Private Equity Law Report
An Acuris company
pelawreport.com

October 1, 2019

FUND STRUCTURES

How PE Sponsors Can Tailor Traditional PE Funds for Shari'a-Compliant Investors

By Barry Cosgrave, K&L Gates LLP

Private fund managers have long believed that it is impossible to raise money from investors that adhere to the principles of Shari'a – typically located in the Middle East and Southeast Asia – without operating a fully Shari'a-compliant fund. The problem is that various attendant burdens associated with operating those funds – including the need to appoint a Shari'a supervisory board – frequently discourage PE sponsors from pursuing that approach.

As a result, PE sponsors are failing to access a huge potential market. Global Islamic-finance assets were estimated at $2.5 trillion in 2018, and they are predicted to exceed $3.5 trillion by 2021. To ease this tension, a new approach has been developed to allow Shari'a-observant investors to invest in conventional PE fund structures that are subject to certain navigable restrictions. This article describes this new fund structure, provides real-life examples of how it has been used and explains how it applies to the PE industry going forward.

For more on fundraising in the Middle East, see "Ways Fund Managers Can Adjust to Rapidly Changing Regulatory Frameworks in the Middle East and Europe" (Jul. 13, 2017); and "K&L Gates Partners Offer Practical Guidance for Fund Managers on Raising Capital in Australia, the Middle East and Asia" (Oct. 30, 2014).

Shari'a Law

Background

Shari'a law, as it is commonly known, is not a single body of law codified in statutes. Instead, it is derived from three main sources:

- the Quran;
- the Hadith – the sayings of the Prophet Mohammed (PBUH); and
- the Sunnah (teachings).

Consequently, the principles that underpin Shari'a are essentially open to interpretation, which is handed down by Islamic scholars. Within Sunni – the most widely adopted form of Islam – there are four main schools of Islamic jurisprudence: Hanafi, Hanbali, Shafi'i and Maliki. Islamic scholars within those schools of Sunni may not always agree on the correct interpretation of complex points, however, which can lead to public disagreement.

Notwithstanding the potential for differences in interpretation, there are certain actions that are deemed forbidden, or Haram, upon which all Islamic scholars agree. These actions include the following:

©2019 Private Equity Law Report. All rights reserved.

- gambling (Mayseer);
- uncertainty or speculation (Gharar); and
- usury, which is charging interest or making money from money (Riba).

In addition, there are certain asset classes into which a Muslim is prohibited from investing. While not exclusive, some of the main ones are detailed below:

- production or distribution of alcohol or tobacco products;
- management of casinos and gambling halls, as well as production of games such as slot machines;
- cinemas and music;
- manufacture and sale of weapons and armaments;
- production and distribution of pork and its derivative products;
- adult entertainment;
- gold and silver trading; and
- hospitality venues that provide prohibited services such as sale of alcohol.

Interplay With Traditional PE Funds

Many of the prohibited sectors listed above – with the exception of pork products – are typically excluded from the list of asset classes in which conventional PE funds typically invest. As such, many PE funds have no issue adhering to those restrictions. Although there are grey areas, such as hotels that have bars that serve alcohol, often the revenue generated from those alcohol sales can be diverted away from Islamic investors.

The real issue for Islamic investors is that PE funds generally take on leverage whenever they make investments. This is almost always a conventional, interest-bearing loan; fixed-income security; or combination thereof that boosts the return on equity. This enhancement has prompted Islamic scholars to conclude that the returns made on PE investments are directly linked to a Haram product, thereby causing any returns achieved over the original amount invested to be non-Shari'a-compliant.

Fundamentally, this practice violates the Islamic prohibition on making of money from money (*i.e.*, an interest-bearing loan), which Shari'a classifies as Riba. The prohibition on Riba is not simply a binary question of direct lending by or to Shari'a investors. Instead, it can apply where assets are leveraged because the resulting returns are generated through the use of an interest-bearing loan.

Traditional Approach: Fully Shari'a-Compliant PE Funds

Given that leverage is such a key part of many PE fund strategies, it has been traditionally thought that full-fledged Shari'a-compliant funds are the only investment options available to Islamic investors. Those funds are subject to a number of strict requirements, including:

1. a tight leverage ratio requiring 85-percent equity, with any debt only incurred on a Shari'a-compliant or an interest-free (Qard Hassan) basis;
2. a requirement that the fund appoint a full-time Shari'a board– which is typically a fund-level expense – to review each investment made by the fund; and
3. an annual audit of the fund to ensure Shari'a compliance.

The annual audit will see the Shari'a board review all investments undertaken by the Shari'a-compliant fund. Any Haram income produced by fund investments must be turned

©2019 Private Equity Law Report. All rights reserved.

over to charity, which is clearly a problem if the income has already been distributed to investors.

It can also be challenging to make swift investment decisions with fully Shari'a-compliant funds, as the board must consider and opine on each investment. This can be a time-consuming process, particularly during certain religious festivals when scholars may be busy with matters of faith. In addition, PE sponsors cannot use subscription credit facilities to bridge this time gap in the board-approval process because of the leverage requirements and the fund-level risk that approval will not be granted.

For more on financing facilities, see "Characteristics and Benefits of NAV Facilities for Secondary Funds" (Sep. 10, 2019); and "Trends in the Use of Subscription Credit Facilities: Structuring Considerations Negotiated With Lenders and Important LPA and Side Letter Provisions (Part Two of Two)" (Feb. 7, 2019).

The restriction on leverage and the additional costs involved have resulted in poor returns for Shari'a-compliant investors compared to the returns achieved by investors in conventional PE funds. As a result, there are very few fully Shari'a-compliant investment funds, and those that do exist tend to produce low, unattractive returns that discourage further investment.

Alternative Approach: Opt-Out Rights

Another option that some PE sponsors have used is to grant a Shari'a investor a specific opt-out right with respect to any investment that it deems to be non-compliant. This right tends to work better for a "fund of one" structure, as multi-investor structures tend to introduce more complications whereby other limited partners (LPs) are forced to fund the gap left by the Shari'a investor.

That being said, the opt-out right does release the general partner (GP) and investment manager (IM) from a lot of the risks associated with raising capital from Shari'a-compliant investors. This is because the investor itself decides whether an asset is suitable for its investment, as opposed to there being any suggestion that it is relying on the GP or IM.

For more on opt-out rights in a traditional PE fund context, see "Current Scope of PE-Specific Side Letter Provisions: Industry Trends, Excusal Rights and Placement Agent Representations (Part One of Three)" (Mar. 19, 2019).

Modern Approach: Murabaha and Musawama

In recent years, scholars and market practitioners have developed an LP structure that enables Shari'a-compliant investors to invest in conventional PE funds, provided the underlying asset classes into which the fund invests do not violate the Shari'a prohibitions. This involves combining a Shari'a-compliant structure called a Murabaha with a unilateral promise (Wa'ad) to enter into a Musawama (described below), all of which allows the investor to join an unaltered, traditional PE fund.

Principles of the Transaction

A Murabaha transaction involves the sale and purchase of certain assets for spot delivery, but with payment being made on a deferred

©2019 Private Equity Law Report. All rights reserved.

basis. Owing to the fact that payment is deferred, the seller is entitled to receive a mark-up or "profit" on that sale. This profit element is calculated on either a fixed or variable basis above the purchase price of the assets. This is the most common of all Islamic finance structures, and it is used for, among other things, bank facilities, derivatives and fund investments.

A Musawama structure is virtually identical to a Murabaha, except that it involves the sale and purchase of certain assets for spot delivery and spot payment. Whereas the profit element of a Murabaha transaction must be incremental to the purchase price of the assets, the price payable in a Musawama is agreed between the parties such that the purchase price may be small and the profit can be very large.

The assets used in these transactions are generally London Metal Exchange (LME) metals, which cause these deals to be referred to as Commodity Murabaha or Tawarruq (a financial instrument in which a buyer purchases a commodity on a deferred payment basis and then sells that commodity to a third party on a spot-payment basis). The reason for this is that, aside from being easily bought and sold in dematerialised form, LME metals have standards that ensure, for example, copper has a certain level of purity – thereby satisfying Shari'a concerns around certainty. Also, LME metals are physically warehoused around the world, which makes physical delivery possible even if it is never requested in practice.

Structuring the Funds

To put the structure in place, two special purpose vehicles (SPVs) are typically established in an offshore jurisdiction (*e.g.*, the Cayman Islands or British Virgin Islands). For more on SPVs, see "How Recent Developments Under BEPS May Affect Fund Managers' Ability to Use Special Purpose Vehicles" (Oct. 5, 2017); and "How Does the Custody Rule Apply to Special Purpose Vehicles Used by Private Equity Funds to Purchase, and Escrow Accounts Used to Sell, Portfolio Companies?" (Jul. 24, 2014).

After receiving capital from the Shari'a-compliant investors, SPV 1 will buy commodities from a commodity broker and sell them to SPV 2 for spot delivery with deferred payment terms – a Murabaha contract. The Murabaha contract is the means by which the Shari'a investor receives periodic distributions and a return of capital from the PE fund.

SPV 2 then sells those commodities to a different broker and uses the proceeds to subscribe for units in the PE fund, the structure of which has not been altered in any way to accommodate the Shari'a investor. Therefore, SPV 2 is the LP in the conventional PE fund, but it acts on the instructions of the Shari'a investor through the various contractual relationships.

As part of this arrangement, SPV 1 also enters into an undertaking to purchase commodities from SPV 2 at the Musawama price. This is necessary because it allows for losses on an investment to be realised, whereas a Murabaha requires the purchase price – which amount cannot be written down – to be returned over the life of the Murabaha.

Therefore, the Musawama price is calculated as the absolute value of any loss realised by the PE fund. SPV 1 agrees to purchase commodities from SPV 2 at this price, and that payment obligation is then set off against SPV 2's

©2019 Private Equity Law Report. All rights reserved.

obligation to pay the deferred purchase price under the Murabaha, giving rise to a net return.

Islamic Scholars' Interpretation

Shari'a scholars look to the Murabaha as the instrument by which a Shari'a investor earns its return, although the ultimate source of income is actually the underlying asset in which the proceeds of the Murabaha are invested. Scholars do not look at the levels of leverage that sit either at the asset or fund levels, which frees PE sponsors from one of the more onerous restrictions of fully Shari'a-compliant funds. This approach also allows the fund to avoid the additional cost and administrative burden of maintaining a Shari'a board to monitor its investment portfolio on an ongoing basis.

A conventional PE sponsor that uses the Murabaha and Musawama structure does not generally rely on Shari'a-compliant investors as a source of more than 20 percent of the total committed capital of a fund, and in reality, it tends to be a lower percentage. Shari'a scholars take a pragmatic view as to an asset's sources of revenue and allow a fund to allocate any "impure" income to non-Shari'a investors. For example, there is no Shari'a issue with generating revenue from hotel rooms; there is, however, an issue with the revenue generated by the hotel bar. The key is that there needs to be sufficient revenue being generated by the Shari'a-compliant assets to fund returns to Shari'a investors.

Attendant Risks

PE sponsors need to have a clear idea of risks that may be presented when raising capital from Shari'a investors.

Non-Shari'a Compliance

One significant concern is what happens if the Shari'a investor claims that a fund structure arranged by a PE sponsor is not Shari'a-compliant or that the investor was misled about its Shari'a compliance. These tactics could be used by as a pretense by a Shari'a investor to avoid its obligations to fund capital commitments; pay fees or indemnities; or recall its capital. In addition, these claims could have an adverse impact on the reputation of a PE fund.

There are, unfortunately, a number of prominent cases of this happening. For example, DanaGas – an oil and gas company in the United Arab Emirates (UAE) – claimed that a Shari'a-compliant bond (Sukuk) under which it was obligor was illegal under UAE law. DanaGas argued, therefore, that it did not have to perform its obligations under the Sukuk because it did not comply with Shari'a.

Uncertain Legal Enforceability

It is important to note, however, that no court ruling has been handed down – in the DanaGas example, or any other occurrence – as to whether Shari'a compliance bears on the enforceability of the contract underpinning the structure. The reason for this is that documents used for Shari'a-compliant structures have uncommon governing law clauses. There is limited English case law in which courts have stated that disputes as to English law documents will be considered using English law rather than Shari'a law, which is a legal system the English courts cannot apply.

In this vein, it is worth noting that Shari'a compliance and legal compliance

©2019 Private Equity Law Report. All rights reserved.

(*i.e.*, compliance with the law of the jurisdiction under which the contract is formed) are distinct issues that need to be considered separately. Ultimately, if a PE fund structure or actions were proven not to comply with Shari'a law, the burden would fall on the Shari'a investor – rather than the PE sponsor – to forfeit any impure income to charity and thus cure the defect. Legal enforcement (*e.g.*, under English law) should not be affected, however.

For more on choice of law provisions, see "Contractual Provisions That Matter in Litigation Between a Fund Manager and an Investor" (Oct. 2, 2014).

Conclusion

While there are risks associated with any Shari'a-compliant structure, those risks have been largely limited by working closely with Shari'a scholars to develop the modern approach that uses Murabaha and Musawama to give Islamic investors access to traditional PE funds. Capital flow from Shari'a investors into conventional PE funds is growing steadily, and this structure provides Shari'a-compliant investors with access to fund management expertise that they have previously not been able to access.

As demographics and lifestyles change in the Middle East – and the search for income beyond oil intensifies – capital from investors in the region will continue to seek reliable investment products offered by proven fund managers. With 30 percent of the world's population identifying as Muslim, it is becoming increasingly important for PE sponsors and other fund managers to provide investment products that allow those investors to grow their capital in a manner that accords with their religious beliefs.

Barry Cosgrave is a partner in K&L Gates' banking and asset finance practice group and divides his time between its London and Dubai offices. Cosgrave concentrates his practice on distressed debt and restructuring, debt capital markets, structured finance and Islamic finance. Cosgrave advises on Middle East regulatory matters and is advisor to leading international banks, hedge funds, investment/asset managers and insurance companies on the full range of banking, funds, securities, broker-dealer and insurance regulation.

©2019 Private Equity Law Report. All rights reserved.