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Shari'a-compliant financing: not as mysterious as expected

One potential source of financing, both in multifamily and other property sectors, available to the market are products designed to serve entities that follow Islamic or Shari'a (Shari'ah) law. Such products are not well understood and may seem mysterious at first glance, thus giving rise to questions, but, when broken down to the component parts, should not. Although this author is not a Shari'a expert, he has participated in transactions that have been structured to be Shari'a compliant and has learned that, once understood, such structures should not cause transaction participants undue worry. Set forth below is a high-level explanation of a common structure used in real estate related transactions.

Initially, it should be understood that the primary source of Shari'a law is the Quran and the Sunnah of the Holy Prophet. Shari'a law is not legislatively or judicially created, and there are no codes or case law that can be consulted to understand it. Accordingly, the interpreters of Shari'a are religious scholars, not judges or other legal professionals. Institutions subject to Shari'a law maintain so-called Shari'a boards made up of such scholars whose role it is to review transactions for compliance with the tenets of Shari'a.

One principal tenet of Shari'a law is a prohibition on paying or receiving Riba, either directly or indirectly. While the true definition is more complex, for the purposes of this description, Riba can be thought of as interest. Because of the prohibition on Riba, an entity subject to Shari'a cannot enter into a conventional loan as either borrower or lender. Accordingly, Shari'a-compliant structures have been developed that allow for borrowing without violating Shari'a through structures that do not involve the affected entity paying interest.

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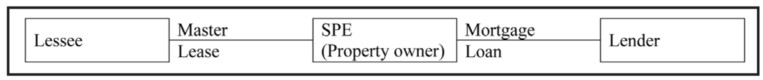
In the real estate context, one common structure is the Ijarah, or lease. There is no prohibition in Shari'a law against paying for the use of an asset (i.e., rent). Once broken down to its components, an Ijarah is very similar to a conventional sale-leaseback transaction. An Ijarah involves a third-party, special purpose entity that is not affiliated with the Shari'a-compliant entity being formed to act as titleholder, lessor and borrower (the SPE). There are service companies, GSS for example, that for a fee will form SPE entities and participate in Ijarah transactions. The Shari'a-compliant entity or its affiliate, for example a joint venture one of whose members is required to comply with Shari'a (the lessee), then leases the property from the SPE. The SPE, in turn, enters into a mortgage with the bank (lender). Graphically, the structure looks like this (see chart).



In the Ijarah structure, the lease and the mortgage are structured to ensure that the SPE is economically neutral. Accordingly, the rent paid by the lessee to the SPE will equal the amount payable by the SPE to the lender as debt service or otherwise. Similarly, the covenants in the loan documents and the covenants in the master lease are designed to be complementary such that performance by the lessee under the master lease will allow for performance by the SPE under the loan documents. In connection with the master lease, but importantly as separate agreements, the lessee and the SPE enter into each of a put agreement and a call agreement (and sometimes a call agreement relating to the sale of the equity interests in the SPE), providing for unilateral options that will allow or require the lessee to purchase the property at the expiration or earlier termination of the lease, the trigger events of which are structured to coincide with the maturity or acceleration of the loan. The purchase price under the put and call agreements is calculated to make the parties whole. In documenting both the master lease and the loan documents, care must be taken to ensure that (a) the two sets of documents work together to ensure that the obligations under the loan documents are, in essence, passed through to the lessee, and (b) that the lessor retains the characteristics of ownership and the expenses that accompany ownership. The burdens of ownership, for example the payment of taxes, can be the responsibility of the lessee pursuant to contract, but the ultimate burden must remain with the SPE as the owner of the property. The manner in which this is done must be taken into account by the applicable Shari'a board. For this reason, it is necessary to retain special counsel who understands both the Shari'a interpretations of the applicable Shari'a board and the commercial transaction along with the usual counsel for the parties involved.

While the above description is by necessity brief and simplified, it suffices to show that when broken down to its components, Shari'a-compliant financing is not as mysterious as it may appear to be at first glance.▲