

Sardar Law Firm Special Bulletin Islamic Financing in an Economic Downturn

Contact Us

12 Desbrosses St.
New York, NY
631.838.0178
sardar@sardarlawfirm.com

About Sardar Law Firm

The SARDAR LAW FIRM leverages our core litigation capabilities with corporate, media, and government backgrounds, allowing us to quickly evaluate and meet targeted client needs. Because our attorneys come from different backgrounds, we have the opportunity to provide our clients with a diverse array of practice areas. Note: This document may contain attorney advertising.

For more information on structuring a deal through an Islamic Financing structure or other corporate law questions, please email Sheheryar Sardar at sardar@sardarlawfirm.com or Benish Shah at bshah@sardarlawfirm.com.

More Information

Follow us on Twitter:
twitter.com/sardarlawfirm

Read More on Our Blog:
sardarlawfirm.blogspot.com

Disclaimer: Disclaimer: Items on this website are not to be considered legal advice or to create any lawyer-client relationship. Articles may include some obsolete information. In addition, taking any legal information out of context, i.e., using it in a different court or a subtly different kind of case, or without the training to understand all of what it means or doing research to verify it, usually has disastrous consequences.



Sheheryar T. Sardar
Partner



Benish Shah
Associate

www.sardarlawfirm.com ♦ 631.838.0178

Structuring Business in an Economic Downturn: Part I: Islamic Financing through a Joint Venture

By, Sheheryar T. Sardar & Benish Shah

Developing your business in an economic downturn creates a host of difficulties for businesses of varying sizes. The most critical issue is the availability of capital to grow the business. With a continuing credit crunch, many banks and lending institutions are denying business loans due to more stringent risk analysis and lack of liquid assets. For those businesses that are able to secure a loan in this economic climate, high interest rates take a toll on company profits.

An untapped lending structure for businesses is found in Islamic Financing principles - a low-risk financing structure that provides much needed investment capital for start-ups, joint ventures, and growing companies.

Structuring the Deal Under Islamic Finance Principles: Mudaraba

The theoretical model of Islamic Financing is based in the concept of profit and loss sharing through the Mudaraba mode of financing. Mudaraba style financing is a form of investment partnership between a lending entity and a business that mandates the share of risk and losses/profits between both parties through a pre-determined business structure. A Mudaraba structure effectively requires the lender to take a stake in the business, with the business investing time and expertise in running the enterprise.

A fundamental component of Mudaraba is the appropriation of profits and loss. The business procuring the loan cannot be placed at the risk of losing any monetary investment/value provided by the lending investor. If the business venture fails, then

the maximum loss to the entrepreneur is the investment they made into the business enterprise themselves, i.e., their own capital investment. Furthermore, a Mudaraba structure releases the investor from management decisions. Day-to-day decision making and enterprise management must be left to the business entity.

Mudaraba for Joint Ventures

It is a misconception that Islamic Financing may only be provided through a banking structure. Developing an

investment strategy through a joint venture accurately utilizes the underlying concept of Mudaraba. In the case of a joint venture, there will be three parties involved in the deal structure: (1) Investors; (2) Fund; and (3) Business Entity. The Investors will deposit their capital investments into the Fund and the Fund shall use the Investors' monies to finance the projects of the business entity. The Fund plays a two-fold role: as the business entity being invested in by Investors and as the investor to the Business Entity. Essentially, the position of the Fund is that of an investment intermediary.

Creating the Fund

The Fund is created through an open "investment" arrangement where time deposit accounts are accepted by the Fund with the explicit understand that the monies will be invested into projects on a profit and loss sharing basis. These Funds bear neither guarantee of capital nor of profit. It is a sharing of risks all risks and profits.

Financing with the Fund

There are three partners under a Mudaraba structure: (1) Investors; (2) Fund; and (3) Business Entity. The investor is a pure financier who plays no other part in the joint venture. The Business Entity is a pure entrepreneur charged with managing and directing the business without investing any monies; the project belongs to the Business Entity. The investment intermediary is the Fund that is charged with multiplying the monies of the investors and financing the Business Entity. The fund invests neither its own money nor its own ideas, but acts as a intermediary and trustee that takes responsibility for development of the business entity and the multiplying of Investors' monies.

Because the Mudaraba system calls for an equal sharing of profit and loss based upon investment, each of the three partners would benefit from equal shares when there is a profit, and in the loss is borne equally based on the same investment strategy. What this means is: each partner will lose what they invest. The Business Entity will suffer the loss of time and work while the Fund and the Investors share equally in the financial loss.

This structure of loss sharing protects Investors and encourages the Fund to

make well vetted investments and forces them to be vigilant in evaluating investment possibilities. In the event of a loss, the Fund must share equally with the Investors, despite not having invested any real monies of their own. This loss sharing relieves the Investors' risk substantially because they will only suffer ½ of the loss they would be responsible for as private investors without an investment intermediary.

Lack of Interest, Lower Debt Risk

Developing a business structure without the weight of lender interest rates optimizes business profits and minimizes the risk of businesses going under or declaring bankruptcy based upon the inability to pay creditors. In the development of a Mudaraba structure, the capital investment is applied to the business without the continuous "pay-back" of the loan. The Investors provide monies in order to get a return on their investment, not to procure money based upon a set interest rate that does not take into consideration the status of the business.

The Mudaraba joint venture scheme expands the availability of investment capital and possibility of business growth by converting repayment structures to profit-sharing, without allowing investors the ability to meddle in the business structure. This structure is advantageous to investors because they are released from day to day issues of running a business; it is also advantageous to businesses because they can progress their venture through investment capital without the need to continuously repay loans with compounded interest.

This untapped lending option is a low-risk financing structure that is cutting edge for companies in the U.S. and in emerging markets. It exists outside the credit crunch, focusing on the development of trust between the Investors and the Fund, and the Business Entity and the Fund.

For more information on structuring a deal through an Islamic Financing structure or other corporate law questions, please email Sheheryar at sardar@sardarlawfirm.com or Benish at bshah@sardarlawfirm.com.

Look out for Part II of this article: [Using Mudaraba as a Partnership-Structure for Small Businesses and Start Ups.](#)