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I. Special Report

Despite an exceptional growth rate,[1] the infant Islamic finance industry remains only vaguely familiar to the broader finance community.[2] Unimaginable changes in global financial markets have occurred since the previous review of Islamic finance. Predictions of massive project and infrastructure spending, particularly in the Middle East, have proven incorrect, at least in terms of timing;[3] spending is significantly below predictions,[4] with limited exceptions for oil-based economies (like Saudi Arabia and Abu Dhabi) that invested cautiously in the last decade. Private equity financings have largely ceased. Real estate financing has evaporated. Global recession has ensued. Private commercial financing is tepid and based upon new models. Equity capital markets are quiescent; debt capital

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1. Verifiable growth rate figures are notoriously elusive, but are estimated at ten to twenty percent annually. *See, e.g., Islamic Finance Growth Seen 10-20 Per Cent in Three Years: Study*, EMIRATES BUS. 24—7, Oct. 26, 2009, http://www.business24-7.ae/Articles/2009/10/Pages/Islamicfinancegrowthseen10-20percentinthreeyearsstudy.aspx.

2. *See generally* Michael J.T. McMillen, *Islamic Project Finance: An Introduction to Principles and Structures, in* 3 GLOBAL INFRASTRUCTURE 1 (Joel H. Moser ed., 2009). And, for an abbreviated history of modern Islamic finance, *see generally* Yusuf Talal DeLorenzo & Michael J.T. McMillen, *Law and Islamic Finance: An Interactive Analysis, in* ISLAMIC FINANCE: THE REGULATORY CHALLENGE 136 (Rifaat Ahmed Abdel Karim & Simon Archer eds., 2007).

3. *See generally* McMillen, *supra* note 2, at nn. 13-16. Regarding project and infrastructure financing activity, *see Emerging Markets Infrastructure: Just Getting Started*, MORGAN STANLEY PERSPECTIVES, July 16, 2008, http://www.morganstanley.com/views/perspectives/print/11203698-41a0-11de-a1b3-c771ef8db296.html.

4. *See, e.g., Gulf Prioritizes Essential Electricity and Water Infrastructure*, MEED, Feb. 22, 2009, *available at* http://www.meed.com/sectors/finance/gulf-prioritises-essential-electricity-and-water-infrastructure/1995515.article; *Islamic Banks Fill Funding Gap for Regional Projects*, MEED, Apr. 8, 2009, *available at* http://www.meed.com/sectors/economy/islamic-banks-fill-funding-gap-for-regional-projects/2017758.article; Karin Maree, *Gulf Projects 25 July 2009: Index Rises 1.1 [Percent]*, MEED, July 29, 2009, *available at* http://www.meed.com/sectors/construction/gulf-projects-25-july-2009-index-rises-11-per-cent/2039291.article; *Middle East Contracts Awarded: June 2009*, MEED, June 11, 2009, *available at* http://www.meed.com/sectors/construction/middle-east-contracts-awarded-june-2009/2033703.article; Hugh Tomlinson, *Key Transport Projects in the Region Weather the Economic Storm*, MEED, Sept. 9, 2009, *available at* http://www.meed.com/supplements/key-transport-projects-in-the-region-weather-the-economic-storm/3000530.article.

markets are largely comatose.[5] Liquidity is severely restricted. Default declarations are commonplace.

In the current crisis, Islamic banks have suffered less damage than conventional banks.[6] This result is attributable in large part to adherence to *Sharia* principles and precepts that preclude investments in mortgage-backed securities, collateralized debt obligations, and derivatives. Fundamental *Sharia* risk-reward principles incline Islamic banks to more measured investing. Additionally, Islamic banks engaged in lower-risk, regionally-focused activities. They avoided devastation in the first phase of the crisis (subprime and credit default swap), and emerged with fewer losses and somewhat greater liquidity. But many Islamic banks, particularly wholesale banks, had heavy regional real estate concentrations that suffered dramatic devaluations necessitating significant adverse loan loss provisioning.[7] They also concentrated deposit bases and high exposure into other illiquid asset classes.

No banks escaped the second phase: the liquidity crisis. But this phase provided Islamic banks with new opportunities. Conventional banks were reluctant or unable to provide fully-financed large-scale projects, necessitating accommodation of the increased structural and doctrinal complexities of *Sharia*-compliant involvement, particularly in regional project—including infrastructure—financings.[8] Local and regional Islamic banks welcomed the opportunity to diversify away from real estate, especially as project financing margins increased, and to provide local currency financings.[9]

Sukuk (Islamic "bonds" and securitizations), which had ascended between 2002 and 2007, approached dormancy, although there are current indications of an uptick, particu-

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5. *See, e.g.*, Melissa Hancock, *Special Report: Capital Markets-Downturn Exposes Investors' Weaknesses*, MEED, July 31, 2009, http://www.meed.com/sectors/markets/capital-markets/special-report-capital-markets-downturn-exposes-investors-weaknesses/2039737.article; *Sovereign Debt Revitalizes Market*, MEED, July 31, 2009, http://www.meed.com/sectors/finance/sovereign-debt-revitalises-market/2039733.article [hereinafter Sovereigns].

6. *See Emerging Sharia Finance Sector Beats the Downturn* 39, MEED, Sept. 25–Oct. 1, 2009, *available at* http://www.meed.com/sectors/finance/islamic-finance/emerging-sharia-finance-sector-beats-the-downturn/3000919.article [hereinafter Downturn] (noting that not a single Islamic institution has foundered during the crisis period); *Special Report: Islamic Banking-The Top 20 Gulf Institutions*, MEED, Sept. 24, 2009, http://www.meed.com/sectors/finance/project-finance/special-report-islamic-banking-the-top-20-gulf-institutions/3000918.article.

7. Higher real estate exposures of Islamic banks are attributable, in part, to the regulatory treatment of these institutions. For example, the twenty percent loan-to-deposit ratio requirements imposed on conventional institutions are not applicable to their real estate portfolios. *See* Downturn, *supra* note 6. Valuation issues for different asset categories are considered in Sophie Evans, *Special Report: Real Estate-Downturn Hits Office Space Supply in Dubai*, MEED, Sept. 30, 2009, http://www.meed.com/sectors/construction/real-estate/special-report-real-estate-downturn-hits-office-space-supply-in-dubai/3001067.article, and related linked articles [hereinafter SRRE]. Increased loan loss provisioning is discussed in Melissa Hancock, *Bad Debts Increase Loan Provisions in the Gulf*, MEED, Sept. 1, 2009, http://www.meed.com/sectors/finance/banking/bad-debts-increase-loan-provisions-in-the-gulf/3000266.article.

8. *See Gulf Seeks to Revitalize Debt Markets*, MEED, Apr. 16, 2009, http://www.meed.com/sectors/economy/gulf-seeks-to-revitalise-debt-markets/2019428.article; *Islamic Banks Fill Funding Gap for Regional Projects*, MEED, Apr. 8, 2009, http://www.meed.com/sectors/economy/islamic-banks-fill-funding-gap-for-regional-projects/ 2017758.article; *Special Report: Banking-Short-Term Loans Plug Finance Gap*, MEED, Feb. 22, 2009, http://www.meed.com/sectors/finance/banking/special-report-banking-short-term-loans-plug-finance-gap/1995533.article.

9. *See* SRRE, *supra* note 7; Sovereigns, *supra* note 5.

larly in Saudi Arabia.[10] Some securitization-type benefits were obtained through cross-collateralized pool financing with commercial banks. There were also changes in the structures used in *Sharia*-compliant financings. For example, mini-perm models (construction loans bundled with brief term loans) expanded from the real estate realm to project financings. The assumption is that there will be a refinancing upon term maturity when construction is complete and operational parameters (and markets) are better defined.[11] And the use of *murabaha* facilities, both term and revolving, has increased dramatically. The *murabaha* is the most frequently used, and, particularly in its metals *murabaha* manifestation, the most frequently abused, structure in Islamic finance.[12]

II. Structuring Shari'ah-Compliant Funds and Recent Trends*

Although "2009 [ ] presented challenges for the funds industry," many "investors in the Middle East still see the value of pooling money into a fund to acquire [undervalued and available] companies and properties globally. . . ."[13] "Many investors in the Gulf Cooperation Council (GCC)[14] countries prefer to" invest "in a *Shari'ah*-compliant fund rather than a conventional fund for religious reasons."[15] "As the *Sukuk* ([Islamic bonds] market has slowed" and "available financing has receded, real estate and private equity firms [ ] increasingly turn[ ] towards *Shari'ah* compliant funds to secure the capital" needed for new investment opportunities.[16]

In general,

> [a] *Shari'ah* compliant fund operates like a conventional fund, but several key differences exist: [i] inability to make investments in companies in sectors that are not *Shari'ah* compliant (*haram*), [ii] certain requirements that investors be treated equally, [iii] inability to utilize conventional financing or invest in companies highly leveraged with conventional debt and [iv] requirement for oversight of fund activities and investments by a *Shari'ah* Board.[17]

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10. A study of all *sukuk* issuances, globally, to November 7, 2009, is found in Michael McMillen & John A. Crawford, *Sukuk in the First Decade: By The Numbers*, DOW JONES ISLAMIC MARKET INDEXES Q. NEWSL., Dec. 2008, at 3, *available at* http://img.en25.com/Web/DowJonesIndexes/DJIM_QNL_120408.pdf.

11. *See* Michael J.T. McMillen, *Islamic Shari'ah-Compliant Project Finance: Collateral Security and Financing Structure Case Studies*, 24 FORDHAM INT'L L.J. 1184, 1243-1247 (2001) (regarding *Shariah*-compliant mini-perm structures in real estate financings).

12. The metals *murabaha* is *Shariah*-compliant in form, but the metal is a vector, not the true object of the transaction. *Shariah* scholars permit, but disfavor these transactions. *See* INVESTING IN THE GCC MARKETS: REGIONAL OPPORTUNITIES AND CHALLENGES (Sohail Jaffer & Kamal Jaffer, eds., 2007); MUHAMMAD TAQI USMANI, AN INTRODUCTION TO ISLAMIC FINANCE (1999).

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13. Nabil Issa & James Stull, *Structuring Shari'ah-compliant Funds*, ISLAMIC FINANCE NEWS LEADING LAWYERS REPORT 2009, Aug. 1, 2009, at 35, *available at* http://www.islamicfinancenews.com/supplement_Leading_Lawyers_2009.asp.

14. The GCC countries are comprised of Bahrain, Kuwait, Oman, Saudi Arabia, Qatar, and the United Arab Emirates. *See* The Cooperative Council for the Arab States of the Gulf-Secretariat General, Member States, http://www.gcc-sg.org/eng/index.php?action=GCC (last visited Feb. 2, 2010).

15. Issa & Stull, *supra* note 13, at 35.

16. *Id.*

17. *Id.*

A. Restricted Investments

"Whether an investment fund is *Shari'ah*-compliant [ ] makes a significant difference" in terms of "how and where the fund may invest its capital."[18] "A *Shari'ah*-compliant fund cannot invest in companies or assets that are" not themselves *Shari'ah*-compliant.[19] The ultimate list of *haram* investments will be determined by the fund's *Shari'ah* Board. Companies that would be *haram* include those that:

- produce, sell, trade, or distribute pork-related products;
- engage in pornography or obscenity;
- engage primarily in the entertainment business;
- engage in gambling, casinos, lotteries, or related businesses;
- conduct conventional financing or insurance;
- produce weapons or are involved in the defense industry; or
- produce, sell, trade or distribute alcoholic beverages, tobacco or related products.[20]

"Careful consideration must be paid" when "target[ing] investment companies that could derive partial income from" "*haram* activities, such as supermarkets, airlines, hotels, and restaurants that may sell pork [and] alcohol."[21] "[A]ny *haram* income of a non-compliant target company that does not exceed [five] percent of overall gross income is [generally] considered marginal or incidental."[22] "The target company would then be considered acceptable, provided [that] sufficient cleansing or income purification occurs in accordance with the guidelines set forth by the *Shari'ah* Board."[23]

"Avoiding interest *(riba)* and conventional debt is critical to a *Shari'ah*-compliant fund when leveraging an acquisition or investment."[24] "*Shari'ah*-compliant financing is readily available in the GCC, but in other parts of the world a fund manager may struggle to find a bank that is willing [to] and capable of providing financing on a *Shari'ah*-compliant basis."[25]

Although *Shari'ah*-compliant funds "are still viewed as a niche practice for raising capital," "the success of many of these funds"—paired with the "struggles of fund managers to raise money"—have prompted many fund managers to research "*Shari'ah*-compliant funds to improve their chances of accessing liquidity in the GCC."[26] "Fund managers wishing to form a *Shari'ah*-compliant fund need to" take into account a number of considerations, "including: [i] the process of appointing the *Shari'ah* Board[,] [ii] local law restrictions and tax consequences depending on the domicile and ownership of the fund[,] [and] [iii] [ ] acquisition structures that contemplate how a *Shari'ah*-compliant financing will be structured in the jurisdiction of the potential target companies or real estate.[27]

18. *Id.*
19. *Id.*
20. *See, e.g., id.*
21. *Id.*
22. *Id.*
23. *Id.*
24. McMillen, *supra* note 11, at 1184.
25. Issa, *supra* note 13, at 36.
26. *Id.* at 37.
27. *Id.*