

Enforceability of Islamic finance contracts in the US

Few Islamic finance market participants understand that New York is able to serve as one of the best jurisdictions for the enforceability of Islamic finance contracts. M SHAMS BILLAH walks us through the established history of US case law on the matter and reviews a recent seminal US case analyzing the treatment of Shariah compliant financing contracts under New York law — the first of its kind in both the US and the UK.



M Shams Billah is a partner at Hughes Hubbard & Reed in New York leading its US Islamic finance practice. He can be contacted at Mushfique.Billah@HughesHubbard.com.

Although Islamic finance is by no means uncharted territory in the US, it remains underutilized and has continued room for growth. The sluggish growth of Islamic finance in the US is partly due to a misunderstanding of the enforceability of Shariah compliant contracts under US law as compared to its counterparts in Europe. The watershed case of *Shamil Bank of Bahrain EC v. Beximco Pharmaceuticals Ltd*, [2004] EWCA (Civ) 19 in the English Court of Appeal spurred the revised Rome I Regulation that now permits both national law and non-national law, such as Shariah law, to be the governing law of a contract in the UK, which was later confirmed by the English High Court decision in *Dana Gas PJSC v. Dana Gas Sukuk Ltd & Ors*, [2017] EWHC 2928.

Following Brexit, the Rome I Regulation continues to apply in the UK because the UK government has enacted domestic legislation regarding the same. However, few market participants in Islamic finance realize that not only does the US have a long history of case law indirectly supporting the enforceability of Islamic finance contracts in the US, but a recent 2022 decision of the US District Court for the Southern District of New York regarding the US bankruptcy proceedings of Arcapita has now opined in detail on the treatment of Shariah compliant financing contracts — one of the first courts in either the US or England to do so. See *In re Arcapita Bank B.S.C.(C)*, 640 B.R. 604 (S.D.N.Y. May 23, 2022).

As background, in the US like in England, most market participants in Islamic finance transactions utilize an Ijarah (sale-leaseback) or Murabahah (cost-plus basis) structure to provide



debt financing that complies with Shariah law's restriction against traditional lending that charges interest on outstanding loans. In particular, in a synthetic commodity Murabahah, the most common form of Islamic debt financing, a lender transfers funds to a borrower and the borrower, acting as an agent for the lender, purchases specified commodities on the lender's behalf. The borrower immediately agrees to repurchase those commodities from the lender on a cost-plus basis to be paid on an agreed future date and thus creates an obligation to repurchase by the borrower, and the lender expects to receive the agreed-upon repurchase price. This arrangement allows the borrower to purchase an asset using financing without paying interest on a conventional loan.

Alternatively, in an Ijarah, the lessee/borrower sells an asset to the lessor/lender, who then leases the asset back to the lessee/borrower for a fixed rental fee. This arrangement essentially serves as the functional equivalent of a conventional finance lease contract where the creditor is deemed to hold nominal title to the collateral through the lease period.

These types of Islamic-based financing arrangements have long been understood to be enforceable under New York law because of the economic substance principle used to determine the legal

consequences of a transaction in the US. In *In re PCH Assocs.*, 804 F.2d 193, 198–99 (2d Cir. 1986), for example, the United States Court of Appeals for the Second Circuit held that under the 'economic realities' test, a sale-leaseback arrangement was not a true lease, but a financing transaction that was driven by tax considerations as evidenced by, among other things, the lessee's assumption of obligations typically associated with ownership, such as the responsibility to pay property taxes and maintain insurance. As a result, the lessor was not entitled to collect rent under the US Bankruptcy Code even though it held nominal title to the land.

Similarly, properly structured Shariah compliant transactions, such as an Ijarah (sale-leaseback), would be equally enforceable as their secular loan counterpart under New York's economic realities test that analyzes and supports substance over form. An Ijarah (sale-leaseback), for instance, would be considered a valid and enforceable secured loan under New York law as long as the borrower exhibits indicia of true ownership and the transaction is motivated by legitimate business purposes.

Additionally, the groundbreaking multibillion-dollar Shariah compliant restructuring of Bahraini investment bank Arcapita a decade ago in 2013 signaled that US courts will enforce

Shariah compliant debt obligations as long as they comply with the US Bankruptcy Code. This was once again confirmed last year by Judge Alvin Hellerstein of the US District Court for the Southern District of New York in his denial of a request to apply the US Bankruptcy Code's safe-harbor protection for securities contracts, forward contracts and swap agreements to a Shariah compliant Murabahah financing arrangement in connection with that same Arcapita bankruptcy matter. See *In re Arcapita*, 640 B.R. at 627.

The court in that case deferred to the parties' own characterization of the Murabahah transaction in question as "loan-like" rather than as a securities contract or commodities forward agreement and agreed with the plaintiff's prior characterization of a synthetic commodity Murabahah as simply "liquidity management tools, designed to allow the equivalent of interest to be paid on loans, rather than investments". Id. at 624.

In summary, borrowers and lenders in the Shariah compliant financing space can take strong comfort that New York courts would enforce a Murabahah transaction as a secured loan transaction and a sale-leaseback not as a true lease with ownership vested in the lessor/lender, but instead as a financing transaction where the lessee/borrower is more properly viewed as a debtor and the lessor/lender as a secured creditor. The most recent Arcapita court opinion in 2022 discussed herein serves as a beacon to guide more Islamic finance market participants to the US to broaden their portfolio.

Although that case is currently pending appeal before the US Court of Appeals for the Second Circuit for reasons other than the enforceability of Murabahah transactions, the US District Court decision is an important landmark as one of the first times that a US (or English) court has conducted a comprehensive legal analysis of the nature of an Islamic finance contract and upheld its enforceability as a financing arrangement.

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Doha



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IFN Oman Forum
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Muscat



IFN Asia Forum
12th October
Kuala Lumpur



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