

No Pain, No Gain: The State of the Industry in Light of an American Islamic Private Equity Transaction

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I. INTRODUCTION

Islamic finance is the recent attempt to bring into compliance with the Divine the finances and economies of both individuals and nations. This attempt follows from a recognition by Muslims that the assumptions, regulations, and objectives of the conventional financial order are not wholly consistent with their religion.¹ It is one of the few areas in which there is an active, contemporary effort by Muslims and those of other faiths to implement the tenets of the Islamic religion to the challenges of the modern world.²

Islamic financial transactions regularly take place in jurisdictions, including Muslim majority nations as well as Europe and the US, in which Islamic law is not the law of the land. Frequently, these transactions play an instructive role because they represent instances of first impression in some form. These include cases where contemporary Muslim jurists have not yet issued legal opinions, or *fatawa*.³ Moreover, these transactions often necessitate creativity in response to the tensions that arise from the interaction between and required compliance

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¹ The author uses the terms “conventional” and “modern” in this Article to refer to the currently dominant financial and banking order. For additional discussion, see Umar F. Moghul and Arshad Ahmed, *Contractual Forms in Islamic Finance Law and Islamic Inv. Co. of the Gulf (Bahamas) Ltd. v. Symphony Gems N.V. & Ors.: A First Impression of Islamic Finance*, 27 *Fordham Intl L J* 150, 156–57 (2003).

² Rules of trade and finance are part and parcel of the Islamic legal system by which Muslims conduct their lives and according to which Muslims order their finances and businesses. The rules of Islamic finance are understood as law. See *id.* at 157–63.

³ A fatwa may be understood as a legal opinion. See generally Muhammad Khalid Masud, Brinkley Messick, and David Powers, eds, *Islamic Legal Interpretation: Muftis and Their Fatwas* (Harvard 1996).

with two or more legal systems, as well as from practical contemporary considerations.

This Article focuses on the classical Islamic contract form of *sharikah* as it is currently implemented by contemporary Islamic private equity transactions. A number of key issues arising from a transaction, in which the author served as counsel to an Islamic investment bank acquiring a non-controlling share in a US company, are presented below to demonstrate the increasing ability of Islamic finance to implement a greater portion of its substantive concepts—a point that demonstrates the industry’s successes in its initial phase. This transaction (“subject transaction”) also shows the impact of Islamic principles on conventional private equity arrangements and highlights some similarities and differences between contemporary Islamic financial practice and classical jurisprudence.⁴

II. THE STATE OF THE INDUSTRY: SOME REFLECTIONS

A common criticism of Islamic finance relates to whether it has remained true to classical Islamic law. Certain critics lament the absence of equity financing structures, despite their contended parallel with the “essence” of Islamic finance. These critics argue that Islamic laws pertaining to business transactions and finance place a strong emphasis on profit- and loss-sharing among transaction participants, including capital providers. In support of this argument, various texts, including the important *hadith*, which states “[Entitlement to] profit must be accompanied by a liability for loss,” are often quoted.⁵ Proponents of this position generally find that the Islamic contract form known as *sharikah*,⁶ a form of joint ownership often translated as

⁴ Readers are encouraged not to assume that if there is a difference between contemporary practice and classical Islamic law, such a difference is inappropriate or somehow un-Islamic. It should be noted that there are a number of important topics related to our subject matter that are beyond the scope of this Article. For example, certain contemporary concerns, such as the use of *sharikah* as a financing mechanism and the securitization of such financings or of private equity pools generally, are not discussed here.

⁵ In Arabic this statement reads: “*Al-kharaj bi al-daman.*” See Sunan Abu Dawud, *Wages (Kitab Al-Ijarah)* No 3501 (undated); Ibn Majah, 2 *Sunan Ibn Majah* 754 (Cairo: ‘Isa al-Babi al-Halabi wa Shurakah undated); Ibn Qayyim, 2 *I’lam al-Munwaqqi’in* 20 (Dar al-Kutub al-Hadithah 1969). There are other maxims that carry the same meaning, such as “*Al-ghurm bi al-ghumm.*” See, for example, Abdul Basir bin Mohamad, *Vicarious Liability: A Study of the Liability of Employer and Employee in the Islamic Law of Tort*, 15 Arab L Q 197, 203 & n 32 (Feb 2000). *Hadith* may be understood as the written record of the Sunnah (defined below). See generally, Ibn Salah al-Shahrazuri, *An Introduction to the Science of the Hadith (Kitab Ma’rifat annwa’ ilm al-hadith)* (Garnet 2006) (Dr. Eerik Dickinson, trans).

⁶ Contemporary Islamic finance has come to prefer the term *musharakah*, derived from the same root as the word *sharikah*. Both terms are commonly translated as “partnership” and denote a certain form of co-ownership, as further explained below. To prevent possible confusion with

“partnership” and defined in greater detail below, most closely approximates modern conventional private equity transactions in which there is joint contractual ownership in an enterprise. To date, however, Islamic financial transactions have been based primarily on two alternative forms: the *murabahah* contract,⁷ and the *ijarah* contract.⁸ Proponents of *musharakah*, or of Islam’s profit- and loss-sharing principles, lament the overuse of these two forms largely because they allow Islamic bankers to more easily and closely mimic the substance and economics of prohibited conventional financings, such as interest-bearing loans.

While this contention is not without merit, it does not account for the youth of the Islamic finance industry among the other social, economic, and political realities in which the industry is situated. Given the current operational structure of Islamic banks and the nature of the risks involved in equity transactions, Islamic banks may not yet be fully ready to regularly undertake such investment transactions.⁹ Moreover, the use of *murabahah*- and *ijarah*-based transactions, and the current state of Islamic private equity, must both be understood in light of the goals of the Islamic finance industry’s first phase. Having begun only some thirty to forty years ago, and given the current state of its development, Islamic finance is only in its nascent stages as an industry. As such, Islamic finance occupies a niche within the larger world of conventional finance—a world within which it must successfully operate and a world that

partnership under certain modern nations’ laws, I have endeavored to use the Arabic terms. Where the Arabic term is not used, readers are asked to keep in mind that a *sharikah* is not the exact equal of a partnership under Anglo-American laws.

⁷ The term *murabahah* is often translated as “cost plus mark-up sale.” See generally Mahmoud El-Gamal, 1 *Financial Transactions in Islamic Jurisprudence: A Translation of Dr. Wabba al-Zuhayli’s Al-Fiqh al-Islami wa Adillatuhu (Islamic Jurisprudence and its Proofs)* 381–434 (Dar al-Fikr 1997) (hereinafter cited to as al-Zuhayli, 1 *Financial Transactions*). The Maliki school defines the *murabahah* contract as one in which a “seller informs [a] buyer of the cost at which the seller obtained an object of sale, and collects a profit margin either as a lump sum, or the seller may state the profit margin as a percentage or ratio of the seller’s original purchase price.” Id. Contemporary *murabahah* transactions may be described as follows: a buyer requests a party (the seller) to purchase an item so that the buyer can, in turn, purchase such item for the seller. The seller informs the buyer of the seller’s price and costs and the two agree upon a profit margin. Generally, in contemporary Islamic financial transactions, the seller is a financial institution and the sale by the seller to the buyer occurs on a deferred installment basis. See Moghul and Ahmed, 27 *Fordham Intl L J* at 173 (cited in note 1).

⁸ An *ijarah* is a lease contract that has been extended in contemporary Islamic finance to the context of finance leases as well as operating leases. For a discussion of classical rules relating to *ijarah*, see al-Zuhayli, 1 *Financial Transactions* at 381–434 (cited in note 7).

⁹ See generally Habib Ahmed, *Operational Structure for Islamic Equity Finance: Lessons From Venture Capital* (Islamic Research and Training Inst 2005), available online at <<http://www.irtipms.org/OpenSave.asp?pub=212.pdf>> (visited Jan 15, 2007).

evaluates it by assumptions, theories, and parameters that are not wholly consistent with those of Islamic finance or the religion of Islam.

Generally, the beginning stages of Islamic finance may be said to have the following goals: (i) educating the market with respect the underlying rationale of Islamic finance, its need, and its differentiation from conventional finance; (ii) implementing and manifesting at least some underlying principles through the consummation of transactions; (iii) establishing bodies for the purposes of education and self-regulation, among others;¹⁰ and (iv) garnering recognition within the greater financial and political community as a viable—and perhaps morally and economically superior—means of conducting business through the demonstration of demand, transaction consummation, and profit.

Initially, Islamic finance had little choice but to place itself in the broader international financial arena, thus facing numerous challenges with respect to educating and persuading financial institutions and authorities. In addition, Islamic finance practitioners face regulatory frameworks that either are not designed to cover Islamic transactions or are preferential to conventional finance. Practically speaking, these regulatory frameworks cannot be expanded or modified quickly. It therefore was—and perhaps still is—both impractical and unwise in such a context to seek to conduct purely or predominantly equity transactions along Islamic lines.

The difficulty in undertaking Islamic financial transactions within the conventional finance paradigm must not be underestimated. Looking only to the US, the applicable regulatory framework can be very restrictive when it comes to certain aspects of Islamic transactional law. The efforts of the Office of the Comptroller of the Currency (“OCC”) (and some state authorities, such as that of Connecticut),¹¹ for instance, which are very important and ought to be applauded, permit US banks to engage in Islamic transactions but on terms that favor a more formalistic approach averse to certain risk allocations prescribed by Islamic law.¹² To these challenges, there are alternatives, including the persistent education of the financial and regulatory communities and the exploration of

¹⁰ Such organizations include the Islamic Financial Services Board (“IFSB”) and Accounting and Auditing Organization for Islamic Financial Institutions (“AAOIFI”). For more information, see generally IFSB, available online at <<http://www.ifsb.org>> (visited Jan 15, 2007); AAOIFI, available online at <<http://www.aoifi.com>> (visited Jan 15, 2007).

¹¹ State of Connecticut, Department of Banking, Advisory Opinion, No 2 (Nov 10, 2005).

¹² Of course, the OCC letters concerning *murabah* and *ijarah* do not specify what principles of Islamic law cannot be adhered to. They are concerned with how lawfully to conduct such transactions under US banking regulations. See Mahmoud A. El-Gamal, “Interest” and the Paradox of Contemporary Islamic Law and Finance 23, available online at <<http://www.ruf.rice.edu/~elgamal/files/interest.pdf>> (visited Jan 15, 2007).

alternative capital sources and financiers capable of greater structural flexibility, and thus greater compliance with Islamic laws.

Having primarily employed *musharakah* alongside *mudharabah*¹³ as the foundation of the Islamic finance industry would have exposed what is in effect a start-up industry to great risk of financial loss through the inherent risks of such transaction forms.¹⁴ Furthermore, during the early stages of Islamic finance, the exclusive or almost exclusive utilization of *musharakah* and *mudharabah* would have been an even greater concern because of the deficiency of human capital and the dearth of targets for equity investing in the Muslim world. Moreover, this arguably less-compromising stance would have prevented necessary diversification. This latter consequence by itself could have threatened the viability of Islamic finance by limiting its attractiveness. By utilizing *murabahah* and *ijarah* as they did, Islamic financiers found greater common ground with conventional finance and thereby limited transactional and certain other risks and reduced various burdens, such as those relating to education and approval. Industry proponents and participants selected a means by which Islamic finance would most probably become better able to achieve its initial aims.¹⁵

The path selected by Islamic finance has raised the question whether finding common ground with conventional finance was best achieved by largely replicating the substance though not the form of conventional transactions.¹⁶ Islamic finance, as noted previously, has to date largely consisted of *murabahah*- and *ijarah*-based transactions—the risk and return profiles of which bear striking similarities to conventional instruments and mechanisms, but the outward forms of which differ. For example, most everyone would agree that *ijarah* transactions are an important tool for the Islamic (or any other) financier. But actual contemporary Islamic leasing transactions in the US have raised the question

¹³ The *mudharabah*, a silent or limited partnership contract, involves the contribution by an owner of capital to one who will manage or invest that capital on the former's behalf. Profits are shared using an agreed upon formula (generally speaking). Financial losses are borne by the provider of capital while the entrepreneur can lose only his efforts. See al-Zuhayli, 1 *Financial Transactions* at 487–501 (cited in note 7).

¹⁴ Of course, the religious counterargument based on *tawakkul* (reliance on God) could be made here and would not be without merit. Consider Abu Hamid al-Ghazali, *Faith in Divine Unity & Trust in Divine Providence* (Fons Vitae 2001) (David Burrell, trans). See also Charles Tripp, *Islam and the Moral Economy: The Challenge of Capitalism* 142–43 (Cambridge 2006) (“Bad decisions by a number of [Islamic] banks in the early, optimistic years of Islamic banking had led to considerable losses and diminished the attraction of [*musharakah* and *mudharabah*] financing as a general rule.”).

¹⁵ Probability can be and very often is binding in Islamic law. See Bernard G. Weiss, *The Spirit of Islamic Law* 88–112 (Georgia 1998).

¹⁶ Of course, there are a few who would argue whether finding common ground was itself appropriate.

why rules pertaining to loss sharing and risk allocation are not fully implemented.¹⁷

In response to these concerns, one might argue that immediate implementation of the substance of Islamic financial laws,¹⁸ wholly and without compromise, would have likely resulted in failure—or at least been less likely to achieve success.¹⁹ Islamic finance proponents increasingly contend that more of the substance of Islamic laws could have been, or now should be, implemented in light of the purposes of Islamic finance and the economic success it has seen. As interest by Muslims in their religion increases, this will likely result in greater substantive implementation coupled with the appropriate forms. An alternative approach might be to regulate some of the existing conventional institutions and mechanisms with the substantive rationale of classical Islamic legal principles.

The current course of Islamic finance may very well prove to have been wise. Conducting and closing transactions has revealed the industry's deficiencies as well as its strengths while allowing a jurisprudence to develop gradually in light of actual instances and realities. Perhaps then, the reliance on *murabahah* and *ijarah* during this introductory phase was appropriate. Yet, it does not follow from such a conclusion that these two contract forms, as currently implemented, are the most suitable methods for approaching the next phases of Islamic finance, which proponents of Islamic finance hope to be more

¹⁷ It must be noted that *ijarah* transactions vary from jurisdiction to jurisdiction. Some such transactions can be and are arguably more compliant with Islamic principles than others.

¹⁸ The distinction between form and substance is a matter addressed by the discipline of *ta'li*, or ratiocination, within Islamic jurisprudence. Consider Ahmad Raysuni, *Imam al-Shatibi's Theory of the Higher Objectives and Intents of Islamic Law* xiv (Intl Ins of Islamic Thought 2005). Jurists have generally held that each rule of law in the realm of *mu'amalat* (temporal, in distinction to spiritual matters) is based on an occasioning factor or effective cause (*'illah*) and a rationale (*bikmah*) to bring about ease and remove hardship. Id at xxv–xxx.

The theory of objectives is generated by sound, rational investigation based on the belief that the Law of God can be nothing other than a law of wisdom and mercy, justice and equity, judicious planning and accurate assessment, since it is on the basis of these qualities that God deals with all His creatures, and since they are necessitated by Divine perfections.

Id at xxxiv. Matters of contract and finance fall in the realm of *mu'amalat*: the realm of Islamic law that is mutable and dynamic, and thus consistent with the temporal and material aspects of human existence and life in this world. This is of special significance to contemporary Islamic finance since classical Islamic legal theories envision the necessity of applying Islamic principles to newly arisen contexts and provide for mechanisms to create new laws. At a particular level, the “substance” of Islamic law—important for constructing new law—might be said to be found in the preservation of the *'illah* and *bikmah*, as well as in the purposes of the law (*maqasid al-Shari'ah*). Id at xxv–xxx. Form is an important consideration not to be cast aside quickly, for it is seen by many jurists as a probable indicator that the substance of the law has been implemented.

¹⁹ I must note that this argument should not be construed as a justification for hyper-formalism or for building a body of law based on exceptions resulting from doctrines of need and necessity.

substantively innovative. A number of sociological realities have come to pass over the last few years enabling the subject transaction and that will likely further enable Islamic financiers to venture more consistently and more deeply into the realm of private equity with a higher probability of success.²⁰ This has and will continue to bring about the industry's desired objectives.

III. PRIVATE EQUITY IN THE MIDDLE EAST: A BRIEF OVERVIEW

Since its inception, the value of assets managed by Islamic finance has grown quickly. Similarly, the number of regularly contributing financial institutions has increased, particularly in the Muslim world where a number of previously conventional institutions have either added Islamic windows or converted their operations entirely in an effort to comply with Islamic principles and meet customer demand. In support of this growth, the number of those servicing the industry, whether by providing legal advice, accounting services, or technological support, has increased.

Although the industry's size remains relatively small at approximately 1 percent of aggregate regional GDP,²¹ private equity in the Muslim world has seen tremendous growth in the recent past.²² Having raised, for example, \$2.3 billion in 2005, private equity has become one of the fastest growing sectors in the Gulf Cooperation Council area ("GCC").²³ As of October 2005, of the approximately 46 private equity funds operating in the Middle East, over 48 percent are in the fundraising stage.²⁴ By some estimates, this industry has experienced a compounded annual growth rate of approximately 41 percent over the 5-year span ending in 2004.²⁵ This growth has been fueled in part by high oil

²⁰ This is of course not to imply or infer that *ijarah* or *murabahab* transactions should be abandoned wholesale, but perhaps further modified in their implementation to accord with the goals of Islamic finance's coming phases. The ability to make such modifications when a US bank is involved is severely limited because of US banking regulations and most US banks' expectations.

²¹ See Khaled Fouad and Syed Farhan Zeidi, *Middle East Private Equity: The Sleeping Giant*, Banker Middle East (Oct 2005), available online at <http://www.bankerme.com/bme/2005/oct/national_investor.asp> (visited Jan 15, 2007).

²² *Middle East Private Equity Industry 'Gaining Ground'*, Gulf Daily News (May 7, 2006), available online at <http://www.gulf-daily-news.com/1yr_arc_Articles.asp?Article=142924&Sn=BUSI&IssueID=29048&date=5/7/2006> (visited Jan 15, 2007).

²³ See Unicorn Investment Bank, *Global Private Equity Division*, available online at <<http://www.unicorninvestmentbank.com/default.asp?action=article&ID=37>> (visited Jan 15, 2007).

²⁴ Fouad and Zeidi, *Middle East Private Equity* at 1 (cited in note 21).

²⁵ *Abraaj Launches ME Private Equity Report*, Abraaj Capital Press Release, available online at <http://www.abraaj.com/mediacenter/Files/pr/AbraajFILE_13-5-2006_03-37-48_28_Abraaj_launches_ME_PE_report.pdf> (visited Jan 15, 2007).

prices and the various factors encouraging investors to keep their wealth in local markets.²⁶ Of course, significant challenges remain, including the dearth of corporate targets, which has resulted in the deployment of only 8 percent of raised funds,²⁷ and the absence of a broader culture of early stage venture capital to support later stage private equity. A strong infrastructure supporting private equity—including IT services for back end support, more accessible angel investors, and effective marketing services—is also very much needed.

Islamic private equity, as a subset of the broader Middle Eastern private equity market, has also grown. The first Islamic investment fund was launched during the 1980s and, over the past fifteen years, Islamic private equity has gradually evolved.²⁸ In the US, Islamic private equity has been in existence for about a decade, beginning (to the best of our knowledge) with the operations of Arcapita in 1997, which has focused on US and European private equity deals in the form of corporate and real property investments.²⁹ Other Islamic private equity firms transact in the US from time to time, often in real estate and increasingly in privately held companies. Most do not maintain a regular physical presence within the US, unlike Arcapita and the more recently established Unicorn Investment Bank.³⁰ Generally, Islamic private equity firms have acquired controlling interests in their targets to ensure, among other things, that they continue to operate per Islamic law post-investment.

IV. ISLAMIC LAW AND JURISPRUDENCE

One cannot properly understand Islamic finance without first grasping, at least at a basic level, Islamic law and jurisprudence. The Shari`ah³¹—frequently, but incompletely, translated as “Islamic law”—constitutes the interaction of beliefs, values, and legal guidelines designed to maintain a proper balance

²⁶ Tariq al-Rifai, *Private Equity Funds Shine as Local Stock Markets Decline*, Islamic Bus & Fin Mag 26–28 (Apr 26, 2006).

²⁷ Rima Fattouh and Abe S. Saad, *Private Equity in the Middle East: No Longer a Mirage*, 23 ABANA Rev 1 (Fall 2006).

²⁸ Al-Rifai, *Private Equity Funds Shine* at 26 (cited in note 26).

²⁹ *About Arcapita: Overview*, available online at <<http://www.arcapita.com/about/corporate/overview.html>> (visited Jan 15, 2007). See also Arthur Macdonald, *Arcapita Finalises \$4.2b Irish Electricity Takeover*, Bus Trib 16 (Dec 11, 2006) (stating that Arcapita has completed transactions valued in the aggregate in excess of \$18 billion).

³⁰ See *Unicorn Investment Bank* (cited in note 23).

³¹ For a general introduction to Islam, see Roger DuPasquier, *Unveiling Islam* (Islamic Texts Society 1992) (T.J. Winter, trans). One must not assume that because a matter is law within Islam that it is therefore to be enforced by some governmental authority. See Sherman A. Jackson, *Islamic Law and the State: The Constitutional Jurisprudence of Shihab al-Din al-Qarafi* 185–224 (EJ Brill 1996).

between the spiritual and temporal components of existence in this world and the Hereafter.³²

The primary sources of the Shari`ah are the Qur'an³³ and the Sunnah and the rules contained therein.³⁴ Detailed practical laws are derived by the application of *usul al-fiqh*: the methods of reasoning and rules of interpretation applied to the texts of the Shari`ah. The result of this interpretive process is known as *fiqh*, a term the author has chosen to translate as "Islamic law."³⁵ Jurists acknowledge that although the sources of Islamic law are divine, their derivation and application is a construct of the human intellect. This is reflected in the epistemology of the legal reasoning they constructed.³⁶

The goals and objectives of the Shari`ah are known in Arabic as *maqasid al-Shari`ah*.³⁷ Securing benefit and preventing harm in this life and in connection with the Hereafter are the most important considerations (*maslahah*) of Islamic law.³⁸ In order for any rule of Islamic law to be valid and applicable, it must not, among other things, violate the ultimate intent and purpose of the Shari`ah.³⁹

³² Moghul and Ahmed, 27 Fordham Intl L J at 158 n 24 (cited in note 1) (stating "The terms 'Islamic law' and Shari`ah are frequently used interchangeably in Western scholarship. It is an oversimplification, however, to equate the Shari`ah with law. The Shari`ah—which we have deliberately chosen not to translate in this Article—may be said to contain law, but one must also recognize that it embraces elements and aspects that are not, strictly speaking, law because they are beyond our conventional understanding of law."). See also Bernard G. Weiss, *The Search for God's Law: Islamic Jurisprudence in the Writing of Sayf al-Din al-Amidi* 1 (Utah 1992).

³³ For Muslims, the Qur'an is the "the book containing the speech of God revealed to the Prophet Muhammad." Mohammad Hashim Kamali, *Principles of Islamic Jurisprudence* 16 (Islamic Texts Society 2003). The Qur'an contains approximately five hundred specific legal injunctions and, for the most part, sets general guiding principles. See Irshad Abdal-Haqq, *Islamic Law: An Overview of Its Origin and Elements*, 1 J of Islamic L 1, 21 (1996).

³⁴ Michael Mumisa, *Islamic Law: Theory and Interpretation* 56 (Amana 2002) ("In its juristic usage, Sunnah refers to the normative practice set up by the Prophet of Islam as a model; his sayings, doings, and tacit approvals which were later established as legally binding precedents in addition to the law established by the Qur'an.").

³⁵ See Jackson, *Islamic Law and the State* at 121 (cited in note 31) (translating *fiqh* as "practical jurisprudence proper").

³⁶ See, for example, A. Kevin Reinhart, *When Women Went to Mosques: al-Aydini on the Duration of Assessments*, in Masud, Messick, and Powers, eds, *Islamic Legal Interpretation* 116 (cited in note 3).

³⁷ See generally Raysuni, *Higher Objectives and Intent* (cited in note 18). See also Imran Ahsan Khan Nyazee, *Theories of Islamic Law: the Methodology of Ijtihad* 237 (Islamabad: Islamic Research Inst 1994) ("Theories") (stating that, according to al-Shatibi, the purposes of the law have been inferred inductively from the texts).

³⁸ Id at 242–44 (commenting that there is a lengthy and rich discourse surrounding the ultimate intent of the law and the Lawgiver).

³⁹ Id at 222–23, 242. In addition to the concepts of *maslahah* and *maqasid al-Shari`ah*, there exists the concept of ratiocination, or *ta`lil*, employed by Muslim jurists when searching into, and deriving Islamic law from, the Shari`ah. Here, Islamic jurisprudence is concerned with the occasioning

A. LEGAL MAXIMS

Islamic legal maxims generally take the form of short phrases or sentences that express a general principle or objective of the Shari`ah derived from the corpus of *fiqh*. As such, they should not be confused with the discipline of *usul al-fiqh*, which is used to derive law from the Qur'an and Sunnah. While some legal maxims apply only to specific branches of the law, others (known in Arabic as *al-qawa'id al-fiqhiyyah al-asliyyah*) are of general application.⁴⁰ Since legal maxims are stated so briefly and in such general terms, they rarely apply absolutely or without exception or particularization.⁴¹

B. THE LEGAL MAXIM AT HAND

The maxim "*al-kharaj bi-daman*" is a *hadith*, the meanings and implications of which are supported by various other texts of the Shari`ah.⁴² Jurists have constructed additional maxims with the same meaning and import, all derived from a myriad of textual sources. That the source of this particular maxim *is* (as opposed to having been derived *from*) a Prophetic statement strengthens its authority as a principle, and this authority is then further strengthened by the presence of numerous other textual sources presenting similar content. As a general, rather than specific Islamic legal maxim, it must be considered and relied upon in light of other Islamic laws. Moreover, the maxim is applicable as a general rule in all financial arrangements, whether private equity, leasing, or otherwise.

One may argue that the primary purpose of this particular maxim is to more fairly balance or situate counterparties. Read in isolation, one may think

factor (*'illah*) and rationale (*bikmah*) of a law to assist not only in understanding, but further extending and applying the law. The establishment and preservation of the *maqasid al-Shari`ah* follows from proper application of *ta'lil*. For more information regarding the science of ratiocination (*ta'lil*) in Islamic jurisprudence, see Muhammad Mustafa Shalabi, *Ta'lil al-Abkam* (Beirut: Dar al-Nahda al-Arabiyya 1981).

⁴⁰ These general maxims include: (i) "Harm must be eliminated," (ii) "Acts are judged by their intentions," (iii) "Custom is the basis of judgment," and (iv) "Certainty is not overruled by doubt." See Mohammad Hashim Kamali, *Qawa'id al-Fiqh: The Legal Maxims of Islamic Law*, 3 Muslim Lawyer (Oct 1998), available online at <<http://aml.org.uk/journal/3.2/Kamali%20-%20Qawaid%20al-Fiqh.pdf>> (visited Jan 15, 2007) (noting that the development of legal maxims represents a somewhat latent development in Islamic legal history).

⁴¹ For example, the maxim "custom is the basis of judgment" permits a court of law to rule on the basis of customary practice where a text of the Shari`ah does not regulate the matter; provided, however, among other things, that such customary practice is not inconsistent with the Shari`ah. Consequently, when a contract is silent as to how an issue is to be addressed, the customary rule may be dispositive. *Id.*

⁴² Readers are reminded that this statement may be translated as "[Entitlement to] profit must be accompanied by a liability for loss."

that this maxim allows the payment and receipt of interest on a loan of money because a conventional lender bears a credit risk. Alternatively, one might contend that this maxim unfairly requires a financier to bear market risks in addition to bearing the opportunity cost of unavailable capital. Relying on the prohibition of *riba* (discussed below), a Muslim jurist might counter that the mere lending of money does not entitle one to gain, for such a gain is unjust for a variety of economic reasons that underlie its forceful condemnation by the Shari`ah. Capital providers must, therefore, also share in the risk of the financed asset or venture along with its other owners. Wealth (*mal*) alone does not provide sufficient entitlement to profit.⁴³ Moreover, and perhaps more interestingly, a Muslim jurist might also present the converse: a party should not be taxed with a burden—the market risk—without a corresponding right to gain.⁴⁴

This maxim thus addresses issues of liability, distinguishing lawful profit from other receipts on capital as well as labor, which may constitute *riba* if there is no corresponding, appropriate liability for loss.⁴⁵ As such, this legal maxim significantly impacts the rights and responsibilities of investors and issuers in private equity transactions.

C. ISLAMIC FINANCIAL LAWS

In many respects, Islamic finance is akin to socially conscious investing since there are, what we might term, substantive principles that speak to the lawfulness of an investment. These laws guide, as to the purpose for which invested money is used, the selection of the target company based on its line of business and the selection of activities that will be advanced by the invested capital. Industries such as gambling, pornography, alcohol, tobacco, and conventional financial and insurance industries are prohibited under these substantive principles.

However, unlike socially conscious investing, Islamic finance also offers procedural principles that speak to the mechanism by which financing or investing occurs. These principles are primarily, though not exclusively, concerned with how capital providers invest money. These rules, especially those

⁴³ The Hanafi jurist al-Kasani writes: “The rule in our view is that entitlement to profit is either due to wealth . . . or work . . . or by bearing a liability for loss As for entitlement [to profit relating to wealth], it is obvious, because profit is a growth in wealth and belongs to its owner. It is for this reason that the *rabb al-mal* in a contract of *mudarabah* is entitled to profit and likewise the partner.” Imran Ahsan Khan Nyazee, *Islamic Law of Business Organizations: Partnerships* 69–70 (Kitab Bhavan 1999).

⁴⁴ Admittedly, there are Islamic directives as to what constitutes proper burden and legitimate gain.

⁴⁵ Nyazee, *Partnerships* at 42 (cited in note 43).

prohibiting *riba*, overlap somewhat with the substantive principles by governing how profits and losses are allocated and distributed.

D. THE PROHIBITION OF *RIBA*

Perhaps the most well-known principle of Islamic finance is its prohibition of *riba*, which in its most common contemporary understanding, is said to include interest on a loan.⁴⁶ One reason advanced for this is that the Shari'ah countenances lending money as a charitable activity and not as a profit-making venture.⁴⁷ The prohibition of *riba* also applies to trading that involves certain other commodities, such as certain foodstuffs, gold, and silver. When these commodities are traded, the trades must be made in equal measure and without deferment.⁴⁸ As can be expected, *riba* presents many other complexities and subtleties for financial transactions.

Instead of financing a venture through a “plain vanilla” interest bearing loan, what we commonly find today in Islamic finance is the use of leasing and asset sales or financings where the contribution of money is tied to risk relating to an asset. As explained above, this is because rules derived from the prohibition of *riba* demand that a financing party bear risk in order to earn profit. This risk must not only be a credit risk—for otherwise interest on a loan would be permitted if not encouraged—but a market or entrepreneurial risk as well. Partnerships and equity arrangements in which the capital provider's profits and losses are contractually tied to that of the venture thus lend themselves more readily to Islamic finance and are arguably more compliant than other more common arrangements seen in contemporary Islamic finance. Yet there are important distinctions between conventional private equity transactions and Islamic principles.⁴⁹

⁴⁶ Compare al-Zuhayli, 1 *Financial Transactions* at 338 (cited in note 7). Muslim jurists have almost unanimously forbidden commercial bank interest. *Id.* at 339–52 (presenting and refuting the arguments of those who contend that banking interest should be permitted).

⁴⁷ See Frank Vogel and Samuel Hayes, *Islamic Law and Finance: Religion, Risk and Return* 77–86 (Kluwer 1998); Ibn Rushd, 2 *The Distinguished Jurist's Primer: A Translation of Bidayat al-Mujtahid* 158–75 (Garnet 1996) (Imran Ahsan Khan Nyazee, trans).

⁴⁸ Al-Zuhayli, 1 *Financial Transactions* 311–14 (cited in note 7) (explaining the types of *riba*).

⁴⁹ Also worthy of mention, though less relevant to our discussion of the subject transaction than the prohibition of *riba*, is the prohibition of *bay' al-gharar* (aleatory sales). “[T]he prohibition against sales involving risk and uncertainty (*bay' al-gharar*) is based on the dual assumption that (1) the element of risk and uncertainty is great and (2) the transactions involves harm which equals or exceeds the degree which the prohibition is intended to prevent.” Raysuni, *Higher Objectives and Intentions* at 48 (cited in note 18). Transactions that entail what is inherently a low degree of risk and uncertainty or of which the benefits outweigh the harms prevented by prohibiting or disapproving the transaction fall outside this prohibition. *Id.* It should be noted that benefit or harm each has

V. PARTNERSHIPS

There is virtually no fundamental disagreement among Muslim jurists regarding the legality of a *sharikah*, or partnership. However, the permissible forms and purposes of a *sharikah* and the detailed Islamic laws that govern the relationships among partners are subject to a difference of opinion among the schools of Islamic jurisprudence.⁵⁰ Detailed rules concerning partnerships are based in large part on the parties' mutual agreement and appropriate mercantile customs.⁵¹ Most of these differences are beyond the purview of this Article and are thus only presented to the extent relevant to our purposes.

Frequently, classical Muslim jurists employed the term *sharikah* to apply broadly to various forms of joint ownership or participation. Existing laws in Muslim countries employ this word, or the related word *shirkah*, in various ways to denote various forms of partnerships and other business organizations.⁵² Broadly speaking, their definitions agree that a *sharikah* is a collective right held by two or more persons to deal with, or in any part of, jointly owned property, thereby sharing in any profits arising therefrom.⁵³ The *sharikah* comes in two primary forms: (i) those that arise without a contractual agreement⁵⁴ and (ii) those that do arise by way of a contractual agreement (*sharikah al-'aqd*).⁵⁵

Islamic private equity investments arise by contractual agreement, and primarily for this reason, the *sharikah al-'aqd* is most important for our purposes. The *sharikah al-'aqd* is articulated (i) by the Hanafis, as "an agreement between two or more persons for common participation in capital and profits";⁵⁶ (ii) by

its own definition and meaning within that context of Islam that generally exclude the gratification of whims, caprices or short-lived pleasures. Id at xxxv.

⁵⁰ See Khaled Abou El Fadl, *The Place of Tolerance in Islam* in Joshua Cohen and Ian Lague, eds, *The Place of Tolerance in Islam* 6 (Beacon 2002) (stating that "Traditionally, Islamic epistemology tolerate[s] and even celebrate[s] divergent opinions and schools of thought."). There are four extant Sunni schools of Islamic law: the Hanafi, the Maliki, the Shafi'i, and the Hanbali. See George Makdisi, *The Rise of Colleges and Institutions of Learning in Islam and the West* 2 (Edinburgh 1981).

⁵¹ Al-Zuhayli, 1 *Financial Transactions* at 445–50 (cited in note 7). For an introduction to the role played by custom (*'urf*) in Islamic law, see Kamali, *Principles* at 369–83 (cited in note 33).

⁵² Nyazee, *Partnerships* at 13 (cited in note 43).

⁵³ Id.

⁵⁴ This would include, for example, a joint ownership of a thing arising by joint purchase or joint receipt (by gift or inheritance, for example) known in Arabic as *sharikah al-milk*. Id at 35–37.

⁵⁵ *Sharikah al-'aqd* includes several subcategories regarding which Muslim jurists have differing opinions. Id at 39.

⁵⁶ Id at 17–18 (quoting Commission of Ottoman Jurisits (1867–77), *Majallat al-Ahkam al-'Adliyah* § 1329 (Constantinople 1305)). Among the differences between a *sharikah al-milk* and a *sharikah al-'aqd* are that the latter requires the formation of a contract and that the latter's principal purpose is profit sharing, whereas this is either not the purpose of or prohibited by the former.

the Malikis, as “a permission [granted by] each [] participant to the others [] to transact in [such granting participant’s] wealth and on their own behalf, while retaining the right to transact personally (in such wealth)”;⁵⁷ (iii) by the Shafi’is, as “in its literal meaning [a] mixing[,] and technically . . . an established[,] undivided right in a single thing or . . . a contract implying this”;⁵⁸ and (iv) by the Hanbalis, as a “participation of two or more persons in transactions.”⁵⁹ The jurist ‘Ali al-Khafif offers what is intended to be a more broadly articulated definition: a “contract between two or more people for participation in capital and its profits, or for participation in transactions in someone else’s capital and its profits, or for the participation in profit without participation in capital or transactions.”⁶⁰

A. UNDERLYING CONTRACTUAL BASES

A variety of contracts underlie the *sharikah*, regulating the relationships among partners. Of these, the contracts of *amanah* (trust), *wakalah* (agency), and *kafalah* (surety) are relevant to our purposes.⁶¹

Translated as a “trusteeship,” the contract of *amanah* requires that the jointly-owned property of a *sharikah* be held by each owner on behalf of the others. Consequently, if the property is destroyed (through no fault of any partner), the liability for bearing such loss is borne by the other partners on a pro rata basis.

Through the contract of *wakalah*, each partner within a *sharikah* is an agent of the others. The Hanafi school distinguishes between such a contract’s objective (*hukm*) and the means employed or the rights and obligations relating to performance (*huquq*) to achieve that objective.⁶² The objective of a sales contract, namely the transfer of title to the asset, passes to the co-owners on a pro rata basis (though in contemporary Islamic transactions it is held in the name of the business entity constituting the joint venture).⁶³ But the *huquq* do

⁵⁷ Id at 19 (quoting Abd al-‘Aziz al-Khayyat, 1 *al-Sharikat* 42 (Ammam: Wizarat al-Awqaf 1971)).

⁵⁸ Id (quoting Shams al-Din Muhammad ibn Abu al-‘Abbas Shihab al-Din Ahmad ibn Ahmad ibn Hamzah al-Ramli, 5 *Nihayat al-Mubtaji li-Sharh al-Minbaj* 3 (Cairo 1967)).

⁵⁹ Id (quoting Muwaffaq al-Din Abu Muhammad ‘Abd Allah ibn Ahmad ibn Muhammad Ibn Qudamah, 5 *al-Mughni fi Fiqh Imam al-Sunnah Ahmad ibn Hanbal al-Shaybani* 3 (Cairo: al-Matba‘ah al-Salafiyah wa-Maktubatuha 1962)).

⁶⁰ Id at 20.

⁶¹ Id at 57–63. The contract of *ijarah* may also underlie a *sharikah*.

⁶² Id at 59.

⁶³ Interestingly, one of the actions which Hanafis list among the rights of a partner is that each partner must fulfill all obligations and collect all rights associated with contracts in which he or she engages.

not pass to the owners; rather, they remain with the transacting partners.⁶⁴ The Hanafis and Hanbalis rule that a partner may trade with any part of the capital in any form of transaction. The Shafi'is state, in summary form, that a partner may deal in any manner acceptable for a legal agent and in any manner that cannot harm the other partners.⁶⁵ Accordingly, any lawful act undertaken by a partner on behalf of the *sharikah* is governed by the rules of *wakalah*.⁶⁶ For example, if a partner purchases an asset on behalf of the *sharikah*, the other partners own a share in that asset on a pro rata basis. Other jurists, including the Shafi'is and some Hanbalis, exclude partners from using the capital of the *sharikah* in credit sales. Others add that a partner does not have the right to put the *sharikah* in debt unless he has been granted explicit permission to do so.⁶⁷

If partners elect to integrate the contract of *kafalah* within their relationship, each becomes a surety for the other, permitting any partner to be liable, both for his or her own share and that of his or her partners, for the performance of contracts entered into by any partner. This may be analogized to American laws of joint and several liability.⁶⁸

B. CONDITIONS TO VALIDITY

Muslim jurists typically set forth a host of conditions coupled with particular contract forms. Their intent is not that all of these conditions always or only follow from the use of a particular contract form, but rather that the mere use of the name of a particular contract form triggers the applicability of all such conditions, unless the parties have lawfully stipulated their own conditions.⁶⁹ Thus, there is no requirement to restate in a contract, whether written or oral (for which this method is especially designed), all of these conditions. Thus, if contracting parties conclude a *sharikah* without mentioning which type, the Hanafis assert that such a *sharikah* shall by default constitute an *'inan*,⁷⁰ the subcategory of *sharikah al-'aqd* with which we are concerned.

Sharikah al-'inan (of which there are further subcategories) may be defined as a “contract based either on *wakalah*, or on *wakalah* as well as *kafalah*, that

⁶⁴ Id.

⁶⁵ Al-Zuhayli, 1 *Financial Transactions* 467, 469 (cited in note 7).

⁶⁶ Nyazee, *Partnerships* 69 (cited in note 43).

⁶⁷ Al-Zuhayli, 1 *Financial Transactions* 468–69 (cited in note 7).

⁶⁸ Nyazee, *Partnerships* at 62 (cited in note 43).

⁶⁹ Id at 25. See also Mohammad Hashim Kamali, *Islamic Commercial Law: An Analysis of Futures and Options* 70 (Islamic Texts Society 2000) (“The forms of trading and transactions that the Qur’an and Sunnah have explicitly validated are not exhaustive, and do not preclude new varieties on which the Shari’ah might have remained silent.”).

⁷⁰ Nyazee, *Partnerships* at 26 (cited in note 43).

permits (i) participation from both sides with wealth, work, or credit-worthiness, and (ii) the sharing of profits in an agreed upon ratio.”⁷¹ At a minimum, an ‘*inan*’ contract implies that each partner is the agent of the others, that no one of them is a surety for any other, and that the undivided share of one partner in possession of the share of another partner is governed by the rules of *amanah*.

Certain elements (*arkan*; sing, *rūkn*) and conditions (*shurut*; sing, *shart*) have been stipulated for any valid *sharikah*, including the ‘*inan*’.⁷² Because the ‘*inan*’ is a contract-based partnership, the various conditions relating to a valid contract, such as proper authority to contract, are applicable.⁷³ Partners must comply with a variety of additional conditions that include:⁷⁴

- (1) As readers may recall, the contract of agency underlies, and the contract of *kafulah* may also underlie, a *sharikah* agreement. As such, partners must have legal authority to contract, delegate authority, and serve as guarantors.
- (2) The majority of jurists, including the Hanafis, hold that the *sharikah* capital must be specified and present at the time of contract.⁷⁵ Generally, the Hanafis, Malikis, and Hanbalis rule that it is not necessary to mix the contributed properties because the purposes of the partnership contract and its underlying contracts may be realized

⁷¹ Id at 102.

⁷² A *rūkn* is defined as that which is inherent or internal to the contract (or act) and which, if absent or unfulfilled, renders the contract invalid such that all legal consequences of it would not follow. See ‘Abd al-Karim Zaydan, *al-Wajiz fi Usul al-Fiqh* 59 (Baghdad: Matba‘at Salman al-A‘zami 1967). A *shart* is a factor external to the contract without which it may be deemed, according to the majority of Muslim jurists, as invalid (*batil*) or, according to the Hanafis, as *fasid*, meaning that certain of the contract’s (or act’s) legal consequences follow. Id. The Hanafis maintain that there is but one element (*rūkn*) to a *sharikah* contract: offer and acceptance. The majority of jurists, however, list additional *arkan*, including the contracting parties and the contract subject matter, which the Hanafis deem to be conditions (*shurut*). The distinction between elements and conditions under Islamic jurisprudence is important for the consequences of contract enforceability. Were a *rūkn* to be absent, the contract would be void (*batil*), but were a *shart* to be unfulfilled, the contract would be (i) according to the majority, still entirely void (*batil*), but (ii) in the Hanafi estimation unenforceable (*fasid*) pending completion of the unfulfilled *shart*. Id at 65–67. But this distinction is of little practical significance in contemporary Islamic transactions thus far (other than Shari‘ah committees seeking to ensure the presence of both in the written contracts), unless the parties were to embody the consequences contractually or perhaps select a different governing law than they usually do.

⁷³ As generally accepted among Muslim jurists, the *arkan* of a sales contract are (1) a seller, (2) a buyer, (3) an object of the contract (both what is priced and the price itself), and (4) expression of the contract (namely mutual assent in the form of a valid offer and acceptance). See Moghul and Ahmed, 27 *Fordham Intl L J* at 165–66 (cited in note 1). See also al-Zuhayli, 1 *Financial Transactions* 91–144, 351–58 (cited in note 7). For an introduction to Islamic contract laws, see Hussain Hamad Hassan, *An Introduction to the Study of Islamic Law* 249–496 (Leaf Publications 1997) (Ahmad Hasan, trans).

⁷⁴ For a more complete list, see al-Zuhayli, 1 *Financial Transactions* at 457–63 (cited in note 7).

⁷⁵ Id at 458.

without doing so. An opinion attributed to Abu Hanifa holds that fungible commodities may be contributed as capital so long as there is a mixing of the commodities such that they can no longer be distinguished from the contributions of other partners. However, the Malikis rule that there must be some mixing, whether legal or physical, of the partnership properties, to equally incentivize the partners. The Shafi'is (and certain others), on the other hand, rule that there must be a mixing of the properties prior to contract conclusion so as to render the contributed properties indistinguishable.⁷⁶

- (3) Most jurists agree that the capital of a *sharikah* must be made of fungible monies, including by analogical reasoning, contemporary currency. Non-fungibles, it is argued, have varying values, thus rendering the partners' shares in the capital (and thus shares in profits) unknown, thereby creating the potential for legal disputes. The Malikis, however, rule that the capital need not be monetary; non-fungibles may be used, in which case the partners' shares would be determined based on the market values of their contributions, thus lessening the likelihood of legal disputes and mitigating the concern for *gharar*⁷⁷ on this basis.⁷⁸
- (4) Jurists differ over the validity of partnerships established with fungible, but non-monetary capital, such as goods measured by weight, volume, or number. The Shafi'i school permits such capital because such capital contributions, once mixed, can be rendered indistinguishable. Likewise, Maliki jurists permit this form of capital on the basis that it can be valued at the time of mixing. The Hanbalis, on the other hand, prohibit this form of capital. Some Hanafi jurists hold that so long as the contributions consist of different genera, such

⁷⁶ Id at 458–59.

⁷⁷ See note 50.

⁷⁸ This condition raises an interesting issue with regard to the securitization of *musharakah*-based financings. Upon acquisition by the partnership of substantial non-liquid assets, participation certificates could be treated as negotiable instruments and bought and sold in the secondary market. It would be allowable to sell the certificates in the secondary market for the price agreed upon, which may be more than the face value of the certificate because the subject matter of the sale is a share in tangible assets, not only in money. However, trading in such certificates would not be allowed when all the assets of the partnership are in liquid form, such as in cash or receivables, because of the prohibition of *riba*. According to Justice Usmani, the Shafi'is would not permit a certificate that represented ownership in a combination of liquid and nonliquid assets. According to the Shafi'is, Justice Usmani writes, the non-liquid part of the business would have to be separated and sold independently. The Hanafi school, however, is of the opinion that whenever there is a combination of liquid and nonliquid assets, the certificate could be sold and purchased for an amount greater than the amount of liquid assets in which case the price would be understood as equal to the amount of liquid assets and any excess above such as the price of the non-liquid assets. Most contemporary scholars have allowed trading in the units of the whole only if the non-liquid assets of the business are more than 50 percent of the assets in total. However, the Hanafis would allow trading of the certificates even if the non-liquid assets equaled less than 50 percent, so long as the size of the non-liquid assets was not negligible. Muhammad Taqi Usmani, *An Introduction to Islamic Finance* 18–20 (Kluwer 2002).

capital can not be utilized, while others contend that if the contributions are of the same genus, then such capital is permissible. Of those that favor the permissibility of such fungible, non-monetary capital, some hold that a *sharikah* to which such capital is contributed may be validated on the condition that profits are shared on a pro rata basis. That is to say, the partners would not have absolute discretion in setting their profit-sharing ratios.

- (5) The ratios of profit-sharing must be known and specified precisely at the time of contract.
- (6) The profit share of each partner may only be specified as a percentage of the profits of the *sharikah*. In other words, profit entitlement is not to be specified as a particular amount nor tied to a particular capital contribution because the total amount of profits are unknown, and Islamic law forbids a guaranteed, fixed return. Muslim jurists differ over whether the ratio of the profit allocated to a partner must equal the ratio of his or her capital contribution to the total capital contributed to the *sharikah*. The Maliki and Shafi'i schools generally hold that it must, while the Hanbali school permits the partners to select the profit ratio they deem fit. The Hanafis agree with the Hanbalis, adding that a passive partner's ratio must be no more than the ratio of its contribution to the total capital committed.
- (7) In the case of loss, nearly all (and according to some commentators, all)⁷⁹ Muslim jurists agree that partners must share losses on a pro rata basis based on the ratio of the investment by each to the total capital committed to the *sharikah*.

VI. THE SUBJECT TRANSACTION

The subject transaction, as noted in the introduction to this Article, involved a foreign Islamic investment bank intending to invest in a US consumer goods business in what is sometimes referred to as a growth equity investment.⁸⁰ The relevance of Islamic law to this transaction begins with the Islamic investment bank itself; unlike most private equity investors, its investment approach and focus is subject to an analysis in light of the previously discussed Islamic financial principles. An Islamic investor must select industries and businesses that do not violate any of the substantive Islamic principles and must then also work to ensure that the mechanism of its investment complies with the previously discussed procedural Islamic principles.

Fortunately, the target company's business in the subject transaction was already lawful by Islamic standards. Certain protective measures were taken, akin

⁷⁹ Id at 8.

⁸⁰ For purposes of this article, an Islamic investment bank refers to an investment bank whose shareholders, management, and business operates in compliance with Islamic precepts, and/or is registered under local laws as such.

to contractual veto rights, to ensure that this would continue to be the case. Primary concerns then revolved around the procedural principles. The manner in which the Islamic bank invested in the company and the manner in which the company had financed and would finance itself had to comply with Islamic principles.⁸¹

Like any private equity investor, this Islamic bank conducted its preliminary due diligence to determine whether this particular investment transaction was economically worthwhile. Detailed due diligence in an Islamic transaction, both financial and legal, must highlight any potential conflicts with Islamic principles as well as matters that are customary in conventional transactions. This would include, for instance, whether the company was party to any conventional interest-bearing financing and might also include whether any agreements to which it was a party, such as operating leases, were sufficiently compliant with Islamic principles or whether they would require amendment. In the case at hand, conventional debt was present in small amounts and the company was party to certain agreements that either violated or could lead to violations of Islamic principles. As discussed in greater detail below, the Islamic investor's Shari`ah committee tolerated certain current violations, but strictly prohibited future ones.⁸²

As is common with private equity transactions, both the Islamic investor and the company in this transaction negotiated a variety of financial terms of the proposed investment at the outset, such as the valuation of the company, until a term sheet was agreed upon. For the most part, the term sheet contained customary and standard provisions and language. These included granting the Islamic investor voting rights, the right to appoint persons to the company's board of directors, anti-dilution protections, and information rights. Some of what was negotiated, however, was particular to the Islamic nature of the transaction, as is discussed in greater detail below. Definitive transaction documentation, such as the amended and restated charter documentation, stock purchase agreement, and registration rights agreement, was left to be drafted and negotiated subsequently, as is the case in conventional transactions.

Because of the congruence between equity investments and Islamic financial principles generally, Islamic financial institutions are not normally faced with significant structuring difficulties when acquiring equity in a lawful

⁸¹ This concern has broader implications that may not be apparent at first. It would, for instance, limit the target company from acquiring another company with *riba*-bearing indebtedness.

⁸² Contemporary Islamic financial institutions typically have a committee of experts whose role is to provide Islamic legal advice in the course of the institution's affairs. The Shari`ah committee assists the institution as to how it may structure and document its transactions under Islamic law. Ultimately, the Shari`ah committee may issue a *fatwa*, declaring the transaction lawful.

enterprise. These difficulties are lessened by the acquisition of a controlling share of equity, which has usually been the case with Islamic private equity investments in the US. However, precisely because this investment was proposed as an acquisition of a minority interest in the company, it raised a number of issues, both legal and non-legal, that are discussed below.

It should be noted that the role of US legal counsel in Islamic transactions is analogous to that of attorneys involved in conventional private equity transactions. US counsel in any Islamic transaction must also work closely with its client and its client's Shari`ah committee to develop appropriate structures and draft documentation that satisfies Islamic legal concerns in light of locally applicable laws and the parties' respective demands and goals. This frequently requires a strong theoretical grasp of local laws and customs and requires an ability to think unconventionally.

A. CONTEMPORARY PRIVATE EQUITY IN LIGHT OF ISLAMIC LAWS

When considering this private equity transaction in light of classical Islamic law (or at least the summary thereof presented earlier), readers are informed that it does not neatly fit within the parameters of any particular classical *sharikah* form, though the key features of *sharikah al-'inan* appear to have been paralleled in large part. Readers are also reminded that many jurists, as discussed earlier, permit modifications to the default *'inan* form, and this would certainly seem to have been the case in this instance. Thus, this transaction may be said to be distinctly modern.

The fruitful approach to modern transactions seeks to first implement the fundamental principles of Islamic law and then to implement its secondary and tertiary rules, including the law with respect to particular contract forms to the extent they remain applicable or have not been lawfully modified by the parties' agreement.

We may begin by asserting that the company itself constituted the *sharikah*, the purpose of which was the advancement of its business and to maximize the profits derived therefrom. By entering into an equity purchase agreement, and purchasing the equity structured particularly for it (as discussed below), the Islamic investor became a co-owner or shareholder in the company. Thus, the Islamic institution may be said to have entered into a partnership, by way of written contracts, crystallized in the form of a conventional business entity, which under local law has a juristic personality distinct from that of its owners. The notion that a legal entity serves as the *sharikah* is a departure from classical formulations of Islamic law. The contractual documentation for this transaction speaks to the business of the joint enterprise, to the shareholders' rights and obligations towards one another and towards the company, and the allocation

and distribution of profits and losses, among other things. In many respects, these contracts address the underlying contractual bases of a *sharikah*.

Pursuant to a shareholders' agreement entered into by the Islamic investor and certain key shareholders, and provisions of other agreements, much of the substance of the contracts of *amanah* and *wakalah* were addressed. The company, rather than any of its shareholders, owns the assets and business—at least directly. Financial losses of the company, absent negligence or some other wrongdoing, are borne by all shareholders in the company on a pro rata basis proportionate to their respective investments. Actions of the company (whether entering into contracts or buying and selling property) are only to be taken by contractually specified individuals adhering to certain norms. The risks and consequences of all such actions (again, absent any particular shareholder's wrongdoing) are borne directly by the company and then by its beneficial owners (namely, the shareholders). These are all key differences from classical formulations of Islamic laws.

B. EDUCATIONAL CHALLENGE

Any counterparty will seek to have an understanding of those with whom it does business. This is all the more so in the case of a counterparty entering into a joint venture which has special operating guidelines. The unique challenge of this transaction was to persuade the company's management to require that the company operate pursuant to Islamic guidelines even though the Islamic bank was to own only a (sizeable) minority share in it.

The religion of Islam has been brought to the fore in current events, and has piqued the curiosity of many, including within the US financial marketplace. This is resulting in an increased willingness to learn. As a consequence of both the financial opportunity and the current liquidity in the Arabian Gulf, a variety of US institutions seek to participate in Islamic finance. In our experience, US businesses generally demonstrate a willingness to understand Islamic financial principles and the flexibility to find solutions (despite incurring increased costs in doing so). Economic rationale most likely drives this willingness and flexibility, but there can be other factors as well. The educational process that was undertaken in the subject transaction took place within the context of the current domestic and international political climate. Moreover, such an education does not take place in a single step or occurrence, but involves a process which itself is evidence of a long term commitment not only to counterparties and the US market, but to Islamic finance generally.

The subject transaction necessitated providing oral and written guidance from experts in Islamic law and from US counsel experienced in handling Islamic transactions. Company management expressed concern as to how Islamic law impacted its operations and why the term sheet it received differed

from those of conventional investors. In this case, both the Islamic investment bank and its US legal counsel had the requisite experience from which to draw a wealth of information and provide necessary comfort. US counsel must also possess an ability to explain Islamic finance succinctly in the language of the listener. Working closely with the Islamic bank, US counsel and the investor answered a myriad of questions regarding Islam, Islamic law, generally and Islamic financial law, as well as relevant contemporary Islamic finance practice.

C. THE RELEVANCE OF THE PROHIBITION OF *RIBA*

The company had in place a conventional working capital facility and other loans from its founders, which it used, along with several smaller loans from its founders, to finance its operations. As can be expected, the Shari`ah committee initially sought to have the loans terminated immediately prior, and as a condition to, the Islamic bank's investment.⁸³ Management of the target company was principally concerned with maintaining the revolving loan, viewing it as important for its future. Ultimately, the matter was settled by tolerating the existing conventional debt so long as outstanding amounts thereunder did not exceed certain contractually specified ratios tied to the value of the company at closing. Thereafter, the incurrence of conventional, but not Islamic, debt was prohibited. The Islamic bank also succeeded in ensuring that the company would not use the investment proceeds to repay these loans—instead, the proceeds were to be used for operations and expansion only. Moreover, the Islamic bank insisted that so long as it held any equity in the company, any future financial transactions undertaken by the target had to be compliant with Islamic law and approved by the Islamic bank's Shari`ah committee. Not only did this mean that further interest-bearing borrowings, including under the aforementioned working capital facility, would be prohibited, but also that future issuances of conventional preferred stock in the company would be prohibited as well.

Both the company and the Islamic bank and their respective legal counsel explored various options to address concerns raised by the company about its consequent future inability to access the conventional debt market and its estimation that future conventional equity investment was made less likely in light of the Shari`ah related restrictions. Chief among the proposed alternatives was the replacement of the revolving credit facility with an Islamic facility, such as a sale-leaseback, and a commitment by the Islamic investor to provide

⁸³ Readers are encouraged not to interpret this as a conflict between the Shari`ah committee and the "business" side of the Islamic bank. These comments are provided to help readers appreciate the primary role and function of each within an Islamic financial institution and the manner in which they work together.

additional equity capital upon certain milestones or at a future date. The first of the aforementioned alternatives brought both parties into discussions with US banks, including in some smaller marketplaces, and necessitated educating financiers about Islamic finance and the opportunity presented by undertaking such a transaction in the Islamic finance industry.

Ultimately, the company's concerns were sufficiently alleviated, and the relationship it forged with the Islamic bank during this educational process was instrumental. This alleviation came in the form of an increased investment at close and an agreement for the possibility of additional funding by the Islamic bank, with an agreeable exit mechanism in the event the Islamic bank elected not to provide such additional capital.

D. LIQUIDATION PREFERENCE AND PROFIT-LOSS SHARING

Closely related to the prohibition of *riba* is the previously discussed legal maxim: '*al-keharaj bi al-daman*' that impacts the concept of liquidation preference commonly found in conventional private equity transactions. A liquidation preference grants certain shareholders a right to receive an amount equal to their investment (or, as often the case, a multiple thereof) prior to other equity holders upon various events such as mergers, sales of the company, dissolution, and bankruptcy, to name a few. This preference has been prohibited under contemporary applications of Islamic law because it is inconsistent with the requirement that allocations or distributions of losses be in proportionate to capital contributions, and, for some jurists, that profits be so allocated and distributed as well.⁸⁴ Consequently, most if not all, previous Islamic private equity transactions have not involved a liquidation preference or conventional preferred stock. Many conventional investors and fund managers have actually preferred this technique since they contend it places the various shareholders on a more equal footing and thus equally incentivizes them.

Due diligence for this transaction revealed the presence of several classes of conventional preferred stock granting liquidation preference rights to their respective holders. The Shari`ah committee advised that in order for the Islamic bank to invest in the company such classes of stock simply could not be present. To address this issue, the charter documentation of the company was amended and restated to eliminate these various classes of preferred stock and reorganize their holders into a single class of stock. Contractual restrictions were also put in place controlling the company's ability to issue equity with Islamically-unlawful features. While voting and management rights of the preferred stock holders

⁸⁴ It should be noted that other common rights of preferred stockholders, such as preferential voting and management rights, are not objectionable to the Shari`ah committees with which the author has experience, including the one opining on this transaction.

were generally maintained, a persuasive argument was successfully made to these shareholders as to why a sacrifice of short term gains should be made in exchange for the significant potential created by the Islamic bank's monetary investment and experienced participation in the company's management. This new equity granted the existing shareholders a greater ability to participate in the growth of the company than would have been the case had they held simple common stock.

The absence of liquidation preference was also of concern to the Islamic bank, primarily because this limited its ability to participate in the growth of the company in greater amounts. The Islamic bank was far less concerned with its ability to recoup its investment in the event of the company's poor performance. Relying on the flexibility of Islamic law's profit-sharing rules, counsel to the Islamic bank articulated a method matching only those certain aspects of liquidation preference not prohibited by Islamic law. Transaction documentation was drafted so as to create a class of equity particular to the Islamic bank and to enable the Islamic bank to participate to a greater extent in the company's growth. This is perhaps the most innovative feature of the subject transaction: the structuring and documentation of a tiered waterfall schedule designed to replicate the permissible features of liquidation preference rights such that upon certain events, such as a merger, consolidation, or sale of the company or its assets, distributions of the net proceeds from such events are shared by both the existing shareholders and the Islamic investor.

With respect to the allocation and distribution of losses, contractual documentation listed certain events upon which the company might cease to exist and specified that on such occasions, following the payment of liabilities, its remaining assets would be distributed to all shareholders on a pro rata basis in accordance with their capital contributions. Predictably, the company's various existing shareholders welcomed these provisions.

E. FIXED RETURNS

Conventional private equity transactions often contractually specify a dividend right and contain redemption provisions that set the return as a multiple of the invested capital. Under the legal maxim that requires profit to be accompanied by a market or entrepreneurial risk, this method of pricing is prohibited. This is not to say, however, that either a dividend or redemption is per se prohibited under Islamic law. Dividends may in fact be distributed so long as they are expressed as a percentage of revenue rather than as an absolute amount. As a purchase price of the shares, the redemption price must be expressed in terms of the shares' market value or some other method that does not contractually guarantee a certain absolute amount as a return to the Islamic investor. These pricing methods can be quite significant in alleviating concerns

of partnering with an Islamic institution. By setting forth redemption prices and dividend amounts in this manner, the Islamic bank demonstrates its strong commitment to the target as a business and not merely as an investment, for the return on its investment is directly tied to and dependent upon the failure or success of the target's business.

The subject transaction did not involve dividends but did contain redemption provisions as separate rights of both the Islamic investor and the company. To avoid a contractually guaranteed or fixed return, the parties agreed to a redemption price that was calculated with reference to the company's market value at the time of redemption.

As noted earlier, the Islamic investor granted the company the right to demand additional capital. In the event the investor did not provide this additional capital, the company sought to have the investor's shares in the company redeemed during a specified period of time in the future. The Shari'ah committee was uncomfortable with the Islamic bank agreeing to a future sale of its shares, arguing that the company could demand such moneys at a time when the bank did not wish to provide it and thereby force a liquidation of the Islamic bank's shares at a low price. Conventional private equity transactions may address this issue by way of a redemption price articulated as a prohibitively high multiple of the invested capital—an impermissible alternative in this case. In addition, it may be argued that there were only two possible scenarios at the time of demand for additional financing: (i) that the company is so profitable that the Islamic bank wishes to increase the amount of its investment, in which case it would readily provide the additional funds, or (ii) that the company is not performing well, in which case the Islamic bank would prefer to liquidate its investment anyhow.

The foregoing, however, did not fully address the Shari'ah committee's concern, which actually centered upon a legal nuance. Specifically, the bank may be in a situation of duress in the future and thus may not be voluntarily consenting to the sale of its shares. Accordingly, the Shari'ah committee initially preferred that the Islamic bank have the right to trigger this redemption—a point to which the company of course objected. Eventually, this matter was resolved such that the Islamic bank promised in a separate written instrument to offer its shares for redemption, and the target retained its right to initiate this particular redemption.

VII. CONCLUSION

Throughout the course of this private equity transaction, participants worked towards a number of the initial goals of the Islamic finance industry. In order to close this transaction, the Islamic investment bank and its counsel patiently undertook a lengthy dialogue with the company and a host of other

American persons and institutions, educating them as to the rationale and purpose of Islamic finance. Through this process, the Islamic bank garnered recognition for conducting business in a viable, thoughtful, and professional manner. By closing this transaction, the Islamic bank successfully implemented, as we have highlighted, many of Islam's legal and financial principles. And the innovation that took place over several months in this private equity investment succeeded in implementing some of Islam's legal and financial principles that had perhaps not been previously implemented or at least not implemented in such an effective manner. These novel features will, it is hoped, enable further minority, growth equity investments that comply with Islamic precepts.

Perhaps the most compelling aspect of this transaction is that an Islamic financial institution making a minority investment was able to convince a US company to operate according to Islamic guidelines. This is a strong testament to the Islamic bank—its willingness to take on the risks demanded by Islamic principles, the relationship it forged with the company throughout the educational dialogue, and the respect it gained for its personnel, their expertise, and their Islamic investment method. These successes are in turn a testament to the rationale and theoretical underpinnings of Islamic law and jurisprudence generally and those of its principles that demand financiers to only profit when they partner in their counterparties' risks.