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New Horizons for Islamic Securities: Emerging Trends in Sukuk Offerings
Ayman H. Abdel-Khaleq* and Christopher F. Richardson**

I. INTRODUCTION

Shari’ah-compliant finance and investment products are fast becoming part of the mainstream of the world economy as Muslim money is increasingly integrated into global capital markets and, generally, the commercial finance system. Once largely restricted to the Middle East and Southeast Asia, Islamic finance and investment now permeate markets throughout Europe, Asia, and even the US. As a number of countries in the Islamic world, emboldened by sustained increases in commodity prices and higher levels of foreign direct investment, look beyond traditional borders for investment opportunities, new forms of Islamic finance and investment have emerged. Perhaps the most significant recent development has been the emergence of sukuk (which roughly translates to “certificates”)—in essence an asset-backed security structured in compliance with the precepts of Shari’ah, somewhat similar to a trust certificate or bond. Initially focused on assets situated inside countries within the Islamic sphere of influence and promoted largely by Muslim financial institutions, sukuk issuances have expanded almost overnight to include offerings by such diverse participants as the German government and, most recently, an oil and gas company in the US. The characteristics of sukuk have made it an attractive source of capital for issuers outside of the Muslim world seeking to tap into the liquidity currently offered by Islamic investors, particularly in the Persian Gulf. Despite their brief history, sukuk offerings have raised billions of dollars and have provided needed capital for infrastructure projects, corporations, and

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governments. Whenever sukuk offerings are backed by assets not already governed by Islamic law, however, special considerations arise. In such situations lawyers, financial institutions, and potential issuers contemplating transactions involving the confluence of Shari‘ah and Western legal systems must approach sukuk offerings with a firm understanding of the complex legal principles involved.

Some recent developments in the US are of particular significance in the context of the growth of sukuk offerings. While the general expansion of sukuk beyond the immediate Islamic world represents a noticeable shift in the origination and marketing of Islamic finance and investment products, the pioneering use of sukuk in the US marks the most dramatic extension of Islamic finance into the world’s most sophisticated capital market. The first US sukuk is a product of the unique marriage of American oil and gas law with Shari‘ah concepts, two jurisprudences that complement each other surprisingly well.\(^1\) Given the compatibility of sukuk with US oil and gas law and the voracious appetite for capital in the petroleum industry, sukuk may provide a relatively small but important (and, in nominal dollar terms, potentially very large) contribution to the growth potential of the energy industry and create additional outlets for Muslim capital investment.

This Article seeks to demystify sukuk by providing an analysis of the nature and application of sukuk structuring techniques, with an emphasis on legal considerations, in the rapidly changing world of Islamic finance.\(^2\) It also attempts to explore emerging trends in the rapidly evolving marketplace for sukuk investments. In particular, this Article will evaluate both the underlying legal principles involved in innovative sukuk structures and the use of assets in non-Islamic jurisdictions to back securitizations represented by sukuk certificates. After providing a general explanation of the fundamentals of sukuk as an Islamic investment vehicle and an overview of the growing importance of sukuk in the marketplace, this Article will turn to a discussion of the primary legal challenges of utilizing assets to back sukuk offerings in non-Islamic jurisdictions. In addition, this Article will provide an analysis of key conflicts of law considerations posed by the “exportation” of sukuk products outside their traditional markets. The first ever sukuk offering involving US assets will be examined as a case study to provide additional insight into how asset-backed sukuk deals in non-Islamic jurisdictions must be carefully structured.

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2. In this Article, reference to “Islamic finance” should be read to include both Islamic finance and investment products.
II. ISLAMIC FINANCE AND SUKUK FUNDAMENTALS

Although a full exposition of the principals of Islamic law is beyond the scope of this Article, a brief overview, with a particular emphasis on the key elements of sukuk, is in order. Islamic law, while generally encouraging honest commercial activity, forbids certain types of commercial behavior that is commonplace in other parts of the world. Most importantly, Shari`ah forbids the charging of interest, or riba. Additionally, Islamic law does not allow the Muslim faithful to undertake a speculative level of risk, known as gharar. Shari`ah also bans commercial support for “sinful” activities, including conventional finance (primarily because of riba and/or gharar associated therewith), gambling, pornography, certain forms of entertainment, and the manufacture or distribution of alcohol, tobacco, pork, or weapons.

Unlike modern religious culture in the West, where theology does not directly regulate commercial endeavors and remains generally divorced from the marketplace, Shari`ah is intended to dictate all behavior undertaken by Muslims, including business affairs. There is no official “clergy” or central religious authority in the Islamic faith. Instead, Islamic theology is a collection of independent mosques and religious centers with varying degrees of allegiance to the teachings of various Muslim sects, creeds, or individual teachers. As such, while certain general guiding principles can be ascertained, any particular Islamic finance transaction needs to be vetted by Islamic scholars to ensure compliance with Shari`ah concepts (and these scholars do not always agree with each other). In the context of Islamic finance, and as far as the Sunni sect is concerned, there are four major schools of Islamic jurisprudence, each with different interpretations on what is allowed and what is proscribed. Given these differences, the review process for a sukuk offering should be tailored to achieve acceptance by the proper school (or schools) of Islamic scholars. Assembling the appropriate Shari`ah advisory or supervisory board is key to the successful marketing of sukuk. A Shari`ah advisory board should be comprised of knowledgeable and experienced advisors who are well-respected in the jurisdictions where an Islamic finance product will be offered. Shari`ah advisors will issue a fatwa, or a Shari`ah pronouncement roughly equivalent to a legal opinion, approving the structure of a deal and providing assurance to Muslim investors that investment in the transaction is acceptable from a religious perspective.

To comply with the various rules and prohibitions imposed by Islamic law, a number of different investment vehicles have been developed over the years and approved by Shari`ah scholars (although not all structures or permutations thereof are accepted by all schools of Islamic jurisprudence). These include, among others, such financial instruments as murabaha (cost plus financing), ijara (lease), musharaka (partnership), mudaraba (sweat capital), wakala (investment
agency), and *istisna'a* (construction/engineering and procurement contract). With support from the Bahrain-based Accounting and Auditing Organization of Islamic Financial Institutions and some pioneering Islamic bankers and institutions, *sukuk* offerings have emerged as a complement to these traditional Shari'ah-compliant structures. For example, many of the *sukuk* offerings structured to date are based on an underlying *ijara* transaction, where the stream of income generated from a sale-leaseback of a real property asset funds the payments to the *sukuk* holders. Another variation on standard *ijara* structures is to supplement *ijara* agreements with an *istisna'a* agreement for purposes of an underlying construction and development of the relevant project, with the *ijara* agreement coming into force once such project, or a portion thereof, is constructed.

A commonly accepted view among Shari'ah scholars in a number of Islamic jurisdictions is that *murabaha* debt cannot be securitized, thus making *sukuk* backed by pools of *murabaha* debt impermissible. This is because the sale of a document representing money is akin to the trading of monies, which is prohibited under the rules of *riba*. However, the prevailing view among Malaysian scholars (in contrast to Shari'ah advisers in more conservative jurisdictions) is that so long as the underlying receivable is connected to a true trade transaction or to a commercial transfer of a non-monetary interest, such a receivable can be traded freely for purposes of Shari'ah. Increasingly, some scholars are encouraging *sukuk* based upon partnership transactions (*musharaka* and *mudaraba*), primarily because such structures are seen as being compliant with the Shari'ah's encouragement to take calculated risks and its prohibition on earning guaranteed income.

Although theoretically a hybrid of debt and equity, *sukuk* can be structured to offer a fixed return similar to that of a conventional bond, making such investments attractive to Muslim investors seeking to diversify their portfolios. That said, it is not permissible for the return of a *sukuk* offering to be directly linked to a “prime rate,” such as the London Interbank Offered Rate (“LIBOR”) or similar market benchmarks, because such benchmarks are interest-based. However, a properly structured *sukuk* may generate a profit-based return that essentially replicates a prime rate or LIBOR. An argument often heard from investment bankers is that Shari'ah requirements achieve the same end result that conventional investment or finance products would achieve in a number of situations. The difference is the utilization of different mechanisms and finance techniques. While this is true in a number of ways, it is

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important to note that an Islamic investment product is a factor of both utilizing specific mechanisms and respecting the fact that the form by which investments are made is as important under Shari'ah as the substance.

III. THE MARKET FOR SUKUK

The overall size of the market comprised of Islamic investments and Muslim capital has been estimated at around $750 billion. Sukuk offerings are a fast-growing piece of this marketplace. The demand for sukuk has grown exponentially since the issuance of financial instruments under Shari'ah was first upheld by the Fourth Annual Plenary Session of the Islamic Jurisprudence Counsel held in Jeddah, Saudi Arabia, in 1988. As of May 2006, over $41 billion in sukuk have been issued. Some analysts expect an additional $9 billion to be issued in the Gulf States alone through the end of 2006. Many sukuk offerings have been made by governments, notably in the Gulf States and Malaysia. These “sovereign” sukuk offerings include Bahrain’s sovereign sukuk program which started in 2001, the Qatar Global Sukuk in 2003 which raised $700 million, and the $1.6 billion sukuk planned to be issued by Dubai’s civil aviation authority.

One noteworthy and pioneering sovereign sukuk offering was carried out by the provincial government of Saxony Anhalt in Germany in 2004. Marking the first sukuk offering by a Western government, the German sukuk raised €100 million from both Middle Eastern and European investors through the issuance of a AAA-rated, five-year, Shari'ah-compliant bond backed by real estate assets held in a trust organized in the Netherlands.

While sovereign sukuk are an important component, the majority of sukuk offerings are corporate (though sometimes the so-called “corporations” are controlled by state governments). Corporate sukuk offerings include the $800 million sukuk offering by Saudi Arabian petrochemical giant SABIC in 2006 and

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4 See David Henry, Islamic Law: Returns Muslims Can Live With, Bus Wk 1, 9 (July 17, 2006).
6 Donna Mitchell, Merrill Lynch Preps Rare U.S. Based True Islamic Securitization, Asset Securitization Rep (July 3, 2006).
7 Farhan Bokhari, Roula Khalaf, and Gillian Tett, Gulf Boom Boosts Islamic Bonds, Fin Times 24 (July 11, 2006); see also Karen Lane, Islamic-Bond Market Becomes Global By Attracting Non-Muslim Borrowers, Wall St J C1 (Nov 16, 2006).
10 Bokhari, Gulf Boom Boosts Islamic Bonds, Fin Times at 24 (cited in note 7).
11 See El-Gamal, Islamic Finance at 113 (cited in note 9).
the $1.27 billion offering by the Malaysian company Jimah Energy Ventures. Dwarfting both of these, Dubai Ports World (which is controlled by the emirate of Dubai) has announced a $3.5 billion sukuk offering for 2006. Most recently, sukuk offerings have been shifting to the utilization of musharaka- and wakala-based structures as opposed to the more popular ijara-based structure. This may be explained by the need to satisfy the expansion demands of some of the leading infrastructure, utilities, and investment companies in the region. Two such examples are the musharaka-based $125 million Lagoon City Musharaka Sukuk in Kuwait and the wakala-based $50 million Bukhatir Investment Sukuk in the United Arab Emirates.

Sukuk offerings, while still concentrated in Malaysia and the Gulf States and focused mostly on assets in Islamic jurisdictions, are a rapidly growing business with involvement by private companies, state enterprises, sovereign governments, Islamic financial institutions, and increasingly, Western-based international investment banks. As discussed in more detail below, sukuk has even arrived in America, where oil and gas assets in the Gulf of Mexico backed a $165.7 million sukuk offering that closed in July 2006, marking the first instance of a sukuk in the US. According to press coverage of the Gulf of Mexico oil and gas sukuk offering, it seems the liquidity in the Islamic world is attracting non-Islamic issuers, and the trend could accelerate now that this first deal has been accomplished.

Within certain limitations, which depend on applicable securities laws, sukuk may be traded. Secondary markets are expected to satisfy this demand. Sukuk offerings now appear on specialized exchanges such as the Dubai International Finance Exchange, the Labuan Exchange in Malaysia, and the Third Market in Vienna (part of the Wiener Bourse). With a secondary market

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13 Bokhari, Gulf BoomBoosts Islamic Bonds, Fin Times at 24 (cited in note 7).


15 See Ivar Simensen, Capital Markets and Commodities: Axa Chooses Hybrids, Fin Times UK 39 (June 16, 2006); see also Lane, Islamic Bond Market, Wall St J C1 (cited in note 7).

16 See id; see also Henry, Islamic Law, Bus Wk at 9 (cited in note 4) (“The [Gulf of Mexico oil and gas sukuk] deal ... is bringing this pool of liquidity to the attention of a lot of people.”) (internal quotations omitted).

developing, albeit slowly, the advent of freely tradable sukuk should only increase the appetite for this form of Islamic investment. The real question is whether the primary center for sukuk trading will be located in Bahrain, the United Arab Emirates, or Malaysia. All are competing for a leading position in this growing market, but it is generally expected that each of them will reap a portion of the growing sukuk market. In the Western world, London may emerge as the leading bridge between Islamic finance and more conventional sources of capital. For example, the first ever US sukuk offering was underwritten and structured by bankers in both London and Lebanon.

IV. LEGAL PRINCIPLES ASSOCIATED WITH SUKUK BACKED BY ASSETS OUTSIDE THE ISLAMIC WORLD

The vast majority of sukuk have been issued by institutions or governments within the Muslim world and have been supported by assets located in jurisdictions governed, to varying degrees of intensity, by the concepts of Islamic law. But this is beginning to change as Western governments, financial institutions, and corporations in need of capital seek out Islamic finance options. This trend appears to find support from regulators in Western jurisdictions who are seeking a better understanding of the mechanics of Islamic finance techniques. First, however, the concept of Muslim or Islamic versus non-Muslim or non-Islamic must be clarified. The sphere of influence of Islamic law encompasses more than merely the so-called “Middle East” or the confines of the Arab world. In reality, individual Muslims residing in any country will likely seek to follow Islamic law, making the reach of Shari’ah concepts in some ways universal and borderless. Furthermore, many scholars of Islamic history and many devout Muslims will argue that the march of Islam into new lands, although perhaps arrested in recent centuries, is ongoing and that the expansion of Islam remains a fluid concept. In practical terms, however, the Islamic or Muslim world includes the broad swath of territory from North Africa through...
the Levant and into Turkey, down to the Arabian Peninsula, then into Iraq, Iran, and Pakistan, up through the Central Asian states, across India and Bangladesh, and finally winding down through Malaysia, Singapore, and Indonesia.

A. SUKUK IN ISLAMIC JURISDICTIONS

One shorthand method useful for covering all of these diverse nations is to focus on countries within either the Organization of Islamic States (“OIS”) or the Islamic Development Bank (“IDB”). Defining the Muslim or Islamic world by focusing on membership in such organizations, while imprecise, has the benefit of including those nations that express the self-awareness of their Muslim identity through their participation, making membership in the OIS or IDB a useful proxy. Most countries that are members of the OIS or IDB have legal systems at least partially influenced by Shari’ah principles (often combined, in the case of Egypt or Pakistan, with colonial European common or civil law contributions), or, in the case of conservative theocratic monarchies like Saudi Arabia, almost entirely guided by Islamic law. In the banking sector of these countries, some, or all in the case of Saudi Arabia, of the financial institutions organized therein are regulated as Islamic banks and subject to certain restrictions. Real and personal property located in these jurisdictions, as well as the banking, tax, and insolvency laws affecting such property, tend to follow, to varying degrees, Shari’ah concepts. This fact makes structuring sukuk in these jurisdictions arguably more straightforward from a legal perspective, although the process is more multi-layered since it will require compliance with Shari’ah as well as with local law. For example, in structuring a sukuk product involving assets in Arab and Muslim countries like Egypt and Jordan, the influence of the Napoleonic Code and the Ottoman Majalat Al-Ahkam Al-Adliyya results in the need to adapt the structure of sukuk to the provisions of the existing civil code and other laws and regulations. While the ultimate structure must comply with Shari’ah, opinions of local counsel are more likely to focus on the effectiveness and validity of the transaction documents under the civil code and other relevant regulations than on their compliance with Shari’ah.

Another relevant aspect is the role of policy makers, government officials, bankers, and issuers based in the Muslim world and the extent to which they are willing to encourage the development of sukuk. For example, Singapore is currently bullish about attracting Islamic banking and finance institutions to cement its status as an international banking hub. Turkey is attempting to attract Islamic investors without affecting its strictly secular regulations. Another such

“operational” aspect is that in these countries Islamic securities offerings benefit from compatible legal systems, accommodating both regulators and experienced professionals who all share a common culture, language, and more importantly, faith. There is, no doubt, a definite benefit, hard to quantify but certainly qualitatively advantageous, that stems from the level of mutual understanding about the nature of the investments in particular and Islamic finance principles in general when doing business in these jurisdictions.

B. SUKUK IN NON-ISLAMIC JURISDICTIONS

The process of structuring sukuk deals outside of the Islamic world is more complicated for both jurisprudential and pragmatic reasons. Sukuk in non-Islamic jurisdictions must abide by all of the traditional limitations of Shari’ah, but face the additional challenge of operating in legal and regulatory environments unaccustomed to Islamic finance techniques. As a threshold matter, the assets underlying the sukuk and the offering company must be Shari’ah-compliant in the manner discussed above. Given the prohibitions on supporting Islamic vices as described above, the assets backing a sukuk cannot be connected with “sinful” activities such as gambling, alcohol, lewd entertainment, or the sale of pork products; the list of prohibited actions also includes traditional finance, where riba would be charged. In Islamic jurisdictions—especially the more conservative ones—this is relatively easy because activities such as gambling and alcohol are banned outright. In Western jurisdictions, this may not be as clear-cut in instances where the issuer of the sukuk has subsidiaries involved in, for example, cable television services, casinos, or fast food restaurants that serve pork. Furthermore, because of the prohibition on riba, an issuer with too heavy a debt load or who directly or indirectly provides conventional finance services would technically be barred from issuing sukuk. This means sukuk issued by Western companies require a financial analysis of existing leverage and debt ratios. Similar prohibitions would apply to the issuing of sukuk related to projects that are considered to be overly speculative or risky because of the ban on gharar, which limits Islamic financings that support issuers engaged in certain types of hedges, forward contracts, swaps, etc., all of which are commonplace in the Western commercial world.

Sukuk offerings centered, in one way or another, outside the Islamic world raise a variety of legal and practical issues. Applicable laws regarding bankruptcy, tax, trusts, corporations, securities regulations, real property, and secured

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21 Id.

22 US- and Middle East-based entities have attempted to develop Shari’ah-compliant alternatives to conventional hedge funds and futures contracts with limited success, particularly in terms of the marketability of such products.
transactions all influence the proper structuring and documentation of asset-backed sukuk transactions in non-Islamic jurisdictions that are marketed to investors outside the Muslim world or issued by entities located in non-Islamic states. Given the highly structured and complicated nature of most sukuk offerings, substantial expertise in the relevant jurisdictions is critical. While such issues must be resolved on a case-by-case basis, some recurring themes can be identified.

Foremost, tax planning and legal analysis of tax implications remain crucial. With assets located in one country and investors located in another, coupled with the utilization of intermediary (often bankruptcy remote) special purpose entities organized in perhaps a third jurisdiction, the task of developing a tax-efficient structure is a challenging one that is complicated by the need for such a tax structure to be compatible with Shari‘ah requirements. Withholding taxes, characterization of income (for example, whether a stream of payments under sukuk represents interest, principal, dividends, etc.), and the categorization of the transaction itself (as a loan, an equity investment, or a sale of an asset) are all common tax issues that arise in the context of a sukuk transaction. Relevant tax treaties could come into play. Tax attorneys and accountants with the requisite experience in the appropriate jurisdictions should be closely involved in the process.

Second, bankruptcy considerations weigh heavily in structuring sukuk offerings. Given the fact that insolvency laws and procedures vary widely between nations, a careful evaluation of the rules of the jurisdiction where the assets are located must be undertaken. For example, the US Bankruptcy Code provides a very complex regime for companies in liquidation or reorganization, so appropriate bankruptcy experts must be engaged. Insolvency laws in other jurisdictions, such as Europe, fundamentally differ from the US Bankruptcy Code and tend to be less debtor-friendly. Concepts of secured financing, such as the application of the Uniform Commercial Code to deals involving US assets, also apply in this context. Depending on where assets are located, attachment and perfection of security interests will have to be evaluated and properly documented. It is therefore important to emphasize that sukuk transactions create an undivided beneficial ownership interest for the sukuk holders in the underlying assets. It follows that creditors of the sukuk issuer will have no recourse to any assets of the issuer other than the trust assets, because the sukuk issuer holds the assets in trust for the sukuk holders.

Third, investment laws often result in the need for innovation, particularly as far as true sale issues are concerned. For example, in the context of an ijara-based sukuk structure, there needs to be a true sale by the originator of the assets

in question to the *sukuk* issuer, with such a sale followed by a leaseback of the assets to the *sukuk* issuer. While being straightforward on its face, a combination of foreign ownership limitations and high ownership transfer taxes may hinder the true sale of the underlying asset to the *sukuk* issuer.

Fourth, securities laws come into play and may require input from attorneys in multiple jurisdictions, depending on the breadth of the marketing effort and whether the *sukuk* certificates will be listed. Under certain securities law regimes, such as in the US, the nature and number of the holders of the *sukuk* can be an important factor. US securities laws do not distinguish between conventional and Islamic products. Generally speaking, the offer and sale of securities in the US must be registered under the United States Securities Act of 1933 ("Securities Act").

Alternatively, transactions can be structured to take advantage of the safe harbors from registration provided by Rule 144A or Regulation S. In the offering circulars of *sukuk*, as is the case in conventional securities where the promoters wish to avoid the registration requirements of the US securities laws, detailed declarations and notices are incorporated into the offering documents and subscription agreements to ensure that investors represent and warrant that they are not US persons and are not subject to the Securities Act in any manner. Investors and financial institutions in Islamic jurisdictions may be largely unaware of the restrictions regarding communications, promotions, and the registration or transfer of *sukuk* certificates. Parties involved in structuring and marketing *sukuk* must be made aware of important limitations on advertising, press releases, and other interactions with the public under securities law regimes in various jurisdictions.

One other dimension is that *sukuk* promoters should be cognizant of the regulatory and compliance requirements of the jurisdictions where the assets represented by the *sukuk* are located or where the *sukuk* are being placed. For example, the compliance criteria promulgated in the USA Patriot Act of 2001 added another layer of complexity to US *sukuk* offerings. However, this should


25 Two general conditions apply to the safe harbors provided by Regulation S: first, the offer and sale must be an "offshore transaction," which generally means the buyer is not someone in (or a resident of) the US; and secondly, there are to be no "directed selling efforts," which generally means that there should be no conditioning the market for the securities in the US.

26 Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA PATRIOT ACT), Pub L No 107-56, 115 Stat 272 (codified in scattered sections of the USC).
not prevent the development of Shari'ah-compliant investment products offered to Muslims in the US or in other Western jurisdictions. To that end, regulatory bodies in the US and the European Union have been supportive of the development of an Islamic financial industry. This is evidenced by the growing number of Islamic financial institutions and Islamic products offered in such markets.

Yet another consideration is that specialized legal advice must be sought in order to identify other issues that may be relevant in selecting the law governing the relevant sukuk documentation and the forum for the settlement of disputes. That legal advice would reveal, among other things, court decisions that may impact a choice of law decision. For example, the English High Court recently decided that English law would take precedence notwithstanding a choice of law provision in a murabaha agreement that provided that the governing law of the contract was English law “subject to the principles of glorious Shari'a.”27 Other instances involve cases in which courts in a number of Persian Gulf countries have ruled that trading in futures or derivatives qualifies as gambling, with the result that the underlying transaction was not Shari'ah-compliant. In jurisdictions where Shari'ah is applicable but where certain codifications have been adopted to facilitate specific transactions, an internal conflict of laws can arise. For example, under Shari'ah, contracting parties are strictly bound by the terms of the contract. Legislative instruments in some jurisdictions may impose additional requirements to those provided in the contract. One such example is that title over real estate must be recorded with the appropriate government authority for the transfer to be valid.

Practical limitations and the relative obscurity of Islamic finance in general and sukuk in particular to most bankers and attorneys practicing in Europe, Asia, and the Americas pose practical challenges. Cultural barriers, including language, sensitivity to religion, and regional approaches to doing business, can be formidable, and it is advisable to seek counsel and advice from those more familiar with conducting business in the Islamic world. A number of Middle Eastern and international banks are acting as lead managers and arrangers with respect to an increasing number of sukuk offerings. This trend is supported by the argument that each institution brings to the table its unique set of skills, including an understanding of the region in which it operates. In addition, leading international investment banks appreciate the need for quality documentation, which should result in an elevation in the quality of sukuk in general. Islamic banks are following suit. Finally, promoters and issuers of Islamic instruments, including conventional banking institutions, should develop

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a generalized understanding of Islamic law and work closely with Shari`ah advisers to ensure they have sufficient understanding of basic Islamic investment structures. Care should be exercised in selecting Shari`ah advisers, particularly in the context of cross-border sukuk transactions, as only a small number of them combine in-depth knowledge of Islamic law with a good understanding of and familiarity with conventional financial and economic concepts. Another factor to be taken into account in selecting a Shari`ah adviser is the ability to communicate and review documents in English.

V. NEW OPPORTUNITIES: OIL AND GAS ASSETS IN THE US

When considering the compatibility of Islamic finance techniques with non-Muslim jurisprudential systems, well-established legal principles may potentially provide an ideal complement to Shari`ah-based securities offerings in certain instances. In the US, this complementary situation exists between the precepts of Islamic finance and the fundamentals of American oil and gas law (or, put more precisely, the treatment of oil and gas under the laws of certain key US states), as demonstrated by the recent successful completion of the first ever sukuk backed by oil and gas assets in America (as described in more detail below). The congruence of classic American oil and gas law with Shari`ah-compliant finance structures, including sukuk, rests largely on the characterization and treatment of oil and gas properties as severable and alienable real property with well-recognized legal attributes.

In many key states where a significant portion of petroleum is produced both onshore and offshore, namely Texas and Louisiana, oil and gas jurisprudence recognizes that oil and gas in the ground, and certain rights granted in such property, are in effect real estate. This characterization, and the concomitant benefits associated with real property rights, extends to grants of royalty interests. Oil and gas law allows for an owner of the surface estate to sever the interests in the oil and gas (called the “mineral estate” in Texas). Such a severance is typically made with a reservation of a reversionary interest, contingent upon compliance with the terms of an oil and gas lease, but such conveyances can create a mineral estate of an indefinite duration.

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28 For a general discussion, see Richardson, 42 Tex Intl L J (cited in note 1).
29 See Davis v Atlantic Richfield Oil Producing Co, 87 F2d 75, 76 (5th Cir 1936); Rogers v Risame Enterprises, Inc, 772 SW2d 76, 80 (Tex 1989); Texas Co v Daugherty, 107 Tex 226, 233 (Tex 1915); Rabichaux v Pool, 209 So2d 77, 79 n1 (La Ct App 1968) (internal citations omitted).
30 For Texas cases, see Kelly Oil Co v Svetlik, 975 SW2d 762, 764 (Tex App 1998); Rogers, 772 SW2d at 80 (cited in note 29); Amoco Production Co v Alexander, 622 SW2d 563, 572 (Tex 1981). For Louisiana cases, see Terry v Terry, 565 S2d 997, 1000 (La Ct App 1990). See also LA Code Civ Proc Ann art 3664 (2006).
rights in oil and gas can take many forms, and the holder of the mineral estate can further sub-divide the bundle of rights associated with the property. For example, the owner of the mineral estate can convey to third parties interests derivative of his rights in the property that include the right to conduct drilling activities—or, he could transfer a purely passive royalty interest, under which the royalty holder takes no part in operations but is entitled to a portion of the production or other purely economic benefits. Therefore, within the relative comfort and with the well-established rules of a real property regime, the owner of an interest in oil and gas property may transfer a non-operating, purely economic interest to a third party who would then hold such an interest as real property. Such a situation fits ideally into the paradigm of asset-backed Islamic finance, which encourages participation by investors in producing underlying assets. The recognition of oil and gas rights, including royalties, as real property carries over to bankruptcy law. This provides additional comfort and some special exemptions aimed at protecting properly conveyed royalty interests from the bankruptcy estate.

VI. STUDY: THE FIRST SUKUK OFFERING BACKED BY US OIL AND GAS ASSETS

Islamic finance has become a global phenomenon, but the arrival of the first ever sukuk offering backed by assets in the US marks a truly groundbreaking event for the industry. The East Cameron Gas Company sukuk offering in July 2006 potentially heralds a dramatic expansion of the pool of assets from which sukuk can be structured. The transaction, ostensibly the first such offering of its kind, entailed the creative application of traditional US oil and gas law to an Islamic financing. The deal required careful structuring to meet both Shari’ah requirements and the tax, bankruptcy, corporate, and securities laws of multiple non-Islamic jurisdictions. Although a relatively small deal in the context of the energy industry ($165.7 million), this particular sukuk offering could generate a disproportionately large amount of interest in American sukuk offerings. The success of the sukuk can be partly attributed to the fact that it was purchased by both Islamic investors and conventional Western investors in a combined Regulation S international offering and a Regulation D US private placement. The sukuk was underwritten and arranged by banks in both London

31 For a general discussion, see John S. Lowe, Oil and Gas Law in a Nutshell 36–45 (West 1995).


33 See Lane, Islamic-Bond Market, Wall St J C1 (cited in note 7); see also Richardson, 42 Tex Intl L J (cited in note 1).
and Beirut, with legal assistance provided by counsel in both Dubai and Houston. The transaction was truly international.

The funds raised will support capital and operating costs associated with drilling and operating wells in the Gulf of Mexico for a Texas-based oil and gas company. To avoid spoliation of the deal due to association with *riba*, the funds raised through the offering were also used to eliminate nearly all of the company’s outstanding conventional debt, leaving it with a debt-equity ratio acceptable from an Islamic perspective. For a combination of reasons, including international tax planning and bankruptcy remoteness, an intermediary issuer (a Cayman Islands limited liability company) issued the *sukuk* certificates. However, the funds ultimately flowed back to the oil and gas operating company. The *sukuk* provided an alternative to traditional borrowing, and allowed this “ultimate” issuer to take advantage of a largely untapped resource: liquidity in the Muslim world.

A royalty interest was chosen as the asset to support the *sukuk*. Given the location of the properties underlying the royalty, the attorneys and bankers structuring the deal had to overcome the difficulties of issuing *sukuk* in a non-Islamic jurisdiction (as detailed above in this Article). The properties burdened by the royalty consist of federal leases located off the coast of Louisiana. The oil and gas company in question, which owns and operates the leases, sold the royalty to a specially created entity. This entity, which will hold the royalty for the duration of the transaction (absent a default), was established using traditional structured finance techniques to maximize its bankruptcy remoteness. The structure employed in the transaction was also designed to take advantage of certain “production payment” bankruptcy law protections. The special purpose entity holding the royalty interest takes no part in the conduct of the drilling or production on the property. Rather the special purpose entity holds only a passive, non-working interest that entitles it to a portion of the stream of income generated by the sale of production from the burdened leases. Given the location of the offshore properties, the property rights analysis was based on the application of Louisiana law (under federal law, federal offshore leases are generally governed by the laws of the adjacent state). The transaction was structured so that the sale of the royalty interest would most likely be considered a “true sale” of a real property interest under Louisiana law. The fact that the conveyance of the royalty was designed to be a true sale of real property helped the deal from both a bankruptcy and a Shari’ah perspective.

The *sukuk* holders receive a fixed return consisting of periodic payments of profit-sharing from the income generated from the royalty, as well as payments

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toward the redemption of the principal. Furthermore, the investors’ return (structured as profit-sharing) and the repayment of the investors’ principal will depend on the performance of the underlying asset and will be in conformance with Shari`ah principles. The sukuk offering was non-recourse in that the ultimate issuer (the oil and gas operator) is not obligated to repay the sukuk holders if the royalty cannot generate sufficient funds. The investors will bear the risk of the oil and gas reserves being insufficient to fully support the issuance of the sukuk, as well as the risk of a natural disaster impacting production. The investors also bear some price risk. In addition to a comprehensive due diligence exercise, including a detailed oil and gas reserve report and an audit of that report, the structure included a number of mitigants and credit enhancements to reduce risk, including reserve accounts, security interests, conservative modeling, and some Shari`ah-compliant hedges. The projected return—at over 11 percent—reflects the calculated risk associated with the transaction. This risk, combined with the characterization of the royalty as a real property asset, is precisely what makes the transaction Shari`ah-compliant. The investors share in the profits or losses derived from the success or failure of the underlying asset. From the perspective of Shari`ah, the sukuk certificates represent an undivided beneficial ownership in the real property (in other words, the royalty). Two international Shari`ah scholars, one based in Bahrain and the other based in the US, were retained by the underwriters. They reviewed the deal and issued a fatwa, making it possible to market the sukuk to Islamic investors.

This first ever US sukuk offering may well encourage future economic cooperation between the US and the Muslim world. By exploiting the congruence of American oil and gas law with fundamental Islamic finance jurisprudence, the bankers, originator, and investors involved were able to overcome traditional suspicions and obstacles associated with issuing sukuk backed by assets in non-Muslim jurisdictions through creative structuring and experienced counsel. The transaction required a careful consideration of all of the issues raised in this Article, including bankruptcy, tax, and securities law concerns, as well as the practical difficulties of cross-cultural cooperation. With the liquidity and growing prominence of the Islamic investment marketplace and the rapacious appetite of Western energy companies seeking capital for expensive projects, Islamic finance may prove to be an ideal complement to existing conventional sources of funds for oil and gas transactions. Given their attributes, sukuk seems to be an ideal format for such deals. As the secondary market develops, trading in sukuk backed by Western energy assets may become commonplace. The connection between Islamic investment markets and the US remains in its nascent stages, but the first US sukuk should encourage optimism on both sides of the cultural divide.
VII. Conclusion

The development of new forms of Islamic finance and the continued integration of Shari`ah-compliant securities into the world economy, though promising, raise a number of challenging legal and practical issues. In this rapidly evolving field, attorneys and the clients they serve must prepare themselves for complicated transactions that will continue to break new ground for years to come, with few existing examples to emulate. Tax, bankruptcy, and securities law concerns, among others, must be addressed in-depth, while concerns over the conflict of laws and lingering Western suspicions and restrictions surrounding Muslim investment also must be considered. Pragmatically, there is a still a need to engage professionals with regional business experience to guide the process through to completion with minimal cultural friction, at least until more Western professionals become competent and comfortable with Islamic finance and Shari`ah (and Islamic investors and bankers become more comfortable with Western ways). Such regional expertise and connections, in both the legal and banking contexts, can ensure better guidance with respect to structuring the deal in line with Shari`ah, assistance in procuring the requisite fatwa, and allowance for a much greater reach in marketing the product.

It is also clear that sukuk has expanded beyond the borders of the Islamic world, and sukuk offerings will likely be increasingly backed by assets in non-Islamic jurisdictions. The extent of sukuk's expansion has yet to be determined, but there are reasons to be optimistic. With the appearance of a sukuk backed by oil and gas producing properties in the US, the possibility for broader assimilation of Islamic finance products, especially sukuk, into capital markets looks increasingly promising. Sukuk backed by non-traditional assets could prove to be a substantial source of funds worldwide. Given the compatibility of American oil and gas law with Shari`ah precepts, energy companies in the US may begin to look to the liquidity of the Muslim world as a major source of investment funds for petroleum projects and operations. The long-term forecast may be difficult to predict, but the immediate market certainly looks promising. Therefore, attorneys across disciplines should begin to familiarize themselves with this growing phenomenon.