

# Combining Conventional and Islamic Real Estate Finance Techniques: How to Get the Deal Done



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**G**lobal Islamic finance assets were estimated at \$1.8 trillion in 2012, and are expected to double over the next three years. The global demand for sukuk (Islamic compliant bonds, often backed by real estate assets) is forecast to grow three-fold from \$300 billion to \$900 billion by 2017.

Due to the importance of having assets to back Islamic compliant structures, this demand has been reflected in the financing of real estate acquisitions in the US and in key cities globally. Equally, non-Islamic investors have sought out alternative sources of finance, including Islamic compliant finance, since usual financing methods have been constrained.

The structural differences between conventional and Islamic compliant tranches of finance mean that issues surrounding drawdowns, payments, cash treatment, intercreditor arrangements, prepayments, security and enforcement need to be considered and documented carefully.

## Overview of Islamic Finance

Key principles of Islamic (or Shari'a) finance include:

- Prohibition of the payment or receipt of interest;
- Avoidance of uncertainty; and
- Prohibition of involvement with certain industries, including gambling and alcohol.

Islamic finance principles in relation to real estate finance do not form a codified system of law and may be subject to varying interpretation by boards of Islamic scholars that oversee the activities of Islamic compliant financial institutions and funds. Interpretations of Islamic principles can differ substantially. Accordingly, it is important for a conventional lender or borrower to identify any specific Shari'a related issues early in the process of working with an Islamic compliant counterparty.

In the vast majority of cases co-financing documentation will be governed by New York, English or other national law, so that the Islamic compliant principles of the transaction need to be documented via such national law.

## Structuring Loan Payments

In a conventional loan, the principal amount may either be drawn in one amount or in stages during an availability period. This will not always be the case with an Islamic tranche of finance. For example, in an ijara (Islamic compliant sale and leaseback structure) facility, where the real estate asset exists when the Islamic compliant facility is entered into, the seller must be paid the full purchase

price upfront. However, if a forward lease is used in conjunction with an istisna'a (Islamic compliant real estate financing structure), the payments could be made by installments or at the end of the istisna'a. It is therefore important to ensure that the istisna'a stage payments match the drawdown profile of the conventional lenders.

In order to coordinate payments to financiers, interest periods under a conventional loan should correspond to the relevant periods under the Islamic financing (which may, for example, depend on lease periods, deferred payment periods or periodic distribution dates) so that payments are made to the Islamic financiers and the conventional lenders at the same time, if this is the commercial deal.

## How Does a Lender Get Paid?

As interest should not be charged or received by an Islamic compliant financier, a return to the financier is structured in other ways, such as a rental or profit payment. In a co-financing, payments are often made in accordance with a common cash flow waterfall with cash being applied at a particular level of the waterfall towards payment of principal and interest under the conventional facility and, for example, the deferred purchase price or base rental and profit on the Islamic compliant financing structure on a pro rata and pari passu basis.

A minor exception to this principle is that although certain amounts may be claimed by financiers on the conventional facility on an immediate indemnity basis (for example, increased costs), financiers of the Islamic compliant financing structure may only be able to claim the equivalent amount at a later date because they will be factored into the deferred purchase price or rental payable by the obligor in a subsequent period.

## Dealing with Intercreditor Issues

In certain circumstances, Islamic financiers and conventional lenders may enter into formal intercreditor documentation, documenting the priority of payments and the ranking of security. This is most likely the case where structural subordination (illustrated in the case study below) is not possible and where the same entity is the borrower under both the conventional and Shari'a finance. An intercreditor agreement between Islamic compliant financiers and conventional lenders is likely to address many similar matters covered in such an agreement between solely conventional lenders, with such adaptation as may be required to account for the Islamic financing structure and the compliance requirements of the parties.

The intercreditor agreement may need to identify the respective rankings of payments under the Islamic and conventional finance documents to deal with allocation of income or proceeds following

acceleration. However, Islamic financiers may regard it as important that the payment waterfalls dealing with the process of payment are kept separate in the Islamic compliant and conventional finance documentation and only cross-referenced in the intercreditor agreement. This is to avoid the possibility of the payment of interest to the conventional lenders tainting the Islamic compliant element.

If the claims of the financiers on the Islamic compliant financing structure rank *pari passu* with those of the financiers on the conventional facility, the intercreditor arrangements are usually relatively straightforward. However, issues can arise in determining the intercreditor voting entitlements if the Islamic compliant financing structure comprises staged advances of money to the borrower and the conventional financing structure advances all the money to the borrower at the beginning of the deal.

### Title to Security

Although there is not a general prohibition on the taking of security under Islamic law, some scholars object to the English law concept of a general pledge (or floating charge) on the basis that the assets that are the subject of the relevant security interest are not specifically identifiable. This can raise intercreditor issues because the conventional lenders may want as extensive a security package as possible. Islamic financiers may want to take security over a specific pool of assets that can be readily identifiable. One of the key principles of Islamic finance is that of certainty. If so then the assets of the obligors will need to be allocated between the different types of financiers for security purposes.

Some documents, such as purchase undertakings in Islamic finance structures, create proprietary or contractual interests in favor of the Islamic financiers. Often the purchase undertakings cannot be mortgaged. The ability of the Islamic financiers to exercise their rights under a purchase undertaking will usually be triggered by an event of default. However, how and when those rights are exercised will need to be co-ordinated with the exercise of the rights of the conventional lenders.

A security agent may hold the security interests under the intercreditor arrangements for the benefit of both the conventional lenders and the Islamic financiers. A conventional lender will not own assets, but will have security interests granted in its favor. However, depending on the Islamic facility (such as an *ijara* or *musharaka*), an Islamic financier may have title to certain assets. In an *ijara* financing it will own the leased asset and in a *musharaka* financing it will own an equity interest in the partnership or joint venture.

Where assets are in the name of the Islamic financier:

- An intercreditor arrangement should set out the agreement to share any proceeds on disposal of the project or any assets on an event of default.
- Depending on the applicable law, it may be possible for the Islamic financier to grant a security interest in favor of the security agent as long as the monetary obligation being secured can be determined.
- If a special purpose vehicle is used, the SPV could grant the security interest to the security agent so that any title transfer to the Islamic financier would be subject to that security interest.
- If the asset that the Islamic financier owns is merely a contractual interest (which may be done so that registration fees are not incurred on the transfer), the obligor (in whose name the legal title remains) could grant the security interest to the security agent.

### Enforcement

In certain types of Islamic financing, on a default, the amount claimed will include a profit element that is calculated over the full finance period. In contrast, with a conventional financing, the amount of interest is that which has accrued up to the occurrence of an event of default. The conventional lenders may, therefore, feel that the Islamic financiers' *pro rata* entitlement to a share in any enforcement proceeds (based on amounts outstanding) means that they benefit more than the conventional lenders. A sharing mechanism must therefore be documented in the intercreditor agreement if equality is the commercial deal.

The typical approach in relation to enforcement proceeds is that they are held by a designated security agent and applied in discharging the amounts outstanding under the conventional facility and the Islamic compliant financing in accordance with a pre-determined order of priority set out in the intercreditor agreement. In some co-financing transactions, Islamic financiers may require that the portion of the enforcement proceeds earmarked for the Islamic compliant structure be held in a separate account so as not to be tainted by the proceeds that are to be used to repay the conventional facility. Issues can arise when the enforcement proceeds include an element of interest (for example, interest accrued on cash balances in an account of the security agent or interest on a sum awarded by a court judgment). Financiers that are Islamic compliant may be unable to share in these amounts, in which case, they may require an equalization payment mechanism to uphold the principle of equal treatment.

### Real Estate Financing Case Study

A recent transaction in the United Kingdom involved the use of conventional and Islamic compliant financing to finance the purchase of a major department store. The investor group had incorporated two special purpose vehicle companies – Holdco and Propco, Holdco being the parent of Propco. Holdco was to receive the Islamic compliant finance and Propco to receive the conventional loan. There was therefore an immediate structural separation between the tranches of finance. However, this deal must be seen on its own facts as other Islamic compliant financiers may immediately have an issue with a subsidiary of its customer taking on conventional debt.

The Islamic financiers comprised the investors and a special purpose vehicle company incorporated for the purpose of the transaction (the SPV). The Islamic financiers had their own board of scholars who approved the whole transaction. However there was a representation in the documentation that a party that itself abided by Islamic principles should not seek to later rely on this status to avoid or disclaim a contract: "Insofar as it wishes or is required for any reason to enter into transactions, agreements and arrangements which comply or are consistent with the principles of the Shari'a ('Shari'a compliant' or 'Shari'a compliance'), each party has made its own investigation into and satisfied itself as to the Shari'a compliance of this agreement and all necessary action to confirm that this agreement is a Shari'a compliant agreement has been taken (including the obtaining of a declaration, pronouncement, opinion or other attestation of a Shari'a adviser, board or panel relevant to it where required)."

The investors put their cash into the SPV. Then the SPV and the Holdco entered into a *tawarruq* (or reverse/monetizing *murabaha*). This is a technique whereby the SPV funded Holdco in order for Holdco to buy an asset (in this case a quantity of platinum) on a deferred repayment basis (plus an agreed mark up). Holdco immediately resold the platinum on the spot market for cash to a third party. This transaction meant that Holdco had an amount of funds in order to make a shareholder loan into Propco. That shareholder loan was interest bearing, which was approved within the context of this transaction; however, an equity investment or non-interest bearing loan by Holdco into Propco may have been required in other circumstances.

Propco then borrowed conventionally from a bank and used that loan and the shareholder loan from Holdco to purchase the investment property.

The terms of the conventional finance documents controlled Propco's cash flow so that rental and other income from the property was paid into an account controlled by the conventional bank and went first to service payments due in respect of the conventional loan. In addition, the conventional finance documents limited Propco's ability to distribute funds to its parent, Holdco. Dividend payments were restricted so that they could only be made in certain circumstances, such as while no default was continuing under the conventional finance documents. HoldCo's shareholder loan to Propco was formally subordinated in a subordination deed between the conventional bank, Propco and Holdco. Whether purely as a result of the structure and the conventional bank's control of cash flow, and/or by a formal subordination deed, the effect was that the Islamic compliant finance was subordinated to that of the conventional bank.

Propco granted conventional security over the property and its other assets to the bank. In addition, Propco entered into a sale undertaking in favor of the SPV, which gave the SPV the right to call for the real estate to be transferred to it. This may seem broadly analogous to third party security for Holdco's payment obligations under the *tawarruq*, but there were crucial differences:

- The sale undertaking was not expressed to be granted by way of security.
- The SPV's rights pursuant to the undertaking were not exercisable only when Holdco defaulted.

Given the second of these points, the conventional lender required comfort that its security had priority over the SPV's rights under the sale undertaking.

In this transaction, the effect of registering the conventional lender's security at the central land registry gave rise to a restriction on the title. This meant that the sale undertaking could not be exercised without the conventional lender's written consent. That ought to remain the case, whether or not the sale undertaking was registered as an option over the land in question, provided there was sufficient evidence of the parties' intentions that the sale undertaking was to be subject to the conventional lender's security.

### Conclusion

As this type of co-financing becomes more common, investors, financiers and their advisers will need to be adept at understanding and combining finance tranches with contrasting structures.