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A legal analysis of the Islamic bonds (*sukuk*) in Iran

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Abstract

Purpose – The purpose of this paper is to provide a legal analysis of *ijara sukuk* in Iran which are expected to be issued in 2009. It reviews the proposed structure and the transactions entered into in respect of the *sukuks* and the legal engineering of those transactions to make them compliant with *Shari'a*. In so doing, this paper explores the rights and obligations that arise from the contracts on which the transactions in *ijara sukuk* are based.

Design/methodology/approach – The analysis offered by this paper has both theoretical and doctrinal orientations. At a theoretical level, this paper concentrates on the traditional contract of lease, as well as the lease-to-purchase vehicle. At a doctrinal level, the purpose of this paper is to highlight the complications embedded in the *ijara sukuk* and the need to rationalize and harmonize various aspects of Islamic banking and project financing.

Findings – It is argued that, while the new *sukuk* structure complies with the requirements of *Shari'a* requirements against *riba* and *gharar*, it goes against a well-established expectation of increasing the level of efficiency of the banking and financial sector.

Originality/value – This paper provides an original insight into understanding *ijara sukuk* in Iran. It also contributes to the literature on Islamic finance according to *Shi'i* jurisprudence.

Keywords Islam, Finance, Law, Contract law, Iran

Paper type Research paper

Introduction

In September 2007, the *Shari'a* Board of the Iranian Securities and Exchange Organization ("the ISEO") approved the compatibility of *sukuk* with *Shari'a* in accordance with the principles of *Shi'i* jurisprudence. Subsequently, the Department of Islamic Development Research and Studies of the ISEO (a body affiliated with the ISEO) drafted the "Regulation on *ijara sukuk*" ("the *sukuk* regulation"), which received approval from the High Council of the ISEO in January 2008[1] and is now before the parliament for final approval.

This paper examines the key elements of *sukuk* within the context the *Shi'i Fiqh* (jurisprudence) and the principles of contract law in Iran, which is based primarily on the *Shi'i Fiqh*. Clearly, a more complete examination of *Shi'i* legal thought, its origin and values is warranted (Modarresi, 1984, 1994), but this paper is not the place to conduct such intensive analysis. Briefly, there are four sources of *Shari'a* according to the *Shi'i* school of Islam. The Koran and the *Sunnah* of the Prophet Muhammad are the main sources of *Shari'a*. *Sunnah* is generally understood as the saying and deeds of the

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Prophet as well as those of the 12 Imams. *Shi'i* legal thought also departs from the *Sunni* legal tradition in two ways. First, it does not consider *Ijma* (consensus among Muslim scholars) as a source on its own but a means through which the opinion of the Prophet or the Imams may be discovered. Second, *Shi'i* jurists reject *Qiyas* (analogical deduction) as the fourth source of *Shari'a*, replacing it with *Aql* or human reason[2].

The authoritative views of *Shi'i* jurists are enacted into Iranian positive law under the mandate of the constitution, which stipulates that judges must make use of "Islamic sources and *fatwas* in matters where the Iranian law books are silent". *Shi'i* law is also applied by *Shari'a* courts in Iraq (Nakash, 2003).

The intention of this paper is to present an analysis of the principles of contract, according to *Shi'i* Islam, that are likely to be most relevant for entities that wish to issue *sukuk*. This analysis has both theoretical and doctrinal orientations.

At a theoretical level, this paper concentrates on the traditional contract of lease, as well as the lease-to-purchase vehicle, which is a rather recent innovation in Islamic financing in Iran. In this context, the paper explores the nature of the legal relations between parties in an *ijara sukuk* transaction. It will further explore the legal character and effect of conditions under which the lessee will be bound to purchase the property. The purpose of this examination is to address the following questions: what are the key requirements of the *ijara* contract? What remedies are available to the parties to a *Sukuk* transaction in the case of breach? What legal rights and obligations arise at the end of the underlying *ijara* contract in lease-to-purchase agreements? Is the condition for the transfer of title valid in Islamic law? This examination relies heavily on readings and issues derived from *Shi'i* jurisprudence and positive law in an effort to establish the consequent implications for *Shi'i* legal doctrine more broadly.

At a doctrinal level, the purpose of this paper is to highlight the complications embedded in the *ijara sukuk* and the need to rationalize and harmonize various aspects of Islamic banking and project financing in order to achieve a conducive environment for business and investment.

The paper has five sections. Section I examines the background to the introduction of the *Sukuk* in the Iranian banking system. In addition, Section I outlines the most significant features of the *Sukuk* regulation. Section II provides a detailed analysis of the contracts in *ijara sukuk* transactions, focusing on the formal requirements of the classical *ijara* contract as well as the rights and obligations of contracting parties. Section II also deals with judicial remedies that are available to the parties and discusses the various purposes that those remedies may serve. Section III examines lease-financing techniques adopted by the *sukuk* regulation to bring the traditional lease contract into asset-based financing arrangements. Section IV concludes by offering suggestions as to a more rigid and clearly defined system of remedies in *ijara sukuk* transactions.

I. Ijara *sukuk*

Definition and background

The term *ijara sukuk* (or Islamic bonds) refers to global bonds structured on *ijara* (leasing) principles. At present, *sukuk* markets are seen as a particularly innovative, rapidly growing area in Islamic financing (El Qorchi, 2005).

While *sukuk* transactions are a recent phenomenon in Iran, the use of *Shari'a*-compliant financial instruments is not a new idea in that country. In fact,

Iran began to adopt Islamic banking principles immediately after the revolution in 1979. As the first step towards Islamising the banking system, Iran's Constitution prohibited *riba* (interest) in all transactions in the Iranian economy (Principle 43 of the *Constitution of the Islamic Republic of Iran* (herein after *the Constitution*); Ansari-Pour (1995)). It also declared that all banks were to be government owned. A further major step was taken in 1983 when the Interest-Free Banking Operations Act ("the IBO Act") was enacted. As the title of the act suggests, the purpose of the act was to give effect to the constitutional provision prohibiting *riba*. It also introduced profit/risk-sharing as the principal method of Islamic banking. On this ground, the IBO Act introduced a number of Islamic financial products such as *Muzare'a* (profit-sharing) and *Musharikat Madani* (partnership).

The IBO Act, however, was drafted as a hasty response to the exigencies of the newly established Islamic order in the country. As it turned out, a major shortcoming of the IBO Act was that it fostered the habit of using the banking system as a means for increasing government capital by mobilizing local savings into the government-owned banks (Mazaheri, 2007).

Another significant problem with the IBO Act was caused by the fact that the Islamic financial products that it introduced did not provide the necessary level of flexibility and transparency which are normally required for the banking sector to operate effectively. Notably, these financing instruments were based on very basic, pre-modern legal concepts and their large-scale application in a modern banking system was totally unprecedented. Moreover, the IBO Act did not contain a sound regulatory mechanism (Mazaheri, 2007). This was perhaps the most remarkable weakness of the IBO Act, which resulted in its failure to bring about any significant positive outcome. In fact, as a result of the excessive regulatory discretion given by the IBO Act to government officials of the Central Bank and other financial and banking bodies, the Iranian capital market remained heavily regulated, immature and confusing. Simply put, there were too many state-controlled regulatory bodies applying too many different sets of rules and regulations to the financial products and services. On the other hand, government rules and policies heavily influenced the asset acquisition of the banking system, a consequence of which was to limit the role of the banks in mobilizing private-sector resources (Khan and Mirakhor, 1990). Therefore, it is hardly surprising that the costs of government intervention were greater than the costs of the market imperfections that the government policies were supposed to remedy (Sadr, 1991).

Further, as Khan and Mirakhor (1990, pp. 373-4) observe, the conversion to Islamic modes has been much slower on the asset side than on the deposit side. One reason for the slower pace of conversion on the asset side is that there is inadequate supply of personnel trained in long-term financing (Iqbal and Mirakhor, 1987).

Another important factor hindering the competitiveness of the Iranian banks has been the rigid application of Islamic legal principles. As Nomani (2003) notes, Iran's large-scale experiment with Islamic banking over the past 25 years has proved that an appropriate regulatory framework for Islamic banking must place greater emphasis on a more innovative and flexible approach to *Shari'a*, while preserving its distinctive ethical and moral dimension.

In recent years, as the pace of privatisation has gained momentum – with a number of public entities reverting to private ownership and the revival of private banks – "the

relative share of direct business ventures undertaken by banks as a form of financing has stagnated" (Yasseri, 1999, p. 234). At the same time, as the process of privatization and further industry restructuring slowly evolves, it is expected that Iran's market will reveal a growing share of equity partnership.

The recent introduction of the *sukuk* structure to the Iranian banking system should be seen against this background. Given the relatively long experience of Iran in using profit-sharing mechanisms and asset-based financing (in the form of lease-to-purchase contracts, discussed in Part III below), many economists and decision makers in the government predict that this innovation would generate growth in the Iranian market (Mousavian and Farahani Fard, 2007, p. 76).

As the following sections will show, the key feature of the *ijara sukuk* is that it represents a notably less rigorous application of the traditional principles of material ownership and liability.

The sukuk *regulation*

In order fully to understand the remedies available to each party in an *ijara sukuk* transaction, we must first obtain a clear understanding of how this form operates. This, in turn, requires an understanding of the provisions of the *Sukuk* regulation.

The *Sukuk* regulation is in 11 parts and has 33 articles. Part A sets out principles and basic definitions. Although the *Sukuk* regulation does not expressly deal with interpretation issues, it is clear that, in interpreting the key concepts contained in it, regard must be had to the empowering provisions in the relevant legislation, including the Civil Code and the Commercial Code; as well as the general law, that is, the principles of *Shari'a* law as a source of law under the Iranian Constitution (*The Constitution*: Principle 167).

Generally speaking, the elements of the *ijara sukuk* as developed by the *Sukuk* regulation are essentially the same as those in other markets. The main procedures involved in the *Ijara Sukuk* transaction are shown in Figure 1.

Normally, a *sukuk* transaction takes one of two forms:

> [. . .] either (i) asset originators themselves issue notes backed by existing Islamic assets, or (ii) the originator sells Islamic assets (and/or the proceeds thereof) to an unaffiliated SPV, which issues notes with a put/tender feature to fund acquisition of assets (Jobst, 2007, p. 19).

In essence, the same approach has been taken under the *Sukuk* regulation in its Part VII. However, the *Sukuk* regulation creates a new body to protect investors more effectively. Where the special purpose vehicle (SPV) is created by the originator, the SPV is required to enter into an agreement with an entity, whose responsibility is to protect the interests of the investors (*Sukuk Regulation*, Article 9). This entity is called the *Amin*, a title typically assigned to one or more of the existing banks or licensed financial institutions (*Sukuk Regulation*: Article 7). The *Amin* is entrusted with control and verification of the securities issued by the SPV (*Sukuk Regulation*: Article 1(9)). It also has a supervisory role with respect to the whole process of *sukuk* and the transactions involved (*Sukuk Regulation*: Article 1(9)). Therefore, the *Amin* acquires a fiduciary duty to "act in the investors' best interest" (*Sukuk Regulation*: Article 1(9)). Accordingly, the *Amin* will be liable where the asset is assessed below its "real value" (*Sukuk Regulation*: Article 11).

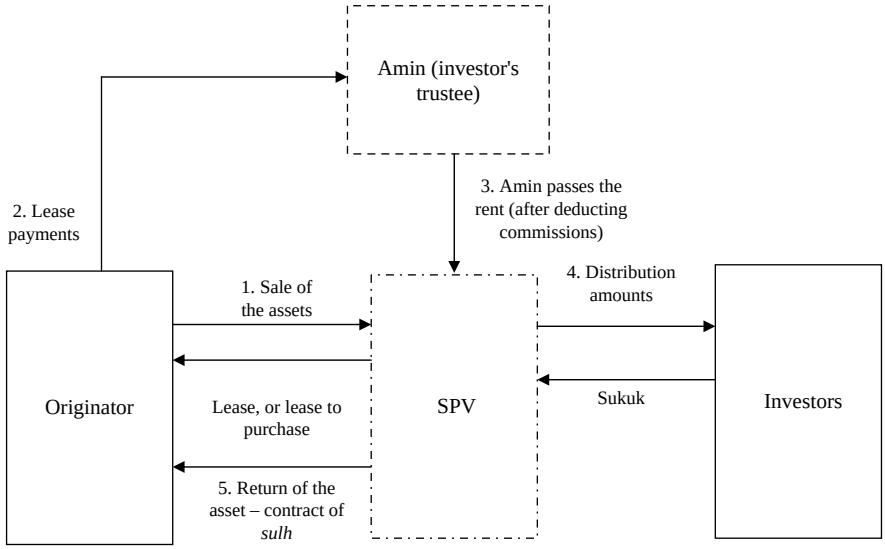

Figure 1.
Ijara sukuk in Iran

As can be seen in Figure 1, an *ijara sukuk* transaction is made up of a master *ijara* agreement between the originator and the SPV (on behalf of the investors), and a number of secondary agreements. The most important secondary contracts are the contract of *Wakalah* (agency), and the contract of *Sulh*. The contract of *Wakalah* is concluded between the SPV and the investors. The SPV is established as a public or private company. The effect of *Sulh* is to perfect the transfer of legal title to the asset to the originator; this is discussed in Part IV.

Furthermore, in order to lessen the likelihood of an involuntary bankruptcy being filed against a SPV by investors that have not been paid, the *Sukuk Regulation* requires that the SPV be established as a single purpose company with the sole purpose of issuing *sukuk* certificates.

In addition, the *Sukuk Regulation* stipulates that, where the parties to the underlying lease contract are subject to a conditional sale agreement, depending on the terms of the contract, the SPV may choose to transfer the legal title to the originator under a unilateral *Sulh* agreement[3].

II. The classical contract of *ijara* (lease)

As the term *ijara sukuk* suggests, the underlying agreement in this mode of financing is the *Ijara* agreement between the originator and the *sukuk* holders (or the SPV on behalf of the latter). In addition, according to Article 1(1) of the *Sukuk* regulation, *ijara sukuk* certificates manifest pro rata ownership by the *sukuk* holders in the tangible assets of the vehicle. The *Sukuk Regulation* further states that "interests in the property are transferred to the lessee or the originator [as the case may be] under an *Ijara* contract" (*Sukuk Regulation*: Article 15). Therefore, it is essential to examine the characteristics of the contract of *ijara* under Islamic law. A full discussion of all the applicable principles of *Shari'a* law is obviously beyond the scope of this paper.

Therefore, the discussion below focuses on the questions of liability and asset ownership in *ijara* contracts insofar as they might arise in an *ijara sukuk* transaction.

Features of ijara

1. Usufructuary right. By and large, jurists from all Islamic schools of thought maintain that *ijara* is the result of the exchange of two interests, or the grant of a usufruct in exchange for a specific consideration (in *Shi'i* jurisprudence, see: Khu'ī, 1962, 1989; *Shāf'ī* School: Nawawī, n.d.; Malikī School: Barakat, n.d.; Hanafī School: Al-Misrī, n.d.; Hanbalī School: Ibn Qadāmah, 1984).

Accordingly, Article 466 of the Civil Code of Iran defines a contract of *ijara* as that "which grants a usufructuary right to the lessee over the subject-matter of the lease over a specific period". In broader terms, a lease is a non-cancellable contract by which the owner of an asset (the lessor) grants the right to use the asset for a given term to another party (the lessee) in return for a periodic payment of rent.

Therefore, it can be said that in a *Sukuk* transaction, when the *ijara* contract is validly made, an change occurs instantly in the status of the subject-matter of the lease in that the lessee (i.e. the originator in the *Sukuk* transaction) acquires a usufructuary right in the asset in exchange for an obligation to pay rent for its use. This reflects an intrinsic and vital principle of contract in Islamic law according to which a contract is expected to exhaust all its purposes as soon as it is concluded (Saleh, 1990, p. 101). On this principle, in *ijara* contracts, the lessor is obliged to make any arrangements necessary to enable the lessee to obtain delivery of the subject matter of the *ijara*. Failure to fulfil this obligation entitles the injured party to withhold the rent and seek an order for performance by the court (Katouzian, 1994a, b, p. 395). Where the lessor fails to comply with the court order, the lessee has the right to terminate the contract.

2. Term. It has already been stated that an *ijara* contract transfers a usufruct right to the lessee for a specified period of time. This is an essential term of *ijara*. Where no term has been fixed, the contract will be void. While the *Sukuk* regulation does not set any period of time for an *ijara sukuk*, it provides that the term of *ijara* must not exceed 80 per cent of the useful life of the asset (*the Sukuk Regulation*: Article 19).

3. Eligible assets. Article 1(3) of the *Sukuk Regulation* defines the asset as "any asset that can be subject of *ijara*". Therefore, we need to know what types of assets are eligible for *ijara* under *Shari'a* law.

As noted above, in *Shari'a* law, as a result of the contract of *ijara*, the lessor acquires a usufruct right in a chose in possession (*a'yn*). In other words, only interests in a chose in possession (as opposed to a chose in action) can be transferred under an *ijara* contract (Najafi, n.d.a, b, p. 204).

A chose in possession may be further divided into two categories of specific and non-specific property. Specific property refers to things that are capable of specification in the real world – for example, the land at 25 Churchill Square. Non-specific property, on the other hand, refers to things described by particulars such as weight, quantity, number, etc. Suppose that an airline enters into a lease contract with an aircraft leasing company to lease four A330 aircraft. If no other specific instructions are given by the airline, the leasing company is free to choose any of the A330 aircrafts available to fulfil its obligation under the contract.

Furthermore, Article 2(2) in Part B of the *Sukuk Regulation* stresses that "there must be no legal or contractual obstacle or restriction to prevent the transfer of the asset and

rights attached to it", and that the asset should not be "subject of any claim by third parties". It is often said that, for an *ijara* contract to be valid, four essential elements are required:

(1) The lessor must hold title to the interest to be transferred under the lease.

(2) The characteristics of the subject matter of *ijara* must be clearly defined.

(3) The interest for which the lease is created must be legitimate.

(4) The interest must be capable of transfer by delivery.

4. Title to the interest. The lessee cannot refuse performance on the grounds that he or she did not own the chose (i.e. the subject-matter of the lease of the lease) upon the conclusion of *ijara* because of the general principle that an *ijara* contract is valid where the lessor, as principal or as an agent, has proprietary ownership over the interests arising from the object (Ardebīlī, 1991, p. 11). Therefore, where a subsidiary, acting as an agent for a holding company, grants a lease for a project to be undertaken on part of the land on which it stands, it would not be able to subsequently rely on the lack of title to the land to avoid performing its obligations under the contract. The situation is more complicated where the lessee has agreed not to sublet an interest in the land without prior consent of the owner of the land. Clearly, if the lessee subsequently sublets the said usufructuary right in the land to a third party, he or she will be in breach of contract. However, it will only render the subsequent subletting contract voidable. The owner may seek to recover the property from the third party and thus render the subletting contract void. Alternatively, he or she may affirm the contract and in this way rectify the problem of lack of title to the interest at the time when the subletting contract was concluded.

As a precautionary measure to ensure that the supplier of the object of the *sukuk* at least holds title to the interests for which the structure has been created, the *Sukuk Regulation* requires that all documents relating to the ownership status of the property be submitted to the *Amin* (*the Sukuk Regulation*: Article 10). It further requires that all information in respect of title be disclosed by the SPV to the *Amin* (*the Sukuk Regulation*: Article 12(4)).

5. Durability and frustration of contract. To be a valid *ijara* contract, the subject matter of *Ijara* must be durable in the sense that it remains available for the specified use by the lessee throughout the contract. Significantly, if at any point in the course of the lease the subject matter ceases to generate the specified return, the lessee will be entitled to terminate the contract for frustration of purpose. It must be noted, however, that for a contract of *ijara* to be frustrated, the frustrating event must be a force majeure Therefore, where the event in question was caused by the negligence or deliberate conduct of the lessor or a third party, the doctrine of frustration will not apply (Katouzian, 1994a, b, p. 434).

This rule has significant implications for investors in terms of liability to compensate for loss with respect to the underlying asset during the operation of a lease project.

Moreover, the *ijara sukuk* is asset-based financing. Therefore, in order to enable commercial exploitation of the asset, Article 2(1) of the *Sukuk* regulation states that the asset must be capable of generating income.

6. Certainty of the subject matter of Ijara. Another requirement for the underlying asset is that its characteristics must be clearly and carefully stated to avoid *Gharar* (uncertainty), which is prohibited in *Shari'a* law. Accordingly, the *Sukuk Regulation* states that the value of assets that constitute the subject matter of the *ijara sukuk* must be determined by registered experts as stipulated by Article 2(3) of the *Sukuk Regulation*.

7. Rent (lease payment). It is said that there is a *Rawāyā* from Īmām indicating that rent is essential to the validity of *ijara* (Katouzian, 1994a, b, p. 390). The amount of rent must be precisely specified by the parties. In a case of dispute over the existence and certainty of rent in a contract, the court will use an objective standard to determine whether the rent has been determined with sufficient certainty by the parties.

The lessee is required to pay the rent to the lessor according to the terms of the agreement. The question that arises here is whether the lease contract provides for payment of interest (in addition to the principal sum) following default.

This question has sparked controversy among clergy and legal practitioners. The Guardian Council of Iran – a state body responsible for ensuring the laws passed by Iran's legislature comply with Islamic teachings – has stated that default interest is only payable when it is specified as a condition in the original contract. This view, however, has been rejected by many other clerics, who argue that the said interest is *riba* and should therefore be prohibited. Nonetheless, it has been argued that the courts must use the evidence available to them to distinguish between the default payment as a mechanism to ensure timely payment and as a means to abuse the defaulting party's genuine inability to pay due to hardship (*'Osr*). Although the latter use of default payment provisions is clearly prohibited under *Shari'a*, there is no valid reason to refuse its application in the former sense (Vahdati Shubairi, 2003, p. 93).

Liability clauses in ijara *contracts*

While the *Shari'a* law grants the lessee an exclusive usufructuary right over the subject-matter of *ijara*, it provides very limited grounds on which the lessee might be found liable to compensate loss in the absence of trespass (*ta'addi*) or negligence (*tafreett*).

Generally, under *Shi'i* jurisprudence, the lessor assumes all liabilities connected with the use of the asset by the lessee (Ansari, 1999, p. 47). This means that the lessor is under an obligation to pay all of the operating, maintenance and repair costs of the equipment or any other asset subject of the lease. The majority of *Shi'i* jurists consider that any agreement to the contrary between the lessor and the lessee is void and renders the original *Ijara* void as well.

The foundation for this argument lies in the doctrine of possession. There are three types of possession depending on the mode in which property is acquired (and lost): possession as the owner (*Yad Maliki*), possession as fiduciary (*Yad Amāni*) and detinue (*Yad Damāni*). Generally, a breach of duty by the owner of property gives rise to a cause of action in tort for breach of the general duty of care to prevent harm to others (Katouzian, 1997, p. 146). On the other hand, the liability of the debtor for breach of a contractual duty depends on whether he or she holds the property with or without permission of the owner. Where it is established that such permission has been given by the owner – either expressly or by implication – the holder is deemed to be in

possession as fiduciary and thus is liable for compensation only when *Yad Damani* is imposed, that is, when he or she commits an act of trespass (*ta'adi*) or negligence (*tafrit*).

In relation to *ijara*, all *Shi'i* jurists contend that as a result of the contract of *ijara* the lessee holds the asset as *Amin*, which can be roughly analogised to a fiduciary position in the common law system. In Islamic law, an *Amin* may not be held liable for loss to the asset unless he or she is found negligent or has committed an act of trespass. For many *Shi'i* jurists, this principle constitutes an essential term of the contract of *ijara* and cannot be superseded by an inconsistent agreement between the parties. For the majority of jurists, the provision that the lessee would be liable for loss other than in trespass or negligence would render the contract of *ijara* void (Bin Yūssīf, 1969, p. 317; Āmilī, 1977, p. 331).

However, a significant number of *Shi'i* jurists argue that an agreement between parties to an *ijara* contract does not suffice to render the whole contract void (Katouzian, 1994a, b, p. 420). Central to their argument is the recognition of freedom of contract as a key organizing principle of Islamic contract law as reflected in the Koran and *Sunna*[4]. The agreement under which the lessee is liable for loss or damage to the asset would not oppose the public order, which might otherwise place limitations on the doctrine of the freedom of contract. Furthermore, even if we accept that the status of the lessee is that of an *Amin*, the entire contract is not contingent upon that status. Therefore, the presence of a separate agreement for liability allowing the lessor to seek damages from the lessee does not render the original contract void. This argument is based on the submission that the essence of the *ijara* is to grant the lessee usufructuary rights, not to make him or her a fiduciary (Katouzian, 1994a, b, p. 420).

In practice, however, the banks normally require the lessee to cover such operating and current costs as insurance, maintenance and property taxes. Article 20 of the *Sukuk Regulation* specifically provides that "the lessee will be responsible for all current costs". Furthermore, the *Sukuk Regulation* in its Article 3 stipulates that "the asset may be insured against any potential damage or costs resulting by accidents that preclude the asset from generating cash flow", hence leaving it up to the parties to deal with insurance arrangements.

III. Asset-based lease financing

The previous section outlined some key issues involved in the contract of lease in terms of validity and liability. This section explores the general structure of *ijara* in the context of asset-based financing.

Islamic project financing rules out the use of credit enhancement techniques, provided that the underlying assets are not recharacterized (Box and Mohammed, 2005, p. 21). In a *sukuk* project, investors are not required to assume all project risks without any kind of credit enhancement. In effect, while the underlying *ijara* contract may contain no post-termination condition, as a common practice a condition is included in the contract under which the lessors (i.e. the investors) agree to sell the asset to the originator upon the termination of the contract (*the Sukuk Regulation*: Article 15(3)). As Jobst (2007) observes, in this mechanism, which can be compared to tranche subordination of conventional securitization:

> [. . .] the issuer would assign partial ownership rights of the underlying asset portfolio in return for fixed rental payments conditional on the option (or obligation) to repurchase the

reference portfolio at a pre-determined sales price at some future date. The rental payment and the repurchase price are set such that they support a fair market return for investment risk.

The lease to purchase agreement, as a *Shari'a*-compliant financing instrument, was first introduced into Iran's Islamic banking system by the Islamic Banking Operations Act as the preferred form of collateral security for banks and financial institutions. It is commonly used by banks as a means of real estate financing. In 2001, assets owned by state banks under lease to purchase agreements were valued at US$45 million (Ahmadi, 2007, p. 15).

There are two types of lease financing: *ijara* with the option to purchase for the lessee: and the lease to purchase arrangement. These are discussed below.

Ijara *with the option to purchase for the lessee*

This form of *ijara* includes a call option, which entitles the lessee to buy the underlying asset at a predetermined price or at a price approved by the *Amin* (*the Sukuk Regulation*: Article 15:3). The lessee, therefore, is not bound to purchase the asset in question but has the right to elect whether to take benefit of the option. Should the optionee proceed to exercise the option to purchase, it must pay the difference between the purchase price and the total amount of rent paid (Katouzian, 1994a, b, p. 77).

Shi'i jurists generally assert that this form of lease is permissible under the general principles of contract in Islamic law (Ansārī, 1996, pp. 229 and 232, 1999). However, the option does not grant the optionee the title to the asset. Normally, after the lessee notifies the vendor of his or her intention to buy, a contract of sale is entered into under which the title to the asset passes to the purchaser.

During the option period, the lessor must refrain from any action that may adversely affect the right of the optionee. This means that the lessor may not sell the asset to a third party and bears the risk of loss. Where the loss is found to be caused by the act of the owner of the asset, the lessee has the right to terminate the *ijara* contract for breach. The reason for this is that the option is normally an essential term of the contract of *ijara*. Furthermore, the option can only be exercised with respect to the specific asset that forms the subject matter of the lease (Ansārī, 1996, p. 148, 1999). Therefore, where that specific asset is fully destroyed or disposed of in a certain way by the lessor, the lessee is entitled to put an end to the contract.

Some *Shi'i* Mujtahids have taken the view that this rule only applies where the subject matter of the lease is a specific object, rather than an object belonging to a class. According to this view, which has been adopted by Article 482 of the Civil Code of Iran, in the latter case, the lessor will be obliged to provide the lessee with another object in the similar class and with identical characteristics (Katouzian, 1994a, b, p. 435). However, what this view fails to take into account is that whether a breach occurs does not depend on the nature of the subject matter of the contract. There is nothing in sources of contractual liability in the Islamic law of contract to indicate that the character of the subject matter of a contract alters the liability of the wrongdoer. Perhaps, a better approach would be to give the injured party the right to elect between two courses of action when faced with the loss. He or she might affirm the contract – hence benefiting from it – while taking the burden of compelling the other party to perform. Should he or she elect to do so, the court will grant an order as to how that contract is to be carried out, replacing the mode in which it should have been carried out.

Alternatively, the injured party might elect to terminate the contract for breach (i.e. non-performance) by the other party and seek damages (Kho'i, 1989, p. 87).

Ijara *leading to transfer of title*

Another type of lease to purchase contract is commonly used in sale of goods and land in Iran. Here, the contract of *ijara* does not provide for an option to purchase to be exercised in the manner mentioned above. Rather, it involves a conditional transfer of title, which is fulfilled upon the termination of the lease contract and the due performance by the lessee of all its obligations under it. The payment of the final rental by the lessee is regarded as sufficient to satisfy this condition. Once this has been done, the seller is not required to do anything but to fulfil the statutory formalities. In the event of default, the court's intervention may only be needed to formally declare that the condition contained in the contract has been fulfilled and title has passed to the plaintiff.

While, in essence, this instrument bears the closest resemblance to a conventional lease-to purchase contract, it must be distinguished from the latter in one important way. In the conventional form, at the end of the lease term, after the lessor receives its expected financial return, the asset (or the project) can be transferred to the lessee (the purchaser) at no further costs. Such an outcome is inconsistent with Islamic law, in which one of the general principles of the law of contract is the certainty of terms. The system of nominate contracts in Islamic law requires that transactions should be devoid of uncertainty. In the case of lease to purchase agreements, uncertainty arises where the parties attempt to create changes in the implications of the underlying contract of *ijara* depriving it of its form and substance. *Ijara* merely confers a usufruct of property. This cannot be affected or changed by the parties' intentions. The effect of contract of sale (*Bay'*), on the other hand, is to transfer the title to the property.

The prohibition of two contracts in one transaction has led prominent *Shi'i* jurists to doubt the legitimacy of lease to purchase agreements (Klarmann, 2004, p. 67). More recently, jurists have distinguished between two types of conditions: one in which the transfer of property forms a consideration of the contract and not a collateral event; and, a condition as a promise to perform upon the termination of the *ijara* contract. In the latter form, the condition merely creates a duty in the party who sets the condition.

The majority of *Shi'i* jurists assert that the condition in Islamic lease to purchase agreements is *Shari'a*-compliant only where it represents a promise to perform (Lankarāni, n.d: 312; Mousavian and Farahani Fard, 2007, p. 78). The promise creates a unilaterally binding commitment by the lessor (in this case the SPV) to give the property back to the lessee. This is normally carried out through the contract of *Sulh*, which will be dealt with in the following section.

Termination of lease: contract of Sulh

In *ijara sukuk*, there are two uses of *Sulh*. The first use is as a binding contract between the SPV and the seller. Under this contract, the seller will be bound to supply the asset, and make the payment in due time (*the Sukuk Regulation*, Article 15(1)(5)). Second, *Sulh* is used at project completion. In fact, performance under the *ijara* contract is only completed when the lessor enters into a contract of *Sulh* with the lessee at lease end.

Unfortunately, in this paper, it is not possible to examine all the aspects of the *Sulh* contract. Nor is it possible to make an in-depth comparison between *Sunni* and *Shi'i* perspectives on this type of contract. Briefly, it can be said that, while in *Sunni* law,

Sulh is a method for fair resolution of disputes, in *Shi'i* jurisprudence, *Sulh* is a distinct type of agreement that can be used in non-dispute situations (Najafi, n.d.a, b, p. 212).

In effect, the *Sulh* contract has the same effect as other nominate contracts such as *Bay'* and *ijara*. It can be used as a means to transfer ownership or usufructuary rights. But *Sulh* does not create the same rights as nominate contracts do. For instance, the right of rescission due to delay in payment does not arise in *Sulh* and the delivery of goods is not a requirement for *Sulh* to be valid. *Sulh* can have unilateral or bilateral status. In a bilateral *Sulh*, the lessee will guarantee that the lessor receives a price (usually, a specified residual value) in exchange for the transfer of title to the lessee. Under Iranian tax law, unilateral *Sulh* transactions for transfer of land are exempt from transfer tax (*the Direct Tax Act of Iran* (1987), Article 63).

From a contract law perspective, the main advantage of *Sulh* lies its flexibility since, unlike other types of contract, it does not prescribe a fixed form or formula for the transaction. Thus, for *Shi'i* jurists and lawyers *Sulh* is deemed fit for freedom of contract to be preserved (Katouzian, 1994a, b, pp. 304-6).

With respect to lease to purchase contracts, *Sulh* is used to deal with inadequacies of the traditional *ijara* contract or to avoid the absurd or unreasonable results that would follow from using other mechanisms such as gift, which was used in the Qatar Global *sukuk* structure. There, the contract included a binding promise to give the asset (land) back as a gift to the state of Qatar at the end of the lease (El-Gamal, 2006, pp. 110-11). As El-Gamal points out, "the bindingness of a promise to give a gift is itself questionable" in Islamic law (El-Gamal, 2006, p. 112). The problem that would arise from this uncertainty is that:

> [. . .] a group of investors may gain ownership of all the trust certificates and then argue that it is contrary to *Shari'a* rules to force them to give the gift when the lease expires (El-Gamal, 2006, p. 112).

This is exactly where the role of the *Sulh* becomes significant. There is little doubt about the consistency of *Sulh* with *Shari'a*. In addition to a number of references to *Sulh* in Koran (the Koran, 4/128, 8/8, 4/35, 49/49), the bindingness and rules governing *Sulh* are drawn from the traditions of the Imams (*Rawāyā*). Moreover, in *Sulh*, the owner passes ownership in property to the assignee (used for lack of a better equivalent in English), while, at the same time, waiving his or her right to dispute the assignee's ownership (Katouzian, 1994a, b, p. 362). Therefore, arguments such as the one concerning the enforceability of contract are ruled out in advance.

The non-fulfilment of the condition to conclude the *Sulh* contract would be a breach of the *ijara* contract. If the contractual duty is not fulfilled, the party who made it is subject to the sanctions of a court. The court may arrogate that duty to itself and purport to fulfil that duty on behalf of the party in default by declaring the title or rights that the party has in respect of the property (Katouzian, 1997, p. 129).

There is a crucial point to emphasize here. The inclusion of the condition obliging the lessor to transfer title to the property through *Sulh* to the lessee once the latter has fulfilled his or her rental obligations does not recharacterize the *ijara* contract as a contract of sale. That is to say, the effects and implications of an *ijara* leading to transfer of title remain the same as the traditional *ijara* contract in Islamic law. As a result, the lessor (the would-be vendor) will continue to carry the burden of the risk and

will assume all of the expenses and liabilities associated with the asset of the lease, except those caused by the lessee's negligence.

In practice, however, the banks require the lessee to cover most or all of the operating expenses including insurance, registration, maintenance and repair costs, as well as any licence fees if applicable (The National Bank of Iran, 1997).

IV. Conclusion

The *ijara sukuk* as developed in the Iranian banking system under the *sukuk* regulation is a combination of asset-based and bond financing. Iranian banks, in the 25 years since Islamic banking was introduced in the country, include mechanisms to ensure the timely performance of lease terms, tax benefits and more respect for the principle of freedom of contract.

Particularly innovative in the *sukuk* regulation are its provisions on transfer of ownership and risk allocation, as well as maintenance arrangements. The innovative approach taken by the *sukuk* regulation can only succeed if the legal system within which it operates is able to adjust to new circumstances of the marketplace while retaining its underlying values. The examination of the *Shi'i* jurisprudence on the contract of *ijara*, which has found expression in Iranian positive law, shows that such an adjustment can be accomplished. It has been shown how obstacles to the legitimacy of lease-to-purchase agreements have been overturned by relying on a more flexible interpretation of contractual conditions. In another case, *Shi'i* clerics have decided that a contractual condition allowing for interest to be charged for late payment of rent is valid and can be enforced against the party in default. None of these views, however, is based on the classical jurisprudence. Rather, they are based on new interpretations of old principles driven by the practical exigencies of the new economic environment.

It is increasingly acknowledged by the *Shi'i* jurists that the role of the jurist is not limited to describing what *Shari'a* law was, but what it ought to be now without departing from the spirit, essential principles and scope of *Shari'a*. Judicial activism in the Muslim world has been a key facilitator for the innovation and growth in Islamic financing. The formulation and implementation of the *Ijara Sukuk* supports the argument that *Fiqh* continues to be attentive to the needs of the banking industry and market forces. While significant in its own right, the practical consequences of this approach for efficient implementation of the *sukuk* form remain to be seen.

Notes

1. As on January 2009, no official English translation of the *Regulations* has been published. All translations are the author's (Hamshahri Online, 2009; The Iranian Securities and Exchange News Agency, 2008a).
2. Abbas Mousavian, the cleric member of the Board of the ISEO observes that the *sukuk* structure is *Shari'a*-compliant "because of its compatibility with human reason, which indicates that it is endorsed by Islam" (The Iranian Securities and Exchange News Agency, 2008b).
3. The passing of legal title may also occur in exchange for an agreed sum of money, or on the basis of the difference between the market value of the asset and the total amount of rent paid by the originator (lessee).
4. "Honour your agreements", *The Koran*, 5/1; the *hadīth* by the Prophet: Al-Horr Al-Ameli (1993).

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