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"ADAPTING THE DEMANDS OF THE ISLAMIC MORAL ORDER TO PROJECT FINANCE: PROSPECTS FOR FRENCH LAW IN CONNECTION WITH AN ISTISNA'A-IJARA (CONTRUCTION FINANCING AND LEASE-TO-OWN) STRUCTURE"

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Introduction

Central Objective of this Study

1. Why utilize project finance? At first glance, it would appear that project finance is consistent with the objectives of Islamic finance. Without going into too much detail about the requirements of Islamic Contract Law–which we will do later in this study–we will succinctly describe the common features of project finance and Islamic finance.

2. Typically in project finance, financial partners form a project company in which the capital is invested and their compensation is a function of how successful the investment project is. Any loans necessary for such funding will be taken out by a special-purpose vehicle[2] (SPV) and are paid back from operating income from the project.

3. As we will see, Islamic Law prohibits the charging or paying of interest, regardless of whether it is usury or not. The charging of a fixed fee that solely is a function of the passage of time and unrelated to the actual profitability of the underlying investment project, goes against Islamic moral principles but it is regarded as unfair.

4. However, the Qur'an does not prohibit the payment of remuneration on money loaned; it only bans the charging of a fixed predetermined interest. That is why financing transactions cannot, in theory, include any fixed remuneration. Only the profits derived from the asset financed can be used to remunerate the money invested. Yet, in project finance

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[2] Report from Group of Banks and Financial Institutions that are members of the Insitut de gestion délégué: "*Le financement des PPP en France*," I.G.D., October 1986, pp.20-21.

transactions, debt servicing relies primarily on future cash flows generated from the project. From this standpoint, debt servicing, unforeseen events, the ability to cover operating costs and a fair rate of return on capital all depend on the profitability of the asset financed[3].

5. Likewise, the Islamic Business Law requires that financial transactions be asset-backed (by a tangible asset) in order share the resulting losses and profits (PLS). So, Islamic banks will give the funds to a businessman and the profits will be shared on a prearranged basis. In project finance, the investment project is necessarily a tangible asset (*i.e.*, airport, electrical power plant, nuclear power plant, desalination plant, university, plant, etc.) and the lenders share the risks along the project developers: the repayment of the loan made to fund the construction of the project depends primarily on cash flows from the project (non-recourse financing). Therefore, there is an underlying asset and a sharing of risks.

6. Furthermore, Qur'anic Law does not allow speculation and risky or hazardous sales (gharar). Gharar is the as a sale of assets "*for which it is not known whether they exist or not, given the risk involved in such probability and which subjects the validity of the transaction to conjecture*.[4]" Qimaars and maysirs are forms of aleatory contracts, such as speculation, standard insurance policies and derivative products. Yet in project finance, each project for new infrastructure requirements huge investments and loans. As a consequent, only an exhaustive analysis of the technical and contractual risks–with a matrix identifying and sharing them–can help optimize the financing terms, i.e. to reduce the cost of the debt, and to eliminate chance which is prohibited under Qur'anic Law.

7. Finally, according to the fundamental tenants of Shari'a Law, the investment project must be legal (halal). Traditionally, some business sectors are excluded. The project must also contribute to social and economic development and play a role in creating jobs. This is hardly ever an issue to the extent that most investment projects are by nature eligible (hospital, airport, nuclear power plant, plant, etc.) for Islamic financing and, because of their size, result in significant economic activity. So project finance fully complies with these requirements.

8. As indicated, the very concept of project finance appears to be consistent with Islamic finance that subjects financing deals to moral, ethical and economic constraints based on Shari'a Law and requires special contractual arrangements. The premises of this study and the contract model test that we propose are based on these focal points.

9. Moreover, given the multiple sources of potential conflict that are associated with it, project finance does not imply that precedents will give rise to the same outcomes. While there is indeed some reliability, there is not however, in theory, a predetermined and efficient method to address the complexity of the topic. Yet, because of its very complexity, project finance offers a very broad field of investigation and shines light on the large number of constraints arising from Islamic moral order. Because it is intricate, project finance combines more moral and business considerations than another form of financing.

10. The syndicated Islamic finance that we call project co-financing refers to the participation of a group of financial institutions in a joint financing deal Shari'a complaint. Islamic banks and the conventional counterparties finance together a project, one or more of the

[3] Sarmet, Marcel, « *Gestion et techniques bancaires*, » RB, no. 392, February 1980.
[4] Karich, Imane. *Le système financier islamique. De la Religion à la Banque*, Larcier, coll. Cahiers financiers, 2002, p. 44.

component parts of which are financed by Islamic financing provided that the project observes Shari'a Law in all respects.

11. The primary goal of this study is to analyze the adaptability of the demands of the Islamic moral order to project co-financing transactions under French Law. In other words, the contractual arrangements must comply with French banking regulations and be consistent with the demands of the Islamic moral order. To this end, this study proposes a model that provides appropriate solutions in French Law that reconcile these conflicting interests.

12. But what does the term Islamic moral order mean? In a broad sense, in Islamic finance law, which has varied sources and schools, there are seven imperative principles: four negative principles (prohibition of riba, gharar, haram, indebtedness above a certain percentage) and three positive principles (profit and loss sharing, existence of an underlying asset and payment of a zakāt). If these principles are observed, it is possible to infer a religious moral order that has as an effect to guarantee a fair contractual balance by subjecting an Islamic contractor to a number of requirements. But this moral order is weighty, as remarked one author, it is not easy to "*break through the wall of a religious moral order built for over a thousand years*"[5] due to the fact that "*the religious moral order that serves as a backdrop to Islamic Law plays a compelling role in contractual activity and in business in general*."[6] The author continues: "*A contract under Islamic Law is an instrument for specific purposes defined by law and which is the equality or the equivalency of reciprocal services. This idea of quid pro quo and fair balance is a moral idea that underlies the entire general theory of Islamic Contract Law and even goes beyond the contractual event since it has as a consequence to restrict the will and freedom to form a contract*."[7]

13. It is of note, therefore, that the paradigms of Islamic finance are based on the principle of the authority of religious rule–Islamic Law is theocratic–and no one can modify the rudiments. The expression of commutative justice, principles of equality and balance in reciprocal services and fair profit refer to a moral system that protects the contractor. These principles, justified by moral rationale, are organized. Order here refers to an organization of a community of individuals (ummah[8]) who share the same norms dictated by the Islamic values that they mean to abide by and make sure they are abided by. This body of rules carries great constraints that must be taken into consideration in financial arrangements. However, the challenge that they bring is less their existence than their dosage. These obligations carry more or less weight depending on their place in the hierarchy of legal norms. For example, a Qur'anic rule such as the prohibition of riba has special legal force that is more authoritative than the prescriptions contained in the Sunna, which itself is more authoritative than the ijmā or urf rules. But, while they apply, they still run counter to classic project finance techniques that sometimes offer tools to satisfy them. However, this often requires using special arrangements that combine several techniques designed to achieve a stated goal while addressing the existing constraints. That is the subject of this study.

14. After a rapid assessment, we see that Islamic finance law is based on a moral order that it is designed to serve. Such that ethical injunctions hit legal rules broadside therefore dictate special structuring of international financial transactions so as to adapt moral rules to conventional contractual arrangements.

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[5] Comar-Obeid, Nayla, *Les contrats en droit musulman des affaires*, Économica, 1995, p. 2.
[6] Comar-Obeid, Nayla, *op. cit.*, p. 2.
[7] Comar-Obeid, Nayla, *op. cit.*, p. 5.
[8] Arabic word meaning the community of Muslim believers or the world Muslim community.

15. This analysis shows fairly clearly the complex nature of project co-financing transactions where conventional finance and Islamic finance have to fall into line. As we will see, the distinctiveness of Islamic finance and the strength of its moral rules make for special challenges of putting together a financing deal. This study, which is intended to highlight the challenges of reconciling the conflicting interests of parties, provides an inventory of the challenges of structuring a deal. On the other hand, regardless of the challenges associated with these rules, these tensions are not insurmountable, although they require a certain degree of sophistication.

Benefits and Objectives of this Study

16. What is the relevance of such a study? In a world where there is growing globalization and increasing competition between the global financial centers, a study of the relationship between French Law and Islamic Contract Law has a two-fold benefit. Firstly, an academic benefit in that is related to the emerging faith-based concept in banking law and financial markets and of which Islamic finance is certainly the most significant illustration. What is it? The faith-based concept "*should not be confused with recognizing in France instruments and contracts executed pursuant to and by virtue of the laws of a foreign jurisdiction that has religious law. These are not, either, contracts containing a foreign element governed, under the parties' agreement, by state or non-state religious laws. These are financial instruments governed by French Law but that comply with religious law*."[9] To the best of our knowledge, not much research has focused narrowly on a study of Islamic Shari'a compliant project co-financing in French Law. The work by the Paris-Europlace Islamic Finance Commission, the whitepapers of a number of law firms and the perspective of certain specialists[10] provided us with invaluable insight.

17. As is the case with any objective analysis, the focus of our investigation is to explore in depth a field of knowledge, namely by examining Islamic financial contracts and the Islamic moral order that they are based on. Islamic finance is an ethical form of finance, which means that it asks what to do in a given situation. Yet, only this detailed study can help surpass the challenges of putting together a financing deal: some are inherent in project finance while others stem from the interventionist nature of a moral order that sometimes tends to be constrictive.

18. Secondly, this study presents a practical benefit, which is of the same essence as the first benefit, namely to identify, through a contractual approach, the constraints of project finance in order to propose a legal structure that is consistent with the requirements of the Islamic moral order. Up until now, recommendations have come from parliaments or

[9] Le Dolley, Erik, *Les concepts émergents en droit des affaires*, L.G.D.J, Coll. Droit et Économie, 2010, p. 163.
[10] Mcmillen J.T., "Islamic Chari'ah Compliant Project Financing. Collateral Security and Financing Structure Cases Studies," *Fordham International Law Journal*, volume 48, May 2001; Grangereau, Pascal and Haroun, Medhi, « Financements de projets et financements islamiques. Quelques réflexions prospectives pour des financements en pays de droit civil », *Banque et droit* n° 97, September-October 2004, pp. 52-61; Grangereau, Pascal and Haroun, Medhi, « Banques islamiques: la problématique de la mise en place de cofinancements », *RB* n° 657, April 2004, pp. 56-60; Boureghda, Maya and Hamra-Krouha, Mohamed, « Problématiques pratiques des financements de projet islamiques », *RB*, n° 253, December 2007; Boureghda, Maya, « Les structures contractuelles islamiques dans les financements de projet » in Jean-Paul Laramée [dir.], *La finance islamique à la française. Un moteur pour l'économie. Une alternative éthique*, Édition Secure Finance, 2008, Chapter 5; Bourabiat, Foued, « Tifert: acid test for Islamic and conventionnally-financed projects in North Africa », *Infrastructure Journal*, September 2009, pp. 1-6; available on: www.ijonline.com; Bertran de Balanda, Jacques and Bourabiat, Foued, « Financements de projets intégrant une tranche islamique: expérience vécue au Maghreb », Herbert Smith LLP, African Islamic Finance Forum, April 7-8, 2010, Casablanca.

professional organizations. Our approach, therefore, is not unbiased and isolated. So, it is worth noting that are early as January 2009, a commission was set up by Paris-Europlace to identify the legal and tax obstacles (when Islamic finance is received in France) and the panel proposed to make a number of minor amendments to certain sections of our civil code which gave rise to a number of conformist objections from conservative-minded individuals. From this perspective, our research could shed light on the subject in a way that may be helpful to lawmakers. We believe that there is therefore a clear benefit in taking part in a project focusing on this financial center; the benefit becomes even clearer in light of the financial crisis and efforts to move away from oil dependent economy.

19. Other arguments are also extremely convincing. The flow of capital from the Gulf countries clearly constitutes a competitive advantage for France. Recently, the Islamic Development Bank (IDB) nearly doubled its infrastructure financing to help member countries prepare themselves for the post-crisis world, as stated in the Message from the President, Mr. Ahmed Mohamed Ali, in the 1430H[11] (2009[12]) annual report. In 1430 H, the IDB Group approved some 457 project financing transactions[13] for a total of DI4,720 million DI (Islamic dinars) or a $7,253.8 million.

20. The IDB provided DI1,816 million, or $2,805 million in finance for development of transportation, production, electricity generation and transmission, water and sanitation infrastructure and other sectors including Industry[14]. According to the aforementioned report, "*Due to the increased focus on developing infrastructure to help accelerate member countries' economic development and make them more attractive to foreign investors, the Bank's financing for infrastructure in 1430H (2009) was 300 percent more than the ID635 million ($931 million) financed in 1427H (2006).*"[15]

21. When one examines the regional breakdown and the type of financing, it appears that majority of the financing was invested in Asia (Indonesia, Bangladesh, Iran), followed by the CIS[16] and Europe (28%), the Middle East (19%), North Africa (13%), East Africa, Southern Africa and Central Africa (3%). Clearly, Islamic financiers are interested in taking part in project financing in Europe alongside traditional investors such as the European Development Bank (EDB).

22. According to IDB estimates[17], the Islamic co-financing volume rose from $19.6 billion in 1428H (2007) to $27.2 billion in 1429H (2008), which amounts to a 32% increase in the words of the Islamic banking institution: "*The European Investment Bank may be considered as one of IDB's earliest co-financing partners, given that it co-financed IDB's very first transaction, Cameroun's Song-Loulou hydropower scheme, which was approved in 1396H (1976). Since then, cooperation has increased steadily, rising sharply in the past five years. Together, IDB and the European Investment Bank have supported 24 projects worth around $11 billion in 12 countries in Africa and Asia, and provided $1,145 million and $2,169 million, respectively. Clearly demonstrating a revitalized cooperation, as*

[11] The letter H refers to the Islamic calendar.
[12] The date in parentheses refers to the Gregorian calendar.
[13] The Islamic Development Bank's 2009 Annual Report, p. 2.
[14] Energies & IT (40%), Transportation (33%) Urban Development and Services (16%), Others (11%).
[15] The Islamic Development Bank's 2009 Annual Report, p. 41.
[16] The Commonwealth of Independent States (CIS) is a regional organization whose participating countries are 11 out of the 15 former Soviet Republics.
[17] The Islamic Development Bank's 2009 Annual Report, p. 57.

indicated above, more than 70 percent of co-financing volume was actually registered during the six-year period 1425-1430H (2004-2009) alone." [18]

23. In 2009, the istisna'a (construction financing) was the most commonly used forms of contract for project finance in IDB member countries (57%), 19% of transactions were financed using ijara agreements (lease-purchase agreement) and 13% using murabaha contracts (form of trust sale). Mudarabah and musharakah equity financing accounted for 5% of the total amount of financing approved. These contracts are most often used to finance Islamic projects and we will see how they can be structured in French Law.

24. After an in-depth examination of project finance and in consideration of experiments carried out by professionals in various places throughout the world, we will now endeavor focus on contrasted figures, their players, in order to identify the challenges of structuring a deal. So, we will try to derive a model, however imperfect, or guidelines to use a term used by practitioners. This is a tall order: a map is not a territory, a flag is not a county, the concept of a dog does not bark, as it was written[19].

25. The investigation will thus concentrate on the possibilities offered by French Law, even if it has to be brought up-to-date, to implement Islamic project finance contractual arrangements. Inventiveness, adaptability and pragmatism–these will guide our reflections. Here, "*a pure contractual imagination*"[20] will be used but isn't that the main purpose of the exercise as it has been suggested: *For a lawyer, project finance is nothing more than a contractual issue. The drafting of the clauses is dictated certainly by financial imperatives but they are not the result of a specific type of contract or a (national or international) standard. It is necessary for legal practitioners to use their full imagination; this assumes that they are truly competent because, until now, project finance has always triggered tensions and conflicts between different legal systems. The major consequence of this is the extreme heterogeneity of the types of contracts used.*"[21] And it can be added that with respect to co-financing, this is even more the case.

Research Questions

26. In attempting to get as a clear a sense as possible of reality, we need to explore the impact of applying Islamic moral order to co-financing. How can structures be adapted to this new environment? How can ethical injunctions be incorporated into an autonomous set of norms? What are the means of this acculturation? What are the binding obligations between conventional and Islamic financiers?

27. All these questions must be borne in mind while avoiding any certainties. We will see that a modification of legal rules in no way leads to an upheaval of conventional rules and the elasticity of French Law offers a flexibility that makes it possible to provide appropriate solutions to the necessary reconciling of conflicting interests. So, there is hope that the arrangements proposed will create a favorable ground for the development of multi-source financing, of which, it should be recalled, there are no examples currently in France.

Research Methodology

[18] The Islamic Development Bank's 2009 Annual Report, p. 72.
[19] « *La constellation du Chien n'aboie pas*. » Spinoza, *Éthique*, I, scolie de la proposition 16.
[20] *Droit financier*, Précis Dalloz, 1e éd., juin 2008, a book containing a collection of articles edited by Professors Alain Couret and Hervé Le Nabasque, p. 1028.
[21] *Droit financier*, *op.cit,* p. 1028.

28. The significance of the expansion of Islamic finance in the global marketplace and the great interest that professionals are showing for it has lead us to examine its role in France in connection with project co-financing operations. From the analysis of the stakes associated with it to the need to introduce an appropriate legal framework, the challenge for France is about being a competitive global financial center. First of all, we should highlight an important point related to our method in this research. For the sake of avoiding any risk in this sort of challenge, we intend to limit our analysis to that of a French lawyer and therefore our reflection rejects any pretention to religious analysis of the subject of the study. Thus, we cannot substitute for a sharia scholar, which has exclusive competence over the subject. Although normative references are sometimes identical, the analysis approaches are necessarily different. In this sense, the method retained here, is that of faith-based, which involves the analysis of financial instruments subject to French Law, while complying with religious law. The study of this topic utilizes a two-pronged approach. The first approach is dynamic in that it requires examining the flexibility of French Law when the Islamic moral order is applied to it. The second approach is static because the research is on contractual solutions in project finance that one has to have a clear idea of. This is necessary for the reader to have the means to understand the higher ambitions of Islamic finance. This is often at the expense of the paradox between, on the one hand, absolute contractual freedom and, on the other hand, a constrictive moral order.

Definition of Co-financing

28. Coming up with a definition of Islamic project finance may seem like an ambitious challenge because, as it is understood from the standpoint of French Law, it is, we believe, the result of a double legal acculturation. The concept of legal acculturation can be defined as "*the overall transformation that a legal system undergoes when it is exposed to another legal system–a process that involves implementing binding means varying in nature and degree and that address certain needs of the society that undergoes it*" [22].

29. So a first legal acculturation in the French legal system is the Anglo-American concept of project finance[23] and a second acculturation the French legal system experienced is the demands of the Islamic moral order. Islamic project co-financing is at the confluence of three different legal cultures: the Common Law, Civil Law and Qur'anic Law systems. If we were to try to theorize this transmutation, we would run the risk of devalue the concepts. Even so, we propose the following definition: Islamic project co-financing is a financial arrangement used to undertake major public and private infrastructure initiatives and that is structured in two legally separate contractual components. These components represent a single economic entity, to wit conventional finance without recourse wherein a SPV, used for the construction and development of an investment project, takes on the debt and contracts are entered into finance a part of the project's assets, the title to which to temporarily transferred to Islamic financiers. These two contractual components, to a greater or lesser extent dependent on each other, combine to form a relatively stable whole.

30. Understood in this way, Islamic project co-financing implies a particular organization of various types of contractual arrangements under domestic law so that they are Shari'a

[22] Rouland, Norbert, *L'anthropologie juridique*, 2e éd., Paris, PUF, Que sais-je ?, 2005.
[23] Dont la traduction française de « Financement sur projet », que nous utilisons dans l'ensemble de notre étude, est empruntée à Michel Lyonnet du Moutier dans son ouvrage *Financement sur projet et partenariats public-privé,* éd. Ems, 2006.

compliant. The process of structuring co-financing is fraught with a permanent tension between these two and the challenge is to create between the parties, through financing contracts with varying degrees of complexity, the terms of a partnership revolving around an investment project.

31. How can one make sure that the precepts of the Islamic moral order and French Law coexist smoothly in a project co-financing deal where the former must necessary pledge allegiance to the latter without being altered by them? In terms of how it is structured, we have seen that co-financing is based on two legally separate components. These components represent a single economic entity, to wit conventional finance without recourse wherein a SPV, used for the construction and development of an investment project, takes on the debt and contracts are entered into finance a part of the project's assets, the title to which to temporarily transferred to Islamic financiers who own the SPV. Here, we will focus our analysis on the structuring of the Islamic financing tranche. This engineering plays out in two stages corresponding to the two project finance phases: the construction and development of the underlying asset. Even though the ability to imagine contractual arrangements may be unlimited, we have elected to focus our analysis primarily on istisna'a-ijara (construction financing and lease-to-own) structures, which, we believe offer the flexibility to overcome the challenges and constraints referred to above and highlight the potentials of Islamic finance.

32. From a practical standpoint, we will see how a model of the Islamic tranche can be built based on a sale for future delivery and a lease-purchase agreement. Firstly, via a SPV, the Islamic bank will make payments to the project company so that it can build Islamic assets[24]. Once the construction has been completed, the project company transfers title to an Islamic SPV[25]. Next, a lease-purchase agreement is entered into and pursuant to which the Islamic SPV (in its capacity as the lessor) makes assets available to the project company (lessee), while at the same time pledging to transfer title after the lease period, in exchange for it making rent payments for the duration of the lease period.

33. The apparent likeness between istisna'a-ijara construction financing and lease-to-own arrangements, construction financing agreements and lease-purchase agreements must not serve to deny the difficulty of the exercise. In fact, there are many stumbling blocks because the diversity of schools of Islamic Law thought means that its norms cannot be standardized. So, conscience of these obstacles, our attempt at building a model does not purport to put an end to the debate by proposing turnkey solutions but rather to stimulate debate by raising issues that have not hitherto been discussed.

These models of contracts will cover successively the construction period (I) and the operation of the completed project of investment (II).

[24] In the project, assets will be identified as being Shari'a compliant (example: " lots" 6, 7, 8 and 9 of a project) that will be referred to as the "Project's Islamic Assets".

[25] The Islamic SPV is owned by the Islamic investors who cannot be directly or indirectly shareholders in the project company because of the substantial debt (generally over 33%).

I. Building a Model Istisna'a Agreement under French Law

Preliminarily, we will examine the similarities and differences between istisna and Sales of Property Not Yet Developed (VEFA) (A). The constraints on the operation through the respective obligations of the parties will be then identified (B), then we will also propose to overcome these constraints by presenting a contractual structure (C). Finally we will analyze the guaranties of the project (D), and the cases of contract termination (E, F).

A. Legal Nature: Similarities and Differences Between Istisna'a Agreements and Sales of Property Not Yet Developed

34. An ideal type of agreement for Islamic project finance, an istisna'a is similar to the sale of property that is not yet developed under French Law. After an analysis of this agreement, we will see how the sale of property that is not yet developed is a Shari'a compliant contract vehicle used Islamic financiers who own a SPV to finance the construction of what we will refer to here as "Islamic project assets."

35. If you look at its etymology, the word istisna'a comes from the word sanaa[26], which means literally "*to make or build something*."[27] Istisna'a agreements are commonly used in connection with finance projects in high-tech sectors such as naval aviation, air and space, airport and in real-estate development; they are also used in the financing of intangible assets such as electricity or gas[28]. Islamic lawyers define it as an agreement by which one party (mustasni) asks another party (sani) to carry out construction or manufacturing work on its behalf. In practice, the Islamic bank, as a profit-making business, will finance its client's purchase of movable or immovable property from a third party and the bank receives a service fee that includes the cost of construction and manufacturing plus a finance charge. Three parties are involved in the transaction: the initial client (the buyer), the Islamic bank (the seller) and the developer.

36. Among the various Fiqh Schools of thought, there are differences in the nature of istisna'a agreements. The Milikites, Shafi'i and Hanbali believe this type of agreement is a derivative of salam sales. Islamic legal scholars from the Hanafi School see it as a pure ijara while others say it is an ijara at the beginning and a sale at the end of the agreement[29]. It is therefore not easy to give an all-embracing approach.

37. To begin, we will present below the main differences between istisna'a agreements and salam, ijara and mourabaha agreements. We should point out at this point that istisna'a agreements have some points in common with salam agreements, in particular the fact that

[26] Ibn Manzur, Muhammad Ibn Mukarram, Lisan al-'Arab, Dar Sadir, Beirut, Lubnan, 1955, Vol. 8, pp. 208-212 in Ph.Muhammed Al-Bashir Muhammed Al-Amine dans Comar-Obeid, *op.cit*., p. 34.

[27] Ibn Yacoub al-Fayrozabadi, al-Qamus al-Muhit, Mua'ssasat al-Risalah, Beirut, 1983, p. 54; also see: E. W. Lane's, Arabic English Lexicon, Islamic Book Centre, Lahore, Pakistan, 1982, Vol. 4, p. 1733 in Ph. Muhammed Al-Bashir Muhammed Al-Amine dans Comar-Obeid, *op.cit*., p. 34.

[28] Habib Toujkani (Mohamed), « Les contrat Salam et Istisnâ'a: Les Sciences de la Chari'a pour les Économistes, les sources du *Fiqh*, ses principes et ses théories; le *Fiqh* des transactions financières et des sociétés; et son application contemporaine », proceedings from a seminar on "Sciences de la *Chari'a* pour les Économistes" held in Niamey, Niger, April 20-29 , 1998, jointly by the Islamic Development Bank's Islamic Research and Training Institute, Jeddah, Kingdom of Saudi Arabia and the Islamic University of Niger, Niamey, Niger, 1998, p. 219.

[29] Ibn al-Humam, Muhammad Ibn' Abd al-Wahid, Fath al-Qadir, Maktabat al-Rashidiyyah, Pakistan, 1985, Vol. 2, p. 32 in Ph. Muhammed Al-Bashir Muhammed Al-Amine dans Comar-Obeid, *op.cit*., p. 34.

the thing being sold or the service to be provided in the future does not exist when the agreement is entered into. Still, there are ways in which they are different:

- istisna'a agreements must always involve a manufactured good unlike salam agreements that can pertain to any identifiable good;

- in salam agreements, the price must be paid in advance whereas in istisna'a agreements payment can be deferred or be made in several installments[30].

38. It should also be noted that there is a significant difference between istisna'a agreements and ijara agreements: in the former, the manufacturer of the good has to use its own equipment; in the case where the client supplies the equipment and the labor, the transaction is an ijara. There are other differences too: mourabaha agreements pertain essentially to the sale of goods for a price that covers the purchase price plus a profit margin agreed to by both parties to the agreement[31] whereas the istisna'a is an agreement for some future thing to be built or manufactured. In other words, the thing does not exist when the parties enter into the agreement. Furthermore, in mourabaha agreements, for the transaction to be valid the Islamic bank must be in possession of the goods before transferring them to the buyer. During this time, the Islamic bank, as the owner, assumes the risk and peril of any damage or loss of the assets whereas in istisna'a agreements the good is only transferred once it is completed. Lastly, the main difference between these two types of agreements the thing that is sold undergoes a transformation: unlike the case of mourabaha agreements, the object of the transaction is the delivery and not the goods purchased in their state and condition, but rather finished products that has been through a process of transformation.

39. The result of practice, the source of this type of agreement is not in scriptural texts; it is the result of contractual freedom. There is no explicit text in the Qur'an and in the Sunna to establish its legality which is derived from other sources such as need and necessity[32], which calls for a preliminary remark. In this regard, Islamic legal scholars have differing opinions on whether agreements that are not regulated by law are lawful. The Milikites, Shafi'i and Hanbali claim that all agreements are considered prima facie as prohibited except those authorized by Shari'a Law. However, other legal practitioners, such as the zahiri are fairly liberal and accept the creation of new agreements that use craftiness (qiyās) and the public interest (maslaha).

40. In support of their case, the opponents of contractual freedom cite a hadith in which the Prophet is believed to have said this: "*if some comes to an act that we have not commanded, then he will be rejected*."[14] The proponents of contractual freedom in Islamic Law assert that individuals are free to define for themselves the terms of their own agreements. They contend that contractual freedom should be the rule and any restrictions, even minor, should be the exception. They base their argument on the following verses from the Qur'an:

"*O ye who believe! Fulfill the bonds. Lawful for you is the flesh of cattle, save what is mentioned to you, and unlawful hunted game when you are in the state of pilgrim sanctity. Assuredly, God decrees as He wills*."[33]

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[30] Al a' al-Din al-Samarkhandi, Tuhfat al-Fuqaha', Mat ba'at Jamiat Dimashq, Damascus, 1983, Vol. 2, p. 538 in Ph. Muhammed Al-Bashir Muhammed Al-Amine dans Comar-Obeid, *op.cit*., p. 38.
[31] Haron, Sudin, *Islamic Banking Rules and Regulations*, Pelanduk Publications, Selangor, Malaysia, 1997, p. 75 in Ph. Muhammed Al-Bashir Muhammed Al-Amine dans Comar-Obeid, *op.cit*., p. 39.

[33] Qur'an, chapter 5, verse 1.

"*And why should you not eat of that over which God's Name has been pronounced, seeing that He has clearly spelled out to you what He has made unlawful to you unless you are constrained to it by dire necessity? But, indeed many people lead others astray, driven by their lusts and fancies without any knowledge. Indeed your Lord is He Who knows best those who exceed the bounds*."[34]

41. While Islamic legal scholars have attempted to establish the legality of this type of agreement by means of different legal sources, such as the Qur'an, the Sunna, the Ijmā, the Qiyās, the Istihsan and the Maslaha seem to us, however, to be the most significant legal basis. This is what the Islamic Fiqh Academy teaches. Along these lines, the scholar Al-Kasani declared:

"*Concerning the legality of istisna'a, in principle it would not be permitted on the basis of Qiyas because it is a sale of what we do not have nor on the basis of Salam and the Prophet had prohibited the sale of what we do not have ... and it is allowed based on Istihsan because people are unanimous about its need. They have used it through the ages and the Prophet has said "My community shall never agree on an error"*[25] *and "What is good for Muslims is good in the sight of Allah*."

42. Some have also asserted, in particular the Hanafi School, that this agreement is based on the Ijmā which refers ideally to the consensus of the scholars of Islam on a legal issue. With respect to the basis of the istisna'a by virtue of the public interest (maslaha), Al-Ashgar considered that "*the use of this agreement, for example, in the construction of buildings, shoes, furniture and other elements, with no objection by researchers, is a matter of general necessity. Consequently, it is lawful when it is based on the public interest*."[35]

43. Under French Law, the istisna'a is similar to a business agreement pursuant to which one party (moustasni) asks another party (sani) to make or build something for a price payable in advance, in installments or over time. In an istisna'a sale, the client asks a developer to build a specific building for it or on behalf of a third party. The fundamental point of this agreement, from the standpoint of Qur'anic Law, is that it relates to a future thing and moral order which seeks to protect the contractor prohibits the sale of a thing that one does now possess (hadith prohibiting the sale of fruits still on the tree or a calf still in the cow's stomach). The istisna'a is however permitted by Islamic exegetists some of whom take that the divine principle "Do not sell what is not with you" to mean that selling what one does not own is prohibited (the tabi'a ma lais 'indaka) at the time of the sale[36]. Other jurists maintain that this hadith applies only to the sale of a personalized object 'al'ayn) and not to freely exchangeable products like those that are easy replaced.

44. Our research found that an istisna'a cannot pertain to natural products such as fruits, vegetables and grains. These products must, we believe, exist when the agreement is entered into. However, there is an exception in the case of industry. Industrially manufactured products (frozen or processed) are not subject to this prohibition[37]. As we indicated, an istisna'a customarily pertains to the construction of physical infrastructure

[34] Qur'an, chapter 6, verse 119.
[35] Habib Toujkani, *op.cit*, p. 222.
[36] Muhammad Ibn Isma'il al-San'ani, Subul al-Salam Sharh Bulugh al-Maram, al-Maktabah al-Tijariyyah, Le Caire, Vol. 3, p. 17 in Ph. Muhammed Al-Bashir Muhammed Al-Amine in Comar-Obeid, *op.cit*., p. 39.
[37] Habib Toujkani, *op.cit*., p. 220.

(power plants, production facilities, etc.) or movable infrastructures (cars, aircrafts, trains, ships, etc.). That is why is frequently used in project finance in Islamic countries.

B. The Obligations of the Parties

45. The respective obligations of the parties are the construction of infrastructure or the performance of work by one party in exchange for remuneration that the other party agrees to pay it. By the end of the term set forth in the agreement, the manufacturer or contractor must deliver the product free of any defects and the buyer is required to pay it the amount of the price. However, it is not mandatory that for goods to have been made by the manufacturer itself. It can be made by a third party[38] provided that the goods meet all the contractual specifications. To this end, the goods must be precisely specified in terms of quality and quantity. The sale price and the date and place of delivery must be specified in advance.

46. Classical Hanafi legal scholars generally divide the obligatory effect of the istisna'a into three phases. In the first phase, the construction work has not yet begun and Hanafi legal scholars are unanimous in saying that the agreement is not binding (lazim) and the developer can choose not to build the building. The two parties to the agreement are therefore discharged of their respective obligations. In the second phase, the manufacturer has completed manufacturing the good, but the good has not yet been delivered. The manufacturer still has the right at that point, we believe, to sell it to another party. In the third and last phase, the building has been completed and delivered to the buyer. In this case, there are differing opinions among Hanafi legal scholars about whether the buyer has the right to refuse to take the building.[39]

47. In business practice, such legal insecurity is an unacceptable situation and that is why it was finally accepted that istisna'a agreements have binding force once it is executed. In this sense, Islamic banks base themselves on Article 392 of Islamic jurisprudence (the Majella uniformed civil code) which holds that "*Once the istisna'a agreement is entered into, none of the parties to the agreement is entitled to breach it. If the product that is the subject of the agreement does not meet the desired criteria, the buyer has the right to choose between continuing or terminating the agreement*." Therefore, the buyer must pay the price of the thing and the manufacturer or the contractor must supply the product according to the requested criteria.

48. Still, if, once production has been completed, the buyer finds that the good does not meet any of the desired criteria, it has options[40]. It can continue the agreement and, if it wants, demand a reduction in the price or it can terminate the agreement. The buyer is also entitled to continue or terminate the agreement if it finds a defect in the product making it unfit for its intended use.

49. In a manner analogous to French Law, professional sellers cannot absolve themselves of responsibility for defects in items sold making them unfit for their intended use. In fact, the

[38] Which cannot be the final intended owner of the goods to be manufactured or property to be developed.
[39] Ibn al-Humam, Fath al-Qadir, Vol.8, p. 116; Al-Kasani, Badai' al-Sanai', Vol.6, p. 2680 in Ph. Muhammed Al-Bashir Muhammed Al-Amine dans Comar-Obeid, *op.cit*., p. 40.
[40] Habib Toujkani, *op.cit*, p. 222.

obligation of the seller[41], who is assumed to be the manufacturer or the producer of the thing sold, is to supply a product free of defects and that meets standards.

C. Presentation of the Contractual Arrangement

50. In connection with co-financing, istisna'a agreements allow Islamic banks or Islamic financiers to advance the funds necessary for the construction of part of the investment project assets, *i.e.*, the Islamic project assets (IPA). To do this, the Islamic SPV will make phased payments to the project company so that it can build the Islamic assets. Once the construction of the Islamic assets has been completed, the project company transfers title thereto to the Islamic SPV, which then enters into lease-purchase agreement for their transaction. We will see below that sukuk bonds can also be issued as part of this.

51. In the financial analysis, there do not seem to be any obstacles to the acceptance of istisna'a agreements in French Law. Based on our research, it appears that an istisna'a can be structured, under French law, for sales of property to be developed. Through this agreement, the seller agrees to develop property by a given deadline and the sale can be done as a sale for future delivery or as a sale of property that is not yet developed. This sale must comply with the requirements under Sections 1601-1 et seq. of France's Civil Code as well as Sections L.2361-9 et seq. of France's Construction and Housing Code.

52. For sales for future delivery, an agreement is entered into whereby a seller agrees to deliver property once its development has been completed to a buyer who agrees to take delivery of the property and to pay the price on the delivery date. The title to the property is transferred automatically by virtue of a legal instrument entered into through a French *notaire* confirming completion of the development of the property; the legal instruction takes effective retroactively as of date of the sale[42].

53. For sales of property that is not yet developed, an agreement is entered into whereby a seller immediately transfers to a buyer its rights to the land and title to existing buildings. Any future buildings to be built will become the property of the buyer as they are built. The buyer is required to pay the price as the construction work progresses. The seller remains the project owner until the delivery of all property[43]. Technically speaking, the seller (reservor) agrees to reserve or set aside for the buyer (reservee) property or part of some property of which the seller is required to specify the nature and state of the property and the deadline for delivery. In exchange, the buyer pays a sum of money that is deposited into a special account.

54. It is common, in practice, for Islamic bank to use a double istisna'a arrangement. First, the bank enters into an agreement with it client(s) (the principals who are instructing the bank) whereby the bank agrees to deliver to them by a given date the property to be developed– the nature, price and payment terms are clearly defined. Then, subsequent to that, a contractor (in our case, it could be the project company) agrees, at the request of the bank, to develop the property in question on the terms and conditions agreed to in the agreement, making sure that the delivery dates are observed. So, there is no legal relationship between the Islamic buyers and the project company: as a financial intermediary, the bank is

[41] Habib Toujkani, *op.cit.,* p. 222.
[42] Civil Code, Section 1601-2.
[43] Civil Code, Section 1601-3.

therefore liable, on the one hand, to the contractor, and on the other hand, to the final buyer, for each or their actions[44].

55. As the seller, the bank is required to give warranties with respect to the property not being occupied and not having any known or latent defect, imperfections or any other flaws. It must also, when necessary, provide an extrinsic guarantee (guarantee facility) or an intrinsic guarantee (funds) to reassure the buyer with regard to completion of the property development. Lastly, the bank is required to deliver the property by the deadline specified in the agreement. In the event of late performance or nonperformance of the agreement by the project company, the bank is ultimately liable.

56. However, given the difficulty of such an arrangement in French Law, it seems to us more reasonable to avoid any intermediation by having the Islamic financiers set up a French company (hereinafter the "SPV") that could in fact be a subsidiary of the Islamic bank. In this type of contractual arrangement, the Islamic SPV would contract directly with the project company both for the construction phased and during the lease period where it would be the lessee, subject to getting authorization from the French Ministry of the Economy, Finance and Industry.

D. Project Guarantees

57. As a business concern, the project company must provide a financial guarantee furnished by one or more banks, guaranteeing completion of the Islamic assets or repayment of all moneys paid by the Islamic financiers. This guarantee comes at a considerable cost that is borne by the project company. Pursuant to the requirements of Section R.261-17 of France's Urban Development and Housing Code, the completion bond is a result of either conditions specific to the transaction or the involvement of a bank, a financial institution authorized to provided mortgage lending, an insurance company authorized for this purpose or a mutual guarantor company organized and existing pursuant to the requirements of Act, as amended, of March 13, 1917, that lends to small and medium sized businesses or to small and medium sized industries. In practice, either financing is made available (the institution advances the funds necessary to the seller or pays on its behalf moneys necessary for the completion of the property), or a completion bond (the guarantor makes a promise to the buyer, sharing joint and several liability with the seller, to pay the moneys necessary for the completion of the property development).

58. It should be noted that the guarantor is not required to continue to property development work until its completion. This is the bank's obligation alone as the project owner. The guarantor is only required to provide the financing necessary for completion of the property development. This guarantee benefits only the Islamic financiers as the buyers of the Islamic project assets and it can be enforced only to finance any remaining work to be done. It cannot be used to finance any repairs or defects; those are the responsibility of the project company as the contractor. Lastly, the guarantor cannot be held liable for any late delivery of the assets to the Islamic financiers.

59. Furthermore, it seems that the project company must provide proof of an extrinsic repayment guarantee to protect the Islamic financiers in case of a failure to complete the property development. This is a guarantee by which the guarantor promises, sharing joint

[44] Guéranger, *op.cit*, p. 123.

and several liability with the seller, to pay back any moneys paid by the Islamic financiers in case of an amicable or court-ordered rescission of the sale as a result of a failure to complete the property development. Since the cost of this guarantee is substantial, we believe it is preferable for the project company to create the conditions necessary to ensure that the construction will be successfully completed by the agreed deadline and the property is delivered by the delivery date defined in the agreement.

60. Five (alternative) situations, and which must exist on the day of the closing on the sale, discharge the seller of its obligation to provide an extrinsic guarantee and allow it to provide only an intrinsic guarantee:

- the property is not flooded and is not encumbered by any mortgage or right of priority;

- the foundations are completed (which is certified by an industry professional) and either 75% of the property financing of the sale price must be provided either sales already made or by loans confirmed by banks (after deducting the value of any loans transferable to the buyers) or 60% of the property financing of the sale price is secured and 30% of it is funds provided by the seller;

- for residential single homes sold but not yet built, there must be an intrinsic guarantee only if the foundations are completed, payments by the buyer as stipulated in the agreement do not exceed 20% upon completion of the foundations, 45% upon the end of any flooding, 85% upon completion of the house, the balance being held in escrow in the event of a dispute regarding conformity. The guarantee covers any unscheduled payments. In the event of a problem, the buyer can have the work completed at no extra cost to it above and beyond the initial price, since the part of the house already completed would be worth more, in such a case, than what was already paid.

- the sale is made either by a public sector construction company or by a company in which a public entity owns at least a 35% stake;

- the sale is made by a public entity that manages government-subsidized housing.

61. The completion or repayment bond ends upon the completion of the property. Legally speaking, the building is deemed to be completed once the work is completed and any equipment necessary is installed so that it is fit for its intended use. Yet, from a technical perspective, the project is divided into several separate and distinct parts, which makes it possible to isolate the Islamic assets, although from an economic standpoint it constitutes a single economic and industrial entity. So, this raises questions about the notion of completion described above. Does one have to wait until all the project assets have been completed, or just the Islamic assets, for the completion bond to end? Even though it is divided into legally separate parts, the project still constitutes, in our opinion, a single uniform technical entity. While it is perfectly conceivable to declare the completion of the property in the case of the building of a hospital in which the Islamic assets represent, for example, a specific building (A, B, C, D), a hesitation would however be understandable in the case, for instance, of the construction of a power plant or a plant where, we believe, the parts (Islamic assets) can hardly be considered completed separately and independently from the whole of which they form a part.

62. Completion must be certified by an industry professional (an architect) or by a court-appointed expert who attests that the work is in compliance with the building permit. It

should be noted, however, that while certification of completion of the work terminates the completion and repayment bonds, it does not imply that the work is in compliance with the initial projections or that the Islamic financiers waive their right to enforce any of the guarantees owed to them separately by the project company. In fact, Section R.264-1 of the Urban Development and Housing Code holds that property sold for future delivery or that is not yet developed is deemed to be completed, as this term is defined in Section 1601-2 of the Civil Code and reproduced in Sections L.261-2 and L.261-11 of the Urban Development and Housing Code, when the work is completed and any equipment necessary is installed so that the contracted property is fit in accordance with its intended use. For purposes of determining completion, no nonconformity to what is stipulated in the agreement is taken into account unless it is material, nor are any defects unless they make the property or any of its parts described above unfit for use.

E. Agreement Termination

64. In Islamic Law, agreements can be terminated, in case of defects, subject to certain requirements:

- the defect has to have existed before the agreement was entered into;

- the defect has to exist when the buyer takes possession of the property;

- the buyer has to be unaware of the defect when the property is delivered;

- the defect has to exist when the buyer demands termination of the agreement;

- the defect cannot be minor.

65. A buyer who discovers the existence of a defect has the option of:

- either terminate or confirm the agreement with the full price stipulated; or

- terminate the agreement or confirm it and demand a reduction of the price.

66. It is commonly known that in French Law, damages and interest are the financial compensation that a person can seek when they have suffered emotional distress or non-economic damage and financial losses. Regardless of whether the damages arise from late performance or nonperformance of an agreement and compensation is the payment of an equivalent amount in capital or an annuity. The amount of damages and interest is a function of the losses sustained and the lost income. How are these dealt with in the Islamic moral order?

In its Resolution 66/3/7, 1992, the Al-Islam Islamic Jurisprudence Academy authorized penalty clauses to be included in istisna'a agreements[45]. However, this clause cannot be used as a means to apply pressure on the liable party and damages and interest may not be computed on banking products; they have to be placed in a zakāt account and paid to a charity or a charitable organization. In this case, in a sale agreement for future delivery between Islamic financiers and the project company a penalty clause can stipulate that in the event of a late delivery of the Islamic project assets, compensation will have to be paid

[45] Al-Ashgar, Bay' al Murabahah, p. 183 in Ph. Muhammed Al-Bashir Muhammed Al-Amine dans Comar-Obeid, *op.cit*., p. 52.

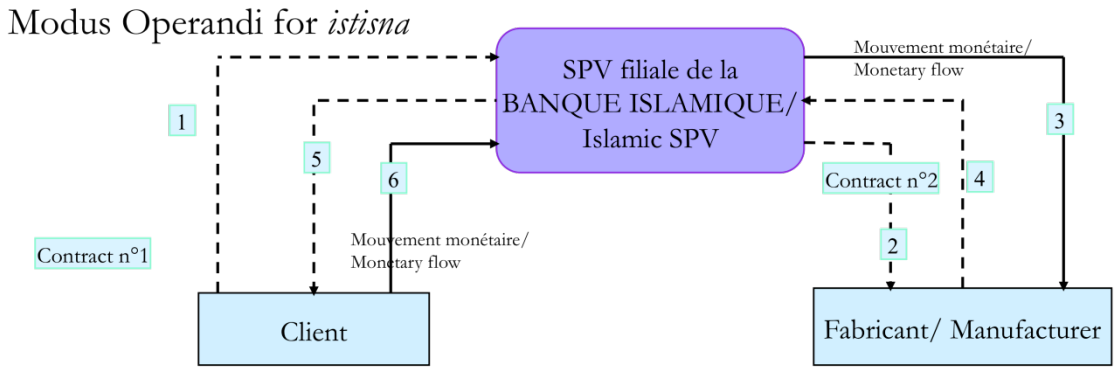
to a specific institution or foundation named in the agreement. This financial sanction represents less damages and interests than a penalty because ultimately it will not compensate the contractor for the loss.

67. There are certain standards for the evaluation of istisna'a investment projects. The object of the istisna'a must be lawful (halal). In other words, an istisna'a cannot be used for investment projects in certain sectors (the construction of infrastructure related to alcohol, pork, gambling clubs, etc.). We will detail them below in the section devoted to lease-purchase agreements. For this reason, extreme care should be used when structuring project co-financing so as not to corrupt the Mulim-financed tranche. The purchase of a hotel, for example, will require a specific structuring in which haram assets (such as the floor on which the bar is located) are isolated and are not part of the part of the project's Islamic assets.

68. What is more, the prime consideration for the acceptability of a project is that there be no interest (riba), that is to say an obstacle in connection with the project co-financing where most of the funding is provided by conventional banks through a loan agreement.

69. The second requirement is that the project be economically viable with cash flows sufficient to cover the direct costs and overheads and get a reasonable return for the investor. Understood in that way, the project must also contribute to social and economic development by creating jobs. So, Islamic financiers will be keen to make sure the project is feasible and a panel of experts will determine whether the project company is on sound financial footing. Experts will be called on to advise the project company and the Islamic financiers on the structuring of the construction agreement. Since the sums in question are considerable, it is of paramount importance that the specifications wished by the client be adhered to. In order to avoid any litigation and conflict of interests between the partners, the Islamic financiers will be responsible for appointing and paying the consultant hired to supervise the performance of the work on the part of the assets that they own.

Simplified Diagram Showing How an Istisna'a Works



(1) Le Client approche la Banque pour lui demander de fabriquer le bien décrit avec des spécifications précises/ The Client approaches the Bank for a specific asset to manufacture;

(2) La Banque approche un fournisseur pour lui demander de fabriquer le produit demandé par son Client/ The Bank approaches a manufacturer to produce the requested asset from the Client;

(3) Le Fabricant construit le bien demandé en recevant des paiements périodiques du banquier selon un échéancier convenu d'avance/ The manufacturer produces the requested asset while receiving periodic payments from the Bank;

(4) Le Fabricant effectue le transfert de propriété en livrant la Banque/ The Manufacturer transfers the ownership by delivering the Bank;

(5) La Banque livre le bien au Client/ The Bank delivers the asset to the Client;

(6) Le Client règle le prix du bien en totalité ou en plusieurs échéances/ The Client pays the asset price at once or in several payments.

70. At this juncture, we should briefly discuss the doctrine of frustration in the Islamic moral order. Under this doctrine, a court must restore the balance of the agreement, the terms of performance of which were seriously changed to the detriment of one of the parties as a result of an event that was reasonably unforeseeable when the agreement was entered into. The event is not necessarily the result of a case of force majeure but it seriously changes the contractual balance, making the performance of the agreement abnormally onerous for one of the parties. This doctrine not recognized by the French courts and in French Law. In Islamic Law, it is possible to find the authority of this doctrine in the following verses of the Qur'an:

"*O ye who believe! Do not dispossess one another of your property by dishonest means. May your trading be based on transactions freely consented to. Do not make attempts on your life for Allah is Full of compassion for you.*"[46]

71. So, when an event making performance of the agreement impossible or fundamentally different from what was contemplated at the outset, the parties can be discharged of their obligations. However, it is possible to suggest a modification of the agreement; if the parties are in agreement, they make the change contractually or, if they are in disagreement, they can take the matter to court. In such a case, the court will become a third party to the agreement. The doctrine of frustration applies only if the event is unexpected, unforeseeable, general in nature, and if it occurs during the performance of the contractual obligation that has become exceptionally onerous. There must also be a direct causal link between the unexpected, unforeseeable and general event and onerous nature of the performance of the obligation. Before modifying the agreement, the court can ask the

[46] Qur'an, chapter 4, verse 29.

parties to the agreement to renegotiate the terms of the contact together. Failing an agreement between the parties, the court will reduce the excessive obligation.

F. Amicable Rescission

72. We are going to explore the validity of arbitration clauses in the Islamic moral order. The significant development Islamic project finance in the Arab World has lead Islamic banks to include arbitration clauses in istisna'a agreements. So, we will examine the legality of such clauses under Qur'anic Law and under French Law. An arbitration clause as typically found in western agreements would be considered gharar because of the uncertainty about the occurrence of a dispute. In fact, out of a concern for fairness and social justice, moral order which seeks to protect the parties to an agreement, prohibits, in Islamic Law, any element of uncertainty or risk (gharar) in agreements. Therefore, the parties would be entitled to revoke any agreement up to the time an arbitral award is rendered. This opinion was expressed in Article 1847 of the Majella. However, these arguments appear to be inapplicable to business practice and this prohibition would be a major obstacle to the development of project co-financing. Certain Islamic Law experts are therefore opposed to this prescription, which, they argue, has no justification in contract law and the freedom-of-contract doctrine that prevail in Islamic Law. It seems, in fact, that any arbitration clause should be considered to be an ordinary contractual undertaking, which is valid and binds the parties by virtue of the general theory of contracts. In this regard, Malikite legal scholars argue that arbitration agreements are irrevocable. Actually, it is interesting to compare this prohibition with the public interest rule that requires giving the parties legal security. In this case, it would appear that protecting parties to an agreement requires the enforceability of arbitration clauses. That is why, Islamic scholars agree on the validity of such clauses in istisna'a agreements and Article 1941 of the Majella now authorizes the appointment of an arbitrator. Below are several prerequisites[47] for the clause to be valid under Shari'a Law:

- the arbitrator must competent[48] to serve as a judge under Shari'a Law;

- the arbitrator must have at least some of the qualifications required of judges;

- the arbitrator can be selected from legal practitioners[49] (judges, lawyers and accountants);

- it suffices that the arbitration be entrusted to a Muslim;

- it is considered that only a Muslim can possess knowledge of Shari'a Law so that he can hand down a decision that is in accordance with the principles of Shari'a Law;

- the Hanafi School accepts that a non-Muslim can do justice to a native non-Muslim;

- Shari'a Law must be the applicable law regardless of whether or not it is designated as such in the agreement, even if it is in conflict with the man-made laws of the country of which one of the parties to the agreement is a national;

[47] Conference on binding arbitration and Islamic transactions, a Speech delivered by Salim El Méouchi, on Thursday, December 1, 2005 in Paris, France, at a seminar on Franco-Arab Mediation and Arbitration System organized by Franco-Arab Chamber of Commerce's Mediation and Arbitration Center.

[48] For example: Article 4 Saudi Arabia's Arbitration Code holds that the arbitrator must be experience, have proper conduct and have his/her full legal capacity.

[49] See Article 3 Saudi Arabia's Arbitration Code.

- the provisions of Shari'a Law are based on notions of justice and fairness, and it is inconceivable that a man-made law is more just and fair than the divine law revealed to man;

- if an arbitral award rendered by an international arbitrator is based on laws that are in conflict with the rules of Shari'a Law, the award will not be able to be enforced in an Islamic country that enforces Islamic law.

- Shari'a Law will apply both to procedural matters and to the substantive issues.

73. There does not seem to be any obstacle to the acceptance of istisna'a agreements in French Law and they can be structured for the sale of property to be developed. In that scenario, the seller agrees to build a building by a specific deadline and the sale could be done as a sale for future delivery or as a sale of property that is not yet developed. Lastly, the other companion financial agreements such as mourabahas or moucharakas can be used to buttress a more complex contractual deal.

II. Building a Model Ijara Agreement under French Law

64. Recently, the Crédit Foncier bank participated in the lease-purchase financing for the construction of a new €54 million hospital facility for the Metz Private Hospitals–a 49,000-square-foot facility with a 613-bed capacity[50]. The financial arrangements include a loan from the European Investment Bank (EIB)–the first time it has ever financed a private hospital project. The pioneering deal is part of the hospital renovation program that the EIB launched in France in 2010 as part of the 2010 Hospital Plan.

65. There is not at the present time any co-financing of Islamic projects in France. In this study, we are trying to show that such a transaction is possible by arguing that the istisna'a-ijara can be structured in French law through a sale agreement for future delivery (construction period) and a purchase-lease agreement (lease period) and the funding necessary for the construction of the asset could be provided via a Shari'a compliant investment fund or by issuing sukuk bonds (see my PhD thesis for a further discussion of this). So, by structuring the transaction in this way, Islamic financiers could finance the construction of part of the assets referred to above as Islamic project assets[51] all the while isolating themselves from conventional investors.

66. We believe that there are other benefits[52] that explain why one would opt for this type of arrangement and here are some of the most important:

- the project company retains its funds[53];

- rent payments are deductible (except for the amortizable part relating to the land, contained in the last rent payments);

[50] Available on: www.bpce.fr/content/.../2637/.../mipim_BPCE_FR_light.pdf.
[51] These are referred to throughout this study alternately as Islamic assets or Islamic project assets.
[52] Duche, R and Penvern, C, « Intérêt financier du crédit-bail immobilier », Document Paris-Commerce 1971, n° 8 spécial, p. 71.
[53] Imbert-Casau (sylvie), « Le financement des investissements immobiliers des entreprises industrielles et commerciales. Le crédit-bail immobilier », *Hommes et Techniques*, 1972, p. 889; Rives-Lange (Jean-Louis), « Financement crédit-bail immobilier », *RD imm*, 1979, p. 234.

- the asset will be amortized for the duration of the lease-purchase agreement, *i.e.*, a shorter period than what applies when the asset is held directly;

- the surplus amortization will be booked by the project company in the year in which the purchase option is exercised, which is akin to a free deferred tax. The surplus amortization will be booked over time;

- likewise, the Islamic financiers may not interfere directly or indirectly in the project company's technical management of the construction of the Islamic assets; while, as we have seen in the second half of this study, conventional investors play an active role in project finance, this is not permitted in the case of a lease-purchase agreement where the lease-purchase company is required to be firmly impartial.

67. To illustrate this analysis, we believe that it is conceivable to use Islamic financing to build a private hospital in France. Let us assume that a hospital is built with a central medical and technical unit and three residential units organized by medical specialty (at an average cost of 173 million euros). The 70,000-square-foot facility has 520 beds and 18 operating rooms. It is structured in four major blocks: a central medical and technical unit, a surgery building, a neurology building and a building dedicated to cardiovascular, hematology, oncology and pulmonology medicine. So, for example, the Islamic tranche could serve to finance the cardiovascular medicine building (immovable property) or operating rooms (movable property). These assets would be identified as Islamic project assets and could be the subject of a lease-purchase agreement, or possibly combination with some other contractual arrangement.

68. After analyzing the similarities and differences between Ijara and conventional leasing contract (A), we will propose a contractual structure (B, E) for overcoming the constraints, which relate to both: the nature of contractors (the problem of banking monopoly) (C), and the type of assets financed (D). Then we will illustrate the parties' obligations (F), the essential clauses in the contract (G), guarantees of the project (H) and the termination of the contract (I).

A. Legal Nature: Similarities and Differences Between Ijara Agreements and Lease-purchase agreements

69. Like the mourabaha, the ijara was not originally a method of financing. It is a lease, which is an agreement by which one party (ajir or mujir) agrees to pay (rent) another party (mustajir) for the use of tangible or intangible property for a specified period of time. However, Islamic financial institutions have over time used the ijara as a financial agreement, which enabled them, among other things, to get around the prohibition of interest-bearing loans.

70. From that standpoint, Islamic financial institutions used the same lease-purchase agreement model[54] as the one used by conventional banks[55], even though a certain number of the terms were not Shari'a compliant. This approach failed to take their differences into consideration. Actually, while the division of ownership is common to both these

[54] Birbes, H, « Aspects juridiques du crédit-bail immobilier », *Cah. dr. Entr.*, 1972/3 and 4, p. 1; Cabannes-Buisson, C, « Le crédit-bail immobilier », *Hommes et techniques*, 1970, p. 1012; Boullay, P, « Le *leasing* immobilier, étude de cas », *Nouvelles techniques contractuelles*, Montpellier 1990.
[55] Bourdeaux, Gautier, « Crédits à l'exportation, crédits acheteurs et fournisseurs », *J.-Cl.Dr.Intern*., Fasc.566-80.

agreements, there are still fundamental differences between present-day lease-purchase agreements and Shari'a authorized ijara agreements and we will examine them.

71. Even though the ijara was not originally a financial agreement, it can still be used to finance investment projects as we showed in the second part of this study. So, it is worth bearing in mind that the compliance of a project to scriptural texts requires an in-depth contextual examination of the deal by the members of the shari'a board designated in the agreement. This entails the interpretation of religious text and case-based reasoning to determine the adequate solution. That is why it is not enough to replace the word "interest" with "rent."

72. Actually, this difference is the same in French Law[56]. Lease-purchase agreements cannot be used as a disguised loan to buy property, even though they have a financial component to them. Taking a closer look, while the 1985 Banking Services Act describes lease-purchase transactions as "credit transactions" it is only by assimilation; the reservation is significant. With respect to Islamic assets, the project company pays a *rent payment*[57] and not *scheduled loan repayments*. In this regard, Act No. 66-1010 of December 28, 1966 on usury loans, money loans and some solicitation and advertising practices, which has since been repealed, did not actually apply at the time to lease-purchase transactions[58]. Let us also add that neither the lease-purchase offer nor the actual agreement can mention the annual equivalent rate[59] (AER), which is used only for loans. Then, let us stress that none of France's Consumer Protection Code provisions[60] relative to protecting borrowers apply. As proof of this, it should be noted, finally, that Section L.312-3 of said code expressly stipulates that:

"*The following are beyond the scope of this chapter:*
1) Loans granted to legal entities under public law;
2) Those intended, in whatever form this may be, to finance a business activity, in particular, that of natural and legal persons who, even if this is secondary to another activity, or by virtue of their company object, regularly procure, in whatever form this may be, properties or parts of properties, whether built or not, whether finished or not, whether apartments or individual houses, under ownership or possession."

But lease-purchase agreements are, under currently applicable law, for the leasing of immovable property used for business purposes.

[56] Mathély and Charrière, H, « Le crédit-bail immobilier », *Banque*, juin 1969, p. 275.
[57] Attal, André, « Le loyer du contrat de crédit-bail immobilier », *AJPI,* 1976, p. 786.
[58] On this subject see: Doll, Paul-Julien, « L'usure, le démarchage et la publicité en matière de prêts d'argent », *Gaz. Pal*. 1967, 1, doctr. p. 99; Vasseur, Michel, « Usure et prêts d'argent », *Banque* 1967, p. 460; Gavalda, Christian and Stoufflet, Jean, « La limitation des taux d'intérêts conventionnels par la loi n° 66-1010 du 28 December 1966 sur l'usure », *JCP G* 1968, I, 2171, n° 25; Gavalda (Christian): Rép. com. Dalloz, 2e éd., V° Usure, n° 21-22; Chabas, François, « La réforme de la clause pénale, loi n° 75-597, 9 juill. 1975 », *D*. 1976, chron. p. 229; Françoise Furkel, note ss French Supreme Court, Business Section, 30 avr. 1974, *JCP G* 1976, II, 18282; Baudoin, E, « Crédit, usure, justice ou déclin de la clause pénale », Rép. Commaille 15 Nov. 1968, n° 17, p. 565; Dessens, note ss Court of Appeals of Rouen, 3 juill. 1970, *D.* 1971, jurispr. p. 465; Rép.min. Habib Deloncle, séance 30 juin 1966: JO Sénat Q 1er juill. 1966, p. 1157; Rép. min. just. n° 25822: JOAN Q 29 nov. 1972, p. 5730; Court of Appeals of Aix-en-Provence, 3e ch., 10 mars 1969, Sté Méditerranée Mosaïque c/ Locafrance, inédit; Court of Appeals of Toulouse, 8 mai 1970, *JCP G* 1970, II, 16481, note El-Mokhtar Bey; *D.* 1971, somm. p. 96; Court of Appeals of Rouen, 3 juill. 1970, *D.* 1971, jurispr. p. 465, note Dessens; *JCP G* 1971, II, 16581, note Bruno Boccara; Court of Appeals of Caen, 3e ch., 6 mai 1971, Launay c/ Somatrens.
[59] Court of Appeals of Aix-en-Provence, June 7, 1989: *Bull. Aix* févr. 1989, n° 59, p. 24.
[60] See Sections L.312-2 et seq.

73. In law, the question of the legal nature of an agreement raises ipso facto the issue of its legal definition. The legal definition makes its legal classification clear. That also helps determine the specific legal provisions that apply. The approach that we propose is a comparative study of the legal content of ijara agreements and lease-purchase agreements used to finance assets. To that end, we will examine the underlying and central question of the permeability of French Law to Islamic moral order rules. This examination does not, in theory, assume the formulation of a positive or negative evaluation but seeks to highlight similarities and differences between these two particular types of agreements. Based on the foregoing, here are three questions: Can the French law provisions that apply to lease-purchase agreements also apply to ijara agreements used in connection with transactions to co-finance projects using Islamic financing? What are the obstacles under Shari'a Law and under French Law that could prevent it from being used? What are some of the solutions in both the legal systems?

74. Based on Section L.313-7 of France's Monetary and Financial Code, lease-purchases cover:

"*The leasing of capital goods or tools specifically purchased for leasing by companies which retain ownership thereof, when such leases, regardless of their nature, give the lessee the possibility of buying some or all of the leased goods at an agreed price which takes account, at least partially, of the installments paid under the lease.*

Transactions through which a company leases real property for professional use which it has bought or had built, when such transactions, regardless of their nature, enable the lessees to become the owners of some or all of the leased properties, upon expiry of the lease at the latest, via transfer upon execution of a promise to sell or via direct or indirect acquisition of title to the land on which the leased property is built, or via automatic transfer of title to the buildings standing on the land belonging to the said lessee."

75. So the lease-purchase mechanism "*relies on the distinction between the beneficial owner and the legal owner of an asset*."[61] A lease-purchase arrangement[62] is a transaction to lease movable or immovable property used for business purposes, purchased or built on behalf of the lessor/seller that comes with an exclusive option to later purchase the home, which is fundamental[63], at the discretion of the lessee/buyer, for an agreed price that takes into account, at least in part, the amount paid in rent payments and allowing the lessee/buyer to become the owner. It is noteworthy, in this regard, that immovable property, unlike the case of movable property, is neither technically nor economically depleted.

76. The rent payment is determined based on the financial cost to the lessor of purchasing or building the property. At the end of a fixed lease period determined as a function of the amortization period of the leased asset, the lessee has three options:

- purchase the property for a price agreed at the outset;

- move out of the property; or

- agree with the lessor to extend the lease period.

[61] Couret, Alain and Rapp, Lucien, *Les 100 mots du droit des affaires*, Paris, PUF, Que sais-je ?, 2010, p. 55.
[62] On the subject see: Cohen-Steiner, Nicolas, « Le contrat de crédit-bail immobilier: six ans d'application de la réforme de 1994 », *Sem. jur.*, Edition N. I, 2001, n° 25, p. 1060; Bergeron, Jean -Yves, Guillemin, Yves, « Le Crédit bail en France: caractéristiques, évolution récente et perspectives », 1979.
[63] French Supreme Court, Business Section, May, 30 1989, *D.*1989, IR 190.

77. Similar to a lease-purchase agreement, an ijara agreement is used to finance (movable or immovable) assets in the medium term through a lease with an option to purchase. In most cases, it entails three successive transactions: a sales agreement by which a financial institution (ajir or mujir) purchases an asset from a third party, then leases it to a lessee (mustajir) in some cases an option to purchase the asset in the future (ijara wa iqtina). It should be noted that an ijara agreement is a bilateral agreement even though the ijara is a tripartite deal.

78. It is also common to combine the ijara with a diminishing moucharaka. The Islamic bank's share in the leased asset diminishes with the capital payments that are made by the client in addition to the rent payments, the objective being ultimately to transfer title of the asset to the client. Technically, the Islamic financier finances some building (*i.e.* a turnkey plant) or capital good on behalf of its client bound by a purchase undertaking. In exchange, the client makes rent payments into an investment account which enable it, at the end of a defined period, to become the owner of the leased property or building. In order to limit its exposure in its capacity as the owner, the financer forms a special purpose vehicle (SPV). As we will see, the financier, through an agency agreement, authorizes the client-borrower to maintain and insure the financed asset. The asset is insured by a takaful.

79. Based on this initial description, it appears that these two agreements are in a class of their own, complex[64] (sale, lease, construction financing agreement, agency agreement, etc.), officially recorded, so they have to be in a particular form (private agreement); they are bilateral agreements in which the lessor agrees to let a lessee use some property in exchange for rent payments to be made for the duration of the lease; they involve a service provided for valuable consideration; the price of the service is known by both parties when the agreement is entered into; since they are concluded on a private placement basis, the agreements are valid only if the parties give their consent and the parties freely negotiate the terms and conditions of the agreement; they are successive since they are performed only through the passage of time.

80. At this early stage of the examination, there is another point that is worthy of attention. While French Law permits the sale of property pursuant to a sale undertaking and expressly precludes the purchase of the property being contingent on the lessee's acceptance (considering that the lessor's sale undertaking is exclusive of the lease-purchase agreement), Islamic Contract Law requires the leased asset to remain the private property of the lessor who cannot be unilaterally bound to sell the property that is the subject of the lease. In other words, the opposite! In short, the nature of the transaction[65] requires in one case a sale undertaking and in the other a purchase undertaking. We will see, as a result, how its acceptance in French Law implies certain changes on both sides.

[64] Carbonnier, Jean, « Le crédit-bail: du bail au crédit », *Defrénois* 1991, p. 1025.
[65] Not without a certain degree of complexity, see: Bey, El-Mokhtar, « De la symbiotique dans le *leasing* et dans le crédit-bail immobilier », *D.*1970; see also: Coillot, Jacques, *Initiation au leasing ou crédit-bail*, éd. J. Delmas, 1968.

B. Presentation of the Contractual Arrangement

81. The ijara can be presented as follows:

- The bank's client makes contact with the seller of the property and prepares all the necessary information.

- The client contacts the bank and asks the bank to prepare an ijara agreement; the client promises the bank to lease the property once the bank has purchased it.

- The bank buys the property at the agreed price from the seller and title to the property is transferred to the bank.

- The bank leases the property to the client, transferring to the client its right of use.

- The client makes rent payments to the bank for the duration of the lease.

- In the end, the property belongs to the bank.

82. An agency agreement can be executed as part of this. In which case, the bank will ask the client to act as its agent. The agency agreement, which is separate from the lease, is prepared and combined with the ijara agreement. The client then chooses the property in the name and on behalf of the bank. It must inform the bank in writing of the details of the deal, such as the name of the seller and the purchase price. The seller conveys the property to the client (the agent) on behalf of the bank (principal). After the bank pays for the property, the agency agreement is terminated and the lease is executed in accordance with the initial undertakings. In both the cases that we just described, the Islamic bank or SPV takes back the leased property at the end for the agreement and this has significant and measurable financial implications.

83. In the ijara wa iqtina scheme, at the end of the lease period the lessor becomes the owner of the asset. In this case, the right to acquire the asset is based on the purchase and sale undertakings and we will examine their construction. The option to exercise an undertaking is in fact a key component of lease-sale or purchase-lease arrangements, which comply with Shari'a Law. However, as we have indicated, although the sale undertaking is at the discretion of the lessee, the form of the amortization is such the lessor has, in the final analysis, a very compelling economic interest to purchase the asset.

84. Of course, each project is unique. Still, we can give the following example of Islamic project co-financing:

- Phase A: the istisna'a[66] (sale agreement for future delivery): istisna'a agreements are used by Islamic banks or financiers to advance the funds necessary for the construction of Islamic project assets. They will make various payments to the project company to enable it to build the Islamic assets. The project company has full control of the building construction and the agreement stipulates in careful detail the technical specifications. Once construction is completed, the project company transfers title to the asset to the Islamic bank, or, in the case in point, to the SPV owned by the Islamic financiers.

[66] See below.

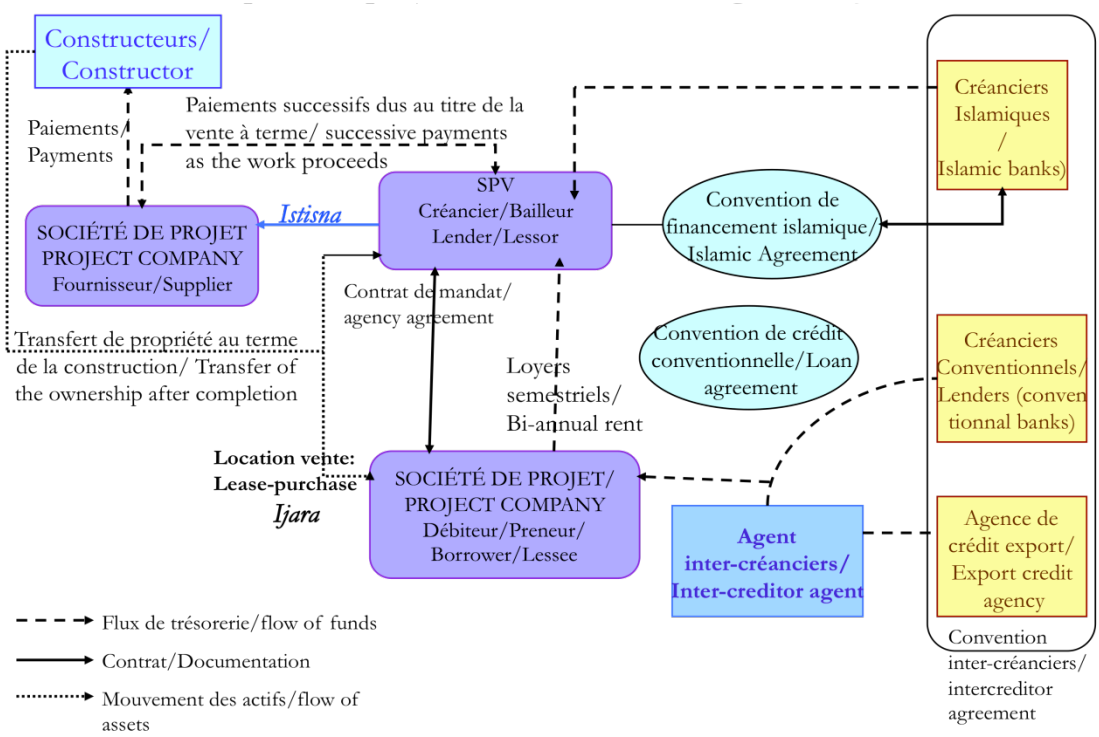
- Phase B: ijara agreements (lease-purchase agreement) are entered into between the Islamic SPV (lessor) and the project company (lessee):

- the project company makes rent payments during the period when it has possession (it is possible to make advance rent payments during the construction period);

- the Islamic SPV, which owns the Islamic assets, undertakes to sell them to the project company at the end of the lease;

- the project company undertakes to purchase the assets.

Example of Project Financing Using an Istisna'a-Ijara



Source: Hugues Martin-Sisteron, "Shari'a Compliant Project Co-financing Arrangements" in French-Saudi Forum for Dialogue Between Civilizations, March 15 and 16, 2010.

C. The Status of the Parties to the Agreement: Issue of Banking Monopoly

85. We will examine lease-purchase agreements from the standpoint of the Islamic moral order and its constraints. The Act of January 24, 1984 gives banks and financial services companies a monopoly on loans, including lease-purchases which are legally likened to loans. So it is illegal for anyone other than a lending institution to routinely provide banking services and, in particular, lease-purchase services. Section L.313-1 of the Monetary and Financial Code, derived from the Act of January 24, 1984, defines lending[67] as a person who makes or promises to make funds available to another person for valuable consideration and takes, to ensure repayment, collateral or a repayment bond. The law considers that lease-purchases and, more generally, any lease with option to purchase is a

[67] Which is classified as a banking service.

form of loan. That is probably due to the fact that, in French law, lease-purchase agreements are regarded as loans and companies that do lease purchases are recognized as lending institutions. In fact: "*a lease-purchase agreement is a complex contract that forms a whole defined by lawmakers, both in 1966 (Act of July 2, 1966) and in 1984 (Act of January 24, 1984) is a substantially a financial service articulated legally around the principal relationship, which gave it its name of lease-purchase, as a service*." Consequently, people who want to enter into lease-purchase agreements to purchase property in France have to get the banking business license provided for in Section L. 511-10 of the Financial and Monetary Code, from France's Prudential Regulatory Authority. European banking business licenses allow investment firms based in another European country to either provide banking services or open up a branch office in any country in the European Economic Area without having to apply for a license in each country.

86. As we saw above, lease-purchase transactions can be handled only by authorized banks or financial services companies that are subject to regulations applicable to banks or by companies associated with the banking services industry. This is undoubtedly the result of the transposition in law of the criteria of providing such services on a routine basis, which is used in general business law, to define business practices. However, it seems possible, using a contrario reasoning, for an unauthorized party to handle a lease-purchase transaction on a non-routine basis without facing criminal or civil penalties instituted to protect the banking monopoly and the public interest. It must therefore be determined what frequency constitutes a routine basis.

87. According to France's Supreme Court, routine starts with the second same type of transaction, regardless of the time period between the two. Notwithstanding any criminal penalties that anyone who breaks the law may face, any authorized party who routinely or even occasionally enters into lease-purchase arrangements runs the risk of the agreements being invalidated[68]. Pending any future changes in the law, it is conceivable that an Islamic SPV be set up to finance a single project, such as, for example, a hospital.

88. A lessor and a mustajir can be either an industrial or a commercial business, regardless of the company's legal form, or a person who is an independent contractor: industrialists, businesspersons, tradespersons, members of the professions, local governments and nonprofit organizations engaging in business. Under French Law, the property has to be used for business purposes and the project company must engage in some business activity. In the case we have been considering, the designation of the property will provide this confirmation.

D. The Nature of Islamic Project Assets

89. What is the nature of Islamic project assets? Things that are immovable by nature are fixed to the ground that cannot move themselves or be removed from one place to another. The criterion is that they be fixed (*i.e.* land or a house). The ground encompasses not only the surface of the Earth but also the subsurface with any deposits that it may contain. Lastly, anything that is affixed to the ground or in the ground is by nature immovable: trees, fruits, vegetables and unharvested crops. Immovables by the objects to which they are applied are

[68] French Supreme Court, Business Section, Nov. 19, 1991, *Bull. civ*. IV, n° 347, *D*. 1992, IR 33, *RJDA* 12/1991, p. 885, rapp. P. Leclercq, *Banque* 1992.426, obs. Jean-Louis Rives-Lange; Lagarde, Christine, « Commune et crédit-bail... prudence », *Bull. Cridon* Paris 1988. IX, p. 49.

rights on or to immovables. This category includes rights in rem established on real estate (mortgage, usufruct), real-estate debts and real-estate stocks.

90. Things that are immovable by their destination are ab initio movable by nature and are accessory to an immovable object but they are considered to be immovable in nature because of this connection. For a movable object to become immovable by destination, both must have the same owner. The connection is economic when they are used to operate an immovable object; so, for instance, machinery that belongs to a manufacturer and that are used in a plant become immovable by destination when the manufacturer is the owner of the premises.

91. The connection can be tangible when objects that are movable by nature are attached to an immovable object "as a permanent feature" and cannot be removed from it without being altered (ex: fireplaces) or damaging the part of the immovable object that they are affixed to. Section 524 of the Civil Code specifies certain attachment scenarios making it possible to infer the owner's intent to attach an object as a permanent feature depending on the location of the objects.

92. Section L.307-7 of the Monetary and Financial Code designates practices by which a business leases immovable property used for business purposes that it purchased or had built. On this account, it appears that an asset that is the subject of a lease-purchase agreement must be immovable and must be used in connection with a business activity. It may be immovable by nature, by destination or, as the case may be, by incorporation. It can be an existing building or a building to be built, or, as examined in this study, property that is yet to be developed.

93. The legal requirement that the property be used for business purposes is intended to make sure that it is actually used. In other words, the status of the lessor and the hypothetical or theoretical purpose for which the property was intended do not affect the classification of the lease-purchase; the only thing that counts is how the property subject to a lease-purchase agreement is used. The business conducted on the property premises will therefore be the only criterion used.

94. In an ijara, the lessor must retain legal ownership of the property and transfer beneficial ownership to the lessee. Moreover, ijara agreements cannot be for consumptible goods. In the objective sense of the term, it can be considered that consumptible goods[69] are consumed the first time they are used. Furthermore, the agreement cannot involve the lease or rental of property directly or indirectly related to:

    - arms industries or services;

    - gambling or casinos;

    - the making or selling of alcohol, tobacco or pork-based products;

[69] A typical example of a consumptible good is money whose traditional function in economic teams is well known; its only use is alineation in the sens that one does not hold on to it. If money were not consumptible *primo usu*, it would not exist; it would have no value. According to the distinction made by Roman legal scholars, property can have three attributes: *jus utendi* (*usus*, the right to use property), *jus abutendi* (*abusus*, the right to alienate property) and *jus fruendi* (*fructus*, the right to profit from the proceeds of property). What makes consumptible good unique is that encompass these categories of property rights. Since they can only be consumed when used, the *fructus* disappears and the *usus* combines to merge with the *abusus*.

- the entertainment industry (pornography, music, media, movies);

- hotel or restaurant businesses;

- conventional financial services (banks, insurance);

- precious metals (gold or silver).

95. The asset must therefore be first examined by a shari'a board that will rule on the validity of the transaction under Islamic Law. The leased property must be clearly identified in the ijara agreement. In the case in point, the hospital sector is not considered to be a haram and financing the construction of a building dedicated to cardiovascular medicine seems to the perfectly Shari'a compliant. That is not the case, we believe, of the following elements: the hospital kitchens, hybrid library or a newsstand (like the Relais H newsstands that sell tobacco products).

E. The Typology of Contractual Arrangements

96. In our study, we make the distinction between three more or less complex forms of lease-purchase contractual arrangements: purchase of the land and construction, purchase of property through a lease-purchase agreement as part of a sale of property that is yet to be developed and a lease-purchase agreement entered into for existing property.

97. A lease-purchase agreement can pertain to existing property. This entails a lease-purchase company or, in the case in point, an Islamic SPV, purchasing property (Islamic project assets) chosen by the lessee, *i.e.* the project company, that negotiated all the terms and conditions in advance. The property will be leased and rent payments will be made for a period agreed to by the project company. The project company has the option to acquire ownership of the property[70] at the end by exercising the sale undertaking that must be contained in the agreement.

98. Purchasing property through a lease-purchase agreement can be done as part of a sale of property that is yet to be developed. In that case, the project company can pick the land and is free to define the specifications of the property to be developed. After the building permit has been obtained, filed in the name of the lessee (the project company) and any third-party claims settled, the lessor (the Islamic SPV) replaces the lessee. It will purchase the barren land and finance the construction and development of the property as the construction works advance.

99. As part of the lease-purchase agreement, the parties will execute a construction financing agreement (istisna'a as described above) in which the lessor (the Islamic SPV) is the project owner[71] and the lessee (the project company) is the general contractor or the delegated project administrator. A delegated project administrator agreement is then entered into for the project company to develop the property on behalf of the Islamic investors who are the temporary owners of the property. As we previously saw, the project company, as the general contractor, will undertake for a fee, on behalf of the Islamic SPV, as the project owner, to perform and inspect the construction works with full independence and without any agent.

[70] Champigny, Daniel, « L'évaluation d'immeubles sous contrats de crédit-bail », *Gaz. Pal.* 1978, 1, doctr. p. 74.
[71] Vallery-Radot, Laurent, « L'immixtion du maître de l'ouvrage dans une opération de construction », *Gaz Pal.* 1982, 2, doctr. p. 572.

100. Based on this proposition, the obligations imposed on the project company–whether it is an agent, general contractor or delegated project administrator–are an enforceable duty to use sufficient means so as to bring about the contractually agreed-upon outcome specified, making it ipso facto liable for any defects or imperfections affecting the buildings, regardless, in fact, of how significant they are.

101. The project company, as the contractor, will be under obligation to maintain the property throughout its construction. It must take out appropriate insurance policies[72], in particular those covering risks associated with the worksite, pollution and radioactivity in the grounds, as well as the costs necessary for any decontamination work; it must also deliver the property at the agreed place and by the agreed date (by virtue of Section 1245 of the Civil Code).

102. The delegated project administrator agreement must define the terms of payment and repayment to be made by the SPV and the terms on which the work will be performed by the project company. The Islamic SPV may pay the bills approved by the project company, in its capacity as the SPV's agent (by virtue of Section 1792-6(1) of the Civil Code). It should be noted that during the construction period, outlays by the project company will be the subject of payment of intercalary interest called "rent prepayments." The rent payments under the lease-purchase agreement commence once the property is completed, which is in point of fact a requirement under Shari'a Law. The amount of the lease-purchase is then adjusted in line with the final amount of the investment.

103. In the event of a default by the project company, any unpaid subcontractors will be entitled to bring action directly against the Islamic SPV as the project owner in order to obtain payment. A certificate of delivery and conformity signed by the project owner, the architects and the contractor certifies that the work complies with market standards, the plans, the estimate and the building permit, completes delivery, which puts an end to the contractual relationship.

104. A lease-purchase agreement can also be used to purchase land and develop and construct property. In this particular case, an agreement is entered into by the parties under which the project company undertakes to build buildings on land title to which is transferred to an Islamic SPV and to maintain them in a proper state of repair for the full duration of the lease. The construction is a key feature of the agreement and failure to complete the construction will result in its termination. So, for instance, a simply duty to make improvements is not sufficient to consider that it is a construction lease agreement. The project company will have to pay rent on the leased land. They are payable in kind (completion of sections of buildings by agreed due dates or delivery of completed buildings by the end of the stipulated lease) or, alternatively, in cash. It should be noted that in the event of nonperformance of these obligations, the Islamic SPV will be entitled to demand termination of the agreement before the contractual term.

105. Moreover, construction lease agreements are not subject to laws on business leases[73] because of their distinctiveness. However, the project company has, for the duration of the lease, temporary rights in rem to the buildings that it built on the leased land, which can raise problems under Shari'a Law. When the construction lease agreement expires, the

[72] Zeller, O and Chanteau, O, « Le crédit-bail immobilier exige des assurances sur mesure », *Assur. fr.,* déc. 1996, p. 51, n° 727.
[73] French Supreme Court, 3rd Civil Section, May 11, 1988, *Bull. civ*. III, n° 89.

Islamic SPV repossesses full title to the property leased and will acquire, subject to special contractual provisions, title to built without any obligation to pay compensation. However, in practice, title will be transferred to the project company.

106. A lease-purchase can also be structured through a special purpose vehicle such as a real estate investment company. The real estate investment company is formed by the Islamic investors and the project company. The special purpose company, whose director as designated in the articles of incorporation is the Islamic SPV, will purchase the property or the partners will contribute the property to its assets. Subsequently, a lease-purchase agreement will be entered into with the real estate investment company that will sublease the property to the project company. In such an arrangement, the purchase-lease company agrees to sell its shares in the company if the purchase option is exercised. However, this arrangement is likely to be invalidated by the shari'a board because Islamic investors cannot have an equity investment in an excessively indebted company as is the case with the project company as a result of the financing agreement it entered into with conventional lenders.

F. The Obligations of the Parties

107. In the ijara and lease-purchase agreement, the object of the parties' respective obligations is the leasing of Islamic project assets by Islamic investors (or an Islamic bank or lending institution as defined in Monetary and Financial Code) in exchange for periodic payment of contractually predetermined rent payments.

108. As the owner of the leased property, the Islamic SPV remains, for the full duration of the lease-purchase agreement, until closing on the sale of the Islamic assets by the project company, the holder of all the legal ownership rights and is responsible for all its legal obligations. The Islamic SPV is therefore automatically subjected to the provisions of Sections 1719 to 1721 of the Civil Code (delivery, maintenance, guarantee) and must make all repairs necessary to maintain the property in a state of repair and normal upkeep of the leased Islamic assets.

109. However, in the practice of co-financing, it is very common for lessors to transfer their obligations to lessees, a practice that is accepted by jurisprudence[74]. In such a case, the Islamic investors are only under obligation to warranty that the property is not occupied by it or by third parties, but that has no practical implications.

110. The Islamic SPV cannot, however, lease the Islamic assets without agreeing to a delivery obligation. There are no specific formalities[75] required for delivery but delivery must occur. In fact, while some argue that lease-purchase arrangements can be fully released of the delivery obligation, especially if the property subject to the lease-purchase agreement cannot be delivered, according to Mr. El-Mokhtar Bey, "*no one has the power to do away with it altogether; that would destroy the agreement, because in order for there to be a lease, something has to be delivered or made available to the lessee so that it can take possession… the lessee's obligations thereby being without consideration, the penalty for*

[74] Court of Appeals of Paris, Oct. 11, 1989, *D.* 1989, IR 275, *Gaz. Pal*. 1990.1. somm.

[75] On methods of delivery for example: « *ayant constaté que le crédit-preneur avait accompli, après achèvement des travaux, des actes démontrant qu'il était en possession de l'immeuble, la cour d'appel a exactement retenu que la livraison du bien construit ne devait revêtir aucun formalisme, et souverainement constaté qu'elle était effectivement intervenue* » (French Supreme Court, 3rd Civil Section, June 6, 1996: Juris-Data n° 002323).

the failure to deliver is the nullity of the agreement or, for certain agreements, termination[76] *of the lease, resulting in the return of any moneys unjustifiably paid, such as early rent payments, and an award of damages and interest for the losses suffered, unless the plaintiff seeks a specific performance order*."[77]

111. On the same topic, Mr. Guy Duranton considers that: "…*this is an instance where there is no consideration and no immediate reason for the agreement. The selection the property and/or the buildings as well as persons in charge of them and the negotiation of the practical, legal and financial terms and conditions of the transaction are dictated by the lessee to the lease-purchase company. These considerations are valid on to the extent that the obligations are transferred to the lessee and that it has accepted a clause stipulating that it will have no recourse against its contractual partner for any reason and that all rights and guarantees were transferred to it by the lease-purchase company. Notwithstanding these contractual provisions, the courts are not always inclined to accept the admissibility of 10-year warranty claims brought by the lessee acting alone such that, in practice, a lessee may have to bring a lawsuit jointly with it principal (the lessor) in construction disputes with contractors and design engineers*."

112. As the lessee, the project company is subject to the Civil Code provisions relating to leases. It must therefore manage the leased property carefully and cautiously, make the rent payments on the agreed terms and (in theory) return the leased property at the end of the lease. The project company must thus refrain from any action affecting the Islamic investors' property rights which last at least until the option is exercised. It may not sell the Islamic assets or create any security interest on the assets, especially because the assignment or creation of any such security interest without the agreement of the Islamic SPV would, in all likelihood, be disallowed by a French *notaire*.

113. In practice, it is common practice for a clause to stipulate that the project company waive its right to demand that the Islamic investors have any work or repairs done, either when possession is taken or during the lease period. So, the project company will agree to make sure, at its expense and under its sole responsibility, the property is maintained in proper repair, including any fixtures that it may have installed and to make and pay for any and all repairs, regardless of their nature[78], including the major repairs provided for under Section 606 of the Civil Code[79] or those that may become necessary as a result of construction defects or imperfections[80].

114. In ijara agreements, lessees are not allowed to use the leased property for unlawful purposes or for purposes other than those set forth in the agreement and they are required to compensate the lessor for any damage caused to the leased property as a result of any misuse or negligence on its part. So, a single wrongful act entitles the lessor to compensation. The lessee is responsible for damage caused to the leased property for the duration of the lease (lessee's liability arising from the ijara agreement).

115. Similarly, upon the expiration of the lease, if the project company has not asked to close on the sale or in case of premature termination, it must prepare along with the Islamic investors

[76] Cohen, Elie, « Une crise juridique dans le crédit-bail immobilier, la faculté de résiliation unilatérale du crédit-preneur et la nullité du contrat », *Gaz. Pal*. 1996.2, doctr. 975.
[77] Bey, El-Mokhtar, « Crédit-bail immobilier », *fasc.* n° 650, JurisClasseur Banque - Crédit – Bourse, 2000, p. 10.
[78] Civil Code, Section 1720(2) and Section 1754(1).
[79] Court of Appeals of Paris, Oct. 11, 1989.
[80] Duranton, Guy, « Crédit-bail immobilier », Recueil, V Crédit-bail, n° 117, 2000, p. 21.

an inventory of the state of the premises, at its expense, confirming that the Islamic assets are in a functioning state. If they are not, the project company is liable for the cost of the necessary repair work.

116. In addition, the project company may undertake, at its expense, works to improve or refurbish the premises. Any work that entails the demolishing or opening of walls, beams, floors or roofing, the building of any outward or upward extensions or a change in the inside layout will require prior written authorization from the Islamic investors, who, if they do give such authorization, may require that their architect exercises oversight and the architect's will be paid by the project company.

117. What is more, the project company will be required to undertake any and all works, regardless of the cost, required as a result of any statutory or regulatory provisions or any administrative order, in particular for the purpose of obtaining a certificate of conformity or in terms of health and safety and the project company will not be able to assert the provisions of Section 1755 of the Civil Code[81]. So the project company agrees to comply with all statutes and regulations on protection against asbestos and to hold the Islamic investors harmless under such legislation.

118. In the event that the Islamic project assets have to be inspected, guarded or undergo work, the project company will generally take on these obligations and will alone pay all expenses associated with them. It will, in fact, have to agree to provide the Islamic investors proof of completion. It is often contractually stipulated that the project company may not claim any reduction in rent payments or terminate the lease on this account, regardless of how much work needs to be done or how long it is expected to last.

119. Separately, anything stationary that is added to the property by the project company will be deemed to be its property during the lease-purchase agreement and will automatically become the property of the Islamic investors, who will not be required to pay any compensation therefor, at the normal expiration of the agreement, if the lessee fails to exercise the purchase option or in case of premature termination. Any performance obligations that the project company incurs pertain only to the Islamic project assets. If the property is part of a building co-operative, with regard to any work to be done on the communal parts that is approved and carried by the building owners association, the project company will only have to refund the Islamic investors for the share of the cost that relates to the leased Islamic assets.

120. As indicated above, all lessees are required to take out rental insurance. The lease-purchase agreement stipulates that the project company must have insurance covering all risks associated with using the Islamic assets. The insurance company must be approved by the Islamic investors who may demand that the project company have the insurer inform them of any irregularities on the part of the project company (late payment, incident, cancellation) with respect to its insurance policy. It is worth noting that traditional insurance, *i.e.* non-Islamic insurance, is permitted in the name of the necessity principle, which means that conventional insurance can be used when there is no adequate system of Islamic insurance.

[81] Section 1755 (created by Act 1804-03-07 promulgated on March 17, 1804) holds that: "no repairs to leased property should be paid for by lessees when they are required as a result of wear and tear or acts of God."

121. The Islamic SPV may also demand that the project company makes sure that the insurance policy stipulates that any insurance payout and/or reimbursement for damage to all or part of the property be paid directly to it. What makes a lease is not the actual use that the lessee makes of the leased property but the intended use that parties mutually agree to. That is why it is useful to include a clause which provides that any change in the intended use without the authorization of the Islamic SPV is a cause for rescission. So, any changes in layout as a result of any demolishing or opening of walls, beams or floors will require prior written authorization from the Islamic investors and possibly require a building permit to be obtained. Any work authorized by the Islamic investors must be performed at the sole expense and risk and peril of the project company and under the supervision of an architect or engineering firm approved by the Islamic SPV.

122. Any such work constitutes improvement or refurbishment work and therefore the cost as well as any insurance premiums on any insurance policies the project company has taken out in connection therewith, the fees of architects or engineering firms, will, in theory, be paid in full by the project company with no recourse against or recovery from the Islamic investors and without being permitted to offset such costs against moneys owed to the Islamic investors for any other reason. However, in the event that such work, because of their extent or nature, has to be justified by the Islamic investors for tax or accounting purposes, it is generally agreed that payment of the corresponding expenses by the project company will be in the form of a special supplemental rent payment.

    However, Islamic Business Law contains special provisions. In the event of the partial destruction of the property, making it unfit for the use for which it was intended, or in case of the total destruction of the asset, the ijara agreement will end on the date the total destruction of the property is certified. However, if the loss or partial destruction of the property is caused by misuse or negligence by the project company, it will be required to indemnify the Islamic investors for the value of all rent payments that have not yet become due and payable. The conventional type of insurance will cover this risk. Indeed, there is currently no efficient system of Islamic insurance (takaful), therefore conventional insurance is allowed under the principle of necessity (dharura).

123. Unlike Islamic sales agreements, the ijara can be entered into for a future date. So, while Shari'a Law does not permit sales for future delivery, ijara for a future date is allowed, provided that rent payments commence only after possession of the property is taken. As a matter of fact, in most conventional lease-purchase agreements, lessors purchase property from lessees. Lessees buy the asset in the name of the lessor who will pay the price to the supplier, either directly or through lessee. This is the case of some financial lease agreements where the lease begins on the same day when the price is paid by the lessor, separately and independently of the fact that the lessee paid the supplier and took possession of the asset; which means that the lessee's is responsible for making rent payments even before it takes possession of the asset. Under Shari'a Law, this practice is akin to a ribawi transaction which is not permitted. That is why rent payments can only be payable after the lessee takes possession of the asset and not on the day the price is paid. If the supplier is late delivering the asset after the full price has been paid, the lessee must not be required to during the late delivery period. During the construction period, outlays by the Islamic investors will be treated as rent prepayments. Rent payments under the lease-purchase agreement will only commence upon completion of the construction of the Islamic assets.

124. It must be clearly understood that when lessee was authorized by the lessor to take possession of the lease asset from the supplier or to build the building, the Islamic SPV and the project company have specific obligations. In the first phase, the project company is authorized by the lease-purchase company to purchase the property on its behalf from the supplier. At that point, the parties' relationship is no longer an agency relationship: the agent is required to perform the terms of the agency agreement that it entered into and it must, in the performance of the agency agreement, act with due care and due diligence. In our case, the lessor and the lessee are not contractually bound by a lease. The second phase begins on the date at which the project company takes delivery of the property from the supplier. That is why, in the first phase, the project company cannot be liable for the obligations that would apply to a lessee. During this period, it is responsible for performing its duty of due care and due diligence as an agent. It is not until the date of delivery of the asset that it liable for the lease obligations. In other words, the lease takes effect as of the effective date of the agreement, which is the date the project company takes delivery of the asset.

125. As the owner of the asset, the lessor is required to pay all sales costs paid by the lessee in its capacity as agent, as well as any expenses incurred to import the asset into the lessor's country. Any agreement otherwise, which are often found in conventional financial leases, are contrary to the Islamic moral order.

126. So, a distinction must be drawn between two situations: one is the building construction is contractually based on the agency agreement as indicated above and the other is a construction financing agreement such as a sale for future delivery (sale of property that is yet to be developed, etc.). In the latter case, the project company is independent and acts without being an agent, which has as a result to reinforce its obligations.

127. The lessee is liable for any loss caused to the asset due to its negligence or misuse. However, it cannot also be liable for the normal wear and tear that occurs during use. But unlike with conventional lease-purchase arrangements, it cannot be liable for the loss of the asset if it is caused by favors beyond its control.

128. Lastly, under Islamic Law, a lessor cannot sublease the property without the lessor's express authorization. Islamic schools of thought are unanimous that subleasing is lawful if the sublessee rent payments are less than or equal to the rent payments to the original lessor. However, opinions are divided in the case where the sublessee is asked to make rent payments that are higher than the rent payments to the original lessor. Muhammad ibn Idris ash-Shafi'i[82] and a number of other Muslim legal scholars consider that the owner of the lease asset should reap the benefit of any extra amount from payments received from the sublessee. That is also the position favored by the Hanafi School. Separately, Abou Hanifa An-Noù'man Ibn Thabi[83] is of the opinion that any extra amount from payments received from the sublessee should not benefit the sublessor who should donate it to charity. However, it should be noted that if the sublessor has modified the leased property by adding anything to it or if it has leased the property in a currency other than the one in which it makes rent payments to the owner, then it may demand higher rent payments from the sublessee and thereby profit from the extra amount. French Law allows subleasing even though a sublease does not create, in principle, a legal relationship between the sublessee and the lessor. From a legal standpoint, though, there is nothing to prevent a lessor from

[82] Founder of the Shafi'i School (150-204 H).

demanding that a sublessee make rent payments directly to it or from ordering it not to make the rent payments to the lessee if the lessee is in default. These options are available by law and set forth in Section 1753 of the Civil Code.

G. Clauses of Critical Importance in the Agreements

129. This section proposes to examine the clauses that are of critical importance in lease-purchase and ijara agreements. In the ijara agreement, the amount of the rent payments must be specified when the agreement is entered into for the entire lease period. Incidentally, the agreement can contain rent payments amounts that vary from one period to the next, provided that the amount is clearly stipulated for each period. Example (1): Islamic SPV A leases a capital good to project company B for a 7-year period. The amount of the rent payments for the first 4 years is €20,000.00 a month and it is agreed that each year the rent payments will increase 10%. Under these circumstances, the ijara is legally valid. Example (2): In the example above, Islamic investors A determine the amount of the rent payments (€20,000.00) just for the first year. Under this set of circumstances, the lease is null and void. This same requirement exists under French Law, which prohibits, for example, a clause containing two paragraphs written in convoluted language that pertains only to a brief period and fails to give the benchmark index.

130. Yet, in long-term leases, it is not in lessors' interest to set the amount of the rent payments in stone because market conditions fluctuate. In this case, lessors have two options:

- a) they can stipulate in the lease agreement that the amount of the rent payments will increase by a specific percentage (for example, 5%) after an agreed period (for instance, one year);

- b) they can enter into a lease agreement for a shorter period and later decide to extend it on new terms. In this case, the lessee may refuse to extend the lease, in which case the lessee returns the leased property.

However, some Muslim legal scholars have accepted that the amount of the rent payments be indexed to a variable benchmark index if the index is sufficiently specific. For example, lease agreements can stipulate that in the event of any increase in taxes levied by the government, the rent payments will be adjusted accordingly. Under French Law, rent payments can be indexed based on the INSEE building and construction cost index defined as the difference between the monetary depreciation rate and the increase in productivity in real estate construction[84] provided that this clause is written in plain language[85]. Similarly, indexing the annual increase of rent payments based on the inflation rate is allowed. So, if the inflation rate goes up by 5%, this will lead to 5% increase in the amount of the rent payments. In this regard, we note however that today's rents rose faster than inflation, and hence it may be interesting to provide indexation on average rents. Some Islamic banks use a benchmark interest rate to calculate the amount of rent payments in order to earn the same amount of profit on a lease-purchase agreement as conventional banks. That is why, Islamic banks adjust the amount of rent payments using an interest rate and the agreement stipulates that the rent payment will be equal to the interest rate or the interest rate plus some margin. Since the interest rate is variable, it cannot be specified for the entire lease period. As a result of this, it is common practice, for the calculation of the periodical rent

[84] Rép. min. éco. et fin., p. 21856, à M. Louis Courroy: JO Sénat Q 26 avr. 1977, p. 658; Court of Appeals of Paris, 5e ch A, 22 avr. 1985, Sté Hôtelière de la Porte de Sèvres c/ Sté Locabail Immobilier: Juris-Data n° 023067.
[85] Court of Appeals of Paris, 16th Chambre-A, Sept. 24, 1985, Sté Sogebail v. Sté CCN: Juris-Data n° 025587.

payment increases, to use the interest rate of a given country as the benchmark (Libor or Euribor). The objection raised with respect to this is that by applying an interest rate to the rent payments, the transaction is akin to ribawi financing like business loans made by conventional banks. This is a surmountable obstacle if the agreement specifies, like in the case of mourabaha, that the interest rate is only used as a benchmark. To the extent that all other requirements applicable to lease agreement under Shari'a Law are observed, then the agreement can use any point of reference to calculate the amount of rent payments. In fact, the fundamental difference between an interest rate and a rent payment is not the amount to be paid to the bank or the lessor, but rather the risks taken on by the parties. In the lease agreement, the lessor assumes risks as owner of the leased asset. If the asset is destroyed during the lease period, the lessor will take the loss. Likewise, if the lease property becomes unusable, not as a result of any misuse or negligence on the part of the lessee, then the lessor will not be able to demand the rent payments. In conventional financing, things are different: the borrower will be charged interest and repay part of the capital with no consideration with regard to the actual use of the loaned funds; in other words, the destruction of an asset financed through a loan has no consequence on repayment of the loan. The obligation to repay interest and the capital is not extinguished if the financed asset disappears or is destroyed. It appears clearly that in the event that this difference is maintained (the lessor assumes the risk associated with the leased asset), the transaction cannot be classified as a ribawi transaction even if the amount of the rent payment paid by the lessee is equal to the interest rate. Under to this analysis, it follows that the use of an interest rate is a mere benchmark does not make an agreement haram in that it is based on interest being charged as part of the transaction. In practice, however, these obligations are often incurred by the lessees who as agents for a fee factored in the calculation of the amount of rent payments. This transfer of risks deprives the distinction of a part of its content. In our opinion, this issue needs to be addressed with great care in for the members of the shari'a board to officially approve the transaction.

131. Based on a careful reading of the provisions of Section L.313-7 of the Monetary and Financial Code, the lessee becomes the owner of the leased property no later than at the expiration of the lease, either through a sale pursuant to a sale undertaking or by directly or indirectly acquiring the property rights to the land on which leased building(s) was(were) built or by transferring full title to buildings built on land owned by said lessee. Under a sale undertaking, which carries a term, the Islamic SPV or its representative must undertake to sell the leased Islamic assets to the project company if the project company elects to exercise its purchase option. The sale undertaking starts running at the end of the minimum irrevocable period after the lease-purchase agreement takes effect and it ends at the contractually agreed end of the lease-purchase agreement. The so-called irrevocable period is the period during which the purchase option cannot be exercised[86]. While parties are generally free to define this period contractually, a practical objection can be made. For tax purposes, there are deadlines that have to be observed and failure to do so can result in dissuasive monetary penalties making the transaction financially complex[87]. The lease-purchase arrangement can in fact be challenged if the irrevocable period is too short or if the purchase option is exercised during this period[88].

[86] Gerber, P, « Levée de l'option dans un contrat de crédit-bail immobilier », *Crédit-bail* avr. 1990, p. 49, n° 10.
[87] See below the tax rules that apply to lease-purchases.
[88] French Supreme Court, 3rd Civil Section, June 10, 1980 and French Supreme Court, Business Section, Jan. 15, 1985.

132. The project company must give exercise notice, by registered letter with signature confirmation of delivery sent to the Islamic SPV's corporate headquarters, at least six months in advance; within three months after that, the project company must pay the Islamic SPV an amount sufficient to cover the sale price and any costs, duties and taxes associated with the sale. Failure to do so may result in the exercise notice being deemed invalid.

133. The agreement can stipulate that if the project company fails to perform its obligations, the sale undertaking will become null and void. The sale price will be determined on the day of the closing in a sale deed entered into through a French *notaire*. The transfer of title will be conditional upon the contractually agreed stipulation that rent payments must be paid on a regular basis and residual value payment be made. Possession will be taken when the property is actually made available. In validly constructed clauses containing exceptions, the parties can expressly agree that the sale will be made at the risk and peril of the project company with no warranties from the Islamic SPV that the property is unoccupied or regarding the existence of hidden defects. In fact, according to legal scholars "*the validity of contractual clauses pursuant to which, as an exception to Section 1641 of the Civil Code, a lessee exercising a purchase option waives its right to bring action against the former lessor for hidden defects affecting the ground or the underground or any imperfections affecting the buildings, is not, in theory, questionable*."

134. What is more, based on Sections 1627 et seq. of the Civil Code, the parties can, through special agreements, agree that the seller will not be required to give any warranty that property is unoccupied. All costs, duties and fees associated with the sale will be paid by the project company, as the buyer. The sale deed must be notarized and the Islamic investors will be required to file a copy of the sale deed with the Mortgage Registry Office as with any property sale. The statutory filing requirements regarding leases and sale undertakings apply, especially the requirement to file a copy of any lease for over 12 years.

135. Under penalty of nullity, Section 1840-A of France's General Tax Code requires that, in order to be legally valid, sale undertakings relating to property, ongoing businesses or a limited number of other things the tax code lists, they have to be entered into either through a French *notaire* or the parties can enter into a private agreement but provided, in this case, that they be registered within 10 days after they are accepted by the beneficiary. However, France's Supreme Court[89] found that "*a lease-purchase agreement is a complex contract in which the sale undertaking only one part of the legal solution enabling the parties to carry out a complete transaction offering them mutual benefits,* [the Supreme Court ruled] *that the appellate court correctly reasoned that such a transaction, by its nature, is not subject to the provisions of Section 1840-A of the General Tax Code*."

136. And, according to the High Court[90], "*a sale undertaking included in a lease-purchase agreement is inseparably linked to a set of mutual contractual obligations and is not subject to the filing requirement stipulated in Section 1840-A of the General Tax Code….*"

137. In an opinion dated January 15, 2002, the Business Section of France's Supreme Court overturned an appellate court ruling with the following reasoning:

[89] French Supreme Court, 3rd Civil Section, Nov. 3, 1981: *Bull. civ*. III, n° 173; *D.* 1982, inf. rap. p. 76; *JCP G* 1982, II, 19867, note El-Mokhtar Bey, upholding Court of Appeals of Bastia, Jul. 19, 1979: *JCP CI* 1980, II, 13260, note David (C), decision involving a lease-back.

[90] French Supreme Court, 3rd Civil Section, June 3, 1982: *Gaz. Pal*. 1983, 1, p. 8, note El-Mokhtar Bey.

"*In reversing the decision, the Court of Appeals, after finding that under the terms of Article 2 of the March 28, 1990 Agreement SGA had agreed to sell the property in question, the description and the price were defined and determinable while SI had no contractual obligation to purchase the property, held that the sale undertaking was consequently unilateral, but the Court of Appeals enunciated that the since the sale undertaking was set forth in an agreement containing a number of mutual contractual obligations, the sale undertaking was not subject to the filing requirement prescribed under Section 1840-A of the General Tax Code*.

But, by so reasoning, without seeking to determine whether there existed the necessary dependency connection between these various mutual contractual obligations liable to modify the terms of the sale undertaking, the Court of Appeals failed to give a legal basis to its decision."

Furthermore, it is important that the undertaking be a sale undertaking from a lessor and not a purchase undertaking from a lessee. This is a crucial point it determines how the agreement will be legally classified. A lessor cannot reserve its acceptance. The party providing a sale undertaking (the Islamic SPV) promises to sell Islamic assets to another party called a beneficiary (the project company) upon receipt of an exercise notice from the beneficiary. It cannot be a purchase undertaking in which the project company agrees to purchase the property whenever the Islamic SPV decides to sell. Such an arrangement is contrary to the very purpose of the lease-purchase agreement.

138. With regard to this, France's Supreme Court a contract cannot be legally classified as a lease-purchase agreement if it stipulates that the lessee had "…*already expressed its intent to acquire the property at the end of the lease, which the lessor duly noted reserving its acceptance…. By finding that such a lease agreement was a lease-purchase agreement, even though it found that the purchase of the property leased by the lessee was contingent upon the lessor's acceptance, such that, far from containing a sale undertaking as required under the aforementioned law, the lessee's expression of intent constituted a purchase undertaking, the Court of Appeals failed to reflect the legal implications of its own findings*."[91]

139. In another precedent-setting case, the Supreme Court[92] also opined that based on the agreement "*the lessor acknowledged the lessee's intent to purchase the property, 'reserving its acceptance'... the purchase of the leased property was contingent upon the lessor's acceptance, such that, far from containing a sale undertaking as required under the aforementioned law, the lessee's expression of intent constituted an exclusive lease-purchase purchase undertaking.*"

140. However, when an agreement contains a purchase option that is subject to a single requirement that the beneficiary inform the lessor of its intent to exercise the option at least one month before the lease expires, the clause in question qualifies as a sale undertaking

[91] French Supreme Court, Business Section, May 30, 1989, Sté Locavehi c/ Skocic, *Bull. civ*. IV, n° 167; *JCP G* 1989, IV, 283.
[92] French Supreme Court, Business Section, June 15, 1999, *RJDA* 10/1999, n° 1118.

required in lease-purchase arrangements[93]. An agreement that does not contain an option to purchase the leased property is not a lease-purchase agreement[94].

141. Yet, Islamic Contract Law requires the leased asset to remain the exclusive property of the lessor that cannot unilaterally undertake to sell the property leased under the lease agreement. In the final analysis, under French Law in order for a lease-purchase agreement to be legally valid, it must contain a sale undertaking from the lessor whereas under Islamic Law specifically prohibits ijara agreements from containing any such undertaking.

142. However, our research has found that in the practice of co-financing, this prohibition under Islamic Law can be gotten around if the sale undertaking is separate from the lease agreement. To do this, the undertaking must be set forth in a document that is separate from the lease-purchase agreement. Muslim legal scholars accept transactions structured in this way. It would have to be determined whether a French court would find that an agreement qualifies as a lease-purchase agreement if the lessor's acceptance is set forth in a separate document. From a tax point of view, the July 23, 2010 tax directive provided clarification on the rules applicable to the ijara, which confirms our interpretation: the two agreements must be executed at the same time and they must form part of the same contractual deal.

143. According to the aforementioned directive, the ijara "*…here is a contract pursuant to which an entity leases a movable or immovable asset to a client for a specific period of time and in exchange for rent payments. The client can be the original owner of the asset. The ijara agreement can contain a sale undertaking or a purchase option exercisable at the end of or during the agreement. The sale undertaking or the purchase option can be separate from the lease agreement*." Based on this explanation, the directive holds that the tax rules applicable to ijaras depends on how the transaction is legally classified, subject to whether or not it is considered to be a lease-purchase transaction as defined in Section L.313-7 of the Monetary and Financial Code or a lease that contains a purchase option (also called a "lease with a sale undertaking"). In point of fact, France's tax authorities consider that, from a legal standpoint, both are loan transactions covered under the second paragraph of Section L.313-1 of the Monetary and Financial Code, which states that: "*Lease-purchasing, and, in general, any leasing transactions that involve a purchase option, are treated as loans*." According to the French tax authorities, it is now possible for sale undertakings to be set forth in a separate document without preventing it from qualifying as a lease-purchase transaction.

H. Project Security Package

144. At first glance, the Islamic investors are just unsecured creditors for all the moneys owed to them by the project company under the lease-purchase agreement[95]. As a result of this, in our opinion, Islamic investors will demand certain guarantees that can be in one of a number of forms. We will examine three of them: pledging a lease-purchase agreement as

[93] French Supreme Court, Business Section, May 13, 1997, *RJDA* 10/1997, n° 1231.

[94] French Supreme Court, Business Section, Apr. 14, 1972, *JCP G* 1972, II, 7369, note Elie Alfandari; French Supreme Court, 1st Civil Section, Oct. 11, 1989, *Bull. civ*. I, n° 327; *D*. 1991, jurispr. p. 225, note Pascal Ancel; *RTD com.* 1990, p. 244, obs. Bernard Bouloc.

[9595] French Supreme Court, Business Section, Apr. 9, 1991, *Bull. civ*. IV, n° 124, D. 1991. somm. 329, obs. Adrienne Honorat, *RD imm*. 1991.371, obs. Phillipe Delebecque and Philippe Simler, *RTD civ*. 1992.152, obs. Monique Bandrac; Court of Appeals of Paris, Jan. 17, 1985, *JCP*, éd. E, 1985. II. 14255.

part of a pledge agreement, assigning sublease rent payments as collateral, a share pledge and a guarantee facility.

145. The project company can pledge and give as security to the Islamic investors the intangible assets arising from the lease-purchase agreement, the right to the lease as well as the benefit of the sale undertaking, with no exceptions or reservations. By means of this pledge, the Islamic investors will have all rights and privileges provided by law to pledge creditor on and to the project assets under the lease-purchase agreement. Under the terms of Section L.313-23 of the Monetary and Financial Code, any loan that a lending institution makes to a private law or public law entity or to an individual for business purposes, may involve the institution being given, by the mere delivery of a written statement, an assignment or pledge by the borrower of any business receivable due and payable by any third party (a private law entity, a public law entity or an individual). Therefore, the project company can, if necessary, assign the receivables in a written statement to guarantee payment of the principal, interest and related costs; if, for example, the receivable is rent payments from a sublease, the statement can reference the name of the sublessee.

146. The Islamic investors can also authorize the project company to receive sublease rent payments on its behalf. In that case, the agreement will need to contain a number of additional clauses. It will have to mention sublease rent payments received by the project company are received on behalf of the Islamic SPV. The Islamic SPV will have to give its express authorization for either party to modify or terminate[96] the sublease agreement. The project company will, we believe, have to agree to refrain from using the rescission clause contained in the sublease agreement and not to extend the sublease without the express written authorization of the Islamic investors.

147. The shares in the project company can be pledged in a pledge agreement entered into through a French *notaire* or as a private agreement that must be notified to the company or accepted by it in a deed prepared by a French *notaire* of which public notice must be given and the date of such public notice will determine the of the pledge creditors. To do this, the project company can pledge and give as security to the Islamic SPV part of its full-paid-up outstanding shares, forming part of its share capital.

148. The Islamic SPV can also demand that the shareholders of the project company agree to maintain the company's share capital in the same geographic location, under penalty of rescinding the lease-purchase agreement. The shareholders will have to agree not to sell their shares in the company and agree to act as guarantors with joint and several liabilities. The Islamic SPV can demand a guarantee facility from a third party as protection against nonpayment of any moneys owed to it.

I. Termination of the Agreement

149. What about termination of the agreement? If the project company fails to perform any of its contractual obligations, the Islamic SPV has the right to terminate the lease-purchase agreement after serving formal notice to pay or formal notice to perform its obligation, that remain unremedied in full or in part. In such a case, the project company may be evicted from property or dispossessed of the asset by order of the superior court, certain terms of which are enforceable notwithstanding any challenge or appeal. The project company will

[96] Virassamy, Georges, « Les clauses contractuelles aménageant l'après-contrat de crédit-bail résolu ou résilié », *JCP E* 1992, I, 137.

then have to return the Islamic SPV's assets or vacate its property immediately, leaving it in a proper state of repair, and provide proof of payment of all taxes, duties, service fees and insurance premiums. This seems impractical when the Islamic assets form, along with the other project assets, an economic entity that is difficult to separate. It is hard to imagine how Islamic assets such as a hospital building that houses a cardiovascular medicine unit can be returned to the Islamic investors.

150. At the end of the lease-purchase agreement, there are three alternatives possible. The first is the parties can negotiate a second lease-purchase agreement. The second alternative is that the project company vacates the premises or returns the asset without exercising the purchase option. The third option, which is most common, is that the project company exercises the purchase option and purchases the property for the residual value, which is the actual value after deducting amortizations included in the rent payments.

151. In such a situation, the Islamic SPV is under no obligation to give notice to the project company if the agreement ends before its term. If the project company remains the owner of the land, the expiration of the lease-purchase agreement occurs at the same time as the construction lease agreement or the long-term lease conferring a right in rem, so that the project company acquires ownership of the buildings with no payment to be made or any expression of intent to be provided.

152. If the lease-purchase is structured such that the purchase is from a real estate investment company, once the property company exercises its purchase option, it will become the owner of the shares that belonged to the Islamic SPV. The determination of the sale price will be a function of the property's residual book value. The price may be calculated as follows:

"*At the contractually agreed end of the lease-purchase agreement, the price will be one euro (€1). For the previous years, the sale price will be calculated as follows: The sale price will be the discounted value, on the effective date of the sale, of all moneys due (rent payments and residual value at the end of the lease-purchase agreement) until the end of the agreement. In any case, this amount may not be less than the outstanding amount due on the date the exercise notice is given, plus three percent (3%). These values will be calculated based on the effective date of the agreement such as, given the base annual rents paid on their due date, the sale price applicable at the end of each calendar year yields an annual rate equal to the transaction's discounted rate. It is expressly agreed that the sale price determined in this way, forms, in the minds of the parties, with the rents paid on their contractually agreed due dates, a whole that constitutes the financial terms of this agreement. Consequently, if, for any reason whatsoever, the Islamic investors that own Company X is forced to reduce the contractual amount of one or more rent payments or the dates by which they must be paid, the sale price will be recalculated taking into account, on the one hand, the moneys actually paid and the payment dates, and, one the other hand, any rent payments that Company X may not have received by the contractually agreed due date, absent any rent reduction or payment due date extension–all such that Company X receives, by means of the recalculated price, the returns arising from the strict application of the terms and conditions of this agreement*."

It is worth noting, in passing, that the parties are free to determine the calculation formula, which means that neither party can attempt to rescind the sale ex post facto claiming that the price is unfair or claiming hardship (which is accepted by French courts).

153. After the project company gives exercise notice, the sale is done. The sale must comply with legal rules and be set forth in a sale deed entered into through a French *notaire*. The *notaire* must filing a copy of the sale deed with the Mortgage Registry Office no later than two months after closing, which makes the sale enforceable on third parties. All taxes and fees from the sale are paid by the buyer. It should be noted that the Islamic SPV has an obligation to deliver the property to the extent that the project company is already in the premises.

154. The agreement can be terminated prematurely by court-order by action taken by either party because the other party fails to perform its obligations. The agreement can therefore stipulate that the failure to pay any rent payment on the due date, any part of it or the corresponding value added tax, or the failure to payment any maintenance charges or to perform any of the other terms and conditions of the agreement, the lease-purchase agreement will be terminated automatically, without the requirement to get a declaratory judgment from a court, one month after formal written notice is served by a bailiff and the nonperformance remains unremedied in full or in part. Furthermore, when the Islamic assets under the lease-purchase agreement require an operating license or some other legal authorization in order to be used, it is generally stipulated that if they are not obtained, or if a final operating license or authorization is not given, the agreement will be terminated automatically at the behest of one of the parties. Under Section 1226 of the Civil Code, the project company would be required to pay the Islamic SPV a fixed amount in compensation for termination that is commonly called a penalty clause payment. The penalty can, for example, be equal to the sale price determined on the effective date of termination, plus the amount of tax refunds, plus two years of rent payments calculated based on the last rent payment notice sent to the lessee before the termination. A value added tax may apply to the penalty payment. Therefore, the fixed penalty payment due to the lease-purchase company may be reduced if it is found to be excessive and it fails to consider that the creditor has kept the property and can resell it[97].

155. Yet, as we have already indicated, the Islamic moral order prohibits Islamic financial products from including late payment penalties. A finance charge for late payment is considered a ribawi. However, in order to avoid the adverse impact of an abusive use of this prohibition, a clause can be included in the lease agreement. In the clause, the project company can be asked to agree, if it fails to make a rent payment by the due date, pay a certain some of money to a charitable organization that works to promote Islam such as, for example, the Arab World Institute in France. In practice, Islamic SPVs may manage a charity fund into which such moneys are paid and used for charitable purposes.

156. The clause could be worded as follows: "*In the event of a late payment of rent that comes due, the project company hereby agrees to pay an amount calculated as…% of the charity fund maintained by the Islamic SPV or designed by it in the agreement; this amount will be used by the Islamic SPV solely for charitable purposes approved by Shari'a Law and may not be included in its balance sheet as income*." While this clause does not compensate the Islamic SPV for its opportunity cost during the default period, it can serve as a powerful deterrent.

[97] Court of Appeals of Versailles, Feb. 26, 1999, *BRDA* 9/1999, n° 9.

157. In lease-purchase operations under French Law, the lessor has the right to unilaterally terminate a lease[98] and to demand payment of the rent payments outstanding for the initial period of the lease. This is not possible under Islamic Law because it goes against the tenants of fairness and social justice under the Islamic moral order that does not accept as a rationale consequence of the termination of a lease that the lessor can just take its property back. Moreover, if the termination is caused by misuse or negligence by the lessee, the lessor can ask it to pay it compensation for the loss caused by the negligence but the lessee cannot be forced to continue to pay the rent for the remaining period. If the leased property is insured, the insurance premiums should be paid by the lessor who will pass on the cost to the lessee.

158. Under the terms of Section L.313-9 of the Monetary and Financial Code, lease-purchase agreements must stipulate, under penalty of nullity, the circumstances under which the agreement can be terminated by the lessee. The termination cannot be based on an implicit interpretation of other termination clauses[99].

159. The termination clause[100] could be worded as follows[101]:

"*The project company may demand the termination of this agreement effective as of [•], subject to the terms and conditions defined hereinafter. This termination may take place effect each year only on the anniversary of the effective date of the lease. The project company must notify the Islamic SPV of its decision to terminate the agreement no more twelve months and no less than nine months in advance by registered letter with signature confirmation of delivery. The project company must vacate the premises no later than ten days before the effective termination date. The Islamic SPV will have an inventory of the state of the premises prepared, at the expense of the project company. The inventory must confirm that the Islamic assets are in a perfect state of repair, in accordance with the provisions of [•] general terms and conditions and that they can be leased for use consistent with their intended use at no expense to the Islamic SPV. The project company must be in compliance with in all its contractual obligations such that the requirements for the Islamic SPV to enforce the rescission clause stipulated in [•] above are not fulfilled. The certificate of conformity must have been obtained. The project company must have paid to the Islamic SPV the fixed penalty payment agreed, equal to the sale price determined on the effective date of termination, plus the amount of tax refunds referred to in [•]. If any of the abovementioned requirements are not fulfilled ten days before the effective date of termination, the Islamic SPV will be entitled, should it so determine, to consider the project company's notice of termination null and void. The Islamic SPV must inform the project company within ten days after the date scheduled for termination, by registered letter with signature confirmation of delivery, explaining which requirement(s) has(have) not be fulfilled. The project company will not have to pay any penalty if, before the date scheduled for termination, it has a third party purchase the property on the following terms: The price must be at least equal to the sale price defined in [•], determined on the day the sale deed was executed in the offices of the French* notaire, *plus any taxes (in particular capital gains taxes) owed as a result of the sale and any tax refunds referred to in [•]. For the purpose of paying real estate conveyance tax, the property's*

[98] Cohen-Steiner, Nicolas, « La clause de résiliation anticipée dans le contrat de crédit-bail immobilier », *Sem. jur*., éd. N. I, 2001, n° 13, p. 661.
[99] French Supreme Court, 3rd Civil Section, Dec. 19, 1983, *Bull. civ*. III, n° 267, *D.* 1984, IR 133.
[100] Pronier, Dominique, *La clause de résiliation anticipée dans un contrat de crédit-bail immobilier*, Supreme Court Rapport, 1998, p. 123 et seq.
[101] Lamy Formulaire commenté Droit immobilier, 2011.

market value, if it is greater than the sale price, will be represented by the parties in the sale deed to be an estimate.

The sale must, furthermore, be carried out on the terms and conditions set forth in [•]. The project company must inform the Islamic SPV, by registered letter with signature confirmation of delivery, of the full name and address of the future buyer of the property and take personal responsibility of all actions by the buyer until closing on the sale; the Islamic SPV will have not responsibility vis-à-vis the project company in this regard.

This agreement will end on the date the sale deed is executed. The project company will be a party to the sale deed to terminate this agreement and to give its personal undertaking to the buyer to vacate the premises without delay. All rent payments and maintenance charges due and payable until the date either of the termination or of the execution of the sale deed in the offices of the French notaire. Any surplus payment will go to offset any moneys that may be owed by the project company or refunded. The penalty payment stipulated in [•] below will also be due if termination is the result of a decision by a receiver appointed in a court order to commence receivership or liquidation proceedings (Article 37 of Act No. 85-98 of January 25, 1985)."

Conclusion

In summary, project finance seems structurally compliant with the Islamic moral order, which we believe designates the set of rules or intangible principles. Firstly, financiers can be repaid from the cash flow generated from the project, which is consistent with the riba prohibition. Secondly, the project's success is based on the performance of the financed asset, which complies with the gharar and asset banking prohibition (speculation). Moreover, the projects involve the construction of physical infrastructure, which meets the requirement that the object be halal (lawful). Lastly, the project risks are borne by the party that is in the best position to evaluate them, which is consistent with the principle of fairness in contractual relations.

However, putting this reasoning into practice is not as easy as it seems and it would be a disservice to suggest that things are set in stone when, in actual fact, they are more flexible and supple. For, as we have seen, while it claims or aims to be unconditional, the Islamic moral order subjects financing agreements to a set of mandatory rules the binding force of which varies in degree. Here is a brief reminder of the principles: the use of conventional hedging practices such as futures and options is prohibited; late performance or nonperformance penalties are prohibited; ownership of the asset must be transferred to the Islamic financiers; the use of certain conditions precedent is prohibited in contracts.

Co-financing involves a comingling of separate rights and obligations and one of the real challenges is achieving a fair balance through their articulation. That is what makes it complex. While conventional financiers seek to preclude their risks, Islamic financiers will not accept to fund any project that is not compliant with moral order.

In a detailed examination, we therefore sought to highlight the differences, stress the rationales and inventory the constraints in order to propose a contractual model that could surmount them. The challenge here was to effectively meet the requirements of both conventional investors and their Islamic counterparties. Now, France has a tax system that

promotes Shari'a compliant investments. It must be noted that with respect to mourabahas, financiers' income is the remuneration from a deferred payment akin, from the tax standpoint, to interest due for the period. This income is taxable, for the duration of the mourabaha, as industrial and business income. Profits can be spread out over the duration of the deferred payments, regardless of the payments made, at a frequency identical to that used for withholdings booked in connection with the operation and in accordance with a schedule appended to the contract. Likewise, moneys paid by the client are exempt from the mandatory fixed tax on fixed income investment products when financiers and not resident in France. In addition, financiers' income is exempt from value added tax, as is the only that part of fees paid for financial intermediation services.

With respect to investment sukuks, they can be considered for tax purposes akin to bonds or negotiable debt securities depending on the legal status and their maturity. From this standpoint, the income paid to bearers of sukuks is treated from a tax perspective like ordinary interest. Their issuers are allowed to deduct from their taxable income a charge corresponding to the compensation due pursuant to the issue agreement and calculated based on a "desired profit margin."

As for the ijara, when the transaction involves and lease-purchase arrangement or a lease with a purchase option, the rules governing lease-purchase agreements apply to them, even when the client's purchase option is set forth in a document separate from the lease agreement, provided that they form part of the same contractual deal.

The istisna is regarded as a conventional purchase transaction involving phased payments and/or payment terms. Consequently, financiers' income is the remuneration from a deferred payment akin to interest due for the period considered.

If recent tax directives are a significant move in the right direction, they do not make it possible, in and of themselves alone, to achieve their stated ambitions. Even though we have managed to overcome the constraints identified, there are still many obstacles to the use of co-financing. That is why, as we come to the end of our study, it is fitting to mention a number of the incentives recommended by the Paris-Europlace Islamic Finance Commission.

Firstly, the fact that Islamic SPVs are not lending institutions means that they cannot receive security and collateral under the Dailly Act. It would be helpful to create a mechanism in France's civil code enabling receivables to be assigned as security or collateral, thereby overturning the December 19, 2006 precedent set by the Business Section of France's Supreme Court.

Secondly, given the current state of our legislation, when an Islamic SPV resells Islamic project assets to a buyer, it is required to give the buyer a warranty regarding hidden defects (warranty required as a matter of public policy), which makes no sense in short-term sale/resale transactions. Therefore, there is a need, on the one hand, when the resale of the financed property occurs at the same time as the first sale, for resellers to be exempt from given a hidden defect warranty (which then bears on the initial seller), and, on the other hand, to clarify the rules applicable to lease-purchase arrangements, which are poorly defined, and expand the rules applicable to trusts.

Thirdly and lastly, it would be helpful for SPVs that are subsidiaries of lending institutions not to be required to obtain a banking business license. In effect, the fact that Islamic SPVs are not lending institutions means that, under normal circumstances, it cannot provide lease-

purchase services. Any subsidiary in which a lending institution has a 90% stake to be authorized as a bank as a part of its parent company (this is the notion of a "banking license loan") which would not be in breach of Directive 2006/48EC.

Glossary of Islamic Banking Terms

The following has been adapted from the SBP Publication, 'Islamic Banking and Finance: Theory and Practice' by Muhammad Ayub, Sr. J.D. IBD, SBP)

Amanah

This refers to deposits in trust. A person can hold a property in trust for another, sometimes by express contract and sometimes by implication of a contract. Amanah entails an absence of liability for loss except in breach of duty. Current Accounts are regarded as Amanah (trust). If the bank gets authority to use Current Account funds in its business, Amanah transforms into a loan. As every loan has to be repaid, banks are liable to repay the full amount of the Current Accounts.

Arbun

Down payment; a non-refundable deposit paid by a buyer retaining a right to confirm or cancel a sale.

Al-'Aariyah

(Gratuitous loan of non-fungible objects) (Al-'Aariyah means the loan of a particular piece of property, the substance of which is not consumed by its use, without anything taken in exchange, In other words, it is the gift of usufruct of a property or commodity that is not consumed on use. It is different from Qard in that it is the loan of fungible objects which are consumed on use and in which the similar and not the same commodity has to be returned. It is also a virtuous act like Qard. The borrowed commodity is treated as liability of the borrower who is bound to return it to its owner.

Bai' Muajjal

Literally this means a credit sale.Technically it is a financing technique adopted by Islamic banks that takes the form of Murabaha Muajjal. It is a contract in which the seller earns a profit margin on his purchase price and allows the buyer to pay the price of the commodity at a future date in a lump sum or in installments. The bank has to expressly mention the cost of the commodity and the margin of profit is mutually agreed. The price fixed for the commodity in such a transaction can be the same as the spot price or higher or lower than the spot price.

Bai' Salam

Salam means a contract in which advance payment is made for goods to be delivered later. The seller undertakes to supply some specific goods to the buyer at a future date in exchange for being paid in advance a price fully paid at the time of contract. According to the normal rules of the Shariah, no sale can be effected unless the goods are in existence at the time of the bargain, but Salam sale forms an exception given by the Prophet himself to the general rule provided the goods are defined and the date of delivery is fixed. It is necessary that the quality of the commodity intended to be purchased is fully specified leaving no ambiguity leading to potential disputes. The objects of this sale are goods and cannot be gold, silver or currencies because these are regarded as monetary values exchange of which is covered under rules of Bai al Sarf, i.e. mutual exchange which must be hand to hand without delay. Barring this, Bai' Salam covers almost everything which is capable of being definitely described as to quantity, quality and workmanship.

Bai' bil Wafa

Sale with a right in the seller, having the effect of a condition, to repurchase (redeem) the property by refunding the purchase price. According to the majority of Fuqaha this is not permissible.

Daman

1) Contract of guarantee, security or collateral;2) Responsibility of entrepreneur/manager of a business; one of two basic relationships toward property, entailing bearing the risk of its loss.

Dayn

means Debt .A Dayn comes into existence as a result of any contract or credit transaction. It is incurred either by way of rent or sale or purchase or in any other way which leaves it as a debt to another.

Duyun

(debts) ought to be returned without any profit since they are advanced to help the needy and meet their demands and, therefore, the lender should not impose on the borrower more than what he had given on credit.

Falah

Falah means to thrive, to become happy or to have luck and success. Technically it implies success both in this world and in the Akhirah (Hereafter). The Falah presumes belief in one God, the apostlehood of Prophet Muhammad, Akhirah and conformity to the Shariah in behaviour.

Fiqh

Islamic law. The science of the Shariah.

Gharar

This means any element of absolute or excessive uncertainty in any business or a contract about the subject of contract or its price, or mere speculative risk. It has the potential to lead to undue loss to a party and unjustified enrichment of the other, which is prohibited.

Al Ghunm bil Ghurm

This provides the rationale and the principle of profit sharing in Shirkah arrangements. Earning a profit is legitimized only by engaging in an economic venture, applying risk sharing principles and thereby contributing to the economy.

Hadith

(see Sunnah)

Halal

Anything permitted by the Shariah.

Haram

Anything prohibited by the Shariah. Examples are wine and pork.

Hawalah

Literally, this means a transfer.Legally, it is an agreement by which a debtor is freed from a debt by another becoming responsible for it, or the transfer of a claim of a debt by shifting the responsibility from one person to another – contract of assignment of debt. It also refers to the document by which the transfer takes place.

Hibah

Gift.

Ijara

means letting on a lease. It refers to the sale of a definite usufruct of any asset in exchange for a definite reward. It refers to a contract of land leased at a fixed rent payable in cash and also to a mode of financing adopted by Islamic banks. It is an arrangement under which the Islamic banks lease equipment, buildings or other facilities to a client, against an agreed rental.

Ijarah-wal-Iqtina‘

means a mode of financing, by way of hire-purchase, adopted by Islamic banks. It is a contract under which the Islamic bank finances equipment, building or other facilities for the client against an agreed rental together with a unilateral undertaking by the bank or the client that at the end of the lease period, the ownership in the asset would be transferred to the lessee. The undertaking or the promise does not become an integral part of the lease contract to make it

conditional. The rental as well as the purchase price are fixed in such a manner that the bank gets back its principal sum alongwith with some profit, which is usually determined in advance.

Ijtihad

Refers to the endeavour of a qualified jurist to derive or formulate a rule of law to determine the true ruling of the divine law in a matter on which the revelation is not explicit or certain, on the basis of Nass or evidence found in the Holy Qur'an and the Sunnah. Express injunctions have no room for Ijtihad. Implied injunctions can be interpreted in different ways by way of inference from the accepted principles of the Shariah

'Illah

This is the attribute of an event that entails a particular Divine ruling in all cases possessing that attribute. 'Illah is the basis for applying analogy for determining permissibility or otherwise of any act or transaction.

Ijma'

Consensus of all or a majority of the leading qualified jurists on a certain Shariah matter in a certain age.

'Inah

(A kind of Bai): this is a double sale by which the borrower and the lender sell and then resell an object between them, once for cash and once for a higher price on credit, with the net result being a loan with interest.

'Inan

(A type of Shrikah): this is a form of partnership in which each partner contributes capital and has a right to work for the business, not necessarily in equal shares.

Istihsan

this is a doctrine of Islamic law that allows exception to strict legal reasoning, or guiding choice among possible legal outcomes, when considerations of human welfare so demand.

Israf

This refers to immoderateness, exaggeration and waste and covers spending on lawful objects but exceeding moderation in quantity or quality; spending on superfluous objects while necessities are unmet; spending on objects which are incompatible with the economic standard of the majority of the population. See also Tabzir

Istisna'a

This is a contractual agreement for manufacturing goods and commodities, allowing cash payment in advance and future delivery or a future payment and future delivery. A manufacturer or builder agrees to produce or build a well described good or building at a given price on a given date in the future. Price can be paid in installments, step by step as agreed between the parties. Istisna'a can be used for financing the manufacture or construction of houses, plant, projects, and the building of bridges, roads and highways.

Jahala

Ignorance, lack of knowledge; indefiniteness in a contract, sometime leading to Gharar.

Kali bil-Kali

The term Kali refers to something delayed. It appears in a maxim forbidding the sale of al-Kali bil-Kali i.e. the exchange of a delayed counter value for another delayed counter value.

Al-Kafalah

(Suretyship) Literally, Kafalah means responsibility, amenability or suretyship. Legally in Kafalah a third party become surety for the payment of a debt. It is a pledge given to a creditor that the debtor will pay the debt, fine etc. Suretyship in Islamic law is the creation of an

additional liability with regard to the claim, not to the debt or assumption only of the liability and not of the debt.

Kharaj bi-al-Daman

Gain accompanies liability for loss. This is a Hadith forming a legal maxim and is a basic principle of Islamic finance– see also Al-Ghunm bil Ghurm.

Khiyar

Means an option or the power to annul or cancel a contract.

Khiyar al-Majlis

Means the power to annul a contract possessed by both contracting parties as long as they do not separate.

Khiyar al-Shart

A right, stipulated by one or both of the parties to a contract, to cancel the contract for any reason for a fixed period of time.

Mal-e-Mutaqawam

Things the use of which is lawful under the Shariah; or wealth that has a commercial value. Legal tender of the modern age that carry monetary value are included in Mal-e-Mutaqawam. It is possible that certain wealth has no commercial value for Muslims. Examples would be pork or wine.

Mithli

(Fungible goods): Goods that can be returned in kind, i.e. gold for gold, silver for silver, US $ for US $, wheat for wheat, etc.

Mubah

Means an object that is lawful (i.e. something which is permissible to use or trade in).

Mudarabah

A form of partnership where one party provides the funds while the other provides expertise and management. The latter is referred to as the Mudarib. Any profits accrued are shared between the two parties on a pre-agreed basis, while loss is borne by the provider(s) of the capital.

Murabaha

Literally this means a sale on mutually agreed profit. Technically, it is a contract of sale in which the seller declares his cost and the profit. Murabaha has been adopted by Islamic banks as a mode of financing. As a financing technique, it can involve a request by the client to the bank to purchase a certain item for him. The bank does that for a definite profit over the cost which is stipulated in advance.

Musawamah

Musawamah is a general kind of sale in which the price of the commodity to be traded is bargained between seller and the purchaser without any reference to the price paid or cost incurred by the former.

Maisir

An ancient Arabian game of chance played with arrows without heads and feathering, for stakes of slaughtered and quartered camels. It came to be identified with all types of hazard and gambling.

Musharakah

Musharakah means a relationship established under a contract by the mutual consent of the parties for sharing of profits and losses in a joint business. It is an agreement under which the Islamic bank provides funds which are mixed with the funds of the business enterprise and others. All providers of capital are entitled to participate in management, but not necessarily required to do so. The profit is distributed among the partners in pre-agreed ratios, while the loss is borne by every partner strictly in proportion to respective capital contributions.

Qimar

Qimar means gambling. Technically, it is an arrangement in which possession of a property is contingent upon the happening of an uncertain event. By implication it applies to a situation in which there is a loss for one party and a gain for the other without specifying which party will lose and which will gain.

Qiyas

Literally this means measure, example, comparison or analogy. Technically, it means a derivation of the law on the analogy of an existing law if the basis (‘illah) of the two is the same. It is one of the sources of Islamic law.

Riba

means an excess or increase. Technically, it means an increase over the principal in a loan transaction or in exchange for a commodity accrued to the owner (lender) without giving an equivalent counter-value or recompense (‘iwad) in return to the other party; every increase which is without an ‘iwad or equal counter-value.

Riba Al-Fadl

Riba Al-Fadl (excess) is the quality premium in exchanging low quality with better quality goods e.g. dates for dates, wheat for wheat, etc. – an excess in the exchange of Ribawi goods within a single genus. The Concept of Riba Al-Fadl refers to sale transactions while Riba Al-Nasiah refers to loan transactions.

Qabul

Acceptance, in a contract; see also Ijab.

Qard

(Loan of fungible objects): The literal meaning of Qard is 'to cut'. It is so called because the property is really cut off when it is given to the borrower. Legally, Qard means to give anything having value in the ownership of the other by way of virtue so that the latter could avail of the same for his benefit with the condition that same or similar amount of that thing would be paid back on demand or at the settled time. It is a loan which a person gives to another as a help, charity or advance for a certain time. The repayment of the loan is obligatory. The Holy Prophet is reported to have said "…..Every loan must be paid……". But if a debtor is in difficulty, the creditor is expected to extend time or even to voluntarily remit the whole or a part of the principal. Qard is, in fact, a particular kind of Salaf. Loans under Islamic law can be classified into Salaf and Qard, the former being loan for a fixed time and the latter payable on demand. (see Salaf)

Riba Al-Nasiah

Riba Al-Nasiah or riba of delay is due to an exchange not being immediate with or without excess in one of the counter values. It is an increment on principal of a loan or debt payable. It refers to the practice of lending money for any length of time on the understanding that the borrower would return to the lender at the end of the period the amount originally lent together with an increase on it, in consideration of the lender having granted him time to pay. Interest, in all modern banking transactions, falls under the purview of Riba Al-Nasiah. As money in the present banking system is exchanged for money with excess and delay, it falls, under the definition of riba.

Ribawi

Goods subject to Fiqh rules on Riba in sales, variously defined by the schools of Islamic Law: items sold by weight and by measure, foods, etc.

Al- Rahn

Means pledge or collateral; legally, Rahn means to pledge or lodge a real or corporeal property of material value, in accordance with the law, as security, for a debt or pecuniary obligation so as to make it possible for the creditor to recover the debt or some portion of the goods or property. In the pre-Islamic contracts, Rahn implied a type of earnest money which was lodged as a guarantee and material evidence or proof of a contract, especially when there was no scribe available to put it into writing. Theinstitution of earnest money was not accepted in Islamic law and the common Islamic doctrine recognized Rahn only as a security for the payment of a debt.

Salaf

Means loan/debt .The word Salaf literally means a loan which draws forth no profit for the creditor. In wider sense, it includes loans for specified periods, i.e. short, intermediate and long-term loans. Salaf is another name for Salam as well wherein the price of the commodity is paid in advance while the commodity or the counter value is supplied in future; thus the contract creates a liability for the seller. Amount given as Salaf cannot be called back, unlike Qard, before it is due. (see Qard)

Al-Sarf

Basically, in pre-Islamic times this was the exchange of gold for gold, silver for silver and gold for silver or vice versa. In Islamic law such an exchange is regarded as ‘sale of price for price’ (Bai al Thaman bil Thaman), and each price is consideration of the other. It also means sale of monetary value for monetary value – currency exchange.

Shariah

The term Shariah refers to divine guidance as given by the Holy Qur’an and the Sunnah of the Prophet Muhammad and embodies all aspects of the Islamic faith, including beliefs and practice.

Shirkah

Means a contract between two or more persons who launch abusiness or financial enterprise to make profits. In the conventional books of Fiqh, the partnership business is discussed under the option of Shirkah and that may include both Musharakah and Mudarabah.

Sunnah

Means custom, habit or way of life. Technically, it refers to the utterances of the Prophet Muhammad other than the Holy Quran. These utterances are known as Hadith, or his personal acts, or sayings of others, tacitly approved by the Prophet.

Tabarru'

Means a donation/gift the purpose of which is not commercial but is done to seek the pleasure of Allah. Any benefit that is given by a person to other without getting anything in exchange is called Tabarru' It is absolutely at the lender's own discretion and without any prior condition or inducement for reward.

Tabzir

Spending wastefully on objects which have been explicitly prohibited by the Shariah irrespective of the quantum of expenditure. See also Israf.

Ujrah

A contract of agency in which one person appoints someone else to perform a certain task on his behalf, usually against a certain fee