issues and the means of resolution are not discussed in this Essay.

Security Agent"). Collectively, the Offshore Security Agent and the Onshore Security Agent are referred to as the "Security Agents." The offshore assets of the SC Project Company are principally cash receipts from offshore sales of benzene and cyclohexane. The onshore assets are principally the project itself and related rights, titles, and interests.

B. *Institutional Requirements*

Financing for the project is provided by a group of international, regional, and local SC Banks. In accordance with their credit policies, the SC Banks have particular expectations as to the type of collateral and the nature of the collateral security interests that secure the loans. The international SC Banks, and some of the regional SC Banks, are intimately familiar with a variety of collateral security systems in different countries. They are accustomed to advanced statutory collateral security systems in which there are precise, but easily understood and implemented, systems for recordation of mortgages, pledges, and other security interests. Many of those SC Banks have precise requirements as to the nature of the security interest that is permissible in a lending transaction, particularly a project financing, involving that SC Bank—perfection of the security interest must be obtainable and the priority of the security interest must rank ahead of all competing creditors—i.e., a first prior perfected security interest; the security interest must cover all the assets comprising the project and those of the SC Project Company. Obviously the requirements are more stringent in a project financing because the SC Banks do not have recourse to the sponsors or any other parties or assets.

Some Middle Eastern regional SC Banks and most local Saudi Arabian SC Banks have a somewhat different view of collateral security, particularly in light of the absence of a recordation system for mortgages, pledges, and security interests in Saudi Arabia and due to the absence of a Saudi Arabian statute pertaining to collateral security. While attempts have been made over the years to achieve recordation and some type of perfection of a security interest in Saudi Arabia, most have been unsuccessful, for both legal and political reasons. For example, as discussed below, "possession" of an asset is necessary for perfection of a security interest under the *Shari'ah* (unlike American and

English systems in which recordation of the nature and extent of the security interest is the touchstone for perfection, without regard to any concept of actual physical possession). Actual possession is a difficult concept to achieve for many types of assets (consider intellectual property rights) and for an operating plant. Thus, local Saudi Arabian banks have focused more on lending transactions involving recourse to a third party, such as a guarantee by a parent company or individual shareholders in the project company or its parent. To each of the SC Banks, maximization of an effective collateral security interest was, and is, essential.

Chevron and SIVCG, like most project equity participants, desired a true limited recourse financing, with recourse limited to the SC Project Company and its cash flows and other assets. Neither wanted to put the credit of its affiliates or shareholders behind the financing obligations. Thus, both equity participants desired to provide to the SC Banks a strong collateral security package—a project financing will not be undertaken by the lenders without an adequate collateral security package.

A sound security structure decreases transactional risks, with a resultant decrease in financing costs for project financing in the relevant jurisdiction. Such a cost decrease is desirable to all project sponsors and developers because of the direct effect on profitability. It is also desirable to the financing SC Banks because of enhanced project economics and increased ability of the SC Project Company to repay financing obligations.

C. *Development of the Collateral Security Structure*

1. General Approach

The challenge that was presented to the lawyers by both the SC Banks and the SC Project Company was to develop a collateral security structure that met the project financing and related credit requirements of all the SC Banks and was satisfactory to the SC Project Company. A structure had to be developed that met the traditional requirements of New York and English financings but was consistent with the *Shari'ah*. In developing such structures in other jurisdictions, lawyers and financiers begin with the New York or English (i.e., Western) model as the base structure. They then attempt to implement that model within the framework of the host country's laws by adding to the

model a variety of procedures and structures from the host country's practice. Those host country practices often have to be modified to fit the pre-existing Western model. This often has the effect of jeopardizing the effectiveness of the host country procedure or structure, which, in turn, weakens the entire collateral security structure.

The approach taken for the Saudi Chevron financing was the opposite: The determination was made to build the base model structure from the point of view of the host legal system, the *Shari'ah*. Thereafter, additions and modifications were made to incorporate procedures and structures from the Western model more familiar to the international SC Banks.

The adoption of this approach was the direct result of discussions with the various *Shari'ah* advisors, Saudi Arabian lawyers, and, in particular, Saudi Arabian jurists. Through those discussions, it became apparent that, the Western conception that there was greater certainty in using Western collateral security structures, was incorrect where legal interpretation might be had in Saudi Arabia. For example, Saudi Arabian jurists are accustomed to thinking in terms of *Shari'ah* precepts and to operating within the *Shari'ah* system. Our discussions revealed that they did not consistently interpret Western legal language and structures. Greater consistency and predictability was obtained in their interpretations of *Shari'ah* precepts. In addition, it was thought to be a much more advisable course because there is greater flexibility in the New York and English legal systems as regards to collateral security and there is greater certainty as to the implementation of certain relevant legal structures (particularly Western elements of the structure) in those offshore jurisdictions. This makes it easier to mold the Western concepts to the Islamic model than vice versa. In addition, and in light of the necessity of asset possession under Islamic law but not New York or English law, we anticipated that we would be able to move certain assets (such as cash from offshore product sales) to an offshore jurisdiction, using those assets as "first-line" collateral, and then feed cash back into the onshore jurisdiction for use in conjunction with the assets comprising the "second-line" or "ultimate" collateral.

When a project experiences difficulties, calls on collateral are often sequential and predictable. Lenders rarely foreclose on all the collateral, although they almost always have the right

to do so. Rather, they attempt to minimize their intrusion into the operations of the borrower and they proceed against the assets in a definable sequence (beginning, in most cases, with cash and other liquid assets). To give effect to those realities, the SC Financing Agreements and SC Security Documents were structured to allocate cash to problem areas without resorting to the more drastic step of calling upon other assets. The security interest in the cash is held, in the first instance, in an offshore jurisdiction with which the international SC Banks are familiar and which meets the credit requirements of those international SC Banks. This satisfies the SC Banks' standards for first-line calls on collateral and the nature and extent of the security interest itself. In the Saudi Chevron transaction, England was chosen as such a jurisdiction (New York would have worked equally as well).

The remaining task was to demonstrate to the SC Banks that a satisfactory security interest could be obtained under the *Shari'ah* in Saudi Arabia. As anticipated, it was not an easy task to convince the SC Banks that such a security interest was satisfactory under their Western-focused credit policies. There was a perception that an adequate security interest is difficult to obtain under the *Shari'ah*, and even more difficult to obtain in Saudi Arabia and that the nature of the security interest is uncertain. The perception was strongest among those unfamiliar with the *Shari'ah* (which was most of the people involved in the transaction). Few completed project financings have joined Islamic and American/European security concepts and it was our challenge to effect that joinder.

2. Scientific Method

The Saudi Chevron collateral security structure was developed from first principles under relevant *Shari'ah* precepts, particularly under the *Hanbali* School of Islamic jurisprudence predominant in Saudi Arabia. Our first task was to achieve both a comprehensive understanding of the relevant *Shari'ah* principles and a precise understanding of how those principles compared, point-by-point, with similar Western concepts. We enlisted a group of legal scholars and *Shari'ah* advisors to supplement the team of lawyers. We provided the scholars, advisors, and lawyers with a detailed description of how a transaction would be structured under a Western model, including descriptions of the im-

portance and legal effect of each structural element. They, in turn, provided a similar description of how a transaction would be structured under the *Shari'ah*, with similar explanatory materials. There was considerable back and forth in arriving at a comparative outline of the two different structures and in achieving a basic understanding of that model.

We then began to probe the legal principles pertaining to each element of the structure in the context of a construction and long-term financing for an operating plant. We began with a series of general questions: How do you get a security interest under the *Shari'ah* with respect to a given type of collateral? What is the nature of the security interest? What degree of certainty can we have with respect to any given security interest? What is necessary to retain that security interest? How is the security interest enforced? What are the respective rights and responsibilities of each of the involved parties? Why was a given element present? Why was it structured as suggested? What if the facts changed in this way or that way? What is the Islamic equivalent of a given Western element, if any, and vice versa? Would a different procedure or technique under the *Shari'ah* better serve the requirements of the project participants? As we moved from the general to the specific, the list of questions ran into the thousands and the process was repeated a number of times as the answers, and the model, were refined.

As an example, we examined each category of assets (*marhoun*) comprising a project or held by a project company and relevant *Shari'ah* precepts for granting a *rahn* (mortgage and pledge) or assignment with respect to each such category. Categories included real estate interests (site leases and easements), immovable property (the plant), movable property (computers and equipment), cash (from sales, investments, and insurance), bank accounts, contracts, accounts receivable, intellectual property, technology licenses, and permits. Certain types of property fall into multiple categories and were appropriately analyzed.

As the model developed, we expanded our participant list from transactional lawyers, legal scholars, and *Shari'ah* consultants to include judges from the Board of Grievances of The Kingdom of Saudi Arabia. We wanted to achieve an understanding of how *Shari'ah* precepts pertaining to each element of the structure (and the developing documentation) might be applied

in specific factual situations. And, as noted above, our discussions were leading us to the conclusion that greater certainty and predictability would be achieved if our structure was *Shari'ah*-based.

Given the complexities of a project financing of a large industrial project, we began with a much simpler analogy. We posited a simple loan from one person to another that was secured by a *rahn* (mortgage or pledge) of a camel. Our questions were retailored to this analogy. Can a *rahn* be granted with respect to the camel? What are the necessary elements of a valid and enforceable *rahn*? Who is responsible for feeding the camel? Who is responsible for caring for the camel? Who is responsible for the security of the camel? Can the camel be milked? Can the milk be sold? Who is entitled to the cash received from the sale of the milk and how should that cash be applied? What are the respective rights and obligations with respect to care of the camel during the period of the *rahn*? What are the rights and responsibilities of the parties if the camel becomes ill? Can a subsequent loan be made that is also secured by the camel? Will that security interest come into effect automatically or will other steps have to be taken to ensure the effectiveness of the new security interest? What if the camel delivers a calf? Does the creditor automatically obtain a *rahn* over the calf? How and when can the *rahn* be enforced?

We then repeated the process on a comparative basis for a loan secured by land and equipment. As the understanding of the precepts and their application developed, we expanded the inquiry to include other types of *marhoun* (collateral).

This list of detailed questions became lengthy, and the conversations even more intricate. The discussions were penetrating, fascinating, and enlightening for all persons involved. Despite the intellectual rigor of the undertaking, humor permeated the entire process. As the model got refined in accordance with *Shari'ah* precepts, we achieved a more precise understanding of the type of structural bridges that would have to be constructed to the relevant Western concepts so as to maintain familiarity to the international SC Banks and to ensure the effectiveness of the entire collateral security structure.

As discussed below, the primary bridge between the *Shari'ah* structure and the Western concepts familiar to the international

SC Banks was the incorporation into the collateral security structure of an *adl.* American and European financings usually involve a trustee that holds collateral on behalf of lenders. The *Shari'ah* does not provide for trustees, at least in a Western sense. However, the *Shari'ah* has long experience with a similar concept, the *adl.* In brief, an *adl* is a trusted and honorable person selected by both the lender and the borrower, a type of "trustee-arbitrator" having certain fiduciary responsibilities to both parties. In addition to providing the necessary structural bridge, incorporation of the *adl* into the structure also solved or minimized numerous difficult issues under Saudi Arabian law, some of which are discussed in the Section V(D).

D. *Exemplary Major Issues and Resolutions*

The structure that was developed for the Saudi Chevron project involved the grant of a *rahn* with respect to the *marhoun* to two *adlan.* A *rahn* is a type of mortgage (with respect to real property) and pledge (with respect to personal property) of property (*marhoun*) that meets certain requirements. The *adlan* are the Onshore Security Agent and the Offshore Security Agent.[30]

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30. The development of the collateral security structure, and the *sharikat mahassa-murabaha* and *istisna'a-ijara* structures, entailed study of many written sources and discussions with *Shari'ah* advisors, Islamic bankers, Saudi Arabian judges, and lawyers practicing in Saudi Arabia, Bahrain, Pakistan, and the United States. Many of the *Shari'ah* principles described in this Essay are based on oral discussions with such persons and with the *Shari'ah* Supervisory Boards of Islamic institutions who have been involved in the transactions described in this Essay and other *Shari'ah*-compliant transactions. Many of the written sources are available only in the Arabic language. The most widely available summary of *Shari'ah* precepts in the English language is the *Majalat Al-Ahkam Al-Adliyah,* a summary of certain principles of the *Shari'ah* as applied by the *Hanafi* School of Islamic jurisprudence in the former Ottoman Empire and countries that were formerly part thereof; it was officially adopted in the Ottoman Empire. The *Majalat Al-Ahkam Al-Shar'iyah* is a summary of certain principles of the *Shari'ah* as applied by the *Hanbali* School of Islamic jurisprudence in The Kingdom of Saudi Arabia. It has not been officially adopted in Saudi Arabia. It is not as detailed as the *Majalat Al-Ahkam Al-Adliyah.* English language translations of relevant portions of the *Majalat Al-Ahkam Al-Shar'iyah* were prepared for the author expressly for the development of the collateral security structure for the Saudi Chevron transaction.

Throughout this Essay, footnote references are made to the translation of the *Majalat Al-Ahkam Al-Adliyah* made by JUDGE C. A. HOOPER, THE CIVIL LAW OF PALESTINE AND TRANS-JORDAN, VOLUME I & II (1933), *reprinted in* 4 ARAB L. Q. (Aug. 1986). Footnote references to the *Majalat Al-Ahkam Al-Shar'iyah* are to a translation made for the author by M.Z. Samhouri and Hassan M.S. Mahassni, each of the Law Office of Hassan Mahassni in association with White & Case LLP, and to translations of portions of the

Implementing the structure involved addressing a variety of legal and financial issues, some of which are noted in this Essay. This Essay first discusses certain Saudi Arabian legal principles bearing on the location of assets. Consideration is then given to the issue of "certainty" of a grant of a *rahn* (and with respect to the taking of various actions by the holder of the security interest). Resolution of these issues led to incorporation of the *adl* into the collateral security structure. Thereafter, the Essay outlines various factors pertaining to the nature of a *rahn* with respect to different categories of collateral.

1. Location of Assets; Governing Law

One of the initial structural determinations was to use both an offshore and an onshore security agent. A security interest in the cash proceeds from the sale of benzene and cyclohexane produced by the project first would be deposited in an English bank account, held with the Offshore Security Agent pursuant to English law, and a security interest would be taken in that bank account. As, and when, needed, cash would then be transferred to an onshore bank account held by the Onshore Security Agent pursuant to Saudi Arabian law. Similarly, in light of Saudi Ara-

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Majalat Al-Ahkam Al-Shar'iyah, and certain applicable *fatawa*, made by Hafedh Maamouri, currently Senior Consultant with Islamic Finance Consultants in Manama, Bahrain, and then Head of Islamic Banking for Saudi American Bank.

Cites to the *Majalat Al-Ahkam Al-Adliyah* are most often made without further reference to the *Majalat Al-Ahkam Al-Shar'iyah*. In many instances, no corresponding provision can be found in the *Majalat Al-Ahkam Al-Shar'iyah*. In some instances the cited principle is interpreted or applied differently, or with modifications, by Saudi Arabian jurists applying principles of the *Hanbali* School of Islamic jurisprudence. Many such differences or modifications were made known to the author orally in discussions and no specific reference is made in this Essay to the variations from the *Majalat Al-Ahkam Al-Adliyah*. Although not all such differences are discussed in this Essay, the various documents for the financings of the Saudi Chevron Project (in particular), the Utility Power Project, the Maconda Park Project and the Truman Park Project included adaptations to give effect to those differences.

Each of the *Majalat Al-Ahkam Al-Shar'iyah* and the *Majalat Al-Ahkam Al-Adliyah* use a single Arabic word (*al-rahn*) for security interests in both real and personal property, without distinction, and the author follows that convention in this Essay. However, in certain instances, the author has chosen to use an English language term. In partial conformity with the *Majalat Al-Ahkam Al-Shar'iyah* and the *Majalat Al-Ahkam Al-Adliyah*, only the English terms "mortgage" and "pledge" are used. The term "mortgage" refers to security interests in real property and other immovable property (essentially "fixtures" under New York and English law), while the term "pledge" refers to all security interests in personal property, including contract rights, cash, accounts, movable assets, permits, and intellectual property.

bian and *Shari'ah* possession concepts, certain other assets (such as executed original copies of certain contracts and negotiable instruments) were also located in England with the Offshore Security Agent, with a security interest obtained in those assets pursuant to English law.

Concurrently, decisions were made as to what law should govern the various documents in the transaction. It was determined that, to the extent possible and practicable, English law would govern the SC Facilities Agreement and certain other SC Financing Agreements and those collateral security agreements that pertained to assets located in England (most notably, the cash receipts account). The remaining documents would be governed by Saudi Arabian law. As a result, two separate sets of documents were constructed, each harmonious with the other. This structure resulted in careful drafting of procedures for contemporaneous operation under each set of documents and cooperation between the two *adlan* (security agents), particularly as regards cash movements and any possible exercise of remedies.

2. Certainty: Powers of Attorney; Agency; The *Adl*

Characterization of a given grant of rights (such as in respect of collateral) is somewhat uncertain under Saudi Arabian law. For example, various security arrangements may be characterized as "powers of attorney" given by the SC Project Company to the SC Banks, with the SC Banks (and the Security Agents) being characterized as mere "agents" of the SC Project Company.

Many, if not most, judges in Saudi Arabia take the position that such powers of attorney and most agency arrangements are revocable at will by either party under the *Shari'ah* and other Saudi Arabian law.[31] If so, the SC Project Company would be in

31. Under the *Shari'ah*, it is unlikely that a mortgage or pledge would constitute a nominate contract of assignment (*hawala*). The Islamic contract of *hawala*, which means literally to "turn over," contemplates a situation where a creditor, A, assigns to his own creditor, C, a debt which is owed to A by B. In order for this contract to be effective as a contract of *hawala*, the amount owed to A by B must equal exactly the amount owed by A to C. Furthermore, A must be indebted to C and B must be indebted to A at the time the contract of *hawala* is concluded. The contract of *hawala* may not relate to future indebtedness, a particularly thorny issue in an ongoing funding regime for a project financing.

It is unclear under the *Shari'ah* whether other rights ancillary to the right to receive

a position to revoke the power of attorney and the agency arrangement, and thus the security interest given to the SC Banks, at the will of the SC Project Company. To the extent that the Banks derive their rights indirectly, through a security agreement, rather than directly, as a party to a contract, the SC Project Company may therefore be able to terminate the rights of the Banks. However, even under construction of relevant *Shari'ah* precepts by jurists applying the *Hanbali* School of Islamic jurisprudence, the use of a *rahn-adl* structure confers a degree of irrevocability not otherwise found.

Further, there is an exception to the irrevocability rule under certain schools of Islamic jurisprudence. That exception makes grants of agency power, and powers of attorney, when coupled with an interest of third parties, irrevocable when a third party relies upon such irrevocability. There is some debate among jurists in the *Hanbali* School as to the extent to which such an exception exists in Saudi Arabia. In any event, jurists of the *Hanbali* School would likely give the narrowest reading to the exception to revocability.[32]

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payment, for example the right to accelerate payment upon the occurrence of a specified default or the right to claim under a tax indemnification provision, are in fact "turned over" to the assignee. With respect to ancillary rights, it can be argued that A may only grant to C the power to act as A's agent in enforcing them, again subject to the various conditions applicable to contracts of agency.

A contract of assignment that does not meet the narrow conditions of the nominate contract of *hawala* will, generally speaking, be considered to be a contract of *wakala*, or agency. In other words, in the present case, under the various SC Security Documents, the SC Project Company would be considered to have granted the Security Agents what is effectively a power of attorney empowering the Security Agents to exercise all or certain of the borrower's (i.e., the SC Project Company's) rights under the various SC Project Documents being assigned.

The characterization of a mortgage or pledge (*rahn*) as a contract of *wakala* has several implications. First, under the *Shari'ah* as applied in Saudi Arabia, contracts of agency are generally considered to be cancelable at will by either the principal or the agent. (An exception is noted in the text of this Essay.) Second, where a principal grants to an agent the power to exercise certain of the principal's rights, the principal retains the power to exercise such rights in its own name independently of the power in the agent and the actions of the principal would be superior to those of the agent (which would be unacceptable to the banks in any financing). Third, a Saudi Arabian court or other adjudicatory authority might construe the grant of the power of agency pursuant to a mortgage or pledge narrowly, finding that the Security Agent has only such powers as are expressly granted thereunder.

32. Notably, where a power of attorney or agency relationship is revoked contrary to the terms of the documents granting such power and one of the parties is thereby harmed, an appeal can be made to the Saudi Arabian courts for relief, as an equitable matter, to make the harmed person whole.

Notwithstanding the strict mandates of the law, however, there is a trend in Saudi Arabian legal practice toward recognition of irrevocability in certain situations. For example, the Saudi Arabian courts have recently indicated that an agency relationship or a power of attorney may not be revocable if there is a specified term for the existence of the agency relationship or the duration of the power of attorney. In addition, the SAMA Committee attempts to interpret contracts in accordance with the expressed agreement of the parties, even where there is a seeming conflict with the *Shari'ah*.[33]

In addition, under Saudi Arabian agency law, the principal (i.e., the SC Project Company) is always entitled to act whether or not the agent (i.e., the Security Agents and the SC Banks) is also entitled to act. The actions and directions of the principal will supersede those of the agent—a most undesirable outcome in a project financing.

Saudi Arabian law, however, acknowledges a type of mortgage/pledge arrangement, *al-rahn*, which is of particular relevance to this financing. *Al-rahn* is the making of a designated property into security for a debt that may be partially or totally recovered from such property or the price thereof.[34] In a *rahn*, the definite property that is made a security for a debt, *al-marhoun*, may be deposited with a type of trustee-arbitrator, a trusted person mutually agreed upon by the parties, *al-adl*.[35] This device is similar in some ways to a bailment arrangement under New York or English law. The practice in Saudi Arabia is that either or both of the *rahn* documents and the *marhoun* may be deposited with the *adl*.[36] The nature of the *rahn*, and the rights and powers of an *adl*, with respect to the exercise of con-

33. Interpretation issues are discussed in Section IV of this Essay. The SAMA Committee (officially, the Banking Disputes Settlement Committee of the Saudi Arabian Monetary Agency) is the enforcement entity in Saudi Arabia that is most likely to have jurisdiction in a dispute pertaining to a financing such a the Saudi Chevron project financing. However, as discussed in Section IV, it is not the only entity that may have jurisdiction.

34. *See, e.g., Majalat al-Ahkam Al-Shar'iyah, supra* note 30, arts. 940-44, 1008-1017, *Majalat Al-Ahkam Al-Adliyah, supra* note 30, arts. 701-61.

35. The *marhoun* may also be held by the mortgagee or pledgee, and the *adl* may be one of the mortgagees or pledgees.

36. The *rahn* structure has been useful in financings of residential property, for example.

tractual rights under third party contracts that are the subject of a pledge is not well developed.

However, it is established that the *marhoun* and/or the *rahn* documents may be placed with the *adl* and may not be removed from the *adl*'s possession without the agreement of both the mortgagor/pledgor and the mortgagee/pledgee,[37] and possession may not be returned to the mortgagor/pledgor without the consent of both such parties in interest. The *adl* may not sell the property given as security without the consent of both such parties in interest. That consent, however, may be provided in the *rahn* documents, which are executed at the commencement of the *rahn* transaction. Such consent will not be treated as a revocable power of attorney.[38] There are various other requirements that must be met in connection with a valid *rahn* with an *adl*.

The implications of the foregoing for the Saudi Chevron project financing were considerable. First, the structure included two *adlan*, one offshore and one onshore. Irrevocable grants were made to the *adlan*, and the SC Project Company, as mortgagor/pledgor, explicitly and irrevocably, authorized the *adlan* to do various things and take various actions from time to time on the occurrence of specific conditions (such as sales of the items of collateral upon the occurrence of an event of default and the exercise of other remedies in connection with an event of default). These authorizations were substantially more specific and detailed than would have been the case in a document governed by New York or English law where there is a substantial body of determinable interpretive precedent and the principle of *stare decisis* is applicable. The nuances of these doctrines under the *Shari'ah* were also addressed in detailed drafting.

The use of recitals to an agreement governed by New York or English law has diminished greatly in recent years. In some cases, the recitals continue to provide some evidence of the legal consideration for the agreements embodied therein. Although there is no equivalent body of law with respect to legal consideration under the *Shari'ah*, the use of detailed recitals is important

37. If the parties so agree, only the consent of the mortgagee/pledgee will be required.

38. There are various instances in which consents must or may be obtained in connection with the application of *Shari'ah* precepts relating to the *rahn*. In many of those instances, the consent may be obtained at the time of entering into the *rahn*.

for other reasons. This is particularly true in a financing such as the Saudi Chevron transaction. Thus, detailed recitals and substantive provisions of the agreements were constructed to make it clear that an agency relationship was not, and is not, contemplated, and that the rights afforded the Security Agents on behalf of the SC Banks are irrevocable and coupled with an interest. The nature of the interest and the reliance of the SC Banks and the Security Agents on the *rahn* and their irrevocability was addressed in detail.

To render even greater certainty to the structure, the SC Banks, directly in certain documents and through the Security Agents in other documents, became parties to agreements that they might have to enforce in the exercise of their rights under those agreements or under any of the SC Security Documents. This resulted in the SC Banks becoming direct parties to more documents than would have been the case in a transaction governed by New York or English law and the Security Agents becoming direct parties to certain other undertakings and guarantees that may otherwise have been unilaterally executed by the SC Project Company or other grantor. Such a structural modification allows the SC Banks directly to enforce the SC Security Documents should it be determined that they are unable to act through the Security Agents with respect to a given matter.

Another device that was used included having the Security Agents become "parties" to various underlying SC Project Documents. This was accomplished by virtue of having the parties to the SC Project Documents execute relatively standard "direct agreements" or "acknowledgments and consents" ("SC Consents"). In the usual case, these SC Consents contain an acknowledgment by the third party that the SC Project Company has granted a security interest in the referenced contract to which the SC Consent relates. They also contain a consent to the pledge of the referenced SC Project Document. In Saudi Arabia, however, the SC Consents contained an explicit acknowledgment by the SC Project Company and the third parties that the Security Agents have the irrevocable right to enforce the underlying SC Project Document upon certain events (such as an event of default under the SC Financing Agreements). Most of the other requirements for such direct enforcement are included in standard consents of this type. These arrangements were designed to effect an "amendment" to each of the underly-

ing SC Project Documents with respect to which a SC Consent was, or is, executed, making the Security Agents direct "parties" to those agreements, to a limited extent. This element of the structure helped alleviate certain of the revocability issues and other Saudi Arabian legal limitations pertaining to collateral assignments of contracts. The Security Agents will be able to enforce the various SC Project Documents in their own right upon the occurrence of events of default under the SC Financing Agreements, without having to proceed under the various collateral assignments.

Specific substantive issues arising under the *Shari'ah*, which would not be addressed in detail in a document governed by New York or English law, were also the subject of precise drafting. For example, the SC Security Documents expressly delineate the rights and powers of the *adlan* in a variety of situations, including a power and right of occupation, use, and operation of the *marhoun* upon the occurrence of an event of default and, as to the application of the proceeds of occupation, use and operation until satisfaction of the outstanding indebtedness.[39] The SC Security Documents specify that the parties intend that the grants of rights and powers to the Security Agents are coupled with an interest and irrevocable. The SC Security Documents also specify that the SC Banks in entering into the transaction have relied on such grants and irrevocability. Grants of powers and rights to the Security Agents are structured to be exclusive of powers and rights in the SC Project Company during the continuance of an event of default, with significantly more separation of rights than would otherwise be the case. The general language that is found in New York and English security agreements will likely be unavailing in Saudi Arabia, which interprets such grants literally based on express language.

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39. The rights of banks to use and operate property that is mortgaged or pledged as collateral, and to apply the proceeds derived from such use and operation to indebtedness secured thereby, is unclear under Saudi Arabian law. The practice in Saudi Arabia is for banks to sell the property granted as collateral rather than to operate such property and apply such proceeds. However, the *Shari'ah*, the *Majalat Al-Ahkam Al-Adliyah*, the *Majalat Al-Ahkam Al-Shar'iyah*, and the Saudi Arabian Banking Control Law do contemplate such use and operation and the application of such proceeds. For example, a camel provided as security must be fed and cared for, and may be milked. The milk may be sold and the proceeds of such sale may be applied to the reduction of the secured debt. This is similar to the fruit of trees on land with respect to which a *rahn* has been granted.

In light of recent Saudi Arabian court decisions, the duration of the grant of a security interest was expressly stated as a quantifiable measurement of time. This should provide for irrevocability in the event of recharacterization as a power of attorney. For example, the term was set as some period of years beyond the term of the debt (to allow for enforcement upon default), with an earlier termination if all obligations of the SC Project Company under the SC Financing Agreements and the SC Security Documents are paid and performed in full.

3. *Rahn* Principles in Saudi Arabia

The land on which the Saudi Chevron project has been constructed is owned by the Royal Commission for Jubail and Yanbu of The Kingdom of Saudi Arabia ("Royal Commission"). The land is leased to the SC Project Company pursuant to a type of land lease agreement ("SC Site Lease"). In the traditional structure, such leasehold interest of the SC Project Company would then be mortgaged to the Onshore Security Agent pursuant to a leasehold mortgage agreement to secure the obligations of the SC Project Company under the various SC Financing Agreements, in particular the SC Facilities Agreement and the SC Notes.

Under Saudi Arabian law, a mortgage of real property is treated, in most respects, identically with the treatment of a pledge of personal property.[40] Real property may be made the subject of a mortgage and used as collateral to secure indebtedness.[41] Personal property may also be made the subject of a

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40. Because the term "*rahn*" encompasses both mortgages and pledges, and because mortgages of real property and pledges of personal property are treated identically for most purposes under the *Shari'ah*, and a *rahn* encompasses both mortgages and pledges, the outline of legal principles in this section makes reference to principles applicable to both types of property, except where otherwise noted by use of the term "mortgage" or "pledge."

See generally FARHAT J. ZIADEH, PROPERTY LAW IN THE ARAB WORLD: REAL RIGHTS IN EGYPT, IRAQ, JORDAN, LEBANON, LIBYA, SYRIA, SAUDI ARABIA AND THE GULF STATES (1979) (discussing an interesting and informative, if dated, comparative analysis of property law in the Middle East and North Africa). Chapter VI addresses mortgages, pledges, and other security interests. *Id.* Due to the absence of a statutory framework, the chapter is not helpful in considering the applicable law in Saudi Arabia.

41. *See, e.g., Majalat Al-Ahkam Al-Adliyah, supra* note 30, arts. 711, 723, 724. SIDF takes a mortgage on leasehold interests. Similarly, in practice, other real property interests may be subjected to a mortgage.

pledge and used as collateral to secure indebtedness.[42] Increases in the value of the *marhoun*, additions to such property, and products from the operation of a project are automatically subject to the *rahn* under *Shari'ah* precepts as applied by some schools of Islamic jurisprudence. Under such precepts as applied by other schools, they may be made subject to the *rahn* by some definitive action or agreement. In each case, interpretations and applications of these precepts vary.[43]

The indebtedness may be totally or partially recovered from the *marhoun*,[44] and the entirety of the *marhoun* will remain subject to the *rahn* until payment in full of the indebtedness.[45] The *marhoun* must be something that can be validly sold. As such, it must (i) be in existence at the time of the execution of the contract of *rahn*, (ii) have a quantifiable value, and (iii) be saleable and deliverable.[46] Accordingly, a *rahn* of "after acquired" (including "subsequently constructed") property is invalid.[47] The "benefits" of a property may not be mortgaged or pledged separately from such property. Thus, rent generated by, or the sales proceeds of products produced by, a property may not be mortgaged or pledged without a corresponding *rahn* of such underlying property.[48] Uncertain sums may not be mortgaged or

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42. *See, e.g., id.* arts. 711, 714. As noted in this Essay, certain types of personal property rights may not be pledged, they must be assigned. Assignment agreements (often incorporated into the relevant SC Pledge (*Rahn*) Agreement) were used for granting rights in such property in the Saudi Chevron financing. In Saudi Arabia, intellectual property is subject to a special set of rules; such rules are not discussed in this Essay.

43. *See, e.g., id.* art. 711 (defining *rahn* of a piece of land as including all trees growing thereon and the fruits of such trees); *id.* art. 715 (discussing increases arising out of pledge or mortgage).

44. *See, e.g., id.* arts. 711, 712, 723, 724 (citing examples of pledges).

45. *See id.* art. 731.

46. *See id.* arts. 709, 710.

47. *Id.* art. 713. This precept, as applied in Saudi Arabia, is critical to many aspects of a project financing structure. In the usual case, the SC Financing Agreements would be executed before there is any real collateral (other than SC Project Documents). Thus, essentially all of the *marhoun* is "after-acquired" or "after-constructed." In the Saudi Chevron financing, various structural modifications were made to continually update the SC Collateral and include all SC Project Company assets therein. Some of those modifications are discussed in this Essay.

48. This element of Saudi Arabian law presented interesting issues at the time that SIDF entered the financing structure (which was some time after the SC Banks had undertaken their financing obligations). SIDF, for example, was interested in taking a mortgage in the property but in leaving the revenue from operations to the SC Banks as collateral security.

pledged.[49] An existing *rahn* may not be valid with respect to future advances or loans in the view of some Islamic jurists, particularly in Saudi Arabia.[50] Finally, assets that are "borrowed" for use by a borrower may not be mortgaged or pledged.[51]

Under the *Shari'ah*, the mortgagee/pledgee is responsible for all expenses incurred in connection with the preservation of the *rahn*, such as the erection of the fence around the property, the wages and fees of the Security Agents, the wages of the guard posted at the property, the cost of erection of the signs, and the like.[52] The mortgagor/pledgor is responsible for all expenses in connection with the improvement and maintenance of the *marhoun*, including repairs and operation and maintenance expenses.[53] Any agreement modifying these allocations is void. If either the mortgagor/pledgor or the mortgagee/pledgee should of their own accord pay the expenses that are rightly paid by the other party, such payment is in the nature of a gift and no subsequent claim may be made for such amounts.[54]

Under the *Shari'ah*, a *rahn* is, by definition, possessory. The *Qur'an* refers to the idea of mortgages as "mortgages with possession" (*fa rihanun maqboudha*). Thus, in order for the security interest purported to be created by a *rahn* agreement to be perfected (i.e., to be enforceable against third-party creditors), the mortgagee/pledgee must have "possession" of the *marhoun*. If the mortgagee/pledgee ceases to have "possession" of the *marhoun*, such mortgagee/pledgee will be treated as an ordinary creditor and would have the same rights as other creditors in the collection of their debts—i.e., a *pro rata* share in the proceeds of the sale of those properties of the debtor that have not been mortgaged or pledged.

In the absence of a clear practical definition of what constitutes "possession," most jurists in Saudi Arabia appear to have taken the position that what is required is actual physical possession by the mortgagee/pledgee of the *marhoun*. However, a

49. *See, e.g., Majalat Al-Ahkam Al-Adliyah, supra* note 30, art. 709.

50. *But see, id.* art. 714.

51. *But see, id.* arts. 726-28, 735, 736.

52. *Id.* art. 723.

53. *Id.* art. 724. In many instances, it is difficult to determine whether a specific arrangement or undertaking is one for "preservation" of the asset or for "operation and maintenance" of the asset in the normal course. Consider, for example, a fence around the property or the guard at the front and back gates of the property.

54. *Id.* art. 725.

principle of the *Shari'ah* is that "possession is in accordance with the nature of the property to be possessed" (*qulu shay'in yuqbadhu bi hasabihi*) and in many instances physical possession is an impossibility.

Perfection of a *rahn* on real property or a real property interest in Saudi Arabia would be normally effected by (a) the preparation of a *rahn* agreement (in the form of a deed) and (b) the recordation of such *rahn* agreement on the title deed evidencing ownership of the relevant real property or real property interest.

Recordation of the *rahn* agreement has been deemed in Saudi Arabia to be a type of "constructive possession" of the *marhoun*.[55] Since 1981, Saudi Arabian Public Notaries have refused to record mortgages of real property in the name of banks as mortgagees on the grounds that such mortgages secure an indebtedness that is most likely related to a transaction that is interest-based and therefore inconsistent with the *Shari'ah*.[56] Thus, recordation of the SC Mortgage (*Rahn*), as a substitute for, and determinative indictor of, possession by the mortgagee is not presently available in Saudi Arabia for commercial banks as mortgagees.[57] Recordation is available to a very limited and

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55. It is to be noted that "constructive possession" is a concept that is not incorporated in the *Shari'ah*. The term is used here solely as an analogy that is familiar to United States and English lawyers and financiers, and further discussion of the principle is provided in this Essay.

Recordation of real property in Saudi Arabia is effected by the Public Notaries according to the system of personal recording (in the name of the owners of the real property) since there is no separate record and number for each parcel of real property. In recording a *rahn* of real property, the Public Notaries inscribe the full text of the *rahn* agreement on the title deed for the particular property and deliver such deed to the mortgagee. Because of the present lack of recordation in Saudi Arabia, an owner of mortgaged real property (the debtor/mortgagor) is not precluded from obtaining a replacement deed (in lieu of the one claimed lost). Thus, such debtor/mortgagor is capable of disposing of such property, by sale or by other property-transferring dispositions, without the consent or knowledge of the mortgagee if the mortgagee is not in possession of such property. Even where there is recordation, Public Notaries require that an annotation be inscribed indicating that the mortgagee has possession of the mortgaged property, and are often very strict in this respect. It is not clear that Public Notaries would be amenable to undertaking not to issue replacement deeds for a particular parcel of land.

56. *See* Supreme Judiciary Council Decision No. 291, dated 25/10/1401 A.H. (Aug. 25, 1981).

57. There is some difference of opinion as to whether recordation of a mortgage is merely evidence of the existence of the mortgage or goes to the validity of the mortgage itself. The weight of authority in Saudi Arabia, particularly given the present practice in

identifiable group of lenders, including SIDF. Other indicators of "possession" include "bills of possession," fencing, signs, the presence of an employee or agent of the Onshore Security Agent exercising dominion and control, and similar factors.[58]

Provided that a mortgagee/pledgee has possession of the *marhoun*, such mortgagee/pledgee has priority under the *Shari'ah* over all other creditors of the debtor in the collection of the secured amounts owed to such mortgagee/pledgee from the value of the *marhoun*. The *marhoun* may not be separately mortgaged or pledged to another mortgagee/pledgee (unless such other mortgagee/pledgee is a partner of the original mortgagee/pledgee and the *marhoun* is mortgaged or pledged to them jointly) because, if such property is mortgaged or pledged to the second mortgagee/pledgee with the consent of the first mortgagee/pledgee, the first *rahn* becomes void.[59]

Neither the mortgagor/pledgor nor the mortgagee/

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which recordation is not available, is that recordation speaks only as evidence of the existence of the mortgage.

58. Local banks in Saudi Arabia have utilized a number of techniques to obtain recordation in the face of the unwillingness of Public Notaries to record. For example, banks have used nominee individuals or companies as mortgagees. More recently, Saudi Public Notaries have refused to record mortgages in favor of any individual or company other than government-owned lending agencies, on the grounds that such individuals or companies are likely to be acting only as nominees for local banks engaged in lending transactions inconsistent with the *Shari'ah*.

Prior to the absolute prohibition on recordation (other than for SIDF and similar entities), another alternative device to obtain adequate collateralization was the transfer of title to the mortgaged real property to a nominee individual (such as a bank officer) or company (such as a company formed by certain shareholders of the bank). The borrower would sell the real property to the nominee individual or company at a nominal price and transfer the title deed to such nominee. The bank would then provide contractually (usually through a "trusteeship" agreement), and through control over the relevant individual or company, that the property so held is held for the benefit of the bank and for the proceeds of any sale to be paid to the bank. Concurrently, the borrower would sign a letter granting the nominee-trustee the right to arrange the sale of the security on first demand.

This solution has not been wholly satisfactory to most local banks, as disputes have arisen upon the death of a nominee or disagreements have arisen among shareholders of the nominee company. There have been, however, several examples where banks have successfully used this mechanism to realize value on their real property collateral by arranging for the sale of such property.

59. *Majalat Al-Ahkam Al-Adliyah, supra* note 30, art. 744. This precept and its application gave rise to delicate structural and drafting issues where both the Banks and SIDF took security interests in the same property. In other transactions, SIDF has permitted second mortgages without regard to the extinguishment possibility. The author is aware of no actions in Saudi Arabia in which the cited principle has been tested.

pledgee may sell the collateral without the consent of the other.[60] If the secured debt becomes due and the debtor/mortgagor/pledgor does not satisfy the debt obligation, the mortgagee/pledgee will not obtain title to the *marhoun*.[61] Rather, a judicially-directed sale of the *marhoun*, initiated at the request of the mortgagee/pledgee, would take place.[62] The mortgagee/pledgee would have priority with respect to those sale proceeds in satisfaction of the secured amounts owed to such mortgagee/pledgee by the debtor/mortgagor/pledgor. In the event that the proceeds from the sale of the *marhoun* are less than the amount of the debt secured by the *rahn*, the mortgagee/pledgee has the right to share with other creditors in the value of the debtor's remaining property.

Prior to a judicially directed sale of the *marhoun*, it may be necessary for the banks to hold such property. The rights of the banks to occupy, use, and operate such property are unclear in Saudi Arabia due to lack of precedent. In current practice, banks avoid exercising their rights to occupy, use, and operate property in Saudi Arabia. Rather, banks are inclined to sell the *marhoun* and apply the proceeds of such sale to the indebtedness due the banks. However, the *Shari'ah*[63] and other elements of Saudi Arabian law[64] contemplate that banks may hold the property for some time prior to a sale, whereupon they will have responsibility for the safekeeping of the *marhoun* during such period, and that the banks may apply the proceeds from the *marhoun* to the reduction of their indebtedness. These principles, while existent in Saudi Arabia, are largely undeveloped.

Although there is no prescribed form of *rahn* in Saudi Arabia, there are, based on general principles of the *Shari'ah*, vari-

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60. *Id.* art 756.

61. Obtaining title would be an option available to the SC Banks in a New York or English financing. Frequently, however, banks are reluctant to take title to a project for reasons pertaining to such matters as lenders' liability issues or environmental law issues. The *istisna'a-ijara* structure discussed in this Essay may involve a bank affiliate taking title to improvements to real property for purposes of effecting a construction financing, as was the case in the Maconda Park and Truman Park transactions.

62. *See, e.g., Majalat Al-Ahkam Al-Adliyah, supra* note 30, arts. 756-61

63. *See also Majalat Al-Ahkam Al-Adliyah* and *Majalat Al-Ahkam Al-Shar'iyah.*

64. *See, e.g.*, Banking Control Law of Saudi Arabia, art. 10, para. 2 (permitting bank to have direct interest, as shareholder, partner, proprietor, or in another capacity, in commercial, industrial, agricultural, or other enterprise, only if such interest accrues to bank in settlement of debt from third party). The bank must liquidate such interest within two years or such longer period as may be determined by SAMA. *Id.*

ous requirements under Saudi Arabian law regarding specificity of the description of the *marhoun* and the indebtedness secured thereby. The *rahn* agreement must include an accurate designation and description of the *marhoun*. In the case of a *rahn* of real property, the location and description of the real property, as specified in the deed pertaining thereto, should be included. A *rahn* of real property may also specify that it covers fixed assets located on the land, such as buildings and immovables (fixtures).[65] The *rahn* will not be valid to the extent that it covers property that does not exist at the time of the execution of the *rahn* agreement. Despite the validity issue, the practice of SIDF in Saudi Arabia is to include "after acquired" and "after constructed" property within the scope of the *rahn*.

The *rahn* agreement must also identify the debt being secured thereby. There does appear to be agreement that a reference to the loan agreement pursuant to which the secured debt is incurred is necessary and that the exact amount of the debt is required to be specified in the agreement.[66] There should be separate detailed specifications of amounts constituting each element of indebtedness—i.e., principal, interest, and other amounts. In the event that the *rahn* agreements are reviewed for compliance with the *Shari'ah* and are determined to secure interest, the practice in Saudi Arabia is that such agreements would be unenforceable only as and to the extent that they secure interest. The remainder of the provisions would remain enforceable.

The *rahn* agreement should also include the terms under

65. Immovable property under the *Shari'ah* is defined as "any property that is stable and fixed so that it may not be moved or transported without damage." It includes land, buildings, and trees. Also regarded as immovable property is movable property placed, by its owner, on immovable property also owned by such owner for the purpose of serving or exploiting such immovable property. Examples include doors and windows in a building that, even though they are originally movable property, become part of the immovable property in actual use. This is equivalent to the concept of fixtures. It is not clear, however, how fixtures would be treated in the context of the Saudi Chevron Project since the SC Project Company would be erecting facilities on land leased, but not owned, by it.

66. Precision as to the amounts of interest or costs and expenses is very difficult, if not impossible in many instances. The SC Security Documents do contain requirements that the SC Security Documents be "amended" from time to time as such amounts become precisely determinable. These amendments are effected as part of the draw-down mechanism in certain instances so as not to become unduly burdensome as an administrative matter.

which it may be exercised and the remedies of the mortgagee/pledgee to occupy, use, and operate the *marhoun*; to sell such assets; and, in each case, to apply the proceeds thereof to pay off the debt secured. All other customary remedies should also be set forth in greater detail than would be the case where New York or English law is applicable.

It is important to note that Saudi Arabian law is somewhat less developed as it pertains to pledges of certain personal property, such as contract rights and permits, than it is with respect to immovables, land, and other tangible assets. For example, it is unclear whether and to what extent contract rights and permits are "saleable" under the *Shari'ah* as applied in Saudi Arabia, and thus whether they can be subject to a pledge. In addition, it is more likely that a pledge of contract rights or permits would be characterized as a power of attorney or agency relationship and thus terminable by either party at will.

A final issue under Saudi Arabian law relates to the ability of the banks to exercise remedies upon the occurrence of an event of default that is not a payment event of default. The weight of authority under Islamic jurisprudence, and in Saudi Arabia, appears to be that a party would be entitled to exercise remedies for non-payment defaults. It is less certain, however, that the banks would be entitled to accelerate the loans and exercise the full panoply of remedies in such a situation; a Saudi Arabian court or other adjudicatory authority, in applying equitable principles, may limit the available remedies.

4. *Rahn* Documentation in the Saudi Chevron Project

As noted above, in order to address the applicable *Shari'ah* precepts, the collateral security structure was developed by dividing the available collateral into different categories. The general categories of collateral and the related *rahn* and assignment agreement are set forth in the following table:

Each type of SC Collateral was independently analyzed with respect to all relevant factors, such as the nature of possession of that type of SC Collateral. In the recitals and in the relevant substantive provisions, each SC Security Document addresses each necessary element of a permissible *rahn* with respect to each category of SC Collateral. Those elements include marketability, value, and deliverability. A Bill of Possession was drafted

TYPE OF COLLATERAL	AGREEMENT
General	Onshore Master Security Agreement
General	Onshore Common Agreement
General	Deed of Possession
General	Security Trust Deed
General	Offshore Security Deed
General	Announcement and Notification
General	Sign Language
Immovables, Real Property Interests, and Related Contracts	Onshore Mortgage (*Rahn*) Agreement
Accounts	Onshore Pledge (*Rahn*) and Assignment of Accounts
Accounts	Offshore Accounts Assignment
Accounts	Offshore Accounts Trust Deed
Contracts	Consents
Contracts	Onshore Pledge (*Rahn*) and Assignment of Contracts
Proceeds, Available Receipts, and Accounts Receivable	Onshore Pledge (*Rahn*) and Assignment of Proceeds, Available Receipts, and Accounts Receivable
Intellectual Property	Onshore Pledge (*Rahn*) and Assignment of Intellectual Property
Approvals and Permits	Onshore Pledge (*Rahn*) and Assignment of Approvals
General Personal Property	Onshore Pledge (*Rahn*) and Assignment of Personal Property
Equipment	Onshore Pledge (*Rahn*) and Assignment of Equipment
General Intangibles, Chattel Paper, Documents, and Instruments	Onshore Pledge (*Rahn*) and Assignment of General Intangibles, Chattel Paper, Documents, and Instruments
Technology Licenses	Onshore Pledge (*Rahn*) and Assignment of Technology Licenses
Technology Licenses	Offshore Assignment of Technology Rights
Letters of Credit and Performance Bonds	Onshore Pledge (*Rahn*) and Assignment of Letters of Credit and Performance Bonds
Letters of Credit and Performance Bonds	Offshore Assignment of Letters of Credit and Performance Bonds

to address possession issues with respect of each type of SC Collateral.

The Onshore Master Security Agreement and the Onshore Common Agreement were designed to unify all the SC Collateral and all rights and remedies in respect of each type of SC Collateral. This allows the Security Agents, among other things, to proceed against the entire SC Collateral package, if necessary, and to coordinate rights and actions in respect of each type of SC Collateral with all other rights and actions in respect of all other types of SC Collateral. In addition, separate SC Security Documents were drafted with respect to each individual type of SC Collateral.[67] Among other things, this allows the Security Agents to proceed on a more limited basis where such an approach is appropriate. The Security Agents could then proceed in respect of only a portion of the SC Collateral and minimize interference with the ongoing operation of the project. Such differentiation also allows the Security Agents greater flexibility in choosing an enforcement entity in any given situation. Each of the SC Security Documents incorporated elements intended to insure that the relevant grants were irrevocable. The structure was designed so that the SC Collateral could be placed in the possession (for *Shari'ah* purposes) of the Security Agents.

Each of the SC Security Documents incorporated traditional representations, warranties, covenants, and events of default for a limited recourse project financing. These were then tailored specifically to incorporate *Shari'ah* requirements. Particular attention was paid to keeping the SC Collateral free of competing liens and maintaining the liens of the SC Security Documents, including those for after-acquired or after-constructed property

67. Set-off rights in respect of bank accounts are one type of right applicable to only a given type of collateral. Two sets of set-off rights applied in the Saudi Chevron financing, one set under Saudi Arabian law and one set under English law. The SC Security Documents were tailored to give effect to the relevant rights in each jurisdiction.

Although there are no specific statutory provisions in Saudi Arabia relating to set-off of debts, the rights of banks in Saudi Arabia to effect a set-off are broad. A set-off is either compulsory by force of law, as in the case of state debts owed by individuals and debts of individuals owed by the state, or by mutual agreement (*hawala wa idhin bil isteefa*) that is irrevocable. The lender may not exercise the right of set-off unilaterally, absent prior irrevocable consent in an agreement (which consent may be given at the time of execution of the relevant SC Financing Agreement or SC Security Document). Absent such an agreement, before setting-off any amounts, the bank has to hold the funds and bring an action in court to allow it to exercise such right of set-off.

and those loans made after the date of execution of the SC Security Documents (i.e., subsequent advances under the SC Financing Agreements). Attention was also paid to placing possession of the SC Collateral with the Security Agents, minimizing costs payable by the Security Agents as *adlan* and bailees of the SC Banks. Furthermore, attention was paid to preventing the SC Project Company from incurring indebtedness other than pursuant to the SC Financing Agreements and the SIDF Loan Agreement, and "bankruptcy proofing" the SC Project Company.

The SC Mortgage (*Rahn*) was drafted in conventional form for recordation in Saudi Arabia, notwithstanding that it could not be notarized and recorded under current practice. Substantive modifications were made to the SC Mortgage (*Rahn*) and to each of the SC Pledge (*Rahn*) Agreements to incorporate and harmonize with other elements of the collateral security structure. The types of modifications that were considered for the SC Mortgage (*Rahn*) included (a) requirements that the SC Project Company (and the Royal Commission) make a notation on the SC Site Lease providing adequate notice of the mortgagee rights of the Onshore Security Agent, (b) recognition, in the SC Site Lease, of the fact that the site is mortgaged in connection with the financing, (c) obtaining the agreement of the Royal Commission to make a notation on its deed pertaining to the mortgaged property to the effect that such property is subject to the SC Mortgage (*Rahn*) in favor of the Onshore Security Agent,[68] and (d) obtaining a Consent from the Royal Commission that contained an agreement that the Royal Commission would not obtain a replacement deed for, or enter into any other lease with respect to, the mortgaged property without the consent of the Onshore Security Agent.

Various structural elements addressed the issue of providing adequate actual notice to competing creditors of the existence of the *rahn* in favor of the Security Agents for the benefit of the SC Banks. For example, notices and signs were posted and are to be maintained on the site and certain items of SC Collateral to provide public notice of the *rahn* on the project and other assets of the SC Project Company. In addition, to provide notice, it is appropriate to publish a notice of *rahn* in the Official

68. The author is not aware of a transaction in which this type of recordation on the deed has been made.

Gazette (the *Umm Al Qura*). It is not clear, however, that the Official Gazette would agree to publish such a notice. However, other notices were provided by virtue of "tombstone" announcements in various financial publications, including those directed at potentially competing creditors, in order to give actual notice of the existence of the security interests.

Each of the SC Security Documents has been structured such that it is updated and amended (i) through the advance request on each drawdown to reflect construction completed and property acquired, since the date of the most recent previous update and (ii) periodically throughout the term of the financing to reflect any property acquired by the SC Project Company since the most recent previous update. The property descriptions are detailed. For example, the SC Mortgage (*Rahn*) includes a precise description of the real property itself, the SC Site Lease, and all "fixtures" and other items of property that might, under Saudi Arabian law, be considered "immovable" property. The descriptions are subject to periodic updating. Each of the SC Security Documents also described with particularity the indebtedness secured thereby. Additionally, a mechanism was included in the advance request and at periodic intervals to update each of the SC Security Documents to reflect continuing drawdowns and an increasing amount of indebtedness.

The remedies provisions of each of the SC Security Documents expressly permit the Security Agents to possess, use, and operate the SC Collateral, including as an operating entity, and to utilize the proceeds of operation to repay indebtedness and other amounts due under the SC Financing Agreements. Other customary remedies, including power of sale, were included in each of the SC Security Documents in greater specificity than would be the case under New York or English law. Given the lack of clarity in Saudi Arabian law, each of the SC Security Documents clearly and unequivocally indicates that the Onshore Security Agent is entitled to exercise remedies, including remedies other than judicial sale, upon the occurrence of events of default that are not payment events of default. The SC Security Documents stipulate that non-payment remedies are integral to the transaction, that the failure to perform with respect to non-monetary matters is likely to have a material adverse effect on the nature of the SC Collateral (indicating the limited recourse nature of the financing), and that the existence of such non-pay-

ment events of default was relied upon by the SC Banks in entering into the transaction.

Because of the provisions of the *Shari'ah* requiring that the SC Banks maintain responsibility for expenses relating to preservation of the *rahn*, among other reasons, the SC Facilities Agreement contains covenants that require the SC Project Company, as part of the project design, to include features that maximize the value, utility, useful life, and secure status of the SC Collateral. These provisions have the ancillary effect of minimizing the cost exposure of the SC Banks. For example, the SC Project Company is required to erect a fence, post the pertinent notices of existence of the *rahn* in the construction contract, and is required to at all times maintain a security force, acceptable to the SC Banks, that acts under the direction of the Onshore Security Agent if an event of default has occurred. Other documentary provisions were fashioned to require that the expenses in connection with the "possessory" interest of the SC Banks be included in various other agreements. In certain instances, the SC Project Company is able to act as agent for the performance by the Security Agents of their responsibilities in respect of the SC Collateral. In addition, traditional reimbursement obligations with respect to these expenses were included in the SC Facilities Agreement.[69]

Each of the SC Security Documents also contains provisions that lay the basis for asserting the jurisdiction of the different Enforcement Entities in Saudi Arabia. And each SC Security Document affords the Security Agents, on behalf of the SC Banks, the widest possible latitude in choosing an Enforcement Entity.

E. *Dispute Resolution in the Saudi Chevron Financing*

Decisions were taken in the Saudi Chevron financing, as they are in any international financing, as to whether arbitration should be a mandatory or a permissible remedy. Numerous transactions have been structured to allow the financing banks the choice of remedies, court actions or arbitration, as well as the choice of forum. In some instances, the remedies vary with the nature of the dispute—providing for court resolution as a

69. If enforcement is had before the SAMA Committee, for example, these provisions are likely to be respected.

possibility in some disputes and mandatory arbitration with respect to other types of disputes. The provisions of the SC Security Documents and the SC Financing Agreements for the Saudi Chevron transaction contain complicated and carefully negotiated remedies provisions incorporating a variety of mechanisms for dispute resolution. On the whole, they allow the SC Banks, at times through the Security Agents, maximum flexibility as to choice of forum in Saudi Arabia (and outside Saudi Arabia, where appropriate), and the provisions include Enforcement Entity, court, and arbitral board options, although the range of options varies with the type and subject matter of the dispute.

VI. *A SHARIKAT MAHASSA–MURABAHA FINANCING STRUCTURE: UTILITY POWER PROJECT*

Islamic alternatives to the debt portion of the financing have been developed and implemented. One example of a transaction in which these alternatives have been implemented is the project financing of a power plant expansion, and related transmission facilities (collectively, "Utility Power Project"), for a Saudi Arabian electric utility company ("Utility") in 1998. The transaction may be characterized as a *sharikat mahassa-murabaha* structure.

A *sharikat mahassa* under Saudi Arabian law[70] is a joint venture, established pursuant to a memorandum of association or other means, and of which third parties are unaware. Importantly, third parties have recourse only against joint venturers with whom they have dealt so long as the existence of the joint venture is undisclosed. If the joint venture is disclosed to third

70. Regulations for Companies, Royal Decree No. M/6 dated 22/3/1385 H. (corresponding to July 20, 1965), as amended by Royal Decree No. M/22 dated 30/7/1412 H. (corresponding to Feb. 3, 1992), and as otherwise amended [hereinafter REGULATIONS FOR COMPANIES], Articles 40-47. *See Majalat Al-Ahkam Al-Adliyah, supra* note 30, arts. 1045-1448 (addressing concepts of joint ownership, including joint ventures and partnerships and the nature of, and rules pertaining to, undivided interests in assets). A partnership is referred to as a *musharaka*, and there are many types of *musharaka* arrangements. *Id. See* Ray, *supra* note 6, at 59-70 (discussing an overview of *musharaka* arrangements); *see also*, Gobar Bilal, *Business Organizations under Islamic Law: A Brief Overview, in* THIRD HARVARD ISLAMIC FORUM, *supra* note 1, at 83-89; MUHAMMAD NEJATULLAH SIDDIQI, PARTNERSHIP AND PROFIT-SHARING IN ISLAMIC LAW (The Islamic Foundation, 1985/1405 H); A COMPENDIUM OF LEGAL OPINIONS ON THE OPERATIONS OF ISLAMIC BANKS: MURABAHA, MUDARABAH, AND MUSHARAKAH 219-61 (Yusuf Talal DeLorenzo, ed. & trans., 1997) [hereinafter DELORENZO LEGAL OPINIONS] (containing a good collection of *fatawa* regarding *musharakah* structures and transactions).

parties, it is treated as a general partnership with respect to such third parties.[71]

A *murabaha* transaction is one in which a bank finances the purchase of an asset by itself, purchasing that asset from a third party and then reselling that asset at a profit to the bank client.[72] The bank is not permitted to sell the asset until the bank has obtained ownership of the asset from the third party. The bank may not obtain payment for the asset from the bank client prior to receipt by the bank of the asset from the third party. The minimum requirement for satisfaction of rules pertaining to receipt of the asset is that the bank be liable for the perishing or loss of the asset.[73] It is permissible for the bank client to enter into a binding agreement stipulating that the bank client will purchase the asset if the bank buys and receives that asset from a third party. The bank may take security for the obligation of the bank client to purchase the asset. The *murabaha* amount payable by the bank client must be a specified sum. The profit to the bank may be calculated by the bank in its discretion, including by reference to prevailing financial indices and with cognizance of the time frame for effectuation of the transaction. However, the amount of the *murabaha* obligation may not be increased after the bank client has assumed liability for payment of such amount. The bank may appoint the bank client as its agent for purposes of inspecting the asset to be purchased and accepting delivery of such asset[74] so long as (a) the bank itself pays the

71. REGULATIONS FOR COMPANIES, *supra* note 70, art. 46.

72. *See Majalat Al-Ahkam Al-Adliyah*, *supra* note 30, arts. 101-403 (addressing concepts of sale); *see also*, Ray, *supra* note 6, at 38-59; VOGEL & HAYES, *supra* note 2, at 117-20, 140-43; Abdul-Rahman Abdullah bin Aqueel, *Shari'ah Precautionary Procedures in Murabaha and Istisna': A Practical Perspective*, *in* SECOND HARVARD ISLAMIC FORUM, *supra* note 2, at 127-30; Yusuf Talal DeLorenzo, *Murabaha, Sales of Trust, and Money-value of Time*, *in* SECOND HARVARD ISLAMIC FORUM, *supra* note 2, at 151-54 (discussing nature of *murabaha* transactions and, as a general references); *see, e.g.*, DELORENZO LEGAL OPINIONS, *supra* note 70, at 1-168 (regarding *fatawa* pertaining to *murabaha* transactions).

73. The author has been involved in a number of transactions in which bank exposure for such losses has been limited by specifying the period during which such loss must occur or be determined and limiting damages as to their source and amount. The specifications and limitations incorporated in these transactions have been approved by different *Shari'ah* Boards of the involved parties.

74. *See Majalat Al-Ahkam Al-Adliyah*, *supra* note 30, arts. 320-35 (pertaining to the option to inspect, which provides a purchaser certain rights to inspect assets to be purchased and to reject such assets in certain circumstances); *id.* arts. 336-55 (addressing related option for defect). These doctrines also have significant application to construction (*istisna'a*) and lease (*ijara*) arrangements. Other types of options that are

purchase price to the third party, (b) the transaction passes through a stage in which the bank is liable for loss or perishing of the asset and the agency arrangement does not protect the bank against such liability, and (c) the bank itself is not capable of receiving and selling that asset. That agency relationship need not be declared to the third party seller (or other persons), so long as the lack of that declaration does not cause harm to third parties.

The Utility Power Project transaction involved five parties: the Utility; three banks providing financing ("PP Banks," one of which is referred to as the "Administrative Bank");[75] and an engineering, procurement, and construction contractor ("EPC Contractor"). The tenor of the financing was seven years, involving a two-year construction period (without repayment) and a five-year financing repayment period. The repayment schedule was based upon sixty equal and consecutive installments commencing on the completion of construction. One of the PP Banks provided fixed rate financing. The other two PP Banks provided floating rate financing for the Utility Power Project. Thus, the framework permits participation by both Islamic and conventional banks. Collateral security arrangements were pursuant to a *rahn-adl* structure.

The documentation for the *sharikat mahassa-murabaha* is streamlined, involving only an engineering, procurement, and construction contract, a *sharikat mahassa* (a type of joint venture that is contemplated by the statutes of most Middle Eastern jurisdictions, including Saudi Arabia, Kuwait, and the United Arab Emirates) agreement, a *murabaha* agreement, and the desired collateral security (*rahn-adl*) agreements.

To give effect to the financing arrangements, the Utility entered into a conventional engineering, procurement, and construction contract ("EPC Contract") with the EPC Contractor. The Utility and the three PP Banks formed a *sharikat mahassa*

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applicable in similar transactions are the contractual options (*id.* arts. 300-09), options for misdescription (*id.* arts. 310-12), options as to payment (*id.* arts. 313-15), and options as to selection (*id.* arts. 316-19).

75. One of the three banks withdrew from the transaction because of interpretive differences between its and the *Shari'ah* Board, on the one hand, and the *Shari'ah* Board for the other two banks. These interpretive differences related to substantive *Shari'ah* issues, the resolution of which directly affected the credit analysis of the transaction.

("*Sharikat Mahassa*") (the Utility and each of the three PP Banks, in their respective capacities as members of the *Sharikat Mahassa*, is referred to as a "Member"). Each Member holds shares ("*Hissas*") in the joint venture. The type of *sharikat mahassa* used for the Utility Power Project is an "undisclosed *sharikat mahassa*," meaning that the PP Bank parties were not revealed to the EPC Contractor or any other entity. This aspect of the transaction is critical to the PP Banks because disclosure results in liability to the PP Banks, whereas their liability is limited if there is no such disclosure.[76] Thus, the Utility covenanted not to disclose the existence of the *Sharikat Mahassa* or the identities of the PP Banks and provided indemnification in the event of any such disclosure. The Utility Power Project is owned by the *Sharikat Mahassa*, with the EPC Contract being assigned to the *Sharikat Mahassa* pursuant to valid assignment arrangements. The Utility acted as the technical manager ("Technical Manager") of the *Sharikat Mahassa*. The Technical Manager retained responsibility for all technical and unforeseen liabilities.

Each of the PP Banks purchased *Hissas* by capitalizing the *Sharikat Mahassa* in aggregate amounts equal to (a) upon initial capitalization, in an amount equal to the cost of pre-existing development work and (b) periodically upon completion of each construction milestone, in an amount equal to the cost of completion of that milestone. To effect each purchase of *Hissas* in connection with capital contributions, the Technical Manager delivered a milestone completion certificate to the Administrative Bank. Thereupon, the Administrative Bank provided a contribution notice to each Member. Each Member made *pro rata* contributions to the *Sharikat Mahassa* in accordance with its initial percentage interest. Transfers of *Hissas* were permitted between each of the Members at any time, but transfers to other persons or entities were permissible only with the consent of the Utility. The PP Banks were not entitled to any profits of the *Sharikat Mahassa*, nor were they liable for any losses or liabilities of the *Sharikat Mahassa*. Each of these elements of the structure is subject to varying interpretations by *Shari'ah* Boards and to mandatory and permissible statutory provisions and modifications. For example, certain *Shari'ah* Boards take the position that a provision limiting the liabilities of the PP Banks with re-

76. REGULATIONS FOR COMPANIES, *supra* note 70, art. 46.

spect to losses to the *Sharikat Mahassa* is void, while others take the position that such a position invalidates the entire *sharikat mahassa* agreement. Some *Shari'ah* Boards will approve the lack of liability and loss sharing in limited *sharikat mahassa* arrangements such as that pertaining to the Utility Power Project.

The *murabaha* portion of the financing structure involved the sale of *Hissas* by the PP Banks to the Utility from time to time. One of the more difficult *Shari'ah* issues in the transaction focused on the timing of the sale of the *Hissas*. Some *Shari'ah* Boards take the position that the sale of the *Hissas* may not occur until all construction of the Utility Power Project has been completed and the project has been accepted as complete. Other *Shari'ah* Boards take the position that a sale of *Hissas* may occur upon completion of each milestone, and that the *Hissas* that may be sold at the completion of such milestone are those issued with respect to contributions used to finance construction up to and including such milestone. Similarly, *Shari'ah* Boards vary in their position with respect to when the *murabaha* agreement relating to the sale of *Hissas* may be executed. Some *Shari'ah* Boards permit execution of the *murabaha* agreement at the inception of the financing transaction, others insist on execution only upon completion of the financing, and still others permit the execution of multiple *murabaha* agreements upon completion of each milestone. Frequently, the position of the *Shari'ah* Board is factually dependent, focusing on the nature of the construction activities and the contribution to value that has been achieved by the time of completion of such milestone. Payment of the purchase price of the *Hissas* is delayed and effected in accordance with the five-year repayment schedule for the financing. There are also differences among *Shari'ah* Boards as to the determination of the *murabaha* purchase price. Some *Shari'ah* Boards require that the purchase price for the *Hissas* be determined by reference to their net asset value (plus profit) at the time of handover (which may be at completion of all construction or completion of a specified milestone), while others use a fair market value standard for purchase price determinations.

VII. *AN ISTISNA'A–IJARA FINANCING STRUCTURE: THE MACONDA PARK AND TRUMAN PARK APARTMENTS*

In June 2000, an Islamic construction financing structure was implemented in a United States residential housing transaction in Austin, Texas ("Maconda Park Project"). In April 2001, that construction financing structure was implemented in a second United States residential housing transaction in Largo, Maryland ("Truman Park Project").[77] The variations in the Truman Park transaction were that (a) the structure was used to take out an existing conventional construction loan, (b) an "orphan" special purpose vehicle was introduced to enter into the two construction contracts in the transaction, and (c) various aspects of the structure were modified in an effort to reduce transactional costs and expedite the documentation process. The structure used in the Maconda Park and Truman Park transactions was designed for project financings of all types and was then modified for the real estate transaction. The structure has been designed to accommodate construction, mezzanine, and long-term project financings, including take-outs of conventional loan financings (as in Truman Park). The author has used modified versions of this structure to implement similar financings in Saudi Arabia. Implementation in the United States is substantially more difficult as a result of, among other things, United States bank regulatory requirements, liability allocation provisions of United States environmental laws, and the standardization of construction contracts in the United States.

The Maconda Park and Truman Park transactions may be characterized as an "*istisna'a–ijara*" structure.[78] An *istisna'a* is a

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77. Insightful and creative contributions to, and many long hours in connection with, the implementation and refinement of the *istisna'a-ijara* structure have been made by Andrew M. Metcalf, Esq. and Jawad I. Ali, Esq., both associates at King & Spalding. These transactions, and similar creative Islamic financings, could not have been achieved without the entrepreneurial vision, patience, and persistence of the people at each of the institutions involved, most notably those at Key Global Capital, Inc., KeyBank, National Association, Gulf Investment House, Fairfield Residential Properties, Inc., and The Dolben Company, Inc. and their respective law firms. Particular acclaim in this regard goes to James M. Godec, Esq. of Key Global Capital, Inc., Bader A. Al-Ali of Gulf Investment House, the *Shari'ah* Supervisory Board of Gulf Investment House, and W. Donald Knight, Jr., Esq. and Isam Salah, Esq., my partners at King & Spalding.

78. The transaction could have been structured as a pure *istisna'a*, in which the bank enters into a construction contract (*istisna'a*) with the construction contractor

type of sale of assets to be constructed or manufactured[79] according to designated specifications and for a specific determined price. An *ijara* is a type of simple hire, or lease, of an object or services.

Some of the relevant *Shari'ah* principles applicable to *istisna'a* (construction) agreements are as set forth in this paragraph.[80] An *istisna'a* is a sale of assets to be constructed in which a bank may finance the construction of permissible assets that can be precisely determined by description and specifications. Although the liability to pay for the construction, and deliver the constructed assets, will be that of the bank providing the financing, the bank does not have to itself construct the assets. The financing bank (*sane'*) may contract with a third party (*mustasne*) to construct the assets so long as this arrangement entails no contractual obligations between the bank client that ultimately desires to purchase the constructed assets[81] and the construction contractor. Payment by the bank client to the bank may be

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and the bank client enters into an agreement with the bank to make payments for the constructed asset on an installment basis. Alternatively, it could have been constructed as an *istisna'a*—parallel *istisna'a*, in which (a) the bank client entered into a construction contract (*istisna'a*) with the bank pursuant to which the bank will construct, or cause construction of, the asset and (b) the bank entered into a construction contract (parallel *istisna'a*) with the construction contractor. The *istisna'a-ijara* structure was used as an alternative to the foregoing for numerous reasons, including those pertaining to United States bankruptcy considerations, the status of leases under state laws in the United States, and flexibility of payment alternatives.

Kuwait Finance House implemented a financing lease (*ijara*) structure as part of combined conventional-Islamic financing of the Equate Petrochemical Company project in Kuwait in 1997. Mohammad S. Al-Omar, *Islamic Project Finance: A Case Study of the Equate Petrochemical Company*, *in* THIRD HARVARD ISLAMIC FORUM, *supra* note 1, at 259-64 (describing financing for Equate Petrochemical Company project in Kuwait).

A range of legal and tax issues pertaining to cross-border Islamic transactions, particularly those implemented in the United States, are discussed in Isam Salah & W. Donald Knight, Jr., *Practical Legal and Tax Issues in Islamic Finance and Investment in the United States*, *in* SECOND HARVARD ISLAMIC FORUM, *supra* note 2, at 155-58. Tax aspects of a cross-border lease (*ijara*) structure with structural aspects in common with the *istisna'a–ijara* discussed in this Essay are discussed in Robert W. Toan, *Cross Border Ijara: A Case Study in the U.S. Taxation of Islamic Finance*, *in* THIRD HARVARD ISLAMIC PROCEEDINGS, *supra* note 1, at 191-197.

79. This Essay focuses on, and refers to, construction of assets, although the principles applicable to manufacturing of assets are identical.

80. *See Majalat al-Ahkam Al-Shar'iyah*, *supra* note 30, arts 338-92; *see also* Abdul-Rahman Abdullah bin Aqueel, *supra* note 72, at 127-134.

81. The bank client would be the *mustasne* in the agreement between such bank client and the financing bank if a parallel *istisna'a* structure were used, and the bank would be the *sane'*.

made up front or pursuant to periodic installment payments. The *istisna'a* amount payable by the bank client to the bank, and by the bank to the construction contractor, must be fixed and known to both parties. The bank client is permitted to inspect and supervise the construction activities to insure compliance with the specifications and for other purposes. The bank client may accept delivery of the constructed assets on behalf of the bank.

It is also helpful to review a summary of certain relevant *Shari'ah* principles relating to *ijara* (lease or hire) arrangements.[82] The *ijara* is a lease of an object or services involving the transfer of the usufruct or *manfa'a* (the use of an object or the services of a person) for a rent consideration where the nature of the *manfa'a* must be precisely defined and the rental consideration must be for a fixed value, whether payable in a lump sum or installments,[83] and the term of the *ijara* must be precisely determined. The lease arrangements may be such that the lessee acquires ownership upon the termination of the lease. Both the rent and the term must be clearly ascertained and designated in the *ijara*.[84] The rent will commence immediately upon execution of the *ijara* if the *manfa'a* has sufficient economic value and substance at that time, meaning that it can be, and is, put to the use for which it is intended.[85] If it does not then have such economic value and substance, the rent will commence when such value and substance does exist. If the rent is reviewed during the term of the *ijara*, each such review and any agreement (if reached) changing the rent results in the creation of a new lease. The rent must be specified as a fixed sum for each *ijara* and the related rental term. However, the rent may escalate or diminish during the rental term so longs as the amounts of such escalation and/or decrease are specified and known to both parties.[86] The lessor of assets is permitted to claim compensation

82. *Majalat al-Ahkam Al-Shar'iyah*, *supra* note 30, arts. 404-611.

83. *Id.* arts. 466-79.

84. *See id.* arts. 450, 454, 464, 484-96.

85. *See id.* arts. 443, 470-72, 477, 478. As noted in the text of this Essay, this is a difficult structural and documentary issue in any project financing involving construction of an asset and is the subject of considerable debate among *Shari'ah* scholars.

86. There is substantial discussion of variable rate rental arrangements in *Shari'ah*-compliant leases of equipment and real property. Many such leases make reference to the London Interbank Offered Rate ("LIBOR") as a base from which to compute periodic rentals. Given the absence of reference rates based on Islamic financial instru-

from the lessee for misuse of the leased assets, but may not make claims in respect of ordinary wear and tear of the assets. The lessor is responsible for structural maintenance of the assets and this obligation may not be passed to the lessee pursuant to the *ijara*.[87] The lessor is entitled to rent as long as the lessee has the enjoyment of the leased assets as specified in the *ijara*. If the lessee does not have such enjoyment, as upon destruction or condemnation of the *manfa'a*, the lessee may rescind the *ijara* and any contrary provision will be invalid.

Against this background summary of relevant *istisna'a* and *ijara* principles, there are significant course-of-business constraints that shape the structure of any such transaction. For example, developers and general contractors in project financing transactions (including real estate financings) have developed financing structures and construction contracts that are relatively standardized, both in terms of risk allocations and in terms of documentation. This is particularly true in the United States and Europe. Islamic *Shari'ah* precepts require risk allocations and documentary terms that are quite at odds with standard United States and European patterns. One of the greatest challenges in structuring the *istisna'a–ijara* transaction for the Maconda Park and Truman Park Projects is related to putting the various parties to the transaction in the same risk-allocated position they would have occupied had the transaction been structured as a conventional financing while still complying with

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ments, most *Shari'ah* scholars allow the use of LIBOR as a reference rate. However, most *Shari'ah* scholars object to the direct determination of rental rates by reference solely to variable or floating rates in the body of an on-going *ijara*. *See, e.g.*, M.A. Elgari, *Some Recurring Shari'ah Violations in Islamic Investment Agreements Used by International Banking Institutions*, in SECOND HARVARD ISLAMIC FORUM, *supra* note 2, at 153. Other methods have been used to structure an *ijara* that have the practical effect of allowing the implementation of a variable rate structure (one such structure being that used in the Maconda Park Project and the Truman Park Project).

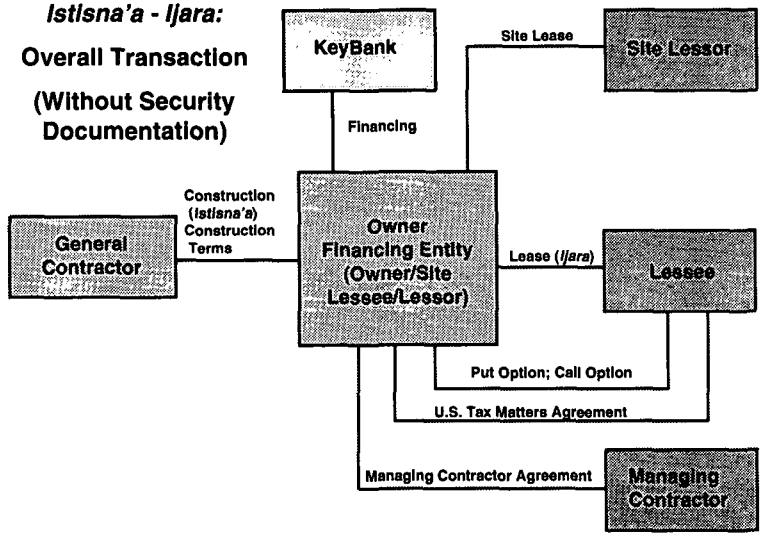
87. *Majalat Al-Ahkam Al-Adliyah*, *supra* note 30, arts. 513-21 (pertaining to the concept of an option for defect). *See also*, *supra* notes 78-9 and accompanying text. These provisions, and the *Shari'ah* precepts implementing these principles, are a major factor in structuring financing leases, particularly in the United States and Europe where financing parties rely heavily on triple-net leasing concepts. This Essay refers to "structural maintenance" and similar concepts. These references are a shorthand, and one often used by *Shari'ah* Boards as well, to those elements of structure, maintenance, and integrity of the project that pertain directly to the benefits sought to be obtained through leasing of the leased assets, and thus may include items beyond pure structural maintenance. Those items will be determined on a case-by-case factual analysis of the leased assets and the purposes of the *ijara*.

relevant *Shari'ah* principles. Then the parties must be satisfied as to these risk allocations without prohibitive transactional cost.

A. *General Structural Overview*

The *istisna'a-ijara* structure discussed in this section is summarized in diagrammatic form in Exhibit 1.

Exhibit 1



A real estate developer ("Developer") desired to develop and construct a residential housing project. The Maconda Park Project, in Austin, Texas, was comprised of approximately 232 units and Fairfield Residential Properties, Inc. ("Fairfield Residential") acted as the Developer. The Truman Park Project is comprised of approximately 284 units and is located in Largo, Maryland, and The Dolben Company, Inc. ("Dolben") was the Developer of that project. In connection with the development of each of the Projects, the Developers, in each case through Key Global Capital, arranged both equity investments and Islamic "debt-equivalent" financing. The Islamic equity financing was provided primarily by Gulf Investment House of Kuwait ("GIH") in each transaction. Other equity participants were an affiliate of Fairfield Residential and affiliates of Key Global Capital, in the Maconda Park transaction and affiliates of Dolben and Key Global Capital, in the Truman Park transaction (collectively, "Is-

lamic Investors"). To implement the Maconda Park financing arrangements, the Islamic Investors formed a special purpose project company as an investment entity, the Maconda Park Limited Partnership ("Maconda Project Company"). In the Truman Park transaction, an existing limited liability company, Truman Park LLC ("Truman Project Company"), was reorganized in connection with the Islamic financing and the infusion of the Islamic investment. A Fairfiled Residential affiliate serves as the "General Partner" of the Maconda Project Company, and a Dolben affiliate serves as the "Managing Member" in the Truman Park transaction. GIH and the Key Global Capital affiliates invested as the limited partners and members in these transactions. KeyBank, National Association ("KeyBank") provided financing for each of the transactions[88] through an affiliated entity (each, an "Owner"). FF Development L.P., an affiliate of Fairfield Residential, as the general contractor ("Maconda General Contractor"), is constructing the apartment buildings and other improvements for the Maconda Park Project ("Maconda Improvements") and Bovis Lend Lease, Inc. is acting as the general contractor ("Truman General Contractor") for construction of the apartments and other improvements ("Truman Improvements") for the Truman Park Project. The Maconda Improvements and the Truman Improvements are referred to as the "Improvements" and the Maconda General Contractor and the Truman General Contractor are referred to as the "General Contractors." The Truman Park transaction involved an entity not present in the Maconda Park transaction, the "Construction Arranger." The Construction Arranger is an "orphan" special purpose vehicle that was created to enter into the Construction Contract with the General Contractor and to enter into the Construction (*Istisna'a*) Agreement with the Owner. The relevant Owner is leasing and will lease the Maconda Park Project to the Maconda Project Company, and is leasing and will lease the Truman Park Project to the Truman Project Company, in each case as described in this Essay. Each of the Project Companies also acts as a managing contractor ("Managing Contractor") for the construction and operation of the respective Projects. The Maconda Project Company owns the site on which the Maconda Park Project is being constructed ("Maconda Site") together

88. The "debt equivalent."

with various easements, licenses, and other real estate interests (collectively with the Maconda Site, "Maconda Premises"). Similarly, the Truman Project Company owns the site on which the Truman Park Project is being constructed ("Truman Site") together with various easements, licenses, and other real estate interests (collectively with the Truman Site, "Truman Premises"). The Maconda Site and the Truman Site are collectively referred to as the "Sites" and the Maconda Premises and the Truman Premises are collectively referred to as the "Premises."

The primary documents for the construction and miniperm financing of each of the Maconda Park Project and the Truman Park Project are, in each case:

(a). "SITE LEASE": The lease of each of the relevant Site (and assignment of related easements) and the remainder of each of the relevant Premises from the Project Company for that Project, as the site lessors, to the relevant Owner, as the site lessee, to allow such Owner to occupy such Site and cause construction and leasing of the Improvements thereon;

(b). "CONSTRUCTION (*Istisna'a*) Agreement": The *Shari'ah*-compliant construction contract between the relevant Owner and the Maconda General Contractor (in Maconda Park) and between the relevant Owner and the Construction Arranger (in Truman Park), in each case for the construction of the Improvements for the relevant Project, having attached thereto the Construction Terms (in Maconda Park) and the Construction Contract (in Truman Park), including the specifications and details of the cost of construction;

(c). "CONSTRUCTION TERMS" and "CONSTRUTION CONTRACT": A standard construction contract[89] between the Maconda General Contractor and the related Owner (in Maconda Park) and between the Construction Arranger and the Truman General Contractor (in Truman Park) with respect to construction of the Improvements for the relevant Project, including all specifications for such Improvements;

89. Such a standard construction contract might be the American Institute of Architects Form A111, Standard Form of Agreement Between Owner and Contractor, and Standard General Conditions and Special Conditions Relating Thereto, as was used in the Truman Park transaction. In the Maconda Park transaction, the Construction Terms were the General Contractor's own customary form of construction contract and conditions.

(d). "LEASE (*Ijara*)": A lease of the Improvements constituting part of each Project, and a sublease of each Premises for such Project, from the Owner thereof to the each of the relevant Project Company;[90]

(e). "PUT OPTION AGREEMENT": An agreement allowing each Owner to cause the related Project Company to purchase its related Project at various times and under various circumstances at the election of such Owner;

(f). "CALL OPTION AGREEMENT": An agreement allowing each Project Company to purchase its related Project from the relevant Owner at various times and under various circumstances at the election of the such Project Company;

(g). "MANAGING CONTRACTOR AGREEMENT": An agreement between each Owner and the relevant Project Company pursuant to which the such Project Company performs various construction and operation activities as the representative of the related Owner; and

(h). "TAX MATTERS AGREEMENT": An agreement to clarify the characterization of the transaction for United States tax and other laws.

The mortgage (*rahn*), security agreement, and other collateral security documentation, including guarantees of payment, completion of construction, and environmental matters (collectively "Security Documents"), are not discussed in this Essay. In addition, there are various consents and similar documents between and among the parties to the transaction that allow for assignment of documents in connection with the Security Documents and also make provision for the exercise of remedies in various default scenarios and provide for damages in such scenarios.

In summary, in the Maconda Park transaction, the Developer and the Islamic Investors formed the Maconda Project Company, with each such entity making equity contributions. The Maconda Project Company, using such equity contributions and the other financing amounts provided by KeyBank through the related Owner as described herein, purchased, and holds title to, the Maconda Site and the other portions of the Maconda Premises. The Maconda Project Company leased the Maconda

90. The obligations of the Lessee under the Lease (*Ijara*) are evidenced by a Basic Rent Note.

Site and granted other rights to the remainder of the Maconda Premises to the Owner pursuant to a Site Lease.

In the Truman Park transaction, the Developer had previously formed the Truman Project Company and had purchased the Truman Site prior to the conversion of the conventional construction loan to an *istisna'a-ijara* financing structure. The Islamic Investors made equity contributions to the Truman Project Company after restructuring of that company. The Truman Project Company, using such equity contributions and the other financing amounts provided by KeyBank through the Owner as described herein, converted the conventional loan financing to an Islamic financing and undertook construction of the Truman Park Project. The Truman Project Company leased the Truman Site and granted other rights to the remainder of the Truman Premises to the related Owner pursuant to a Site Lease.

KeyBank provided and provides financing for both Projects by making amounts available to separate affiliates of KeyBank, the respective Owners. The Owner of the Maconda Park Project disbursed the financing amounts into the Maconda Park Project by making payments with respect to acquisition of the Maconda Premises. On a periodic basis, the Owners of each of the Projects will disburse further amounts with respect to construction of the Improvements pursuant to the Construction (*Istisna'a*) Agreements. Each Owner holds legal title to the Improvements constituting a part of its related Project. In the Maconda Park transaction, the Owner is causing the General Contractor to construct the Improvements pursuant to the Construction (*Istisna'a*) Agreement between such entities. The Construction (*Istisna'a*) Agreement incorporates the General Contractor's conventional construction contract, the Construction Terms, including specifications and milestone payment provisions, and also modifies the Construction Terms to comply with applicable *Shari'ah* precepts. In the Truman Park transaction, an "orphan" special purpose entity was established to enter into the Construction (*Istisna'a*) Agreement with the Owner and to enter into the Construction Contract with the General Contractor. The Construction Contract is incorporated in, and modified in accordance with *Shari'ah* precepts by, the Construction (*Istisna'a*) Agreement. The use of this entity resulted in the General Contractor being able to use its customary Construction Contract without adaptation to the Islamic structure, isolated the

General Contractor from the Islamic transaction, and resulted in substantial savings in transactional costs and implementation time. Each Construction (*Istisna'a*) Agreement contains the "lending and disbursement half" of a conventional loan agreement, including conditions precedent to funding.

Each of the Owners is leasing and will lease its constructed Improvements, is subleasing and will sublease its related Site, and has grant rights to the remainder of the relevant Premises to the related Project Company in its capacity as lessee under each Lease (*Ijara*) (in their respective capacities thereunder, each Owner is referred to as the "Lessor" and each Project Company is referred to as the "Lessee"). The Lease (*Ijara*) is the primary financing document for the transaction, particularly as regards repayment of financing amounts through rent mechanisms, events of default, remedies, and covenants.

Each Project Company will be permitted to purchase the Project that it is leasing on a date elected by such Project Company pursuant to the Call Option Agreement. The provisions of the Call Option Agreement include the voluntary prepayment concepts of a conventional loan agreement. Similarly, each Owner will be permitted to sell its Project to the related Project Company in certain circumstances, such as defaults under the Lease (*Ijara*), pursuant to the Put Option Agreement. The provisions of the Put Option Agreement are akin to the mandatory prepayment provisions of a conventional loan agreement. As a general rule, put option agreements are disfavored under the *Shari'ah*. As a result and despite the name of the agreements, the Put Option Agreement and the Call Option Agreement were structured to comply with the many *Shari'ah* precepts applicable to agreements of sale and purchase.

Each Owner, as the holder of title to its related Improvements and lessee and grantee of the related Premises, and each Project Company, as the Managing Contractor for the related Project, entered into a Managing Contractor Agreement. Pursuant thereto, the Managing Contractor supervises construction activities under the related Construction (*Istisna'a*) Agreement, inspects the related Project as it is being constructed, and upon completion of milestones accepts that Project on behalf of the related Owner. The Managing Contractor also maintains the related Project to the extent that its Owner does not do so under

the Lease (*Ijara*). Applicable Islamic *Shari'ah* precepts permit a managing contractor or agent to act in this capacity.

Each Owner, each Project Company, and other entities also entered into the Tax Matters Agreement, which acknowledges the transaction as a financing for purposes of U.S. tax law. This acknowledgment allows each Project Company to take economic advantage of various expense and depreciation provisions of the U.S. tax law (such as allowing the payment of certain amounts to offshore investors without withholding tax) and other U.S. federal and state laws pertaining to the liability exposure of financiers (such as environmental liability laws).

B. *Structural and Documentary Shari'ah Issues*

1. Site Lease

Each Site has been made available to the related Owner, as the site lessee, pursuant to a Site Lease from the relevant Project Company, as the site lessor (in such capacity, "Site Lessor"), in consideration for the payment of site lease rent ("Site Rent"). The Site Lease is unusual, considered from the vantage of a customary project financing or real estate financing in the United States. The differences from a conventional ground lease relate to applicable Islamic *Shari'ah* precepts and to risk allocations that must be made to accommodate use of the *istisna'a–ijara* structure in the United States with parties that are accustomed to a specified pattern of risk allocations. As examples of the structural differences from customary ground leases, in the *istisna'a–ijara* structure, the Site Lessor, as owner of the Site, retained responsibility for environmental liabilities, the state and condition of the Site, unforeseen circumstances pertaining to the relevant Site, compliance with legal requirements by the Lessee, and payment of taxes and other amounts, among other things. In addition, the Site Lessor has the obligation to prevent unlawful use of the Site, unlawful conditions on the relevant Site, and other uses of that Site that may give rise to damages or liabilities pertaining to use or occupation of that Site, including compliance with environmental laws. The Site Lessor also provided indemnities to the related Owner/Site Lessee and other indemnitees in respect of such matters.

2. Construction (*Istisna'a*) Contract; Construction Terms; Construction Contract; Total Construction Cost

The Maconda Park Project is being and will be constructed by the Maconda General Contractor pursuant to the Construction (*Istisna'a*) Agreement with the relevant Owner. The Construction Terms were negotiated by the Maconda Project Company with the Maconda General Contractor. The Construction Arranger will cause the construction of the Truman Park Project (by the Truman General Contractor) pursuant to its Construction (*Istisna'a*) Agreement with the Owner, which incorporates the Construction Contract between the Construction Arranger and the Truman General Contractor. The Construction Contract for the Truman Park Project was negotiated by the Truman Project Company with the Truman General Contractor.[91] The Maconda General Contractor (in Maconda Park) and the Construction Arranger (in Truman Park) agreed in the Construction (*Istisna'a*) Agreement to construct and deliver the relevant Project to its Owner, who has legal title to the related Improvements. The total cost for construction of each Project pursuant to the Construction (*Istisna'a*) Agreement is referred to as the "Total Construction Cost" of that Project.

Payments under each Construction (*Istisna'a*) Agreement are made in the same manner, on the same schedule and subject to the same conditions that advances would be made in connection with a conventional construction financing arrangement. Those conditions precedent that would be conditions precedent to the initial advance and all subsequent advances in a conventional construction financing are conditions precedent to the making of payments under each Construction (*Istisna'a*) Agreement. Conditions precedent for subsequent advances are addressed through the construction payment request mechanism, which, in turn, incorporates a milestone completion payment mechanism. Thus, for example, each General Contractor, the Construction Arranger, and the Managing Contractor will pre-

91. The customary practice is that each construction contractor (i.e., each General Contractor in the *istisna'a-ijara* transaction) dictates the form of construction contract that it uses. Many construction contractors use a widely recognized standard form (such as those of the American Institute of Architects, which was used, in modified form, by Bovis Lend Lease, Inc. as the General Contractor in the Truman Park transaction). Others use their own forms, which are precisely tailored to that individual construction contractor, such as in the Maconda Park transaction.

pare payment requests and milestone completion certificates that will resemble advance requests in a conventional construction financing. The obligation of each Owner to make such payments will be conditioned upon compliance with performance of matters relevant to the payment request.

In the event that a payment request cannot be given due failure of a Project Company to satisfy one or more of the relevant conditions precedent, the General Contractor (in Maconda Park and Truman Park) and the Construction Arranger (in Truman Park) will continue to be entitled to pursue their respective rights to payment, but only against the relevant Project Company. However, it will have to do so under the Managing Contractor Agreement and certain other documents. The amount of damages that a General Contractor and the Construction Arranger will be entitled to collect will be limited to amounts obtainable from the relevant Project Company and other amounts payable through performance bonds, warranties, completion bonds, insurance proceeds, and similar arrangements. Neither of the General Contractors nor the Construction Arranger is entitled to pursue remedies against an Owner for failure to perform a funding condition.

3. Lease (*Ijara*)

The Lease (*Ijara*) is the primary financing document on the repayment side of the transaction. Each Project Company, as the Lessee, repays the financing amounts made available by its related Owner through the payment of periodic basic rent ("Basic Rent"). Commencing upon an agreed date, the Lessee will be required to begin paying Basic Rent in installments over the agreed rental period ("Rental Term").[92] The Lease (*Ijara*) was executed at the same time as the other financing documents, but cannot become fully effective at such time due to a *Shari'ah* principle that prohibits the payment of rent for an asset until that asset has sufficient economic value and sufficiency for *Shari'ah* purposes—i.e., until the asset can be, and is, put to the intended use. Different *Shari'ah* Boards take different positions as to

92. The documentation for each of the Projects is for a construction financing. As such, the Rental Term is likely to be in the range of one to four years, with a permanent long-term financing take-out contemplated during, or at the end of, such period. The structure could be extended to cover a long-term financing of either Project. In other transactions, a long-term lease (*ijara*) has been used.

when an asset has sufficient economic value and sufficiency. This determination is dependent upon the specific facts of the project being considered. For example, each of the Projects is comprised of numerous buildings with many units in each building. Construction commences with the first building and moves in sequential fashion through each of the buildings. As a result, the first building will be completed and occupied prior to completion of construction on the last building. Rental activities with respect to the buildings will thus commence substantially before the entire project is constructed.[93]

Under one of the strict interpretations of relevant Islamic principles, *Shari'ah* Boards may allow an *ijara* to become effective only on a building-by-building basis as construction nears completion. Such an interpretation might require the use of nine lease (*ijara*) agreements (assuming eight buildings and common property), and nine construction (*istisna'a*) agree-

93. Significant construction or expenditure may be completed or made at the time of entering into, or very shortly after execution of, the Lease (*Ijara*) because approximately 20-25% of the construction costs may already have been incurred and related activities completed. The 20-25% represents the equivalent of the equity investment in the project that must have been spent on approved expenditures before the Owner thereof will make payment advances under the Construction (*Istisna'a*) Agreement. As a result, the related Site will have been acquired, much of the site preparation work may be completed, and the related Premises may already contain sewers, roads, water, and other infrastructural improvements. Some *Shari'ah* Boards have indicated that this degree of expenditure upon a project is sufficient to cause the Basic Rent provisions to become effective because the value of the related Premises will be substantially, and sufficiently, increased by this time. Further, and as noted in the Lease (*Ijara*), construction of certain blocks and segments of the Improvements for each Project will be completed before completion of other blocks or segments. Certain blocks and segments will have considerable lease value, and units will actually be rentable, prior to completion of other blocks and segments. Thus, significant rental income will already be generated prior to completion of the entire Project in either financing transaction. This, in turn, allows full effectuation of all provisions of the Lease (*Ijara*) at a relatively early time.

Although the determination of sufficient economic value and sufficiency of status to permit the intended use are significant and vexing *Shari'ah* issues, they are not difficult issues in a practical sense in projects such as the Maconda Park Project and the Truman Park Project. This is because the transaction is a construction financing in which no Basic Rent is payable during the construction period, *i.e.*, for approximately two or two and one-half years from commencement of the financing. Construction is complete for the entire Project by the end of that period. Although no Basic Rent is payable during that period, most construction financings include a feature that capitalizes interest (in a conventional financing) or profit (in an Islamic financing) during the construction period. The capitalization method used in each Project, and in similar projects, is particularly complex and has received the approval of various *Shari'ah* Boards. That capitalization method is not discussed in this Essay.

ments, to provide financiers with required certainties of repayment and perfected security interests over all funds advanced in respect of construction.[94] This, in turn, might require nine filings under local law of memoranda of leases, mortgages, and other security agreements. Filing and recordation fees and title insurance costs alone might make such an approach prohibitively expensive. Such a transaction would be complicated and difficult to implement. Other *Shari'ah* Boards acknowledge the practical difficulties of multiple filings of mortgages and have taken a pragmatic view of the financing process in Europe, the Middle East, Southeast Asia, and the United States. Those *Shari'ah* Boards have allowed a single lease (*ijara*) to become effective as to all provisions other than the Basic Rent provisions at the inception of the transaction. The Boards have allowed the Basic Rent provisions to become effective at the time that marketing and rental activities commence with respect to any part of the project or some other similar date that relates to commencement of binding activities in respect of rent generation. The date of effectiveness of the Basic Rent provisions ("Full Effectuation Date") for the projects is then determined in accordance with relevant *Shari'ah* principles as specified by the *Shari'ah* Board.

The GIH *Shari'ah* Board that considered the structure of,

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94. The author has worked on transactions in which multiple leases were used, one for each phase of the project. This approach permits different leases, and financing arrangements, for different aspects of construction, and allows each lease to be tailored to a different intended use. Given that the *Shari'ah* precept focuses on the intended use, effectuation of the leases under *Shari'ah* precepts can be obtained at an earlier point in the overall financing transaction, and the various leases can be closely tailored to construction milestone completion and funding.

The author is presently working on an *istisna'a-ijara* transaction that poignantly raises the effect of factual variation on the *Shari'ah* determination of full effectuation of the lease. The transaction involves the acquisition of a large farm. An Islamically acceptable joint venture has been formed to subdivide the farmland, obtain certain permits for construction and related activities, and construct infrastructure (roads, sewers, lighting, and the like). Each parcel will be sold off to another residential or commercial developer, or a commercial enterprise, which will construct the housing or commercial facilities for that specific parcel. The entire purpose of the joint venture is so limited. Clearly, the intended construction activities are limited, and substantial economic value and sufficiency, especially when considered from an "intention" perspective, is obtained at a very early stage in the business cycle. Another factor affecting substantial economic value and sufficiency issues, particularly in the United States, is the fact that obtaining a permit or zoning approval, without more, will frequently substantially enhance the value and sufficiency of the land (without regard to any physical construction).

and documentation for, the Maconda Park Project and the Truman Park Project was intimately involved in defining and implementing the mechanism for determining and implementing the Full Effectuation Date. The Board took a rigorous position with respect to the determination of sufficient economic value and sufficiency. However, based upon the factual configuration of each Project and its development, the Board also allowed each of the transactions to be structured using a single Lease (*Ijara*), a single Construction (*Istisna'a*) Agreement, and a single set of Security Documents. In each Project, if the Full Effectuation Date has not occurred by a stated date, then the Owner may cause the relevant Project Company to purchase that Project in accordance with the Put Option Agreement.

Pursuant to the Lease (*Ijara*), each Owner, as the Lessor, leases its Improvements, and subleases the related Site, to the relevant Project Company, as the Lessee. The Improvements and the Site will be leased and subleased, respectively, as-is, where-is, as the same is constructed or otherwise provided to the Owner.[95] Property becomes subject to the Lease (*Ijara*) on a continuous on-going basis as construction is completed and each Project is inspected and accepted by the relevant Managing Contractor. Except as prohibited by applicable *Shari'ah* precepts, the Lease (*Ijara*) is a triple net lease, with all costs associated with the use and operation of the relevant Project being payable by the related Lessee,[96] and with broad indemnity provisions similar to those found in triple-net financing leases, although such indemnity provisions must themselves be modified to comply with *Shari'ah* precepts.[97] Each Lessee has and will have the right to operate and use its Project and the obligation to maintain that Project (except, for example, that structural maintenance will remain the responsibility of the Owner as the Lessor).

The Basic Rent payable under the Lease (*Ijara*) has been structured to include a profit to the Lessor. The profit amount is determined on the basis of a weighted group of LIBOR refer-

95. As noted in Section VII(B)(6), a Managing Contractor, among other things, supervises construction activities, inspects construction of each Project on an on-going basis, accepts that Project, and provides for maintenance (including major and structural maintenance) pursuant to the Managing Contractor Agreement.

96. Certain modifications to the triple net lease concept that are necessary for compliance with *Shari'ah* precepts are discussed below.

97. *See* M.A. Elgari, *supra* note 86, at 151-54.

ence rates for different time periods and advance allocations ("Lessor Profit").[98] The Basic Rent is due and payable on the leased assets (i.e., the relevant Improvements) commencing upon the Full Effectuation Date or a later scheduled repayment commencement date thereafter. The Basic Rent payable at any given time is a *pro rata* portion of the Total Construction Cost paid to the Maconda General Contractor or the Construction Arranger, as appropriate, at such time, plus the Lessor Profit on such amount. Thus, the Basic Rent will be redetermined on a time schedule (for example, a monthly basis) in lock step with the payments by the Owner to the General Contractor (in Maconda Park) and the Construction Arranger (in Truman Park). This arrangement keeps the Basic Rent Payments in harmony with the on-going partial payments in respect of the Total Construction Cost and the increase in the portion of each Project that has been completed, inspected, and accepted. The mechanism for achieving this recalculation of Basic Rent, which involves change orders accepting completed work, has been structured so as to comply with relevant Islamic *Shari'ah* precepts and does not involve an uncertain rent amount under such precepts.[99] Change orders for each transaction will become effective only when agreed upon by the General Contractor, the Construction Arranger (in Truman Park), the Managing Contractor, the Owner, and the Lessee for that transaction. Part of such approval process will include an addition of such items to the leased asset base under the Lease (*Ijara*) in the relevant period (i.e., for future periods).

The standard supplemental rent provision is used to provide for payment of costs of use and operation of each Project above and beyond the Basic Rent ("Supplemental Rent"). Supplemental Rent includes taxes, impositions, third-party payments, and indemnity payments. Pursuant to the sublease arrangement for each Site under the relevant Lease (*Ijara*), the Lessee is responsible to pay the Site Rent directly to the relevant Site Lessor. Basic Rent, Supplemental Rent, and Site Rent for

98. *See id.* at 151-54.

99. *See, e.g.*, Dow Jones Islamic Market Indexes, *at* http://indexes.dowjones.com/djimi/imiinvest.html; Islamic Business & Finance Network ("IBFNET"), *at* http://islamic-finance.net/islamic-equity/equity1.html; Abdul Hamid, *Investing in Equities: Some Issue from the Islamic Perspective*, *in* THIRD HARVARD ISLAMIC FORUM, *supra* note 1, at 91-101.

each Project are collectively referred to as "Rent" for that Project.

In the event that the Lease (*Ijara*) is terminated during the Rental Term of a Project, and in a case where no long-term financing takes out the construction financing pursuant to the Lease (*Ijara*) for that Project, all Rent due to such date of termination or otherwise permissible under relevant *Shari'ah* precepts will be immediately due and payable. In addition, the relevant Owner will be entitled under the Put Option Agreement to cause the relevant Project Company to purchase its Project at such time.[100]

Various *Shari'ah* precepts pertaining to leases resulted in the Lease (*Ijara*) being structured differently from customary United States leases. For example, under the *Shari'ah*, a lessor must retain responsibility for structural maintenance of leased property. The obligation for structural maintenance cannot be passed to the lessee under an *ijara*. Similarly, some *Shari'ah* Boards require the lessor to retain the obligation to provide

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100. The form of lease (*ijara*) that served as the structural basis for the Lease (*Ijara*) has been used in numerous Islamic financings and the adjustment mechanism has been approved by several *Shari'ah* Boards. Analytically, the Lease (*Ijara*) can be thought of as a lease for a specified period (for example, one month). The Basic Rent payable under the Lease (*Ijara*) is determined by dividing the absolute amount of the Total Construction Cost paid to the first day of such month by the overall payment period, and then adding the applicable Lessor's Profit. Analytically, the Lease (*Ijara*) will then terminate on the last day of such month unless the parties agree to extend for another period (say, another month). If the Lease (*Ijara*) is so extended by virtue of a new and otherwise identical lease, the Basic Rent is recalculated to increase by the amount of Total Construction Cost advanced to the first day of such second month, and, again the weighted reference rate analysis is applied to determine the applicable Lessor's Profit for the new lease. This process is repeated with respect to each subsequent rental period. Payment of some or all of the Rent is deferred during the construction period so long as there is a continuous and contiguous series of leases.

If the Lease (*Ijara*) is not renewed at the end of any month or other rental period, the Lease (*Ijara*) terminates and the total amount of Rent accrued to such date becomes immediately due and payable and can no longer be deferred. Pursuant to the Put Option Letter, the relevant Owner is entitled to cause the relevant Project Company to immediately purchase its Project in its then-existing state and condition for a specified amount.

In practice, the Lease (*Ijara*) is written such that it automatically renews each period (for example, each month) unless there is a cancellation. These, and other structural elements, are designed to minimize the administrative and financial burden on the parties (especially the Lessee) and streamline the renewal and recalculation process and to avoid various complications of various United States laws, including bankruptcy laws, mortgage recordation laws, and recordation and taxation requirements in different jurisdictions.

property casualty insurance. The Lease (*Ijara*) for each of the Projects was structured in compliance with these, and other similar, *Shari'ah* precepts.

The events of default in the Lease (*Ijara*) are those that are customary for a lease of such type, and include most of the events of default usually found in a conventional construction financing. Certain other events constitute events that permit the purchase and sale of each Project under the related Put Option Agreement. As with a conventional construction financing, an event of default will allow the Lessor a broad choice of remedies, including the ability to terminate the Lease (*Ijara*) and related arrangements, to sell the related Project, and to collect the purchase price in respect of such sale. The remedies provisions have been structured to reflect those available to a lender in a conventional loan financing. The overall structure also allows each Owner to exercise its right under certain of the financing documents to suspend or cease making payments to the General Contractor (in Maconda Park) and the Construction Arranger (in Truman Park) upon the occurrence of events of default under those documents, assign rights under the Lease (*Ijara*) (and/or related documents) to the related General Contractor in certain circumstances, and be relieved of further liability to the General Contractor, the Construction Arranger, and the Lessee.

4. Put Option Agreement and Call Option Agreement

In order to allow each Project Company to prepay the financing and obtain ownership of its Project, each Owner and its related Project Company entered into a Call Option Agreement. The applicable provisions of each Call Option Agreement basically reflect the optional prepayment provisions of a conventional loan agreement, with certain limitations to preclude adverse bankruptcy and other undesirable results.

In addition, to allow the Owner to exit the transaction in certain cases (such as defaults by the Lessee and certain instances of illegality), each Owner and its related Project Company entered into a Put Option Agreement. The Put Option Agreement allows the Owner to sell its Project to the related Project Company. Cases in which such sale will be permitted include defaults under the Lease (*Ijara*) or the other financing

documents, including the failure of the Project Company to make payments or to accept any property that is required to be subject to the Lease (*Ijara*) or the other Project Documents, termination of the Lease (*Ijara*), the Site Lease, the Managing Contractor Agreement, and certain other agreements prior to the last day of the stated Rental Term, certain agreed termination events, illegality, and certain termination events relating to excess payments in respect of the Project. There are significant *Shari'ah* issues with respect to any put option as put options are generally considered to be executory agreements that are cancelable by either party to the options. With the assistance of the GIH *Shari'ah* Board, the Put Option Agreement (and the Call Option Agreement) for the Maconda Park and the Truman Park transactions were structured to comply with *Shari'ah* precepts applicable to valid sale and purchase agreements.

Numerous *Shari'ah* precepts are applicable to irreparable damage or destruction of assets and to the application of insurance, condemnation, or similar payments that are received in respect of destroyed assets. These precepts require termination provisions to be structured quite differently than conventional construction and project financings. However, within the ambit permitted by applicable *Shari'ah* precepts, the transaction must be structured to insure full repayment of all financing amounts and put the financiers in the same position they would occupy in a conventional financing. In the Maconda Park and Truman Park transactions, upon destruction or total condemnation of the relevant Project, the Lease (*Ijara*) will terminate immediately as required by *Shari'ah* precepts, the Rent then due and payable (but not future rents) will be paid to the Lessor, the related Project Company will be required to purchase its Project and pay the purchase price therefore, and the proceeds of such insurance, condemnation, and other payments will be applied to the payment of the purchase price for that Project (and related transfer costs) and any excess thereafter remaining will be paid over to the relevant Project Company. Difficult issues arise in connection with the determination of the relevant purchase price as *Shari'ah* principles generally restrict payments to the fair market value of the Projects after the event of destruction or condemnation.

Upon any purchase by a Project Company of its Project, the Construction (*Istisna'a*) Agreement (and related rights and

agreements) will be assigned to that Project Company and that Project Company will assume all of the obligations of the related Owner thereunder. Similarly, all insurance policies and warranties will be assigned and assumed such that the Project Company is afforded complete ownership rights.

5. Security Documents

The obligations of the Maconda Project Company and the General Contractor, in the Maconda Park transaction, and the Truman Project Company and the Construction Arranger, in the Truman Park transaction, are secured by the related Security Documents, which include a mortgage (*rahn*) on, and other security interests in, the relevant Site, the cash flows of such entities, including in respect of operation of the relevant Project, and any other assets of such entities. Those Security Documents also include various guarantees of the Developer or others that would be required by a bank in a conventional construction financing (such as general guarantees, completion guarantees, and environmental guarantees). These documents are provided to, or assigned for the benefit of, the relevant Owner and KeyBank in the Maconda Park and Truman Park transactions.

6. Managing Contractor Agreement

As previously noted, Islamic *Shari'ah* precepts require an Owner to retain obligations in respect of structural maintenance of its Improvements. Other *Shari'ah* precepts pertain to inspection of property being constructed, responsibility for latent defects, acceptance of leased (or purchased) assets, and operation and maintenance of leased assets. In order to achieve, as closely as possible, the risk allocations found in a conventional financing, it was necessary to structure the transaction in reliance upon a body of *Shari'ah* principles that allows an owner of property to contract with other entities to perform activities on behalf of such owner. Generally, these principles pertain to concepts of agency and contracting for services under the *Shari'ah*. Those principles also incorporate certain of the doctrines of Western jurisprudence applicable to the retention of independent contractors to perform activities on behalf of a property owner.

It is permissible under applicable *Shari'ah* precepts for an Owner to retain a Managing Contractor to perform certain of

the activities retained by that Owner under the Lease (*Ijara*) and accept responsibility for them in connection with the performance of its duties. The Maconda Park and Truman Park transactions were each structured to allow the Owner to hire and appoint the related Project Company as the Managing Contractor for the primary purposes of (a) supervising and managing the design, engineering, and construction of the relevant Project by the General Contractor (and the Construction Arranger, in Truman Park), (b) inspecting that Project, (c) accepting delivery of that Project, (d) enforcing the rights of the Owner as against the related General Contractor and the Construction Arranger, and (e) operating and maintaining that Project, all pursuant to the Managing Contractor Agreement.

This Managing Contractor Agreement has been structured such that the Managing Contractor bears the risks (i) of construction of the relevant Improvements in compliance with specifications and other terms and conditions of the Construction (*Istisna'a*) Agreement (including the Construction Terms or Construction Contract, as applicable) to the extent permissible applying *Shari'ah* precepts pertaining to the options of inspection and defect, and to precepts applicable to supervision and acceptance, and (ii) for maintaining the structure of the relevant Project and certain related matters throughout the Rental Term. The arrangement facilitates immediate and continuous inspection and acceptance by each Project Company of the work and assets comprising its Project and insures on-going maintenance of that Project, including in respect of its structural integrity. In accordance with *Shari'ah* precepts, each Owner, as the titleholder of its Improvements, retains some of the exposure on these items. The liability exposure of each Owner for such defects and conditions will be limited by express substantive provisions and by provisions that limit the payment obligation of that Owner to amounts actually collected under applicable warranties, performance bonds, completion bonds, guarantees, insurance policies, and similar documents and instruments. Similarly, claims of the Project Companies under each respective Lease (*Ijara*), and other documents, against each of the respective Owners, including as the Lessor and the owner of the related Project, are limited to amounts collectible from the relevant Managing Contractor, the relevant General Contractor, the Construction Arranger (in Truman Park), and relevant insur-

ance policies, performance bonds, completion bonds, warranties, guarantees, and similar documents and instruments.

The Managing Contractor also has responsibility for enforcing the insurance agreements, condemnation award proceedings, performance bonds, completion bonds, warranties, and similar documents and instruments in respect of the related Project, although these obligations and related rights are restricted in various situations (such as default scenarios) and are subject to defined parameters. This arrangement removes the Owner from involvement in the enforcement process to the greatest possible extent. The Managing Contractor Agreement extends to enforcement, on behalf of the relevant Owner, of any claim under the Construction (*Istisna'a*) Agreement that such Owner may have against the Maconda General Contractor, in the Maconda Park transaction, or the Truman General Contractor and the Construction Arranger, in the Truman Park transaction. As a corollary, in any circumstance where the claim of a Project Company relates to any matter covered by insurance, bonds, warranties, or similar arrangements, that Project Company's damage recovery will be limited to amounts recovered thereunder or otherwise from the relevant General Contractor (and the Construction Arranger, in Truman Park).

7. Tax Matters Agreement; Other Documents

The Tax Matters Agreement has been designed to afford legal recognition to the fact that the *istisna'a-ijara* structure is a financing arrangement under applicable United States law. Various characterizations are also made under relevant state law (for example, New York law for the financing, and the relevant state law for mortgage and other real property purposes). These characterizations may be somewhat different than those appearing in the Construction (*Istisna'a*) Agreement or the Lease (*Ijara*). For example, the Tax Matters Agreement clarifies that the entire transaction is, for purposes of United States tax law and applicable state law, a loan financing, and that all amounts (other than costs and expenses) payable to an Owner in excess of the Total Construction Cost are to treated as interest for United States tax and bank regulatory purposes. This is important in order to allocate tax benefits (such as depreciation, interest deductions, and various project expenses) to each Project Company (and thus to the General Partner or Managing Mem-

ber and the Islamic Investors). It additionally allows payments to Islamic Investors that are not U.S. persons to be made without tax withholding in accordance with the relevant portfolio interest provisions of U.S. tax laws. Environmental matters are also addressed in this agreement, with the relevant Project Company having all risks in respect thereof as regards any exposure of the relevant Owner.

Various consents and other documents have been structured to specifically address structural matters, including *Shari'ah* principles. For example, payment obligations of the relevant Owner under the Construction (*Istisna'a*) Agreement cannot be conditioned on the status, actions, or omissions of its Lessee under the Lease (*Ijara*). Thus, a default by, or bankruptcy of, a Lessee will not relieve an Owner of its obligation to make payment to the Maconda General Contractor or the Construction Arranger under the Construction (*Istisna'a*) Agreement, except in certain circumstances. Documents have been structured to address this difference from a conventional construction financing in a manner that puts the various parties, as nearly as possible, in the same position they would occupy in such a conventional financing. This is effected in part by documents that provide for agreed methods of enforcement of claims and agreed limitations on damage amounts and sources of damage awards or compensation in delineated circumstances. For example, in certain situations awards and damages are limited to amounts collected in respect of insurance policies, warranties, performance bonds, completion bonds, guarantees, other similar documents and instruments, and other security and amounts available from the estate of the bankrupt entity. In other situations, mandatory and voluntary assignments of rights and assumptions of liabilities, temporary and permanent, are operative to reallocate risk and responsibility to effect the allocations that would exist in a conventional financing.

CONCLUSION

The application of Islamic structures to project financings is in the early stages, just as the development of a true Islamic economy is in its infancy. The transactions described in this Essay, and others, are efforts to lay the critical base and explore the use of a variety of Islamic techniques within a framework that

must acknowledge the critical security, credit, economic, cultural, religious, and legal concerns of both Western and Islamic participants. The techniques and structures thus far implemented will be further refined to achieve simplicity, greater economics of implementation, and a smooth interface between a Western interest-based system and an Islamic interest-averse system. New structures are being developed as more and more Western financial institutions move into Islamic banking, which is an accelerating trend.

The Saudi Chevron structure is now the basis for a wide variety of project financings and other secured lending transactions in Saudi Arabia and elsewhere in Islamic jurisdictions. Lending transactions of all types are incorporating the possessory concepts relating to a *rahn* of a *marhoun*, even where additional collateral is available to secure the loan. Various business groups, as well as banks, are considering ways in which to use the *rahn-adl* structure to promote residential housing finance in Saudi Arabia where the absence of a dependable collateral security system (and, particularly, the unavailability of recordation of security interests) has resulted in an unavailability of financing for home purchases by anyone that is not wealthy. The *rahn-adl* structure has been implemented in the collateralization of large equipment leases and fleet leases. Proposals are being discussed for the establishment of a private security interest recordation system in Saudi Arabia to achieve the broadest possible achievement of notice of a *rahn*. As lender comfort increases, there should be decreased reliance on personal and corporate guarantees and greater use of secured financing techniques. This would allow individuals and companies to deploy assets over a wider investment base and banks to make loans of longer tenor, increasing capital investment throughout the economy.

The *adl* structure is also being implemented in diverse transactions. These range from employee stock participation programs to securitizations to debt instrument issuances to project financings. The increased certainty and stability of *adl* arrangements will insure that its use becomes commonplace in capital market transactions as well.

The author is unaware of any use of the *sharikat mahassa-murabaha* structure in project financings other than in the financing of the Utility Power Project. The structure does hold promise for use in similar financings although the *Shari'ah* issues

involved in this structure are somewhat more problematic than those in other structures.

The Maconda Park/Truman Park *istisna'a-ijara* structure is being widely used, particularly in residential, commercial, and industrial real estate projects throughout the world. The availability of a practical Islamic structure of this type has also given rise to the development of a range of related Islamic financial products. For example, the author is currently working on a number of real estate funds that will invest in properties and projects in Europe, Southeast Asia, Australia, New Zealand, Canada, and the United States. The majority of those funds will investment in residential real estate projects in the United States, all financed using the *istisna'a-ijara* structure. Those projects will be diversified as to geography, tenant base, and other characteristics. The funds will be sold to Islamic investors, primarily in the Middle East and Europe. A similar fund will use Islamic acquisition (primarily *ijara*) and *istisna'a-ijara* techniques to invest, initially, in commercial (primarily) and residential and industrial properties in Australia, New Zealand, France, Japan, Portugal, Spain, Sweden, the United Kingdom, Canada, and the United States. This fund has obvious geographical risk diversification. It is also being structured to provide industrial and credit diversification through its focus on leases to select tenants in different *Shari'ah*-compliant industries. A *Shari'ah* screen, similar to those used for *Shari'ah*-compliant equity funds, will be applied to tenants under the various *ijara* agreements implementing the financings.[101] That fund will be sold to Islamic investors in the Middle East and Europe. The *istisna'a-ijara* structure is also being applied to equipment and vessel financings, including *Shari'ah*-compliant *ijara* charter parties for liquified natural gas tankers. This will enable Islamic construction financing for those vessels and the development of related financial instruments to allow Islamic investment in those financings.

We are on the threshold of a bright future for *Shari'ah*-compliant project financing. The structures discussed in this Essay, and many others, are being developed to facilitate *Shari'ah*-compliant financings with joint participation, as to both equity and

101. *See, e.g.*, Dow Jones Islamic Market Indexes, *at* http://indexes.dowjones.com/djimi/imiinvest.html; IBFNET, *at* http://islamic-finance.net/islamic-equity/equity1.html; Abdul Hamid, *supra* note 99, at 91-101.

"debt equivalent" financing, by Western and Islamic investors and financiers. This is leading to greater familiarity of Western financiers with the Islamic market and its significant opportunities and Islamic investors and their sensitivities. And that, in turn, is resulting in enhanced interest and involvement of Western financial institutions in the development of not only Islamic project financing techniques, but a wide range of other Islamic financial products. From the vantage of both financiers and legal practitioners, there is a marked movement toward the development of an Islamic alternative to each Western financial product.