The Project Finance Law Review

Editor

David F Asmus

The LawReviews

© 2019 Law Business Research Ltd

THE PROJECT FINANCE LAW REVIEW

Reproduced with permission from Law Business Research Ltd
This article was first published in May 2019
For further information please contact Nick.Barette@thelawreviews.co.uk

Editor
David F Asmus

THE LAWREVIEWS

© 2019 Law Business Research Ltd

PUBLISHER
Tom Barnes

SENIOR BUSINESS DEVELOPMENT MANAGER
Nick Barette

BUSINESS DEVELOPMENT MANAGER
Joel Woods

SENIOR ACCOUNT MANAGERS
Pere Aspinall, Jack Bagnall

ACCOUNT MANAGERS
Olivia Budd, Katie Hodgetts, Reece Whelan

PRODUCT MARKETING EXECUTIVE
Rebecca Mogridge

RESEARCH LEAD
Kieran Hansen

EDITORIAL COORDINATOR
Gavin Jordan

HEAD OF PRODUCTION
Adam Myers

PRODUCTION EDITOR
Rakesh Rajani

SUBEDITOR
Janina Godowska

CHIEF EXECUTIVE OFFICER
Paul Howarth

Published in the United Kingdom
by Law Business Research Ltd, London
87 Lancaster Road, London, W11 1QQ, UK
© 2019 Law Business Research Ltd
www.TheLawReviews.co.uk

No photocopying: copyright licences do not apply.
The information provided in this publication is general and may not apply in a specific situation, nor does it necessarily represent the views of authors' firms or their clients. Legal advice should always be sought before taking any legal action based on the information provided. The publishers accept no responsibility for any acts or omissions contained herein. Although the information provided is accurate as at April 2019, be advised that this is a developing area.
Enquiries concerning reproduction should be sent to Law Business Research, at the address above.
Enquiries concerning editorial content should be directed
to the Publisher – tom.barnes@lbresearch.com

ISBN 978-1-912228-72-0

Printed in Great Britain by
Encompass Print Solutions, Derbyshire
Tel: 0844 2480 112

ACKNOWLEDGEMENTS

The publisher acknowledges and thanks the following for their assistance throughout the preparation of this book:

ALLENS

KIRKLAND & ELLIS LLP

L&L PARTNERS

MAYER BROWN LLP

MILBANK, TWEED, HADLEY & McCLOY LLP

MORGAN, LEWIS & BOCKIUS LLP

NORTON ROSE FULBRIGHT LLP

SIDLEY AUSTIN LLP

SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP

URÍA MENÉNDEZ ABOGADOS, SLP

VEIRANO ADVOGADOS

WEBBER WENTZEL

© 2019 Law Business Research Ltd

CONTENTS

PREFACE v
David F Asmus

Chapter 1 WHAT IS PROJECT FINANCE? 1
David F Asmus

Chapter 2 PROJECT FINANCE ARRANGEMENTS IN GENERAL 7
Rajiv K Luthra and Pallavi Bedi

Chapter 3 BOND MARKETS AND DEBT PLACEMENTS 16
David Armstrong and Robert Warfield

Chapter 4 MULTILATERAL LENDERS AND REGIONAL DEVELOPMENT BANKS 29
Ana Carolina Barretto and Amanda Leal Brasil

Chapter 5 EXPORT CREDIT AGENCIES AND INSURERS 38
Barry N Machlin

Chapter 6 CORE PROJECT AGREEMENTS 46
Richard M Filosa

Chapter 7 COUNTERPARTY RISK 54
Ben Farnsworth

Chapter 8 LENDER RELATIONSHIP WITH PROJECT COUNTERPARTIES 64
David Armstrong and Gregory Howling

Chapter 9 PROJECT CASH, TYPICAL ACCOUNT STRUCTURES AND PROJECT CASH WATERFALLS 74
Brian A Bradshaw

© 2019 Law Business Research Ltd

Chapter 10 TYPICAL SECURITY ARRANGEMENTS FOR A SINGLE SOURCE PROJECT FINANCING 80
Borja Contreras and Ignacio Álvarez

Chapter 11 COMMON COLLATERAL FOR MULTI-SOURCE FINANCING 90
David F Asmus and Adam Cowan

Chapter 12 PUBLIC-PRIVATE PARTNERSHIP AND THE PRIVATE FINANCE INITIATIVE 96
Ania Gorna

Chapter 13 TAX-EQUITY FINANCING 101
Scott Cockerham, Brian Greene, Kelann Stirling and Mateo Todd Aceves

Chapter 14 ISLAMIC FINANCE 113
Munib Hussain

Chapter 15 GOVERNMENT PROCUREMENT 122
Alexandra Felekis, Mzukisi Kota, Nonkululeko Nojoko, Tina Terblanche and Ntokozo Qwabe

Appendix 1 ABOUT THE AUTHORS 131
Appendix 2 CONTRIBUTORS' CONTACT DETAILS 139

© 2019 Law Business Research Ltd

PREFACE

Many of the classic project finance texts are becoming increasingly dated as the years go by, while project finance itself continues to evolve with the markets it serves. The purpose of this volume is to provide a living guide to project finance that will be updated on a regular basis, while still tackling the core project finance concepts that every practitioner needs to understand.

As the inaugural addition, this volume seeks to cover the most salient topics while leaving scope for expansion into other key areas (such as mezzanine financing, government funding, and social and environmental issues) in the second edition. As discussed briefly at the end of chapter 1, all three of these areas have been in great flux, with newer funding sources (e.g., private equity), changes in the bond insurance market and more substantial environmental restrictions in effect at key lending institutions (particularly with respect to climate change concerns) all combining to change the complexion of the project finance market. The next several years should bring more clarity to all of these subjects, including particularly the future of project finance in the large oil and gas industry.

I would like to express my thanks to all of the authors of this inaugural edition. It is never easy to be a pioneer, which in this case entailed late nights drafting chapters from scratch for a new publication. Our authors have executed this task with distinction and aplomb. It is the hope of all of the authors that this volume not only will be of use to all of its readers today, but will also continue to grow in scope and utility in the years ahead.

David F Asmus
Sidley Austin LLP
Houston
April 2019

© 2019 Law Business Research Ltd

Chapter 14

ISLAMIC FINANCE

Munib Hussain[1]

I INTRODUCTION

Islamic finance is concerned with the conduct of commercial and financial activities in accordance with Islamic law, or *shariah* (derived primarily from the *Quran*, the holy book of Islam, and the *Sunnah*, words or practices instituted or approved by the Prophet Muhammad (PBUH)). Islamic finance emphasises productive economic activity over pure speculation, and encourages transaction counterparties to share profits and losses to promote collaborative efforts.

For project financings to be *shariah*-compliant, structures and techniques have been developed to accommodate the priorities of such Islamic-compliant participants. This chapter will:

a outline the key principles relevant to Islamic finance transactions (Section II);
b examine the typical funding structures deriving from those principles (Section III);
c discuss the application of Islamic finance principles and structures in a project finance context (Section IV); and
d address the particular challenges of combining Islamic finance with conventional project financing techniques (Section V).

II PRINCIPLES OF ISLAMIC FINANCE

Shariah is a body of law applicable to Muslims governing conduct within Islam, and is derived from two main sources; the *Quran* and the *Sunnah* (the words and deeds of the Prophet Muhammad (PBUH)).

There are a number of prohibitions under *shariah* which are relevant to commercial activities. Generally, if something is not prohibited (*haram*), it is allowed under *shariah* (*halal*). Therefore, to ensure compliance with Islamic law, individuals and companies must seek ways to arrange their affairs in accordance with a set of key principles that underpin the relevant prohibitions.

The *shariah* principles that are relevant to project finance are as follows:

i Riba (excess)

Riba means making unjust or excessive gains from commercial arrangements while assuming little or no risk, and is strictly prohibited under *shariah*. The prime example of *riba* is the charging of interest on a loan – mere exposure to the creditworthiness of the borrower over

1 Munib Hussain is a senior associate at Milbank, Tweed, Hadley & McCloy LLP.

© 2019 Law Business Research Ltd

time is seen as insufficient risk for the reward received. The effect of this principle is that any provision involving payments that could be deemed interest would be void. Instead, the lender must participate in some way in the potential profits and losses of the enterprise being financed.

ii Gharar (uncertainty)

The prohibition on *gharar* means that any agreement whose fundamental terms are deemed too uncertain is invalid under *shariah*. For example, some insurance contracts where there is uncertainty around the occurrence of an event could be void under this principle. This is to encourage disclosure of details as between the parties and limit the impact of chance.

iii Maysir (speculation)

While the ordinary commercial risk of carrying on a business is permissible, *shariah* prohibits transactions that rely predominantly on speculation. On the basis of this principle, together with *gharar* above, many conventional derivatives contracts are problematic from an Islamic finance perspective.

iv Qimar (gambling)

In a similar vein to some of the above principles, any transactions which are tantamount to gambling are prohibited under *shariah*.

In addition to complying with the above principles, lenders wishing to be *shariah*-compliant must take care not to invest in certain prohibited (*haram*) products or businesses, such as casinos or drinking establishments.

III ISLAMIC FINANCE STRUCTURES

The primary structures used in Islamic finance transactions represent a way to meet the priorities of investors and entrepreneurs in various circumstances while adhering to Islamic finance principles. These structures are in widespread use among industry participants seeking to be *shariah*-compliant, though there may be nuances according to the jurisdiction and other local considerations.

All of the main Islamic finance structures share common features. These include the sharing of profit and loss among transaction parties (and consequently a preference for equity over debt), and the involvement of real and tangible assets. Because of these features, Islamic finance is used as a form of both asset-backedand asset-based financing.

i Ijarah (lease)

The *ijarah* is typically used in project financings where the asset already exists in some form. It is a type of lease arrangement whereby the lender takes ownership of an asset and leases certain usage rights over it (known as usufruct) to the project company in return for rental payments.

The two types of *ijarah* are the *ijarah wa iqtina*, in which the asset is sold back to the project company either at the end of the term or over the course of the lease period (akin to a finance lease), and an arrangement more akin to an operating lease whereby the lender retains the asset after the lease has ended.

© 2019 Law Business Research Ltd

Forward sales are generally prohibited under *shariah* for reasons of uncertainty (*gharar*). However, *shariah* does permit a form of forward lease common in project financings known as *ijarah mawsufa fi al-dhimma*. Under this arrangement rental payments only become due once the project company takes delivery of the asset, which ensures sufficient certainty.

ii Istisnah

The *istisnah* is also commonly found in project financings as well as other contexts. Unlike the *ijarah*, it is more suited to financing an asset that is yet to be built or developed. Under this structure, a contractor undertakes to construct or develop an asset, and in return receives payment from the financier, either in the form of an upfront advance or phased payments over the course of the construction period. On completion, and provided certain specifications are met, the contractor delivers the asset to the financier who sells (or leases) it immediately on to the project company. In practice, this company is often the same entity as or affiliated with the contractor.

iii Murabahah

The *murabahah* is well suited to trade finance scenarios and can be adapted to form a structure that mirrors the effect of a conventional loan without *riba* (the commodity *murabahah*). Under the traditional *murabahah* structure, the financier purchases the asset from a supplier then sells it on immediately to the customer in return for a deferred payment. This deferred payment includes a mark-up reflecting the amount that would be paid as interest under a conventional facility agreement.

iv Mudarabah

The *mudarabah* is suitable for investment ventures in which the financier agrees to have a closer involvement in the project, and is used for *shariah*-compliant investments. It is a joint arrangement in which the financier (known as the *rab-al-mal*) contributes capital and the other party (the *mudarib*) is responsible for carrying out the work, usually for a fee. The parties agree in advance the proportions in which to share any profits between them.

It is worth noting that the *rab-al-mal* is the only party that assumes the risk of losses resulting from the venture, and any attempts to transfer this risk to the *mudarib* are likely to be prohibited under *shariah* principles. A recent example of this is UAE-based issuer Dana Gas, who was arguing that its *mudarabah* should be unenforceable as the risk of losses was improperly mitigated by a guarantee provided to the *rab-al-mal* by the *mudarib*.

v Musharakah

The *musharakah* is seen as the most suitable vehicle for sharing profits and losses in accordance with *shariah* principles. This is because it involves agreeing the proportions in which profits are shared but agreeing that losses are to be distributed to the parties according to the amount of capital each has invested. Control in this arrangement is usually exercised by one of the parties as agreed, though both are entitled do so under the *musharakah* structure.

In a variation of this structure, one party can buy out the interests of the others (for a negotiated fee) over the term of the *musharakah*. This is known as *musharaka muntahiya bittamleek*, or a diminishing *musharakah*.

© 2019 Law Business Research Ltd

vi Sukuk

Sukuk are bond-like instruments and are often referred to as such. However, although they mirror the effects of conventional debt securities, they are trust certificates. Under a *sukuk* instrument, one party holds an asset on trust for the *sukuk* holders, and the issuer of the instrument makes predetermined payments to those investors based on the income from the underlying assets. Those payments ensure a regular return and the certificates can be redeemed once they mature. In addition, *sukuk* are in certificated form and can be traded on securities exchanges if listed. Such features mean *sukuk* act in analogous ways to conventional debt-based bonds, while complying with *shariah* principles.

The two main types of *sukuk* structures are asset-backed *sukuk* (where certificate holders hold direct (beneficial) rights in the underlying assets), and asset-based *sukuk* (where investors are only entitled to the cash generated by those assets).

Each of the structures referred to above can also be combined effectively in a project financing context. A common example of this would be using a *mudarabah* or *musharakah* as an investment vehicle to provide capital for the construction of an asset by means of an *istisnah*. An *ijarah* structure could then be used for the leasing of the completed asset to the project company.

IV ISLAMIC PROJECT FINANCE TECHNIQUES

Typically, a large project will require multiple funding sources for both the construction and post-completion phases (a multi-source project), enabling project risk to be spread among a greater number of investors. The need to obtain funding from certain countries may also be driven by geopolitical considerations.

In a *shariah*-compliant financing, such sources might include financial institutions providing facilities analogous to loans, Islamic financial institutions (IFIs) or investors in *sukuk* (transferable financial instruments analogous to bonds), alongside conventional lenders, Export Credit Agencies (ECAs) and bondholders.

Each of these participants has different objectives and requirements. IFIs must ensure a high level of adherence to *shariah* principles, both in how finance is provided and the purpose or purposes for which the funds are used. ECAs, on the other hand, are concerned with the extent to which funds are used to promote exports for the country of origin.

The way in which the financing is arranged must therefore accommodate the needs of each of these funding sources. For example, a separate Islamic facility with separate documentation will cater for the IFI that is prohibited from lending directly to the project company lest any return be considered *riba*. Meanwhile, project *sukuk* might also be used to gain access to a larger pool of investors.

The remainder of this section will examine the Islamic facilities and project *sukuk* financing methods in more detail within the context of a multi-sourced project financing.

© 2019 Law Business Research Ltd

i Islamic facilities

The two main types of Islamic facility are *wakala-ijarah* and *istisna'a-ijarah*.[2] These both enjoy widespread commercial acceptance and tend to be used in combination. Project *sukuk* have also been used in multi-source project financings in the Middle East.[3]

Wakala-ijarah and istisna'a-ijarah facilities

First, the assets to be financed using Islamic bank facilities are identified, known as the Islamic assets. The construction financing for these Islamic assets only is provided by the *wakala* agreement under the *wakala-ijarah* facility, and the *istisna'a* agreement under the *istisna'a-ijarah* facility. Meanwhile, conventional facilities provide the financing for the rest of the assets in the project.

In a conventional project financing arrangement, the project company will make phased payments upon request to an engineering, procurement and construction (EPC) contractor, known as EPC milestone payments, out of funds received under a bank facility. In an Islamic facility, amounts equivalent to EPC milestone payments are instead provided by the IFI to an Islamic facility agent, which then pays these amounts to the project company. In return, the project company makes rental payments (mirroring the interest under a conventional facility) to the IFI's agent. These will be paid in advance while the Islamic assets are being constructed.

Once the Islamic assets are complete and operational, the IFI leases the right to use the assets to the project company in return for lease payments, under an agreement known as the *ijarah mawsufa fi al dhimma*. Generally, once the lease period expires, the project company takes ownership of the Islamic assets. However, in certain cases, ownership might be transferred gradually to the project company over the course of the lease, for example, in an *istisna'a-ijarah* arrangement.

Governing law and dispute resolution

Islamic facility agreements give rise to particular challenges when it comes to both the governing law to be used and the appropriate jurisdiction for the resolution of disputes. One common preference is for English law to be the governing law in respect of Islamic bank facilities in project financings and for the English courts to resolve disputes arising under them. This is because the English courts have long been prepared to hear disputes arising in other countries provided that the agreements are governed by English law. It also means the parties can rely on an established and consistent case law that does not have multiple interpretations (or *madhabs*) and is used to dealing with issues arising in complex, cross-border financings. The English courts are also seen as generally more favourable to creditors than forums in other jurisdictions.[4]

---

2 The Shuaibah IWPP project in Saudi Arabia was the first to use the *wakala–ijarah* facility structure in December 2005. It was later used in the Marafiq IWPP located in Jubail, Saudi Arabia (May 2007), the Al Dur IWPP located in Bahrain (June 2009), and the PP11 IPP (June 2010). Examples of the application of *istisna'a–ijarah* structures include the Qatargas 2 LNG project located in Qatar (December 2004), the Rabigh refinery located in Saudi Arabia (March 2006), and the PP11 IPP.

3 The Sadara Integrated Chemical Project located in Saudi Arabia (June 2013) and the SATORP Jubail Export Refinery Project located in Saudi Arabia (June 2010) were both examples of this.

4 Though it has been implemented in various countries such as Saudi Arabia, *shariah* cannot be said to pertain to any particular country. This connection is a requirement of an agreement's governing law under the Convention on the Law Applicable to Contractual Obligations 1980 (the Rome Convention).

© 2019 Law Business Research Ltd

However, this approach gives rise to the risk of conflict of laws issues. This is firstly because of the doctrine of *lex situs*, which states that it is the law of the jurisdiction in which an asset is located that should govern the proprietary aspects of that asset. This means that if the project is to finance an asset in one country, then the law of that country may have automatic jurisdiction over the agreements underpinning the project. Moreover, a given agreement may be unenforceable if it is inconsistent with the local country's laws.

A second concern in respect of *shariah*-based provisions is that it may be unclear whether English law or *shariah* principles should prevail in case of a conflict. In approaching this question, it is worth asking whether English judges possess the necessary expertise to decide cases involving Islamic principles, and if they were to do so, which interpretation (or *madhab*) they would apply.

The English courts have customarily approached these issues by ruling that any *shariah*-based elements are part of the commercial content of an agreement, not its legal and justiciable provisions. Therefore, only English law principles will be applied and the parties must satisfy themselves that the document is *shariah*-compliant using other channels.[5]

In practice, this is done by an agreed expert on *shariah* giving a *fatwa* (or ruling) to the above effect, before the parties enter into the agreement. The parties will typically include provisions within the facility agreement acknowledging that each is satisfied that the document in question is fully compliant with *shariah* and that the *fatwa* stating this is legitimate.[6]

Participants in project financings are increasingly opting for Islamic facility documents to be governed by local laws, particular for Middle Eastern projects. This may be owing to the requirements of the local country, the doctrine of *lex situs* as outlined above or the influence of domestic lenders.

Events of default

With multiple financing instruments using a variety of structures and having a variety of objectives, it is important for the project company in multi-source project financings to agree a common terms agreement (CTA) with the financing parties, which sets out the terms that are common to all the instruments in the project. It will then need to be an event of default under the CTA if an event of default occurs under one of the Islamic facility documents. This guarantees that the various facility documents are linked for the purposes of events of default, remedies, revenue and enforcement cash waterfalls, and that the conventional facilities are ranked *pari passu* with the IFIs where this reflects the intention of the parties.

---

5 See *Shamil Bank of Bahrain v. Beximco Pharmaceuticals Ltd* [2003] 2 All ER (Comm) 849. A recent judgment in the English High Court (*Dana Gas PJSC v. Dana Gas Sukuk Ltd and others* [2017] EWHC 2928) also confirmed that this was the correct approach. The latter case involved a UAE-based issuer called Dana Gas (DG), which argued that its *mudarabah sukuk* should not be enforced on several grounds, including non-compliance of the *sukuk* with *shariah*. DG initially attempted to obtain a judgment in the Sharjah Federal Court of First Instance. However, since it was English law that governed several of the *sukuk* documents, it also successfully applied to the English High Courts for an interim injunction preventing any declaration of event of default or dissolution event from the certificate holders under the *sukuk*. DG partially based its argument for this on the *Ralli Bros* principle, which renders unenforceable any contract governed by English law containing an obligation to take an action in a certain location where doing so in that location would be unlawful. A judgment handed down on 17 November 2017 found DG to be unsuccessful on all grounds.

6 Any *sukuk* prospectus will also include a similar disclaimer from the issuer.

© 2019 Law Business Research Ltd

Termination and mandatory prepayment

In a conventional loan facility, the lender accelerates the amounts lent on the occurrence of an event of default, by issuing an enforcement notice and calling in the loan pursuant to the relevant provisions in facility documents. In a *shariah*-compliant arrangement, acceleration occurs by the providers of the Islamic financing requiring a 'termination sum' from the project company. In an *istisna'a–ijarah* facility, this is done by the IFIs exercising a kind of put option known as a purchase undertaking, while in a *wakala–ijarah* facility, they would require the lessee to make a termination sum payment in accordance with the lease agreement.

ii Project sukuk

Under a *sukuk*, the returns payable to the certificate holders are based on the performance of a real asset, which makes it an ideal structure for use in project financings.

One type of structure that is frequently used is the *sukuk al–ijarah*, which is employed in asset-backed and asset-based financings. Under this arrangement, the trust certificates are issued by a special purpose vehicle (SPV), which uses the proceeds to acquire certain assets from the seller (the Islamic assets). The SPV acts as agent and trustee for the *sukuk* holders, who each have a joint and undivided proprietary interest in the Islamic assets (along with the other holders). The Islamic assets are then leased to the project company, which makes rental payments to the SPV in exchange. The amounts paid as rent will include both the price of the assets and a margin as markup, which may be fixed or floating (based on LIBOR). The issuer uses the rental proceeds to make periodic payments to the certificate holders such that each investor obtains a return on their investment on a pro rata basis. At maturity, the project company is required to purchase the Islamic assets from the issuer for an amount equal to the outstanding rental payments. The issuer uses these funds to make a final distribution in redemption of the certificates from the investors.

In a multi-sourced project financing, project *sukuk* are typically asset-based, meaning that the issuer is a senior creditor and is entitled to the monies received from disposal of the assets should investors vote to accelerate upon an event of default, among other sources of funds. Thus, the certificate holders are only entitled to the cash amounts due and payable to the issuer – they do not have a right to take ownership of the underlying assets or sell them to repay debts owing to them under the certificates. It is only when all the finance parties vote for a general acceleration pursuant to an inter-creditor agreement that the issuer, acting on behalf of the certificate holders, has right as a senior creditor to take possession over the secured assets of the project.

Status of the project sukuk

The parties must decide, prior to entering into a project *sukuk*, how the instrument should rank in relation to the other senior facilities. If a *pari passu* arrangement is chosen, there are several issues to consider: whether the periodic distribution amounts should be paid at the same level in the cash flow waterfall; whether the security given by the project company should be shared among different creditors; and what arrangements should be put in place in respect of to inter-creditor voting rights.

Holders of *sukuk* certificates may enjoy rights akin to those granted to investors in conventional bonds issued under Regulation S or Rule 144A of the US Securities Act 1933.

© 2019 Law Business Research Ltd

This is the case in respect of certain voting rights such as on specified waivers or the right on an event of default to trigger and vote on enforcement action. Investors in both types of instrument also receive the benefit of incurrence covenants only.[7]

Other matters to consider when structuring and issuing a project sukuk

The following key considerations apply when structuring and issuing a project *sukuk* (most are also relevant to conventional bond issuance).

Given that the distributions made to certificate holders by the issuer may be treated differently for tax purposes depending on the jurisdiction, it is important to choose the place of incorporation for the SPV issuer with this consideration in mind.

If the project *sukuk* are denominated in a different currency to that in which the revenues of the project are generated, this will expose investors to exchange rate fluctuations. The currency of the *sukuk* certificates may therefore need to be the same as the project currency. There may also be local regulations that restrict the currencies that can be used for the project *sukuk*.

The SPV issuer, together with the project company, will need to publish a prospectus and comply with any other applicable capital markets regulations. While this document will in most respects be the same in form and content as prospectuses for conventional listed securities, a project *sukuk* prospectus will also include the *fatwa* attesting to the instrument's compliance with *shariah*. This is typically prepared by the *shariah* supervisory board of the SPV issuer, the project company, or the joint lead managers of the sukuk.

More generally, the risk of non-compliance with *shariah* principles should be mitigated to the extent possible, both when it comes to the project *sukuk* and any other Islamic finance arrangements. The importance of this was seen in the recent case of *Dana Gas PJSC v. Dana Gas Sukuk Ltd and others*.[8] In that case, one party argued that a *mudarabah* agreement governed by UAE law did not comply with key *shariah* principles (following a development in jurisprudence), and that as a result the purchase undertaking agreement based on it (which was governed by English law) should be found to be void on the grounds of mistake. This argument was rejected by the English High Court because there were contractual safeguards that addressed any risk of non-compliance with *shariah* that had been agreed between the parties. In addition, there was a dispute over the location in which the obligations of the contract should be considered to have been performed. The court found that as payments under the purchase undertaking agreement had been made to a London bank, the correct location was not the UAE but England. Neither *shariah* nor UAE law were therefore relevant to whether the agreement was enforceable. The case demonstrates the

7 In a possible exception to this, however, the project *sukuk* in two Saudi Arabian projects (the Sadara Integrated Chemicals Project and the SATORP Jubail Export Refinery Project) ranked predominantly *pari passu* in relation to the conventional senior debt. This was done so that the certificates would appeal to Saudi Arabian investors who buy these kinds of securities with a view to holding them for a long period of time. This is for several reasons: firstly, conventional debt securities issued under Rule 144A or Regulation S would not normally have the level of protection afforded by both maintenance and incurrence covenants; secondly, certificate holders would be able to redeem them early whenever any of the senior facilities were subject to a mandatory redemption; and finally, investors would also benefit from the security given in the project financing on a *pari passu* basis with the other senior creditors.

8 [2017] EWHC 2928 (Comm).

© 2019 Law Business Research Ltd

essential nature of provisions within contracts that deal with non-compliance with *shariah* (for example warranties and representations). The outcome also has a significant bearing on the performance of payment obligations in jurisdictions that are not governed by *shariah*.

V INTEGRATING THE CONVENTIONAL AND ISLAMIC FACILITIES

Any issues that might appear when combining the Islamic structures discussed above with conventional elements of the financing must be addressed and solved as early as possible in the structuring process. Many of those issues and their solutions have been mentioned already in other sections of this chapter. The most important among them are those relating to the relationships between the different finance parties, and in particular the inter-creditor arrangements between IFIs and conventional lenders.

For example, it is essential as an inter-creditor matter to harmonise provisions dealing with events of default and the exercise of remedies between the conventional facilities and the Islamic facilities. No creditor would be willing to accept another being able to accelerate its loan following an event of default under that facility, but not be able to accelerate itself upon occurrence of the same event. After all, though the asset or assets in question may have several very different sets of funding arrangements, it is one project being funded and must be treated as such.

Care must also be taken over the coordination of payments from the project company from its cash waterfall to the creditors, both when it comes to scheduled payments and prepayments (mandatory or voluntary). This depends on the commercial terms that have been agreed, but will be especially important if the IFIs rank *pari passu* with the conventional lenders. In a typical pre-enforcement waterfall under an inter-creditor deed, the IFIs and the senior conventional lenders are entitled to returns in proportion to the level of their investments.

However, some scholars ruling on *shariah* compliance may not allow certain funds to be distributed to conventional lenders, such as sale proceeds from the Islamic assets or rental payments under a lease made prior to the transfer of the asset to the project company.

The Islamic and conventional financing parties must therefore agree the following:

a the circumstances under which decisions under the inter-creditor agreement and the common terms agreement (CTA) are to be made jointly between the conventional lenders and the IFIs;

b whether an IFI can unilaterally take a decision to accelerate its own facility, with the effect that acceleration is not required to occur under the conventional facilities; and

c if the conventional lenders need to be consulted on an acceleration decision, what the voting threshold should be – a lower threshold is advisable since there are usually many more conventional lenders than IFIs, so it may be difficult to obtain sufficient consent.

The extent of the security given by the project company is also a significant consideration when incorporating Islamic finance into a project financing. A key question is whether the scope of the security should be limited to the project company's obligations to the conventional lenders, or whether it should also cover obligations to the IFIs. Finally, since security is usually given over the whole project, it is important to take into account the effect of this on the Islamic assets and any sharing of security among the various creditors, including with the conventional banks.

© 2019 Law Business Research Ltd

Appendix 1

ABOUT THE AUTHORS

MUNIB HUSSAIN

Milbank, Tweed, Hadley & McCloy LLP

Munib Hussain is a senior associate in the London and Tokyo offices of Milbank, and a member of the firm's global projects, energy and infrastructure finance group and Islamic finance business unit. Munib has advised both lenders and sponsors on a number of international projects, energy and infrastructure financings, specialising in multi-sourced financings involving export credit agencies (ECAs), multilaterals, Islamic banks and *sukuk* holders. As a member of Milbank's Islamic finance business unit, Munib has advised the joint lead managers of the US$2 billion project *sukuk* on the Sadara Integrated Chemicals Project; advised the joint lead managers on the US$1.25 billion *sukuk* issued by PETRONAS; advised the lenders on the petrochemicals expansion of the PetroRabigh combined refinery and petrochemicals facility; advised the unsecured creditors committee of Arcapita Bank BSC in relation to the issuance of a US$550 million *sukuk*; and represented the project company on the US$1 billion *murabahah* facility on the QSTec polysilicon project. Munib is recognised as an expert for Islamic finance in *Who's Who Legal 100*.

MILBANK, TWEED, HADLEY & McCLOY LLP

10 Gresham Street
London
EC2V 7JD
United Kingdom
Tel: +44 20 7615 3013
Fax: +44 20 7615 3100
mhussain@milbank.com
www.milbank.com

© 2019 Law Business Research Ltd

ISBN 978-1-912228-72-0

© 2019 Law Business Research Ltd