

Islamic Construction Financing in the United States: Middle Eastern Investors Lead the Way

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Emerging Trends

Middle Eastern investors continue to search for ways to develop an investment portfolio diversified over the world's economies. Finding Islamic investment alternatives in jurisdictions such as the United States has always been difficult. But that trend is changing rapidly, and is being led by investors such as Kuwait Finance House (KFH), Gulf Investment House of Kuwait (GIH), First Islamic Investment Bank of Bahrain (FIIB) and Abu Dhabi Islamic Bank (ADIB). KFH, GIH, FIIB and ADIB have pioneered the development of Islamic structures for US investments working closely with US banks and financial institutions, a US law firm, and US developers, construction contractors and other companies.

FIIB has developed Islamically acceptable structures for financing US company acquisitions. The first transactions occurred in the late 1990s and involved the acquisition of a water sports equipment company and a computer software company. Since then, FIIB has made acquisitions of a road paving machinery company and two portfolios of multi-family real estate projects. Islamic financing structures for these transactions have been implemented by Bank of America, HSBC and Freddie Mac.

KFH developed an innovative self-lending tax-efficient structure for investment in U.S. real estate and one of the first Islamically-compliant funds in the U.S. ADIB has developed a diversified investment fund that invests in US equipment leases and is *Shari'ah* compliant. The leases relate to construction, manufacturing, transportation, computer, medical and other *Shari'ah*-compliant equipment.

GIH worked with Key Global Capital (an affiliate of Cleveland's KeyBank) and the law firm of King & Spalding in New York and Atlanta (as did FIIB and ADIB for their transactions) to develop Islamic structures for US construction financings. The first financing using a *Shari'ah*-compliant structure involved the Maconda Park Apartments, a residential housing development in the Austin, Texas, in late June. It is being followed by a series of similar US

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transactions involving different US developers and contractors and a wider range of Middle Eastern and US equity investors.

These construction finance, acquisition and fund programs for US transactions illustrate the growing awareness, and comfort, of US banks and financial institutions in developing and implementing Islamic structures. They exemplify the increasing interest of US developers, contractors, owners, manufacturers and vendors in looking to a broader investor base. In each case, the US participants have shown a willingness to substantially modify traditional US financing structures to comply with Islamic precepts. These transactions also illustrate the ability of US banks and financial institutions to accommodate Islamic precepts within the extensive bank regulatory environment in the US. Equity investments are being made by a combination of Middle Eastern and US investors, usually through a single investment vehicle that accommodates the needs and requirements of all investors.

As the comfort of financiers, developers, sellers, contractors, manufacturers and vendors increases, there should be greater use of Islamic techniques in the US, a significant increase in investment opportunities for Islamic investors, further development of an Islamic economy both inside and outside the Middle East, and an enhanced flow of capital between the Middle East, the United States and Europe. Increased comfort of US and European institutions with Islamic structures within the US and European markets should also result in greater involvement of these institutions with financings within the Middle East, resulting in greater foreign capital flows into the Middle East. This would allow individuals and companies, both Middle Eastern and foreign, to deploy assets over a wider investment base within the Middle East, including in secured financings, which would allow Middle Eastern banks to provide more financing opportunities of greater diversity and tenor, increasing capital investment throughout Middle Eastern economies.

An Islamic Construction Financing Model

Financing for the Maconda Park project was provided by a KeyBank affiliate. The developer and construction contractor were affiliates of Fairfield Residential, a prominent US real estate company. The leading investor in the project was GIH and also included affiliates of Key Capital and Fairfield. The transaction exemplifies the foregoing trends: Middle Eastern and US equity and US financiers, investors, developers and contractors.

From a structural perspective, the implications of the Maconda Park financing are even greater. The structure is being replicated in a variety of construction financings in the US (and elsewhere). The structure involves some particularly noteworthy features: there is no loan of any type; a US bank affiliate owns the project for financing purposes despite the significant restrictions of US law on bank ownership of real property; the bank affiliate contracted for construction of the project, which is unique in US financings; the bank affiliate leases the project to the project investment company in which GIH is the lead investor; the standard US construction contracts, leases and other financing agreements have been significantly modified to comply with *Shari'ah* precepts; and all transactional parties have accepted significant modifications to traditional US financing arrangements, including risk allocations quite unlike those in traditional US financings.

In the customary US construction financing, a bank makes an interest-bearing loan to a project company in which equity investors participate. That project company enters into the construction contract for the project. The bank has no direct relationship with the construction contractor. The contractor is entitled to be paid for its construction work whether or not loan funds are available to the project company. The bank has no risks relating to the project other than economic viability.

The Maconda Park transaction is the first of its kind in the US. It is based on a construction contract (*istisna'a*) and lease (*ijara*), both involving the bank affiliate, and related documents. The structure was developed from first principles under relevant *Shari'ah* precepts, with extensive structural and documentary review by GIH's *Shari'ah* Committee. The structure complies with both US law (including bank regulatory requirements and tax laws) and *Shari'ah* precepts. It allows the financiers to comply with traditional US bank credit policies. One of the most significant aspects of the transaction relates to overcoming the perceptions of, and restrictions on, the US participants in order to implement a joinder of Islamic and US/European financing concepts.

The *istisna'a-ijara* structure was developed under Islamic precepts. A KeyBank affiliate with relevant regulatory clearances became the project owner, for financing purposes. The bank affiliate entered into an *istisna'a* (construction) contract with a Fairfield affiliate. This contract is unique in US financings given increased contractor risks, and the flexibility of Fairfield was critical to implementing the structure. The contractor is not entitled to be paid by the bank affiliate for construction work if funding conditions are not met or if any of the transaction parties is in default.

The bank affiliate implements the financing pursuant to an *ijara* (lease) to the project company. To provide the bank affiliate with the ability to exit the transaction in certain situations, such as defaults, there is a put option allowing the sale of the project to the project company. Similarly, the project company is entitled to purchase (and sell) the project pursuant to a call option, providing investors with an exit strategy. Arrangements were also made whereby a managing contractor, for consideration, assumed certain risks that would otherwise be retained by the bank affiliate. The put and call options, the managing contractor agreement, a US law agreement and other documents allow the bank affiliate and the other parties to comply with a wide range of US laws, to insure that the project company remains the project owner for US tax (and other) purposes, and to insure favorable tax treatment to GIH as a foreign investor, all without causing a violation of *Shari'ah* precepts.

The Maconda Park *istisna'a-ijara* structure is now the basis for a variety of construction financings in the US (and other jurisdictions). The comfort of bank financiers, equity investors, real estate developers and construction contractors with the structure is growing and there will be a significant increase in these types of transactions in the US, Europe and the Middle East. These transactions are being considered and implemented by a wider range of developers and contractors. And a broader group of financiers is considering how they may provide Islamic construction financing capability in the US and Europe. Key Capital and King & Spalding are developing structures, including variants of the *istisna'a-ijara* structure, to address longer-term financing needs of participants in construction, project and

equipment financings. Banks and other financiers are developing greater comfort with Islamic techniques and working to develop a broader range of financing and investment products to serve the Islamic community. In all these efforts, innovative Islamic investors are leading the way.