ISLAMIC FINANCE IN NORTH AMERICA:
A HIGHLY ABBREVIATED, RUTHLESSLY SELECTIVE, AND OVERTLY PERSONAL HISTORY

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Introduction

This paper has been prepared in connection with the launch of Islamic Finance Trade Association of North America ("IFTANA") on June 16, 2026. I am honored to be one of the original members of the IFTANA board of directors and that Curtis, Mallet-Prevost, Colt & Mosle LLP is a founding member of IFTANA. North American Islamic finance practitioners have long desired an organization such as IFTANA. Its launch is occurring at REDmoney's second annual IFN Investor Americas Forum. This also is a welcome expansion of Islamic finance initiatives in North America. While the presence of IFTANA and the IFN Forum are recent, the practice of Islamic finance in North America has a long—and underrecognized—history. Shariʿah-compliant investment in North America is in the billions of U.S. dollars. Some of the most important developments in modern Islamic finance occurred in the United States.

I was asked to speak on the history (including developments and scope) of Islamic finance in North America and to write an accompanying paper. It would take a substantial book to treat those topics. That book has not yet been written (although I did attempt a start in 2007 by interviewing about twenty of the most notable early participants). In various papers and presentations, I have attempted to chronicle aspects of that history, mostly in discussions of transactions and structures, with a few addressing the history more broadly.[2]

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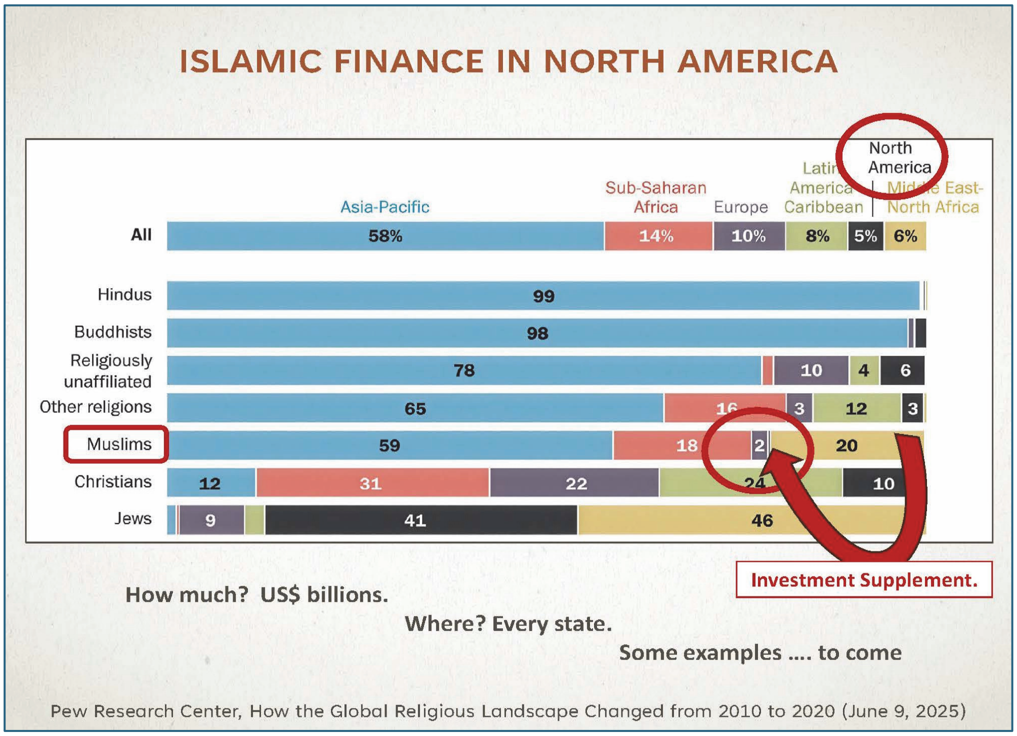
[2] Examples of writings that discuss historical developments are Michael J.T. McMillen (for all of the following, as indicted by "_____"), ISLAMIC FINANCE AND THE SHARIʿAH: THE DOW JONES FATWA AND PERMISSIBLE VARIANCE AS STUDIES OF LETHEANISM AND LEGAL CHANGE (2013) ("McMillen, Islamic Finance"), _____, *Islamic Capital Markets: Market Developments and Conceptual Evolution in the First Thirteen Years*, (draft of March 8, 2011), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1781112, Yusuf Talal DeLorenzo and Michael J.T. McMillen, *Law and Islamic Finance: An Interactive Analysis*, chapter 7 of ISLAMIC FINANCE: THE REGULATORY CHALLENGE, Simon Archer and Rifaat Ahmed Abdel Karim, eds. (2007) (a broader historical analysis), McMillen, Islamic Project Finance, *infra* note 5, McMillen, Third Harvard, *infra* note 5, _____, *Trends in Islamic Project and Infrastructure Finance in the Middle East: Re-Emergence of the Murabaha* (2010) (involving an entity headquartered in the U.S.), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1753252, ______, *An Introduction to Shariʿah Considerations in Bankruptcy and Insolvency Contexts and Islamic Finance's First Bankruptcy (East Cameron)* (2010-2012) (the bankruptcy was in Louisiana), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1826246_____, *Islamic Finance and Investment In U.S. Expected to Grow*, 248 (No. 8) NEW YORK LAW JOURNAL 1 (July 12, 2012), _____, *Sequelae of the Dow Jones Fatwa and Evolution in Islamic Finance: The Real Estate Investment Example* (2013), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2272636, _____ and John A. Crawford, *Sukuk in the First Decade: By the Numbers*, DOW JONES ISLAMIC MARKET INDEXES NEWSLETTER (2008), available at



For the speech, I chose topics personally known to me. Since 1996, my primary area of legal practice has been Islamic finance, which allows me a range of choices regarding early developments. Selected slides addressing this early history, including some not included in the speech, are included in this paper along with a bit of background on those slides. No topic is treated in its entirety. That is left to other writings.[3]

My topical selections are selective and overtly personal. Contributions to the history of Islamic finance in North America were made by many people not referenced in these materials. No slight is intended by that failure. I have selected events and developments that I adjudge to have made the greatest contribution to the development of Islamic finance, in North America and globally. Others will likely have different assessments.

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https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2293690, _____, *Sukuk in Its Infancy: Misstep and Sequel*, DOW JONES ISLAMIC MARKET INDEXES NEWSLETTER 3 (2008), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2293693, _____, *Asset Securitization Sukuk and Islamic Capital Markets: Structural Issues in these Formative Years*, 25 WISCONSIN INTERNATIONAL LAW JOURNAL 703 (2008), and _____, *Structuring a Securitized Shari'a-Compliant Real Estate Acquisition Financing: A South Korean Case Study*, ISLAMIC FINANCE: CURRENT LEGAL AND REGULATORY ISSUES, S. Nazim Ali, ed. (2005) (a U.S. insurance company investor and financial advisor).

3 Pioneers of Islamic finance, as determined by Euromoney Institutional Investor Plc in 2004, are discussed in *Pioneers of a burgeoning market* and the related *Profiles*, each included as Exhibit A. Global leaders in Islamic finance as of 2014 are discussed in Emmy Abdul Alim, GLOBAL LEADERS IN ISLAMIC FINANCE: INDUSTRY MILESTONES AND REFLECTIONS (2014), the table of contents of which is set forth in Exhibit B. Perusal of Exhibits A and B reveals the extent of neglect of Islamic finance in the United States. I am the only North American included in the lists of pioneers and leaders, and there is no discussion of Islamic finance in North America, except as pertains to discussions of me.

I and others associated with IFTANA have been asked to make our writings on Islamic finance available through the IFTANA web site (https://iftana.org/), which is currently a work in progress. We urge you to use the IFTANA site as an information source.

Beginnings

My history with Islamic finance in North America begins in Saudi Arabia in 1996. This section tells part of that story. Experiences here recounted determined how I became involved with Islamic finance and how I approach the implementation of Islamic finance arrangements, in North America and globally.

In 1996 I assumed responsibilities for the offices of a United States law firm in Saudi Arabia. I lived and practiced law in Saudi Arabia for four years. In 1996, I knew nothing about the Shariʿah or Islamic finance. I worked on project financings and was fresh off stints in India (power projects), Uzbekistan (a gold mine), Peru (three gold mines), …, and the United States (an array of power, industrial, and infrastructure projects). I was sent to Saudi Arabia to rid the firm of pesky little matters and establish a transactional base focusing on large-scale project financings, beginning with privatizations in the electric generation sector and including petrochemical, oil and gas, mining, industrial, infrastructure, and real estate projects. All matters being political, or giving rise to political agendas, the privatization initiative soon collapsed and I was left alone and adrift, without significant transactional work and knowing not a single person.[4]

Before long I was working on financings for construction of real estate projects, asset purchases, and general corporate matters. Most of these transactions were structured as interest-based loans. As the market inched toward Islamic financing alternatives, construction transactions used *istisnaʿa* contracts and general corporate financings sometimes used *murabaha* arrangements. The early Shariʿah-compliant structures were relatively unrefined.

My first significant project finance transaction came in 1996. We were instructed to represent a group of international, regional, and local banks as lenders financing of a large petrochemical project: the Saudi Chevron benzene and cyclohexane project. This was the first limited recourse project financing in Saudi Arabia.[5] The transaction was not an Islamic financing (it involved an interest-bearing loan). However, it involved Shariʿah-related collateral security concepts that are integral to Islamic financings.

The transaction involved a large interest-bearing, multi-tranche construction loan to a Saudi Arabian joint venture. The first project financing transaction in a country is always a daunting and challenging endeavor. It is customary to use a tried-and-true structures and concepts that have been refined and tested over the course of years. That approach allows the parties to remove many of the critical issues, particularly collateral security issues and cash management issues, to a relatively predicable sphere.

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4 Much of this section is taken from McMillen, Islamic Finance, *supra* note 2, at 22 *et seq*.

5 The transaction is described in Michael J.T. McMillen, *Islamic Shariʿah-Compliant Project Finance: Collateral Security and Financing Structure Case Studies*, 24 FORDHAM INTERNATIONAL LAW JOURNAL 1184 (2001) ("McMillen, Islamic Project Finance"), at 1184-1232. An earlier version of portions of this article pertaining to the collateral security structure is Michael J.T. McMillen, *A Rahn-ʿAdl Collateral Security Structure for Project and Secured Financings* ("McMillen, Third Harvard"), in PROCEEDINGS OF THE THIRD HARVARD UNIVERSITY FORUM ON ISLAMIC FINANCE: LOCAL CHALLENGES, GLOBAL OPPORTUNITIES (OCTOBER 9-10, 1999) (2000) ("Third HIFIP Proceedings"), at 111.

In its pure form, project financing is defined as a harmonized body of structural elements and techniques of implementation for financing the construction (usually) of a project in which (in the pure case) the source of funds and recourse afforded the financier for repayment of the financing are limited to revenues generated by the project, either as operating income or disposition proceeds. There is little or no recourse to the sponsors. There are no guarantees that the project will be constructed, that it will be constructed properly, that it will ever be operational, or that it will operate as projected. Project financing risks are significant. Ensuring dedication of project funds and assets to the lenders, unimpeded by claims of competing creditors, is critical to the structure. That dedication is achieved by providing, for the benefit of the lenders, first priority perfected mortgages and security interests (however defined in a given jurisdiction) and a rigorous cash management regime. As one might expect, the financing banks in the petrochemical project financing felt it prudent to obtain these mortgages and security interests.

Customarily, the collateral security structure is based upon an English, New York, or civil law (*i.e.*, in all cases, Western) model as the base structure. These structures are familiar and generally yield the greatest degree of certainty and predictability of result, particularly in respect of remedies and the enforcement outcomes. They are 'tried and true' in addressing identified and identifiable project risks. To these model structures, lawyers and financiers add procedures and structures from the host country's practice. Those procedures and structures often have to be modified to fit the pre-existing Western model. Often, this jeopardizes, to some extent, the effectiveness of the host country procedure or structure, which, in turn, weakens the entire collateral security structure. Adaptations are also made to the pre-existing model, although they are usually less extensive and are made only with reluctance.

Early in the structuring for the Saudi Chevron transaction, it became clear that the customary Western model could not be adapted for use in Saudi Arabia. Mortgages and pledges were not recorded in Saudi Arabia, except in favor of Saudi Industrial Development Fund and Public Investment Fund.

Deadlock ensued. The international banks were accustomed to Western collateral security systems. Their credit and underwriting policies and practices, including their conceptions of prudent banking practices, assumed the existence of those systems. Including, for example, mechanisms for determining the priorities of security interests. Regional and local banks took a different view of collateral security, particularly in light of the absence of both an available recordation system and clear legal rules on priority. They demanded structures that included recourse, such as a guarantee from a parent company or shareholders in the project company or its parent (*i.e.*, sponsors). That alternative was not available in the Saudi Chevron transaction. Its sponsors and equity participants desired to limit recourse to the newly established special purpose project company and its cash flows and other assets. No sponsor or shareholder was willing to provide a guarantee or any credit support. Still, the sponsors and shareholders expected the reduced interest rate costs associated with a robust collateral security package.

The challenge for the lawyers was apparent; the path to resolution was unclear. The lawyers had to develop a collateral security structure that met project financing, and related credit and underwriting, requirements of the banks and was satisfactory to the project company and its sponsors and shareholders. Bank satisfaction was premised on meeting traditional requirements of English and New York financings, including as to risk allocations and coverages, especially in enforcement scenarios, and satisfaction of credit and underwriting criteria, (among others). Satisfaction to the project company and the sponsors meant an absence of recourse.

Some critical elements of the Western model structure were amenable to isolation and the use of English law as the governing law for part of the structure. For example, and as is standard in international transactions, certain assets (such as cash from offshore product sales) were moved to London and cash was then fed back into Saudi Arabia as needed. This allowed lenders to proceed sequentially against project assets in an exercise of remedies, which was efficient and minimally intrusive upon project operations. Actions could first be taken against cash in London bank accounts, rather than physical assets in Saudi Arabia. However, the bulk of the assets securing the financing remained in Saudi Arabia. It was necessary to face Saudi Arabian legal hurdles.

Novel approaches to achieving an understanding of the nature of Shariʿah determinations in dispute resolution forums in Saudi Arabia led the lawyers to the conclusion that the in-country collateral security structure should be in accordance with the principles of Shariʿah. The reluctance of the bankers was significantly more difficult to overcome.[6]

The paramount law of the land is the Shariʿah, which governs commercial and financial matters (and all else). Business dealings and human, needs, desires and conduct being what they are, the Shariʿah must have some collateral security concepts. My Saudi Arabian law partner, Hassan Mahassni, was patient in schooling me on the nature of the *rahn*, which is both a mortgage and a pledge under the Shariʿah. Our assembled body of advisors voiced doubt that this would be of significant aid in achieving our objective. Mahassni was more supportive.

For the transactional lawyer, this was progress: a starting point; more than a glimmer. It suggested that we could and should build a base model collateral security structure using Shariʿah concepts. Which meant learning about the relevant Shariʿah principles, starting with the *rahn*, but moving rapidly to a plethora of interrelated substantive concepts and to the intricacies of enforcement. The initial responses of the bankers to this proposal as "incredulity." That response was not easily overcome. Nor did the undertaking prove as manageable or expeditious as one would hope.

I began reading everything that could be found in English relating to the Shariʿah, particularly as it applied to commerce and finance: the Quran, hadith collections, the few treatises available in English, a smattering of books that touched upon topics of interest, and a few journals. The writings, not surprisingly, were rather theoretical as there was no real concept of Islamic finance at the time; meaning there was no developed application of the Shariʿah to commerce and finance as practiced in contemporary times. Which meant conversations with anyone willing to discuss the topics of interest: another series of exercises in high theoretics.

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[6] We attempted to break the customary Western model into segments and apply Saudi Arabian law to discreet segments. Concurrently, an unscientific study was undertaken to test the degree of certainty and predictability of judicial interpretation of, and dispute resolution under, the Western model for a dispute litigated or otherwise determined in Saudi Arabia. Different dispute scenarios were developed and presented to Saudi Arabian jurists and lawyers. These jurists and lawyers opined regarding determination and enforcement of each scenario under Saudi Arabian law. The conclusions were clear. Interpretations of, and dispute resolutions under, a Western model when applying Saudi Arabian law were uncertain and unpredictable. The jurists thought in terms of Shariʿah precepts within the Shariʿah system. They did not consistently interpret Western legal language and structures, and the inconsistencies were not predictable. It seemed, and was later established, that greater interpretive consistency and predictability were obtained using a structure built around Shariʿah principles. Our glimmer of hope theory yielded a glimmer, and we supplied the element of hope.

To alleviate my frustrations (and stem the flow of questions), Mahassni arranged for me to speak to a few judges from Saudi Arabian courts that apply the Shariʿah. These consultations occurred from around nine to midnight two or three days per week. The judges spoke no English. I spoke no Arabic. Mahassni acted as translator-intermediary. These were truly fascinating (and humorous) discussions, but suffered from the infirmity that all knowledge flow was unidirectional: to me, from the judges.

I made some progress in understanding the nature of a *rahn*, but only after I undertook a study of many other concepts, such as Shariʿah-compliant debts and obligations (e.g., rental obligations under an *ijara*). In the course of these studies, I came across an account that seemed to deal with the pledge of a camel. Which led to a question to the judge as to whether he could pledge his camel to me as collateral to secure a valid Shariʿah-compliant debt obligation owing to me (a rather rudimentary query). Without hesitation, he replied: "Yes, of course: the *rahn* is well-known under the Shariʿah".

We discussed camels for a year. What are the necessary elements of a valid and enforceable *rahn*? How is the *rahn* perfected? Can the camel be milked? If so, can the milk be sold and who is entitled to the proceeds? Can the milk be sold on a deferred payment basis? If so, what are the implications for our security arrangement? What are the rights of the initial creditor and the initial grantor of the *rahn* on the camel with respect to those future payments and in situations where there is a default on those future payments? What are the respective rights and obligations with respect to care and feeding of the camel during the period of the *rahn*? What are the rights and responsibilities of the parties if the camel becomes ill? What are the rights and responsibilities if the camel is injured as a result of the acts or omissions of the debtor/mortgagor, the creditor/mortgagee and/or a third party? Can a subsequent additional obligation also be secured by that same camel? Can there be multiple security interests with respect to a single camel? Can there be multiple priorities of security interests with respect to a single camel, each in favor of a different person? Will that security interest come into effect automatically or will other steps have to be taken to ensure the effectiveness of the new security interest? What if the camel delivers a calf? Does the creditor automatically obtain a *rahn* over the calf? Can the calf be sold? If so, who is entitled to the proceeds from a sale of a calf? How and when can the *rahn* be enforced?

The questions were many and intricate. After achieving some understanding of the relevant Shariʿah principles in the context of the *rahn* of a camel, the discussions moved on to date palms and other assets and arrangements. This was a logarithmic multiplication of complexity to one striving for simplicity: at least that was the initial impression. Over the years, more simplistic harmony is evident than it was upon introduction.

In the course of considering the camel, our discussions lost their unidirectional character. I felt compelled to contribute something to the discussions. As the script pertained, at that point, to camels, I asked the judge if he knew how a camel stored water and why the camel did not dehydrate in extreme heat. And thus we embarked upon a fascinating progression: first, through discussions of the physiology of water storage and retention in camels (which led to nucleated, oval red cells, renal physiology, the structure of camel hair, and a host of other topics); second, on forays into the origin and evolutionary development of camels; and third, on meanderings through other intriguing aspects of physiology, evolutionary history, cultural history and the myriad inquiries available to the unconstrained human mind. Which is not to say that these sessions lost their focus a financing structure; just that they became more extended and interactive.[7]

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[7] The temperature of a penguin's blood upon entering the penguin's heart is an example of one discussion. This is a matter of considerable consequence to the penguin's viability, and, as a physiologic process, an astounding

Back to the financing structure. The first task was to achieve both a comprehensive understanding of the relevant Shariʿah principles and a precise understanding of how those principles compared, point-by-point, with similar Western concepts. Various legal scholars and Shariʿah advisors were enlisted to supplement the team of lawyers. After the point-by-point analysis, and with spirited discussion, a Shariʿah-based transactional structure was built. Next, practical implementation of the structure was considered. Initially, we developed a series of general questions, building upon our accumulating knowledge of camels, date palms, and the like. How does one obtain and maintain a security interest under the Shariʿah with respect to a given type of collateral? What is the nature of the security interest? What degree of certainty can be obtained with respect to any given security interest? What is necessary to retain that security interest? How is the security interest enforced? What are the respective rights and responsibilities of each of the involved parties? Why was a given element present? Why was it structured as suggested? What if the facts changed in this way or that way? What is the Shariʿah equivalent of a given Western element, if any, and vice versa? Would a different procedure or technique under the Shariʿah better serve the requirements of the project participants? Each category and subcategory of assets was considered, along with relevant Shariʿah precepts for granting a *rahn* or assignment with respect to each such category of assets to be used as collateral (*marhun*).

This list of questions became lengthy, and the conversations even more intricate. The discussions were penetrating, fascinating, and enlightening for all involved. Despite the intellectual rigor of the undertaking, humor permeated the entire process. As the model got refined in accordance with Shariʿah precepts, the team achieved a more precise understanding of the type of structural bridges that would have to be constructed to the relevant Western concepts so as to maintain familiarity to the international banks, to maintain compliance with their credit and underwriting criteria, and to ensure the effectiveness of the entire structure.

Standing alone, *rahn* concepts did not provide sufficient comfort. Examples of factors found disconcerting were the possession requirements for perfection of a *rahn* and the uncertainties that Saudi Arabian courts, applying principles of the Hanbali *madhhab*, would adopt and enforce constructive possession doctrines of the Maliki *madhhab*. We needed a trust and a trustee. But those concepts are absent from Saudi Arabian law and the Shariʿah (*waqf* and *amanah* concepts did not quite satisfy the structural needs). However, the Shariʿah has long experience with the *adl*, a type of trusted person, a type of arbitrator-intermediary. The *adl* became yet another area of focus, and was eventually incorporated into the structure.

But could we have any comfort that a Saudi Arabian court, applying Shariʿah principles, would enforce a *rahn* that secures an interest-bearing debt? What entity would enforce the structure, and how? Assuredly, answering those questions (and a host of others) was an endeavor equivalent to that upon which we had already embarked. It led to a fulsome study of enforcement bodies and their procedures and practices. Fulsome inquiry does not necessarily yield certainty, as we quickly learned. That is particularly true where the substantive principles are not codified, and not even available as written compilations, and where enforcement bodies are not subject to *stare decisis* concepts and do not publish their determinations, let alone their opinions.

Given our skepticism (and paranoia), born largely of unfamiliarity, we repeated our enforceability study, reexamining how different judges and authorities would determine different disputes in defined factual

topic given that the penguin's feet, through which the blood flows continually, are permanently (or nearly so) in contact with ice at a lethal temperature. Contemplating countercurrent mechanisms leads to an entirely new universe of thoughts: some physiological, others not.

circumstances. This time, the focus was on determining certainty and predictability of approach and outcome if the base structure were built around Shariʿah principles and concepts. The results of this study were stunning. The degree of correlation among the Saudi Arabian jurists and lawyers in respect of their determinations when applying Shariʿah principles was high: much higher than had been obtained in any scenario under the Western structure. Certainty and predictability of outcome were significant: much greater than had been achieved in any scenario under the Western structure. And this despite the fact that the Shariʿah, as applied by these jurists and lawyers, is not embodied in any written materials; it is shared oral learning.

The last hurdle was to convince the bankers that there was sufficient predictability and certainty to justify using an unfamiliar structure built on unfamiliar and unwritten legal principles being enforced by courts in an unfamiliar environment, which structure did not seem amenable to the credit and underwriting evaluations customarily used by the bankers. No small task, this. One can imagine the responses of the underwriting and credit committees, and senior management, at the various banks. This was truly an exercise in reasoned persuasion. The approvals were eventually received.

For present purposes, this story is relevant to how I became involved in Islamic finance and the study of Shariʿah, how I came to present one of the first transactional papers presented at the forums of the Harvard Islamic Finance Information Program in the United States, and how I approach the structuring and implementation of Islamic finance arrangements, both globally and in North America. Even as things have changed so much, they have changed so little.[8]

Critical Developmental Events

The box entitled "Eight Critical Developments" embodies events that are critical, in my opinion, to the development of Islamic finance, globally and in North America. This list was first developed in 2006 for an Islamic finance class that I teach at the University of Pennsylvania Carey Law School. Ever since, I have tinkered with the list and discussed its contents with many people. Not all agree with my list. But I stand by it. While the reasons for inclusion of specific matters in the list are not addressed in this paper, I am always willing to discuss those reasons. Of interest for present purposes, three events occurred solely in the United States. I

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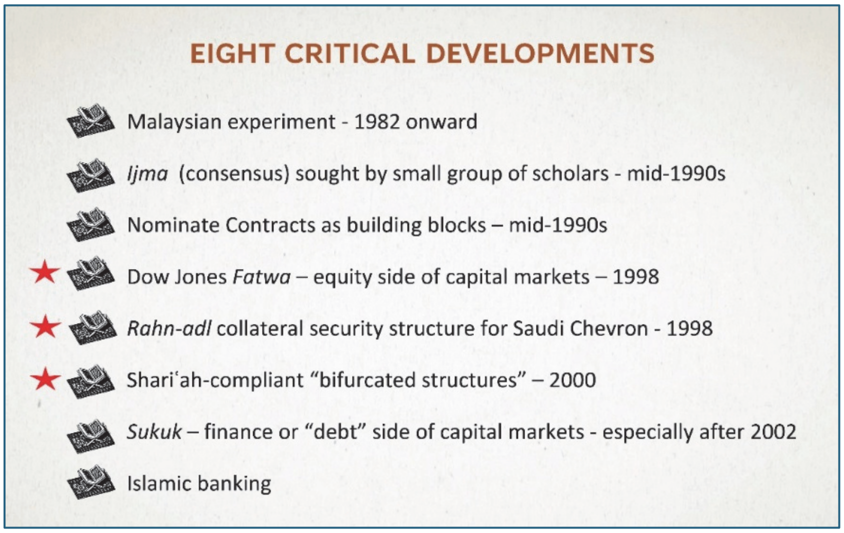
[8] As a footnote to this story: Prior to designing and implementing the *rahn-adl* collateral security structure, the "midnight judge" spoke the most gratifying words that I have heard in my professional career: "Sheikh Michael: I suppose you are going to tell me that we are not discussing a camel, that we are discussing a petrochemical project. You can do this."

This story has other lessons. For example, lessons regarding preconceptions, simplicity, adherence to principle, conceptual multiplicity, risk identification, analysis and management, and the nature of and entitlement to reward, among many others. See McMillen, Islamic Finance, *supra* note 3. The transaction also demonstrated to international banks, including from then United States and England, that acceptable collateral security structures are available under the Shariʿah.

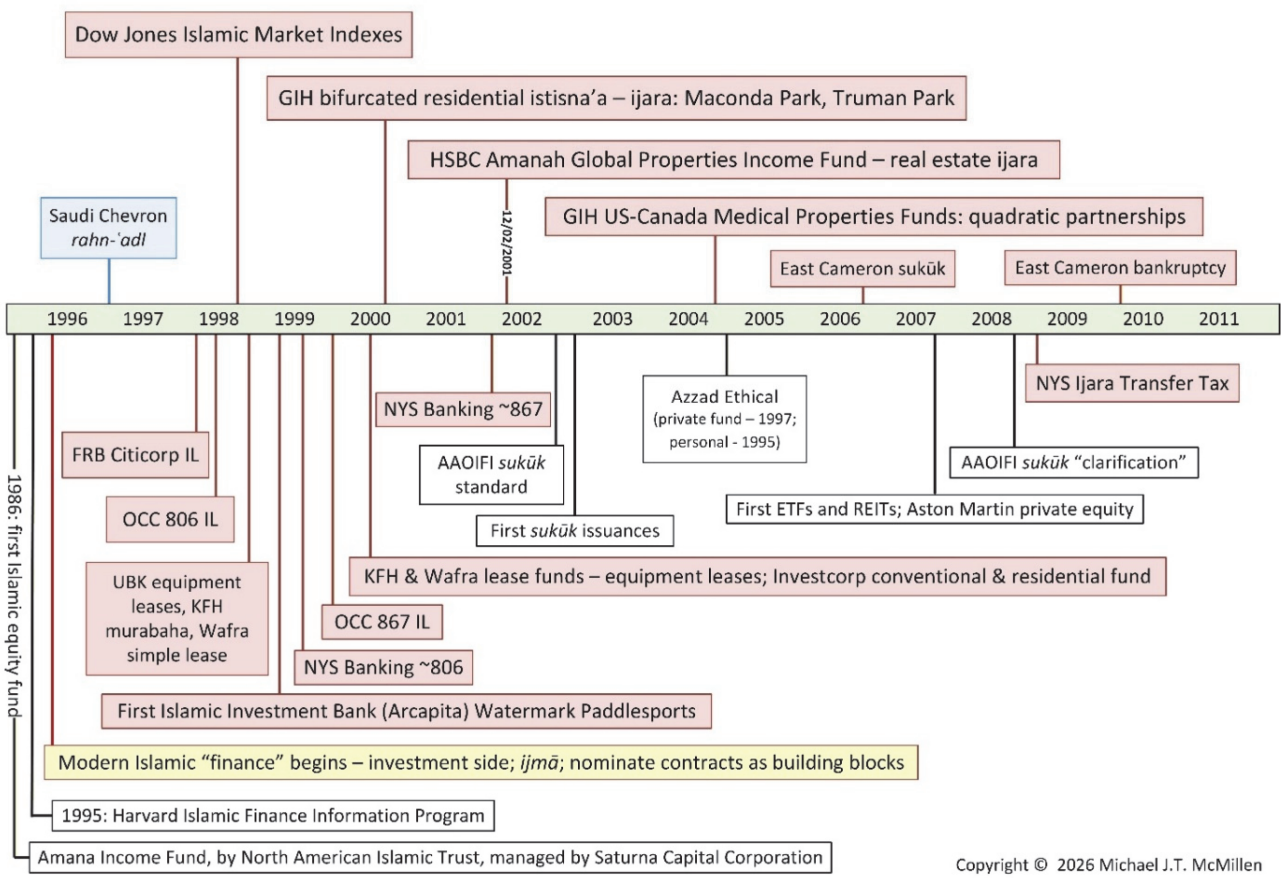
Although the observation was made in respect to comparisons of Christianity and Hinduism, consider Siddha Mohana Mitra, ANGLO-INDIAN STUDIES (1913), at 232: "The pity is that men, led astray by adventitious differences, miss the essential resemblances." This quotation was included in C. Snouck Hurgronje, SELECTED WORKS (1957) ("Hurgronje"), at 177-78, as being preferred to Kipling's poetical despair as evidenced in the words: "East is East and West is West, And never the twain shall meet". Hurgronje, at 177, characterizes Kipling's words as follows: "with regard to the Moslim world, these words seem almost a blasphemy."

selected two of those for my speech: the Dow Jones *Fatwa* and Shariʿah-compliant bifurcated structures, each of which is addressed *infra*.



TIMELINE: NORTH AMERICAN ISLAMIC FINANCE AND INVESTMENT: 1994 TO 2012

Timeline placements are approximate



The timeline presented in this section is abbreviated from a more extended timeline that I originally drafted for McMillen, Islamic Finance (*supra*, note 2) and for my law school Islamic finance class. Certain early events are not discussed in this paper. These include the *murabaha* financing of the Watermark Paddlesports transaction of First Islamic Investment Bank, Wafra Investment Advisory Group participation in a simple, direct Shariʿah-compliant lease financing, and Kuwait Finance House *murabaha* financings.[9]

The timeline references five government issuances pertaining to Shariʿah-compliant financings in the United States. Federal and state regulators have been supportive of bank efforts to engage in Shariʿah-compliant financing activities in the United States. A fundamental aspect of bank regulation, the federal tax system, and other aspects of United States laws, regulations, and regulatory processes is the importance of an economic substance analysis of a proposed activity. The form of the proposed activity is of much lesser import. For example, in considering bank requests, regulators engage in an analysis of whether the Shariʿah-compliant financing is equivalent to a loan financing in economic substance. The receptivity of these regulators is one of the reasons that I aver that the United States is the easiest jurisdiction in the world in which to implement Shariʿah-compliant financings. To provide a flavor for the regulatory treatment of Islamic financing proposals, the five government issuances are discussed below.[10]

The Board of Governors of the Federal Reserve System issued an interpretive letter to Citicorp of New York City on December 18, 1997, allowing *murabaha* financings to be provided by through Citi Islamic Investment Bank, Manama, Bahrain, P.T. Citicorp Securities Indonesia, Jakarta, Indonesia, Citibank Berhad, Kuala Lumpur, Malaysia, and Citibank International, plc, London, England.[11] The letter was issued to a United States bank and related to offshore financing activities of subsidiaries of that bank. It did not pertain to onshore financing activities of Citicorp or its subsidiaries.

Interpretive letters relating to financing activities under the National Bank Act applicable to U.S. branches of foreign banks were issued in 1997 and 1999. U.S. national banks are subject to the same interpretations of the National Bank Act regarding what constitutes the business of banking. The Office of the Comptroller of the Currency issued interpretive letters to The United Bank of Kuwait PLC on October 17, 1997 ("OCC Letter #806") and June 1, 1999 ("OCC Letter #867").[12] OCC Letter #806 allowed the bank branch to offer net lease

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[9] For Watermark Paddlesports, reference is made to my interview of Isam Salah on June 20, 2017 on the history of Islamic finance in North America ("Salah Interview"). Watermark Paddlesports refers to a group of acquisition transactions involving canoe and other companies in June of 1998. My knowledge of early Kuwait Finance House transactions in the U.S. is from discussions with W. Donald Knight, Jr. and various officers of Kuwait Finance House with whom I worked on U.S. transactions. A diagram of the lease arrangements used by Wafra Investment Advisory Group is set forth in Robert W. Toan, *Cross-Border Ijara: A Case Study in the U.S. Taxation of Islamic Finance* ("Toan, Tax"), in Third HIFIP Proceedings, *supra* note 2, at 191. See, also, the references to Salah & Knight, *infra*, in the text following notes 16 and 21.

[10] Other reasons include the possibilities of disregarded entity status and the availability of check-the-box elections in respect of United States federal income tax.

[11] FRB Interpretive Letter, FRB 1997 WL 1143667 (F.R.B.) of the Board of Governors of the Federal Reserve System, dated December 18, 1997, issued to Citicorp of New York City.

[12] Office of the Comptroller of the Currency Interpretive Letter No. 806, ¶81-253 Federal Banking Law Reporter, October 17, 1997 (net lease home financing products), and Interpretive Letter No. 867, ¶81-361, June 1, 1999 (murabaha financing products).

(*ijara*) home finance products meeting certain structural requirements to satisfy the needs of Muslim customers who, for religious reasons, cannot borrow money if a lender charges interest. The *ijara* structure was determined to be "functionally equivalent to or a logical outgrowth of secured real estate lending or mortgage lending, activities that are part of the business of banking" under the National Bank Act. OCC Letter #867 allowed such a bank branch to offer certain *murabaha* financings for real estate properties, real estate construction transactions, commercial inventory operations, and commercial equipment acquisitions to satisfy the needs of Muslim customers whose religious beliefs prohibit the borrowing of money at interest. The *murabaha* financing transactions were determined to be "functionally equivalent to conventional financing transactions" permissible under the National Bank Act, with bank ownership of the real estate permissible during the financing period despite prohibitions under the National Bank Act.

The Department of Financial Services of the State of New York issued two Banking Interpretations that are substantially identical to OCC Letter #806 (on April 12, 1999) and OCC Letter #867 (on August 27, 2001). The first was applicable to New York state-chartered commercial banks and addressed net lease financings. The second was applicable to a mortgage corporation subsidiary of a New York state-chartered commercial bank and addressed *murabaha* financings.[13]

An example of an advisory opinion from a state taxing authority is the April 28, 2008, Advisory Opinion of the Office of Tax Policy Analysis, Taxpayer Guidance Division, Commissioner of Taxation and Finance of the New York State Department of taxation and Finance, issued to Ahli United Bank (UK) PLC, formerly The United Bank of Kuwait PLC. This Advisory Opinion clarified that an *ijara* financing of a home purchase provided by a state-chartered bank in New York does not entail multiple real estate transfer tax payments when the financed property is purchased out of the financing at the end of the financing term.[14]

HIFIP

Activities of the Harvard Islamic Finance and Information Program (HIFIP) were among the earliest efforts to promote Islamic finance in North America. HIFIP was established in late 1995 under the aegis of the Center for Middle Eastern Studies at Harvard University with a grant from Islamic Investment Company of the Gulf, the investment arm of Dar Al Maal Al Islami. HIFIP was an academic program that grew out of a 1993 Islamic Investment Study at Harvard, as did an influential early book of Frank E. Vogel and Samuel L. Hayes III: ISLAMIC LAW AND FINANCE: RELIGION, RISK, AND RETURN (1998) ("Vogel & Hayes"). The Founding Director of HIFIP was S. Nazim Ali and the Executive Director was Thomas D. Mullins. Members of the Operating Board and Advisory Board included Sam Hayes, Frank Vogel, Nazim Ali, Tom Mullins, Dale Flecker, Iqbal Khan, and Amr Alfaisal Al Saudi.[15]

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[13] The Banking Interpretation that is substantially the same as OCC Interpretive Letter #806 is available at https://www.dfs.ny.gov/legal/interpret/lo990412.htm, and the Banking Interpretation that is substantially equivalent to OCC Interpretive Letter #867 is available at https://www.dfs.ny.gov/legal/interpret/lo010827.htm.

[14] Office of Tax Policy Analysis, Taxpayer Guidance Division, Commissioner of Taxation and Finance of the New York State Department of taxation and Finance, TSB-A-08(2)R, Petition No. M071001A, issued to Ahli United Bank (UK) PLC, formerly The United Bank of Kuwait PLC, on April 28, 2008.

[15] A short history of HIFIP is Munir Zilanawala, *A Brief History of the Harvard Islamic Finance Information Program*, in and Proceedings of the Fifth Harvard University Forum on Islamic Finance: Islamic Finance: Dynamics and Development (April 6-7, 2002) (2003) ("Fifth HIFIP Proceedings"), at 283. Reference is also made

The broad objective of HIFIP was to further research in Islamic finance, Islamic economics, and related issues through establishment of an information databank, hosting annual forums on Islamic finance, and providing support for individual researchers and students. The databank was largely academic materials as Islamic finance transactional activity was then sparse and relatively primitive. The forums, and the Proceedings of each of the forums, provide a wealth of information on the growth of Islamic finance in North America, from a theoretical perspective. Evidence in the forums and Proceedings of the development and growth of Islamic finance from a transactional perspective is meager.

The first forum was held in 1997 as a small one-day event. Commencing in 1998, the forums were hosted by the Harvard Law School. No proceedings were published for the first forum. Proceedings were published for the second through the fifth forums, with the PROCEEDINGS OF THE SECOND HARVARD UNIVERSITY FORUM ON ISLAMIC FINANCE: ISLAMIC FINANCE INTO THE 21ST CENTURY (OCTOBER 9-10, 1998) (1999) ("Second HIFIP Proceedings") being published in September of 1999. Copies of the tables of contents of the proceedings for the second through the fifth forums are included as Exhibit C. I was privileged to attend and contribute to each of the second through the fifth forums.[16]

As indicated by the tables of contents included as Exhibit C, HIFIP was an academic initiative that focused on economics and Shariʿah principles and theoretical aspects of Islamic finance, especially Islamic banking and Shariʿah interpretation. It did not initially focus on commercial and financial transactions. After issuance of the Dow Jones *fatwa* in 1998, Shariʿah matters of relevance to equity investing were included. Studies of the application of Shariʿah principles in the transactional context were relatively uncommon. The Second HIFIP Proceedings included two papers addressing U.S. taxation of investments by foreign entities in U.S. transactions (Toan, Tax and Salah & Knight, each *supra* note 9). Salah & Knight sketched a U.S. transactional structure. My modifications of that structure became the bifurcated *ijara* structure whose first transactional uses are described in McMillen, Islamic Project Finance, *supra* note 2, at 1237-1263, in Michael J.T. McMillen, *Shari'a-Compliant Financing Structures and the Development of an Islamic Economy* in Fifth HIFIP Proceedings, and in a subsequent section of this paper.[17] A fulsome discussion of the Saudi Chevron petrochemical project financing was included in the Third HIFIP Proceedings as McMillen, Third Harvard, *supra* note 2. The Third HIFIP Proceedings also included Mohammad S. Al Omar's paper on the *ijara* financing provided to Equate Petrochemical Company by Kuwait Finance House. Al Omar was then the Assistant General Manager of Kuwait Finance House.[18]

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to my interview of Frank E. Vogel on June 22, 2017, on the history of HIFIP, his involvements with Islamic finance, and the development of Vogel & Hayes, *supra*, text preceding note 15.

16 Third Harvard Proceedings is defined in note 2, *supra*, and Fifth HIFIP Proceedings in defined in note 12, *supra*. See, also, PROCEEDINGS OF THE FOURTH HARVARD UNIVERSITY FORUM ON ISLAMIC FINANCE: THE TASK AHEAD (SEPTEMBER 30- OCTOBER 1, 2000) (2001) ("Fourth HIFIP Proceedings").

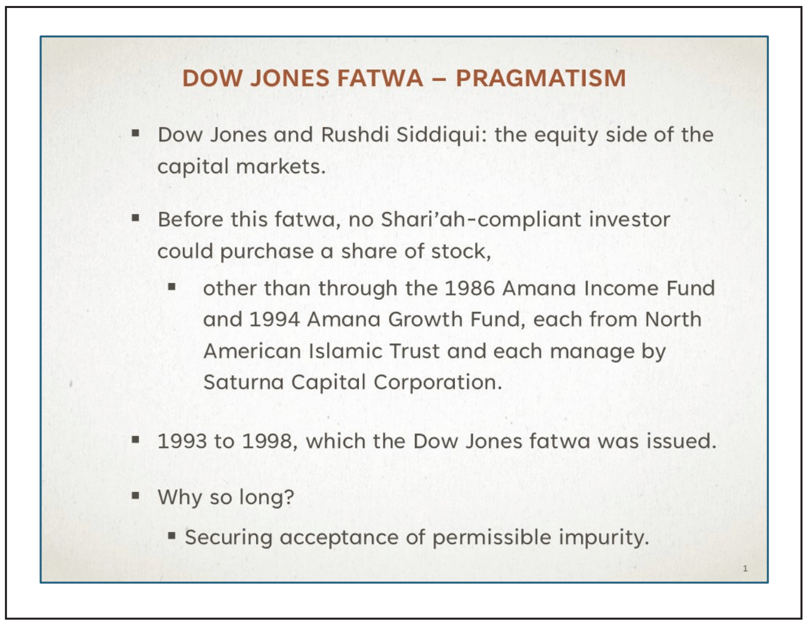
17 Fifth HIFIP Proceedings, at 89-107 ("McMillen, Bifurcated Ijara Structures").

18 Mohammad S. Al Omar, Islamic Project Finance: A Case Study of the Equate Petrochemical Company, in Third HIFIP Proceedings, *supra* note 2, at 259-64. Another paper in the Third HIFIP Proceedings illustrates the more theoretical approach taken in HIFIP forums and proceedings: Mohammed Obaidullah, *Designing Islamic Contracts for Financing Infrastructure Development*, Third HIFIP Proceedings, at 163-76.

Dow Jones Fatwa

Prior to 1998, and with only two exceptions, a devout Muslim was unable to purchase a share of stock or other equity interest in any entity because, among other reasons, virtually all entities either paid or received interest or engaged, to some extent, in impermissible business activities.[19] Interest-based financing dominated the markets, as it had for centuries. Shariʿah compliant financings were unavailable. Available cash could only be invested in interest-bearing securities or interest-bearing accounts. The Islamic finance industry remained focused, primarily, on Islamic banking. The investment side of the Islamic finance equation was largely neglected: until the middle of the 1990s. There were no Shariʿah-compliant capital markets, for equity or debt. Standards for investing in equities were almost nonexistent; the few existing guidelines were inconsistent and lacking in rigor. The exceptions to the foregoing statements were few. For example, North American Islamic Trust established the first Islamic equity fund, the Amana Income Fund, in 1986. It was managed by Saturna Capital Corporation.[20]

Rushdi Siddiqui, under the auspices of the Dow Jones Islamic Market Indexes ("Dow Jones") in New York City, sought to create an index for Shariʿah-compliant equities and develop the equities side of the Islamic capital markets. Dow Jones assembled a Shariʿah board comprised of eminent scholars and undertook the Herculean task of bringing Islamic finance into the global capital markets.



In 1998, after almost five years of debate (often heated debate) among Shariʿah scholars throughout the world, the Dow Jones Shariʿah issued a *fatwa* that, in the opinion of this author, is one of the most important *fatawa* issued in respect of modern Islamic finance. It is candidly pragmatic, from various perspectives. It is that pragmatism that gave rise to the years of debate. The *fatwa* implicitly recognizes that the global financial markets are dominated, and will continue to be dominated, by interest-based concepts, practices, and instruments. The *fatwa* implicitly recognizes that Islamic finance can succeed only if it is integrated into the global financial markets; Islamic finance cannot succeed if operated as an isolated system.

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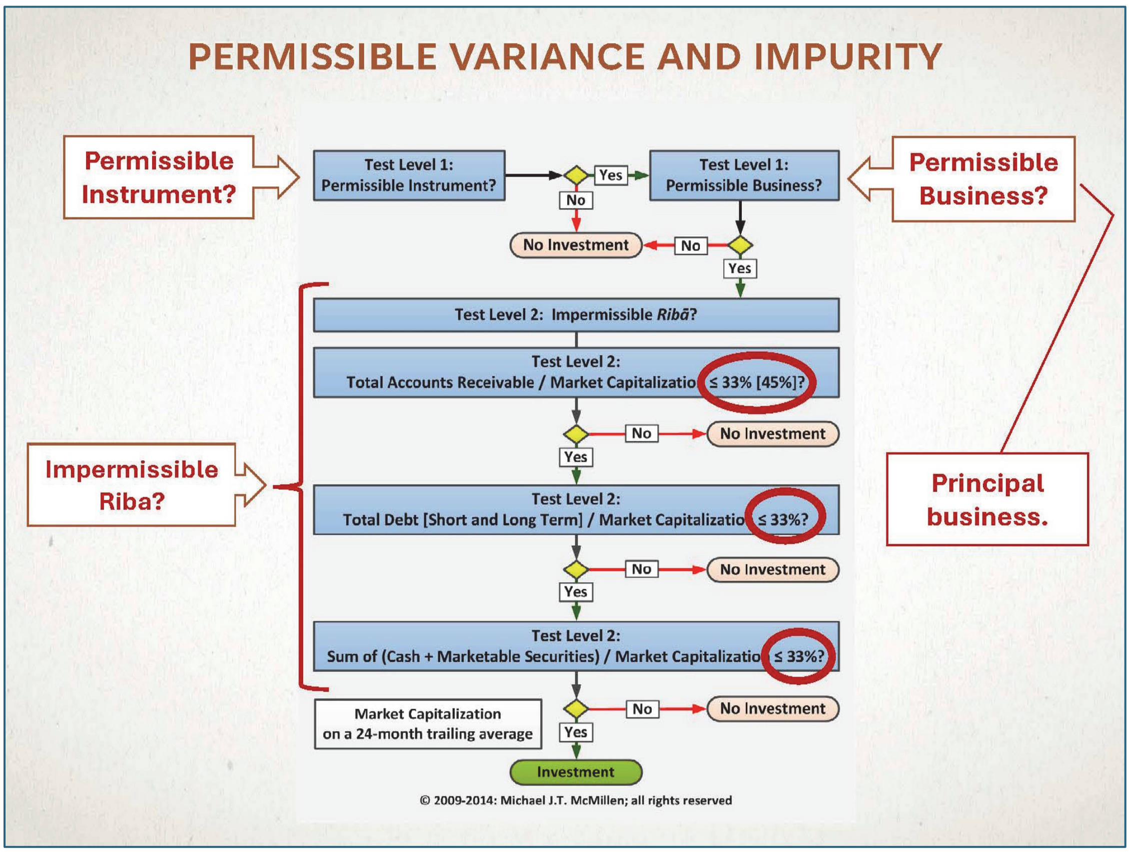
[19] The exceptions were two funds of the North American Islamic Trust, each managed by Saturna Capital Corporation: the Amana Income Fund of 1986 and the Amana Growth Fund of 1994.

[20] F. Scott Valpey, *Structuring Islamic Equity Funds: Sharia Board, Purification, Portfolio Management, and Performance Issues*, Fourth HIFIP Proceedings, at 263 ("Valpey").

The *fatwa* implicitly recognizes that Islamic finance will compete with interest-based finance (including concepts, practices, and instruments) in essentially all markets.[21]

Most importantly, the Dow Jones *fatwa* expressly recognizes that, to achieve its objectives and function within these recognized constraints, modern Islamic must accommodate some impurity. The Dow Jones *fatwa* institutionalized, provisionally and not without discomfort, some permissible impurity or permissible variance from rigorous Shariʿah standards. The *fatwa* also requires the investor in an issuer entity to purify or cleanse any impure revenue received in respect of each investment. Notably, the Dow Jones *fatwa* did not invent the concept of permissible impurity; it institutionalized that concept. Similarly, the Dow Jones *fatwa* did not invent the concept of purification or cleansing (discussed *infra*); it institutionalized the concept and practice. The tests set forth in the Dow Jones *fatwa* are summarized in the following flow chart.



Having accepted the concept of permissible variance, fundamental questions come to the fore. In what circumstances is impurity to be accepted? How much impurity is too much impurity? How is impurity to be determined and measured? What standards should be applied to the various issues that arise when applying

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[21] See Rushdi Siddiqui, *Islamic indexes: the DJIM framework*, in ISLAMIC ASSET MANAGEMENT: FORMING THE FUTURE FOR SHARIʿA-COMPLIANT INVESTMENT STRATEGIES, Sohail Jaffer, ed. (2004), Rushdi Siddiqui, *Shariʿah Compliance, Performance and Conversion: The Case of the Dow Jones Islamic Market Index*[SM], 7 CHICAGO JOURNAL OF INTERNATIONAL LAW 495 (2007), and McMillen, Islamic Finance, *supra* note 2, which is devoted entirely to the Dow Jones *fatwa* and its sequelae.

Shariʿah principles and precepts to modern businesses that are not conducted, and will not be conducted, strictly in accordance with the Shariʿah, recognizing that the business practices of those businesses cannot be changed? These are only a few of the fundamental questions; there are many more. The answers are provided in a host of writings, including my book (McMillen, Islamic Finance, *supra* note 2) and many other articles. The reader is left to those sources to consider the implications and ramifications of the Dow Jones *fatwa*, although a few are discussed later in this paper.

A few observations are in order. The Dow Jones *fatwa* tests are applicable where the acquisition is of a non-controlling equity interest in the issuer of the equity securities. If a controlling interest is obtained, the entirety of the issuer and its operations must be Shariʿah compliant. Only *riba* is measured by the financial tests. A test supplemental to those set forth in the Dow Jones *fatwa* is added to test impure income from other sources. The trailing average mechanism was amended (as was the total accounts receivable test). During the dot.com travails of 1999 it became apparent that the previous trailing average mechanism was too limited and captured equities in circumstances where there was no relevant change in the financial circumstances of the issuer but the equities violated the test because of general market movements. Use of market capitalization as the denominator in the financial tests was chosen (over other alternatives, such as a balance sheet measure) to minimize possibilities for manipulation.

One of the more difficult issues addressed in the Dow Jones *fatwa* is whether the business of the issuer of the securities is permissible as a Shariʿah-compliant investment. Prior to implementation of the Dow Jones *fatwa* any impermissible business purpose precluded investment. The permissible business tests of the Dow Jones *fatwa* incorporate some permissible variance concepts. They are not quantitative, although quantitative analysis is relevant. There are pronounced qualitative elements as well. Generally, the analysis focuses on the principal business of the issuer entity. Which is not to say that other businesses are irrelevant. Illustrative examples included the following. Is it permissible to invest in a non-controlling interest in the stock of a major United States automobile manufacturer? Suppose that the company primarily manufactures automobiles and trucks. Suppose further that the manufacturer has a finance company subsidiary providing interest-based financing to purchasers of its automobiles and trucks. In our transactional experience, it is likely that Shariʿah scholars will permit the purchase of stock in the manufacturer parent if the financing activities of the finance subsidiary are circumscribed and relatively limited as to revenue. What if the finance subsidiary becomes so large as to dominate revenue generation of the corporate group, such as occurred with General Electric Credit Corporation? In our transactional experience, the Shariʿah scholars are unlikely to permit the purchase of stock in the parent company in this scenario. The factual circumstances to be analyzed are myriad, even infinite, and require close involvement of the Shariʿah scholars reviewing the equity investment programs.

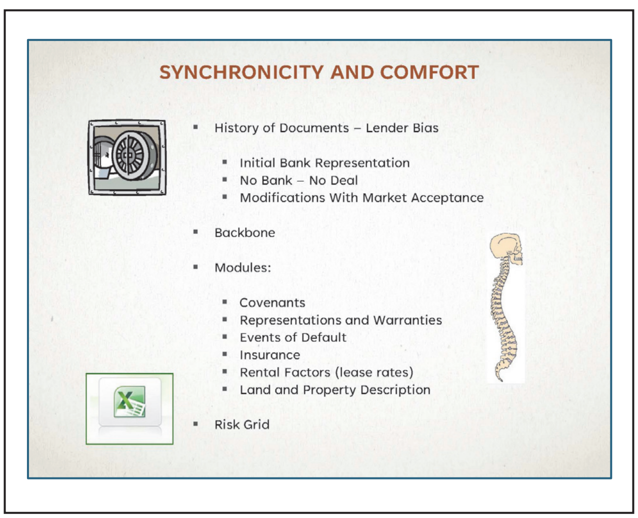
Importantly, the permissible variance principles institutionalized in the Dow Jones *fatwa* have influenced a wide range of activities and considerations apart from determining when an investment may be made in an equity security. An important example is the determination of whether any given entity may be a tenant in a building owned by a Shariʿah -compliant investor. The analysis entails application of the permissible business principles set forth in Test Level 1 as the second test in the process specified in the Dow Jones *fatwa*. That issue is considered int the next section of this paper.

Bifurcated Ijara Structures

In January of 2000 I moved from White & Case in Saudi Arabia to New York City and joined Isam Salah and W. Donald Knight, Jr. to build an Islamic finance practice at King & Spalding. Isam and Don started building the Islamic finance practice in the mid-1990s by attending conferences, working on rudimentary leasing structures, participating in some *murabaha* transactions, and, after being engaged by First Islamic Investment Bank ("FIIB", which later became Arcapita) in 1997-1998, starting to work on more sophisticated Shariʿah-compliant transactions. My early clients included Gulf Investment House ("GIH"), Wafra Investment Advisory Group ("Wafra"), and HSBC Amanah Global Properties Income Fund ("GPIF"). These clients (and others) were focused on real estate investments in the United States by Middle Eastern investors.[22]

My first undertakings in 2000 were development of efficient structures for the Shariʿah-compliant real estate construction finance transactions of GIH and Wafra. Isam and Don had begun working on an *ijara* financing structure for FIIB private equity transactions. Salah & Knight, supra note 9, was a report on that structure. I began with the framework they had developed.

My work since 1983 had focused primarily on project and infrastructure financings, which in those years were predominantly U.S. leveraged lease financings in the electricity and industrial sectors. I restructured the framework that Salah and Knight had developed to conform to lease financing concepts (including risk allocations), practices, and documentary provisions (and, in some cases, to add construction financing elements) and to utilize (even assume) interest-based loan financing structures and documents. The objective was to provide United States banks and financial institutions with comfort. They knew nothing of Islamic finance. They feared that Islamic financings would disrupt accepted risk allocations, credit analyses, and underwriting determinations, result in horrific tax and regulatory issues, be unfamiliar to lawyers, accountants and other advisors, and result in a raft of other uncertainties. The restructuring needed to allow the continuing use of the same structures and documents that these financing institutions customarily used, cause no change in credit, underwriting, tax, regulatory, or other practices of these institutions, and leave these institutions in the same risk-allocated position as the interest-bearing financings they routinely provided.



To provide greater comfort, the documents were drafted to be somewhat biased in favor of the banks and financial institutions, allowing them a better risk allocation than interest-based market allocations. With time, as the banks and financial institutions became comfortable with these Islamic financings, we could move back to market standard allocations. All in due course.

Each bank and financial institution has its own forms of loan documents. The Shariʿah documents (the *ijara* and two understandings) had to mirror the documents of each bank and financial institution. And the documents had to be constructed in a way that allowed the Shariʿah scholars to efficiently review the documents for Shariʿah compliance. That was achieved by creating a Shariʿah compliant backbone that would be used for every *ijara* transaction for every bank and financial institution. Those elements that were specific or unique to a bank or financial institution were then placed in modules that could be attached to the backbones. Each bank and financial institution had

[22] The pre-2000 observations are from Salah Interview, *supra* note 9.

its own set of modules. The Shariʿah scholars would only have to review changes to the standardized backbones and modules.[23]

From many years of lease finance experience, the solution seemed clear to me. Build the financing around a lease that looked and functioned like a leveraged lease. Essentially all bankers, financiers, finance lawyers, accountants, regulators, and courts are familiar with leveraged leases. The bifurcated *ijara* structure was fundamentally the same as a fractional undivided interest leveraged lease. And I had done many of those.

The *ijara* (and related undertakings) would be mirror images of the interest-based loan agreement and related documents in terms of covenants, representations, warranties, insurance provisions, repair and replacement provisions, events of default, timing mechanisms (including for payments), and other features. Adjustments would have to be made in some regards to ensure Shariʿah compliance. As more was learned about the *ijara*, it became apparent that the differences between an *ijara* and a U.S. finance lease are relatively few. And disregarded entity concepts under United States federal tax law ensured that we could easily preserve the economics of these bifurcated ijara transactions.

The following conceptual diagrams illustrate the creation of the *ijara* and related understandings to mirror a conventional loan agreement. Of course, the *ijara* and understandings were modified to adhere to comply with applicable Shariʿah requirements. In considering the following diagrams, note that the Understanding to Purchase and the Understanding to Sell are not "options" under Shariʿah principles. However, they function economically much like an option.

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[23] The "risk grid" reference in the "Synchronicity and Comfort" box requires explanation. In the first transactions, we had to demonstrate that the bank's risk allocated position was essentially unaltered by the Shariʿah-related documents. We put each provision of each loan-related document on one axis of a spread sheet and each provision of each Shariʿah-related document on the other axis. Where treatment of a risk in one set of documents did not correspond to treatment of that risk in the other set, the cell of intersection was marked in red. There were remarkably few red cells. We then addressed those discontinuities in the documents. We were informed that this approach was exceptionally helpful to the banks and their committees, lawyers, and accountants. This was an expensive undertaking. I commend the foresight (and courage) of Bader Al Ali, the CEO of Gulf Investment House, for seeing this exercise through. Bader is one of the unsung heroes of Islamic finance.

GENERIC STANDARD LOAN AGREEMENT

- Left Column:
- Disbursement
- Matters relating to money out from Bank

LOAN AGREEMENT

- Commitment to Lend
- Disbursement Mechanics
- Conditions Precedent
- Representations and Warranties

- Rate Calculations
- Amortization
- Mandatory Prepayment
- Voluntary Prepayment
- Covenants
- Events of Default
- Remedies
- Indemnities
- Representations and Warranties

- Right Column:
- Repayment
- Matters relating to money paid to Bank

DISBURSEMENTS AND REPAYMENTS

LOAN AG

- Commitment to Lend
- Disbursement Mechanics
- Conditions Precedent
- Representations and Warranties

REEMENT

- Rate Calculations
- Amortization
- Mandatory Prepayment
- Voluntary Prepayment
- Covenants
- Events of Default
- Remedies
- Indemnities
- Representations and Warranties

REALLOCATION OF PROVISIONS

LEASE (*IJARA*)
(*ISTIṢNAʿA*)]

- Commitment for Construction
- Disbursement Mechanisms
- Conditions Precedent
- Representations and Warranties
- Covenants

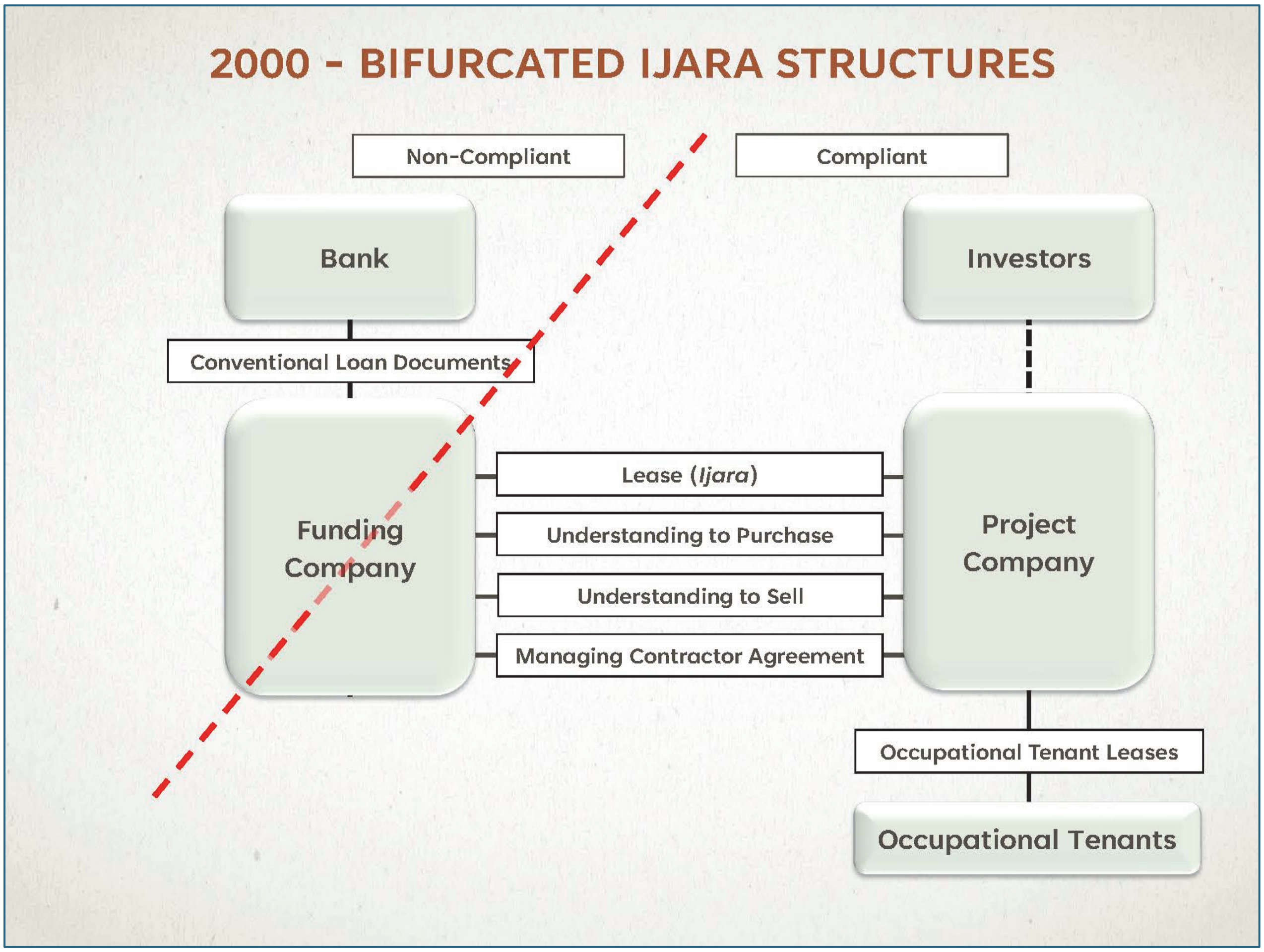
LEASE
(*IJARA*)

- Rent Rate Calculations
- Covenants
- Representations and Warranties
- Events of Default
- Remedies
- Indemnities
- Periodic Rent

Acquisition transactions have no *istiṣnaʿa* – that is for construction financings with multiple draws

UNDERSTANDINGS TO SELL AND PURCHASE:
ECONOMICALLY "`PUT" and "CALL" OPTIONS

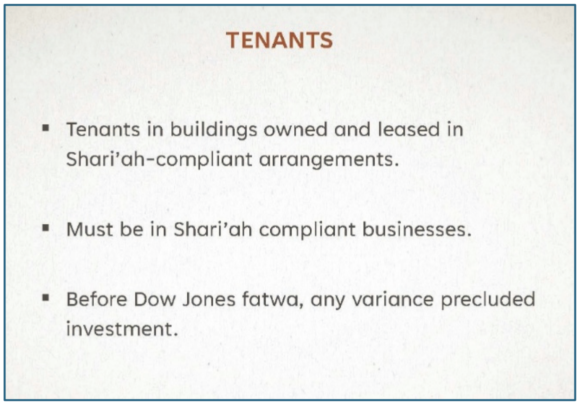
- Mandatory Prepayments
- Voluntary Prepayments



The structure that ultimately evolved, for asset acquisition financings, is depicted in the diagram next preceding this paragraph. I have discussed this structure, and the operations of each component of the structure, at length in other articles. I refer the reader to those articles for further details and information. McMillen, Islamic Project Finance, *supra* note 2, describes the first United States transactions using the structure that was developed in early 2000. The financing was for construction of two residential apartment projects, Maconda Park Apartments and Truman Park Apartments. The structure included an *istisna'a*. Over the years the structure has been refined and streamlined.[24]

Early Shariʿah-compliant investments in the United States focused on residential housing. The residential housing markets were booming. Construction periods were short: in the neighborhood of two to three years. Exits from the investments were smooth. And, from a Shariʿah perspective, individual apartment dwellers and home owners were not subject to investigations as to Shariʿah compliance. Dozens of Shariʿah-compliant residential housing construction financings were completed in the early 2000s, as suggested by the following slide boxes.

[24] See McMillen, Islamic Project Finance, *supra* note 2, at 1241, for a diagram of the Maconda Park and Truman Park transactions, which each included an *istisna'a* arrangement (in a form that has been superseded).



The bifurcated *ijara* structure was refined and proven in dozens of transactions. Banks and financial institutions were open to financing Shariʿah-compliant transactions. The United States was recognized by foreign Shariʿah-compliant investors as a jurisdiction providing stability and almost unmatched risk diversification opportunities. U.S. bank and tax regulatory positions were supportive of Islamic finance structures and transactions. The availability of disregarded entity and check-the-box exemptions for U.S. federal income tax treatment and rulings on state transfer taxes avoided the double taxation concerns experienced by Islamic finance transactions in other jurisdictions.[25] Real estate construction transactions, which were favored in the early years, were compatible with the desires of Middle Eastern investors for investments of approximately two to three years. Hold periods for commercial property investments were usually in the range of five to seven years. The amount of funds available for Shariʿah-compliant real estate investments in the United States was staggering. There was pressure to identify larger investments. The

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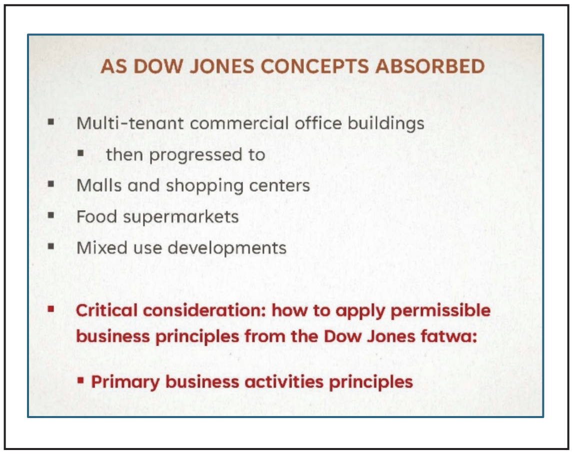
[25] Double taxation exists for two or more events in the application of most Islamic finance structures in jurisdictions that impose income tax on payments of rent and asset sales and transfer taxes on sales of real estate properties and other assets. The double taxation issues have been major impediments to the introduction of Islamic banking and other forms of Islamic finance in jurisdictions around the world. England is one example. As my work with the World Bank has revealed, the issues are ubiquitous around the globe. A third area of tax considerations relates to payments of amounts out of the United States to foreign investors.

In the bifurcated *ijara*, the Funding Company uses the rent payment received from the Project Company (which benefits the Shari'ah-compliant investor) to pay principal and interest to the bank providing financing. The rent payment amount equals the sum of the principal amount of the financing due to the bank and the interest amount due. Without an exemption or other regulatory relief, the entire amount of the rent—both the principal and interest equivalents—is taxed as income at the Funding Company level. The interest component is taxed as income again at the bank level upon receipt from the Funding Company. Disregarded entity and check-the-box exemptions, together with tax rulings and the economic substance approach of the relevant tax laws and regulators, eliminates the issue in the United States. In the *ijara* structure, the transaction attracts a transfer tax when the property is acquired into the Funding Company, before being leased to the Project Company. After full payment of the *ijara* and financing, absent tax regulatory relief, the property is transferred to the Project Company, attracting a second transfer tax. Rulings such as that in New York State eliminate duplicative transfer tax issues. The portfolio interest or portfolio loan exemptions for payments of investment returns and investment principal to foreign investors, coupled with liquidating distribution provisions of U.S. federal tax laws, are highly beneficial to foreign investors in U.S. properties, often reducing tax impositions to zero on distributed income.

industry began to consider acquisitions of commercial properties. U.S. real estate developers need financing. U.S. businesses seized the opportunities to sell their existing real estate properties to Shariʿah-compliant investors and then lease those properties back from the investors. These sale and leaseback transactions allowed the U.S. businesses to realize immediate cash from the property sale and ongoing tax deductions for rental payments on the *ijara* rather than the meagre depreciation deductions available for owned real estate.[26] There were a host of other reasons supporting the use of bifurcated ijara transactions for real estate and private equity transactions.



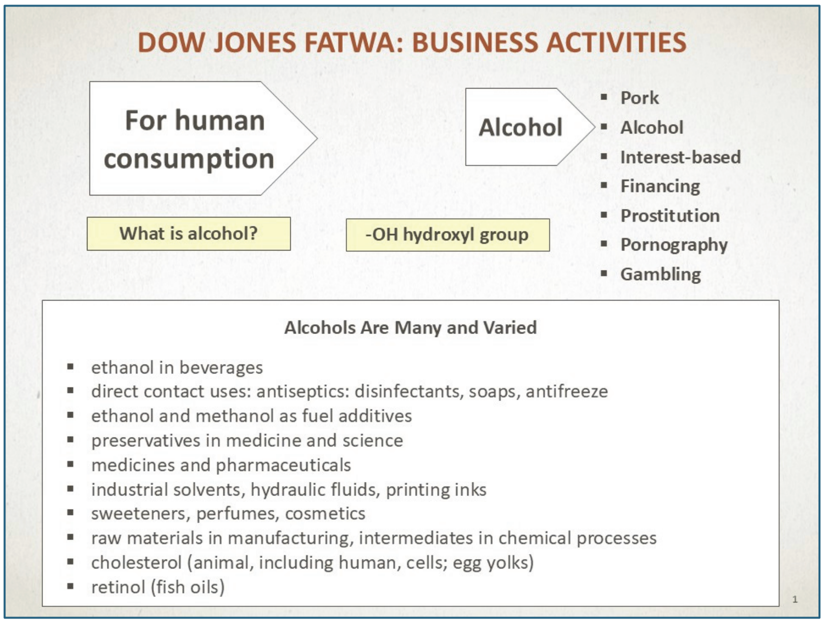
Commercial properties had business tenants. Those tenants would have to be engaged in Shariʿah-compliant business activities. Which would entail screening tenants with respect to the Shariʿah compliance of their business activities. There were relatively few standards for that type of screening. And the pool of available tenants in the United States was limited, from a Shariʿah perspective. A large proportion of the possible tenants were engaged in interest-based finance activities. Other tenants might be engaged in impermissible movie and entertainment activities, or be engaged in or intertwined with entities that were engaged in the sale of alcohol.

Proceeding with caution, the Shariʿah compliant investors, and funds that served those investors, initially sought to acquire single tenant, credit lease properties. This allowed the investors and funds to gain experience with the due diligence processes and the applicable Shariʿah standards in screening for activities involving interest, alcohol, pork, pornography, gambling, and other impermissible activities. After that experience was gained, the investors and funds moved to acquisitions of multiple tenant properties. It was immediately apparent that the permissible business tests from the Dow Jones *fatwa* would be applied in analyzing tenant business activities and that application is not a simple, straight-forward recitation of general categories of impermissible activities.

One of the first applications of the permissible variance principles to tenant business assessments involved the presence of a stand-alone ATM in a four story office building with a single tenant that was in a clearly permissible business. The machine was owned by an interest based commercial bank. No other banking business was conducted at the site. Prior to issuance of the Dow Jones fatwa, many Shariʿah scholars would not have permitted the acquisition of this building due to the presence of the ATM. Applying the permissible variance principles, the Shariʿah scholars allowed the acquisition of the building and the rental revenue from that space was donated to charity in purification. Another early example was a tenant that manufactured computer chips, some of which were used in slot machines in casinos. More difficult issues arose where a property included a restaurant that served alcohol or a grocery store in a mall that sold pork or beer or wine. The possibilities for some impermissibility are infinite. Addressing these issues takes a significant amount of time. The body of knowledge regarding the lines for permissibility/impermissibility has become quite refined.

[26] Depreciation on real estate assets was often 30-year straight line. The expense deduction for *ijara* rent was 100% of the rental payment.

Tenant involvements with alcohol provide an interesting illustration of the types of considerations that became daily grist. Tenant business inquiries focus on the question of what constitutes alcohol? Alcohols are myriad, created by attaching a hydroxyl group to a carbon atom of an alkyl group.[27] The result obviously includes ethanol used in alcoholic beverages for human consumption. But there are many other types of alcohols. Alcohols are among the most common organic compounds. They are used as antiseptics, as sanitizers, as sweeteners, as fuels and fuel additives, in soaps, in cosmetics, in foods, in pharmaceuticals, as preservatives, as solvents and cleaners, as antifreeze, as an ingredient of hydraulic fluids, as printing inks, as resins, as raw materials in manufacturing, as intermediaries in chemical reactions, and for other purposes. Those other types of alcohols are not impermissible, in the views of many (if not most) Shariʿah scholars.



The Dow Jones *fatwa* prohibits investments in entertainment company stocks. Why? Are entertainments provided by the characters depicted in the following illustration box violative of and impermissible under Shariʿah principles? Most Shariʿah scholars do not classify entertainment of the type so depicted as violative or impermissible. So, why does the *fatwa*, on its face, preclude investment in entertainment company stocks?

There are a few reasons. First, the criteria set forth in the *fatwa* are intended as screening criteria at the index level, and are not intended to address permissibility at the individual entity level where the inquiries are granular. Second, the cost and expense of screening every type of entertainment stock is prohibitive, especially at the index level. Third, Shariʿah scholars and index providers have neither the capability or the resources to

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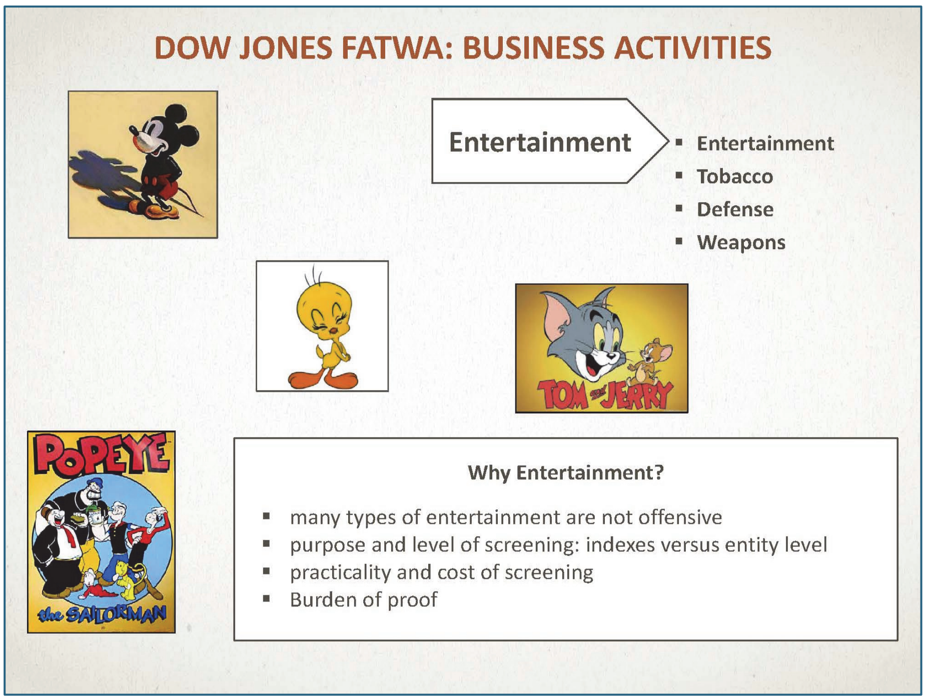
27 An alcohol may be considered an organic derivative of water (H_2O) in which the hydrogen atom is replaced by an alkyl group. Water itself possesses two hydroxyl groups. The hydroxyl group is denoted as -OH. In ethanol (ethyl alcohol), the alkyl group is the ethyl group, $-CH_2CH_3$. Alcohols readily form hydrogen bonds with water, and vice versa, rendering alcohols relatively soluble in water. Alcohols are obtained through distillation, fermentation, saponification, reduction, and other processes. Some alcohols are extracted from natural sources, including animals and plants. Naturally occurring alcohols include cholesterol (found in most animal tissues and egg yolks) and retinol (found in fish liver oils).

screen the many entertainment companies that might be considered for inclusion in an index, some of which engage in both permissible and impermissible entertainment activities.

Fourth, and probably most importantly, the *fatwa* establishes a burden of proof. If an investor desires to invest in an entertainment company, the burden is on the investor to demonstrate that the particular company in which investment is contemplated does not engage in impermissible entertainment activities.

In short, the prohibition in a *fatwa* addressing an index is not intended to act as a blanket prohibition when an investment in a specific entity is being considered. This sort of perspective is important in many different aspects of modern Islamic finance. Consider carefully the substance of a Shariʿah principle or precept in interpreting its applicable to specific activities, arrangements, transactions, or circumstances. Nuance and attention to detail are critical. Especially in a field still in its infancy where we are still only beginning to learn how to apply these principles and precepts. Shwaya, shwaya.



Conclusion

This is a great deal of background for just a few slides. Yet, we have only barely touched on the topics addressed in this paper. Suffice it to say that the Islamic finance industry has largely ignored Islamic finance in North America, even though developments that originated in the United States have been disproportionately innovative and had profound effects on the global Islamic finance industry. This paper alludes to a few of those innovations. There are many others.

Shariʿah compliant investors and United States businesses, on the other hand, have not ignored Islamic finance in the United States. Quite the contrary. Billions of U.S. dollars have been invested in Shariʿah-compliant transactions in North America. In my experience, most of the investments have been in the real estate sector. I have acted as legal counsel to two Shariʿah-compliant real estate funds that had more than US$ 2 billion in property investments, including the HSBC Amanah Global Properties Income Fund, which was the first open-end Shariʿah-compliant real estate fund and eventually had extensive investments in both North

America and Europe. I have worked on dozens of other Shariʿah-compliant real estate investment funds, many of which had investments totally in the hundreds of millions of US dollars, and some of which had investments under US$ 100 million. I have worked on Shariʿah-compliant funds that invested in the construction of medical facilities across the Untied States and Canada, financing approximately eighteen facilities using a unique quadratic partnership structure. I have worked on arrangements that allow real estate developers to convert GNMA (Government National Mortgage Association) certificates from their projects into Shariʿah-compliant instruments that are essentially fixed income mortgage products (if the certificate pool sizes are large to invoke the law of large numbers). I have worked on bespoke structures for investments by large U.S. insurance companies in South Korean real estate projects.

In the June 16 speech, I presented a list of entities that have been involved in Shariʿah-compliant transactions in the United States, sometimes as tenants and sometimes as acquired entities in private equity transactions. This list barely scratches the surface of the number of entities that have been involved in North American Shariʿah-compliant investments. The identities of participants and the size of Islamic finance in the United States are difficult to determine. Most transactions are private investment transactions which are not publicly discussed. Given the ease with which Shariʿah-compliant transactions can be implemented in North America, the favorable regulatory positions of federal and state governments in the U.S., the favorable tax environment for Shariʿah-compliant (and other) investments (for example, disregarded entity practices and portfolio interest exemptions), the large amount of capital available for such transactions, the tax and operating benefits available to U.S. businesses, and the broader involvement of banks such as Stearns Bank N.A. in Islamic finance, the future of Islamic finance in North America is encouraging. Innovation will again come to the fore.[28]

[28] I have long believed, and continue to believe, that North America could lead the world in a range of different types of Islamic financing and assist in providing the necessary backbone for development of the "debt" side of the Islamic capital markets. *Sukuk* are a leading example (I can cite many others). *Sukuk* are Shariʿah-compliant securitizations. No jurisdiction in the world has more experience with securitizations or more Shariʿah-compliant assets. No jurisdiction in the world has more experience with rating securitizations, including those sponsored by private commercial entities. The roadblock on ratings for private sector *sukuk* issuances would be broken with relative ease. Tradable rated paper would become widely available, including for Islamic banks that seek to manage their tier capital requirements. The iceberg picture is from a blog by Karl Williams, *What is the Iceberg Theory and How Can It Help Your Writing?*, available at https://www.finaldraft.com/blog/what-is-the-iceberg-theory-and-how-can-it-help-your-writing.