9.61 *The 'MD&A'*: This is the management's discussion and analysis of financial condition and results of operations.[20] This section should go into significant detail about the factors that affect the project's results of operations, such as market pricing mechanisms, interest or exchange rate fluctuations, types of costs unique to the project, and occurrences or trends that could impact revenues or expenses. This section should also describe the critical accounting policies—those policies followed by management for which management must use discretionary judgment. To the extent that historical financial statements exist, income statement, balance sheet, and cashflow line items should be compared over a historical period (usually two or three years), with detailed commentary explaining movements and trends in each line item.[21]

9.62 *A description of the issuer's management team and board of directors*: Usually, this section includes short biographical descriptions of the senior management, including age, educational background, and professional experience. Note that in a deal registered with the SEC, specific details of management and director compensation would need to be disclosed.

9.63 *Description of shareholders/sponsors*: Depending on the transaction structure, where a project is heavily dependent upon sponsors' shareholders, disclosure about those shareholders may be necessary to ensure a fulsome description of the entire project. In particular, financial guarantees, completion guarantees, and any other credit support provided by a sponsor will need to be described. For further details about completion guarantees, see Chapter 11.

9.64 *Related party transactions*: Related parties to a project company include its controlling shareholders—the sponsors—and its senior management and directors. This section is intended to disclose relationships that may exist between the project company and these related parties in addition to their primary roles. For example, a sponsor may be a controlling shareholder but also have other roles such as that of a supplier of construction or operating services, a supplier of raw materials and utilities, or an off-taker. The disclosure of these additional roles is necessary given that they represent potential conflicts of interest such as additional ways in which a project relies upon a sponsor's performance, opportunities for a sponsor to extract revenue from the project ahead of debt service payments on the bonds, or the potential for below-market sales to the sponsors. As another example, if a director is also part of the management for a services provider to the project, a potential

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[20] The SEC has published detailed guidance as to the purpose of the MD&A, which describes at length the types of disclosure that should be considered for inclusion in this section. SEC Release Nos. 33-8350, 34-48960. A copy of the release is available on the SEC website at <http://www.sec.gov/rules/interp/33-8350.htm>.

[21] Note that for a greenfield project, no historical financial information will exist. Historical financial information should be available for an existing project where expansion financing is sought in the capital markets.

conflict of interest arises. Features like this, if they exist, will be material to investors and need to be disclosed.

9.65 *Regulatory, tax and accounting matters*: To the extent material to a project or the consequences of holding a bond, the offering circular will include sections on regulatory requirements affecting the project, currency exchange controls (particularly if the project generates its revenues in a different currency from that of the bonds), foreign investment controls in the country where the project is located, special tax benefits on which the project relies, and the tax treatment of the bonds (withholding tax on interest payments, for example).

9.66 *Use of bond proceeds*: Normally, this is a brief section explaining how the bond proceeds will be applied, whether to a specific aspect or for general purposes of the project.

9.67 At the same time as the issuer and its legal counsel are working on the sections described above, the underwriters and their legal counsel will be working together to produce drafts of the sections of the offering circular specifically related to the terms and conditions of the bonds and the underwriting process, such as:

(1) Risk factors relating to the project bonds. These can include any enforcement or insolvency risks related to the issuer's jurisdiction of incorporation or the location of the project, risks related to intercreditor arrangements or subordination provisions vis-à-vis other project indebtedness and risks associated with floating interest rates or currency exchange, if applicable.
(2) The 'description of the notes' or the 'terms and conditions of the notes'.[22] In particular, this section sets forth the covenants to which the issuer will be bound and the events of default under the project bonds (see discussion below at 9.83).
(3) The 'plan of distribution' or 'subscription and sale' description, explaining the terms of the underwriting arrangements. This section provides information about the size of each underwriter's commitment, special terms of the underwriting arrangements such as restrictions on the issuer issuing other securities for a period after the bond issuance, and securities law compliance procedures to be followed in certain specific jurisdictions where the project bonds are to be offered.
(4) Bond mechanics. Several sections of the offering circular will deal with administrative details of the securities, such as transfer restrictions and clearance and settlement mechanics for trading the bonds.

[22] Practice in transactions governed by New York law is to describe the terms of the bonds in a section entitled 'Description of the Notes', the terms of which will be contained in the New York law-governed indenture. For transactions governed by English law, the terms are included in a section entitled 'Terms and Conditions', which is usually appended in its entirety to the English-law governed trust deed.

9.68 Throughout the drafting process, the issuer, the underwriters and their respective legal counsels will meet on multiple occasions for 'drafting sessions' where questions are raised and comments and suggestions are provided. Drafting sessions serve not only to improve the disclosure, but also as another form of due diligence, given that specific aspects of the issuer's business will be discussed at length. Drafting an offering circular is an iterative process that requires ongoing consideration and input and it is likely that the final draft will be very different from (and better than) the first draft.

Financial information

9.69 The offering circular generally will include,[21] to the extent they exist, two to three years of financial statements of the issuer (and sometimes those of guarantors of the bonds). These will be included at the end of the offering circular in a separate section known as the 'F pages', short for financial pages. The auditor's report on those financial statements also will be included, consent for which may be required from the auditors. If the accounts are not prepared under IFRS or US GAAP, the offering circular often will include a qualitative description of the material differences between the accounting standards under which the issuer's financial statements are prepared and either IFRS or US GAAP.

9.70 Depending on the transaction structure and, potentially, the listing requirements of any stock exchange on which the bonds may be listed, historical financial statements for the same periods may need to be included with respect to any guarantors of the bonds.

Preliminary and final offering circulars

9.71 Generally, the offering circular is completed in two stages. First, the deal team completes the preliminary offering circular, often referred to as the 'red herring'.[23] The preliminary offering circular should be complete in all respects, except that pricing-related information—total aggregate principal amount, issuance date, maturity date, interest payment dates, and yield—is not yet included.

9.72 After a roadshow and marketing (described above), the underwriters will be in a position to 'price' the deal—literally, the determination of the final offering price. Immediately after pricing, the underwriters and their lawyers will produce a final pricing term sheet, the form of which will have been pre-agreed with the issuer and attached as a schedule to the underwriting agreement.

9.73 This pricing term sheet and the preliminary offering circular together comprise the 'time of sale' information, which is considered the package of marketing materials

[23] So named because the front cover typically has a legend in red ink indicating that the offering circular is not an offer to sell securities; before inclusion of the final terms, the document cannot be considered to be the offer to sell securities, since material information is missing.

on which an investor's decision is based. The time of sale information concept has developed under US law to acknowledge the fact that the completion and circulation to investors of the final offering circular lags behind the time of pricing and, therefore as a practical matter, is not the document on which an investor makes its final investment decision. As such, disclosure liability attaches under US law to the combination of the preliminary offering circular and the pricing term sheet, and any other supplementary data used up to the time of pricing to market the bonds to investors.

9.74 After pricing, the underwriters' and issuer's lawyers will work together to insert all of the pricing-related data into the preliminary offering circular in order to create the final offering circular.[24]

Subscription/underwriting agreement

9.75 The underwriting agreement[25] is the principal contract between the bond issuer and the underwriters, pursuant to which the underwriters commit to purchase the securities from the issuer at a particular price. It will be executed after the roadshow has been completed. Until the agreement is signed, the underwriters are not legally obligated to purchase the bonds. Even after the agreement is signed, the underwriters' obligations will be subject to representations and warranties given at closing and the satisfaction of various conditions, described further below.

9.76 The agreement will establish the underwriters' commission for underwriting the transaction, which the underwriters usually recover by simply retaining the commission from the proceeds of the bond offering that are paid over to the issuer when the bond are issued. In other words, the underwriters' commission is derived from the price difference between the price they pay the issuer and the higher price paid by investors who purchase the bonds from the underwriters.

9.77 The agreement typically contains representations and warranties by the issuer regarding the business and other matters. Depending on the issuer, its industry, and its geographic location, these representations and warranties can be quite extensive and cover a broad range of topics, including, among others:

(1) the accuracy of financial statements;
(2) the efficacy of internal controls;
(3) the due incorporation of the issuer and any material subsidiaries;
(4) the due authorization of the underwriting agreement and all of the transaction agreements;

[24] For a certain period of time after the closing of the bond offering, dealers must deliver a final offering circular to 'after-market' purchasers of bonds.

[25] Often referred to as the 'subscription agreement' when governed by English law or the 'purchase agreement' when governed by New York law.

(5) the due authorization of the securities and the bond offering;
(6) the absence of defaults and conflicts of law;
(7) the absence of labour disputes;
(8) the ownership of material properties;
(9) the ownership of material intellectual property;
(10) the possession of necessary licenses and permits;
(11) environmental liabilities;
(12) off-balance sheet transactions;
(13) adequate insurance;
(14) compliance with relevant securities laws and any distribution restrictions;
(15) compliance with relevant anti-money laundering and corruption laws;
(16) compliance with 'OFAC' rules (i.e. no dealings with or in jurisdictions or parties subject to US sanctions); and
(17) related party transactions.

9.78 Also included in the representations will be the '10b-5 representation', wherein the issuer will represent that the offering circular does not contain any untrue statement of a material fact or omit to state a material fact required to be stated therein or necessary to make the statements therein not misleading. This representation is critical because it is designed to ensure that the issuer has considered the disclosure in its entirety to make certain it is complete and accurate in all material respects before publishing the offering circular.

9.79 If there is more than one underwriter, their obligations will be several and not joint, meaning each underwriter is responsible only for the share of the securities it is committed to purchase, and does not have an obligation to cover defaults by other underwriters.[26] Under the agreement, the issuer also will have to indemnify the underwriters for, among other things, losses arising from material misstatements in, or material omissions from, the disclosure in the offering circular. Such losses will also include the indemnified party's litigation expenses and legal fees.

9.80 The underwriting agreement will include customary 'MAC' and 'market-out' clauses that will entitle the underwriters to terminate the agreement (during the period between pricing and closing the bond offering as described below) if an event occurs that causes a material adverse change in the business or if a negative event, such as a banking crisis that has caused banks or stock exchanges to close temporarily in key financial centres such as New York City and London, has occurred. In practice, these termination clauses are rarely, if ever, exercised but will nonetheless be required by the underwriters.

[26] However, see the discussion at para. 9.93 below for circumstances where non-defaulting underwriters may have responsibility for the obligations of a defaulting underwriter.

9.81 The underwriting agreement will be signed at the time of the pricing of the bonds. Closing, which entails the actual issuance of bonds against payment of funds, will occur a few days later. Typical timing is to close three, five, or seven business days after pricing. In addition to the MAC and market-out clauses described above, the underwriting agreement will set forth the other conditions precedent to the underwriters' obligations at closing. These conditions precedent customarily include the following items, among others:

(1) delivery of an officer's certificate of the issuer confirming that the representations and warranties in the underwriting agreement remain true and correct at the time of closing and that no 'MAC' has occurred since the time of signing the underwriting agreement;
(2) delivery of a secretary's certificate of the issuer certifying that attached copies of the issuer's charter documents and resolutions of the board of directors approving the transaction are accurate, valid, and binding;
(3) delivery of legal opinions (as discussed below);
(4) delivery of the auditor's comfort letter (as discussed below); and
(5) all filings necessary to perfect the security package being completed (except as otherwise agreed).

9.82 As a practical matter, most of these items will have been confirmed, and drafts produced, prior to signing the underwriting agreement.

Bond trust deed/indenture and global note

9.83 Although the terms and conditions of the bonds will be set forth in the offering circular, the contractual documentation that actually binds the issuer to the terms and obligations of the bonds are contained in the indenture[27] or trust deed[28] and the note itself. The note is the formal security reflecting an obligation to repay a certain principal amount at a future date. Sometimes, specific terms of the bonds are included within the note itself. Other times, most of the terms will be included in the indenture or trust deed under which the note is constituted (and therefore the terms of which the note is subject).

Global note

9.84 An investor in a bond will not receive a physical bond certificate. Instead, the bonds will be issued in the form of a global note and holders will have individual interests in the global note which are held through an electronic book-entry system. The global note itself will be issued as a physical instrument, registered in the name of a nominee for a bank that acts as the depositary for the institution or institutions

[27] As the document is known under New York law.
[28] As the document is known under English law.

that provide clearing and settlement services—normally, The Depository Trust & Clearing Corporation ('DTC') in the US and Euroclear or Clearstream outside the US. When the bonds are traded, changes in ownership will be recorded through the electronic book-entry systems of the participants in the clearing systems and the entities for whom the participants hold interests in the global note.

Trust deed/indenture

9.85 The trust deed or indenture is a contract between the issuer (and any guarantors), on the one hand, and a trustee who represents the bondholders, on the other hand. In addition to including the basic terms of the bonds, such as principal, interest rate, interest and principal payment dates, and the maturity date, the indenture will also include, where applicable, provisions regarding optional or mandatory redemption, covenants, events of default, and amendments and waivers, as well as certain administrative provisions such as notice requirements and procedures, indemnities for the trustee and the issuer's consent to jurisdiction in the relevant court system (New York or England and Wales).

9.86 The covenants and events of default will vary with each transaction and will be impacted by the overall credit rating and position of the project. Often, project bonds will benefit from the covenants and obligations of the issuer that are contained in the 'common terms agreement'. For further details about common terms agreements, see Chapter 7. In other cases, the bonds may be completely separate from the covenant structure of the rest of the project financing.

9.87 Some bonds may contain covenants/restrictions with respect to any or all of the following:

(1) the future incurrence of additional indebtedness;
(2) the making of certain kinds of investments or 'restricted' payments, such as dividends or certain other types of distributions;
(3) ongoing reporting to bondholders of financial and operational results;
(4) mergers and acquisitions;
(5) asset disposals; and
(6) operational covenants, such as maintenance of the project and its assets, compliance with applicable laws and regulations, maintenance of insurance coverage, and maintenance of supply and off-take agreements.

9.88 In addition, some bonds may require the issuer or the project group to meet certain financial ratios based on leverage or interest cover thresholds.

Intercreditor arrangements

9.89 Depending on the transaction structure, it is likely that the bond trustee will be party to the intercreditor agreement, which governs interactions and the relative positions among the project's various groups of lenders, in particular with respect to their respective rights

to exercise remedies if the issuer breaches its obligations or other events of default occur. For further details about intercreditor agreements, see Chapter 7.

Security documents/collateral deed

9.90 As with other types of project finance, project bonds are usually secured by the underlying project assets. In addition, the shares of the issuer usually will be pledged to the bondholders. For further details about project finance security arrangements, see Chapter 11.

Auditor's comfort letter

9.91 The comfort letter is a document provided by the issuer's auditors at the time of signing of the underwriting agreement and again at the closing of the bond offering. The comfort letter is addressed to the underwriters and often to the board of directors of the issuer. This letter provides 'comfort' that certain financial information contained in the offering circular has been audited and that certain tests and procedures have been undertaken by the accountants with respect to the period subsequent to the date of the latest financial statements (whether annual or interim) included in the prospectus. Based on these procedures, the auditors essentially confirm that they have compared certain financial information in the prospectus with the books and records of the issuer and that the numbers agree. The auditors also will provide 'negative assurance' that their procedures have not uncovered any undisclosed specified events, such as the incurrence of material new debt or material losses or other events affecting stockholders' equity, since the date of the last published financial statements.[29]

9.92 The comfort letter is one critical element for underwriters in building a due diligence defence, as it helps to demonstrate that due diligence was performed on the financial information disclosed in the offering circular. As mentioned above, and related to the comfort letter process, the underwriters will often request a due diligence meeting with the issuer's auditors to inquire about matters such as the quality of the issuer's internal control structure, the openness of management in the audit process, any disagreements between management and the auditors about accounting treatment, and prior audit adjustments. Recently, auditors have become reluctant to participate in such sessions due to concerns about liability. In some cases, the auditors will only participate if the underwriters sign a 'hold harmless' letter absolving the auditors of legal liability in connection with statements made by the auditors in such a session.

[29] For a Rule 144A deal, the standard form of comfort letter is dictated by Statement on Auditing Standards 72 (better know as SAS 72) as promulgated by the Auditing Standards Board of the American Institute of Certified Public Accountants. Another common form, used sometimes for transactions wholly outside the US, is the form of comfort letter published by the International Capital Markets Association (ICMA).

Agreement among underwriters

9.93 As mentioned above, many transactions, particularly higher value bond issuances, tend to have multiple underwriters. In such cases, it is common for a subset of the underwriters to be responsible for underwriting a larger proportion of the overall transaction and, therefore, to take the lead in managing the transaction on behalf of the other underwriters. In such circumstances, the underwriters often enter into a formal 'Agreement Among Underwriters' or AAU. This agreement sets the parameters of responsibilities, effectively delegating authority to the lead underwriter or underwriters to manage the transaction. The AAU may also provide for 'defaulting underwriter provisions', which set forth the extent to which the underwriters may have to cover the individual underwriting commitment of an underwriter who defaults on such commitment.[30]

Role of legal counsels and legal opinions

9.94 On a typical transaction, the issuer and the underwriters will each be represented by international counsel (usually with US and/or English law capability, as most international project bonds are issued under New York or English law). In addition, the issuer and the underwriters will have counsel in the project jurisdiction, which will take the lead on, among other things, security governed by local law, non-English due diligence, and domestic corporate matters. To the extent the transaction has other requirements, such as multiple jurisdictions, or the need for special counsel on, for example, tax issues, additional sets of legal counsel may be required.

9.95 As part of the bond offering process, the counsels will issue legal opinions at the time of the closing of the bond offering, which together will cover corporate matters such as enforceability of the bonds, the indenture, the subscription agreement and the security, corporate authorizations for the transaction, and validity of the choice of law (i.e. New York or English), as well as any other legal matters specific to the transaction.

9.96 In addition, for a Rule 144A bond offering into the US, the underwriters will require both their US counsel and the issuer's US counsel to issue '10b-5 disclosure letters' as part of fulfilling their own due diligence defence requirements.[31] Often mentioned in shorthand as '10b-5 opinions', such letters are not actually opinions of law. The 10b-5 disclosure letter will cite the work performed by the law firm as part of its due diligence and then state that nothing has come to the attention of that law firm that causes it to believe that the disclosure contained or contains an

[30] Usually the lead underwriter(s) will have twenty-four hours to find replacement purchasers to cover the defaulting underwriter's commitments. If the lead underwriter is unable to make any such arrangements, and if the defaulted securities commitment does not exceed 10 per cent of the total, then the other underwriters are usually obliged to purchase the defaulted commitment in an amount proportionate to their share of the total underwriting.

[31] See the discussions above regarding Rule 10b-5 and the due diligence defence.

untrue statement of a material fact or omitted or omits to state a material fact necessary in order to make the statements therein, in the light of the circumstances under which they were made, not misleading.

9.97 This 10b-5 statement will speak as of the time of the final offering circular and usually as of the earlier date of the 'time of sale' information, which refers to the time at which an investor had all information in order to make an investment decision. As described above, this point in time generally occurs when the investor has received the preliminary offering circular plus the pricing term sheet, as the investment decision is completed before receipt of the final offering circular. Note that law firms will usually carve out from coverage under the 10b-5 statement any financial, accounting, statistical, and other information that is provided by other professional experts such as auditors and engineers.

Listing

9.98 Often, bonds will be listed on a stock exchange. Such listings are undertaken primarily to accommodate certain large institutional investors, such as pension funds, that, as a matter of regulation or corporate governance provisions, are restricted in their ability to invest in unlisted securities. Listing the bonds therefore can facilitate their placement with a wider range of investors. Listings are not undertaken to facilitate trading and few project bonds actually trade over exchanges. Such listings are often referred to as 'listings of convenience'. Project bonds may be listed on many different exchanges, though commonly they are listed on one of the markets of the London Stock Exchange, the Luxembourg Stock Exchange, or the Irish Stock Exchange.

9.99 The listing rules of the relevant stock exchange will impact the disclosure required to be included in the offering circular. As a general matter, though, offering circulars that follow US-style disclosure requirements should cover disclosures required by the relevant exchange. Certain 'unregulated' exchanges in Europe permit issuers who are targeting only sophisticated institutional investors (as are most project bond issuers) to opt-out of the more rigorous disclosure requirements under European regulations, such as the Prospectus Directive, that are aimed at protecting small-scale retail investors.

9.100 Depending on which exchange a listing is sought, the issuer may need to engage a listing agent to help navigate the listing application process through the exchange. The listing agent can provide guidance as to the more mechanical and administrative requirements that need to be met in order to facilitate a smooth application process. In conducting their review of the offering circular in advance of approving the bonds for listing, most exchanges will not comment on the quality of the disclosure included in the offering circular, but rather will focus only on whether or not specific technical requirements of the exchange's listing rules have been satisfied.

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10

ISLAMIC PROJECT FINANCE

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Introduction

10.01 With approximately 1.5 billion adherents, the global population of Muslims equates to over 22 per cent of the world's population.[1] This, in conjunction with the rapid growth in the wealth of many Middle Eastern countries and the trend of a significant number of governments, financial institutions, and individual Muslims of investing in a manner which is consistent with Islam, means Islamic finance has now moved from the niche to the mainstream. Islamic finance is concerned with the conduct of commercial and financial activities in accordance with Islamic law.

10.02 In the Middle East and parts of Asia, a growing proportion of the financing for projects is sourced in accordance with Islamic finance principles. With traditional

[1] 'Mapping the Global Muslim Population, A Report on the Size and Distribution of the World's Muslim Population' October 2009, Pew Research Centre.

project finance structures being rooted in conventional interest-based systems, the manner in which risks are allocated and transaction structures are implemented needs to be reassessed as the investment of the Islamic-compliant participant will no doubt be conditional on compliance with Islamic finance principles. Structuring the investment of such capital therefore requires a comprehensive understanding of Islamic finance principles, knowledge of international and domestic laws and documenting such arrangements in a manner that satisfies the priorities of all the project participants including those not necessarily constrained by Islamic finance principles.

10.03 This chapter analyses how these priorities are accommodated and how Islamic finance techniques are applied in project financings. Context is paramount to achieve this aim, and so by way of introduction, the sources of Islamic finance are discussed, followed by a brief analysis of the principles and financial techniques that underpin Islamic finance. For those unfamiliar with Islamic finance principles, this will enable a better understanding of the ensuing discussion of the issues that commonly arise in a project financing that is entirely or in-part financed with Islamic compliant funding. Then, the focus is turned to assess how Islamic project finance techniques are utilized in practice, including how such arrangements are documented.

Sources of Islamic Finance[2]

10.04 Islamic finance is concerned with the conduct of commercial and financial activities in accordance with Islamic law. Islamic law is a manifestation of the divine will of Allah (SWT) and finds its expression in the *Qur'an* (Book of Allah (SWT)) and *Sunnah* (words or acts) of the Prophet (PBUH). The *Qur'an* is the most sacred canonical text in Islam and perceived by Muslims as the word of Allah (SWT) for which reason it is a primary reference for Muslims and is inviolable.[3] The *Sunnah* is comprised of all the sayings, acts and approvals (tacit or otherwise) of the Prophet (PBUH)[4] as compiled by the *Sahabah* (closest companions of the

[2] Throughout this chapter, the term 'SWT' follows the name of Allah (SWT) (which means 'praise and exaltation') and the term 'PBUH' (which means 'Peace be upon Him and His Family') follows the name of the Prophet Muhammad (PBUH). Also, following the names of other venerable Muslims, the term 'RA' (which means 'May Allah (SWT) be pleased with him') is used. These are terms used by Muslims as a mark of veneration and respect.

[3] The *Qur'an* must be interpreted in light of the exegesis (*Tafsir* and plural *Tafasir*) of the *Qur'an*, the most notable being Imam as-Suyuti's (RA) *Tafsir, Ad-Durr al-Manthur Fi't-Tafsir Bi'l Ma'thur*.

[4] Each saying, act, or approval of the Prophet (PBUH) is called a *Hadith* (singular of *Ahadith*) and these have been collated according to stringent rules most of which are documented in the six canonical collections (*as-Sihah as-Sittah*) which include *Sahih Bukhari, Sahih Muslim, Sunan al-Sughra, Sunan Abu Dawood, Sunan al-Tirmidhi*, and *Sunan Ibn Majah*.

Prophet (PBUH)).[5] The law contained in both of these primary sources is known as the *Sharia'a* which means 'the road to the watering place [and] the clear path to be followed'. Reflecting the *Qur'an* and *Sunnah*, *Sharia'a* is therefore a compilation of the values, norms, and rules which govern all aspects of a Muslim's life (such as family life and economic activities). *Sharia'a* is pervasive in that a Muslim is obliged to comply with *Sharia'a* at all times and in all respects:

> Then We placed you on the right road [*Sharia'a*] of Our Command, so follow it. Do not follow the whims and desires of those who do not know. (*Qur'an*, *Surah Al-Jathiyah* 45:18)

10.05 Notwithstanding its breadth (as exemplified in figure 10.1), *Sharia'a* is not amply codified to rule on every matter that may arise in contemporary scenarios since the *Qur'an* and *Sunnah* were settled over 1,400 years ago. *Sharia'a* has, however, remained relevant and addresses the myriad of original situations through the use of secondary sources that are based on *Ijtihad*[6] namely:

(1) *Ijma*: consensus of the independent jurists qualified to exercise *Ijtihad* (a *Mujtahid*) on a particular interpretation of the *Sharia'a*; and
(2) *Qiyas*: interpretation by analogical reasoning where one situation is measured against another by the *Mujtahid*s, in each case subject to and in accordance with the *Qur'an*, *Sunnah* and *Ijma*.

The principles derived from the application of *Ijma* and *Qiyas* to the *Sharia'a* form the body of jurisprudence known as *Fiqh* (understanding and knowledge applied to any branch of knowledge). The body of rules that underpin the derivation of *Fiqh* is referred to as *Usul al Fiqh*.[7]

10.06 Certain *Sharia'a* principles may be ambiguous not least because of the numerous *Tafasir* of the *Qur'an* and the voluminous *Ahadith* as well as the *Mujtahid*s involved in the practice of *Ijtihad*, interpreting the *Sharia'a* in different yet equally permissible ways because of the interpretation methodologies they may apply. This means that often there can be different legal opinions (*fatawa*) on the same aspect of the *Sharia'a*. This difference of methodology for interpreting the *Sharia'a* and the body of *fatawa* derived thereby, is one reason why there have developed several schools of

[5] Of the *Sahabah*, Imam Ali ibn Abi Talib (AS) has contributed significantly to the development of the *Tafasir* of the *Qur'an*, *Fiqh*, *Usul al Fiqh* and the Islamic normative sciences. The contributions of Imam Ali (AS) have been such that the Prophet (PBUH) was reported to have said in the *hadith* narrated by Ibn Abbas (RA) as is documented in *Al-Mustadrak alaa al-Sahihain Hakim*, that 'I am the city of knowledge and Ali is its gate'.

[6] *Ijtihad* means the individual interpretation of *Sharia'a* principles by *Mujtahids* to infer expert legal rulings from foundational proofs within or without a particular *Madhab*.

[7] For a general discussion on *Usul al Fiqh*, see Prof Ahmad Hasan, *The Principles of Islamic Jurisprudence, the Command of the Sharia'ah and Juridical Norm* (Adam Publishers & Distributors, 2005).

thought/*Fiqh* (*Madhabs*) to which a *Mujtahid* would ordinarily be aligned. The renowned *Madhabs* are:

(1) *Hanafi*, founded in Kufa, Iraq by Imam Abu Hanifa Nu'man Ibn Thabit (RA)[8] and based largely on logical deduction by the *Mujtahid*s;
(2) *Maliki*, founded in Medina, Saudi Arabia by Imam Malik ibn Anas (RA);[9]
(3) *Shaf'i*, founded by Imam ash-Shaf'i (RA);[10] and
(4) *Hanbli*, founded by Imam Ahmed Bin Hanbal (RA)[11] which is predominate in the Arabian peninsula and is perceived as the more doctrinal of the *Madhabs*.

As *Fiqh* is law derived by *Mujtahid*s interpreting the *Sharia'a* in accordance with the methodology ascribed by a *Madhab*, differences on a matter relating to *Fiqh* is inevitable but there can be no difference on the *Sharia'a* itself, as this is law derived from the *Qur'an* and *Sunnah*.

10.07 With respect to these differences, the Prophet (PBUH) was reported to have said, 'My community's differences of opinion (*ikhtilaf*) are a blessing'[12] and evidently this process has derived a comprehensive corpus juris providing guidance on almost every facet of a Muslim's life (see figure 10.1). For commercial organizations, however, the various methodologies of interpreting the *Sharia'a* and the different *fatawa* derived as a result mean that in order for them to determine the legitimacy

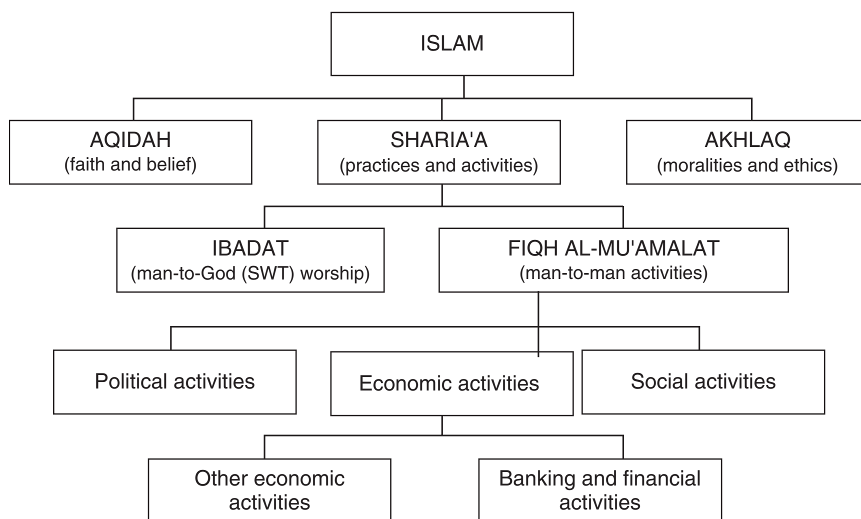

Figure 10.1 Islamic Construct

[8] (80-150 AH / 699-767 CE). Imam Abu Hanifa (RA) is known in the Islamic world as 'The Greatest Imam' (*al-imâm al-a`zam*) and his school has assisted with the development of the principles of Islamic finance not least because of its application of *Qiyas*.
[9] (93-179 AH / 712-795 CE).
[10] (150-204 AH / 767-820 CE).
[11] (164-241 AH /780-855 CE).
[12] *Al-Jami as-asghir*, Jalal ad-Din as Suyuti.

of a particular commercial activity with the *Sharia'a*, they may need to seek expert guidance.

The role of Sharia'a scholars and regulators

10.08 This has led to the role of specialist *Sharia'a* scholars and *Sharia'a* advisory firms rising to prominence. Most banks, sponsors and *Sharia'a*-compliant funds retain independent *Sharia'a* scholars (who are usually renowned in the relevant domestic market) and who sit as a *Sharia'a* board to issue *fatawa* certifying the compliance of a transaction structure or a financial product, for example, with the *Qur'an*, *Sunnah*, and typically a specific *Madhab*. The duties of the *Sharia'a* board include:

(1) assisting in the development of products and structuring transactions;
(2) issuing *fatawa* relating to certain activities, products, or transactions having reviewed their legitimacy from a *Sharia'a* perspective;
(3) day-to-day oversight of the operations of the institution to ensure *Sharia'a* compliance; and
(4) providing a letter on an annual basis to indicate *Sharia'a* compliance by the institution for inclusion in its annual report.

10.09 This approach of retaining independent *Sharia'a* scholars became the subject of some criticism since it appeared to result in a lack of harmonization and hampered the development of common principles across international and even domestic financial markets. This had the ancillary effect of undermining regulatory confidence in Islamic finance. In order to mitigate this, bodies of interpretation such as the *Sharia'a* Supervisory Board and the Islamic *Fiqh* Academy, endeavour to issue *fatawa* to deal with contemporary issues that may arise in the Islamic finance context. And in order to systematize and regulate Islamic finance with the intention one day to have globally accepted *Sharia'a* standards for Islamic finance transactions, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the International Islamic Financial Market (IIFM), and the Islamic Financial Services Board (IFSB) are playing a prominent role. Their issuance of practice directions and standards for accounting have gone some way towards becoming global standards and thereby instilling investors with confidence to invest in *Sharia'a*-compliant products. This chapter will consider Islamic project finance structures that are compliant with the core consensus of Islamic scholars and these leading regulators.

Islamic Finance Principles

10.10 Akin to Western legal systems, in Islam there is a presumption that everything is permissible (*halal*) unless there is an express law which rebuts that presumption by declaring it as forbidden (*haram*). Financiers are therefore expected to carry

out their activities subject to and in accordance with *Sharia'a* principles. The pertinent *Sharia'a* principles that relate to Islamic finance are that the following are avoided in any transaction: *riba* (excess or increase); *gharar* (uncertainty); *maisir* (speculation); and *qimar* (gambling). Two other general *Sharia'a* principles that apply are the prohibition on investing in or being involved with *haram* products and activities (such as alcohol and gambling establishments) and the prohibition of becoming unjustly enriched.[13]

10.11 *Riba* has been declared *haram* on numerous occasions in the *Qur'an*[14] and *Sunnah*.[15] *Riba* means any excess paid or received on the principal or an additional return received on the principal derived by the mere passage of time.[16] There are two types of *riba*; *Riba al-Naseeyah* (a pre-determined premium on the principal received by a lender solely due to the passage of time) and *Riba al-Fadal* (excess compensation received by one party from an exchange or sale of goods without adequate consideration). Interest paid on a conventional loan is a form of *Riba al-Naseeyah* and certain exchange of commodities contracts may contain *Riba al-Fadl* if on an exchange of commodities of similar value, one party pays excessive compensation to the other party. The philosophy behind the absolute prohibition of *riba* (which has the effect of rendering any contract harbouring *riba* as being void), is that *Sharia'a* regards money as having no intrinsic value in itself (unlike commodities such as gold, silver, dates, and wheat) and is merely a means of exchange to procure goods and services. Money cannot therefore derive a profit either from the exchange of money of the same denomination or due to the passage of time as is the case with interest.

10.12 *Sharia'a* by no means prohibits the making of profit, but it does scrutinize the basis upon which profit is made as, for example, charging interest could exploit the client in a time of hardship whilst the financier's wealth is increased by no effort of its own. Islam instead empowers the financier to derive a profit by investing its money or other consideration directly (or indirectly through a joint venture arrangement, for example) in real assets using one or more of the Islamic finance techniques discussed below.[17] The financier will then generate a profit and recoup the principal sum invested in the asset by exercising its rights as an owner; using, leasing, or selling the asset. Here, unlike conventional finance, the money itself has not yielded the profit; instead the assumption of the risks and responsibilities as owner of the

[13] For example, if a financier charges a late payment fee when their client is in default, this is not typically retained by the financier and is instead donated to charity.

[14] *Qur'an*, *Surah Al Baqara* 2:275, *Qur'an*, *Surah Al Baqara* 2:276-280, *Qur'an*, *Surah Al-Imran* 3-130, *Qur'an*, *Surah An-Nisa* 4:161, and *Qur'an*, *Surah Ar-Rum* 30:39.

[15] *Majma al-Zawa'id*, Ali ibn Abu Bakr al-Haythami (vol 4, 117).

[16] For a detailed study of *riba* and a discussion of the related *fatawa* of the various *Madhabs*, see Wahbah Al-Zuhayli, *Financial Transactions in Islamic Jurisprudence* (tr. Mahmoud A. El-Gamal; rev. Muhammad S. Eissa) (Dar Al-Fikr, 2003), Vol. 1, Chapter 10 ('Al-Zuhayli').

[17] See paras 10.14–10.22 below.

asset or as a partner in the venture has yielded the profit made by the financier. This depicts the preference of Islamic finance for equity over debts and seeking to deal in tangibles and explains why Islamic finance is often referred to as a form of asset-backed financing. Therefore, in facilitating financing arrangements, if the client requires money for a profit-seeking venture, the client and the financier enter into an equity-sharing arrangement and if the client requires money for an asset, rather than simply loaning the money, the financier purchases the asset outright from the supplier and sells it on to the client for a profit.

10.13 *Gharar* can be defined as the sale of probable items whose existence or characteristics are uncertain or speculative (*maisir*), the risk of which makes it akin to gambling (*qimar*).[18] The rationale for prohibiting *gharar* and *maisir* stems from the belief that bargains should be based upon contractual certainties as far is possible in order to bring about transparency and avoid conflict over key terms of a contract such as the object, the quality of goods, the time for delivery, and the amount payable. Contemporary examples of *gharar* include: the sale of an object prior to it coming into existence, which subject to certain exceptions,[19] would render the contract as void; where the object is unknown; where the specifications of the object are unknown; and where the price or rent cannot be ascertained with certainty.

Islamic Finance Techniques

10.14 Profit and loss sharing forms the bedrock of Islamic finance since Islam perceives that the ideal relationship between contract parties should be that of equals where profit and losses are shared. *Mudarabah* (investment fund arrangement) and *Musharaka* (joint venture arrangement) are two finance techniques which facilitate this priority. With the need for diversity in risk/return profiles and conventional lender reluctance to enter into a profit and loss arrangement where the lender would otherwise expect the client to remain liable for the principal and interest regardless of how the venture performs, certain traditional Islamic trading techniques have been adapted which, to an extent, are *Sharia'a*-compliant versions of conventional finance products. These include *Murabaha* (cost plus financing), *Istisna'a* (commissioned manufacture of a specified asset), and *Ijarah* (lease purchase finance). Finally, a key source of *Sharia'a*-compliant financing is the *Sukuk* (trust certificates), which have similarities to conventional bonds. The focus of this chapter will be on the *Istisna'a* and the *Ijarah* structures as these techniques form the building blocks of

[18] For a detailed discussion of *gharar,* see Al-Zuhayli 82–7.

[19] Examples of Islamic forward contracts include *Bai Salam* and *Istisna'a*. On the other hand, conventional forward contracts and futures are not permitted as the object of the sale may not exist at the time the trade is to be executed and are therefore also considered akin to *qimar*.

the single tranche and the multi-tranche *Sharia'a*-compliant transactions which are discussed below.

Mudarabah

10.15 A *Mudarabah* is an investment fund arrangement under which the financiers act as the capital providers (*rab al-mal*) and the client acts as the *mudareb* (akin to an investment agent) to invest the capital provided by the *rab al-mal* and manage the partnership. The profit of the venture, which is based on the amount yielded by the fund that exceeds the *rab al-mals*' capital investment, can be distributed between the parties at a predetermined ratio but with any loss (subject to whether the loss is caused by the *mudareb*'s negligence) being borne by the *rab al-mal*. The fund is controlled by the *mudareb* with the *rab al-mal* as a silent partner. In practice, however, conventional investment agency arrangements are used instead of the *Mudarabah* enabling the *rab al-mal* to exercise further control over the fund and potentially to limit the discretion of the *mudareb* when it comes to investing the capital, for example.[20]

Musharaka

10.16 In a *Musharaka*, the financing arrangement is similar to a *Mudarabah* except that the losses are borne in proportion to the capital invested by both the client and the financier. Each party to the *Musharaka* has the right to participate in the affairs of the enterprise but each can also choose to waive that right and instead be a silent partner as in a *Mudarabah*.[21] However, the silent partner will then only be entitled to profits in proportion to its capital investment and not more. Under a 'Continuous *Musharaka*', each partner retains its share of the capital until the end of the project or in the case of a 'Diminishing *Musharaka*' (*Musharaka Muntahiya Bittamleek*), it is agreed at the outset that one of the partners will purchase units in the *Musharaka* from the other partner at a pre-agreed unit price.

Murabaha

10.17 A simple *Murabaha* transaction involves the purchase of an asset by the financier (on behalf of the client) who then sells the asset to the client for the cost of the asset plus a pre-stated margin on a deferred payment basis which may be pegged to a benchmark such as LIBOR.[22] The profit margin earned by the financier is legitimate profit and not interest because the financier acquires ownership of the asset (and therefore the risk associated with ownership of the asset) before on-selling it to

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[20] For a detailed discussion of *Mudarabah*, see Al-Zuhayli, Chapter 28.

[21] For a detailed discussion of *Musharaka*, see Al-Zuhayli, Chapter 21.

[22] Where the financier does not disclose the cost of the asset and the value of the margin charged, such a transaction is called a *Musawama*. The *Musawama* has recently been adopted in the context of *Sharia'a*-compliant hedging.

the client. The client is also not bound to accept delivery of the asset, although in practice, the financier will mitigate this risk by seeking a letter of credit, a good faith down-payment (such as *arbun*),[23] or a unilateral purchase undertaking from the client. This transaction is effected through a *Murabaha* contract which reflects a conventional sale and purchase agreement. Upon acquiring ownership of the asset, the client may go a step further and sell the asset to a third party for cost price so that the client now has the money it may have always wanted (rather than the asset) whilst it remains liable to the financier to pay the cost-price of the asset plus a pre-stated margin on a deferred payment basis. In this case, the underlying asset could be a base metal such as copper, but not commodities which were originally used as a means of exchange or money such as gold, silver, and wheat. For larger transactions, it may not be possible to purchase the required amount of commodity on, for example, the London Metals Exchange and so an alterative is to acquire shares in a publically trading company since shares represent an ownership interest in the relevant company. This variation of the simple *Murabaha* is commonly referred to as 'Commodity *Murabaha*'.[24] In the project financing context, there has been a recent trend to utilize the Commodity *Murabaha* to provide both working capital funds required by a project company and equity contributions that a sponsor is obliged to make to a project in a *Sharia'a*-compliant manner.[25]

Istisna'a

10.18 An *Istisna'a* is a construction and procurement contract for the commissioned manufacture of a specified asset and can be used during the construction phase of a project financing. Here, following a request from the client, the financier procures the contractor to manufacture an asset which meets the specifications of the client for delivery by a specified date. The financier will in practice appoint the client as its *Wakil* (agent) (which can be facilitated pursuant to a *Wakala* agreement) to enter into the EPC contract with the contractor. *Sharia'a* requires that the price payable for the asset is fixed at the outset (but not necessarily paid in full at this point) and only altered if the specification of the asset is amended by the client. The date on which and the proportion of the price payable will usually be the same as the

[23] Note, however, that the majority of the *Mujtahids* have ruled that an *arbun* is a forbidden type of sale for contradicting the *Sunnah* and containing *gharar* as the buyer of the asset may or may not purchase the asset at a future date (see Al-Zuhayli, 99–100). Recently, *arbun* has been used to mirror conventional covered call options giving the holder the right to buy a fixed quantity of an underlying asset on or before a specified date in the future.

[24] A variation of Commodity *Murabaha*, which is referred to as *Tawarruq,* is where the intention of the client is not to own the commodity but to sell it instantaneously and obtain the required funds using one single transaction where the bank buys from, and sells the commodity back, to the broker as the client's agent. *Tawarruq* is considered to be a *makruh* (reprehensible) sale in the opinion of Imam Malik (RA); however it has been accepted as a financing technique by contemporary *Sharia'a* scholars in the absence of a viable alternative.

[25] See para. 10.63 below.

milestone payments due under the EPC contract. Although the client will contract under the EPC contract as a *Wakil*, there will not be privity of contract between the client and the contractor once the asset has been constructed, so the warranties given by the contractor to the financier in respect of the asset in respect of defects to the assets, for example, will be assigned to the client. The manufactured asset must be accepted by the client if it meets the given specifications. Once the asset has been constructed, title to the asset must be transferred by the contractor to the financier, who will then either sell the asset to the client outright or alternatively lease the asset to the client pursuant to an *Ijarah*.

Ijarah

10.19 The *Ijarah* is a form of lease financing pursuant to which the usage (*usufruct*) of an asset or the services of a person are leased by the lessor to the lessee for rental consideration.[26] The nature of the asset or service must be precisely defined in the lease. Under the *Ijarah*, the lessor (the financier) will purchase the asset from the supplier and then transfer possession to the lessee (the client) with the profit margin built into each lease payment over the term of the lease. The lessee may act as the lessor's agent to purchase the assets from the supplier. It is also possible for the lessee to own the asset which it sells to the lessor who, in turn, will lease it back to the lessee. The lease can take effect as an operating lease, with the asset returning to the lessor at the end of the lease term, or akin to a finance lease, with title to the asset being transferred to the lessee at the end of the lease term or ownership units being transferred to the lessee during the term of the lease (an *Ijarah-wa-iqtina'a*). The lease will commence immediately upon execution of the *Ijarah* if the assets have sufficient economic value and substance so that it can and is used for the purpose intended. If the assets do not have sufficient economic value at the time the lease is executed, then the rent will only become payable when such value and substance does exist. In any event, although *Sharia'a* does not permit a forward sale, the *Ijarah* can become effective at a future date provided the rent is only payable after the leased asset is delivered to the lessee.[27] This type of forward lease is called an *Ijarah Mawsufa fi al-Dhimma* and is most prevalent in the project financing context.

10.20 As will be explored further below, it is useful to note that the *Ijarah* has become the mechanism by which the principal and the profit margin are returned to the financier during the post-construction period of a project financing as rental consideration comprising the purchase price of the asset as well as a fixed and/or floating profit margin calculated by reference to LIBOR.

10.21 Although the lessor can claim compensation from the lessee for misuse of the leased assets, akin to an operating lease, the lessor remains responsible for all maintenance

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[26] For a detailed discussion of *Ijarah* see Al-Zuhayli (Chapter 13).
[27] This is subject to the payment of advance rentals: see paras 10.46 and 10.47.

and repair incidental to ownership, including structural maintenance of the leased assets.[28] In practice, the lessee will be appointed as an agent of the lessor to ensure adequate insurance is in place for the leased assets through the service agency agreement (see para. 10.58 below). The lessee is only liable to pay the rent so long as the asset exists, so if the asset is destroyed and therefore cannot be used by the lessee, the lessee can then terminate the lease without further liability and the lessor's only recourse will be to pursue a claim under the insurances.

Sukuk

10.22 Although *Sukuk* (plural of *sakk*) are often referred to as 'Islamic bonds', they are more akin to Islamic trust certificates representing an undivided beneficial ownership interest in an underlying asset where the return is based on the performance of that underlying asset. The key attributes of *Sukuk* are that they are asset-based securities and any profit or benefit derived from the *Sukuk* must be linked to the performance of a real asset and the risks associated with ownership of that asset. *Sukuk* are therefore distinguishable from conventional bonds which are bearer negotiable debt securities that pay the holder fixed or floating interest on a periodic basis during the term of the bond. *Sukuk* do share certain features with conventional bonds, such as being in certificated form, being freely transferrable on the secondary market if the *Sukuk* is listed, paying a regular return, and being redeemable at maturity, but conventional bonds are also tradable debt which *Sharia'a* prohibits. Therefore, *Sukuk* have to be linked to an underlying asset using, for example, an *Ijarah* or *Musharaka* arrangement to generate revenues that mirror the coupon payments received under a conventional bond. The return generated is justified as the *Sukuk* holder has an ownership interest in the underlying asset as represented by the *Sukuk* and is therefore assuming ownership risks.

Islamic Project Finance Techniques

10.23 As mentioned above, a reassessment of how risks associated with the construction, operation, ownership, and financing of a project are allocated and how transaction structures are implemented will need to be undertaken in order to contemplate the priorities of all the project participants in the most commercially acceptable manner. Conventional project finance structures have evolved to take into account these risks by apportioning the risk to the participants according to their role and who is best able to assume the risk. Such structures have, however, been developed in Western *riba*-based financial systems and as a result have not contemplated

[28] The lessee will remain responsible for any routine maintenance and repair of the Islamic assets.

certain additional priorities that an Islamic participant possesses, most notably, compliance with the principles of *Sharia'a*. These priorities have been accommodated in two types of *Sharia'a*-compliant project finance transactions: a single tranche transaction comprising only *Sharia'a*-compliant funding with no conventional *riba*-based financing; and a multi-tranche transaction where conventional and *Sharia'a*-compliant tranches of funding are integrated in a single financing. The former type of transaction is not common, especially in large project financings since the liquidity of Islamic banks and the capitalization requirements of such banks means that they cannot alone finance such projects. What follows, therefore, is a brief discussion of conventional project finance structures in order to visualize how such structures need to be adapted to a *Sharia'a*-compliant model. Then there follows an analysis as to how the multi-tranche project finance transaction is facilitated in practice, including how such arrangements are documented.

Conventional Project Finance Structures

10.24 In a conventional project financing, the sponsors will incorporate a single-purpose project company to build and operate the project. A syndicate of banks and other financial institutions (such as ECAs) will finance the construction of the project pursuant to one or more interest-bearing facility agreements. There will be a common terms agreement (the CTA) to govern the rights between the lenders and the project company and an intercreditor agreement or coordination deed to govern the rights, obligations and priorities of the lenders as between themselves. During the construction phase, the project company will ordinarily be obliged to pay interest on the loan which will typically be based on an inter-bank lending rate (such as LIBOR) plus a specified margin. During the operating phase, the project company will then begin to repay the principal monies borrowed according to a repayment schedule in addition to interest payments.

10.25 The project company will enter into a series of project contracts, including, the construction contract between the project company and the contractor to construct the project and deliver ownership of the same to the project company upon completion. In return, the project company will make stage payments to the contractor upon achieving certain milestones.

Multi-tranche Sharia'a-compliant Financing

10.26 Most project financings source the monies required to construct and operate the project from various sources, for reasons that include, accessing a broader pool of funding and using local banks or international financial institutions for geopolitical reasons. Apart from the commercial lenders, who provide a *riba*-based loan facility

to the project company, one or more tranches of financing can be provided by other financial institutions, such as ECAs, development banks, and Islamic financial institutions (referred to herein as the IFIs). Each tranche may serve different purposes in the financing. An ECA, for example, may have a separate facility agreement from the commercial lenders stating that its facility is to be used for the acquisition of certain equipment or services provided to the project by a company of the same national origin as that ECA. Likewise, because the priority of an IFI is to invest in accordance with the *Sharia'a*, such IFIs will expect their investment to be made in the project in accordance with Islamic finance principles. The IFIs cannot lend, akin to the conventional lenders, directly to the project company as one of the many *Sharia'a* issues that would arise includes the return on the investment being deemed as *riba*. Therefore, as is the case with the needs of the ECAs, the priorities of the IFIs are accommodated by adapting the structure of the project, as manifested through separate documentation, comprising the IFI tranche.

10.27 There have been many instances in practice, where a single project financing comprises more than one IFI tranche.[29] The reason for this may, perhaps in part, be due to irreconcilable differences between the investment criteria of certain IFIs which arise because:

(1) the investment criteria of the IFIs may be based on a specific *Madhab* and so may mean one IFI accepts a particular Islamic finance technique, but another IFI does not;
(2) a *Qur'anic* ruling is interpreted differently;
(3) an IFI may not accept a particular *hadith* or does not assign it particular credence because the conditions applied to collate that *hadith* were contrary to the methodology applied by a particular *Madhab*; or
(4) the *fatwa* of a *Mujtahid* or *Sharia'a* scholar authorizing a particular Islamic financial technique is not accepted.

Such marked differences generally arise in cross-border financings where an IFI may be aligned with the more doctrinal *Hanbli Madhab*, which has a more stringent investment criteria than an IFI based elsewhere and who abides by the more liberal *Hanafi Madhab*. In order to resolve this issue, separate documentation for each Islamic tranche will need to be entered into by the IFIs to suit their respective *Sharia'a* requirements. Regardless of the number of IFI tranches, the structure of each IFI tranche will in practice be, for the most part, the same, although their manifestation in the documentation will differ.

10.28 The Islamic financing strategies adopted in recent project financings are now explored to discuss the structural considerations and documentation involved in

[29] PP11 IPP located in Saudi Arabia (June 2010) is an example.

projects with one or more IFI tranches, as well as the issues that arise when integrating the conventional tranches and the IFI tranches in a single project financing.

10.29 Recent Islamic project financings have included one or two Islamic structures, such as a *Wakala-Ijarah* tranche and an *Istisna'a-Ijarah* tranche, which are two of the most prevalent, commercially accepted and *Staria'a*-compliant structures for an Islamic tranche in a multi-tranche project financing.[30] The structure and documentation applied to implement a *Wakala-Ijarah* tranche is depicted in figure 10.2. The structure for an *Istisna'a-Ijarah* tranche largely reflects the *Wakala-Ijarah* structure and any variation is analysed further below.

10.30 During the construction phase, the *Wakala* agreement in the *Wakala-Ijarah* tranche and the *Istisna'a* agreement in the *Istisna'a-Ijarah* tranche provide the construction financing for certain assets (referred to as the Islamic assets), isolated from the overall project, up to the value of the financing to be provided under the relevant Islamic tranche. The remainder of the project assets are financed using the monies from the conventional tranches. Upon a phase payment request from the project company (for an amount equivalent to the EPC milestone payments payable by the project company to the EPC contractor pursuant to the EPC contract), the IFIs provide the required funding to the Islamic facility agent who disburses the same to the project company. During the construction period, the project company makes advanced rental payments to an agent for the IFIs which mirrors the interest payable by the project company to the financiers under the conventional tranche. Upon construction of the Islamic assets, on or before the scheduled commercial operation date, the operations phase begins and the *Ijarah Mawsufa fi al-Dhimma* becomes effective to lease the usage of the Islamic assets to the project company. The project company pays lease payments during the course of the lease and at the end of the lease (as is the case in the *Wakala-Ijarah* tranche), ownership of the Islamic assets will, be transferred to the project company. An alternative is that units of the IFIs' ownership interest in the Islamic assets are transferred to the project company during the course of the lease, as is the case in the *Istisna'a-Ijarah* structure.[31]

10.31 Prior to embarking on a discussion of the Islamic documentation used in recent financings, it is useful to note that the Islamic facility agent or Investment Agent acts as agent for the IFIs. The Islamic facility agent is appointed for the *Wakala-Ijarah* tranche pursuant to the terms of an asset agency agreement and the investment agent is appointed for the *Istisna'a-Ijarah* tranche pursuant to the terms of an investment agency agreement. The advantage of appointing an agent is that: (i) the agent

[30] The *Wakala-Ijarah* tranche structure was introduced in the *Shuaibah* IWPP located in Saudi Arabia (December 2005) and subsequently also applied in the Marafiq IWPP located in Jubail, Saudi Arabia (May 2007), the Al Dur IWPP located in Bahrain (June 2009), and PP11 IPP. An Istisna'a-Ijarah structure was applied in Qatargas 2 LNG project located in Qatar (December 2004), in the Rabigh refinery located in Saudi Arabia (March 2006) and also in PP11 IPP.

[31] See also para. 10.19 above.

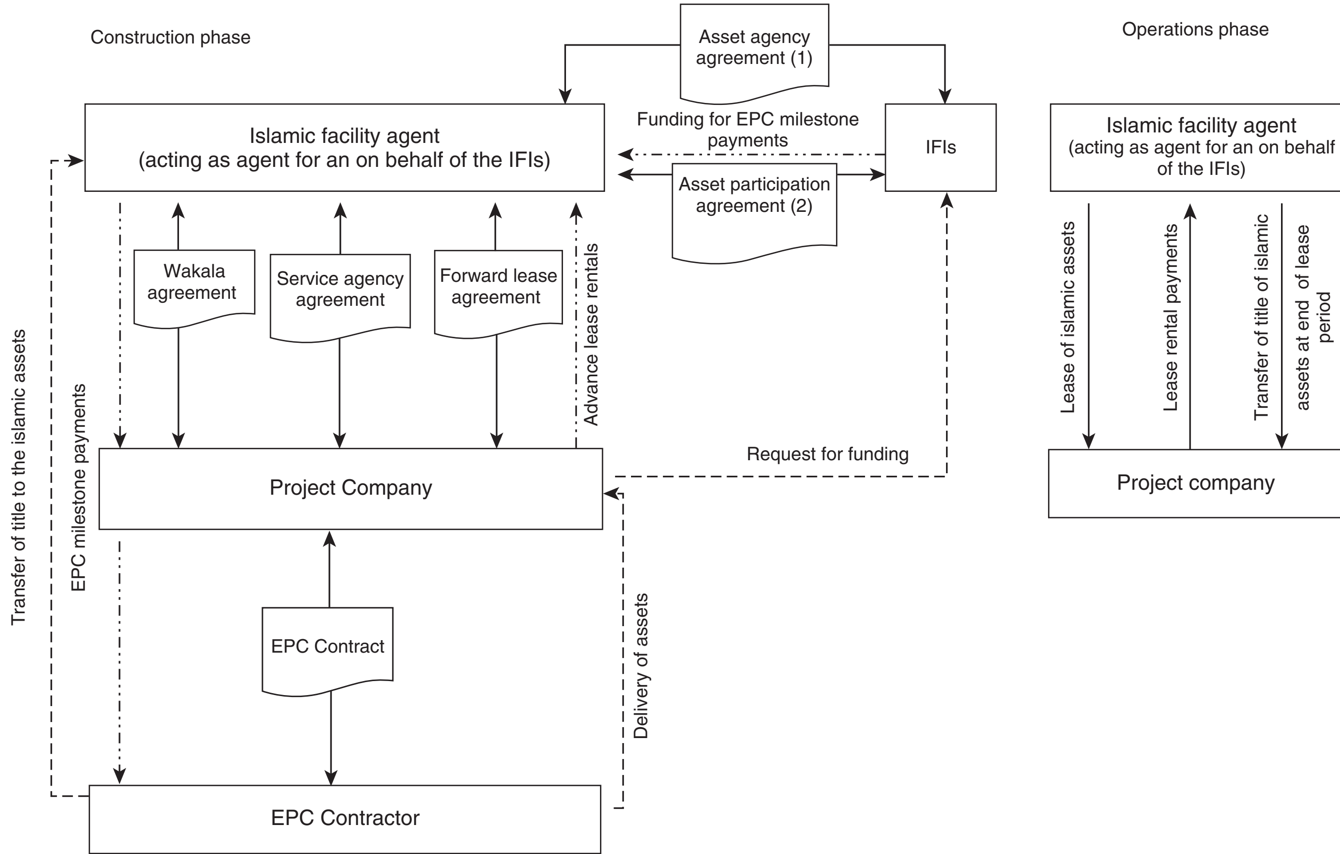

Figure 10.2 *Wakala-Ijarah* **tranche**

acts as a liaison between the project company and the IFIs during the course of the project; (ii) the agent can if required, sign the Islamic documentation on behalf of all the IFIs; and (iii) the agent would also be involved in receiving and disbursing monies received from the IFIs and the project company in accordance with the finance documents. The agent may also receive from the EPC contractor title to the Islamic assets upon their construction. It is usual, in practice, to appoint an IFI who is participating in the Islamic tranches and, therefore, familiar with the transaction, as the agent.

Wakala-Ijarah tranche

Wakala agreement

10.32 Under the *Wakala* agreement, the IFIs appoint the project company to act as their *Wakil* in respect of the procurement of the Islamic assets from the EPC contractor pursuant to the EPC contract, but subject always to the terms of the *Wakala* agreement. The EPC contract effects the *Istisna'a* arrangement (commissioned manufacture of the Islamic assets) between the IFIs and the EPC contractor. The parties to the *Wakala* agreement will be the project company, as the *Wakil*, and the Islamic facility agent, acting on behalf of the IFIs.

10.33 The *Wakala* is an agency contract that has been applied in many project financings. It is preferred by IFIs, as the *Wakil* assumes the responsibilities for project execution and completion and supervision of the construction of the Islamic assets. The *Wakil* will also be responsible for negotiating the terms of the EPC contract, based upon the specifications required by it, as the eventual lessor of the Islamic assets; this is a key requirement of *Sharia'a*. The *Wakil* will also indemnify the IFIs and the Islamic facility agent against all claims, losses, and liabilities incurred by them as a result of the negligence or wilful misconduct of the *Wakil*. From the perspective of the project company, the *Wakala* arrangement does not adversely impact on its management of the project, since it can continue to deal with the EPC contractor with little involvement from the IFIs, so long as it acts in accordance with the terms of the *Wakala* agreement.

10.34 The Islamic assets, together with their cost, are specifically identified in a schedule to the *Wakala* agreement in order to avoid *gharar*. During the construction period, as is depicted in figure 10.2, upon a drawdown request from the *Wakil* for an amount equal to an EPC milestone payment under the EPC contract, the IFIs pay the equivalent amount as a phase payment under the *Wakala* agreement to the Islamic facility agent for onward disbursement to the *Wakil*. A key requirement of *Istisna'a* is that the asset price is fixed at the outset and therefore such contracts are either fixed-price or capped. A schedule to the *Wakala* agreement specifies the date and the amount of the phase payments in order to, inter alia, avoid *gharar* as to when payments are made. There is flexibility as to amending the phase payment schedule, if required. The maximum amount of the total phase payments is expressed

in the agreement as being the cost of constructing the Islamic assets, which is the total facility amount to be contributed by the IFIs. In some financings, on or before each phase payment date, the *Wakil* is obliged to deliver a promissory note up to the value of the phase payment to the IFIs. The *Wakil* is also entitled to a one-off *Wakil* fee payable by the Islamic facility agent which is usually set-off against the monies owed by the *Wakil* as lessee under the *Ijarah*.

10.35 Upon construction of the Islamic assets, the *Wakil* agrees to accept delivery of the same from the EPC contractor, whilst acknowledging that title to the Islamic assets will pass automatically to the Islamic facility agent. It is critical that ownership is transferred directly from the EPC contractor to the Islamic facility agent as depicted in figure 10.2, as certain *Sharia'a* scholars do not favour ownership of the Islamic assets being transferred via the *Wakil*, prior to being transferred to the Islamic facility agent and then being leased back to the project company pursuant to the lease agreement.[32] Although uncommon in project financings, as an alternative to leasing the Islamic assets to generate a return, the Islamic facility agent may instead sell the Islamic assets by way of a parallel *Istisna'a* that is entered into at the time of the original *Istisna'a* for the construction of the Islamic assets. The sale of assets not in existence or owned by the seller at the time the contract is entered into is ordinarily prohibited by *Sharia'a*, but the *Istisna'a* is an exception to this prohibition. This does not, however, permit the Islamic facility agent to sell the Islamic assets to the project company as *Sharia'a* prohibits a sale and buyback. The sale could, however, be to a special purpose vehicle owned by a corporate service provider, which is not related to the project company, or to a third party on an arm's length basis. Upon delivery of the Islamic assets, the *Wakil* will also be responsible for ensuring that all licenses and permits are in place and all filings have been made to protect the ownership interest of the Islamic facility agent.

10.36 The *Wakala* agreement ends on the date on which title to all the relevant Islamic assets is received by the Islamic facility agent from the EPC contractor. Upon the occurrence of an event of default under the *Wakala* Agreement, the lease agreement, and/or the finance documents, the Islamic facility agent may be entitled to terminate the *Wakala* agreement subject always to the terms of the intercreditor agreement. Upon termination, the *Wakil* will be liable for all losses, liabilities, and damages resulting from such termination, which will be equal to the aggregate of the phase payments disbursed by the IFIs.[33]

[32] Some *Sharia'a* scholars have not favoured a mechanism where the project company would hold title to the assets on behalf of the IFIs as one effect of this is that the IFIs become insulated from ownership risks in respect of the Islamic assets.

[33] On a termination of the *Istisna'a*, the IFIs will be responsible for repayment of any advance rentals received from the project company as further discussed below.

10.37 When structuring an Islamic project financing, a pertinent consideration that needs to be settled at the outset is the governing law that applies to the agreement and the forum for settling any disputes arising thereunder. Although the principal determinant as to the validity of the Islamic finance documents will be based on compliance with the *Sharia'a*, there are no internationally recognized *Sharia'a* courts applying universally settled principles of *Fiqh* that have developed with respect to issues, such as insolvency, that arise in the context of complex cross border project financing. Project participants will require a level of certainty as to interpretation of law and the remedies available to be able to anticipate how courts may deal with project related issues so that, inter alia, the lenders can determine whether to lend to the project and so that risks can be apportioned appropriately amongst the participants. For these reasons, the finance parties will insist on specifying a governing law which is accessible, has a developed jurisprudence covering issues that arise in a complex cross border financing and which has a consistent law which is not subject to different interpretation methodologies, as is the case between the *Madhabs*.[34] English law is often chosen as the governing law in many complex cross-border financings because of its globally renowned creditor-friendly approach, established system of precedent and the willingness of the English courts to accept jurisdiction to hear disputes governed by English law even when there is little connection to the jurisdiction other than the election of the parties.

10.38 Using English law as the governing law raises several conflict of laws issues because the law of the jurisdiction in which the project is located may have automatic jurisdiction or the agreement may not be enforceable in the jurisdiction in which the project is located as the agreement may be inconsistent with its laws. Another issue, which *Sharia'a* scholars are more concerned with, is whether English law or *Sharia'a* law takes precedence in the event of a conflict between the two sets of legal principles. From this flow the related issues of whether an English qualified judge is qualified to adjudicate on a dispute relating to an Islamic agreement; whether *Sharia'a* law or English law will be applied and if *Sharia'a* law, then which particular *Madhab* will be applied. The approach of the English courts, in the main, has been to distinguish between the *Sharia'a* and the contractual governing law of an Islamic agreement by ruling that *Sharia'a* issues are not justiciable in the English courts. That element of the agreement is deemed as forming part of the commercial agreement (which English courts will rarely interfere with) and not the legal agreement. Instead the dispute will be dealt with applying the ordinary principles of English law and an English court will avoid ruling or commenting on the compliance of the agreement with *Sharia'a*.[35] In practical terms, the parties to the Islamic documentation must

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[34] The Convention on the Law Applicable to Contractual Obligations 1980 (the 'Rome Convention') also requires that a governing law of an agreement must belong to a country and the *Sharia'a* does not belong to a particular country although it has been adopted by countries such as Saudi Arabia.

[35] See *Shamil Bank of Bahrain v Beximco Pharmaceuticals Ltd* [2003] 2 All ER (Comm) 849.

satisfy themselves as to their validity and compliance with the *fatwa* giving legitimacy to those documents, as being in accordance with *Sharia'a*, prior to entering into the agreements. The Islamic documentation will usually contain a provision where each party acknowledges that it is satisfied with the legitimacy of the *fatwa* and the compliance of the Islamic documentation with the *Sharia'a*.

10.39 However, for a number of reasons, which may include the participation of domestic lenders, a legal necessity of the jurisdiction in which the project is based or where there is no real choice of law as a result of the applicable principles of conflict of laws such as the doctrine of *lex situs*,[36] there is a trend for Islamic documentation to be governed by the relevant local law, especially where the project is based in the Middle East. *Sharia'a* scholars in a number of Saudi project financings have required that the governing law of the Islamic agreements be the laws of Saudi Arabia (which has a *Sharia'a* legal system) instead of English law and that the parties submit to the jurisdiction of the Saudi courts or a special committee established to deal with banking disputes. This is to ensure that any dispute is settled before a Saudi judicial forum that applies *Sharia'a* which will no doubt, however, be guided by the *fatawa* and interpretation methodology of the *Hanbli Madhab*. This may mean that a *fatwa* as to the legitimacy of an Islamic transaction given by a scholar aligned with the *Hanfai Madhab*, for example, may be declared invalid by a Saudi court if that *fatwa* contradicts an equivalent *Hanbli fatwa*.

Asset participation agreement

10.40 The asset participation agreement is an agreement between each IFI to participate in financing the acquisition of and ownership of the Islamic assets in pre-agreed proportions. Each IFI will be obliged to pay its participation upon the project company serving a drawdown notice to the Islamic facility agent pursuant to the *Wakala* agreement as depicted in figure 10.2. The asset participation agreement will also contain provisions in relation to an IFI transferring its participation to another IFI.

Asset agency agreement

10.41 The asset agency agreement documents the terms upon which the IFIs appoint the Islamic facility agent as their agent in connection with the project. The Islamic facility agent is authorized to enter into the finance documents on behalf of the IFIs as well as to hold title to the Islamic assets if this has been agreed. Aside to this, the obligations of the Islamic facility agent do not differ markedly from that of a facility agent to the conventional lenders.

[36] The rule that the law applicable to proprietary aspects of an asset is the law of the jurisdiction where the asset is located.

Istisna'a-Ijarah tranche

Istisna'a agreement

10.42 As an alternative to the structure documented in the *Wakala* agreement, the IFIs will appoint the project company to procure the Islamic assets on the terms of the *Istisna'a* agreement. The project company (as Procurer) then takes the necessary steps to construct the Islamic assets, including contracting with the EPC contractor by entering into the EPC contract. In return the IFIs agree to purchase the Islamic assets and pay the agreed amount to the project company in order to fund the construction of the Islamic assets in phase payments. The main difference between the *Istisna'a* agreement and the *Wakala* agreement is that there is no agency arrangement between the IFIs and the Procurer to procure the Islamic assets; the Procurer is simply contracted to procure the construction of the Islamic assets and the IFIs act as purchasers of those Islamic assets. This may be preferred by the IFIs since the project company at all times remains responsible for procuring the Islamic assets and so, for example, the IFIs will not be liable for any delays in the construction of the Islamic assets. In other respects, the *Istisna'a* agreement operates in much the same way as the *Wakala* agreement with the Procurer making requests to the Investment Agent for phase payments reflecting the EPC milestone payments under the EPC contract. It is to be noted that although the project company is not appointed as a *Wakil*, similar obligations are imposed on the project company in respect of entering into the EPC contract with the EPC contractor and maintaining the licenses and permits for the Islamic assets upon their delivery.

10.43 The parties to the *Istisna'a* agreement are the project company, as the Procurer, and the Investment Agent, acting on behalf of the IFIs. In certain projects where an *Istisna'a* agreement has been entered into, instead of the Investment Agent contracting with the Procurer, the IFIs have incorporated a special purpose vehicle company (SPV Co) owned by the IFIs in proportion to their respective investments. The SPV Co acts as purchaser of the Islamic assets from the project company, which in turn procures the construction of the Islamic assets from the EPC contractor pursuant to the EPC contract. An advantage of this SPV Co structure is that the IFI interest in the Islamic assets becomes insolvency remote and asset-risk remote. Certain *Sharia'a* scholars have, however, not favoured the Islamic assets being held by an SPV Co, preferring the Islamic facility agent, who is usually a reputable IFI in the jurisdiction where the project is situated, to hold title to the Islamic assets for and on behalf of the IFIs. The rationale for such an approach is that the IFIs should be seen to take risk on the assets and not be shielded from liability by the SPV Co.

Investment and investment agency agreement

10.44 This agreement contemplates the terms of both the asset participation agreement and asset agency agreement whereby the IFIs agree to participate in the financing of the acquisition of the Islamic assets and the Investment Agent is appointed to hold

title to the same. This agreement also documents the decision making procedure between the IFIs, conduct of business between the IFIs, the payment mechanics for the IFIs pursuant to the terms of the finance documents, and the treatment of any late payment fees levied on the project company.

Wakala-Ijarah tranche and Istisna'a-Ijarah tranche

Lease agreement (Ijarah Mawsufa fi al-Dhimma)

10.45 Once constructed, the IFIs lease the usage of the Islamic assets to the project company by way of an *Ijarah* pursuant to the lease agreement. The *Ijarah*, in practice, has become the mechanism by which the principal and the profit margin are returned to the IFIs during the post-construction period of a project financing, as rental consideration. Rental consideration comprises the purchase price of the Islamic assets as well as a fixed and/or floating profit margin which, in a conventional project financing, would be equivalent to the debt service payable by the project company. The profit margin can be structured as variable rentals which are adjusted according to agreed terms so that the rate of return can be benchmarked against LIBOR, for example, but in each case, the basis for determination and adjustment must be disclosed to the lessee prior to the execution of the lease agreement. Benchmarking the variable rental against LIBOR has the advantage that the *Ijarah* tenor can be longer, as the rate of return takes into account market conditions which a fixed return would not contemplate. Most *Sharia'a* scholars agree that benchmarking against LIBOR is acceptable, since although typically LIBOR is used to calculate interest, here LIBOR is being utilized as a benchmark alone and no *riba* is present in the lease agreement itself, as the lessor is taking risk in the ownership of the asset, and therefore entitled to a profit. Certain scholars have held that benchmarking the variable rental against LIBOR can impute *gharar*, since any fluctuations in LIBOR are not foreseeable, and therefore, an element of the rental payable is not foreseeable. *Gharar* can be resolved here by renewing the lease agreement each time LIBOR is revised, or providing that the variable rental amount can only be up to a certain percentage above or below LIBOR.[37]

10.46 Although the lease agreement will be executed at the same time as the other finance documents, the rental consideration will only be payable once the Islamic assets have sufficient economic value and substance that they can be used for the intended purpose. This will be the scheduled date on which the operations phase of the project begins, as will have been forecasted by the technical advisers. This scheduled date will be expressed in the lease agreement in order to avoid *gharar* as to when the

[37] This approach has been supported by Mufti Taqi Usmani in *An Introduction to Islamic Finance* (Maktaba Ma'ariful Quran, 2007) 168–71.

rental consideration becomes payable.[38] Whilst the lease period only commences from this date, the forward lease has an essential use for the IFIs during the construction phase by obliging the project company to pay advance rentals during the construction phase (equivalent to the debt service amount that a lender would receive during the construction phase under a conventional financing). The lease agreement will contain a schedule of dates on which advance rental payments are to be made.

10.47 There has been debate as to whether accepting advance rentals is permitted by *Sharia'a* law, since the IFIs are generating a return from the Islamic assets prior to their construction, and therefore prior to the same being available to the IFIs to lease to the project company. Such a return has been perceived by certain *Sharia'a* scholars as *riba*; the IFIs making a return on monies they disburse to the project company (as *Wakil* under the *Wakala* agreement or as Purchaser under the *Istisna'a* agreement) for the construction of the Islamic assets, rather than the return being generated by the project company making use of the Islamic assets. This has been resolved by providing for the deduction of the aggregate amount of the advance rentals paid during the construction phase from the first rental payment that is due once the operation phase has begun, or on a pro rata basis during the term of the *Ijarah*. The lease agreement usually contains a gross-up clause whereby the project company will pay a supplemental rent reflecting the advance rentals deducted during the operations phase, as otherwise, the rationale for the IFIs obtaining a return during the construction phase would be thwarted. However, if during the construction phase an event of default results in the termination of the *Wakala* agreement or the *Istisna'a* agreement (as the case may be), the IFIs will be obliged to refund the aggregate of all the advance rentals already paid by the project company. An amount equal to the refunded amount would then be incorporated within the termination sum payable by the project company under the *Wakala* agreement or *Istisna'a* agreement.

10.48 With respect to events of default, the project financing will need to be structured so that any event of default under the lease agreement (and the other Islamic documentation) constitutes an event of default under the CTA. This is achieved by including the Islamic events of default in the CTA to the effect that any default under the Islamic documentation will constitute a CTA event of default. Conversely, *Sharia'a* scholars look unfavourably on treating a CTA event of default as an Islamic event of default. This is because cross-referring to the conventional finance documents in this manner may taint the Islamic tranche, especially since the rationale

[38] The Lease Agreement may contain a mechanism to adjust the first rental payment date if the scheduled operation date is postponed for certain reasons up to a long stop date. An alternative is for the lessor and lessee to enter into an 'Agreement to Lease' which operates during the construction phase and obliges the lessor and lessee to enter into the Lease Agreement once the operations phase actually begins.

for having separate documentation for the Islamic tranche is to keep it distinct from the conventional tranches to the extent possible. Several techniques have developed to keep the Islamic tranche separate from the conventional tranches. These include the use of an Islamic common terms agreement which mirrors the terms of the conventional CTA.[39] An alternative approach which has grown in prevalence because of its simplicity and inexpensive nature, is for the Islamic facility agent (acting on behalf of the IFIs) to be a party to the relevant finance documents including the CTA and the intercreditor agreement. These approaches ensure that to the extent possible, the Islamic tranche is kept distinct, whilst with respect to events of default, the exercise of remedies, and the project's revenue and enforcement cash waterfalls, there is coordination between all the tranches and a *pari passu* relationship (where this has been agreed) between the conventional senior lenders and the IFIs.

10.49 It is useful specifically to outline some of the pertinent features of a lease agreement which enable the *Ijarah* to be applied as an effective Islamic finance technique by which the principal and the profit margin are returned to the IFIs during the post-construction phase of a project financing.

(a) Voluntary prepayment

10.50 Under a conventional financing, the project company has a right to make voluntary prepayments of the facility on terms specified in the facility agreement. Likewise, the project company can, subject to the terms of the CTA and intercreditor agreement, make voluntary prepayments of the IFI tranche either by the exercise of a call option (referred to as a sales undertaking), as is the case in an *Istisna'a-Ijarah* tranche, or by making early rental payments pursuant to the lease agreement, as is the case in a *Wakala-Ijarah* tranche.

10.51 The sales undertaking, which is documented separately, is a unilateral promise (*wa'd*) granted by the IFIs to the project company to sell all or some of the Islamic assets at their outstanding value on specified lease payment dates (to avoid break costs) during the term of the lease. Exercising the sales undertaking in respect of all the Islamic assets is akin to voluntarily prepaying the entire conventional facility and exercising the sales undertaking in respect of certain Islamic assets is akin to making a partial voluntary prepayment of the conventional facility. Where several Islamic assets have been leased, the sales undertaking will be exercisable (by the service of an exercise notice) against specific Islamic assets, and go towards satisfying the total outstanding value of such Islamic assets. The sales undertaking may provide that the prepayment applies to all the Islamic assets on a pro rata basis so that the project company purchases an interest in all the Islamic assets in accordance

[39] The definitions used in the Islamic common terms agreement will be revised so that 'Interest' is replaced with 'Commission' or 'Profit Return', for example. The parties to this agreement will also only include the IFIs and the Islamic facility agent.

with their value. This will result in the project company owning a beneficial interest in the Islamic assets in accordance with the proportion of interest in the Islamic assets it has acquired, with the remainder of the beneficial interest remaining with the IFIs. Although the beneficial interest will not entitle the project company to an equivalent proportion of future rentals payable under the lease agreement, the return of the IFIs will decrease, as their ownership interest in the Islamic assets will have been reduced. At the end of the lease term, the IFIs will, pursuant to the sales undertaking and a sales agreement (a form of which will be appended to the sales undertaking), transfer their legal interest in the Islamic assets to the project company for a nominal amount, or on a cashless basis, since at the end of the lease agreement term, the IFIs have recovered the cost of acquiring the Islamic assets and their profit margin thereon.[40]

10.52 The alternative, as is the case in a *Wakala-Ijarah* tranche, is for the project company to make early rental payments (on specified payment dates in order to avoid break costs) which are applied pro rata to reduce all the remaining rental payments due under the lease agreement. If the project company wishes to acquire all of the Islamic assets prior to the expiry of the lease agreement term, then it will need to pay the termination sum, which is the aggregate of the outstanding principal amount that the IFIs paid to acquire the Islamic assets and any rental consideration due but unpaid. At the end of the lease term, the IFIs will transfer the ownership of the Islamic assets to the project company (pursuant to a transfer of ownership instrument) for a nominal amount or on a cashless basis.

(b) Termination and mandatory prepayment

10.53 Upon the occurrence of an event of default and the issuance of an enforcement notice, the conventional lenders and the IFIs will accelerate the monies paid under the various tranches. Under the conventional tranche, the lenders would call in the loan in accordance with the terms of the facility agreement and the intercreditor agreement. Under an IFI tranche, the IFIs may accelerate by requiring the project company to pay a termination sum by exercising a put option (referred to as a purchase undertaking) as is the case in an *Istisna'a-Ijarah* tranche, or obliging the lessee to pay the termination sum pursuant to the lease agreement as is the case in an *Wakala-Ijarah* tranche.

10.54 The purchase undertaking is a *wa'd* granted by the project company to the IFIs to purchase all the Islamic assets upon the issuance of an enforcement notice subsequent to an event of default. Following payment of the termination sum,

[40] The Sales Undertaking will also cover the circumstance where the project company elects to replace or repay a single IFI in specified circumstances, such as where the relevant IFI requires the project company to increase the rental consideration payable to take account of a tax deduction payable in respect of that payment by the project company.

ownership in the Islamic assets is transferred to the project company pursuant to a sale agreement, a form of which will be appended to the purchase undertaking. The alternative, as is the case in a *Wakala-Ijarah* tranche, is that upon the issuance of an enforcement notice subsequent to an event of default, the project company will be obliged to pay the termination sum following which the IFIs will assign the ownership of the Islamic assets to the project company. If the lessee fails to pay the termination sum, then the lessor will have the right to take possession and sell the Islamic assets.

10.55 It should be noted that the purchase undertaking will also cover mandatory prepayment events or 'early settlement events', as is the case where there has been a change of law which adversely affects the economics or legality of the project as a consequence of which the conventional lenders and/or the IFIs may desire, or be required by law, to cease their participation in the project. In such circumstances, upon the IFIs serving an exercise notice upon the project company pursuant to the purchase undertaking, the project company will generally be obliged to prepay the outstanding amount contributed by the relevant IFI affected by the mandatory prepayment event, by acquiring that IFIs beneficial interest in specific Islamic assets. The lease agreement in a *Wakala-Ijarah* tranche also contains similar provisions, but rather than acquiring a beneficial interest in specific Islamic assets, the rental amounts thereunder are reduced pro rata in proportion to the interest of the relevant IFI that has been prepaid.

(c) Total loss of the Islamic assets

10.56 If an event causes a total or partial destruction of the Islamic assets as a consequence of which the Islamic assets cannot be used by the lessee to generate a return, the IFIs will not have a right to receive further rental payments from the project company, with the IFIs' only recourse being to the insurances they are obliged to maintain as owners in respect of the Islamic assets. As owners, the IFIs will be assuming the risk of a total loss of the Islamic assets as well as risks associated with renewal payments under the policies, together with any delay in the processing and payment of claims under the insurance policies. Where the loss or damage to the Islamic assets arises from the wilful misconduct or gross negligence of the lessee, then the lessee will continue to remain liable for the rental consideration in addition to reinstating the Islamic assets. In practice, the IFIs will appoint the project company as the service agent pursuant to the terms of the service agency agreement to, inter alia, maintain the appropriate levels of insurance. Should the service agent not maintain the appropriate levels of insurance, the service agent will be obliged to indemnify the IFIs to cover the outstanding amounts under the *Ijarah* not covered by the insurance proceeds. Where a total loss of the Islamic assets is not a CTA event of default, but only an Islamic event of default, the conventional lenders may decide against accelerating the financing, and so the service agent will ordinarily be required to replace the Islamic assets with other assets that are designated as Islamic assets, and

then lease the same to the project company pursuant to a new or replacement lease agreement. This ensures that the pari passu treatment of the conventional and Islamic tranches is maintained.

(d) Late payment fees

10.57 Under a conventional financing, where the project company fails to comply with its payment obligations under a facility agreement, default interest is levied on the unpaid sum. Lenders justify this additional rate as compensation for the increased risk of lending to the defaulting project company so long as the rate of default interest is reasonable as a matter of English law, i.e. the default interest is not deemed a penalty offending the rules laid down in *Dunlop Pneumatic Tyre Co Ltd v New Garages & Motor Co Ltd*.[41] *Sharia'a* law, however, regards such additional compensation which adds to the income of an IFI after a debt has become payable, as *riba*. Therefore, under the lease agreement, the lessor cannot charge the lessee a late payment fee for payment of the rent consideration after the due date where such a fee, once paid, would form part of the income of the lessor. In order to avoid a situation where the lessee takes advantage of this prohibition, the lease agreement will stipulate that the lessee pay the late payment fees directly (or through the lessor for onward payment) to a registered charity or charitable fund maintained by the lessor. As a consequence, the late payment fees do not form part of the income of the lessor whilst the lessee is deterred from delaying rental payments under lease agreement. As is the case in an *Istisna'a-Ijarah* tranche, certain scholars also permit a deduction from the late payment fee of any actual costs (excluding opportunity costs and funding costs) incurred by the IFIs due to the lessee making a late payment. The remainder of the late payment fee is then paid to charity.[42]

Service agency agreement

10.58 As outlined earlier, the IFIs as owner of the Islamic assets remain responsible for insurance, structural maintenance, settlement of ownership taxes and maintenance of consents in respect of the Islamic assets. The project company will be appointed as the IFIs' service agent pursuant to the service agency agreement, since it is best placed to undertake these obligations. The project company, in turn, passes through some of these obligations and associated costs, to the O&M contractor pursuant to an O&M agreement. The IFIs will remain responsible for each of these obligations and will indemnify the service agent for the costs incurred by the service agent in undertaking its obligations under the service agency agreement. The IFIs will, however, usually be counter-indemnified by the project company (as lessee under the lease agreement) for such costs by way of supplemental rent. In addition, as discussed earlier, where there is a total loss of the Islamic assets and the service

[41] [1915] AC 79

[42] For a critique of the reasons given by such scholars, see Mufti Taqi Usmani, *An Introduction to Islamic Finance* (Maktaba Ma'ariful Quran 2007) 131–40.

agent has failed to maintain adequate insurance cover in respect of the same, the service agent will be required to indemnify the IFIs for any shortfall between the amount of the insurance proceeds and the aggregate amount of the remaining rental consideration due under the lease agreement. The IFIs will pay the service agent a service agency fee which will usually be netted off against the amounts the project company owes to the IFIs.

Other techniques utilized in a multi-tranche project financing

Sukuk

10.59 Having outlined the nature of *sukuks* earlier in this chapter, it is useful to note how *sukuks* are increasingly being considered as a means of sourcing additional *Sharia'a*-compliant financing as they provide an opportunity for a wider investor base to participate in the financing of a project. The most commonly used *sukuk* structure is the *Sukuk al-Ijarah* (as illustrated in figure 10.3). The structure involves the acquisition by a special purpose vehicle (the SPV Issuer), as agent and trustee for the investors (the Certificate Holders), of assets from the seller using proceeds generated from the issuance of the *sukuks* to the Certificate Holders. Each Certificate Holder will have a joint and undivided property interest, together with the other Certificate Holders, in the assets. The SPV Issuer then leases the assets to the lessee in return for the rent which equates to the purchase price of the assets plus a fixed and/or variable margin, which may, akin to the margin payable under a lease agreement entered into by Islamic banks, be benchmarked against LIBOR. Using the rental proceeds, a return is then paid to the Certificate Holders, in proportion to their investment, periodically or as may otherwise have been agreed between the Certificate Holders and the SPV Issuer. At the end of the term of the *sukuk*, the SPV Issuer will exercise a purchase undertaking requiring the lessee to acquire the assets; the price payable under the purchase undertaking will be the balance of the fixed rent that has not yet been paid and all other rental amounts that are then outstanding under the lease. The proceeds of the sale will then be distributed to the Certificate Holders in repayment of the capital contributed by the Certificate Holders.

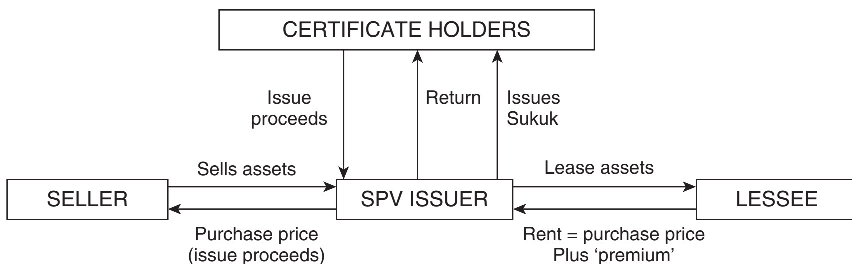

Figure 10.3 ***Sukuk al-Ijarah***

Commodity Murabaha

10.60 As outlined earlier in this chapter, recently there has been an increasing use of the Commodity *Murabaha* to provide both the working capital funds required by a project company, as well as to fund the equity contributions that a sponsor is obliged to make to a project, in accordance with the *Sharia'a*. As illustrated in figure 10.4, the project company (as the Purchaser) requests the Investment Agent (appointed pursuant to a separate *Murabaha* facilities investment agency agreement) to purchase certain commodities from a supplier for the cost-price with funds made available by the IFIs. The Investment Agent then sells the purchased commodities to the Purchaser for the relevant deferred price (which includes the cost-price of the commodities plus a pre-stated margin) on deferred payment terms. The Purchaser then sells these commodities to a third party for the cost-price so that at the end of this process, the Purchaser (as the project company) receives an amount equivalent to the equity contributions of the sponsors. The obligations of the Purchaser to repay the deferred price to the IFIs is set forth in the equity subscription agreement.

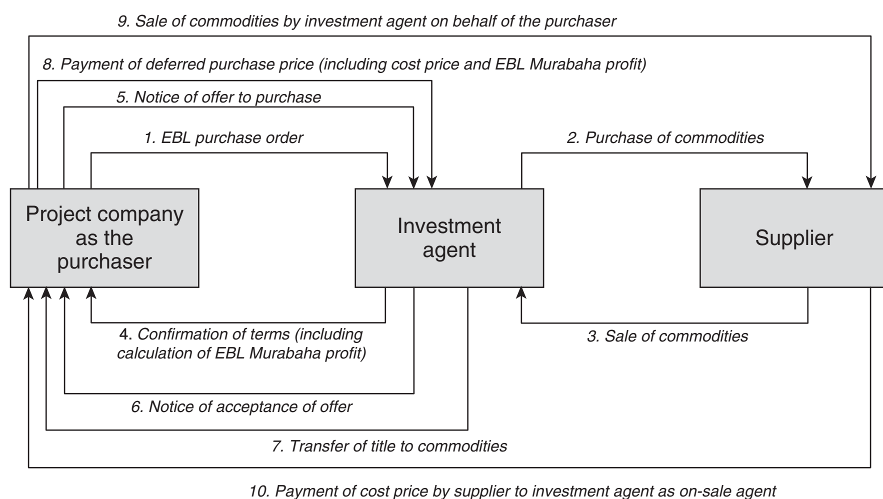

Figure 10.4 Commodity *Murabaha*

Musharaka

10.61 During the construction phase of a project, an alternative to the *Wakala* and *Istisna'a* is the Diminishing *Musharaka*, as documented in a *Musharaka* agreement.[43] Although the *Musharaka* is not often applied in project financings, it is a useful

[43] The *Musharka-Ijarah* structure was adopted in the Al Waha project located in Saudi Arabia (December 2006).

mechanism by which the IFIs and the project company can agree to procure and enjoy joint ownership of the Islamic assets with the profits being shared in pre-agreed proportions and losses being borne according to the capital contributions made to the venture. The Islamic facility agent enters into a separate *Istisna'a* agreement with the project company to procure the Islamic assets, which does so by entering into an EPC contract with the EPC contractor. Title to the assets will, however, first transferred to the project company by the EPC contractor, following which the project company transfers the IFIs' proportion of the Islamic assets to the Islamic facility agent pursuant to the *Musharaka* agreement. The IFIs generate a return during the operating phase by leasing their ownership interest to the project company pursuant to an *Ijarah* and receiving the principal amount they invested in the *Musharaka*. The IFIs transfer a portion of the Islamic assets to the project company by selling ownership units in the Islamic assets on each principal payment date.

Integrating the Conventional and Islamic Tranches

10.62 It is essential that the issues and tensions that arise when integrating the conventional tranches and each IFI tranche in a single project financing are resolved (or at least mitigated) at the outset. Most of these matters have been discussed earlier in this chapter, and it will have become apparent that the most pertinent issues to resolve relate to the complex intercreditor arrangements between the conventional lenders and the IFI. It is paramount that the events of default and the exercise of remedies in a default scenario between the conventional tranche and the Islamic tranche are harmonized. This is because the project is an indivisible whole and, as an intercreditor matter, it would not be acceptable for one tranche to be accelerated as a result of an event of default, whilst others are unable to because there is no corresponding event of default in the documents relating to that tranche.

10.63 Furthermore, conventional banks and IFIs need to be paid from the project's cash waterfall on a pari passu basis. So there is a need to ensure that scheduled payments, as well as mandatory or voluntary prepayments are coordinated in a commercially acceptable manner. Usually, prepayments are distributed pro rata to both the senior conventional lenders and the IFIs in the pre-enforcement payment waterfall pursuant to the intercreditor agreement. Issues may arise, however, if the *Sharia'a* scholars do not permit proceeds from the sale of the Islamic assets or early lease payments to be distributed to the conventional lenders. It is for this reason that the IFIs and the senior conventional lenders will need to agree: (i) when the IFIs will jointly make decisions with the conventional lenders under the CTA and the intercreditor agreement; (ii) whether acceleration under an IFI tranche can be undertaken without consulting the senior conventional lenders so that accelerating

the IFI tranche does not necessarily mean the other tranches also have to be accelerated; and (iii) what voting threshold applies if a process of consultation does need to take place, noting that if the threshold is high, it will be unlikely the IFIs will obtain the requisite consent for the prepayment to proceed, since the IFI tranches have traditionally been smaller in proportion to the aggregate amount of the conventional tranches.

10.64 Although project security is covered in detail elsewhere in this book, an important issue to consider when structuring an Islamic project financing is whether the security granted by the project company will be in respect of the project company's obligations under just the conventional tranches, or will it also directly cover any Islamic tranche. Furthermore, as the proposed security package would usually cover the project as a whole, the impact on the Islamic assets will need to be considered as well as the extent to which security will be shared with the conventional lenders.

11

ANCILLARY FINANCE DOCUMENTATION

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General Overview

11.01 Chapter 3 provides an overview of a number of the sources which may provide funding for a particular project, including equity funding, subordinated and other debt funding of one sort or another; Chapters 7 to 10 consider the principal contracts pursuant to which such other debt funding is made available to a project and identify the main requirements associated with documenting the different financing arrangements that are encountered most frequently.

11.02 As discussed in Chapter 3, where a project is being financed by a combination of, on the one hand, debt and equity provided by the sponsors and, on the other, debt provided by third party lenders, the claims against the project company in respect of the debt advanced by the third party lenders will invariably be classified as being 'senior' to both the debt and the equity claims of the sponsors, their claims as shareholders being subordinate as a matter of law in most jurisdictions and their claims

as lenders being subordinate by agreement.[1] Even in projects where the third party lenders are divided into senior and non-senior categories (the latter usually being labelled as junior or mezzanine lenders), the rights of the lenders providing the non-senior categories of debt will be classified as 'senior' to the rights of the sponsors, both as providers of equity capital and as providers of debt.

11.03 The simplest financing arrangement for a project might involve the provision of debt finance by a single lender pursuant to a single credit agreement the terms of which require that the sponsors' equity contributions are made in full (by way of the subscription for shares in the project company) before the lender advances any funds to the project. However, the sheer scale of the costs involved in the development of a major project necessitates the ever-wider syndication of credit facilities and the tapping of ever-more diverse sources of funding. The result of this is that financing arrangements have become increasingly complicated as more and more parties become involved. The combination of this multiplicity of parties and an ever increasing need to balance the diametrically opposed demands for, on the one hand, the minimization of costs (to make a project economically competitive) and, on the other, the generation of adequate financial returns to investors, means that the principal credit documentation for most projects is anything but simple. The complexity, however, comes not so much from what the different stakeholders are doing (each is essentially providing money for the development of the project on terms such that the money, and some sort of return on it, will be paid back over time from the revenues generated by the project once it has been completed) as from the fact that the different stakeholders have different ways of doing things (often necessitated by particular political considerations and legal constraints) and different attitudes to risk.

11.04 This chapter examines:

(1) some of the myriad types of financial support that is given to the project by its sponsors and the way that that support is provided (Equity Support, paragraphs 11.05–11.46 below);
(2) the types of assets over which security is taken to ensure that, to the extent possible and practicable, the senior lenders' claims against the project are indeed senior to the claims of the sponsors (Security Arrangements, paragraphs 11.47–11.104);

[1] For the purposes of this chapter, and indeed this book, we are assuming that contractual subordination works from a legal perspective in the relevant jurisdiction. Where there are doubts as to the efficacy of contractual subordination (as may be the case in some countries), and if the circumstances justify the incremental costs and complexities, the financing arrangements may be structured so that the subordinated creditors have no debt claims against the project company at all. Instead, they make their loans to the project company's holding company which then uses the loan proceeds to subscribe for shares in the project company. This achieves so-called 'structural subordination' because the claims of the subordinated lender are necessarily subordinated to the claims of the project company's creditors (which will include the 'senior' lenders).

(3) the contractual documentation between the senior lenders and the counterparties to the principal commercial contracts in relation to the project which allow the senior lenders to step into the project company's contractual shoes and thereby take control of the project in order to protect their commercial interests (Direct Agreements, paragraphs 11.105–11.114); and
(4) the way in which formal legal opinions are used in relation to a project financing as a means of confirming the extent to which the contractual arrangements for the project operate as the different parties and groups of parties intend (Legal Opinions, paragraphs 11.115–11.128).

Equity Support

Introduction

11.05 The equity support for a project will take essentially one of two forms—financial and non-financial—and all projects will be dependent on both. Non-financial support for a project can, and does, take the form of virtually any sort of obligation to provide things that the project will need other than money.

11.06 Money is of course necessary if a project is ever to get beyond the stage of being simply an idea, but in relation to many projects money is less important in terms of determining the identities of the sponsors of the project and ensuring its success than the non-financial support that the sponsors are able to offer. Indeed, it may well be the strength of a particular sponsor's non-financial support that dictates which of the competing bidders is awarded the project in the first place.

11.07 There are almost as many examples of non-financial support from sponsors for projects as there are projects, but some of the classic examples of non-financial support that sponsors will provide to a project include:

(1) the contribution of their know-how and other expertise, including the technical and organizational skills needed for the efficient construction and operation of comparable projects, wherever located;
(2) the application of their specialist knowledge of the commercial and political environment in which the project will operate and the legal regime to which it will be subject (recognizing that in most instances these issues will involve international considerations as well those in the jurisdiction in which the project is located);
(3) the dedication of natural resources that constitute the feedstock or fuel for the project, whether because they own these resources or because they are able to obtain access to them in preference to others (or on more favourable terms than others);
(4) the provision of specialist marketing services to the project in order to gain access to a potential customer base for its products that would otherwise take a considerable time to establish; and

(5) the provision of, or of access to, port, pipeline, or other transportation facilities that the project will need, whether for its fuel and feedstock or for the product that it produces.

11.08 Our concern in this chapter is not, however, with the many types of support that sponsors provide to a project but with the financial support that the senior lenders will require them to provide to the project and the financial interests that the senior lenders will require them to maintain in the project.

11.09 It is perhaps worth making an obvious comment here, that being that even where a promise to provide funds for a project is, to quote a phrase adopted in countless legal opinions, 'legal, valid, binding and enforceable', a promise is only as strong as the person that makes it. It is often the case that the 'real' sponsors of a project are not the companies that sign the contractual documentation regulating the sponsors' equity contribution obligations. Tax considerations, in particular, frequently mean that the sponsors' obligations are in fact obligations of special purpose, and minimally capitalized companies established in jurisdictions selected more for their tax treaties than for their links to the business interests of the sponsors. In such cases (and also in cases where the creditworthiness of different sponsors is particularly unequal, which is often the case as between international sponsors and the local sponsors for a project), it is likely that another important part of the contractual arrangements relating to the provision of the sponsors' equity contributions will be a credit enhancement agreement such as a guarantee issued by the ultimate sponsor (or one of its affiliates) or a letter of credit issued by an unrelated creditworthy institution such as a bank.

Equity capital contributions

11.10 The simplest form of financial equity support that the sponsors will provide for any project will be in the form of the subscription for shares in the project company or (or, more probably, and) the making of long-term subordinated shareholder loans to the project company. Chapter 7, whilst ostensibly focusing on the differences between the various types of credit agreement encountered in project financings, also emphasizes the fact that, despite the differences, the various ways in which lenders provide credit to a project have many elements in common. Indeed, they are essentially the same in that ultimately the relationship between the project company and the lenders is that of debtor and creditor.

11.11 The fact that equity support is usually provided by means of two fundamentally different routes (one giving rise to an ownership interest in the project company and one giving rise to a debtor-creditor relationship with the project company), coupled with the fact that tax considerations will inevitably drive different sponsors to adopt different ownership and financing structures for projects in different jurisdictions, means that there will always be considerable diversity in relation to the

contractual arrangements for the provision of equity support for projects in different countries. As a result, and also because different host countries have their own preferences for the ownership arrangements for projects in particular sectors (which may or may not involve an element of state ownership), it is difficult to discuss the contractual arrangements in relation to the provision of equity support otherwise than in rather general terms. This being so, the main thing to note about the contracts regulating equity support arrangements is that they are diverse. They often involve a shareholders' agreement (which is designed to regulate the sponsors' commitments *inter se*) and a separate equity support agreement (which is intended to benefit the project company and the lenders). Some equity support agreements provide a framework for the support to be provided pursuant to other contracts (such as share subscription agreements, partnership agreements, or subordinated loan agreements), while others themselves contain appropriate legally binding undertakings to make moneys available to the project company.

11.12 Ultimately, there will be contracts (probably governed by the laws of a mix of jurisdictions) pursuant to which the sponsors are bound to provide their support to the project (these contracts being the subject of this chapter) and further contracts that deal with the rights of the sponsors to extract their investment returns from the project. A discussion in relation to the continued support the lenders may require from the sponsors after completion is included in paragraphs 11.42–11.45.

Quantum

11.13 The extent of the total equity (whether constituted by share capital or subordinated loan capital) that will be invested in a project over its construction phase as a proportion of the total capital cost of the project will be influenced in particular by the extent of the risk associated with the project: the greater the degree of predictability associated with the project once it is in operation the lower the amount of equity that the project lenders will insist be contributed to the project. Conversely, increased volatility in relation to a project's cashflows will, as a rule, mean that the project lenders will wish to see a lower ratio of debt to equity. The basic logic for this is simply that the more equity that is invested in a project, the lower the risk that interruptions in the project cashflows will lead to a failure by the project company to meet its debt service obligations. This is because the effect of the cash waterfall[2] is such that the first casualty of any cashflow disturbance will be the distributions payable to the sponsors. The greater the equity investment, the greater the level of

[2] As discussed in Chapter 7, the cash waterfall is the contractual provision that (by agreement among the project company, the lenders, and the sponsors) stipulates the sequence in which the moneys for the time being available to the project company are applied in or towards the discharge of its payment obligations. Broadly speaking, the sequence ensures that operating costs are paid before obligations owed to the senior lenders and hedge providers, which in turn are paid before moneys are paid to junior lenders or are available for distribution to the sponsors.

distributions available for the sponsors and so, necessarily, the larger the 'cushion' protecting the senior lenders.

11.14 The high proportion of equity to debt in relation to mining projects as compared with power projects, for example, reflects the fact that unforeseen geological and hydrological problems, whilst not irrelevant in the context of the development of a power project, could have a far greater impact on the development of a mine and, more significantly, its operation. The extent of the equity contribution requirement for any given project is thus almost an irrelevance from a legal perspective—the legal objective is simply to provide an effective contractual framework that specifies the circumstances in which the sponsors are obliged to make their agreed contributions (including 'standby' contributions[3]) available.

Shares or subordinated loans?

11.15 Although the sponsors' equity investment in the project will invariably consist of a combination of share capital and subordinated loan capital, in most jurisdictions there are minimum capitalization requirements in relation to the formation of companies, often for tax reasons because interest payments on loans are deductible in calculating income for tax purposes while dividend payments are not. These so-called 'thin capitalization' rules will necessarily prevail over the preferences of the parties to the transaction. In particular, they will prevail over the sponsors' general preference to maximize the extent to which their contributions are constituted by the making of loans, a preference which, as well as usually being more tax efficient, is driven by the fact that loans provide them with greater flexibility than shares when it comes to the extraction of funds from the project company.[4] This enhanced

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[3] As with any financial projection, the capital budget for a project will be prepared on the basis of certain assumptions. Inevitably, things will happen over the construction phase of the project that prove the assumptions were wrong. As a result, estimates in the budget will usually be conservative, with cash outflows generally being, if anything, overstated (and assumed as being required to be made sooner rather than later) and cash inflows being, if anything, understated (and assumed as arising later rather than sooner).

In addition, the lenders will require that the project company will have available to it funds that it might need to meet 'contingencies' (i.e. funds to meet project costs that have not been anticipated or to meet incremental project costs attributable to unexpected (or longer than expected) delays in the development of the project). Such 'standby' funding arrangements usually involve funding commitments from both lenders and sponsors which are only available for drawing by the project company once it has exhausted its other sources of funding. Because these facilities are by definition not expected to be utilised, the fees which the project company will be required to pay for them is often structured on two bases: a fee of x% if the facility is not used and a fee of x + y% if the facility is used.

Standby debt and equity facilities are usually drawn proportionately. However, it is not uncommon for the sponsors to make their standby contributions available first and for there to be a 'true-up' advance made by the lenders at the time of completion which will bring the overall debt to equity ratio back to an agreed level.

[4] The sponsors' rights to extract funds from the investment will, of course, be subject to the terms of the finance documents, which will regulate both the timing and the extent of payments to the sponsors (whether by way of the payment of interest on, or the repayment of, amounts they have provided

flexibility derives from the fact that the laws relating to the formation and operation of companies in most jurisdictions include maintenance of capital rules which, and independently of any minimum capitalization rules that may be applicable in that jurisdiction, operate to impose constraints on a company's rights in relation to the repayment of its share capital.

Maintenance of capital rules

11.16 In England, maintenance of capital rules are basically designed to protect a company's creditors.[5] Although it is logical to assume that, to a greater or lesser extent, this is also the case elsewhere, it may well be that the reasons for the rules in particular jurisdictions are different to the reasons for them in others in the same way that the rules themselves will differ from jurisdiction to jurisdiction.

11.17 As well as restricting the redemption of issued shares, rules on the maintenance of capital also restrict the ability of companies to make distributions to shareholders out of capital by requiring that dividends are paid out of profits, which in this context means (a) undistributed profit for prior accounting periods to the extent they have not been offset by subsequent losses and (b) undistributed profit for the current accounting period after they have been reduced to offset losses in earlier accounting periods.

11.18 Although the actual operation of maintenance of capital rules will vary from jurisdiction to jurisdiction, their very existence means that a project company and its board of directors will not be free to decide to make payments to the project company's shareholders merely because, for example, the project company has cashflow (as opposed to profit) that is surplus to its immediate operating requirements. If the project company's payment to its shareholders involves a reduction of capital, then before the payment may lawfully be made the applicable rules must be satisfied. The rules could range from the very stringent in a jurisdiction which requires that the payment is sanctioned by the court or approved by a governmental department (or both), to the more relaxed in a jurisdiction that will allow the payment subject to the delivery of an auditor's certificate satisfying particular criteria. However, irrespective of the specific tests, the end result is that the project company will not be able to pay money to its shareholders as and when its board of directors elects to do so.

to the project company in the form of loans or by way of the payment of dividends on amounts they have provided by way of share capital).

[5] *Trevor v Whitworth* (1887) 12 App Cas 409. In the words of Lord Watson (at 423, 424): 'Paid-up capital may be diminished or lost in the course of the company's trading; that is a result which no legislation can prevent; but persons who deal with, and give credit to, a limited company, naturally rely upon the fact that the company is trading with a certain amount of capital already paid . . . and they are entitled to assume that no part of the capital which has been paid into the coffers of the company has been subsequently paid out, except in the legitimate course of its business.'

Shareholder loans

11.19 Since a company's obligations to repay loans that have been made to it by its shareholders (and to pay interest thereon) are not necessarily within the scope of the rules on the maintenance of capital, the simplest way that shareholders can avoid the constraints of such rules in relation to their investment in a project is to make loans to the project company instead of subscribing for shares. As well as providing the shareholders with greater flexibility in terms of the withdrawal of cash from the project, in most jurisdictions interest paid on loans will constitute an expense which is deductible from the project company's income in the determination of its income for tax purposes. As a result, both the lenders to the project and the authorities seeking to collect tax revenues from the project have their own reasons for controls that have much the same effect as the rules on the maintenance of capital.

(1) Lenders are creditors of the project company and as such will want to ensure that the project company does not make payments to its shareholders (or the sponsors) if to do so might operate to their potential detriment (by leaving the project company in a position such that it is less likely to be able to meet its future obligations (and, most importantly, its obligations to the lenders)).
(2) The tax authorities will want to minimize the amounts that are deducted in the computation of taxable income because their tax revenue will necessarily be reduced by every such deduction.

11.20 The lenders protect their interests by (a) insisting on the subordination of the loans to the project company which are made by the shareholders and the sponsors to the loans which are made by the lenders (so that in the project company's insolvency the lenders, the shareholders, and the sponsors are all in the respective positions in which they would have been had the loans made by the shareholders and the sponsors constituted share capital) and (b) prohibiting the project company from making payments in relation to the loans made to it by its shareholders or the sponsors (whether by repaying the principal thereof or paying interest thereon) unless it meets specific financial criteria that demonstrate that the project company is healthy (and then only so long as the project company is not in breach of any of its obligations under its finance documents).

11.21 The tax authorities protect their interests through 'thin capitalization rules' of one sort or another that limit the amount of interest that a company can deduct on loans made to it by its shareholders (or others) to the level of the loans that (when expressed as a proportion of the project company's total share and loan capital) could be expected to be provided by third party commercial lenders on normal arm's length terms (which in this context can be taken to mean on terms that are not directly influenced by the profitability of the project company).

To whom should the promise of equity be made?

11.22 For a variety of reasons (some of which, on detailed analysis, have less validity than others), the contractual arrangements pursuant to which shareholders undertake

to subscribe shares in, or make loans to, the project company are often quite different.

11.23 One of the reasons that there may be a divergent approach to the contractual arrangements regulating the shareholders' obligations for equity funding is that, in the course of the commercial debate between a project's potential lenders and its potential shareholders regarding the extent of the relative amounts of debt and equity to be contributed to the project, the fact that the project will necessarily involve a third party (namely the project company) does not always remain fully in sight. As a result (and even though the credit agreement will include a requirement that the shareholders must have entered into a suitable contribution agreement (and, at any given time, to have made a prescribed level of contributions pursuant thereto) as a condition precedent to the entitlement to make drawings thereunder), the parties to the relevant contribution agreement may not include the project company. On the assumption that, as is usually the case, the contribution agreement contains a provision to the effect that a person that is not party to it will have no right to enforce any of its provisions by virtue of the Contracts (Rights of Third Parties) Act 1999, the shareholders' promises to make their agreed contributions are thus promises made to the lenders alone.[6]

11.24 Given that the project company will be the recipient[7] of all equity contributions (whether in the form of the subscription moneys for shares or in the form of shareholder loans), it is important that the contractual undertaking to provide the contribution is made to the project company. Apart from anything else, the project company is the natural person to whom the promise of making the money available should be made because it is the project company that needs the money. The lenders are obviously interested in the promise but their interests can be adequately served by means of a security assignment of the project company's rights to call for, and receive, the shareholder's equity contributions.[8] On this basis, therefore, there is no

[6] Even where the project company is a party to the relevant equity contribution agreement, it is often the case that the shareholders' promise to make funds available to the project company is specifically given to the lenders rather than to the project company (or to both the lenders and the project company, a hedged approach which rather suggests indecision more than clear analysis).

[7] Even if the proceeds of the contribution are paid to a third party such as the EPC Contractor, the project company should be treated as the recipient of the contribution because the contribution gives rise to a liability on the part of the project company.

[8] It may be that in some jurisdictions a company cannot effectively assign or otherwise encumber its uncalled capital. Where this is the case, there would seem to be no objection to providing for the capital to be credited to a bank account which has been made the subject of appropriate security interests in favour of the lenders. However, it must be questionable whether (irrespective of the jurisdiction) such an arrangement could be effective to ensure that a contribution paid after the onset of insolvency could be claimed by the lenders to the exclusion of the project company's liquidator on the basis that there must logically be a moment between the time at which the moneys are paid by the shareholder and the time that they are credited to the relevant bank account when they are 'owned' by the company but not subject to any encumbrance.