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LEGAL REGIME FOR SECURITY RIGHTS IN MOVABLE COLLATERAL:

AN ANALYSIS OF THE UNCITRAL MODEL LAW FROM A SHARI'AH PERSPECTIVE

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A NOTE ABOUT THIS REPORT

Portions of this report are taken from Michael J. T. McMillen, COLLATERAL SECURITY (RAHN) IN ISLAMIC FINANCE: SECURED TRANSACTIONS USING SHARIAH-COMPLIANT REQUISITES, currently in draft form and to be published by RiverStone Publishing Group as part of the "Islamic Finance in Practice Series." Portions of this report were previously presented by Michael J. T. McMillen at an international conference held on September 19, 2014 in Geneva, Switzerland entitled "The Draft UNCITRAL Model Law on Secured Transactions: Why and How?" and in an article based upon that presentation, which is available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2526079.

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ACRONYMS AND ABBREVIATIONS

GLOSSARY

Executive Summary

This Executive Summary summarizes the report entitled "Legal Regime for Security Rights in Movable Collateral: An Analysis of the UNCITRAL Model Law from a *Shari'ah* Perspective", dated February 1, 2016, and addressed to the World Bank, International Bank for Reconstruction and Development, International Development Association, and International Finance Corporation (the "Report"). Table 1, in the section entitled "Comparison of Model Law and Relevant Shari'ah Principles, which precedes section 1 of the Report, provides a detailed comparison of the the draft model law on secured transactions (the "Model Law") prepared by Working Group VI (Security Interests) (the "Working Group") of the United Nations Commission on International Trade Law ("UNCITRAL") against the relevant *Shari'ah* principles; this table should be reviewed. Table 2, in section 1 of the Report, presents definitions of defined terms taken from the Model Law. Table 3, in section 1 of the Report, defines terms used in the body of the Report. This Executive Summary is subject in all respects to the complete Report, including its notices, defined terms, and qualifications.

1. INTRODUCTION

An effective legal regime for security rights in property—particularly movable property—is crucial for economic growth and for the promotion and operation of commercial and financial markets. The existence, nature, and operation of the legal regime for security interests in movable property influence both perceptions of, and determinations relating to, certainty, predictability, and stability of commercial and financial arrangements. These factors are a primary consideration in risk assessments and pricing determinations. They influence determinations as to whether an individual person will participate in a market, and thus are a fundamental factor in determining whether external capital will be attracted to a specific market and in allocating capital within and across markets.

Securities rights in movable property are critical to small and medium sized enterprises ("SMEs") because these enterprises frequently have only movable property assets to provide as security for financing (they rarely have immovable property available for such purposes). A secure legal regime for moveable collateral enables working capital and some forms of firm income to be pledged as collateral.

The Working Group has developed a comprehensive legal regime for secured transactions over movables: the Model Law (and supporting documents). The Model Law is proposed for adoption by, or as a source of inspiration to, countries that desire to adapt their legislation to current developments and contemporary markets.

The Model Law, and supporting materials, focus on systems that do not apply *Shariʿah* principles. However, there is a pressing and immediate need to develop and implement legal regimes for secured transactions that will be enforceable under the *Shariʿah* due to the growth of Islamic finance and the relative dearth, or fragmentary nature, of existing security regimes (both conventional and *Shari'ah*-compliant) in many of the jurisdictions in which Islamic finance is practiced.

The Report considers select provisions of the Model Law from the *Shariʿah* perspective. The objective is to provide a comparative vantage on the types of adjustments that must be considered in adapting the Model Law to jurisdictions in which *Shariʿah* principles are applied. The particular focus is on areas in which the Model Law must be adjusted to optimize the provision of *Shariʿah*-compliant financing to SMEs. This Executive Summary highlights a few of the critical differences between the Model Law and the relevant *Shariʿah* principles in this context.

2. COMPARISONS OF REPRESENTATIVE PROVISIONS OF MODEL LAW AND *SHARI'AH* (*RAHN*) PRINCIPLES

Each of the four primary orthodox Sunni schools of Islamic jurisprudence (Hanafis, Hanbalis, Malikis, and Shafi'is) interprets the relevant *Shariʿah* principles differently. Some interpretive differences are relatively slight; others are significant. Dispute resolution authorities may have to make adjustments to ensure enforceability of the adapted Model Law where *Shariʿah* principles are applied; these adjustments will vary significantly from one country to another. This will entail detailed discussions with *Shariʿah* scholars and jurists on a jurisdiction-specific basis. Whatever the interpretations of the relevant *Shariʿah* principles, they cannot be varied by the transactional parties in a manner similar to the variation allowed by the Model Law because the *Shariʿah* principles are divinely revealed.

This summary discusses only a few of the many topics that are addressed in the Report. The intention is to select a few illustrative topics to provide an introduction to the types of adjustments that will have to be made to the Model Law. These topics are discussed at a general level, focusing on general principles. No mention is made here of the qualifications and conditions that attach to these principles, nor does this summary address all (or even most) of the differences the Model Law formulations and the relevant *Shari'ah* principles.

The Model Law can and should be reconciled with the relevant *Shari'ah* principles, although reconciliation will entail some creative effort and immersion in the details that are not discussed in this summary. In light of variations among the different schools of Islamic jurisprudence and some areas of notable difference between Model Law conceptions and *Shari'ah* principles, reconciliation must begin with efforts to distill the essential principles that are agreed by all schools of Islamic jurisprudence, and then progress to creative accommodation. The efforts of the Accounting and Auditing Organisation for Islamic Financial Institutions ("AAOIFI") are illustrative, and a commendable start. But they are only a start, and much work remains.

A. Possession

SME Need: SMEs must retain possession and use of the encumbered asset to conduct their business and generate income to repay the amount financed. SMEs generally have no "excess" assets, and they have little or no real property assets: essentially all available assets are "movable" assets.

Model Law: Possession of the encumbered asset by the secured creditor is not necessary or required.

Shari'ah: There are two conflicting *Shari'ah* principles. First, there should be no waste of the usufruct of a property: it should be used productively. Second, a secured creditor must retain possession of the encumbered asset during the term of the security right. The secured creditor must receive and possess the encumbered property (absent the required possession, the creditor is treated as an unsecured creditor). The required possession is physical possession, except for the Maliki school, which accepts constructive possession concepts. The schools differ regarding the permissibility of debtor possession and use of the encumbered asset during the term of the security right. The Malikis do not allow debtor possession and use. The Shari's allow debtor possession and use. The Hanafis and Hanbalis allow some debtor possession and use of the encumbered asset with the permission of the secured creditor.

AAOIFI: The AAOIFI Standard distinguishes between and acknowledges both "actual" and "legal" possession. Legal possession is based upon registration of a security right in a registration system and operates as a type of constructive possession concept. The secured creditor has no right to use or benefit from the encumbered asset free of charge, whether or not the debtor has given permission for use. If the

debtor does give permission for use, the secured creditor must pay the "normal pay" for similar assets to the debtor.

Reconciliation Suggestion: Acknowledgement of registration systems as effecting the required possession (along the lines of the AAOIFI Standard) works well, but will require the implementation of registration systems. Secured creditor permission for debtor use should be effected in all documentation. *Shariʻah* scholars are currently considering the implications of registration systems from the *Shariʻah* vantage.

B. Future Advances

SME Need: SMEs need continuing access to financing for working capital, inventory acquisition and maintenance, and operations and maintenance expenditures. Typical required arrangements are revolving credit arrangements, which provide for multiple future advances. These are cost-effective means of financing SMEs.

Model Law: Future advances and uncertain sums (to a maximum amount) are secured.

Shariʻah: Uncertain sums and unmatured obligations may not be the subject of a valid security right. The schools are split on the permissibility of a grant of a security right before a related secured obligation has been established. There are differences among the schools as to when an obligation is "established" and when an obligation has "matured". Some schools interpret an obligation to be matured when a definitive obligation to repay has been established.

AAOIFI: Future advances are secured if there is a grant of a security right at the same time or before the secured obligation is established and the obligation (debt) is adequately defined.

Reconciliation Suggestion: The AAOIFI Standard is a good base, and should be further refined to incorporate interpretations that define a matured obligation relative to establishment of the repayment obligation.

C. Remedies

SME Need: SMEs need the remedies process to be cost-efficient, but also need adequate debtor protections against overreaching and aggressive creditor actions. The availability of self-help remedies to the creditor increases willingness to lend or otherwise finance. This is an area of careful balancing of interests.

Model Law: Self-help by a creditor is permissible.

Shariʻah: Classical principles disfavor extra-judicial remedies. Usually, a secured creditor cannot sell, dispose of, lease, or license an encumbered asset in a public or private arrangement. The debtor owns the property, and the general rule is that only the debtor can sell, dispose of, lease, or license the encumbered asset (or the court will do so if the debtor fails to do so). The principles seem based on considerations of debtor protection.

AAOIFI: The secured creditor can be appointed as the agent of the debtor to effect extra-judicial sales, dispositions, leases, and licenses.

Reconciliation Suggestion: The AAOIFI Standard is a good base. It incorporates fiduciary concepts attendant upon agency doctrines.

D. Proceeds and Additions

SME Need: The availability of proceeds to both the SMEs and the secured creditor is critical. SMEs need the proceeds to support continuing operations, maintenance, and expansion. Asset values of the encumbered assets are usually insufficient, and supplementation of the collateral by proceeds is important to provide adequate collateral, thereby reducing transaction costs and increasing the availability of financing. The means of production and the proceeds of production are intimately connected and should be addressed jointly and simply for the benefit of both the debtor and the secured party.

Model Law: Proceeds are available to both the debtor (for use and expenditure) and the secured party, whatever the source of the proceeds.

Shari'ah: Classical principles are essentially the same as under the Model Law, where the proceeds arise as a result of (a) asset sales and dispositions, and (b) loss, damage, and destruction of the encumbered asset. Both the *Shari'ah* principles and the Model Law substitute the proceeds for the encumbered asset in these situations. In other cases, *Shari'ah* principles differ; the difference depends upon the nature and type of proceeds. Accretions and increases (including "rent") are separate property of the debtor and not subject to an existing security right (unless they fall within certain categories, such as crops that have not been severed from the land). The *Shari'ah* rules are complex.

AAOIFI: Appreciation of the value of the encumbered asset and income from the encumbered asset are subject to the existing security right.

Reconciliation Suggestion: The AAOIFI standard is a good base, and should be refined relative to the more complex *Shari'ah* principles with respect to specific types of assets and their status at various points in time.

E. Subsequent Liens and Priorities

SME Need: As SMEs grow, and particularly as they become medium-sized entities, they need to raise expansion capital, as well as working capital, inventory financing, trade financing, and operations and maintenance finance. This may entail use of different subordinated financing arrangements, and these will entail considerations of creditor priority.

Model Law: Second and subsequent liens, and multiple priority arrangements, are permissible.

Shari'ah: Classical principles for the non-Malikis are that it is not permissible to grant a second security interest on an encumbered asset (it voids the first security interest). The Malikis allow second security interests if the value of the encumbered assets exceeds the amount of the first secured obligation.

AAOIFI: The AAOIFI Standard allows multiple liens of different ranks and multiple security rights of different priorities.

Reconciliation Suggestion: The AAOIFI Standard is a good base, and should be refined relative to the nuances of the *Shari'ah* rules (which have not been presented here). Considerations relating to registration systems, which are currently being considered by *Shari'ah* scholars, are likely to be supportive of multiple lien, multiple priority differentiations.

F. Occupied, Occupying, and Connected Property

SME Need: SME have limited assets. Their assets are tightly integrated. There is a need for efficient collateral security arrangements with low associated transaction costs using these assets.

Model Law: The Model Law does not distinguish between, and can separately grant security interests in, occupied and occupying property.

Shari'ah: Classical principles vary by the type and nature of the property and are relatively detailed and complex, with variations by school of Islamic jurisprudence. As general statements: A security right cannot be granted on a property that is occupied by another property that is not subject to the security right (for example, a security right on land must include a security right on the crops growing on that land). A security right can be granted on occupying property without granting a security right on the occupied property (for example, a security right on furniture inside a house may be granted without granting a security right on the house). A security right cannot be granted on a property that is connected to another property, unless both are included in the grant of the security right (for example, a grant on the fruit of a tree must include a grant on the tree).

AAOIFI: The AAOIFI Standard has not issued any guidance on these issues. However, the "appreciation in value" concepts described in the AAOIFI treatment of proceeds tends toward a simple solution that is harmonious with Model Law concepts.

Reconciliation Suggestion: Encourage the AAOIFI to issue rigorous guidance on these issues. This is an example of a reconciliation that will entail rather detailed parsing of the relevant principles, particularly as to the nuances of and qualifications to the general principles made in this summary. The reconciliation effort will have to be extend to leased and licensed property and similar arrangements.

3. CONCLUSION

There are numerous areas and topics that are not discussed in this summary in which and with respect to which reconciliation will require research as to the relevant *Shari'ah* principles (and their variations and qualifications under the interpretations of the different school of Islamic jurisprudence), as well as creative collaborative effort. These include: rules with respect to specific types of property (usufructs, debts, accounts, financial instruments, intellectual and other intangible property, fungible and nonfungible property); the nature of categories of proceeds, accretions, and increases ("contiguous", "derivative" "non-derivative", "separate", and "separately identifiable", among others); expenses relating to encumbered assets and the respective obligations of the debtor and the secured creditor; and sales, transfers, leases, licenses, and other dealings with respect to encumbered assets.

As illustrated by the topics discussed in this summary, reconciliation of the Model Law is both possible and practicable. Achieving that reconciliation is critical given the growing number of jurisdictions in which the *Shari'ah* is applied, and the importance of SMEs to the global economy. (It can be argued that the Model Law is not really an "effective" legal regime if it is not adaptable to those jurisdictions that apply the *Shari'ah*.) In any case, reconciling the Model Law with applicable *Shari'ah* principles will do much to enhance the certainty, predictability, and stability of commercial and financial arrangements, particularly risk assessments and pricing determinations that influence determinations as to whether an individual

will participate in a market, whether external capital will be attracted to a specific market, and allocations of capital within and across market

1. DEFINED TERMS

Terms defined in the draft Model Law on Secured Transactions (the "Model Law") prepared by *Working Group VI (Security Interests) (the "Working Group") of the United Nations Commission on International Trade Law ("UNCITRAL")* have the meanings provided therein. Selected definitions from the Model Law are set forth in Table 2. The definitions in Table 2 are not verbatim from the Model Law, and the reader should refer to the text of the Model Law for precise definitions. The definitions for these terms are provided in Article 2 of the Model Law. Bracketed language in the definitions (and in material quoted from the Model Law) is also bracketed in the current draft of the Model Law, usually because that language is still being considered by the Working Group. (The reader should consult the Notes to the Working Group that are included in the current draft of the Model Law with respect to such bracketed language.)

A few cautionary notes are in order regarding defined terms as used in this report. The defined terms in the Model Law are not capitalized. This can be confusing when the same term is used outside the context of the Model Law. Moreover, the same terms are used in discussing the Shari'ah principles, and those terms may have a somewhat different meaning as used in the Shari'ah context.

TABLE 2
SELECTED DEFINITIONS FROM THE MODEL LAW

Term	Definition
bank account	An account [, other than a securities account,] maintained by a bank, to which funds may be credited or debited, including checking and current accounts and savings and time deposit accounts; but not including rights against a bank for payment that are evidenced by a negotiable instrument.
competing claimant	A creditor of the grantor or other person with rights in the encumbered asset that may be in conflict with the rights of the secured creditor in that same encumbered asset, including another secured creditor, another creditor (such as a judgment creditor), or other creditors pursuant to State law, an insolvency representative in insolvency proceedings with respect to the grantor, and a buyer, [other transferee,] lessee, or licensee of the encumbered asset.
control agreement	(a) With respect to an uncertificated non-intermediated security, a written agreement among the issuer, the grantor, and the secured creditor pursuant to which the issuer agrees to follow instructions of the secured creditor regarding the securities without further consent from the grantor; and (b) with respect to rights to payment of funds credited to a bank account, a written agreement among the depositary bank, the grantor, and the secured creditor pursuant to which the depositary bank agrees to follow instructions of the secured creditor regarding the payment of funds from that account without further consent from the grantor.
debtor	A person that owes a payment or other performance of a secured obligation, whether or not that person is the grantor of the security right secured by that obligation. The term includes a secondary obligor, such as a guarantor of a secured obligation, and the transferor in an outright transfer of a receivable.
debtor of a receivable	The person that owes payment of a receivable.
encumbered asset	A tangible or intangible movable asset that is subject to a security right, including a receivable that is the subject of an outright transfer.

equipment	A tangible asset [primarily] used [or intended to be used] by a person in the operation of its business.
future asset	A tangible or intangible movable asset that does not exist or which the grantor does not have rights in or the power to encumber at the time the security agreement is concluded.
grantor	A person that creates a security right to secure either its own obligation or the obligation of another person, including the transferor in an outright transfer of a receivable.
intangible asset	All forms of movable assets other than tangible assets, including receivables, rights to performance of obligations other than receivables, rights to payment of funds credited to a bank account, money, negotiable instruments, negotiable documents, and non-intermediated securities.
inventory	Tangible assets [primarily] held by a person for sale or license in the ordinary course of the grantor's business, including raw and semi-processed materials (work-in-process).
mass or product	Tangible assets other than money that are so physically associated or united with other tangible assets that they have lost their separate identity.
money	The lawful currency of a State, but not including funds credited to a bank account or negotiable instruments.
non-intermediated security	A security other than a security credited to a securities account or rights or interests in securities resulting from the credit of a security to a securities account.
possession	The actual [physical] possession of a tangible asset, money, negotiable instrument, negotiable document, or certificated non-intermediated security by a person or its representative, or by an independent person that acknowledges holding it for that person.
priority	The right of a secured creditor to derive the economic benefit of its security right in an encumbered asset in preference to a competing claimant.
priority	The right of a secured creditor to derive the economic benefit of its security right in an encumbered asset in preference to a competing claimant.
proceeds	Whatever is received with respect to an encumbered asset, including as a result of a sale, other disposition, collection, lease, or license of the encumbered asset, civil and natural fruits, insurance proceeds, claims arising from defects in or damage to or loss of an encumbered asset, or proceeds of proceeds (civil fruits covers revenues, dividends, and distributions).
receivable	A right to payment of a monetary obligation, excluding a right to payment evidenced by a negotiable instrument, a right to receive the proceeds under an independent undertaking, and a right to payment of funds credited to a bank account.
registry	A general security rights registry under or as contemplated by the Model Law.
secured creditor	A creditor that has a security right, including an outright transferee of a receivable.
secured obligation	an obligation secured by a security right, excluding outright transfers of receivables.
securities	An obligation of an issuer or any share of similar right of participation in an issuer or an enterprise of an issuer that (a) is one of a class or series or, by its terms, is divisible into a class or series, of obligations, shares, or participations; (b) is of a type dealt in or traded on a securities exchange or in a financial market or is a medium for investment in an area that is issued or dealt in or traded, or (c) is specified by the enacting State to be a security.

security agreement	An agreement, regardless of whether the parties have denominated it as a security agreement, between a grantor and a secured creditor that creates a security right, including an agreement for the outright transfer of a receivable.
security right	A property right in a movable asset that is created by an agreement to secure payment or other performance of an obligation, regardless of whether the parties have denominated it as a security right, and regardless of the type of asset, the status of the grantor or secured creditor, or the nature of the secured obligation, including the right of the transferee in an outright transfer of a receivable.
tangible asset	All forms of goods, including goods, equipment, and inventory [but not money, negotiable instruments, negotiable documents, or certificated non-intermediated securities].)

Table 3 presents abbreviated definitions for certain terms that are defined in this report. The reader should consult the more formal definition contained in this report for each such term.

A few points regarding language conventions in this report are in order. First, this report uses the Arabic term *rahn* rather than mortgage, pledge, security right, security interest, or one of the many other English-language terms. A *rahn* has unique characteristics, as noted in this report. It is a generalized term that applies to all the transactions and contracts denoted by the different English-language terms. Each of the English language terms has a meaning that does not really comport with the meaning of *rahn*—and, in any event, describes a specific type of legal transaction or document.

Second, this report uses both the English-language term "encumbered asset" and the Arabic term "*marhun*". Although the English-language term is used in many instances in this report, the reader is cautioned that the term "encumbered asset" in the context of *rahn* principles does not have precisely the same meaning as the term "encumbered asset" as used in the Model Law or any other secular law. Most importantly, *marhun* must meet the specific requirements that are discussed in this report, principally those described in section 7.

TABLE 3
DEFINITIONS FROM THIS REPORT

Term	Definition
AAOIFI	*Accounting and Auditing Organisation for Islamic Financial Institutions.*
AAOIFI Standard	*Shariʿa Standard No. (39), Mortgage and Its Contemporary Applications* of AAOIFI , issued 17 Rabi Awwal 1430H, corresponding to March 15, 2009.
AAOIFI Standards	SHARIʿA STANDARDS OF THE ACCOUNTING AND AUDITING ORGANISATION FOR ISLAMIC FINANCIAL INSTITUTIONS (2010).
'adl	*A trusted person that acts as type of "trustee".*
fatwa (*fatawa*)	*Opinion as to a Shari'ah matter;* fatawa *is the plural.*
Legislative Guide	UNCITRAL Legislative Guide on Secured Transactions.
madhhab (*madhahib*)	*School of Islamic jurisprudence;* madhahib *is the plural.*
masnu	*The collateral (or encumbered asset) subject to a* rahn.
Model Law	Model Law on Secured Transactions of UNCITRAL (draft 63, April 2015), see footnote 2.

person	A natural person, corporation, limited liability company, partnership, limited partnership, trust, governmental entity, and any other entity.
rahn	A security right in property under the Shari‘ah, encompassing both security rights in movables and immovables and both mortgage and pledge concepts.
Section	A section of this report.
Shari‘ah	Islamic Shari‘ah, particularly as applied to commercial and financial matters.
SMEs	Small and medium sized enterprises.
State	*A jurisdiction enacting the Model Law, or any legal regime pertaining to security rights in property or other laws referred to or incorporated in the Model Law, or any legal regime pertaining to security rights in property.*
Terminology and Recommendations	UNCITRAL Legislative Guide on Secured Transactions: Terminology and Recommendations *(2009).*
UCC	The Uniform Commercial Code of the National Conference of Commissioners on Uniform State Laws and the American Law Institute of the United States of America.
UNCITRAL	United Nations Commission on International Trade Law.
Working Group	*Working Group VI (Security Interests) of UNCITRAL.*
Working Group Session Minutes	*Report of Working Group (VI (Security Interests) on the Work of its Twenty-Seventh Session (New York, 20--24 April 2015)* of UNCITRAL.

2. INTRODUCTION

An effective legal regime for security rights in property—particularly movable property—is crucial for economic growth and for the promotion and operation of commercial and financial markets.[1] The existence, nature, and operation of the legal regime for security interests in movable property influence both perceptions of, and determinations relating to, certainty, predictability, and stability of commercial and financial arrangements. These factors are a primary consideration in risk assessments and pricing determinations. They influence determinations as to whether an individual person will participate in a market, and thus are a fundamental factor in determining whether external capital will be attracted to a specific market and allocations of capital within and across markets.

Securities rights in movable property are also critical to small and medium sized enterprises ("SMEs") because these enterprises frequently have only movable property assets to provide as security for financing; they rarely have immovable property available for such purposes. ***A secure legal regime for moveable collateral enables working capital and some forms of firm income to be pledged as collateral.*** The Working Group—Working Group VI (Security Interests)—of the United National Commission on International Trade Law ("UNCITRAL") has developed a comprehensive legal regime for secured transactions concerning movables: the Model Law.[2] The Model Law is proposed for adoption by, or as a source of inspiration to, countries that desire to adapt their legislation to current developments and contemporary markets.

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[1] See, e.g., Alejandro Alvarez de la Campa, "Increasing Access to Credit through Reforming Secured Transactions in the MENA Region", Policy Research Working Paper 5613, THE WORLD BANK (2011) ("Alvarez, Secured Transactions"), available at http://search.worldbank.org/all?qterm=alejandro+alvarez+de+la+campa&op=.

This report uses the term "security rights" because that is the term used in the Model Law. However, the substance of the term "security rights", as used in this report, varies with the context of the discussion. In discussions of the Model Law, the definition from the Model Law is intended. In discussions of the Shariʻah and related concepts (e.g., *rahn* and *marhun*), the definitions and concepts of the Shariʻah are intended.

[2] Both the current and past drafts of the Model Law are available at http://www.uncitral.org/uncitral/en/commission/working_groups/6Security_Interests.html. That web page contains links to all of the documents produced by Working Group VI.

The draft of the Model Law used in the preparation of this report is comprised of A/CN.9/WG.VI/WP.63 (dated 30 January 2015), A/CN.9/WG.VI/WP.63/Add.1 (dated 9 February 2015), A/CN.9/WG.VI/WP.63/Add.2 (dated 9 February 2015), A/CN.9/WG.VI/WP.63/Add.3 (dated 6 February 2015), and A/CN.9/WG.VI/WP.63/Add.4 (dated 6 February 2015), each under the heading "27th Session, 20–24 April 2015, New York".

The Model Law is currently a draft and a work-in-progress: changes continue to be proposed and made. See, e.g., *Report of Working Group (VI (Security Interests) on the Work of its Twenty-Seventh Session (New York, 20-24 April 2015)*, UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW (2015) (the "Wording Group Session Minutes"), available at the URL noted at the beginning of this footnote.

The Model Law is supported by the UNCITRAL Legislative Guide on Secured Transactions (the "Legislative Guide"), and the UNCITRAL Legislative Guide on Secured Transactions: Terminology and Recommendations (the "Terminology and Recommendations"),3 among other documents.4

The Model Law and supporting materials focus on systems that do not apply principles and precepts of Islamic shariʿah (the "Shariʿah"). However, there is a pressing and immediate need to develop and implement legal regimes for secured transactions that will be enforceable under the Shariʿah. That need arises as a result of the growth of Islamic finance5 since the 1970s, and particularly since the mid-1990s, and the relative dearth, or fragmentary nature, of legal regimes for secured transactions (both conventional and Shariʻah-compliant) in many of the jurisdictions in which Islamic finance is practiced.6

[3] *UNCITRAL Legislative Guide to Secured Transactions* (2010), UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW, United Nations Publication Sales No. E.09.V.12, 2007, available at http://www.uncitral.org/pdf/english/texts/security-lg/e/09-82670_Ebook-Guide_09-04-10English.pdf. *UNCITRAL Legislative Guide to Secured Transactions: Terminology and Recommendations* (2009), UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW, Annex I to the Legislative Guide, United National Publication Sales No. E.09.V.12, 2009, available at http://www.uncitral.org/pdf/english/texts/security-lg/e/Terminology-and-Recs.18-1-10.pdf.

[4] See, for example, the legislative guides pertaining to proceeds, attachments, masses or products, negotiable instruments, receivables, intellectual property, and registries at http://www.uncitral.org/uncitral/en/commission/working_groups/6Security_Interests.html.

[5] "Islamic finance" is comprised of four areas of activity that are conducted in accordance with Shariʿah principles: banking; financing; investing; and *takaful* (Shariʻah-compliant cooperative insurance).

[6] The development of contemporary Islamic finance is discussed in: Michael J.T. McMillen, THE SHARIʿAH AND ISLAMIC FINANCE: THE DOW JONES FATWA AND PERMISSIBLE VARIANCE AS STUDIES IN LETHEANISM AND LEGAL CHANGE (2013) ("McMillen, Islamic Finance"); Yusuf Talal DeLorenzo and Michael J.T. McMillen, *Law and Islamic Finance: An Interactive Analysis* ("DeLorenzo and McMillen"), in ISLAMIC FINANCE: THE REGULATORY CHALLENGE, Simon Archer and Rifaat Ahmed Abdel Karim, eds. (2007) at 136-50; Michael J.T. McMillen, *Islamic Capital Markets: Market Developments and Conceptual Evolution in the First Thirteen Years*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1781112 ("McMillen, Islamic Capital Markets"); and Michael J.T. McMillen, *Islamic Capital Markets: Developments and Issues*, 1 CAPITAL MARKETS LAW JOURNAL 136 (2006) ("McMillen, Capital Markets"). The development of contemporary Islamic banking is discussed in: Zamir Iqbal and Abbas Mirakhor, AN INTRODUCTION TO ISLAMIC FINANCE: THEORY AND PRACTICE, SECOND EDITION (2011) ("Iqbal and Mirakhor"), at 13-24; Ibrahim Warde, ISLAMIC FINANCE IN THE GLOBAL ECONOMY, SECOND EDITION (2010) ("Warde"), at 70-92; Zamir Iqbal and Abbas Mirakhor, *The Development of Islamic Financial Institutions and Future Challenges*, in ISLAMIC FINANCE: INNOVATION AND GROWTH, Simon Archer and Rifaat Ahmed Abdel Karim, eds. (2002) ("Archer and Karim"), at 42; Hossein Askari, Zamir Iqbal and Abbas Mirakhor, GLOBALIZATION AND ISLAMIC FINANCE: CONVERGENCE, PROSPECTS AND CHALLENGES (2010), at 11-25; Hennie Van Gruening and Zamir Iqbal, RISK ANALYSIS FOR ISLAMIC BANKS (2008), at 10-15; Samer Soliman, *The Rise and Decline of the Islamic Banking Model in Egypt*, in THE POLITICS OF ISLAMIC FINANCE, Clement M. Henry and Rodney Wilson, eds. (2004) ("Henry and Wilson"), at 265; Michael S. Bennett and Zamir Iqbal, *How Socially Responsible Investing Can Help Bridge the Gap Between Islamic and Conventional Markets*, 6 INTERNATIONAL JOURNAL OF ISLAMIC AND MIDDLE EASTERN FINANCE AND MANAGEMENT 211 (2013), especially at 211-19, available at http://www.emeraldinsight.com/journals.htm?issn=1753-8394&volume=6&issue=3&articleid=17094588&show=abstract; Monzer Kahf, *Islamic Banks: The Rise of a New Power Alliance of Wealth and Shariʿa Scholarship*, in Henry and Wilson, at 17; Mohammad Nejatullah Siddiqi, *Islamic Banking and Finance*, UCLA INTERNATIONAL INSTITUTE, available at http://www.international.ucla.edu/article.asp?parentid=15056 (2001); Rodney Wilson, *The Evolution of the Islamic Financial System*, in Archer and Karim, at 29; Michael J.T. McMillen, *Islamic Capital Markets: Market Developments and Conceptual Evolution in the First Thirteen Years* (2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1781112; Michael J.T. McMillen, *Asset Securitization Sukuk*

This report considers select provisions of the Model Law from the Shariʿah perspective. The objective is to provide a comparative vantage on the types of adjustments that must be considered in adapting the Model Law to jurisdictions in which Shariʿah principles are applied. In certain instances, suggestions are made as to how the Model Law might be modified to take cognizance of the relevant Shariʿah principles.

This report first introduces the Shari'ah and summarizes some of the fundamental Shari'ah principles that are applicable to security rights (i.e., *rahn* principles). This initial presentation of the principles is generalized and summary in nature, and, for the most part, does not discuss any of the variations as among the different schools of Islamic jurisprudence (*madhahib*; *madhhab* is the singular). This material is covered in section 3.

Then the report analyzes various terms and provisions of the Model Law from the Shari'ah perspective, including variations among jurisprudential schools. The framework for analysis of this report is based upon the following principles or pillars of secured transactions law applicable to movable property:[7]

- **Scope**: Types of legal structures that can be used to secure obligations (security right, mortgage, pledge, *rahn*, etc.); types of financing transactions (secured loans, title retention, financial leasing, assignments of receivables, consignments, sales of assets, etc.); types of movable property that can be used as security; types of debtors that may give security.
- **Creation and Effectiveness**: The legal requirements for giving and taking an effective security right.
- **Priority**: The rules that determine the relative rights among conflicting claims against the collateral.
- **Publicity and Registration**: The means of making a claim against collateral transparent to third parties, including possession, registration in a public registry, direct notice and others.[8]
- **Enforcement and Remedies**: The process for enforcing a claim against collateral when there is a default with respect to the secured obligation, including both judicial and non-judicial enforcement and remedies.

At the beginning of each section of this report from section 4 onward, a "Generalized Summary" table is presented with respect to some topics that are of particular importance to SMEs. Not all topics addressed in this Report are addressed in the Generalized Summary sections. Each Generalized Summary table addresses the following categories of information: (a) SME needs; (b) Model Law provisions; (c) relevant corresponding Shari'ah principles; (d) AAOIFI treatment, if any; and (e) suggestions for reconciliation of the Model Law and the relevant Shari'ah principles. Each Generalized Summary table is intended as a point of orientation for the material

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and Islamic Capital Markets: Structural Issues in the Formative Years, 25 WISCONSIN INTERNATIONAL LAW JOURNAL 703 (2007); and Delwin A. Roy, *Islamic Banking*, 27 MIDDLE EASTERN STUDIES 427 (1991), especially at 427-30.

Warde subdivides the period from World War II to the present into three stages: First Stage (1975–91; the first Islamic banks); Second Stage (1991–-2001; growth of Islamic banks and entry of conventional banks); and Third Stage (2001–present). Warde does not address non-bank investment activities. Iqbal and Mirakhor subdivide the period into three phases: Phase I: Pre-1960; Phase II: 1960s–80s; Phase III: 1990s–Present. DeLorenzo and McMillen subdivide the period into two subperiods: revival and recovery, and transformation and adaptation.

[7] See Alvarez, Secured Transactions, *supra* note 1, at 9, and the discussion at 12 *et seq*.

[8] This report does not discuss the structure and operation of public registration systems, other than to note their effect and importance in the context of priorities of security rights.

in the section in which the table is presented, with a particular focus on SMEs. The material presented in each Generalized Summary table is subject to the more detailed discussion in the text of the Report.

3. OVERVIEW OF SHARIʿAH (*RAHN*) PRINCIPLES

3.1. The Shari'ah

For purposes of this report, and as an oversimplification, the Shariʿah is Islamic law. The Shariʿah is derived from two divinely revealed sources: (a) the Qurʿan, or holy book of Islam; and (b) the *sunna* (established practices that Muslims are required to follow, embodied in *hadith*, or verified reports of the utterances, actions, and tacit approvals of the Prophet Mohammed).[9] There are other means of ascertaining the Shariʿah from non-revealed sources. The most frequently referenced are *ijma*, or the consensus (in present times) of scholars of the Shariʿah, and *qiyas*, or reasoning: however, there are many others.[10]

The Shariʿah principles discussed in this report derive from Sunni Islam. That is because Sunni principles predominate in the countries in which application of the Model Law will be most widespread, and Sunni principles are predominant in international Islamic finance generally.

From the global perspective, four Sunni schools of Islamic jurisprudence (*madhahib*) are most frequently encountered in Islamic finance.[11] These are the Hanafi, Hanbali, Maliki, and Shafiʿi schools. Each school tends to interpret the relevant Shariʿah principles somewhat differently. The influences of the different schools correlate broadly with different geographic regions: Hanafi in countries that were within the former Ottoman Empire; Hanbali in Saudi Arabia and the Pakistan-Afghanistan border regions; Maliki in Northern Africa; and Shafiʿi in Southeast Asia and the Persian/Arabian Gulf. Mainly because of interpretive variations among schools, this report does not suggest a greater number of modifications of the Model Law text: the precise modification will depend upon which jurisprudential school is, or schools are, applied in a specific jurisdiction.

Developing structures (including products and legal regimes) that are acceptable to all four schools of Islamic jurisprudence is a particularly challenging exercise in contemporary global markets. The Shariʿah scholars are acutely aware of the challenges and have striven to support the global Islamic finance initiative and find resolutions that allow a type of global standardization. By way of example, a structure may be designed so as to be acceptable to all four schools despite differences in interpretive reasoning as to why particular elements of the structure are acceptable.[12]

Where doctrinal diversity is irrelevant or unnecessary, the interpretation of a single school may be dispositive. Thus, the implementation of a legal regime for secured transactions in Saudi Arabia, where

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9 With respect to *sunna* and *hadith*, see, e.g., Zafar Ishaq Ansari, *Islamic Juristic Terminology Before Šāfiʿī: A Semantic Analysis with Special Reference to Kūfa*, 19 ARABICA 255 (1972).

10 For a discussion of the *Shariʿah*, *Shariʿah* scholars, *fatawa*, the four Sunni schools referenced in this report, and contemporary Islamic finance, see McMillen, Islamic Finance, *supra* note 6, especially chapters 5–7 and sources cited therein.

11 There are other schools of Islamic jurisprudence, such as the Ibadi (which is dominant in the Sultanate of Oman) and the Zahiri (which is adhered to by communities in Morocco and Pakistan).

12 See McMillen, Islamic Finance, *supra* note 6, for a discussion of this topic, including an example of a *fatwa* that includes a footnote setting forth the varying positions of *Shariʿah* scholars from different jurisprudential schools as to why a particular aspect of a lease (*ijara*) structure is acceptable, despite interpretive disagreements among the schools as to the relevant *Shariʿah* basis.

the Hanbali school predominates, may take little or no cognizance of Hanafi, Maliki, or Shafiʿi principles. In some jurisdictions, the interpretations of more than one school may be taken into account. The implementation of the Model Law in different jurisdictions must be sensitive to these varying approaches to relevant principles and interpretive positions.

3.2. The *Rahn*: General Principles

3.2.1 Introduction

Security rights concepts have been integral to the Shariʿah since the earliest days of Islam. The relevant principles are incorporated in the term "*rahn*".[13] This term encompasses principles pertaining to security interests in both movable and immovable property, both real and personal property, without

[13] The term "*rahn*" is used to denote both (a) the contract or transaction involving a security right and (b) the asset that is the subject of that contract or transaction. In this report, *rahn* is used in the former sense, and the term "*marhun*" is used to denote the encumbered asset. A *rahn* is a contract and subject to the Shari'ah rules applicable to contracts generally: those contract rules are not discussed in this report. See also note 16, *infra*.

Linguistic formulations of the term "*rahn*" refer to either (i) constancy or (ii) holding and bindingness. See, e.g., Wahbah Al-Zuhaylī, AL-FIQH AL-ISLAMI WA-ADILLATUH (ISLAMIC JURISPRUDENCE AND ITS PROOFS), WAHBAH AL-ZUHAYLĪ, FINANCIAL TRANSACTIONS IN ISLAMIC JURISPRUDENCE (Mahmoud El-Gamal, translator, and Muhammad S. Eisaa, revisor) (1997) ("al-Zuḥaylī"), at 79. al-Zuḥaylī is a translation of Volume 5 of AL-FIQH AL-'ISLAMI WA 'ADILLATUH, FOURTH EDITION and appears in two volumes (*al-rahn* concepts are discussed in part X, chapters 69-74, volume II, at 79-194; all references in this report are to volume II, unless otherwise specifically indicated by a reference to volume I), at 79. The legal texts and the Shari'ah principles focus on the second of these referentials: holding. That is to say, they focus on "possession" and holding as a means to achieve repayment of the secured obligation if that obligation is not otherwise repaid. As noted in section 5.2.3(a), that conception corresponds to the principle that the entirety of the object held in possession (the *marhun*) secures the entirety (payment in full) of the secured obligation. It also for this reason that the legal texts and scholars (such as al-Zuḥaylī) refer to a *rahn* as a "pawning" or a "pawn" arrangement. This report does not use the terms "pawning" and "pawn",' but the essence of that type of relationship pervades this report: the *marhun* is held by or on behalf of the secured creditor until repayment in full of the secured obligation.

distinction.[14] A *rahn* consists of a mortgage or pledge (which are treated identically)[15] by a *rāhin* (mortgagor, pledger, or grantor; this report uses the term "grantor") to a *murtahin* (mortgagee, pledgee, or grantee; this report uses the term "grantee", but uses the term "secured creditor" on the assumption that the secured creditor is the grantee, following the conception of the Model Law) of *marhun* (or *marhoun* or *marhoon*; identified property that is the subject of the *rahn*; sometimes referred to in this

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[14] *Rahn* principles are discussed in: (a) al-Zuhaylī, *id.*, at 75-232; (b) the "Majelle", at articles 701-61, of which there are two accessible English language translations, MAJALAT AL-AHKAM AL-ADLIYAH (a translation prepared by Judge C. A. Hooper as THE CIVIL LAW OF PALESTINE AND TRANS-JORDAN, VOLUMES I AND II (1933; volume II was originally published in 1936) ("Hooper, Majella"), and reprinted in various issues of the ARAB LAW QUARTERLY (volumes 1-5, 1986-1990; C. A. Hooper, *The Majelle: Book V: Pledges*, was published in 2 ARAB LAW QUARTERLY 315 (1987), and C. R. Tyser, D. G. Demetriades, and Ismail Haqqi Effendi, THE MAJELLE: BEING AN ENGLISH TRANSLATION OF MAJALLAH EL-AHKAMI-ADLIYA AND A COMPLETE CODE ON ISLAMIC CIVIL LAW (2001); (c) Ibn Rushd, THE DISTINGUISHED JURISTS' PRIMER, VOLUME II, BIDĀYAT AL-MUJTAHID WA NIHĀYAT AL-MUQTASID (Imran Ahsan Khan Nyazee, translator, and Mohammad Abdul Rauf, revisor) (1996) ("Ibn Rushd"), Book XXXVII, at 325-33; and (d) Ali Ibn Abi Bakr Burhan al-Din al-Marghinani, THE HEDÀYA, OR GUIDE: A COMMENTARY ON THE MUSSULMAN LAWS: TRANSLATED BY ORDER OF THE GOVERNOR-GENERAL AND COUNCIL OF BENGAL, BY CHARLES HAMILTON (1791), four volumes (digital scan edition of ECCO Publications) (the "Hedaya"), at Book XLVIII, Volume 4, 189-269. A contemporary formulation of *rahn* principles is set forth in *Shariʿa Standard No. (39), Mortgage and Its Contemporary Applications*, issued 17 Rabi Awwal 1430H, corresponding to March 15, 2009 (the "AAOIFI Standard"), of the Accounting and Auditing Organisation for Islamic Financial Institutions ("AAOIFI") and set forth in SHARIʿA STANDARDS OF THE ACCOUNTING AND AUDITING ORGANISATION FOR ISLAMIC FINANCIAL INSTITUTIONS (2010) (the "AAOIFI Standards"). The AAOIFI Standards should be considered a starting point from which to branch out into more detailed study by reference to the interpretations of the various relevant jurisprudential schools.

The two translations of the Majelle are essentially identical (the minor differences are irrelevant for current purposes). The Majelle is an unfinished and selective digest of principles and rules of the *Shariʿah* under the Hanafi school as applied in civil law transactions (*muʻamalat*). It was prepared by a committee of Ottoman Hanafi scholars during the period from 1869 to 1888, was published between 1870 and 1877, and was codified as law in the Ottoman Empire as applicable to matters outside the commercial code. The Majelle should also be considered a starting point from which to branch out into more detailed study. See S. S. Onar, *The Majalla*, in LAW IN THE MIDDLE EAST, Majid Khadduri and Herbert J. Liebesny, eds. (1955), and W. M. (William M.) Ballantyne, *The Majella: An Introduction*, 1 ARAB LAW QUARTERLY 364 (1986), introducing the presentation of Hooper, Majella. Abū al-Walīd Muhammad ibn Ahmad ibn Rushd, known in the West as Averöes, died in 1198 C.E. (595 H.). This work of ibn Rushd is considered a book of *khilāf*, a discipline that records and analyzes the differences among Muslim jurists: a type of comparative Islamic law. As an orientation to the citations set forth in this report, a review of the Introduction to ibn Rushd, at xxvii to xlii, is recommended

See also Nicholas H.D. Foster, *The Islamic Law of Real Security*, 15 ARAB LAW QUARTERLY 132 (2000) ("Foster, Security") ("real security" here referring to security that concerns, or is dependent upon, a "thing" or "*res*", rather than a person), and Nicholas Foster, *Commercial Security over Movables in the UAE: A Comparative Analysis in Light of English Law, French Law and the Sharia*, 4 YEAR BOOK OF ISLAMIC AND MIDDLE EASTERN LAW 3 (1997-1998). Foster, Security presents a comparative analysis of the Commercial Code of 1993 of the United Arab Emirates in light of English common law, French law (from which many countries that apply the Shariʻah derive their secular law), and the Shariʻah. Also of relevance is Nicholas H. D. Foster, *The Islamic Law of Guarantees*, 16 ARAB LAW QUARTERLY 133 (2001).

[15] This Report avoids the use of the English language terms "mortgage" and "pledge" because of the many legal nuances that attach to those terms under both common law and civil law. Rather, the terms "security right" and, in certain instances, "*rahn*" are used.

report as "encumbered property"' so as to be consistent with the Model Law).[16] That is, using the transactional frame of reference, *al-rahn* is the making of a designated property into security for a debt (secured obligation)—the *al-marhun bihi*—that may be partially or totally recovered from such property or its price.[17]

To provide some orientation, it is helpful to consider generalized summaries of a few fundamental *rahn* principles.[18] These will be refined and modified in the course of the comparative discussions of the Model Law, particularly to note interpretive variations of different jurisprudential schools. The discussion in this section is an introduction that is subject in its entirety to the discussions in later sections of this report.

A note on the AAOIFI Standards is in order as background to this report. The AAOIFI Standards, including the AAOIFI Standard, are relatively high-level statements of Shari'ah principles in the contemporary context. They are recommended standards, in the sense of "best practices," and are not binding upon any person (unless a State adopts them into the secular law). The AAOIFI Standards are given further substance by jurists who implement these standards in a given jurisdiction, transaction, or contract. It is thus unclear exactly how a given AAOIFI Standard, including the AAOIFI Standard, will ultimately be interpreted and applied in practice.

This report generally assumes that the debtor is the grantor of the relevant security right and that the encumbered property is that of the debtor-grantor, although the Shariʿah permits the grant of a *rahn* by third parties (as non-debtor grantors), including with respect to the property of those third parties. Where the assumption of debtor-as-grantor is not applied in a discussion, a distinction is made in the text (or in related footnotes, which are sometimes referred to as "notes", especially in cross-references).

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16 See, e.g., Ibn Rushd, *supra* note 14, § 37.1, Majelle, *supra* note 14, articles 701-04, and AAOIFI Standard, *supra* note 14, at § 2. The term "*rahn*" is sometimes used to describe the act of granting the security interest (often translated as "pawning" or "insuring"), sometimes as the security interest (often translated as the "insurance" for the secured obligation), and sometimes as the collateral subject to the security interest.

17 See, e.g., Majelle, *id*., articles 701–61, and al-Zuḥaylī, *supra* note 13, at 79.

18 For convenience and simplicity, many of the principles described in this summary are of the Hanafi school as set forth in the Majelle (with a few references to the principles adopted by the AAOIFI Standard). The Hanafi principles discussed in this summary are further refined in subsequent sections of this report, and the principles applied by the Hanbali, Maliki, and Shafi'i schools and under the AAOIFI Standard are also discussed.

For a discussion of *rahn* principles as applicable to modern secured transactions regimes, see Michael J.T. McMillen, *Implementing Shariʿah-Compliant Collateral Security Regimes: Select Issues*, in EBRD RESEARCH HANDBOOK ON SECURED LENDING IN COMMERCIAL TRANSACTIONS (2015), at 97 (a chapter that highlights select issues that arise in developing and implementing Shari'ah-compliant collateral security regimes in select countries within North Africa and the Middle East). See also Michael J.T. McMillen, *Rahn Concepts in Saudi Arabia: Formalization and a Registration and Prioritization System* (2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1670104 (discussing a Saudi Arabian legal regime) ("McMillen, Saudi Rahn") and contained, in an earlier version, in ISLAMIC CAPITAL MARKETS: PRODUCTS AND STRATEGIES, M. Kabir Hassan and Hans-Michael Mahlknect, eds. (2011), and Michael J.T. McMillen, *Islamic Shariʿah-Compliant Project Finance: Collateral Security and Financing Structure Case Studies*, 24 FORDHAM INTERNATIONAL LAW JOURNAL 1184 (2001) ("McMillen, Project Finance") [discussing the development of the *rahn-'adl* collateral security structure under the *Shariʿah* for the first project financing in Saudi Arabia, a particularly revealing exercise given that, since 1981, Saudi Arabian Public Notaries have refused to record security interests (in most instances) on the grounds that such mortgages secure an indebtedness that is likely related to an interest-based transaction and therefore inconsistent with the *Shariʿah*: see Saudi Arabia Supreme Judiciary Council Decision No. 291, dated 25/10/1401 A.H. (Aug. 25, 1981)].

3.2.2 Overview of Shariʻah Principles

Under the Shariʿah, a "mortgage" of real property or immovables is treated, in most respects, identically to the treatment of a "pledge" of personal property or movables. Each may be made the subject of a *rahn,* and each may be used as collateral to secure indebtedness or another obligation.[19] The same principles are applicable to both categories of property.

However, there are some variations in the interpretation of the relevant principles that are responsive to the different characteristics of real versus personal property or immovable versus movable property. Examples of those interpretive differences include, for example, the constituent elements of "possession" or "receipt" (as further discussed in this report).

To obtain a security right in the "benefits" of a property given as security from which an obligation may be paid (encumbered property, or *marhun*), the underlying property must be subject to a *rahn*.[20]

There is no prescribed form of *rahn* under the Shariʿah. However, numerous principles are applicable to the descriptive characteristics of a valid *rahn*, particularly as to the specificity of the description of the encumbered assets, the secured obligation, the terms under which enforcement may be sought, and the remedies that are available.[21]

Increases in the value of the encumbered asset, and accretions and additions to and products derived from that asset, are automatically subject to the *rahn* of that asset for certain, but not all, jurisprudential schools.[22] Under the applicable precepts as applied by other schools, however, such increases, accretions, additions, and products may be made subject to the *rahn* only by some definitive action or agreement. In each case, interpretations and applications of these precepts vary.[23]

The indebtedness may be totally or partially recovered from the encumbered asset.[24] The entirety of the encumbered asset will remain subject to the *rahn* until the secured obligation has been paid in full.[25]

The encumbered asset (*marhun*) must be something that can be validly sold.[26] As such, it must (a) be property, (b) be in existence at the time of the execution of the *rahn* contract, (c) have a quantifiable value,

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[19] See, e.g., Majelle, *supra* note 14, articles 711, 723, and 724, with respect to real property and immovables, and articles 711 and 714, with respect to personal property and movables, and al-Zuḥaylī, *supra* note 13, at 79-80. Certain types of rights may not be made subject to a *rahn*: they must be assigned: see McMillen, Project Finance, *id.*, at 1203-05, 1213-14 (including footnote 31), and 1217-21 (including footnote 42).

[20] AAOIFI Standard, *supra* note 14, at § 3/2/8, provides that both (a) appreciation in the value of the *marhun* and (b) income derived from the *marhun* are considered to be subject to the *rahn* on the *marhun,* unless the debtor and the secured creditor otherwise agree. These concepts are discussed in section 8.

[21] See the further discussion in section 5.2.1.

[22] See, e.g., Majelle, *supra* note 14, article 711 (defining a *rahn* of a piece of land as including all trees growing thereon and the fruits of such trees) and article 715 (discussing increases of or arising out of the *marhun*), and AAOIFI Standard, *supra* note 14, at § 3/2/8. But see section 5.2.6.

[23] See the more detailed discussion in section 5.2.6.

[24] See, e.g., Majelle, *supra* note 14, articles 711, 712, 723, and 724 (citing examples), and AAOIFI Standard, *supra* note 14, at §§ 2, and 3/4.

[25] See, e.g., Majelle, *id*., article 731, and AAOIFI Standard, *id.*, at § 3/1/7. Correlatively, the entirety of the secured obligation is associated with the *marhun*.

[26] See, e.g., Majelle, *id.*, articles 709 and 710, and Ibn Rushd, *supra* note 14, § 37.1. Sale principles are discussed in al-Zuḥaylī, *supra* note 13, Volume I, at 1-366 and, with respect to leases, which are a sale of usufruct, at 381-434, Majelle, articles 1-611 (which includes leases), and ibn Rushd, §§ 24-30 (which includes leases). Elements of property, including value, saleability, and other relevant considerations, are discussed in greater detail, and with greater nuance, in section 7.2.1(a).

and (d) be saleable and deliverable. Accordingly, a *rahn* of "after acquired" property (including "subsequently constructed" property) is presumptively invalid.[27]

Uncertain sums may not be mortgaged or pledged.[28] An existing *rahn* may not be valid with respect to future advances or loans, in the view of some Islamic jurists.[29]

Under the Shariʿah, the secured creditor is responsible for expenses of safeguarding the secured property and preserving the *rahn*, such as the cost of erecting the fence and posting signs around the property, and the wages and fees of the security agents and/or guard posted at the property.[30]

The debtor is responsible for all expenses in connection with the improvement, operation, and maintenance of the encumbered asset, including repairs and operation and maintenance expenses.[31] Any agreement modifying these allocations is void. If either the debtor or the secured creditor should of its own accord pay the expenses that are rightly paid by the other, that payment is in the nature of a gift, and no subsequent claim may be made for such amounts.[32]

Under the Shariʿah, a *rahn* is, by definition, possessory. The Qurʿan refers to the idea of a *rahn* as a "*rahn* with possession" (*fa rihanun maqboudha*). Thus, effectiveness and enforceability of a security right against third parties is dependent upon "possession" of the encumbered asset (the encumbered collateral) (as well as other factors, such as "receipt" of the encumbered asset by the secured creditor).[33] If the secured creditor ceases to have "possession" of the encumbered asset, the secured creditor will be treated as an ordinary unsecured creditor.

To satisfy this requirement, some jurists and scholars require actual physical possession. Only one school of Islamic jurisprudence (the Maliki) expressly acknowledges "constructive possession" concepts. However, a Shariʿah principle is that "possession is in accordance with the nature of the property to be possessed" (*qulu shay'in yuqbadhu bi hasabihi*), and in many instances, physical possession is an impossibility. In that vein, the AAOIFI Standard distinguishes "actual possession" (putting a hand on the property) and "legal" possession (which may be accomplished through registration or documentation.[34]

All jurisprudential schools stipulate receipt of the encumbered asset by or on behalf of the secured creditor as a critical element of a valid *rahn*.[35]

Provided that a secured creditor has possession of the encumbered asset, that secured creditor has priority, under the Shariʿah, over all other creditors of the debtor in the collection of the secured obligations owed to that secured creditor from the value of the encumbered asset.

Subject to qualifications, borrowed property may be subject to a valid *rahn* by the borrower to another secured creditor with the permission of the owner of the secured property.[36] However, there are significant consequences to any such grant to a second secured creditor. For example, in many (if not

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27 But see Majelle, *id.*, article 713.

28 See, e.g., Majelle, *id*., article 709.

29 See, e.g., Majelle, *id*., article 714. And see sections 5.2.1, 5.2.2, and 6.

30 See, e.g., Majelle, *id*., article 723. With respect to expenses, see the discussion in section 12.2.2.

31 See, e.g., Majelle, *id*., article 724. In many instances, it is difficult to distinguish between arrangements for safekeeping of the property and preservation of the *rahn* from those pertaining to improvement, operation, and maintenance of the property.

32 See, e.g., Majelle, *id*., article 725.

33 See the discussion in section 5.2.

34 AAOIFI Standard, *supra* note 14, at § 3/1/2.

35 Receipt concepts are discussed in detail in section 5.2.4.

36 But see, Majelle, *id*., articles 726-28, 735, and 736, and see the discussion of the positions of the different jurisprudential schools in al-Zuḥaylī, *supra* note 13, at 128-30. See the AAOIFI Standard, *supra* note 14, at § 3/2/3.

most) instances, the original *rahn* will be voided under classical interpretations.[37] The AAOIFI Standard allows multiple *rahn* interests of different ranks and priorities.[38]

Neither the debtor nor the secured creditor may sell the collateral without the consent of the other.[39]

If the secured obligation becomes due and the debtor does not satisfy the secured obligation, the secured creditor may not—and usually cannot—obtain title to the encumbered asset. The basic principle is that the encumbered asset remains the property of the debtor (or other grantor on behalf of the debtor) after the *rahn* is granted, and only the owner of property has a right to sell that property. Thus, the debtor will sell, or be coerced to sell, the encumbered asset, or a judicially directed sale of the encumbered asset will be effected.[40] The secured creditor will have priority with respect to the proceeds of a sale of the encumbered asset in satisfaction of the secured obligation due and payable to it to the extent of such proceeds. If the proceeds are insufficient to pay in full all secured obligations owing to a secured creditor, that secured creditor will become an unsecured creditor with respect to the remaining unpaid balance of its secured obligations.

While the practice of secured creditors is to avoid holding collateral prior to a judicially directed sale of the encumbered asset, the Shariʿah does contemplate such a holding: in fact, possession of the encumbered asset by the secured creditor is a fundamental precept of the Shariʻah. In any such case, the secured creditor will have responsibility for the safekeeping of the encumbered asset during such period.

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37 See, e.g., Majelle, *id*., article 744. An example of an exception to this statement relates to granting of a security interest to a partner of the original secured creditor. See the discussion in section 10.

38 AAOIFI Standard, *supra* note 14, at § 3/2/3.

39 See, e.g., Majelle, *supra* note 14, article 756. See the discussion in section 11.

40 See the discussion in section 15. See also, e.g., Majelle, *id.*, at articles 756-61.

4. SCOPE OF APPLICATION AND VARIATION OF PROVISIONS

GENERALIZED SUMMARY SCOPE OF APPLICATION AND VARIATIONS	
SME NEED	SMEs need flexibility in structuring and administering their financing arrangements to accommodate the wide range of business activities ecompassed within this category, to suit the individualized entrenepreneurial styles of SME operators, and to encourage and sustain creativity and innovation.
MODEL LAW	The Model Law excludes some matters from the coverage of the law, allows the enacting State to adapt or modify some provisions of the law, and allows the parties to the secured transaction to vary other provisions of the law. The Model Law applies to designated categories of movables (personal property).
SHARIʻAH	The coverage of the Shariʻah is all-encompassing. The parties have some ability to adopt different interpretations, but the opportunities are limited and variances may violate Shariʻah principles. The Shariʻah principles apply to both movables and immovables (real and personal property).
AAOIFI	Does not speak to variance by parties to a transaction, with very limited exceptions. The AAOIFI Standard sets forth general Shariʻah principles, for the most part, and leaves implementation in accordance with variations of the different schools of Islamic jurisprudence to those who utilize the AAOIFI Standard (utilization is voluntary and may be by transactional parties, States, regulatory bodies, and others).
RECONCILIATION SUGGESTION	The Model Law should be adapted on a jurisdiction-specific basis in consulation with Shariʻah scholars and judges who apply the Shariʻah in that specific jurisdiction to ensure a clear understanding of the relevant interpretations in that jurisdiction.

As a point of embarkation in the comparative analysis, it is fruitful to begin at the highest level: at the level of the secular legal system and its legal admonitions, on the one hand, and the Shariʿah and its admonitions, on the other hand. Considerations and issues that arise at this level pervade any comparative analysis of collateral security regimes.

They also pervade the process of interpreting and implementing any law, including the Model Law, in jurisdictions in which the Shariʿah is incorporated, to some greater or lesser extent, in the operative secular legal regime. Moreover, whether or not the Shariʻah is incorporated in the secular law, the Shariʻah has a significant influence on how the secular law is interpreted and applied in practice. It is an integral part of the culture, both religious and otherwise, of many jurisdictions. It significantly influences the law in practice, whatever the state of the law on the books. There is a "dual reality in which the *sharia* and secular law do not necessarily exclude but often complement each other."[41]

These considerations and issues are present to some degree in virtually every matter that is discussed in this report, although they will not be specifically noted in other sections. They are mentioned at this point in the discussion in order to emphasize that one should be cognizant of these issues throughout this report.

[41] Samir Saleh, COMMERCIAL AGENCY AND DISTRIBUTORSHIP IN THE ARAB MIDDLE EAST (1995), at 1; and see Foster, Security, *supra* note 14, at 5-6.

The Shariʿah is divinely revealed, comprehensive, and immutable over time.[42] As such, it is not permissible, as a pure Shariʿah matter, to exclude topics from its coverage or allow variations of the principles applicable to topics, even with unanimous consent of the involved parties. Secular law (including the Model Law as currently drafted), on the other hand, allows for such exclusions and variations.

The initial provisions of the Model Law illustrate the contrast well. These initial provisions (a) exclude some matters from the coverage of the Model Law, and (b) allow the parties to the security agreement to modify many of the provisions of the Model Law in accordance with their desires. Both that exclusion and that allowance raise issues under the Shariʻah that must be considered in structuring and implementing a law that is compliant with, and enforceable under, the Shariʿah.

The Model Law "applies to security rights in movable assets", and (with specific exceptions) to outright transfers of receivables.[43] The term "movable asset" is not defined. However, there are references in the Model Law to "tangible assets" and "intangible assets" constituting movable assets, and "encumbered asset means a tangible or intangible movable asset that is subject to a security right".[44] The term "tangible assets" is defined as "all forms of goods," including consumer goods, equipment, and inventory, and is intended to exclude money, negotiable instruments, negotiable documents, and certificated non-intermediated securities.[45] The use of the term "goods" may be replaced in future drafts of the Model Law because this concept has a particular meaning in common law jurisdictions.[46] The term "intangible asset" is defined as all movable assets other than tangible assets, including money, receivables, rights to payment funds credited to bank accounts, rights to performance of obligations other than receivables, negotiable instruments and documents, and non-intermediated securities.[47] Some intangible assets are capable of "possession", as defined in the Model Law.[48]

The Model Law excludes a range of different interests, transactions, and categories of assets from its scope and application. For example, the Model Law is not applicable to rights to draw under an "independent undertaking", certain assets that are subject to specialized secured transaction and asset-based registration regimes under other laws of the State enacting the Model Law (the "State"). Common examples include: aircraft, railroad rolling stock, ships, and mobile equipment; intellectual property (to the extent of any conflict between the Model Law and other intellectual property laws of the State); intermediated securities (except as expressly provided in the Model Law and subject, in most instances,

[42] And, although it has been defined narrowly as Islamic law for purposes of this report, it has strong moral and ethical imperatives.

[43] Model Law, Article 1, ¶ 1 and, with respect to outright transfers of receivables, ¶ 2.

[44] Model Law, Article 2.

[45] Model Law, Article 2.

[46] See the Note to the Working Group in version 63 of the draft Model Law pertaining to the definition of "tangible asset". And see, for example, the definition of the term "goods" under § 9-102 of the Uniform Commercial Code of the National Conference of Commissioners on Uniform State Laws and the American Law Institute (the "UCC"): "all things that are movable when a security interest attaches", including fixtures, timber to be cut and removed under a conveyance or contract of sale, the unborn young of animals, crops grown, growing or to be grown, manufactured homes and computer programs embedded in and constituting a part of goods. Various categories of assets are expressly excluded from this definition, including accounts, chattel paper, commercial tort claims, documents, instruments, general intangibles, letters of credit and letter-of-credit rights, money, and oil and gas before extraction.

[47] Model Law, Article 2.

[48] See the various discussions of possession in this report, including that in section 5.2.4.

to State intellectual property law); certain netting arrangements; and payment rights under foreign exchange transactions.[49]

Further (and importantly, in contrast to the Shariʻah), the Model Law is either subject to, or does not affect, the application of laws relating to the protection of parties to transactions made for "personal, family and household purposes", as elected by the State.[50]

The Shariʿah stands in stark contrast to this approach. *Rahn* principles apply to both movable and immovable property, to real and personal property, without distinction or qualification. The Shariʻah makes no distinction as among categories of assets (such as equipment or inventory), with a very limited range of exceptions.[51] *Rahn* principles apply equally, and comprehensively, to both commercial and consumer transactions, again without distinction.

The Model Law acknowledges the right and power of each State and the parties to the security agreement giving rise to the security right to vary the scope and coverage of the Model Law, with certain exceptions.[52] The exceptions relate to (a) good faith and commercial reasonableness in the exercise of rights and performance of obligations, (b) the necessity of a security agreement for creation of a security right, (c) the required description of encumbered assets, (d) certain situations regarding "acquisition security rights", (e) the obligation of a person in possession of an encumbered asset to preserve that asset, (f) the obligation of a secured creditor to return an encumbered asset, (g) certain matters pertaining to waivers of post-default rights, and (h) the applicable law with respect to various security rights.[53]

Again, if the Shariʿah were the sole framework for analysis, these variations would not be permissible: neither the State nor the contracting parties is permitted to exclude or modify the coverage of any of the applicable Shariʿah principles.

Some conclusory statements seem appropriate at this point.

- The Shariʻah will be mandatorily applicable to and will supersede the Model Law, any other State legislative or judicial mandate, and any contract of the parties, including (x) in the case of any conflict between the Model Law, other State mandate or contract, on the one hand, and the Shariʻah, on the other hand, (y) in the case where the parties determine to have a contract, arrangement, transaction, or matter be subject or not subject to the Model Law, other State Mandate, or contract of the parties, or (z) in the case where the Model Law, other State mandate, or contract includes or excludes any contract, arrangement, transaction, or matter; and
- The Shariʻah will be mandatorily applicable to and will encompass any contract, arrangement, transaction, or matter included or excluded by the Model Law, any State mandate, and any contract between the parties.

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[49] Model Law, Article 1, ¶¶ 3-4.

[50] Model Law, Article 1, ¶ 5. See also the definition of "consumer goods" in Article 2, clause (f) (tangible assets that a natural person or individual grantor uses or intends to use for personal, family or household purposes), Article 21 (which provides that an acquisition of a security right in consumer goods is effective as against third parties upon its creation), Articles 49 and 51 (addressing priorities of acquisition and non-acquisition security rights in respect of consumer goods), and Article 61 (acquisition security rights in tangible assets used or intended for use in personal, family, or household purposes).

[51] Transfers of receivables, which are addressed by the Model Law, are one such (quite complicated) exception under the *Shariʿah*.

[52] Model Law, Article 1, ¶ 3, Article 3, and Article 4 (especially ¶ 1). Article 4 addresses derogation and variation by agreement of the parties.

[53] Model Law, Articles 5, 6, 47-51, 62, 63, 81, ¶ 1, and 96-111, respectively.

As a practical matter, the Shariʿah is not the sole determinative framework, however. In virtually all States, the legal regime is structured primarily around the concept of the primacy of secular law. The Shariʿah may have a role, and may be incorporated in the body of applicable law, but (with only one or very few exceptions) the Shariʿah is not the paramount law of the land.[54] The exact role of the Shariʿah in any given jurisdiction varies. And, as previously observed, the influence of the Shari‘ah as a matter of culture and religion will always be present and influential, whether or not the Shari‘ah is formally incorporated in the secular law.

Thus, while theory as regards the Shariʿah may suggest that neither the State nor the contracting parties should be permitted to exclude or vary the relevant principles, it seems appropriate to construct the Model Law to allow for variations. This would allow variation to accord with the principles, of whichever jurisprudential school(s), that are applicable in any given jurisdiction. Exclusions or variations can be permitted, leaving any Shariʿah-based rejection or modification of those matters to the discretion of the States that incorporate the Shariʿah in their body of secular law, and even to the contracting parties, who will seek guidance from, or be provided with guidance by, Shariʿah scholars who are involved in the regulation of Shariʿah-compliant commerce and finance.

[54] The sole exception known to the author is Saudi Arabia where, in theory, the *Shariʿah* is the paramount law of the land. However, Saudi Arabian practice sustains non-compliant contracts and arrangements.

5. BINDING SECURITY AND *RAHN* AGREEMENTS

GENERALIZED SUMMARY BINDING SECURITY AND *RAHN* ARRANGEMENTS (Receipt and Possession are treated in a separate Generalized Summary)	
SME NEED	SMEs need certainty of their financing arrangements. These arrangements often entail future financings that are not "established" (for Shari'ah purposes) or well defined at creation of the security right. SMEs may deliver other or different collateral after creation of the security right. Flexibility is important to allow the financing arrangement to be established early, allow business planning based upon these arrangements, and allow continuing flexibility in collateral and financing arrrangements.
MODEL LAW	A security agreement is required, and it must meet stated requirements. It may be oral if the secured creditor has possession of the encumbered asset. When a security right is "binding" is determined pursuant to local secular law. Usually, bindingness results from offer and acceptance, adequate consideration and satisfaction of other customary requirements. In civil law jurisdictions, the classification of the arrangement will affect bindingness determnations.
SHARI'AH	A *rahn* may be revoked by the secured creditor prior to satisfaction of all elements, including receipt and possession by the secured creditor. It may be oral or written. No prescribed language is required. Most other requirements (other than the conditions noted below) are similar to the Model Law, but the degree of specificity and detail may be greater, particularly as regards the secured obligation and its elements, the use of the asset, and rights and methods with respect to sales and other remedies. Bindingness occurs for the Malikis upon offer and acceptance, whether or not there has been receipt of the asset by the secured creditor. For the other *madhahib*, receipt and possession (among other elments) are necessary for bindingness.
	Each jurisprudential school has detailed cornerstones or conditions that must be satisfied for a valid *rahn* contract.
	The validity of grants of security rights prior to establishment of the relevant secured obligation varies with jurisprudential school.
	The jurisprudential schools differ as to whether a contract is unitary or multiple, and the situations in which each arisis. This has implications for release of the encumbered asset, the ability of the secured creditor to sell or exercise other remedies, and the nature of the liability of the secured creditor for loss, damage and destruction of that asset.
	For the Hanafis, the possession of the encumbered asset is a "possession of trust", and the secured creditor is liabile for the full value of the asset only if there has been transgression by or negligence of the secured creditor. The other schools conceive of this possession as a "possession of gurantee", and the secured creditor is potentially liable for the full value of the asset whether or not there has been a transgression by or negligence of the secured creditor. These principles are important where there is loss, damage, or destruction of the encumbered asset during the term of the security right.
AAOIFI	The validity of grants of security rights prior to establishment of the secured obligation is permissible, so long as the *rahn* contract is executed before or

	contemporaneously with the execution of the agreement establishing the secured obligation.
	Bindingness occurs upon offer and acceptance, whether or not the encumbered asset has been delivered and received.
RECONCILIATION SUGGESTION	The AAOIFI Standard is a good base with respect to the few elements that are addressed in the standard. The Model Law is a good base with respect to many of the fundamental elements of the security right and attendant arrangements. Exploration of other relevant elements and details with Shariʿah scholars and judges in each relevant jurisdiction is needed to specifically define the security rights and security rights arrangements in each jurisdiction and appropriately adapt the Model Law in each jurisdiction.

GENERALIZED SUMMARY RECEIPT AND POSSESSION	
SME NEED	SMEs must retain possession and use of the encumbered asset to conduct their business and generate income to repay the amount financed. SMEs generally have no "excess" assets, and they have little or no real property assets: essentially all available assets are "movable" assets.
MODEL LAW	Possession of the encumbered asset by the secured creditor is not necessary or required (but is permitted).
SHARI'AH	There are two conflicting Shari'ah principles. First, there should be no waste of the usufruct of a property: it should be used productively. Second, a secured creditor must receive and then retain possession of the encumbered asset during the term of the security right. The secured creditor must receive and possess the encumbered property (absent the required possession, the creditor is treated as an unsecured creditor). The required possession is physical possession, except for the Maliki school, which accepts constructive possession concepts. The schools differ regarding the permissibility of debtor possession and use of the encumbered asset during the term of the security right. The Malikis do not allow debtor possession and use. The Shari's allow debtor possession and use. The Hanafis and Hanbalis allow some debtor possession and use of the encumbered asset with the permission of the secured creditor.
AAOIFI	The AAOIFI Standard distinguishes between and acknowledges both "actual" and "legal" possession. Legal possession is based upon registration of a security right in a registration system and operates as a type of constructive possession concept. The secured creditor has no right to use or benefit from the encumbered asset free of charge, whether or not the debtor has given permission for use. If the debtor does give permission for use, the secured creditor must pay the "normal pay" for similar assets to the debtor.
RECONCILIATION SUGGESTION	Acknowledgement of registration systems as effecting the required possession (along the lines of the AAOIFI Standard) works well, but will require the implementation of registration systems. Secured creditor permission for debtor use should be effected in all documentation. Shari'ah scholars are currently considering the implications of registration systems from the Shari'ah vantage.

5.1. Model Law Provisions

Under the Model Law, a security right is created pursuant to a security agreement that satisfies the requirements set forth in the Model Law.[55] Those requirements are that the security agreement must:

(a) Provide for the creation of a security right;
(b) Identify the secured creditor and the grantor;
(c) Describe the secured obligation;

55 Model Law, Article 6.

(d) Describe the encumbered assets in a manner that reasonably allows their identification, which may be a reference to all assets within a category of assets or a reference to all of the grantor's assets;[56] and
(e) Indicate the maximum monetary amount for which the security right may be enforced.

A security agreement may be oral if the secured creditor has possession of the encumbered asset.[57]

The Working Group has not yet determined whether the final Model Law will apply the requirements in clauses (a) through (e) to all security agreements or only those not involving possession by the secured creditor. Additionally, the Work Group has not finally determined whether oral security agreements are permissible only in situations where the secured creditor has "possession" or also in situations in which the secured creditor has "control" of the encumbered asset: the control concept being applicable primarily in circumstances in which the secured creditor has control of a bank account or non-intermediated security.[58]

The determination as to when the security agreement will become binding for purposes of the Model Law is a matter of local secular contract law. Most often, under local law, a security agreement will become binding when there has been offer, and acceptance and other customary requisites for a binding contract are satisfied. Some of these requisites under common law include mutuality of obligation (or meeting of the minds) as demonstrated through offer and acceptance, certainty, adequate consideration, capacity of the parties, and a lawful purpose of the contract. The common law focuses on enforceable promises of the parties.

Civil code law and its derivatives focus more on the obligations of the parties to each other. The requisites of a binding contract under civil law are determined in part by the classification to which a contract is assigned. Some of the more frequently encountered civil law classifications are bilateral, unilateral, onerous, and gratuitous contracts.[59]

Some civil law contracts create binding obligations that would not be binding obligations under common law. An example is the payment of a donative gift. Another example pertains to onerous and gratuitous contracts. Each of these is enforceable under the civil law; only an onerous contact is enforceable under the common law. Onerous contracts are those in which both parties to the contract expect to receive an advantage in exchange for a good or service that they provid. A gratuitous contract is one in which only one of the contract parties provides an advantage, without expecting to receive anything in return.[60]

56 See Model Law, Article 9.

57 Model Law, Article 6, ¶ 3.

58 Model Law, Article 6, ¶ 5, Note to the Working Group.

59 Although not discussing bindingness concepts, see Foster, Security, *supra* note 14, at 13-18, for an introduction to applicable French civil law and considerations of the sources, complex mechanisms, enforcement, and other considerations relating to pledge arrangements under French civil code law and derivatives, including as enacted in the United Arab Emirates and other jurisdictions in which the Shari'ah is of relevance.

60 Thus, Shari'ah scholars sometimes assert that the Shari'ah is more akin to the common law analysis. The elements of contract formation, for example, are quite similar, as are the distinctions in validity and bindingness regarding onerous and gratuitous contracts. A *rahn* is a contract under the Shari'ah and must satisfy its contract validity bindingness requirements.

5.2. Shariʻah Provisions

5.2.1. Nature of the *Rahn* Contract

A *rahn* contract is a voluntary, charitable contract (*tabarruʻ*).[61] It is a contract that is binding upon the debtor, but not upon the creditor; that is to say, a debtor may not void the *rahn* contract, while a creditor has the right to void the *rahn* contract. The *rahn* contract is said to be exclusively for the benefit of the secured creditor.[62]

It is also a contract involving non-fungible property, and thus is not considered totally binding until the object of the contract (the encumbered asset or *marhun*) is delivered to and, most critically, received by (or on behalf of), the secured creditor. While the principle seems not to be fully implemented in modern transactions, some schools (most notably the Shafiʿis) define a *rahn* as involving "non-fungible property" as the insurance against a "fungible debt".[63]

There is no prescribed form of *rahn* under the Shariʿah. No particular language is required for establishment of the contract, although the substance of the arrangement must be clear from the language and actions.[64] The *rahn* contract may be written or oral. Unlike the Model Law, oral *rahn* contracts are not specifically limited to situations in which the secured creditor has possession of the object of the *rahn*. However, possession is a requirement for all *rahn* contracts, so no specific differentiation need be made.

However, there are numerous principles applicable to the descriptive characteristics of a valid *rahn*, particularly as to the specificity of the description of the encumbered asset and the secured obligation. A *rahn* contract is a contract, and, as such, is subject to all relevant Shariʻah principles pertaining to contract formation (including validity and bindingness). For example, it may be written or oral and it must have sufficient certainty, including with respect to descriptions of the secured obligation and the encumbered asset that is used to secure the obligation.

A general summary comparison to the Model Law is that the requirements for the agreement (be it written or oral) are not markedly different that those of the Shariʻah. There are some qualifications to that statement, and those are noted in the succeeding paragraphs of this section. The qualifications relate to (a) the amount of detail that may be required for specific items and terms, and (b) those areas where the underlying substantive Shariʻah principles are different from those embodied in the Model Law. In comparison to the Model Law, the qualifications pertain primarily to the requirements set forth in clauses (c), (d), and (e) of the first paragraph of section 5.1.

Examples of the former qualification are the amount of detail that may be required with regard to the secured obligation (e.g., regarding payment dates and amounts). The necessity for greater detail relates, in turn, to Shariʿah principles applicable to, for example, enforcement and the application of proceeds from realization on the encumbered asset (*marhun*).

An example of the latter qualification is the questionable nature of future advances under classical interpretations of the relevant Shariʻah principles. Another example of the latter qualification relates to

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61 There are five voluntary charitable contracts: gifts, simple loans, deposits, loans, and *rahn*.

62 However, as is evident in the subsequent discussions, the debtor is entitled to various benefits after the *rahn* contract has become binding. Many of these benefits are those of resulting from the obligations and responsibilities of the secured creditor under the *rahn* arrangements.

63 See, e.g., al-Zuḥaylī, *supra* note 13, at 79. AAOIFI Standard, *supra* note 14, makes no reference to fungibility concepts.

64 See section 7.2.1, particularly section 7.2.1(d).

the Shari‘ah principles that require a *rahn* on the occupied property (a tree, land, or house) if a *rahn* is to be effective on the occupying property (fruits, growing crops, or furniture).[65]

The *rahn* contract must include an accurate designation and description of the *marhun*. The *rahn* will not be valid to the extent that it covers property that does not exist at the time of the execution of the *rahn* contract, with limited exceptions. The AAOIFI Standard provides that the encumbered asset should be "well specified (through pointing, naming or description)", which is indicative of the flexibility afforded under the Shari‘ah principles so long as the identification is relatively specific.[66]

In the case of a *rahn* of real property, the location and description of the real property, as specified in the deed pertaining thereto, should be included. A *rahn* of real property may also specify that it covers fixed assets located on the land, such as buildings and immovables (fixtures).[67] Mention is here made of real property principles because it is illustrative and because of the possibility of immovables becoming "integrated" into, and thus coming to constitute, movable property for Shari‘ah purposes.[68] The description of the encumbered asset must also be sensitive to substantive Shariʿah requirements, such as the rules that prohibit a *rahn* on an occupying property unless the occupied property is also subject to the same *rahn*.[69]

The *rahn* contract must identify the secured obligation with the requisite specificity. This set of requirements is interactive with determinations as to whether an obligation is "matured" or "established" under the relevant Shari‘ah principles, which vary by school of Islamic jurisprudence.[70]

There appears to be agreement that the *rahn* agreement should describe (a) at least by reference, the agreement pursuant to which the secured obligation arises, (b) the exact amount of the secured obligation, and (c) the terms of repayment (including payment dates and amounts and other fundamental terms).

Only a secured obligation described in the *rahn* contract will be covered by the security right, which suggests careful description of all existing secured obligations and all potential future advances and incurrences.

Often, the amounts constituting each element of indebtedness (i.e., principal, profit, and other amounts) must be specified in detail.[71] The level of detail is increased in circumstances where future advances and incurrences are involved.[72]

Rules regarding the specificity of secured obligations descriptions are applied with rigor because of their relevance to other Shari‘ah considerations (such as enforcement and remedies). These are all matters to be carefully studied as the Model Law is tailored to any specific jurisdiction.

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65 See the discussion in sections 5.1, 7.2.1, and 7.2.2.

66 AAOIFI Standard, *supra* note 14, at § 3/2/1.

67 Immovable property under the *Shariʿah* is defined as any property that is stable and fixed so that it may not be moved or transported without damage. It includes land, buildings, and trees. As noted subsequently in this report, movable property may become immovable property.

68 See the discussion in section 8.2.

69 See the discussion in sections 5.1, 7.2.1, and 7.2.2.

70 See the discussion in section 6.2.

71 Of course, interest is not permissible under the *Shariʿah* and a *rahn* securing interest payments is unenforceable, at least to the extent that it secures the interest payments. See the discussion in section 6.2.1 for a more nuanced discussion of this set of considerations.

72 See the discussion in section 6.2.

The *rahn* agreement should also include the terms under which it may be exercised and the remedies of the secured creditor to occupy, use, and operate the encumbered asset, and to sell such assets, and, in each case, to apply the proceeds thereof to pay off the secured obligations.[73]

5.2.2. Cornerstones and Types of *Rahn* Contract

The various jurisprudential schools define both "cornerstones" and "conditions" that must be met or satisfied for a valid *rahn* contract to exist.

(a) Cornerstones

The cornerstones, for the Hanafi, are the following:

(i) The *debtor* (who grants the security right in the encumbered asset);
(ii) The *creditor* (who receives the encumbered asset as insurance for the debt;
(iii) The *marhun* (the encumbered asset) that is the object of the *rahn*; and
(iv) The *obligation* (e.g., a debt) in lieu of which the object is granted.

The Hanafi (and the Hanbalis and Shafiʻis) require that the encumbered asset be delivered to and received by the secured creditor in order for the *rahn* contact to be finalized and binding (the Malikis base bindingness on offer and acceptance). Delivery and receipt may occur, particularly for the Hanafis, in relation to transportation of the encumbered asset or, in the case of real property and some other assets, granting of access to the encumbered asset.[74]

The Hanbalis, Malikis, and Shafiʻis also stipulate four cornerstones of the *rahn*. They are:

(A) Contract *language*;
(B) Contracting *parties*;[75]
(C) The *marhun* (encumbered asset) and
(D) An *underlying debt* (or secured obligation).

Conditions of the non-Hanafis relate to each of conclusion, validity, and bindingness of the *rahn* contract.

(b) Arrangements for Creation of Security Rights

Under the Shariʿah, for analytical purposes there are three types of security rights, in terms of their origination:[76]

- Those *originating with the debt-generating contract*, such as a condition in a sale agreement that a security right be provided to secure payment of the sale price;
- Those originating after the establishment of the relevant secured debt; and
- Those *granted prior to the establishment of the relevant secured debt*, such as on property prior to incurrence of any or some indebtedness.

[73] See the discussion in section 15.

[74] Anecdotally, despite the enunciated principles set forth in this report, in contemporary practice, and in light of customary practices in the markets (particularly markets that have registration systems for security rights), Shariʻah scholars seem to be interpreting "possession" to include the granting of access to movable property that constitutes *marhun,* as well as immovable property that constitutes *marhun*.

[75] The Hanafis consider this to be a condition, rather than a cornerstone.

[76] al-Zuḥaylī, *supra* note 13, at 91.

All jurisprudential schools agree that security rights originating with the debt-generating contract and those originating after the establishment of the secured debt are valid (assuming satisfaction of all other requirements, and leaving aside, for the moment, future advances).

Under classical interpretations, the jurisprudential schools disagree as to the validity of *rahn* grants prior to establishment of the relevant secured debt. The Shafiʻis and the Hanafis allow this as valid, while the Malikis and most Hanbalis do not recognize this grant prior to establishment of the relevant secured debt as being valid.[77] The AAOIFI Standard expressly states that the establishment of the secured obligation need not precede the grant of a *rahn* secured that obligation. However, the *rahn* contract must be executed before or contemporaneously with the execution of the agreement establishing the secured obligation.[78]

These different interpretations have implications for numerous contemporary financing arrangements that involve funding subsequent to the grant of the security right, as is discussed later in this report. For the present, it is worth noting that the Model Law has no such restriction as to subsequently established debt or future advances: they are expressly acknowledged to be obligations that may be secured by a security right.[79]

5.2.3. Implications of Association of Secured Obligation and Encumbered Asset

(a) Fundamental Principles

Fundamental Shariʿah principles pertain to the association of the encumbered property with the underlying secured obligation, and vice versa.

- The secured obligation is associated with the entirety of the encumbered asset.[80]
- The encumbered asset is associated with the entirety of the secured obligation.[81] This is the basis for allowing the secured creditor to retain possession of the entirety of the encumbered asset (*marhun*) until payment in full of the secured obligation.

These principles of association of the secured obligation and the encumbered asset have a range of implications. One implication relates to the continuing status of the encumbered asset upon repayment of all or part of the secured obligations in different situations (i.e., where there is a unitary *rahn* contract or a multiplicity of *rahn* contracts). As a first principle, repayment or forgiveness of part of the secured obligation leaves the remaining unpaid portion of the secured obligation associated with the entirety of the encumbered asset. No portion of the encumbered asset is released until payment in full of the secured obligation (even if there are multiple debts or multiple assets granted as encumbered asset). But there are variations on that principle, as discussed in this section.

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77 See al-Zuḥaylī, *supra* note 13, at 83. In practice, Shariʻah scholars often focus on when the debt is "established" in addressing these requirements.

78 AAOIFI Standard, *supra* note 14, at § 3/3/1.

79 See Model Law, Article 7.

80 See al-Zuḥaylī, *supra* note 13, at 144-46, Majelle, *supra* note 14, article 731, and AAOIFI Standard, *supra* note 14, at § 3/1/7.

81 See AAOIFI Standard, *supra* note 14, at §3/1/7. This discussion ignores situations involving multiple debtor, multiple creditor, and multiple secured obligations, each of which is subject to separate *Shariʿah* principles.

Further, there are implications for who will have continuing possession of the encumbered asset, who will be permitted to use the encumbered asset, and who will be permitted to sell the encumbered asset in default scenarios.[82]

(b) Unitary Contract or Multiple Contracts

While all four primary orthodox Sunni jurisprudential schools agree on the foregoing principles (secured obligation associated with the entire encumbered asset, and vice versa), some interpretive differences arise when the principles are implemented. Those differences derive from the views of the different scholars as to whether a *rahn* contact is properly viewed as a single contract or a multiple contracts. The consequences of the determination relate primarily to when collateral is released in different payment scenarios.

The Hanafis view is that a *rahn* contract is unitary if it is concluded in (i) a single agreement or (ii) an arrangement that specifies or implies an encumbered asset that secures the entirety of the secured obligations, whether there is a single underlying secured obligation or many. To be treated as multiple *rahn* contracts, the language of the *rahn* arrangements must clearly indicate that intention.

For the Hanafis, if the *rahn* contract is unitary, no part of the encumbered asset may be released until payment in full of all of the related secured obligations. That is, if there is a single *rahn* contract, the debtor that repays one of the several underlying secured obligations is not entitled to release of any of the encumbered asset (it remains to secure the remainder of the secured obligations). This result obtains even if the *rahn* contract specifies a correspondence between individual items of the encumbered asset and individual secured obligations. And this rule applies whether or not there are multiple debtors and/or multiple creditors, and whether or not there is identification of independent secured obligations to separate independently identified debtors.

The Maliki rule is that there is a unitary single contract if the *rahn* contract names a single debtor and a single creditor, even if there are actually multiple underlying secured debts and/or multiple objects constituting the encumbered asset. If there is a single contract involving multiple debtors, then repayment of some part of the secured obligation would leave the encumbered asset securing the remainder of the unpaid total secured obligation, even if the part that was repaid was the total secured obligation of the individual debtor that made the repayment.

On the other hand, the Malikis rule that if there are multiple *named* debtors, multiple *named* creditors, or both, then the arrangement is viewed as being comprised of multiple *rahn* contracts. In such a case, a single debtor that pays that debtor's secured obligation in full is entitled to return of the encumbered asset contributed by that debtor, or, if the encumbered asset was not contributed by a single debtor or is fungible, to a portion of the total encumbered asset determined by the relationship of that debtor's secured obligation to the aggregate of all secured obligations secured by the *rahn* arrangements. That is true even though the remainder of the secured obligation is not then repaid in full.

If there are multiple secured creditors, the Malikis rule that the debtor may recover its contributed encumbered asset, or a portion so determined, by repaying to any one secured creditor (or group of creditors) the total secured obligation owed by that debtor. If the encumbered asset is indivisible, then the encumbered asset may be moved to the possession of an *'adl* or kept by the secured creditor on a possession of trust relationship.

The Hanbalis determine one of the rules (relating to a unitary contract) in essentially the same manner as the Malikis. A single debtor and single secured creditor result in a determination that there is

[82] See sections 12.2.3 (use of *marhun*) and 16.2 (sale of *marhun*).

a unitary single *rahn* contract. The entirety of the encumbered asset then remains to secure the secured obligations until payment in full.

The Hanbalis take the position that any multiplicity of debtors or creditors results in a determination that there are multiple *rahn* contracts. The number of contracts is determined on the basis of the total number of permutations, with each debtor and each creditor having a contract between them. Thus, for example, two debtors and two creditors means there are four *rahn* contracts, with one-quarter of the encumbered asset corresponding to each *rahn* contract (assuming equality of the secured obligations relating to each *rahn* contract). Each debtor is then entitled to release and return of its encumbered asset (or relevant portion) upon payment of any of its individual *rahn* contracts.

Finally, the Shafi'is believe that the determination as to whether the *rahn* contract is unitary or multiple depends upon whether the underlying secured obligation is unitary or multiple. If the debtors are multiple or the secured creditors are multiple, it is usually determined that the secured obligations are multiple, even if the debtors act through a common agent. A similar result obtains where there are multiple secured obligations.

There is a difference between the Shafi'is, on the one hand, and the Malikis and Hanbalis, on the other hand, with respect to a single secured obligation owed by one debtor to multiple creditors. For the Shafi'is, repayment in full of the secured obligation to any one of the secured creditors entitles the debtor to release and return of the encumbered asset. The debtor must clearly identify one of the secured creditors as the recipient of debt repayment to qualify for this treatment. As a correlative, if the debtor borrows the object used as encumbered asset from two (or more) people, and then repays one-half of the secured obligation, then half of the encumbered asset must be released and returned.

The principle that the encumbered asset is associated with the underlying secured obligations has other implications apart from releases of collateral in situations where there may be a determination as to whether there is a unitary contract or multiple contracts. These are discussed further in other sections of this report, but the reader should be aware of these implications from the outset.

The association principles imply the right of the secured creditor to permanently hold and possess the encumbered asset (i.e., without allowing debtor use) until payment in full of the secured obligations.[83] The secured creditor thus has the right to prevent the debtor from recovering the encumbered asset prior to such repayment in full.

The secured creditor is entitled to extract repayment from the encumbered asset, but because the secured creditor is not the "owner" of the encumbered asset, it does not have the right to sell the encumbered asset. This assertion has important implications for concepts of enforcement and remedies.[84]

Further, the encumbered asset has a financial property characteristic, and it is from that characteristic that repayment may be extracted. Thus, the value of the encumbered asset (i.e., its financial aspect) is the critical focus. If the value of the encumbered asset exceeds the amount of the secured obligation, that excess is held by the secured creditor in trust for the debtor.

The foregoing is a summary of the view of the Hanafi school. The Hanbalis, Malikis, and Shafi'is have a slightly different view as regards the rights of the secured creditor to sell the encumbered asset.[85]

The matters referred to in the preceding four paragraphs also relate to, and are complicated by, the rules applicable to possession of the encumbered asset by the debtor. The Shafi'is permit the debtor to use the encumbered asset during the term of the *rahn* and to extract value from the encumbered asset during this period (so long as such use and extraction does not harm the encumbered asset). The

83 See the discussion in section 12.2.3. And see AAOIFI Standard, *supra* note 14, at § 3/1/7.

84 See section 15.2.

85 This is also discussed in section 15.2.

encumbered asset must then be returned to the secured creditor if the secured creditor must extract value from the encumbered asset to effect repayment of the secured obligation. Under the AAOIFI Standard, the secured creditor may not use the encumbered asset free of charge, whether or not the debtor allows such a use. The secured creditor using the encumbered asset must make "normal" payment for any such use.[86]

The differences in opinion on these matters as between the Shafi'is, as one group, the Hanafis, Hanbalis and Malikis, as another group, and AAOIFI, as a third group, result in differences in interpretation of various other rights, responsibilities, and obligations. In particular, there are resulting differences in approach to (x) debtor use during the term of the *rahn*,[87] (y) whether the *rahn* includes non-contiguous growths in the encumbered asset and thus may be sold by the secured creditor[88] and (z) whether an unidentified portion of a property may be made subject to a *rahn*.[89]

5.2.4 Bindingness

A critical initial determination regarding any *rahn* contract is whether it is binding, and if so, exactly when it becomes binding. There are two points of view. The Malikis determine bindingness based upon offer and acceptance. The Hanafis, Hanbalis, and Shafi'is determine bindingness based upon receipt of the encumbered asset.

For the Malikis, and for the AAOIFI, the contract becomes binding upon valid offer and acceptance.[90] Receipt of the encumbered asset (*marhun*) completes the contract, but is not a condition to bindingness.

The AAOIFI Standard adopts the Maliki position. The *rahn* contract is valid upon conclusion of the contract, and the grantor has no right to revoke the *rahn* contract once concluded: it is a binding contract.[91] The AAOIFI Standard does not require physical delivery and receipt. With respect to delivery, it states that the encumbered asset must be capable of delivery.[92] Possession, under the AAOIFI Standard, is addressed in two ways. Registration in a registry of security rights functions as legal possession (a substitute for delivery) under the AAOIFI Standard, which bolsters the possession concept.[93] With respect to debts that constitute encumbered asset, possession occurs by possession of the documents giving rise to the debt or by attestation of the debt at the time of the execution of the *rahn*.[94]

Under the Maliki interpretation (and presumably under the AAOIFI principle), if the debtor does not deliver, or cause the delivery of, the encumbered asset, the debtor can be legally compelled to make or cause the delivery of the encumbered asset, with (for the Malikis) four exceptions. Those four exceptions

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[86] AAOIFI Standard, *supra* note 14, at § 3/2/9; and see the discussion in section 12.2.3 (and related footnotes).

[87] For example, the Shafi'is allow debtor use of the *marhun* during the term of the *rahn*; the Hanafis do not; and the AAOIFI use provisions are as just stated. See section 12.2.3.

[88] See sections 7.2.2(b) and 8.

[89] See section 7.2.2(a).

[90] Consider, for example, al-Zuḥaylī, *supra* note 13, volume I, at 8-12, which discusses offer and acceptance in the context of sales contracts. Recall that, under the Model Law, this issue is one of contract formation under local secular law. The determination of the Malikis shares many elements with common law determinations of when a valid and binding contract is formed. And see AAOIFI Standard, *supra* note 14, at § 3/1/1.

[91] AAOIFI Standard, *id.*, at § 3/1/1.

[92] AAOIFI Standard, *id.*, at § 3/2/1.

[93] AAOIFI Standard, *id*., at § 3/1/2.

[94] AAOIFI Standard, *id*., at § 3/2/12.

are: (i) intervening death of the debtor;[95] (ii) demands by other creditors, prior to delivery and receipt of the encumbered asset, that the debtor pay debts to them; (iii) intervening bankruptcy or insolvency of the debtor;[96] and (iv) intervening terminal illness or insanity of the secured creditor.[97]

For the Hanafis, Hanbalis, and Shafi'is, the *rahn* contract does not become binding until the encumbered asset has been *received* by or on behalf of the secured creditor. Prior to delivery and receipt of the encumbered asset, the debtor is entitled to void the *rahn* contract.[98]

Another set of fundamental principles relates to the nature of the *rahn*. Here, also, interpretations vary by school of Islamic jurisprudence. There are two different conceptions of the *rahn* contract (and the *rahn* arrangement). Each of these conceptions relates to somewhat different conceptions of the nature of the possession of the encumbered asset by the secured creditor.

- The Hanafis conceive of the possession of the encumbered asset as a possession of trust with respect to the encumbered asset itself (and, in some instances, a possession of guarantee and repayment of the secured obligation with respect to the financial aspect of the encumbered asset). Under a possession of trust, the secured creditor is liable for the full value of the encumbered asset only if there is transgression by or negligence of the secured creditor. Under a possession of trust as interpreted by the Hanafis, the secured creditor is liable for the value of the encumbered asset up to the outstanding amount of the secured obligation, or, if less, the value of the encumbered asset.[99]
- The Hanbalis, Malikis and Shafi'is conceive of the possession by the secured creditor as a possession of guarantee. This means that the secured creditor guarantees the full value of the encumbered asset, whether or not the secured creditor is responsible for a transgression or negligence.

The substance and importance of this difference becomes apparent if the encumbered asset is lost, damaged, or destroyed while in the possession of the secured creditor. The difference profoundly affects whether the secured creditor will have liability with respect to the loss, damage, or destruction, and if so, the amount of the liability exposure. The rules pertaining to loss, damage, and destruction and related liabilities are discussed in conjunction with specific topics throughout this report and in section 15.

5.2.5 Receipt

Receipt is agreed to be a condition to bindingness of a *rahn* contract by the Hanbali, Hanafi, and Shafi'i schools, and may be required and compelled pursuant to a binding *rahn* contract (made binding by valid offer and acceptance) by the Maliki school (and, presumably, where the AAOIFI Standard is applicable). Receipt of the encumbered asset is not discussed in the AAOIFI Standard. Because registration in a registry is permissible, and constitutes legal possession, it may also be thought to constitute receipt as contemplated by the AAOIFI Standard.[100]

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95 Under the AAOIFI Standard, *id*., at § 3/1/5, the death of the debtor and the death of the secured party have no effect on the validity of the *rahn* contract, and the respective heirs are substituted as parties to that contract.

96 Under the AAOIFI Standard, *id*., at § 3/5/3, a bankruptcy of the debtor does not affect the priority of the secured creditor.

97 al-Zuḥaylī, *supra* note 13, at 142-43.

98 Receipt is discussed in section 5.2.5.

99 With respect to possession of trust concepts under the AAOIFI Standard, see section 5.2.7.

100 See AOIFI Rahn Standard, *supra* note 14, at § 3/1/2.

No school of Islamic jurisprudence allows possession to remain with the debtor under classical formulations.[101]

The primary differences among the jurisprudential schools relate to whether receipt is a condition of bindingness (or validity) or a condition of contractual completion.

- Where it is a condition of bindingness, the implication is that a grantor may change his, her, or its mind prior to delivery of the object. Upon and after delivery of the encumbered asset, the *rahn* is binding upon both parties.
- Where it is a condition of contractual completion, as for the Malikis (and under the AAOIFI Standard), the *rahn* contract becomes binding at contractual conclusion (i.e., offer and acceptance) and the grantor may be compelled to deliver the encumbered asset. More, for the Malikis, if the secured creditor does not require and enforce delivery of possession, the *rahn* is deemed invalid. This becomes particularly important in circumstances in which possession is left with the grantor, then the *rahn* is invalid.

Receipt of immovable property (primarily real property), for all four schools, may be established by either actual physical receipt of the encumbered asset or the removal of impediments to actual physical receipt.

Matters are more complex for movable property, and the different schools take divergent positions. Most Hanafi scholars have taken the position that removal of impediments to physical receipt constitutes receipt for present purposes, and is equivalent to delivery and receipt, even if there is no physical transportation of the object.

The Shafiʻis, the Hanbalis, and ʼAbu Yusuf take the position that provision of access to movable property is not sufficient to constitute receipt: they require transportation, physical receipt, and official transfer of possession rights.[102]

There are three primary conditions to receipt:

- *Permission of the debtor* (or grantor), orally, in writing, or by implicit permission (e.g., delivery by the grantor): the debtor or grantor will lose the right to demand return of the encumbered asset subsequent to valid receipt;[103]
- Contractual and *legal eligibility* of the contract parties;[104] and
- *Permanency of receipt* until the secured obligation is paid and performed in full or the encumbered asset is sold to extract payment.

The permanency-of-receipt requirement gives rise to issues in contemporary practice. The most important issues arise in connection with allowing the debtor or grantor to use the encumbered asset during the term of the *rahn* (i.e., returning the encumbered asset to the debtor to allow use). Similar issues arise in arrangements involving a loan or deposit of the encumbered asset to or with the debtor or grantor.

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101 See section 12.2.3 with respect to use of the *marhun* during the term of the *rahn*.

102 Anecdotally, there seems to be a trend in contemporary transactions and arrangements for scholars from all the different jurisprudential schools to recognize "removal of impediments to access" as adequate receipt for movable property, particularly where a registration system is in effect. This observation is made from a small sample of transactions and arrangements, and is very strongly influenced by the determinations of individual Shariʻah scholars.

103 There are differences of interpretation and analysis where a creditor usurps an object without the grantor's permission, and the grantor later provides consent to possession by the secured creditor; see al-Zuḥaylī, *supra* note 13, at 109.

104 See al-Zuḥaylī, *id*., at 110-11.

These are obviously significant issues given that most debtors (especially SMEs) require the use of the encumbered asset to generate revenue for the ongoing conduct of their businesses, including the repayment of the secured obligation.

The Malikis rule that the *rahn* is invalidated if the debtor or grantor is allowed to use the encumbered asset during the term of the *rahn* or if the encumbered asset is loaned by the secured creditor to or deposited by the secured creditor with the debtor or grantor during the term of the *rahn*.

The Hanafis rule that, if the debtor or grantor is permitted to use the encumbered asset during the term of the *rahn* or the encumbered asset is loaned to or deposited with the debtor or grantor by the secured creditor during the term of the *rahn*, the *rahn* remains valid, but is no longer guaranteed by the secured creditor (with the secured creditor being relieved of many care and custody liabilities relating to the guarantee concept).[105]

The Hanbalis rule that the bindingness of the *rahn* is removed, as if the encumbered asset had never been delivered (with the ability of the grantor to opt out of the arrangement), if the debtor or grantor is allowed to use the encumbered asset during the term of the *rahn* or the encumbered asset is loaned to or deposited with the debtor or grantor during the term of the *rahn*.

If the encumbered asset is redelivered to the secured creditor, the *rahn is* reinstated (Hanbalis) or is capable of reinstatement only pursuant to a new contract (Hanafis and Malikis).

The Shafi'is take a quite different view, which is dependent upon whether the encumbered asset may continue to exist after the use, loan, or deposit. If the encumbered asset may continue to exist, they rule that the *rahn* continues to exist (that is, the secured creditor may grant permission for grantor use of the encumbered asset, and may loan or deposit the encumbered asset). If the encumbered asset would be consumed or otherwise not continue to exist, the grantor may not request continuing possession for use by or on behalf of the grantor.

The timing of receipt of the object of the *rahn* may be critical, as well. Issues arise, in particular, where the secured creditor has possession of the object prior to the time the *rahn* is effected. Situations in which this might arise in contemporary practice include lease arrangements, loans, and deposits (as well as usurpations). Three schools (the Hanafis, the Hanbalis, and the Malikis) rule that the prior receipt is sufficient receipt for the *rahn*, and no new receipt is necessary, although the reasoning of each of these schools is different and differently premised.[106]

5.2.6 'Adl (Trustee): Receipt and Possession

Receipt of the object of the *rahn* may be by the secured creditor or an agent of the secured creditor.[107] Appointment of the debtor as the agent of the secured creditor is not permissible. And, as previously noted, the encumbered asset may not be left in the possession of the debtor under the Shari'ah (although it is allowed under the Model Law).

Many—probably most—contemporary financing arrangements involving security rights in movable property, particularly those involving SMEs, allow the debtor to retain the movable property used as collateral. In many (if not most) cases, it is critical to leave the movable property with the debtor for debtor use. The debtor needs the property to conduct its business and generate the income necessary to

105 See the discussion in section 12.2.

106 See al-Zuḥaylī, *supra* note 13, at 112-15.

107 See, e.g., AAOIFI Standard, *supra* note 14, at §§ 3/1/3 and 3/2/4. The AAOIFI Standard recognizes two types of agency in this regard, one of which bears some similarities with the '*adl* in being mutually agreed and unable to transfer the *marhun* without the consent of both the grantor and the secured party, but which is specifically designated as a "notary." See section 5.2.7.

service the secured obligation and to otherwise sustain and grow the business. This is almost universally true of SMEs.

Issues pertaining to debtor use of the encumbered asset during the term of the *rahn* are among the most important Shari'ah issues in contemporary financings.

A possible solution to the debtor-possession issue under classical principles is to place the possession of the object of the *rahn* with a third party that is trusted by both the debtor and the secured creditor: a type of "trustee", known as the *'adl*.[108] Even where this arrangement does not resolve the debtor use issue, it is increasingly common for transactions to be structured so that the encumbered asset is held by an *'adl*.

Returning to consideration of the classical principles applicable to an *'adl*, the debtor and the secured creditor may agree that the debtor may act and function as the *'adl* or as a joint *'adl*. Structuring this relationship is difficult, and its acceptability in cases when the structure uses the debtor as *'adl* varies by school of Islamic jurisprudence.

If this agreement of the debtor and the secured creditor is reached prior to receipt of the encumbered asset by the secured creditor, all schools are of the opinion that the *rahn* is invalid.

If that agreement is reached subsequent to the receipt of the object of the *rahn* by the secured creditor, then the Shafi'is permit the arrangement and the non-Shafi'is rule that the *rahn* is invalid.

A contemporary practice that promises to be more broadly acceptable entails appointing the debtor as a joint *'adl* subsequent to receipt of the encumbered asset by an independent third party *'adl* that was otherwise appropriately appointed prior to receipt of the encumbered asset.

The *'adl* acts for and on behalf of both the debtor and the creditor and must be agreed upon by both parties.

- Acting on behalf of the debtor, the *'adl* holds the object of the encumbered asset in a possession of trust with all related obligations to protect the property, as discussed later in this section.[109]
- The *'adl* acts for and on behalf of the secured creditor in taking receipt of the encumbered asset, retaining possession of the secured object, and guaranteeing the financial aspect of the encumbered asset.

Most jurists are of the opinion that receipt by an *'adl* is valid and binding. A few jurists are of the opinion that receipt by an *'adl* is not valid, on the theory that the parties themselves must consummate a contract.

An *'adl* must satisfy all requirements of competency to be an agent (e.g., capacity).

The Hanbalis and the Shafi'is allow for use of multiple (usually two) joint *'adl*.

Neither a guaranteed debtor nor the guaranteed debtor's partner may act as the *'adl* in a transaction in which the guarantor of the debtor provides the *rahn* and the encumbered asset. Similarly, the *rabb ul-maal* in a *mudaraba* may not act as *'adl* on behalf of the *mudarib* in that *mudaraba*.

An *'adl* has various rights and obligations under the Shari'ah. The *'adl* must protect the encumbered asset with the same degree of skill, in the same manner, and to the same standards as the *'adl* would

108 An early use of two *'adl* as collateral security agents in a project financing is McMillen, Project Finance, *supra* note 18, at 1184-1232. The *'adl* is discussed in al-Zuḥaylī, *supra* note 13, at 115-22, and the Majelle, *supra* note 14, at articles 752-55.

109 Continued ownership of the *marhun* by the debtor is both the classical formulation and that of the AAOIFI Standard, *id.*, at § 3/2/4 (assuming that the debtor is the grantor).

protect his, her, or its own property. The obligations and responsibilities are the same as those imposed upon a depositary.[110]

Both an ʼ*adl* and a depositary are permitted to keep the encumbered asset themselves or have the encumbered asset kept by a person with whom the ʼ*adl* would otherwise keep his, her, or its property. This sometimes allows the ʼ*adl* to give possession of the encumbered asset to either the debtor or the secured creditor, but only with the permission of both the debtor and the secured creditor. The requirement for the permission of both the debtor and the secured creditor is based upon the fact that each has rights in the encumbered asset and the ʼ*adl* acts on behalf of both in the arrangement.

This set of requirements has important ramifications. For example, if the encumbered asset were placed in the possession of either the debtor or the secured creditor without the consent of both, and were lost, damaged, or destroyed while in the possession of either the debtor or the secured creditor, the ʼ*adl* would still be required to guarantee the value of the encumbered asset despite not having possession. The guarantee of the ʼ*adl* also continues when the ʼ*adl* provides possession of the encumbered asset to a third party without the consent of both the debtor and the secured creditor. In such a situation, the ʼ*adl* guarantees the lesser of the value of the encumbered asset and the amount of the secured obligation. In each of the foregoing examples, the ʼ*adl* is considered a "transgressor" for not having obtained the consent of both the debtor and the secured creditor.

These examples can be extended. Assume that the debtor pays the secured obligation in full and then demands the return of the encumbered asset from the ʼ*adl*. If the ʼ*adl* had inappropriately delivered the encumbered asset to the debtor, then the debtor is not entitled to collect the value of the encumbered asset, whatever the state and condition of the encumbered asset at the time. If the ʼ*adl* had inappropriately delivered the encumbered asset to the secured creditor, then the ʼ*adl* would be liable to the debtor for the value of the encumbered asset. Whether the ʼ*adl* would be entitled to recover the payment to the debtor from the secured creditor then depends upon whether the transfer of the encumbered asset to the secured creditor was a lease, loan, or deposit, on the one hand, or a secondary *rahn*, on the other hand. In the former case, the ʼ*adl* would not be entitled to recover the payment. In the latter (a secondary *rahn*), the ʼ*adl* would be entitled to recover the payment that the ʼ*adl* made to the debtor.

The ʼ*adl* is entitled to hold the encumbered asset during the period of the *rahn*, but is not entitled to use or benefit from the encumbered asset during this period. Thus, the ʼ*adl* is not entitled to lease, lend, or grant a *rahn* in the encumbered asset, other than as previously noted. Nor is the ʼ*adl* entitled to sell the encumbered asset, unless specifically authorized in the agreement establishing the appointment, rights, and obligations of the ʼ*adl* (which is usually, and most safely, the *rahn* contract itself).

If an object constituting the encumbered asset is sold by the ʼ*adl*, that object is no longer subject to the *rahn*. The sales price will be substituted for that object as the encumbered asset. In such a case, the purchaser at the sale becomes the owner of the object that previously constituted the encumbered asset.

Different schools have somewhat different positions as to what types of sales are permitted, and the terms of those sales. The Shafiʻis and the Hanbalis, for example, allow only cash-and-carry sales in the domestic currency. The Hanafis allow both cash-and-carry and credit sales by the ʼ*adl* (where otherwise permissible), and they allow sales at the value of the encumbered asset, or at an amount slightly below that price if that lower price is within the range of normal market price variations. In both instances, the sales price becomes the encumbered asset and that encumbered asset is guaranteed by the ʼ*adl*.

Loss, damage, and destruction of the encumbered asset while in the possession (or guarantee) of the ʼ*adl* are treated in the same manner as if the loss, damage, or destruction had occurred while the

[110] See note 297, *infra*, regarding depositaries and deposits.

encumbered asset was in the possession of the secured creditor (assuming the *'adl* is not a transgressor, as noted above).[111] For example, the Hanafis rule that the secured creditor guarantees the lesser of the value of the encumbered asset and the amount of the secured obligation. For the non-Hanafis, the secured creditor guarantees the value of the encumbered asset.

The rules vary if the either an *'adl* or a third party becomes responsible for guaranteeing the value of the encumbered asset. That occurs if the *'adl* is a transgressor in delivering possession to the debtor, the secured creditor, or a third party, or if a third party becomes a guarantor of the value of the encumbered asset. In these circumstances, the *'adl* must deliver the value of the encumbered asset to the debtor or, if the secured obligation has not been repaid, to the secured creditor (to the extent of the unpaid secured obligation). If the transgressor was a party other than the *'adl*, the Hanbalis and Shafi'is allow the *'adl* to retain the value as encumbered asset.

If the grantor of the encumbered asset is not the debtor, and that grantor demands a return of the encumbered asset in any case of transgression, then return of the encumbered asset is required. If the encumbered asset provided by a grantor other than the debtor is lost, damaged, or destroyed prior to a demand for its return by the grantor, then the grantor has the right to elect whether the debtor or the *'adl* is responsible for guaranteeing the value of the lost, damaged, or destroyed object (encumbered asset). If the grantor elects to hold the *'adl* responsible, the *'adl* has a right of recovery from the debtor.

Rulings applicable to resignation of the *'adl* also vary. For the Shafi'is and the Hanbalis, an *'adl* may resign at any time and for any reason. The rulings of the Hanafis turn on whether the *'adl* was appointed before or after the conclusion of the *rahn* contract. If the appointment was subsequent to the conclusion of the *rahn* contract, the position is that the *'adl* may resign at any time for any reason. If the appointment was prior to the conclusion of the *rahn* contract, however, the Hanafis rule that the *'adl* may not resign without the consent of the secured creditor. This ruling is designed to protect the secured creditor, and is a condition of the *rahn* contract.

Under the Hanafi rulings, the *'adl* may be forced to sell the encumbered asset at the maturity of the secured obligation (if the secured obligation is not paid in full). If the *'adl* refuses, the *'adl* may be incarcerated, and if the *'adl* continues to resist, the judge may order a sale of the encumbered asset. To complicate matters further, some jurists and Shari'ah scholars allow the *rahn* agreement to include provisions to the effect that the *'adl* may not resign without the consent of both the secured creditor and the debtor.

5.2.7 Notary Possession under AAOIFI Standard

The AAOIFI Standard does not address *'adl* arrangements, at least in terms of the appointed person being designated or referred to as an *'adl*. Instead, it speaks of placing possession of the encumbered asset with a notary that is appointed by both the debtor and the secured creditor (a requirement applicable to *'adl* arrangements, as well).[112]

The notary is characterized as having a possession of trust, and thus the liability exposure that accompanies some interpretations of classical possession of trust arrangements.[113] Both the secured creditor and an agent of the secured creditor are treated in the same manner as a notary, and characterized as having a possession of trust.

111 See section 14 with respect to a range of loss, damage, and destruction scenarios.
112 AAOIFI Standard, *supra* note 14, at § 3/1/3.
113 AAOIFI Standard, *id*., at § 3/2/4.

If the encumbered asset is lost, damaged, or destroyed in the possession of the notary, and the loss, damage, or destruction does not involve the transgression or negligence of the notary, the notary shall not have responsibility for such loss, damage, or destruction, and the secured obligation remains valid and unaffected.[114]

If the loss, damage, or destruction of the encumbered asset is attributable to the notary, the possession of the notary becomes a possession of guarantee. The notary is then responsible for the full value of the encumbered asset as of the date of the loss, damage, or destruction. In such a case, the obligation of the notary may be offset against the secured obligation.[115]

114 AAOIFI Standard, *id*., at § 3/2/4.

115 AAOIFI Standard, *id.*, at § 3/2/4.

6 OBLIGATIONS THAT MAY BE SECURED, INCLUDING FUTURE ADVANCES

GENRALIZED SUMMARY **OBLIGATIONS THAT MAY BE SECURED** (Future Advances are addrssed in a separate Generalized Summary) (Subsequent Liens and Priorities are addressed in Section 10)	
SME NEED	The financing obligations of SMEs include the full range of possibilities (present; future; determined; determinable; conditional; unconditional; fixed; and floating), and may secure more than one obligation.
MODEL LAW	The Model Law may secure any type of obligation: present; future; determined; determinable; conditional; unconditional; fixed; or floating. It may secure one or more obligations.
SHARI'AH	Some Shari'ah scholars allow interest-bearing debt to be secured by a valid *rahn* to the extent of the principal (but not the interest elements). Some Shari'ah scholars also permit *rahn* arrangements on *haram* assets in transactions involving non-Muslims.
	All schools all an encumbered asset to secure one or more obligations.
	Classical principles are more stringent with respect to determinable obligations than are Model Law principles. Future advances are addressed in a separate Generalized Summary. As a general matter, conditional obligations may not be secured by a valid *rahn*, but there is variation as to what constitutes a "conditional" obligation. See athe separate Generalized Summary pertaining to Future Advances.
AAOIFI	The AAOIFI Standard allows an encumbered asset to secure one or more obligations.
	The AAOIFI Standard requires that the secured obligation constitute permissible debt under the Shari'ah (and excludes interest-bearing loans and non-debt of different types).
	The AAOIFI Standard allows future income to be encumbered if the asset from which the income is derived is also subject to a valid *rahn*.
RECONCILIATION SUGGESTION	The AAOIFI Standard is a good base. AAOIFI should be encouraged to clarify the AAOIFI Standard further to ensure coverage for as broad a range of secured obligations as is permissible under the Shari'ah.

GENRALIZED SUMMARY FUTURE ADVANCES	
SME NEED	SMEs need continuing access to financing for working capital, inventory acquisition and maintenance, and operations and maintenance expenditures. Typical required arrangements are revolving credit arrangements, which provide for multiple future advances. These are cost-effective means of financing SMEs.
MODEL LAW	Future advances and uncertain sums (to a maximum amount) are secured.
SHARI'AH	Uncertain sums and unmatured obligations may not be the subject of a valid security right. The schools are split on the permissibility of a grant of a security right before a related secured obligation has been established. There are differences among the schools as to when an obligation is "established" and when an obligation has "matured". Some schools interpret an obligation to be matured when a definitive obligation to repay has been established.
AAOIFI	Future advances are secured if there is a grant of a security right at the same time or before the secured obligation is established and the obligation (debt) is adequately defined.
RECONCILIATION SUGGESTION	The AAOIFI Standard is a good base, and should be further refined to incorporate interpretations that define a matured obligation relative to "establishment" of the repayment obligation. The adequate definition concept of "establishment" embodied in the AAOIFI Standard is to be encouraged.

6.1 Model Law Provisions

A security right under the Model Law may secure any type of obligation: present or future; determined or determinable; conditional or unconditional; fixed or fluctuating.[116] It may secure one or more obligations.

A security right in a tangible asset with respect to which intellectual property is used does not extend to that intellectual property. A security right in intellectual property used with a tangible asset does not extend to that tangible asset.[117]

6.2 Shari'ah Provisions

Vareious different Shari'ah provisions separately address the formulation of obligations that may be secured. The different Shariʿah doctrines are separately addressed in this section 6.2. Some of the matters discussed in this section 6.2 of necessity include discussions of the property that may be subject to a *rahn*.

Initially, it may be observed that the Hanafis, Hanbalis, Malikis, Shafi'is, and AAOIFI all allow an encumbered asset to secure one or more obligations.

6.2.1 Shariʿah-Compliant Obligations and Encumbered Assets

As a starting point, the general rule is that each of the secured obligation and the object of the *rahn* must always be compliant with the Shariʿah, at least if the grantor and the secured creditor are both Muslim.

[116] Model Law, Article 7.
[117] Model Law, Article 15.

As one (but probably the most prominent) example of a class of impermissible obligations, consider an interest-bearing loan or other interest-bearing obligation. May a *rahn* secure an interest-bearing loan or obligation? Neither the payment nor the receipt of interest is permissible under the Shari'ah. That would seem to preclude all interest-bearing obligations. Other obligations that are contrary to Shariʿah principles raise similar issues. Is an obligation to deliver wine or swine valid and enforceable under the Shari'ah? Not if the debtor and the creditor are both Muslim. But what if the parties are not Muslim and Shari'ah principles are applicable?

To answer these questions, it is necessary to know more about the relevant transaction. In any event, the answers to these and similar questions vary, primarily as a function of the jurist, the interpretations of the relevant Shari'ah principles under an individual jurisprudential school, and the status and identities of the parties.

In the case of the *rahn* securing an interest-bearing obligation, some jurists believe the *rahn* may be valid to the extent of the principal amount of the loan but invalid with respect to the interest component of the loan. Other scholars might find the entire arrangement impermissible. Or it may be that the arrangement will be enforced under the Shari'ah if both the debtor and the secured creditor are not Muslim.

Anticipating the discussion in section 7, consider the broader issue from the vantage of the entire transaction and the property that is subject to the *rahn*. A Muslim is not allowed to grant a *rahn* in a *haram* property (it has no "value"), nor is a Muslim allowed to accept a *haram* property as an encumbered asset. These requirements are independent undertakings that harken back to sale principles under the Shariʿah.[118] In any of these cases, the obligation, whether otherwise permitted to be secured by a *rahn*, will not be capable of being secured by a *rahn* due to the nature of the property that is to be used as the encumbered asset.

The classical rule is a bit different in some circumstances where a Muslim is involved as the grantor of the *rahn* and a non-Muslim is involved as the secured creditor. Here the *haram* encumbered asset may have value to the non-Muslim (consider wine as an example). Although the wine is valueless non-property to the Muslim, it is valued property to the non-Muslim. Thus, the wine may be sold to make payment of underlying secured obligation.

If a non-Muslim grantor and a non-Muslim secured creditor enter into a *rahn* arrangement involving wine, pork, or another *haram* property as the *marhun* (encumbered asset), many jurists and scholars are of the opinion that the Shari'ah would recognize the *rahn* as valid because both parties recognize the encumbered asset as having value and being susceptible to sale to satisfy the secured obligation.[119]

The AAOIFI Standard sets forth standards applicable to each of the secured obligation and the encumbered asset.

With respect to the secured obligation, the AAOIFI Standard provides that the secured obligation should be comprised of acceptable debt under the Shari'ah.[120] It further provides that the secured obligation should not be a debt that is prohibited by the Shari'ah (such as a usurious loan) or a non-debt (such as a usufruct of an object, a specific price, or a spot sale commodity that is still in the possession of the seller).[121]

118 See the sources cited in section 7.2.1(a).

119 al-Zuḥaylī, *supra* note 13, at 103.

120 AAOIFI Standard, *supra* note 14, at § 3/3/1.

121 AAOIFI Standard, *id*., at § 3/3/1.

Nothing further is stated in the AAOIFI Standard that might assist in addressing the types of issues previously discussed in this section. This formulation would seem to preclude the use of the principal amount of a usurious loan.

Interpretation and transaction-specific implementation of the AAOIFI admonition is left to individual jurists of different schools of Islamic jurisprudence, who are likely to apply classical principles that vary from one school to another. In contemporary financing practice, numerous scholars have allowed the principal component of a usurious loan and the usufruct of an asset to constitute the secured obligation. Examples include project and infrastructure financings in which the debt is provided by both Shari'ah-compliant financial institutions and conventional interest-based financial institutions. Some such transactions provide that the secured obligation is the principal component of the debt and that the proceeds from a sale of the encumbered asset may only be applied to permissible expenses and the principal component of the debt (not the interest component of the debt).

The AAOIFI Standard provides that the encumbered asset should be a Shari'ah-permissible property, and says no more that might assist in addressing the types of issues previously discussed in this section.[122] Here again, interpretation and transaction-specific implementation of the AAOIFI admonition is left to individual jurists of different schools, who are likely to apply classical principles that vary from one jurisprudential school to another. In contemporary financing practice, numerous scholars have allowed the usufruct of an asset to constitute the encumbered asset. Examples include *ijara* (lease) transactions involving aircraft, vessels, rolling stock, and industrial plants.

6.2.2 Conditions Pertaining to Secured Obligation

Each jurisprudential school imposes conditions regarding the underlying secured obligation. The Hanafis have three such conditions; the Shafi'is and Hanbalis have three somewhat different conditions; and the Malikis state a general principle with two exceptions to that principle.[123]

The AAOIFI Standard leaves most determinations with respect to these matters to the various schools' interpretations. Other than as previously discussed, this standard provides that it is not permissible to stipulate *rahn* as a condition in a trust-based contract. Trust-based contracts include proxy, *musharaka* (partnership), *mudaraba* (service-capital partnership), lease (*ijara*), and deposit contracts.[124]

The AAOIFI Standard allows a valid *rahn* contract to be entered into prior to "establishment" of the secured obligation (specifically, the "debt") if the *rahn* contract is executed at the same time as the contract giving rise to the secured obligation.[125] This implies that future advances are permissibly secured by the *rahn* if the secured obligation is adequately defined in the contract giving rise to the secured obligation: i.e., that the debt is "matured" and "established" as contemplated by the classical formulations that are discussed in this section (assuming that the contract, including obligations to advance and repay, is binding and enforceable). This construction is compatible with the classical Hanafian and Malikian interpretations pertaining to promised loans, as discussed in this section.

Further, the AAOIFI Standard allows *rahn* contracts whose encumbered asset is future income if the asset from which that income is derived is also "specified" (which is interpreted as "also subject to a *rahn*"

[122] AAOIFI Standard, *supra* note 14, at § 3/2/1.

[123] The discussion in this section follows, primarily, al-Zuḥaylī, *supra* note 13, at 93-101.

[124] The provisions of the AAOIFI Standard, *supra* note 14, addressing debt that may be the subject of a *rahn* are set forth in § 3/3, and were discussed in section 3.2.1. The provision relating to the impermissibility of trust-based contracts is set forth in § 3/3/2.

[125] AAOIFI Standard, *id.*, at § 3/3/1.

in light of the further statement that this is "valid whether the income is to be mortgaged along with the principal or independently").[126] Income from an encumbered asset is presumed to be subject to the *rahn* unless the grantor and the secured creditor otherwise provide.[127]

The Hanafis stiputate three conditions of regarding the underlying obligation:

- The underling right in lieu of which the *rahn* is granted (i.e., the secured obligation) must be binding and *matured as a liability* of the debtor;
- It must be possible for the secured creditor to *extract repayment* of the secured obligation from the encumbered asset; and
- The liability underlying a *rahn* (i.e., the secured obligation) must be *known to all parties* (e.g., it cannot be an unnamed debt out of two or more debts that are owed to the secured creditor).

The first of these three conditions is complicated in practice, and is subject to considerable interpretive variation among Shariʻah scholars (even within the same jurisprudential school). Some discussion is warranted. The questions that arise pertain to when a debt or other secured obligation is "matured" and various situations related to non-fungible debts.

What constitutes a "binding" and "matured" debt (as an example of a secured obligation)? Formulations of what constitutes a "matured" debt vary with school and Shariʿah scholar. Generally, it is said to be a debt that is established as a binding liability of the debtor or a debt that is due (here the customary lawyer's distinction between a debt that is "due" and a debt that is "due and payable" is important).

The most common interpretation is that the relevant liability or debt must be fully established and known, or definitively established as a fully defined binding liability. Relevant factors include whether there is a promise regarding the debt to be secured and whether the underlying debt is certain to arise or is probabilistic.

Future advances and future incurrences, even under a single agreement providing for those advances up to a designated maximum amount, are an area that exemplifies the critical issue. Obviously, these are of considerable relevance to contemporary financing practices, such as future advances, whether pursuant to a revolving credit arrangement or the funding of a single future financing amount.

The Hanafis and the Malikis rule that a *rahn* with respect to (in lieu of) a future promised loan is a valid *rahn*.[128] The critical factor in the rulings of the Hanafis and the Malikis with respect to future loans is the promise regarding the future debt and whether the promise is binding.[129]

The Shafiʻis and the Hanbalis rule that it is not valid to provide a *rahn* with respect to a future debt or liability, whether or not the future debt is the subject of a promise.[130] In their view, the mere promise of a future financing or loan does not establish a liability. The debt must be fully advanced or incurred and the

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126 AAOIFI Standard, *id.*, at § 7.

127 AAOIFI Standard, *id.*, at § 3/2/8.

128 See, e.g., Majelle, *supra* note 14, article 714.

129 al-Zuḥaylī, *supra* note 13, at 93-98, particularly at 97.

130 There are express exceptions to this statement. Consider an *istisnaʿa* (construction or manufacture agreement with multiple advances) and a *salam* (forward sale, in which payment is made in the future). The positions of the schools vary with respect to whether the future payment obligation in a *salam* may be secured. See, for example, al-Zuḥaylī, *id.*, at 94-95.

liability must be definitively known (although it need not then be due and payable). The basis for this position is that the insurance of a legal right cannot precede the establishment of the legal right.

Thus, future advances under a Shari'ah-compliant revolving credit arrangement[131] may not constitute a matured debt for some Shafi'i and Hanbali scholars, given the uncertainty as to whether there will be future advances.

The position of the Hanbalis and the Shafiʿis obviously raises significant issues in contemporary financing arrangements, particularly regarding future advances and subsequently incurred indebtedness under an existing agreement, including in cases when the existing agreement provides for the future or subsequent advance or incurrence. In this context, consider, as examples, revolving credit facilities of different types, rent for usufruct as yet unreceived (i.e., future rent under an *ijara*), and wages for future services under a service agreement.

Other scholars (particularly Hanafi and Maliki scholars and those applying the AAOIFI Standard) may allow the future advances as "matured" debt because the obligation is established as a promise in the relevant financing agreement and is usually specified, at least as to the maximum amount of the permissible obligation. The facts of each individual transaction will be critical in determining whether such arrangements are permissible.

The Shafi'is and the Hanbalis stipulate three conditions:

- The liability must be binding and *matured as a fungible debt* of the debtor (e.g., a loan to be repaid, or the value of a destroyed object). Work to be performed in a joint hiring contract is an impermissible debt under the Hanafi school because the debt is not fungible. The Shafi'is and the Hanbalis take the position that the encumbered asset may be sold to hire another person to perform the contracted work);
- The debt must be *mature* or *about to be matured*; and
- The debt must be *known* in amount and characteristics to both parties to the *rahn* contract.

The second condition deserves a further comment. Examples of a debt that is about to be matured include the price of a sale during the option period before the sale becomes binding. This is a debt that would be permissible for securing by a *rahn* for the Shafi'is and the Hanbalis (although a promised loan would not be a permissible debt). These statements also imply that any price that would be payable pursuant to a binding sale will satisfy the "maturity" requirements for the Shafi'is and the Hanbalis.

The relevant principle of the Malikis[132] is that all fungible binding liabilities are eligible for securing by a *rahn* except for two: are (1) the price of a *salam* (forward purchase); and (2) either part of a currency exchange contact. The fungibility condition implies that an obligation pursuant to a trust arrangement is not a valid underlying debt.[133] Examples of trust arrangement obligations include deposits, capital payments under a *musharaka* (partnership) or a *mudaraba* (service-capital partnership), the object of a lending arrangement (i.e., the object that is lent), and the object of a lease (*ijara*) (i.e., the object that is leased).

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[131] Examples include an *ijara* arrangement in which the rent is increased with future advances under a related loan in a bifurcated structure (see McMillen, Islamic Finance, *supra* note 6, at 189-228) or a master *murabaha* arrangement involving a series of *murabaha* transactions under a single master agreement (and a series of individual *murabaha* agreements) (see McMillen, Islamic Finance, *supra* note 6, at 247-62).

[132] al-Zuḥaylī, *supra* note 13, at 100-11. The AAOIFI Standard expresses no fungibility requirement.

[133] That is the position of the AAOIFI Standard, as noted at the beginning of this section.

The Malikis also impose a requirement as to the fungibility of the underlying debt: non-fungible debts and their usufruct may not be the basis for a valid *rahn* arrangement. As an example,[134] if a sale or lease of a specific animal or car is consummated and the seller or lessor provides an encumbered asset to ensure against a defect in the animal or car, it is not possible to deliver exactly the same animal or car, and such an obligation is not permissible as a basis for a *rahn*. With regard to this requirement, contemporary Shari'ah scholars may be inclined to characterize this as a fungible debt rather than a non-fungible debt in the case of a car (feeling that the debt is fungible because the encumbered asset obligation is a car of the same make, model, mileage and other characteristics). Clearly, it is important to consult with the relevant Shari'ah scholars regarding fungibility requirements.

Finally, the Malikis also include a condition that the debt be matured or about to be matured, in much the same analysis as the Shafi'is and Hanbalis.

The addition of a second secured obligation to an existing *rahn* arrangement with respect to an original secured obligation reveals different positions of different schools.[135] Most Hanafis and Hanbalis, and some Shafi'is, do not permit this arrangement. They characterize this as a second *rahn* on an existing *rahn*, which is also not permissible. The Malikis and some Hanafis rule that the addition of the second secured obligation is permissible, as is the addition of a second property as encumbered asset for an individual secured obligation. They analyze the transaction as a voiding of the first *rahn* and the establishment of a new *rahn* with respect to the combined secured obligations.

[134] al-Zuḥaylī, *id.*, at 101, footnote 27.

[135] See section 7.2.2(f) for a more detailed and nuanced discussion of the issues and rules applicable to a grant of a *rahn* on an existing *marhun*.

7 PROPERTIES THAT MAY BE ENCUMBERED, FUTURE ASSETS, AND UNDIVIDED RIGHTS

GENRALIZED SUMMARY PROPERTIES THAT MAY BE ENCUMBERED, FUTURE ASSETS, AND UNDIVIDED RIGHTS	
SME NEED	SMEs need the flexibility to be able to grant security rights in all aspects of both their current and future property (including generic categories of, undivided rights in, and portions of assets) in order to maintain operational flexibility and address unforeseen developments without frequent periodic transaction cost incurrences. Granting a security right in a usufruct (a leased tractor or manufacturing equipment) may be important to SMEs as they often do not own critical business assets, and they may also use non-owned assets as collateral for *sukuk* transactions. SMEs may also grant security rights in generic categories of assets due to turnover of assets within a category.
MODEL LAW	Any type of movable asset may be encumbered, including futures assets, parts of assets, undivided rights in assets, and generic categories of assets. Separate rules apply to certain categories of assets, such as negotiable documents, tangible assets covered by negotiable documents, non-intermediated securities, negotiable instruments, rights to payment of funds credited to bank accounts, and receivables.
SHARI'AH	The Shari'ah imposes limitations on the types of property that may be subject to a security right. As a threshold matter, for a security right in any property to be valid, the property (i) must be "saleable" under Shari'ah principles, (ii) must constitute "property" under the Shari'ah, (iii) must have "value" so that it can be sold, (iv) must be known, (v) must be owned by the grantor of the security right (with limited exceptions), (vi) must be unoccupied by other property, (vii) must be separate from and unconnected to other property, and (viii) must be clearly identified and separated from (i.e., "distinguished" from) other property.
	As a general statement, Shari'ah principles do not distinguish among types of property. There are exceptions, including unidentified property shares, connected or occupied property, fungible liabilities (debts, cash, accounts), leased or loaned non-fungible assets, lease or borrowed non-owned assets, property of others, property subject to a previous security right, indebted estates, perishable property, fruit juices, religious books, and intellectual property. Certain of these types of property are addressed in separate, asset-specific generalized summaries in this section.
	Ususfruct: Hanafis, Hanbalis and Shafi'is hold that a usufruct may not be the subject of a security right (*rahn*).
	Known assets and inclusive designations: Hanafis allow these designations as sufficient for "knowledge" of the assets (e.g., a house and its contents), which Hanbalis and Shafi'is may say the designation is uncertain and insufficient for a *rahn*.
	Hanbalis, Malikis and Shafi'is generally allow security rights in unidentified property shares (shares in common property) if the shares are identifiable and can be sold separately, and subject to specific possession rules. Similar positions prevail with respect to connected property (fruit on a tree) and occupied property.
AAOIFI	Usufruct may be subject of a *rahn*.
	Security rights on shares of common property (and undivided interests) are permissible if the share can be identified in some manner and can be sold separately. AAOIFI does not separately address connected and occupied properties.
RECONCILIATION SUGGESTION	Where AAOIFI has enunciated a postion (such as regards usufruct and unindentified shares of property), the AAOIFI standard is a good base and should be further developed. Majority positions of the schools of Islamic jurisprudence are also a good base for certain property issues (such as connected and occupied property) and should be promoted.

7.1 Model Law Provisions

Under the Model Law, a security right may encumber any type of movable asset, including future assets, parts of assets, undivided rights in movable assets, generic categories of movable assets, and all or part of a grantor's movable assets. The Model Law also applies to outright transfers of receivables.[136]

Although not related to the topic of properties that may be encumbered, the Model Law sets forth various rights and obligations of third party obligors under different types of instruments and arrangements that are subject to security rights under the Model Law: negotiable documents, tangible assets covered by negotiable documents, non-intermediated securities, negotiable instruments, rights to payment of funds credited to a bank account, and receivables.

Descriptions of these provisions are included in this section because of the relevance of section 7.2.2(c) pertaining to fungible liabilities, which relate to these same instruments and arrangements. The remaining paragraphs of this section 7.1 discuss the comparability of Shari'ah principles with respect to these matters.

The Model Law leaves to the enacting State the power and responsibility to establish the relevant law relating to negotiable documents, tangible assets covered by a negotiable document, and the rights of the secured creditor in a negotiable document as against the issuer of the negotiable document and any other person obligated on that document.[137] The State has the same power and responsibility with respect to negotiable instruments[138] and non-intermediated securities.[139]

In addressing the rights and obligations of the depositary bank as regards rights of payment of funds credited to a bank account, the Model Law is parsimonious.[140] The rights and obligations of the bank where a bank account is maintained are not affected by any creation of a security right in payments of funds credited to that bank account without the consent of the bank maintaining the account. The depositary bank is not obligated to provide information regarding that bank account to any third parties. Nor are the set-off rights of the depositary bank under relevant State set-off law affected by any security right that the bank may have in a right to payment of funds credited to a bank account maintained with the bank.

The Shari'ah principles relating to banks holding funds in bank accounts are, for the most part, those applicable to depositaries and primarily affect the liability exposures of the depositary of the encumbered asset that is lost, damaged or destroyed in the possession of the depositary. In any event, the principles pertaining to depositaries are highly fact-specific. These matters are discussed in sections 5.2.6, 6.2.2, 7.2.2(c), 7.2.2(d), 7.2.2(e), 12.2.1, 14.2, 14.7(b), and 14.7(c).

The Model Law focuses most on receivables and the rights and obligations of third-party obligors with respect to receivables.[141] Notification of a security right in a receivable or a payment instruction relating to a receivable[142] is effective upon receipt by the debtor of a notice (if it reasonably identifies the receivable and the secured party and is in a language that is reasonably expected to inform the debtor of

[136] Model Law, Article 8 and Article 1, ¶¶ 1 and 2.
[137] Model Law, Article 78.
[138] Model Law, Article 76.
[139] Model Law, Article 79.
[140] Model Law, Article 77.
[141] Model Law, Articles 69-75.
[142] See Model Law, Articles 68 and 69 regarding payment instructions.

the receivable of its contents).[143] A notification may relate to existing receivables or receivables arising after the notification.[144]

The rights and obligations of the debtor of a receivable, including payments terms in the contract giving rise to the receivable, are unchanged by the creation of a security right in the receivable (except as otherwise provided in the Model Law). The failure of a grantor to perform the terms of the contract giving rise to the receivable does not entitle the grantor to recover from the secured creditor a sum that is paid by that debtor on the receivable to the grantor or the secured creditor, nor does it affect any rights of that debtor against the grantor under any other law.[145]

With respect to payment instructions, a payment instruction in the security agreement may be changed as to the person, address, or account to which payment is made. But no change may be made in the currency of payment or the State in which payment is to be made.[146]

In any action by the secured creditor against the debtor on the receivable, the debtor on the encumbered receivable is entitled to raise against the secured creditor all defenses and rights of set-off such debtor had under the original contract giving rise to the receivable (and other related contacts), as if the security right in the encumbered receivable had not been created (as well as other available rights of set-off).[147] The exception is where the debtor on the receivable agrees in writing with the grantor of the receivable to the secured party not to raise a defense or right of set-off (defenses arising from fraudulent acts may not be waived).[148]

It is likely that the Shari'ah principles regarding debtor rights to raise defenses and rights of set-off will not be appreciably different than those under the Model Law. For the most part, the rights of the obligor under a receivable will be unaffected by a valid and continuing *rahn* on the receivable.

With regard to payments on encumbered receivables, consider the provisions of the Model Law pertaining to proceeds of payments on those receivables and tangible assets that are paid with respect to those receivables. As between the grantor and the secured creditor, the secured creditor is entitled (i) to retain any such proceeds paid to the secured creditor and any such tangible assets returned to the secured creditor, (ii) to any such proceeds paid to the grantor and any such tangible assets returned to the grantor, and (iii) to the any such proceeds paid to another person and any such tangible assets returned to such person if the secured creditor has priority over the right of that other person.[149] A failure of the grantor to perform a contract that gave rise to an encumbered receivable does not entitle the debtor of the receivable to recover from the secured creditor any sum paid by the debtor of the receivable to the secured creditor or to the grantor.[150] Any rights of the debtor of the receivable against the grantor for such breach are unaffected.

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143 Model Law, Article 70.
144 Model Law, Article 70, ¶ 3.
145 Model Law, Article 75.
146 Model Law, Article 69. The timing of any change to the original contract establishing the debtor's obligation on the receivable is critical, and is binding upon the secured creditor if executed before the notification of the security right in the receivable. See Article 74, ¶ 1. Any change in the original agreement executed after the notification of the security right is ineffective against the secured creditor unless the secured creditor consents to that change and meets certain other requirements. See Article 74, ¶ 2.
147 Model Law, Article 72.
148 Model Law, Article 73.
149 Model Law, Article 67.
150 Model Law, Article 75.

The Shari'ah principles applicable to payments on the receivable where the receivable is subject to a valid *rahn* are primarily those discussed in sections 7.2.2(c) and 8.

A debtor that makes payment on a receivable is discharged by paying in accordance with the original contract until that debtor receives notice of the security right. Thereafter, that debtor is discharged only by paying the secured creditor, or in accordance with a written payment instruction from the secured creditor. Matters become a bit more complicated where there are multiple notifications of different types.[151]

- If the debtor on the receivable receives more than one payment instruction relating to a single security right of the same receivable by the same grantor, it is discharged by paying in accordance with the last such payment instruction received from the secured creditor before payment is made.
- If the debtor on the receivable receives notification of more than one security right with respect to the same receivable created by the same grantor, that debtor is discharged by paying in accordance with the first notification received.
- If the debtor on the receivable receives notification of one or more subsequent security rights in the same receivable, that debtor is discharged by paying in accordance with the last such notification.
- If the debtor on the receivable receives notification of the security right in a part of or an undivided interest in one or more receivables, it is discharged by paying in accordance with the notification or, if no notification is received, by paying in accordance with the relevant article of the Model Law as if no notification has been received,[152] and any payment in accordance with the notification is discharged only to the extent or the undivided interest that is paid.
- Until the debtor of the receivable has had adequate time to determine the validity of various security rights, that debtor is discharged by paying as if no notification has been received in circumstances involving notifications of subsequent secured creditors and subsequent security rights.

Other grounds for discharge are unaffected by this provision of the Model Law.

All defenses and rights of set-off in the document giving rise to the payment obligation of the debtor on the receivable may be raised against the secured creditor as if the security right had not been created and the claim on that debtor was being made by the grantor,[153] unless that debtor on the receivable has agreed in writing with the grantor not to raise such defenses in an action, suit, or proceeding by the secured creditor.[154]

The relevant Shari'ah principles are likely to be quite similar to the provisions of the Model Law.

7.2 Shari'ah Provisions

Here, again, the formulation under the Model Law is addressed by a range of different Shari'ah doctrines. It is first necessary to consider the fundamental elements of a property that is eligible to constitute a *marhun* (encumbered asset). Thereafter, it is necessary to consider the separate and distinct principles and rules that are applicable to future assets, to portions of assets, to undivided and unidentified assets

151 Model Law, Article 71, ¶¶ 3-9.
152 Model Law, Article 70.
153 Model Law, Article 72.
154 Model Law, Article 73.

and portions of assets, to assets that are occupied by other assets, to assets that occupy another asset, and to specific types of assets, among others. Each of these Shari'ah doctrines is separately addressed in this section 7.2.

7.2.1 Elements of the Property

(c) Saleability

The validity of property as a *marhun* (an encumbered asset) under the Shariʿah derives and proceeds from sales principles. As a first principle, the property must be eligible for sale (because, among other reasons, it is sold to make payment of the obligation if the obligation has not been paid).

Whether property is eligible for sale is itself a complicated, and fundamental, inquiry in *fiqh*.[155] Among the relevant critical sale elements are the following:[156] (a) the property must *exist* at the inception of the contract; (b) the property must be *deliverable* at contract inception;[157] and (c) the property must constitute "*property*"[158] and be *valued, known, owned*,[159] *unoccupied* by a non-*rahn* property, *separate*, clearly *identified*, and *received* by the secured creditor.[160]

There are some exceptions to the sale requirements. By way of example, fruits on a tree and offspring of sheep that are not yet born are not eligible for sale, and thus not eligible as collateral for a *rahn* for the Shafi'is and the Hanafis. The Malikis and Hanbalis make exceptions for fruits prior to ripening and have no requirement for cutting of the fruits to make them eligible to constitute a *marhun* (an encumbered asset) The Malikis and the Hanbalis allow *rahn* arrangements using green plants that have not yet been harvested. They even allow use of runaway and lost animals as the basis for a *rahn*. The Malikis and Hanbalis impose the condition that these items not be sold until they become eligible for sale (e.g., the fruits ripen or the lost animal returns).[161] It is suggested that a high degree of caution be exercised in determining the application of these principles in any given jurisdiction or transaction: consultation with the relevant Shari'ah scholars is an imperative.

[155] *Fiqh*, as a classical Islamic discipline, is the study of law. The word is derived from an Arabic root word, f-q-h, meaning understanding. Classical *fiqh* texts relating to commercial and financial matters customarily begin with sales. See, e.g., Wael B. Hallaq, SHARĪʿA: THEORY, PRACTICE, TRANSFORMATIONS (2009), at 551-55, Appendix A, summarizing the topical arrangement and organizational scheme of books of *fiqh* as an historical matter and the relative percentage of discursive attention, as a generalization, allocated to each topic. Appendix A examines the AL-MĪZĀN AL-KUBRĀ of ʿAbd al-Wahhāb al-Shaʿrānī, which Hallaq takes to be representative. al-Zuḥaylī, *supra* note 13, is another example.

[156] The elements of a valid sale under the Shari'ah, the types of sales, and other sale rules are discussed in al-Zuḥaylī, *id*., at volume I, 1-366, Majelle, *supra* note 14, at articles 1-403, Ibn Rushd, *supra* note 14, Book XXIV, at 153-263, and Hedaya, *supra* note 14, Book XVI, at 361-567.

[157] Consider, in connection with deliverability, the view of the Hanbalis, Malikis, and Shafi'is that usufruct is not deliverable at the inception of the *rahn* contract because it does not exist at that time, and it vanishes immediately following its transient existence.

[158] For example, the Hanafis do not consider usufruct to be property. The Shafiʿis prohibit the use of usufruct as a valid *marhun* at the inception of the *rahn* contract, but permit usufruct as *marhun* subsequent to inception of the *rahn* contract. al-Zuḥaylī, *supra* note 13, at 103.

[159] Ownership is not a condition to validity of the *rahn*; it is a condition to executability of the *rahn*. Permission of the owner may make render a *rahn* of non-owned property permissible.

[160] These conditions are discussed in al-Zuḥaylī, *id*., at 101-39, and in more abbreviated form, in ibn Rushd, *supra* note 14, § 37.2.

[161] See the discussion in al-Zuḥaylī, *id*., at 101-02.

Considering these elements in the context of a *rahn*, the Hanafis have listed eight conditions for the *marhun* or encumbered collateral. It must be:

(i) ***valued*** property;
(ii) ***known***;
(iii) ***deliverable***;
(iv) ***received***;
(v) ***possessed***;
(vi) ***unoccupied*** by a property or item that is not subject to the *rahn*;
(vii) ***separate*** from other properties; and
(viii) ***distinguished*** from other properties.

Each of these elements is summarized below. The last three elements all relate to delivery and (particularly) receipt of the object that is the subject of the *rahn*.

(d) Property

The rule applied by all schools is that non-properties (e.g., dead animals) may not be the subject of a *rahn*. Application of this principle in contemporary finance is often concerned with usufruct. Most Hanafis, Hanbalis, and Shafi'is are of the opinion that usufruct may not be the subject of a *rahn*. The Shafi'is qualify this principle by forbidding a *rahn* on usufruct at the inception of the *rahn* contract, but permit usufruct to be the subject of a *rahn* if the usufruct is not used to establish the *rahn* contract (e.g., a person dies in debt while having the right to a future usufruct of a house or some other property, in which case the usufruct may become the subject of the *rahn* and the rents may be used to pay secured creditors).[162]

The AAOIFI Standard allows a usufruct that is owned to be secured by a *rahn* (i.e., a security right may be taken in some property to secure payments due with respect to that usufruct).[163]

Consideration of the use of usufruct is important in the context of contemporary financing transactions, especially for SMEs. It is relatively commonplace for a debtor in need of financing to grant a security right in an asset that is leased to the debtor. Consider, for example, (x) the grant of a security right, with the consent of the property owner, in the usufruct of a tractor or harvester or other farm equipment that is leased to the debtor, (y) or the grant of a security right in the usufruct of a piece of manufacturing equipment that is leased to the debtor, or (z) the grant of a security right in the usufruct of an aircraft, vessel, or rolling stock that is leased to the airline, shipping company, oil and gas company, or railroad. Frequently, SMEs do not own the more expensive equipment that they use in their businesses, so this set of considerations is of particular importance to these SMEs. Usufruct rights are also frequently used as collateral in both securitization transactions and *sukuk* transactions.

(e) Value

The object to serve as the *marhun* (encumbered asset) must have value so that it may be sold to effect payment of the secured obligation. Value concepts are discussed in section 6.2.1.

[162] See also the discussion in sections 7.2.2(d) and 7.2.2(e) with respect to leased and borrowed property and section 7.2.2(f) with respect to the property of others.
[163] AAOIFI Standard, *supra* note 14, at § 3/3/1.

(f) Known

All four Sunni orthodox jurisprudential schools require that there must be sufficient knowledge of the object of the *rahn* contract to allow for its identification, with only minor uncertainty and at such a level as would make it customarily unlikely for a dispute to ensue as to the identity of the object.

How this requirement is interpreted and applied in practice varies by jurisprudential school, and the rules are those pertaining to sales of the relevant object.

For example, the Hanafis would allow a *rahn* of "a house and all its contents" without specific identification of the contents. However, the Shafi'is and the Hanbalis would characterize such a specification as uncertain and would not permit that phrasing as the basis for a valid *rahn*. The same determinations as to validity and invalidity apply with respect to those same jurisprudential schools if the designation of the object were "one of two houses": the Hanafis would characterize the *rahn* as valid, subject to an option of election in the secured creditor (or purchaser); and the Shafi'is and Hanbalis would characterize this designation as invalid for both a sale and a *rahn*.

(g) Owned

The fundamental principle of ownership is that the property must be owned by the grantor of the *rahn*.[164] The principle is subject to certain exceptions.

The Hanafis and Malikis allow a grant of a *rahn* of the property of another person (a) with the permission of the owner (e.g., a *rahn* of borrowed or leased property), and (b) without the permission of the owner if the grantor is a legal guardian of the owner. The Shafi'is and the Hanbalis do not allow a *rahn* of the property of another person without that other person's permission. All four schools allow a *rahn* of borrowed property.[165]

This requirement also has significant ramifications for contemporary financing transactions. As noted under the heading of "Property" in this section, the usufruct of leased assets is frequently used as collateral for financings, securitizations, and *sukuk* issuances. Depending upon how the relevant jurisprudential school and Shari'ah scholars interpret the ownership principle, it may be necessary to either get the permission of the property owner (which is always advisable and is suggested) or have the property owner grant the *rahn* on the borrowed or leased asset itself (which may be considerably more difficult to arrange, and will be significantly more costly (if it can be arranged) because of the increased risk to the property owner).

(h) Unoccupied

The general rule is that it is not permissible to create a *rahn* on property that is occupied by other property of the debtor (grantor) that is not subject to the *rahn*. Thus, one may not grant a *rahn* on agricultural land without also granting a *rahn* on the crops growing on that land.

The general rule with respect to the obverse situation is that it is permissible to grant a *rahn* on the occupying property without granting a *rahn* on the property that is occupied. Thus, it is permissible to grant a *rahn* on the furniture within a house without granting a *rahn* on the house itself. However, this

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[164] See AAOIFI Standard, *supra* note 14, at § 3/3/1, which indicates that a usufruct may be owned property, and may be secured by a *rahn*.

[165] See also the discussion in sections 7.2.2(d) and 7.2.2(e) with respect to leased and borrowed property and section 7.2.2(f) with respect to the property of others.

latter rule is subject to qualifications: for example, as to fruit or growing crops that have not been severed.[166]

(i) Separate

As a general rule, it is not permissible under the Shari'ah to grant a *rahn* on property that is connected to other properties. By way of example, one may not grant a *rahn* on fruits without granting a *rahn* on the trees on which those fruits are growing.[167]

(j) Distinguished

For a *rahn* to be permissible, the object of the *rahn* must be clearly identified and separated from other property. That is, the object must be distinguished from other property.

Thus, for example, it is not permissible to grant a *rahn* on a fraction of a house or car, even if both the grantor and the secured creditor are both partners in the ownership of the house or car. The Shari'ah reasoning goes to the ability to receive, or consummate receipt, of the object. It will be recalled that receipt of the object is a fundamental condition for all charitable contracts, including *rahn* contracts, and that prior to delivery of the object the general position is that the *rahn* is cancellable.[168]

7.2.2 Specific Types of Property

Under the Shari'ah, there are general rules applicable to the granting of security rights in properties, and there are specific rules relating to the granting of security rights in specific types of property. The remainder of this section addresses some of the specific rules relating to the granting of security rights in: (a) unidentified property shares (including undivided interests); (b) connected or occupied properties; (c) fungible liabilities; (d) leased or loaned non-fungible properties; (e) leased and borrowed properties; (f) the property of other persons; (g) property that has been the subject of a previous (and continuing) *rahn* (i.e., a second *rahn*); (h) indebted estates; (i) perishable property; (j) fruit juices (a transformable property); (k) religious books; and (l) intellectual property.

(k) Unidentified Property Shares[169]

The AAOIFI Standard permits a valid *rahn* in, and as a valid *marhun* (encumbered assets), a share of a common property.[170] It imposes two qualifications on that standard. First, the share must be identified. Second, the share must be sold separately (presumably meaning: the share is capable of being sold separately). The AAOIFI Standard is compatible with the classical positions of the Hanbalis, Malikis, and Shafi'is relating to the fundamental principle. As with other provisions of the AAOIFI Standard, interpretation and implementation are left to the applications of the different schools.

How this standard will be interpreted and implemented is unclear. For example, is a fractional undivided interest that is common in contemporary arrangements "identifiable"? It certainly is for secular law purposes, and it is certainly saleable for secular law purposes. The examples are legion: tenancies in common; cooperatives; undivided interests in common areas in real estate (including condominiums and cooperative arrangements); and undivided interests in virtually every type of commercial asset, including power plants, aircraft, vessels, medical equipment and many other types of assets. It is unclear whether

166 See also the discussions in sections 7.2.2(b) and 8.2.

167 See also the discussions in sections 7.2.2(b) and 8.2.

168 See section 7.2.2 with respect to unidentified property, including undivided interests in property.

169 See al-Zuḥaylī, *supra* note 13, at 122-25, with respect to classical formulations.

170 AAOIFI Standard, *supra* note 14, at § 3/2/2.

jurists applying the Shariʻah will interpret the AAOIFI Standard in such a manner or whether more classical identification concepts will be applied.

Under classical interpretations, the Hanafis prohibit the creation of a security right in an unidentified part of a property (including undivided interests) and rule that an unidentified part of a property may not constitute a valid *marhun* (encumbered asset). This rule applies for the Hanafis whether or not the property is divisible and whether or not the debtor and the secured creditor are partners in the ownership of the whole of the property.

The bases for this determination are numerous, including that it is not permissible for the secured creditor to possess that portion of a property that is not subject to the *rahn* and the impossibility of possession of an unidentified portion of the property without possession of the entirety of the property. Additionally, the permanency-of-receipt requirement is preclusive because possession must be shared with the owner of the remainder of the unidentified property.

The Hanbalis, Malikis, and Shafiʻis, on the other hand, allow the creation of a security right in unidentified property and the validity of an unidentified part of a property as *marhun* (encumbered assets). These schools take this position whether or not the property is divisible and whether or not the debtor and the secured creditor are co-owners or partners in the ownership of the entirety of the property.

However, there are unique requirements for possession and receipt of the unidentified portion for these schools. The Maliki rule is that possession must include all that is owned by the debtor, including those portions of the property that are owned by the debtor but are not subject to the *rahn*. This is necessary to ensure that the debtor does not retain possession of any portion of the encumbered asset. If there are portions that are owned by persons other than the debtor, the secured creditor does not need to take possession of those other portions. The Malikis also rule that the permission of the co-owner is not required (but should be sought as a courtesy) for the creation of a valid *rahn* or to subject the unidentified portion to the *rahn*.

The Hanbalis and the Shafiʻis rule that possession of an unidentified portion of a movable object requires physical delivery, and thus the consent of the co-owner. If a co-owner objects to delivery of the object to the secured creditor, but agrees to the *rahn* on the unidentified portion, then the property may be left in the co-owner's possession as agent for the secured creditor (if the secured creditor agrees to such an arrangement). If the secured creditor does not agree to such an arrangement, a judge may appoint an *'adl* to hold the property as a trust.

(l) Connected or Occupied Property[171]

The principles applicable to connected and occupied properties that are intended to constitute *marhun* (encumbered assets) are similar to those pertaining to unidentified property shares.

Thus, the Hanafis do not permit as valid encumbered asset properties that are attached to another property or properties that are occupied by another property that is not subject to the same *rahn*. Examples of attached properties include fruit on a tree and growing plants on land. Examples of the latter category include a *rahn* on a house without a *rahn* on the furniture inside the house.[172] The basis for these rulings is that it is not possible to possess the tree, the land, or the house without also possessing the fruit, plants, or furniture.

[171] See al-Zuḥaylī, *id.*, at 125-26.

[172] See also section 8.2.

The Hanbalian, Malikian, and Shafi'ian jurists generally permit a *rahn* on connected properties and those that are occupied by other properties. There are some differences of rulings, however.[173] For example, for the Hanbalis, the *rahn* of trees includes any growing fruit that is observable at the time of the consummation of delivery and receipt, but not fruit that is not observable at such time. For the Shafi'ians, the fruit is not considered to be included in the *rahn*, whether or not it is observable at such time.

The AAOIFI Standard does not specifically address connected or occupied properties, leaving these matters to the Shari'ah scholars of the different schools in the context of interpretation and implementation. However, the AAOIFI Standard does set forth a general principle that appreciation in the value of, and income derived from, the encumbered asset are considered to be subject to the *rahn* of the encumbered asset, unless the parties otherwise agree.[174]

(m) Fungible Liabilities (Debts, Cash, Accounts)[175]

The AAOIFI Standard specifies that debts, cash, and current accounts may be the subject of a *rahn* and may constitute valid *marhun* (encumbered assets).[176] Debts may be owed by the secured creditor or any other person.[177] *Sukuk*,[178] financial papers, and equity in which it is permissible to invest under the Shari'ah[179] may also be the subject of a valid *rahn* and constitute a valid *marhun* (encumbered assets).[180] Current accounts and cash may be subject to a valid *rahn*.[181] And future income streams from permissible income-producing properties may be valid *marhun*.[182]

These categories encompass most of the concepts relating to receivables, negotiable instruments, negotiable documents, and rights to amounts in bank accounts under the Model Law. The Shari'ah does not specifically and separately address these concepts, other than within the debts, cash, and accounts categories.

A debtor may create a *rahn* in an asset that is owed to the debtor by the secured party (and, presumably, in the obligation that obligates the delivery of the asset).[183] This is permissible whether the asset is kept by the secured party as a possession of trust (such as deposited or lent assets) or as a

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173 See section 8.2.

174 AAOIFI Standard, *supra* note 14, at § 3/2/8.

175 See al-Zuḥaylī, *supra* note 13, at 126-27.

176 AAOIFI Standard, *supra* note 14, at §§ 3/2/2, 3/2/11, 3/2/12, 4/1, 4/2 and 4/3, with respect to debts and cash, and § 5, with respect to current accounts and cash.

177 AAOIFI Standard, *id.*, at §s 3/2/11 and 3/2/5 (the latter dealing with assets owed to the debtor by the secured creditor).

178 See Michael J.T. McMillen, *Asset Securitization Sukuk and the Islamic Capital Markets: Structural Issues in These Formative Years*, 25 WISCONSIN INTERNATIONAL LAW JOURNAL 703 (2007) ("McMillen, Securitization Sukuk"), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2276578, Michael J.T. McMillen, *Contractual Enforceability Issues: Sukuk and Capital Markets Development*, 7 CHICAGO JOURNAL OF INTERNATIONAL LAW 427 (2007) ("McMillen, Enforceability"), available at http://papers.ssrn.com/sol3/papers/cfm?abstract_id=2275558, McMillen, Islamic Capital Markets, *supra* note 6, and McMillen, Capital Markets, *supra* note 6, and sources cited in each of the foregoing.

179 See McMillen, Islamic Finance, *supra* note 6, at 157-261, and particularly at 157-88, and Michael J.T. McMillen, *Sequelae of the Dow Jones Fatwa and Evolution in Islamic Finance: The Real Estate Investment Example*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2272636.

180 AAOIFI Standard, *supra* note 14, at § 5.

181 AAOIFI Standard, *id.*, at § 5.

182 AAOIFI Standard, *id.*, at § 7.

183 AAOIFI Standard, *id.*, at § 3/2/5.

possession of guarantee (such as current accounts and assets retained after nullification of contracts). In the latter case, the status of the secured creditor changes from one holding in a possession of trust to one holding in a possession of guarantee.[184]

No further principles are enunciated with respect to these items, nor are interpretative principles or inclinations indicated, with one exception. The AAOIFI Standard does indicate that, where a *rahn* is granted on a current account for the benefit of a bank at which that current account is maintained, the bank should not use that current account unless and until it is transferred to an investment account. In such a case, the bank becomes entitled to the profit share on the investment account as the *mudarib* in a *mudaraba*.[185]

As in other elements of the AAOIFI Standard, how these provisions will be interpreted and applied is left to the jurists.Thus, it is unclear what principles will be applied. Certainly it is appropriate to apply the principles of other AAOIFI Standards. Those are also compilations of base principles that are appropriate and acceptable in the view of the Shariʻah supervisory board of AAOIFI. It is likely that many jurists and scholars will give flesh to the AAOIFI Standards by applying relevant classical interpretations, as well.

Thus, it is again prudent to consider classical Shariʻah interpretations.

The Hanafis rule that a fungible liability (a debt owed to the debtor by a third-party debtor) may not constitute a valid *marhun* (encumbered asset) or be the object of a valid *rahn* contract because it is not a property (*māl*) and cannot be "received" in the same sense as non-fungible property can be received.

The Shafiʻis and most Hanbalis rule that a valid *marhun* (encumbered asset) must be a non-fungible property that can be sold. Thus, a liability owed by a third party (as debtor or obligor) to a debtor (as creditor, and debtor in the security arrangement involving the fungible liability as a potential *marhun*) may not constitute a valid *marhun* (encumbered asset). However, the *rahn* arrangement is kept intact because the liability may at some future time become a valid encumbered asset.

The Malikis allow the sale of certain debts (liabilities). As a result, certain liabilities may constitute a valid *marhun* (encumbered asset). The Malikis impose specific requirements to ensure the validity of the transaction (e.g., delivery of the documentation evidencing the liability, such as a promissory note, and the requirement that the maturity of the liability that constitutes the encumbered asset must be earlier than the maturity of the underlying secured obligation, but not be mature at the time of the *rahn* is created).

(n) Leased or Loaned Non-Fungibles[186]

As a general rule, all jurisprudential schools allow a *rahn* of property that is owned by a grantor and is leased or on loan to other persons. Differences among the schools focus on the method by which a *rahn* is created and effected with respect to these types of property.

The Hanbalis take the broadest view of *rahn* rights with respect to leased and loaned property and the validity of such properties as *marhun* (encumbered assets). They allow the grant of a *rahn* by a lessor, lender, or depositor on leased, loaned, and deposited property owned by the grantor and property usurped by the grantor. Each can constitute a valid encumbered asset.

The Shafiʻis also take a broad view. Leased, loaned, and deposited property may be valid *marhun* (encumbered assets) and *rahn* arrangements involving grants by a lessor, lender, or depositor that owns the property are permissible with respect to such properties. The secured creditor must accept the lessee, borrower, or depositary under the arrangement, with the grantor as a trustee on behalf of the creditor. If

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184 AAOIFI Standard, *id*., at § 3/2/5.

185 AAOIFI Standard, *id.*, at § 5.

186 See al-Zuḥaylī, *supra* note 13, at 127-28.

the secured creditor does not accept that arrangement, two variations are possible. If the lessee permits the *rahn*, the lease is invalidated and the *rahn* continues. If the *rahn* is not permitted by the lessee, the *rahn* is invalidated.

The Hanafis allow a valid *marhun* on property that is leased or on loan by the lessor or lender that is the owner of the property (a) to a third party and (b) to either the debtor or the secured creditor. In the latter case, a *rahn* would be valid, but the lease would become invalid upon creation of the *rahn* (a lease or loan to a person and a *rahn* of the same property to the same person may not co-exist simultaneously). If the lease or loan of a property is granted to a person after that property is subject to a *rahn* to the same person, then the *rahn* ceases to exist (it is invalidated).

The Malikis allow the grant of a *rahn* in a property by a lessor to a lessee (who is also the secured creditor) of that same property. For the Malikis, the possession of the lease is substituted for the necessary possession under the *rahn*. They also allow the grant to a secured creditor of a *rahn* on a property that is leased to a third person. As a condition to this *rahn*, however, the Malikis require that the secured creditor appoint a trustee to take the role of the secured creditor as possessor of the property because the possession of the lessee third party cannot be substituted as the secured creditor's possession. Finally, the Malikis allow the granting of a *rahn* on agricultural land that is in the possession of a share-cropping tenant.

(o) Leased or Borrowed, Non-Owned[187]

Two situations may arise with respect to the granting of a *rahn* on property owned by persons other than the debtor/grantor. The first situation, discussed here, is where the grantor of the *rahn* has leased or loaned the property from the other person and has obtained the consent of the other person for the grant of the *rahn*. The second situation, discussed in section 7.2.2(f), is where the grantor does not have a legal right (such as permission) to grant the *rahn* and is thus a usurper or transgressor.

As a first principle, all schools rule, under classical principles, that it is permissible for a debtor that borrows property to grant a *rahn* in that property, and for that property to constitute valid *marhun* (encumbered assets) if the owner of the property consents to these arrangements. From this point, interpretive differences arise among the schools.

The Hanbalis take the view that the first fundamental consideration is whether the owner has provided any constraints on the nature of the *rahn* arrangements. If the property owner imposes no constraints, then the borrower-debtor-grantor is unconstrained in granting the *rahn* on the borrowed property, including with respect to where, to whom, and what secured obligation. If the property owner does impose constraints, those constraints must be honored.

For example, the property owner may impose constraints as to the amount of the secured obligation for which the property may serve as encumbered asset. In such a case, the grantor in the *rahn* of the borrowed property may grant the *rahn* on that property to secure an obligation of an equal or lesser amount. Or the property owner may limit the genus of the secured obligation, or the maturity of the secured obligation. Or the property owner may otherwise limit, restrict, or constrain use of the property.

The Hanafis, Shafi'is, and Malikis take the view that if the encumbered asset is lost, damaged, or destroyed in the possession of the secured creditor, and the grantor has violated a constraint imposed by the property owner, the property owner has the right to demand compensation from either the grantor (the borrower of the property) or the secured creditor. The grantor-borrower guarantees the value of the encumbered asset as a transgressor. If the grantor-borrower pays full compensation to the property owner, the grantor-borrower becomes the owner of the encumbered asset, in whatever state or condition

[187] See al-Zuḥaylī, *id.*, at 128-32.

it then exists. If the property owner seeks compensation from the secured creditor, and the secured creditor makes payment in full of the value of the encumbered asset, the secured creditor has the right to demand reimbursement of that payment from the grantor-borrower as a transgressor and the ultimate guarantor of the value of the encumbered asset..

There are somewhat more precise rules where a property is borrowed for the purpose of using that property as *marhun* (encumbered assets) in a *rahn* arrangement. The Hanafis consider the borrower of such property to be a depositary, and thus able to use the property only as encumbered asset in a permitted *rahn* arrangement, and with no right to use the property before or after the term of the permissible *rahn*. If the borrower makes use of the property other than for purposes of the *rahn*, the borrower becomes a guarantor of the property. The borrower is otherwise not a guarantor of the property (it is held in trust, rather than guarantee) before and after the *rahn* period. The Malikis and Shafi'is, and most of the Hanbalis, have a somewhat different conception. They consider the borrower to be a guarantor of the property in many, if not most, circumstances, including before and after the permissible use as encumbered assets.

If a property is borrowed for the purpose of using it as *marhun* (encumbered asset) and the property is lost, damaged, or destroyed in the possession of the secured creditor, the positions of the jurisprudential schools also differ. Under Hanafi rulings, the amount to which the property owner is entitled is the lesser of its value and the amount of the underlying secured obligation (and the borrower-grantor will not be responsible for the difference if the amount of the underlying secured obligation is less than the value of the property). The Malikis allow the property owner compensation equal to the full value of the property (*marhun*) as of the date of the loan of the property owner to the borrower-grantor. The Shafi'is and most Hanbalis allow the property owner compensation equal to the full value of the property (*marhun*) on the day of its loss, damage, or destruction (assuming no transgression).

The Hanafis, Hanbalis, and Shafi'is rule that the property owner may demand the return of the loaned property at any time (loans are non-binding conditions). If the borrower-grantor is unable to return the loaned property that is being used as *marhun* (encumbered assets) then the property owner may require the secured creditor to release the property to the property owner against payment to the secured creditor of some amount (usually the value of the encumbered asset) and the property owner may demand compensation from the borrower-grantor for that amount. The Malikis permit the property owner the right to recall the property only in unrestricted simple loan arrangements.

It is also permissible for a lessee to grant a *rahn* in a leased property, assuming that such an arrangement is not prohibited by the terms of the lease and is acceptable to the property owner. Possession by a lessee is a possession of trust, and not of guarantee. The lessor has no right to terminate the *rahn* arrangement until the termination of the lease. This is a particularly helpful set of principles in the context of modern commercial arrangements in circumstances where the property owner is amenable to the arrangement. That, of course, is subject to considerable negotiation, is quite asset-specific, and may be costly.

The AAOIFI Standard also permits a debtor to create a *rahn* in, and use as *marhun* (an encumbered asset) a property that is borrowed or leased by the debtor with the permission of the owner of the property.[188] As always, interpretation and implementation is left to the scholars applying the principles as enunciated by the different schools.

If the borrowed or leased asset is sold in the exercise of remedies by the secured creditor, the property owner has recourse against the debtor for the value of the borrowed or leased property (the *marhun* or

[188] AAOIFI Standard, *supra* note 14, at § 3/2/6.

encumbered asset or assets). The right of recourse is in-kind, if the *marhun* is fungible property. The right of recourse is for the full value of the *marhun*, if the *marhun* is not fungible property.[189]

If the encumbered asset constitutes borrowed or leased property and is lost, damaged, or destroyed in the possession of the debtor during the term of the *rahn*, the obligations of the debtor vary. For borrowed property, the debtor is responsible for the full value of the encumbered asset. If the encumbered asset is leased, the debtor is responsible to the property owner only if the loss, damage, or destruction was the result of a transgression or negligence of the debtor. That is, the leasing arrangement is treated as a possession of trust.

(p) Property of Others[190]

No person is permitted to grant a *rahn* in the property of another person without having some legal right to grant that *rahn*. A person granting such a *rahn* is a usurper and transgressor.

For the Hanafis, the *rahn* is suspended pending receipt of permission from the property owner. If that permission is declined or not forthcoming, the *rahn* is invalid. The usurper or transgressor (i.e., the debtor) is a guarantor of the value of the property in such cases.

Under Hanafi interpretations, if the property is lost, damaged, or destroyed while in the possession of the secured creditor under such an arrangement, the property owner has the right to demand payment from the grantor of the *rahn* or, if the secured creditor knew, at any time, that the grantor did not have the legal right to grant the *rahn*, from the secured creditor. Both parties are considered transgressors, with full guarantee of the value of the property, in such circumstances. If the property owner receives compensation from the grantor, the secured creditor is considered repaid on the secured obligation to the value of the property serving as the encumbered asset(s). If the property owners seeks and receives compensation from the secured creditor, the secured creditor may demand reimbursement of that compensation from the grantor-debtor *plus* an amount equal to the outstanding secured obligation.

In interpreting these principles, the Hanbalis distinguish between situations in which the secured creditor has knowledge of the usurpation or transgression and those where the secured creditor does not have such knowledge.

If the secured creditor had knowledge and accepted or allowed continuation of the *rahn* arrangements using the property as an encumbered asset, the secured creditor is liable as a full guarantor of the value of the property. For the Hanbalis, the property owner may seek compensation from either the grantor or the secured creditor (as with the Hanafis). However, if recovery is made against the grantor (debtor), then the grantor is entitled to demand reimbursement as compensation from the secured creditor.

If the secured creditor did not have such knowledge, and the usurped or transgressed property was lost, damaged, or destroyed, the Hanbalis consider the cause of the loss, damage, or destruction.

If the loss, damage, or destruction resulted from the negligence or transgression of the secured creditor, the secured creditor is liable for the value of the property.

If the loss, damage, or destruction was not the result of negligence or transgression by the secured creditor, there are three differing interpretive positions.

- First, the secured creditor is liable as guarantor of the value of the property.
- Second, the secured creditor is not a guarantor of the property's value, but has a possession of trust.

[189] AAOIFI Standard, *id.*, at § 3/2/6.

[190] See al-Zuḥaylī, *supra* note 13, at 132-34.

- Third, the property owner has the option of demanding compensation from the secured creditor or the grantor, but the grantor is the ultimate guarantor of the value of the property.

For the Hanbalis (and the Shafi'is) the secured obligation is not repaid out of the payment by the grantor.

(q) Second *Rahn*[191]

This section addresses situations in which all or a portion of a valid encumbered asset is made subject to a second *rahn* on the same object. That is, a second *rahn* is granted on all of a portion of the encumbered asset of a first *rahn*. *Rahn* arrangements relating to a portion of a valid encumbered asset are treated differently under the Shari'ah principles than *rahn* arrangements with respect to the entirety of the encumbered asset.

The AAOIFI Standard permits multiple *rahn* interests of differing ranks and priorities in the same encumbered asset, without invalidating the first *rahn*, and with payment in full of a more senior priority secured creditor pursuant to a more senior *rahn* interest before payment of more junior *rahn* interest holders.[192] That is seemingly contrary to the classical positions of at least some schools (as are portions of some contemporary laws that set forth *rahn* principles).[193] As previously noted, the AAOIFI Standards, including the AAOIFI Standard, are relatively high-level statements of Shari'ah principles in the contemporary context. They are recommended standards, in a sort of "best practices" sense, and are not binding upon any person (unless a State adopts them into the secular law). As such, the AAOIFI Standards are given further substance by jurists who implement these standards in a given jurisdiction, transaction, or contract in accordance with principles set forth by different schools. It is thus unclear exactly how a standard, such as that pertaining to multiple *rahn* interests, will ultimately be given effect.

The discussion turns now to classical formulations of the relevant principles and rules.

A second *rahn* with respect to a portion of the encumbered asset under the first *rahn* is subject to the rules just discussed regarding *rahn* arrangements with respect to unidentified portions of property.

Recall that the Hanbalis, Malikis, and Shafi'is allow a *rahn* of unidentified portions of property. Thus, if an unidentified portion of a property constitutes the encumbered asset for one secured obligation, then the remaining unidentified portion of that property may be subject to a valid *rahn*, and may constitute a valid encumbered asset, for a second secured obligation or additionally as an encumbered asset for the first secured obligation, whether to the same secured creditor or another secured creditor. If the second *rahn* is to a second secured creditor, then it is necessary to obtain the consent of the second secured creditor to the continuing possession by the first secured creditor, or to appoint an *'adl* by mutual agreement of the debtor and each of the first and second secured creditors.

Recall, further, that the Hanafis do not permit a *rahn* on an unidentified portion of a property. The second *rahn* issues thus do not arise in the case of the Hanafis with respect to partial property arrangements.

The Hanafis, Hanbalis, and Shafi'is rule that it is not permissible to grant a second *rahn* on the entirety of the encumbered asset subject to a first *rahn* . They provide an exception to this rule if the secured creditor that has a security right pursuant to the first *rahn* consents to the second *rahn* of the object constituting the encumbered asset of the first *rahn*. In the case of that exception, the first *rahn* is voided

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191 See al-Zuḥaylī, *id.*, at 134-36.

192 AAOIFI Standard, *supra* note 14, at §3/2/3.

193 See McMillen, Saudi Rahn, *supra* note 18.

and the second *rahn* constitutes a valid *rahn* whose encumbered asset is now the object that was previously the encumbered asset for the first *rahn*.

These three schools permit a secured creditor that has received an encumbered asset to grant a security right in that encumbered asset to a second secured creditor with the permission of the owner of the encumbered asset (i.e., the original grantor). As a consequence, the first *rahn* is voided and the second *rahn* is treated as the equivalent to the grant of a *rahn* in a borrowed property. If the secured creditor under the first *rahn* grants the second *rahn* without the consent of the owner of the encumbered asset, the second *rahn* is void and the original grantor has the right to demand the return of the encumbered asset to the first secured creditor.

These arrangements have implications in the case of loss, damage, or destruction of the encumbered asset. If the encumbered asset is lost, damaged, or destroyed in the possession of the second creditor, the Hanafis allow the debtor to seek compensation from either the first secured creditor or the second secured creditor. If compensation is sought from the first secured creditor, the first *rahn* is considered valid. If compensation is sought from the second secured creditor, the first *rahn* is considered invalid, although the first secured creditor remains the ultimate guarantor of the value of the encumbered asset. Thus, if the second secured creditor compensates the debtor (original grantor), the second secured creditor is entitled to compensation from the first secured creditor.

For the Malikis, it is generally permissible to grant a *rahn* in an existing encumbered asset so long as the value of the encumbered asset exceeds the amount of the first secured obligation. This general rule is subject to some qualifications. The Malikis then afford the second secured creditor a second priority in the encumbered asset, with repayment of the first secured obligation having first priority, and the second priority being applicable only to the excess of the value (e.g., sale proceeds) of the encumbered asset over the amount of the first secured obligation.

As a qualification, the Malikis rule that the consent of a trustee (*'adl*) is required to retain the trustee if the encumbered asset is in the possession of a trustee at the time the second *rahn* is made. This qualification applies whether or not the second secured creditor is the same as the first secured creditor.

Another qualification pertains to the consent of the first secured creditor where there is a second *rahn* involving the same encumbered asset. There are three positions regarding this consent: (i) it is not required; (ii) it is required; and (iii) the second *rahn* is not permissible whether or not the first secured creditor provides consent.

If, under Maliki interpretations, the second *rahn* is permissible, then the maturity dates of the first secured obligation and the second secured obligation must be ascertained.

No particular issues arise if the maturity dates are the same.

If the first secured obligation matures before the second secured obligation, then the encumbered asset may not be sold prior to the maturity of the first secured obligation (leaving aside perishable property considerations for the moment). Sequential payments will then be made to the first secured creditor, until payment in full of the first secured obligation. Thereafter, the excess will be paid to the second secured creditor as an encumbered asset for the second secured obligation.

If the second secured obligation matures prior to the maturity of the first secured obligation, the encumbered asset is divided between the two secured obligations (assuming division does not reduce the value of the encumbered asset). The first secured creditor is repaid first, until repayment in full, and the excess, if any, is then paid to the second secured obligation.

The same principles apply where the encumbered asset is not divisible and must be sold as an entirety.

(r) Indebted Estates[194]

The base-level general rules applicable to *rahn* arrangements with respect to an indebted estate are similar to those applicable to the *rahn* of an existing encumbered asset. First, it is not permissible to grant a *rahn* on property to which persons other than the debtor have an interest. Second, the *rahn* is suspended until the permission of the interested third party is obtained. An "indebted estate" for these purposes is an estate associated with a liability of the decedent obligor.

Thus, for the Hanafis, a *rahn* on an indebted estate that is granted by an heir is suspended until repayment of the outstanding liability of the decedent obligor. After repayment of that liability, the heir may grant a *rahn* in the estate.

The Malikis rule similarly. The *rahn* is suspended. If the liabilities of the decedent obligor are not satisfied, the *rahn* of the heir is voided.

The Hanbalis also recognize the ability of the heir to grant the *rahn* on the indebted estate. If the liabilities of the decedent obligor are satisfied (out of assets of the estate or by payment by the heir or otherwise), the *rahn* on the previously indebted estate continues as a valid *rahn*. If the liabilities are not satisfied, the creditors of the decedent obligor may take the property constituting the estate, including any said to be subject the *rahn* of the heirs, and apply those properties (and their proceeds) to payment of the outstanding obligations of the decedent obligor.

The positon of the Shafi'is is that the *rahn* on the indebted estate is valid. However, the Shafi'is prohibit the heir from dealing in any part of the indebted estate until payment in full of the outstanding liabilities of the decedent obligor.

The AAOIFI Standard provides that the death of the grantor and the secured creditor have no effect on the validity of the *rahn*, and the heirs of the deceased substitute for the deceased.[195] This implies that the priority of the secured creditor continues after the death, and that the rights of the heir are those of the original grantor.

(s) Perishables[196]

For the Hanafis, Hanbalis, and Malikis, it is permissible to subject perishable properties to a *rahn* and the perishable properties may constitute a valid *marhun* (encumbered asset). The AAOIFI Standard also allows the creation of a *rahn* interest in perishables, and recognizes their validity as encumbered assets.[197]

For these three schools, which are applying classical interpretations (which may be applied under the AAOIFI principle), the use of perishable properties as encumbered assets creates some unique obligations for safekeeping of the encumbered asset. If the perishable property can be dried or frozen for storage or to make it less perishable (e.g., dates and grapes), the debtor has an obligation to dry or freeze the property. If the perishable property cannot be dried or frozen for storage or to make it less perishable, then the perishable property must be sold prior to perishing and the sale price will be substituted as the encumbered asset. The obligation is on the debtor as the owner of the perishable property. However, as noted in section 15 of this report, the secured creditor is also afforded rights to sell to protect the value of the encumbered asset.

The Shafi'is make a distinction regarding the permissibility of subjecting perishable property to a *rahn* that focuses, first, on whether the perishing will or may occur prior to the maturity of the secured obligation, and, second, on whether the selling the perishable property is addressed as a condition in the

194 See al-Zuḥaylī, *id.*, at 136-38.

195 AAOIFI Standard, *supra* note 14, at § 3/1/6.

196 See al-Zuḥaylī, *supra* note 13, at 138, and AAOIFI Standard, *supra* note 14, at 3/2/2.

197 AAOIFI Standard, *id.*, at § 3/2/2.

rahn contract. If the *rahn* contract provides for sale of the perishable property to prevent its ruin, the *rahn* contract will be valid. If no such condition is included in the contract, the *rahn* contract is invalid. If it is uncertain whether the perishable property will perish prior to the maturity of the secured obligation, most Shafi'is take the position that an unconditional *rahn* is invalid. These principles may also be applied by scholars interpreting or implementing the AAOIFI Standard.

(t) Fruit Juices (Transformable Properties)[198]

Fruit juices are treated separately because they constitute properties that are capable of transformation into *haram* properties (through fermentation). Fruit juices may constitute encumbered property (*marhun*). If the fruit juices ferment into vinegar, they remain valid encumbered assets. If they ferment into wine or another intoxicant, the *rahn* is rendered non-binding and invalid and the wine or intoxicant must be discarded (upon this disposal, the *rahn* becomes invalid).

(u) Religious Books[199]

The Hanbalis rule that it is impermissible to grant a security right in the Qur'an (sales of the Qur'an are prohibited). Other religious books (including compilations of *hadith*) may be subject to a *rahn* and may constitute encumbered assets (*marhun*), however. This includes granting a security right in these other religious books to a non-believer, so long as the books remain in the possession of a Muslim trustee.

The Hanafis, Malikis, and most Shafi'is allow the Qur'an and all other religious books to be made subject to a *rahn* and to constitute *marhun*. There is a mandatory constraint on any such arrangement, however: the secured creditor is not permitted to read the Qur'an or other religious books (the secured creditor has a right to possession, but not use). The books, as *marhun*, are subject to a guarantee of the secured creditor.

(v) Intellectual Property

Up to this point, this report has avoided the distinction between tangible and intangible property, and the concept of intellectual property, in the discussions of Shari'ah principles, with a few exceptions (such as usufruct).[200] That is intentional. The question of whether intangible property, and intellectual property in particular, constitute "property" for the purposes of the *rahn* principles is a matter of intense debate.[201]

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198 See al-Zuḥaylī, *supra* note 13, at 139.

199 See al-Zuḥaylī, *id.*, at 139.

200 Intellectual property is, broadly considered, the legal rights that result from intellectual activity in industrial, scientific, literary, and artistic fields. It encompasses patents, trademarks, service marks, certification marks, industrial designs, integrated circuits, geographical indications, copyright, and other similar categories. See, e.g., WIPO INTELLECTUAL PROPERTY HANDBOOK, World Intellectual Property Organization (2004; reprinted 2008), available at http://www.wipo.int/freepublications/en/fulltext_pubdocs.jsp?q=history+of+intellectual+property, and WHAT IS INTELLECTUAL PROPERTY?, World Intellectual Property Organization (2003), available at http://www.wipo.int/freepublications/en/fulltext_pubdocs.jsp?q=wipo+publication+450. See also Jacob Loshin, *Secrets Revealed: How Magicians Protect Intellectual Property Without Law* (July 25, 2007), available at http://ssrn.com/abstract_1005564.

201 A broad range of arguments in support of and against the validity of characterizing intellectual property as "property" under the Shari'ah can be found in the following sources: Qais Ali Mahafzah, Basem M. Melhem and Hitham A. Haloosh, *The Perspective of Moral and Financial Rights of Intellectual Property in Islam*, 23 ARAB LAW QUARTERLY 457 (2009); Ida Madieha Azmi and Engku Rabiah Adawiyah Engku Ali, *Legal Impediments to the Collateralization of Intellectual Property in the Malaysian Dual Banking System*, 2 ASIAN JOURNAL OF COMPARATIVE LAW 1 (2007); Amir H. Khoury, *Ancient and Islamic Sources of Intellectual Property Protection in the Middle East: A Focus*

To briefly summarize current thinking on this matter, the primary sources of the Shari'ah neither expressly negate the concepts of intangible property and intellectual property nor expressly indicate the validity of these concepts. The debate is not resolved in this report.

In the contemporary practice of Islamic finance, intangible assets, including intellectual property, have been granted as collateral, and approved as encumbered property, in many and varied transactions that have been approved by Shari'ah scholars. In informal discussions with Shari'ah scholars, numerous scholars have expressed the opinion that intangible property, including intellectual property, constitutes property that may be the subject of a valid *rahn*.

These matters are mentioned only to highlight that matters involving intangible property, including especially intellectual property, should be very carefully explored with the relevant Shari'ah scholars in connection with any effort to modify the Model Law (or any other law) for effective implementation in each and every jurisdiction where the Shari'ah is of relevance.

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on Trademarks, 43 IDEA–THE JOURNAL OF LAW AND TECHNOLOGY 151 (2003); Ali Khan, *Islam as Intellectual Property*, 31 CUMBERLAND LAW REVIEW 631 (2000-2001); Richard E. Vaughan, *Defining Terms in the Intellectual Property Protection Debate: Are the North and South Arguing Past Each Other When We Say "Property"?: A Lockean, Confucian and Islamic Comparison*, 2 ILSA JOURNAL OF INTERNATIONAL AND COMPARATIVE LAW 307 (1995-1996); Steven D. Jamar, *The Protection of Intellectual Property Under Islamic Law*, 21 CAPITAL UNIVERSITY LAW REVIEW 1079 (1992). .

8 PROCEEDS, ACCRETIONS, AND ADDITIONS

GENERALIZED SUMMARY PROCEEDS, ACCRETIONS, AND ADDITIONS	
SME NEED	The availability of proceeds to both the SMEs and the secured creditor is critical. SMEs need the proceeds to support continuing operations, maintenance, and expansion. Asset values of the encumbered assets are usually insufficient, and supplementation of the collateral by proceeds is important to provide adequate collateral, thereby reducing transaction costs and increasing the availability of financing. The means of production and the proceeds of production are intimately connected and should be addressed jointly and simply for the benefit of both the debtor and the secured party.
MODEL LAW	Proceeds are available to both the debtor (for use and expenditure) and the secured party, whatever the source of the proceeds.
SHARI‘AH	Classical principles are essentially the same as under the Model Law, where the proceeds arise as a result of (a) asset sales and dispositions, and (b) loss, damage, and destruction of the encumbered asset. Both the Shari‘ah principles and the Model Law substitute the proceeds for the encumbered asset in these situations. In other cases, Shari‘ah principles differ; the difference depends upon the nature and type of proceeds. Accretions and increases (including "rent") are separate property of the debtor and not subject to an existing security right (unless they fall within certain categories, such as crops that have not been severed from the land). The Shari‘ah rules are complex.
AAOIFI	*Appreciation of the value of the encumbered asset and income from the encumbered asset are subject to the existing security right.*
RECONCILIATION SUGGESTION	The AAOIFI standard is a good base, and should be refined relative to the more complex Shari‘ah principles with respect to specific types of assets and their status at various points in time.

8.1 Model Law Provisions

As noted in section 7.1, a validly created security right in an asset extends to the identifiable proceeds of that asset.[202] "Proceeds" are defined as whatever is received with respect to an encumbered asset, whether as a result of a sale or other disposition, lease or license, civil and natural fruits (including revenues, dividends, and distributions), insurance proceeds, claims arising from defects in, damage to, or loss of an encumbered asset, and or proceeds of proceeds.[203]

If a security right is effective against a third party, then whether the security right in proceeds of that asset is effective against third parties depends upon the nature of the proceeds. Two cases are addressed in the Model Law.[204]

(a) If a security right is effective against a third party, then the security right in proceeds of that asset is effective against third parties without further action by the grantor or the secured creditor, if the proceeds are in the form of (i) money, (ii) receivables,

[202] Model Law, Article 10, ¶ 1.

[203] Model Law, Article 2, clause (bb), and the Note to the Working Group with respect to that clause.

[204] Model Law, Article 17, ¶¶ 1 and 2, respectively.

(iii)negotiable instruments, or (iv)rights to payment of funds credited to a bank account.[205]

(b) If the If If the proceeds are other than those enumerated in case (a), the security right must be made effective by a separate action in accordance with specific requirements.[206]

A validly created security interest attaches to commingled assets and to the value of an asset or proceeds immediately prior to the commingling.[207]

Security rights in a tangible asset continue in a "mass or product."[208] The Model Law defines "mass or product" as tangible assets, other than money, that have become so physically associated or united with other tangible assets that they have lost their separate identity. Anticipating the discussion of correlative Shari'ah concepts, this definition includes both fungibility concepts (e.g., a kernel of grain in a silo) and integration concepts (e.g., a gear in a machine).[209]

The obligation secured by a security right that continues into a commingled mass or product is limited to the value of the asset that is commingled, determined immediately before it became part of the mass or product.[210] If security rights in tangible assets continue in the same mass or product and if each is effective as against third parties, then the secured creditors of each of those security rights are entitled to share in the aggregate maximum value of their security rights in the mass or product in accordance with the ratio of the value of their respective secured obligations.[211] An "acquisition security right" in a separate tangible asset that becomes incorporated in a mass or product may also be effective as against third parties. Such an acquisition security right has priority as against a security right granted by the same grantor in the mass or product.

The Model Law has specific rules that relate to specific types of assets. Those assets are certain receivables,[212] other intangible assets, negotiable instruments, and rights to payment of funds credited to

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205 Of relevance to the Shari'ah principles, the Note to Working Group with respect to Model Law, Article 17, indicates that this provision does not make reference to a description of the proceeds in the notice. The reason is that "once the proceeds are described in the notice (in line with the security agreement), they constitute original encumbered assets, not proceeds". See Model Law, Article 17, Note to the Working Group, at 20. That is, the proceeds are "substituted" for the original collateral. The Shari'ah principle is essentially the same with respect to this "substitution" concept in many circumstances. As previously discussed (and as will be discussed in section 8.2), and leaving aside accretions and additions, "proceeds" that do not derive from operation of the *marhun* (such as those relating to loss, damage or destruction of the *marhun* or sale of the *marhun*) are similarly "substituted".

206 As discussed in section 8.2, the Shari'ah rules vary significantly from these Model Law provisions.

207 Model Law, Articles 10 and 11 (the latter addresses commingling in a "mass or product").

208 Model Law, Article 11, ¶ 1. See, also, the discussion of priority under the Model Law in section 10. Each security right retains the same priority as the competing security rights had relative to one another immediately before the mass or product was incorporated.

209 Model Law, Article 2, clause (t).

210 Model Law, Article 11, ¶ 2.

211 Model Law, Article 11, ¶ 3.

212 The receivables to which these rules are applicable are limited to certain categories of receivables, specifically:(a) those arising pursuant to a contract for the supply or lease of goods other than financial services, construction contracts, and sales or lease of immovable property; (b) those arising from a contract for the sale, lease, or license of industrial or other intellectual property or proprietary information; (c) those representing payment obligations on credit card transactions; and (d) those arising upon either net settlement payments under netting agreements involving more than two parties or the termination of all transactions under such agreements. The Working Group is still considering clause (d). See Model Law, Article 12, ¶ 4.

a bank account.[213] A security right with respect to any of these types of assets is effective as between the grantor and the secured creditor and as against the debtor on the receivable or intangible asset, the obligor on the negotiable instrument and the depositary bank on such funds (even where the debtor-grantor to the secured creditor is subject to a restrictive agreement limiting that debtor-grantor's right to create the security right) where such restrictive agreement is between (a) the initial or any subsequent grantor and (b) either (i) the debtor on the receivable or other intangible asset, the obligor on the promissory note or the depositary bank or (ii) any subsequent secured creditor.[214] Any person that is not a party to the restrictive agreement is not liable for the grantor's breach of that restrictive agreement.

8.2 Shari'ah Provisions

The concept of proceeds under the Shariʿah overlaps and is consistent, to a considerable extent, with that of the Model Law, and is essentially the same as regards amounts received with respect to (a) a sale or other disposition of the encumbered asset, whether prior to or in connection with the enforcement and the exercise of remedies pursuant to the *rahn*, and (b) loss, damage, or destruction of the encumbered asset. The proceeds are substituted for the encumbered asset, and upon substitution become the encumbered asset. Thus, the concept would likely extend to amounts received pursuant to a lease or license of the encumbered asset as well, if the lease or license were permitted as a remedy with respect to the *rahn*. However, as noted in section 15 of this report, the Shariʿah has a marked preference for sale of the encumbered asset in order to pay the secured obligation. Leases and licenses of the encumbered asset in an enforcement and remedies context are rare, if they exist at all in the context of enforcement and remedies.

As has been discussed in this report, proceeds resulting from sales, other dispositions, leases, and licenses of the encumbered asset in a non-enforcement, non-remedies context are treated somewhat differently than proceeds under the Model Law. How they are treated depends on the nature of the proceeds.

The general rules (in broad summary) are:

- Proceeds derived from the operation and functioning of the encumbered asset (excluding, for example, loss, damage, and destruction scenarios) are presumed to be the property of the owner of the object that constitutes the encumbered asset (usually the debtor, but possibly another grantor).
- Amounts received with respect to loss, damage, and destruction of the encumbered asset are generally treated as a substitute for the encumbered asset that was lost, damaged, or destroyed (and thus are also treated as property of the owner of the object).

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[213] The Working Group is considering alternative provisions relating to the personal or property rights that secure or support payment or performance of the encumbered receivable, intangible asset, or negotiable instrument. The security right will either extend to those personal or property rights automatically or will extend without a new act of transfer if the encumbered instrument is transferable or allows the grantor to make the necessary act of transfer if the encumbered asset is not transferable. See Model Law, Article 13.

[214] Model Law, Article 12, ¶ 1. Model Law, Article 12, ¶ 2, clarifies that these provisions do not (a) relieve the debtor-grantor of any liability on the referenced agreement that restricts the debtor-grantor's ability to create the security right, (b) allow the other party to the security agreement to avoid the contract giving rise to the receivable, intangible asset, negotiable instrument, or rights to funds in a bank account or the security agreement on the sole ground of breach of that restrictive agreement, or (c) allow the other party to that restrictive agreement to raise a claim against the secured creditor as a result of the breach of that restrictive agreement.

- Accretions and increases of the encumbered asset are treated separately (and discussed in this section).
- Additions to the encumbered asset are treated separately (and are discussed in this section).

Before discussing these categories, it is important to note the concept of "integration" under the Shariʿah. Integration of properties may of itself change the characterization of the property. For example, movable property placed, by its owner, on immovable property also owned by such owner for the purpose of serving or exploiting that immovable property becomes immovable property. Examples include doors and windows in a building that, even though they are originally movable property, become part of the immovable property in actual use. This is akin to the concept of "fixtures" under the Uniform Commercial Code in the United States of America.

However, the concept of integration shades off, under the Shariʿah, in some instances, into the realm of "increases" to the encumbered asset (both attached and unattached increases).

The Shariʻah treats different types of proceeds differently. It is essential to determine what type of proceeds are being discussed and whether a valid *rahn* has been created in those proceeds.

Some portions of the proceeds derive from operation of the encumbered asset and are the property of the grantor. An example is rent from an asset of the grantor-debtor that has been leased to a third party. These situations are discussed in the remainder or this section.

Other portions of the proceeds may be substituted as encumbered asset, such as those received in situations of loss, damage or destruction of the encumbered asset. Whether the proceeds such as these may be applied to the secured obligation prior to the maturity of the secured obligation depends upon the interpretations of the specific school of Islamic jurisprudence whose principles are being applied, the individual Shariʻah scholars, and the facts of the matter being considered. For example, is the loss, damage, or destruction total or partial? If it is total, most scholars will allow immediate application of the proceeds (say, insurance proceeds) to the secured obligation. Some, however, will not allow that application until the scheduled maturity of the secured obligation. The proceeds will then be placed in an account and will be distributed as periodic payments with respect to the secured obligation in accordance with the original repayment schedule on the secured obligation.[215]

Accretions and increases of, and output from, the encumbered asset are Shariʻah concepts that also have considerable overlap with the proceeds concept of the Model Law. The concept of "additions" overlaps with the Model Law concept of commingling, to some extent. Each of these concepts, and the related principles and rules, are discussed in the remainder of this section.

The relevant provisions of the AAOIFI Standard provide that appreciation in value and income from the encumbered asset are subject to the *rahn* on the encumbered asset.[216] It is not clear that "appreciation in value" encompasses accretions and increases, as discussed in the remainder of this section. That will be left to the scholars applying the principles of different schools.

The Hanafis, Hanbalis, Malikis, and Shafiʻis all agree that "increases" of, and output from, an encumbered asset are the property of the grantor of the encumbered asset.

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[215] See the discussion of Saudi Arabian law in section 15 and in McMillen, Saudi Rahn, *supra* note 18, whereby the proceeds are placed in a bank account and distributed in accordance with the original amortization-repayment schedule for the secured obligation.

[216] AAOIFI Standard, *supra* note 14, at § 3/2/8. In addition, § 3/2/9 addresses "benefits" of the *marhun*. However, this section seems to apply more to "use" concepts, although it might be interpreted more broadly to include accretions, increases and any other benefit of the *marhun*. See the discussion in section 12.2.3(f).

The differences of interpretation arise in defining what constitutes an increase or output (and how a *rahn* is granted in various types of proceeds). As a result of the interpretations of the various sale elements, and with variations among schools (particularly the Malikis), security rights cannot be separately created in increases to property, such as, (a) fruits of a tree, (b) wool on sheep, (c) unborn offspring of cattle, and (d) a fraction of a house (although Hanafis allow creation of a security right in an unidentified portion).[217] Upon severance of the increases (fruits, wool, or calves), separate security rights can be granted in these properties.

As a general principle, increases in or growths to an encumbered property, prior to severance, go with the encumbered property (*marhun*) and are subject to a security right (*rahn*) on that property. To grant a security interest in the increase in a property prior to severance, it is necessary to grant a security right in the principal property that gives rise to the increase. Granting a security interest in a tree will result in a grant of a security interest in the fruit of that tree. A grant in sheep will include a grant in the wool from the sheep. A grant in a cow will ensure a grant in the unborn calf.

In the discussions that follow, particular attention should be paid to security interests (*rahn*) in "rent", and whether the rent constitutes a portion of an existing encumbered asset. Usually, it is not part of the encumbered asset; but rent would be included as part of the encumbered asset under the AAOIFI Standard.

These general statements are subject to considerable variation from one jurisprudential school to another. Consider the following positions (noting the different classifications of specific items for each of the jurisprudential schools).[218]

- Hanbali: All increases, growths, and output of an encumbered property are part of the encumbered property and subject to the *rahn* on the underlying encumbered asset. As a result of these interpretations, a sale of the original encumbered asset requires that there also be a sale of all growths, whether contiguous (e.g., fruits, wool and milk) or separate (e.g., offspring). Contiguous and separate growths are treated in the same way.
- Hanafi: Derivative growths and increases are part of the encumbered asset and subject to the security right of the secured creditor. This is true whether the growths and increases are contiguous or separate . However, separate, non-derivative growths (e.g., rent) are not part of the encumbered asset (*marhun*) and belong, separately, to the debtor.
- Maliki: Contiguous and non-contiguous growths and products (e.g., offspring and palm shoots) and non-separable growths (fat) are part of the encumbered property and subject to the *rahn*. Increases that are not of the same form as the underlying property that is the encumbered asset, whether derivative (e.g., fruits and milk) or non-derivative (e.g., rent and products of land), are the property of the debtor and not subject to the *rahn* of the underlying property. In a fine distinction, wool growing on the back of sheep is subject to the *rahn* of the sheep if the wool existed at the time of the grant of the *rahn.*
- Shafiʿi: Contiguous growths (fat), increases in size, and fruit are part of the encumbered property and subject to the *rahn*. Separate and separately identifiable growths and increases are not part of the encumbered property and are separate property of the debtor outside the security right on the encumbered asset (e.g., offspring, milk, eggs, wool, hair, and rent). Separate, non-derivative growths (e.g., rent) are the property of the debtor and not subject to the *rahn* of the property that is rented.

[217] See sections 7.2.2(a), 7.2.2(b), and 7.2.2(i).
[218] See al-Zuḥaylī, *supra* note 13, at 183-85, and ibn Rushd, *supra* note 14, § 37.2.

A related category of accretions to the encumbered asset under Shariʻah principles is an "addition", most commonly adding a second property to the encumbered asset. This concept may overlap with, but is not coextensive with, the "commingling" concept of the Model Law. Fungibility concepts under the Shariʻah also overlap to some extent with the "mass or product" concepts of the Model Law. Fungibility concepts, of themselves, do not embody the idea of a subsequent act of commingling, however.

Most jurists and scholars allow the addition of property to the encumbered asset so that both the original property and the added property jointly constitute the encumbered asset. However, a minority of jurists and scholars take the position that the addition of property is not permissable because it leads to a lack of identification of the respective properties to the secured obligation. These scholars rule that the original property constituting an encumbered asset must be released from the *rahn* when the second property is added. Other jurists and scholars address this issue by dividing the secured obligation and allocating it to the two properties constituting the encumbered asset in accordance with their respective values on the dates of their respective receipts by the secured creditor.

There are obvious and significant implications of these types of interpretive differences in implementing a legal regime for secured transactions. Consider the care that must be taken in ensuring a sound understanding of the definition of each of the relevant categories, such as "contiguous", "derivative", "non-derivative", "separate" and "separately identifiable", among others, and then assigning properties to each category.

In the context of modern commercial and financial transactions, critical sets of considerations arising out of these Shariʿah principles relate to security rights in after-acquired property and determinations as to when such property is or is not subject to an existing security right. Alternatively, covenants (both positive and negative) may need to be imposed that specifically address these types of property, continual reporting and monitoring may be needed, and new security rights may need to be established.

9 EFFECTIVENESS OF A SECURITY RIGHT AGAINST THIRD PARTIES

GENRALIZED SUMMARY EFFECTIVENESS AGAINST THIRD PARTIES	
SME NEED	SMEs need to retain possession and use of encumbered assets used in the businesses of the SMEs and this imperative should not defeat the security rights in those assets that allows creditors to participate in SME financings.
MODEL LAW	A security right in encumbered property (and its proceeds) is effective againt third parties if there is registration in a security rights registry or the secured creditor has actual physical possession of the encumbered property.
SHARI'AH	Effectiveness of a security right as against third parties is based on possession (and receipt) of the encumbered asset. Physical possession principles are consistent with those of the Model Law. Only the Malikis recognize constructive possession principles. Shari'ah scholars of all schools of Islamic jurisprudence are currently considering registration as an adequate substitute for physical possession (and seem to be inclining toward the acceptance of registration in a security rights registry as sufficient for Shari'ah purposes).
AAOIFI	AAOIFI recognizes registration in a security rights registraty as sufficient possession.
RECONCILIATION SUGGESTION	The AAOIFI standard is a good base. Discussion with the Shariah scholars should be directed at explaining the operation of modern security rights registration systems and elucidating the benefits of these registration systems, including benefits that are consistent with and supportive of Shari'ah possession concepts and their underlying principles.

9.1 Model Law Provisions

The Model Law sets forth a group of simple rules regarding the effectiveness of a security right against third parties. As with other provisions, the Model Law provides two categories of rules: the first set of effectiveness rules applies generally; and the second set of rules applies to specific groups of assets, such as bank accounts, negotiable documents, and non-intermediated securities.

The fundamental rules set forth in the Model Law are that a security right in an asset is effective against third parties if: (a) notice with respect to the security right is registered in the general security rights registry (the "Registry") or in any specialized registry or title certificate specified by the enacting State; or (b) the secured creditor has possession of the asset.[219] A security right that is made effective against third parties remains effective against third parties even if the asset is sold or otherwise transferred, leased, or licensed.[220]

If a security right is effective against a third party, then the security right in proceeds of that asset is effective against third parties depends upon the nature of the proceeds. Two situations are addressed in the Model Law.[221]

(a) If a security right is effective against a third party, then that security right in proceeds of that asset is effective against third parties without further action, if the proceeds are in the form

219 Model Law, Article 16.

220 Model Law, Article 20.

221 Model Law, Article 17, ¶¶ 1 and 2, respectively.

of (i) money, (ii) receivables, (iii) negotiable instruments, or (iv) rights to payment of funds credited to a bank account.[222]

(b) If the proceeds are other than those enumerated in case (a), the security right must be made effective by a separate action, specific actions may will be required within specified times frames.[223]

The concept of "possession" under the Model Law is defined as "actual [physical] possession of a tangible asset, money, negotiable instruments, negotiable documents and certificated non-intermediated securities by a person or its representative, or by an independent person that acknowledges holding it for that person".[224] Thus, possession is applicable to all types of "tangible assets" and the enumerated list of non-tangible assets.

Further, possession for Model Law purposes may be achieved by (1) a person, (2) a representative of a person, or (3) an independent person that acknowledges that it is holding the asset for the relevant person.

Possession of the relevant asset makes the security right effective against third parties. It also makes the security right effective in proceeds of that asset automatically and without further action by the grantor or the secured creditor if the proceeds are money, receivables, negotiable instruments, or rights to payment of funds credited to a bank account. If the proceeds are other than these items, the security right is effective against third parties for a few days, but effectiveness must then be achieved independently by one of the means specified in the Model Law with respect to the specific type of asset constituting the proceeds. In this context, it should be noted that possession does signify an intent to create a security right, but it does not positively publicize the existence of a security right: the transferee's possession is consistent with non-security arrangements, such as leases and deposits.

A security right that has been made effective against third parties by one method under the Model Law may subsequently be made effective against third parties by any other method applicable to the relevant type of encumbered asset under the Model Law.[225] The security right will remain continuously effective against third parties so long as there is no time when the security right is not effective against third parties: i.e., there is no gap in third-party effectiveness.[226] If a lapse in third-party effectiveness occurs, the effectiveness may be re-established by any method applicable to the relevant encumbered asset under the Model Law.[227] In such a case of lapse and re-establishment, the effectiveness of the security right against third parties resumes only as of the time it is re-established: i.e., there will be a gap in effectiveness against third parties until the re-establishment.[228]

Asset-specific rules under the Model Law are applied to bank accounts, negotiable documents, and non-intermediated securities.[229]

With respect to rights to payment of funds credited to a bank account, a security right may be made effective against third parties by the methods noted above and by any of three other methods: (I) creating

[222] See note 205, *supra*.

[223] As discussed in section 8.2, the Shari'ah rules vary significantly from these Model Law provisions.

[224] Model Law, Article 2.

[225] Model Law, Article 18, ¶ 1.

[226] Model Law, Article 18, ¶ 2.

[227] Model Law, Article 19, ¶ 1.

[228] Model Law, Article 19, ¶ 2.

[229] Model Law, Article 23 (bank accounts), Article 24 (negotiable documents), and Article 25 (non-intermediated securities).

the security right in favor of the depositary bank; (II) conclusion of a control agreement; and (III) having the secured creditor become an account holder. A control agreement is an agreement among the depositary bank, the grantor, and the secured creditor providing that the depositary bank will follow the instructions of the secured creditor pertaining to the payment of the relevant funds without further consent of the grantor.[230]

The term "negotiable document" is not defined in the Model Law. As a point of reference, the term is defined in the Terminology and Recommendations: "a document, such as a warehouse receipt or bill of lading, which embodies a right to delivery of tangible assets" and satisfies legal requirements regarding negotiability under relevant law.[231]

A security right in a negotiable document that is effective against third parties extends to the tangible asset covered by the negotiable document if the issuer of the negotiable document is in possession of the asset at the time the security right in the negotiable document is created.[232]

The Working Group has not yet resolved the issue of whether the possession, under the Model Law, may be indirect as well as direct.[233] Possession of the negotiable document is effective as to the tangible asset covered by that negotiable document.[234] The effective security right in the negotiable instrument remains effective for a short period, as established by the State, after the negotiable instrument has been relinquished to the grantor or other person for the purpose of ultimate sale or exchange, loading, unloading, or otherwise dealing in the assets covered by the negotiable document.[235]

A security right in uncertificated non-intermediated securities may be made effective under the general principles noted above or by (a) novation of the security right or entry of the name of the secured creditor as the holder of the securities in the books of the issuer of the securities, or (b) conclusion of a control agreement.[236]

9.2 Shari'ah Provisions

The Shariʿah principles pertaining to effectiveness of a *rahn* security right against third parties are based on possession (although other elements are also necessary, such as receipt of the encumbered asset by the secured party).[237]

For the most part, the actual possession orientation of the Model Law is harmonious with *rahn* principles. Three schools require actual possession for a *rahn* to be valid. For these, it is necessary to physically possess movables, and a valid *rahn* is not binding until the secured creditor has received the encumbered asset (i.e., before receipt, the debtor is permitted to withdraw from the transaction).[238]

The Maliki school recognizes constructive possession concepts. The Malikis also take the position that delivery can be required by the secured creditor where there has been offer and acceptance.[239]

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230 Model Law, Article 2.

231 Terminology and Recommendations, under "Terminology".

232 Model Law, Articles 14 and 24, ¶ 1.

233 Legislative Guide, Recommendation 28, at 101, advocates both direct and indirect possession.

234 Model Law, Article 24, ¶ 2.

235 Model Law, Article 24, ¶ 3.

236 Model Law, Article 25.

237 See the discussion in section 5.2, particularly sections 5.2.4 and 5.2.5.

238 See section 5.2.5 and al-Zuḥaylī, *supra* note 13, at 106. The principles applicable to immovables permit of either physical possession or removal of the impediments to receipt and physical possession. See al-Zuḥaylī, 106-22, for a detailed discussion of the rather intricate receipt principles and rules

239 al-Zuḥaylī, *id.*, at 107, and see the discussion in sections 5.2.4 and 5.2.5.

All four schools agree that conclusion of an agreement with a stipulated condition that the encumbered asset remains in the possession of the debtor invalidates the *rahn*. This illustrates the critical distinction between possession and use of the encumbered asset.[240]

Practices, both ancient and modern, regarding the holding and operation of the encumbered asset during the period of a *rahn* hint at the complexities of Shariʿah-based possession concepts.[241] It has not been uncommon, historically, although it has not been universally accepted, for the debtor to hold and use the encumbered asset during the term of the security right or *rahn*. Where debtor operation was permitted, the debtor was required to produce the encumbered asset for confirmation upon demand by the secured creditor in certain circumstances, such as at the specific dates of repayment.

The interplay between the debtor use principles and the possession principles illustrates some of the tensions within the Shariʿah paradigm. These tensions are more easily accommodated under the Maliki constructive possession model and the principles of the AAOIFI Standard.

The AAOIFI Standard recognizes registration in a registry as legal possession for purposes of a *rahn* and its object (the *marhun* or encumbered asset).[242]

The AAOIFI Standard indicates the trend of the debates among Shariʿah scholars regarding the implications of security rights registries. Do these constitute possession for Shariʿah purposes? Registration certainly is not physical possession, which is the base concept under the Shariʿah. Registration systems certainly do serve some of the underlying principles that are served by the Shariʿah requirement of physical or actual possession. They enhance information flow, reduce disputes about proof, and diminish doubts as to the nature of the creditor's rights with respect to the encumbered asset.

In most systems, registration co-exists as an alternative with actual or constructive possession. Both are methods for achieving third-party effectiveness of security rights, at least with respect to certain types of assets. Certain assets (e.g., negotiable instruments, where possession also confers a priority advantage) continue to require physical possession concepts. Long-standing commercial practices frequently rely on physical possession, at least in certain areas of commerce and finance.[243]

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240 See the discussion in section 12.2.3.

241 See section 12.2.3 with respect to debtor use of the *marhun*.

242 AAOIFI Standard, *supra* note 14, at § 3/1/2, speaking of "legal" possession.

243 The Legislative Guide endorses co-existing registration and possession methodologies for achieving third-party effectiveness of security interests.

10 PRIORITY

GENERALIZED SUMMARY PRIORITY AND SUBSEQUENT LIENS	
SME NEED	As SMEs grow, and particularly as they become medium-sized entities, they need to raise expansion capital, as well as working capital, inventory financing, trade financing, and operations and maintenance finance. This may entail use of different subordinated financing arrangements, and these will entail considerations of creditor priority.
MODEL LAW	Second and subsequent lines, and multiple priority arrangements, are permissible.
SHARI'AH	Classical principles for the non-Malikis are that it is not permissible to grant a second security interest on an encumbered asset (it voids the first security interest). The Malikis allow second security interests if the value of the encumbered assets exceeds the amount of the first secured obligation.
AAOIFI	The AAOIFI Standard allows multiple liens of different ranks and multiple security rights of different priorities.
RECONCILIATION SUGGESTION	The AAOIFI Standard is a good base, and should be refined relative to the nuances of the Shari'ah rules (which have not been presented here). Considerations relating to registration systems, which are currently being considered by Shari'ah scholars, are likely to be supportive of multiple lien, multiple priority differentiations.

10.1 Model Law Provisions

The Model Law defines "priority" as the right of a person to derive the economic benefit of its security right in preference to a competing claimant.[244] A primary focus of the Model Law, as is true in all secular legal regimes applicable to secured transactions, is on the relative priorities of those holding security rights.[245] The priority of a security right created by a grantor in an encumbered asset is determined according to the order of third-party effectiveness.[246] The priority afforded proceeds of an encumbered asset is the same as the priority afforded the related encumbered asset. The determination of third-party effectiveness requires both creation and an act of third-party effectiveness , as discussed in previous sections of this report.

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[244] Model Law, Article 2, clause (v). A "competing claimant" is defined in Model Law, Article 2, clause (e), as a creditor of a grantor (in this report, most often the debtor) or other person with rights in an encumbered asset that may be in conflict with the rights of the secured creditor in the same encumbered asset, including (a) another secured creditor with a security right in that same encumbered assets (including its proceeds), (b) another creditor of the grantor that has a right in the same encumbered asset (such as a judgment creditor), (c) bankruptcy or insolvency representatives in respect of the grantor, and (d) a buyer, lessee, or licensee of the encumbered asset.

[245] Consider, for example, Chapter V, Articles 42-62, of the Model Law, which address priority considerations, and Article 86, ¶ 1, of the Model Law, which allows a secured creditor having priority over an enforcing creditor to take over the enforcement process at any time prior to sale of the asset.

[246] Model Law, Article 41. Model Law, Article 41, ¶ 2, sets forth a special rule pertaining to transfers of encumbered assets and preservation of third-party effectiveness where competing security rights are created by different grantors in the same encumbered asset. That situation may arise where the original grantor and successive transferees, as grantors, grant security rights in the same encumbered asset.

The priority of a security right with respect to which notice has been registered in the Registry before a security agreement has been concluded (or, in the case of a security right in a future asset, before the grantor acquires rights in the future asset or the power to encumber that future asset) is determined according to the time of registration.[247]

The Model Law allows a person to, at any time, subordinate its priority with respect to any existing or future competing claimant without the need for the beneficiary to be a party to the subordination.[248] Any such subordination does not and will not affect any other competing claimant.

Subject to the rights of judgment creditors, the priority of a security right extends to all related secured obligations, including those arising or incurred after the security right became effective against third parties. Similarly, the priority of the security right covers all encumbered assets described in the notice registered in the Registry, irrespective of whether they are acquired by the grantor or come into existence before or after the time of registration.[249] A secured creditor's knowledge of the existence of a security right does not affect its priority.[250]

If two or more security rights in the same tangible asset continue in a mass or product, each of those security rights retains the same priority as those security rights had relative to one another prior to the incorporation in the mass or product. If security rights in tangible assets continue in the same mass or product and if each is effective against third parties, then the secured creditors of each of those security rights is entitled to share in the aggregate maximum value of their security rights in the mass or product in accordance with the ratio of the value of their respective security obligations. An "acquisition security right" in a separate tangible asset that becomes incorporated in a mass or product and is effective against third parties has a priority as against a security right granted by the same grantor in the mass or product.[251]

So long as there is no gap in the effectiveness of the security right against third parties, a change in the method by which the security right is made effective against third parties will not affect the priority of the security right.

The Model Law also addresses priority in certain specific circumstances.[252] For example, security rights that are effective against third parties at the time of commencement of an insolvency proceeding against the grantor retain the priority they had before such commencement, unless a State law otherwise specifies.[253] States are permitted by the Model Law to specify preferential priority for judgment creditors that were unsecured creditors in certain circumstances.[254]

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[247] Model Law, Article 51.

[248] Model Law, Article 52. The Working Group has not yet determined whether such a subordination must be in writing or may be either written or oral, and has left open various other subordination issues, indicating that these will be addressed in the Guide to Enactment, when drafted. See Note to the Working Group for Article 52.

[249] Model Law, Article 53.

[250] Model Law, Article 54.

[251] Model Law, Article 2, clause (b), defines an acquisition security rights as a security right in a tangible asset, intellectual property, or the rights of a licensee under a license of intellectual property that secures an obligation to pay any unpaid portion of the purchase price of a purchased asset or an obligation incurred or credit otherwise provided to enable the grantor to acquire the asset.

[252] See, e.g., Model Law, Articles 44-50, with Articles 46-50 addressing acquisition security right situations of different types.

[253] Model Law, Article 44, ¶ 1.

[254] Model Law, Article 46, particularly ¶ 1.

Turning to asset-specific rules, under the the Model Law a transferee of encumbered money acquires its rights free of the security right unless the transferee has knowledge that the transfer violates the rights of the secured creditor under the security agreement.[255] The Model Law provides that it does not affect any rights that the secured creditor might have as an owner or licensor of the intellectual property under State law.[256]

The Model Law has more extensive provisions regarding negotiable instruments, rights to funds credited to a bank account, negotiable documents and tangible assets covered by those documents, and non-intermediated securities.

A security right in a negotiable instrument that is made effective against third parties by possession of the instrument has priority over a security right in the instrument that is made effective against third parties by registration of a notice in the Registry.[257] A buyer or consensual transferee of an encumbered negotiable instrument acquires its rights free of the security right that is made effective against third parties by registration of a notice in the Registry if the buyer or other consensual transferee meets certain requirements: such a buyer or transferee qualifies as a "protected holder" under State law, or takes possession of the negotiable instrument and gives value without knowledge that the sale or other transfer is in violation of the rights of the secured creditor under the security agreement.[258]

A security right in a right to payment of funds credited to a bank account that is made effective by the secured creditor becoming the account holder has priority over a competing security right that is made effective against third parties by any other method and over a competing security right made effective by any method other than by the secured creditor becoming the account holder.[259] A security right in such a right by a control agreement (determined as of the time of the agreement is concluded) has priority over a competing security right other than a security right of the depositary bank or a security right that is made effective against third parties by any method other than by the secured creditor becoming the account holder.[260] A security right in such a right that is made effective by a method other than registration of a notice in the Registry has priority over a competing security right made effective against third parties by such registration.[261] A depositary bank's right under other law to set off obligations owed to it by the grantor against the grantor's right to payment of funds credited to a bank account maintained with the depositary bank has priority over a security right in the right to payment of funds credited to the bank account, except a security right that is made effective against third parties by the secured creditor becoming the account holder.[262] A transferee of funds from a bank account pursuant to a transfer initiated or authorized by the grantor acquires its rights free of a security right in the right to payment of funds credited to the bank account, unless the transferee has knowledge that the transfer violates the rights of the secured creditor under the security agreement. The does not, however, adversely affect the rights of transferees of funds from bank accounts under relevant State laws to the contrary.[263]

A security right in a tangible asset made effective against third parties by possession of the negotiable document covering that asset has priority over a competing security right made effective against third

255 Model Law, Article 57.
256 Model Law, Article 59.
257 Model Law, Article 55, ¶ 1.
258 Model Law, Article 55, ¶ 2.
259 Model Law, Article 56, ¶¶ 1 and 2.
260 Model Law, Article 56, ¶¶ 3 and 4.
261 Model Law, Article 56, ¶ 5.
262 Model Law, Article 56, ¶ 6.
263 Model Law, Article 56, ¶¶ 7 and 8.

parties by registration of a notice in the Registry or by possession of the negotiable document or the assets covered thereby. This arrangement does not apply to a security right in a tangible asset, other than inventory, if the security right of the secured creditor not in possession of the negotiable document was made effective against third parties before the earlier of: (a) the time that the asset became covered by the negotiable document; and (b) the time of conclusion of an agreement between the grantor and the secured creditor in possession of the negotiable document providing for the asset to be covered by a negotiable document, so long as the asset became so covered within a short period of time specified by the enacting State, such as 30 days, after the date of the agreement. A transferee of an encumbered negotiable document under relevant State law acquires its rights free of a security right in the negotiable document and the tangible assets covered thereby that is made effective against third parties by registration of a notice in the Registry or by possession of the documents or the assets covered thereby.[264]

A security right in certificated non-intermediated securities made effective against third parties by the secured creditor's possession of the certificate has priority over a competing security right by the same grantor in the same securities made effective against third parties by registration of a notice in the Registry. A security right in such securities made effective against third parties by a notation of the security right or registration of the name of the secured creditor as the holder of the securities in the issuer's books has priority over a security right in the same securities made effective against third parties by any other method. A security right in such a security made effective against third parties by the conclusion of a control agreement (determined as of the date of conclusion of the agreement) has priority over a security right in the same securities made effective against third parties by registration of a notice in the Registry. The rights of holders of non-intermediated securities under State laws are not affected by these provisions.[265]

10.2 Shariʻah Provisions

Priority, in the Shariʿah context, relates to the priority of the secured creditor to the price of the property (encumbered asset) subject to the *rahn* in favor of that secured creditor as against other creditors of the debtor. It allows the secured creditor to be the first to recover in the value or price of the encumbered asset, leaving other creditors to share equally in the excess of the price over the unpaid amount of the secured obligation.[266] It also allows the secured creditor to recover in preference to other creditors that have a right to the specific object or property that is the subject of the encumbered asset. The Shariʻah affords the secured creditor priority in any compensation, in value or in kind, that is paid by a usurper or transgressor that guarantees the encumbered asset under Shariʻah principles. Further, the priority extends into the bankruptcy and insolvency context where the estate of the debtor is put under legal control (*hajr*). The secured creditor retains its priority in a debtor bankruptcy or insolvency, including under the AAOIFI Standard.[267] If the price realized from the encumbered asset is less than the amount of the secured obligation, the secured creditor will be allocated the entire price and be left to compete with other creditors for realization out of other assets of the debtor.[268]

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264 Model Law, Article 58.
265 Model Law, Article 60.
266 See, e.g., al-Zuḥaylī, *supra* note 13, at 175, and AAOIFI Standard, *supra* note 14, at §§ 3/3/2, 3/4/1, 3/4/2 and 3/4/3.
267 AAOIFI Standard, *supra* note 14, at § 3/4/3.
268 See, e.g., AAOIFI Standard, *id*., at §§ 3/4/1, 3/4/2 and 3/4/3.

The reference to equal sharing in the next preceding paragraph is based upon an important Shariʿah consideration that is at odds with modern conceptions of priority in non-Shariʿah realms. The relevant *rahn* principles are hostile to multiple grants of security rights.

A review of second *rahn* principles under the Shari'ah is warranted (despite the repetition of portions of section 7.2.2(g)).

The AAOIFI Standard permits multiple *rahn* interests of differing ranks and priorities in the same encumbered asset, without invalidating the first *rahn*, and with payment in full of a more senior priority secured creditor pursuant to a more senior *rahn* interest before payment of more junior *rahn* interest holders.[269] If a grant of a *rahn* is to be made to a second (or subsequent) secured creditor, the consent of all secured creditors of the same priority rank and any higher priority rank as the new *rahn* must be obtained. If that consent is obtained, all *rahn* interests of the same rank have proportionate interests in the encumbered asset determined by the amount of their respective secured obligations.[270] Interpretation and implementation of these principles are left to the jurists applying the principles of different schools.

The AAOIFI Standard provides that the priority afforded a secured creditor over an encumbered asset that is comprised of a debt that is possessed by the secured creditor is afforded first priority.[271] This is consistent with classical interpretations. It is also indicative of the importance of possession concepts in determining both the validity of a *rahn* and the priority of a *rahn*. It is unclear whether this principle will be extended to other intangible assets, but that would seem probable if the relevant jurist is of the opinion that intangible property constitutes "property" for Shari'ah purposes. Here, also, interpretation and implementation are left to the jurists applying the principles of different schools.

The AAOIFI Standard provides that the priority of a secured creditor in an encumbered asset is retained during the bankruptcy of the debtor.[272] If the proceeds realized upon the sale of that encumbered asset are less than the outstanding amount of the secured obligation (plus expenses, presumably), the secured creditor is treated as an unsecured creditor with respect to the recovery of the shortfall.[273] This position is consistent with classical interpretations of the relevant Shari'ah principles.[274]

Under classical interpretations, *rahn* arrangements relating to a portion of a valid encumbered asset are treated differently, under the Shari'ah principles, than *rahn* arrangements with respect to the entirety of the encumbered asset, whether the encumbered asset is a single asset or more than one asset.

A second *rahn* with respect to a portion of the *marhun* (encumbered asset(s)) under the first *rahn* is subject to the rules discussed in sections 7.2.2(a) and 7.2.2(g)regarding *rahn* arrangements with respect to unidentified portions of property.

The Hanbalis, Malikis, and Shafi'is allow a *rahn* of unidentified portions of property. Therefore, if an unidentified portion of a property constitutes the *marhun* for one secured obligation, then the remaining unidentified portion of that property may be subject to a valid *rahn*, and may constitute a valid *marhun* (a) for a second secured obligation or (b) additionally as *marhun* for the first secured obligation, whether to the same secured creditor or another secured creditor. If the second *rahn* is to a second secured

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269 AAOIFI Standard, *supra* note 14, at § 3/2/3.

270 AAOIFI Standard, *id*., at § 3/2/3.

271 AAOIFI Standard, *id*., at § 3/2/12. Possession by the secured creditor is effected by possession of the document evidencing the debt obligation or creating the debt obligation (it is unclear) or by attestation of the debt at the time it is made subject to the *rahn*.

272 AAOIFI Standard, *id*., at § 3/5/3.

273 AAOIFI Standard, *id*., at § 3/5/3.

274 See the discussion in section 10.2.

creditor, then it is necessary to obtain the consent of the second secured creditor for the continuing possession by the first secured creditor, or to appoint an *'adl* by mutual agreement of the debtor and each of the first and second secured creditors.

The Hanafis do not permit a *rahn* on an unidentified portion of a property. The second *rahn* issues thus do not arise in the case of the Hanafis with respect to partial property arrangements.

The Hanafis, Hanbalis, and Shafi'is rule that it is not permissable to grant a second *rahn* on the entirety of the *marhun* (whether a single asset or more than one asset) that is subject to a first *rahn*.[275] They provide an exception to this rule, where the secured creditor under the first *rahn* gives consent to the second *rahn* over the same *marhun*. In the case of that exception, the first *rahn* is voided and the second *rahn* constitutes a valid *rahn* whose *marhun* is now the object that was previously the *marhun* for the first *rahn*.[276]

These three schools permit a secured creditor that has received a *marhun* to grant a security right in that *marhun* to a second secured creditor with the permission of the owner of the *marhun* (i.e., the original grantor). The consequence of this arrangement is that the first *rahn* is voided and the second *rahn* is treated as the equivalent to the grant of a *rahn* in a borrowed property.[277] If the secured creditor under the first *rahn* grants the second *rahn* without the consent of the owner of the *marhun*, the second *rahn* is void and the original grantor has the right to demand the return of the *marhun* to the first secured creditor.[278]

For the Malikis, it is generally permissible to grant a *rahn* in an existing *marhun* (encumbered asset or group of assets) so long as the value of the encumbered asset(s) exceeds the amount of the first secured obligation. This general rule is subject to some qualifications. The Malikis then afford the second secured creditor a second priority in the *marhun;* repayment of the first secured obligation has first priority and the second priority is applicable only to the excess of the value (e.g., sale proceeds) of the *marhun* over the amount of the first secured obligation.

As a qualification, the Malikis rule that the consent of a trustee (*'adl*) is required to retain the trustee if the encumbered asset is in the possession of a trustee at the time of the making of the second *rahn*. This qualification applies whether or not the second secured creditor is the same as the first secured creditor.

Another qualification pertains to the consent of the first secured creditor where there is a second *rahn* involving the same encumbered asset. There are three positions regarding this consent: (i) it is not required; (ii) it is required; and (iii) the second *rahn* is not permissable whether or not the first secured creditor provides consent.

If, under Maliki interpretations, the second *rahn* is permissible, then the maturity dates of the first secured obligation and the second secured obligation must be ascertained.

- No particular issues arise if the maturity dates are the same.
- If the first secured obligation matures before the second secured obligation, then the encumbered asset may not be sold prior to the maturity of the first secured obligation (leaving aside considerations pertaining to perishable property for the moment). Sequential payments will then be made to the first secured creditor, until payment in full of the first secured obligation. Thereafter, the excess will be paid to the second secured creditor as an encumbered asset for the second secured obligation.

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275 See, e.g., Majelle, *supra* note 14, article 743, with respect to the Hanafis.

276 See, e.g., Majelle, *id*., articles 743-745, with respect to the Hanafis.

277 Section 7.2.2(e) discusses the considerations attendant upon a *rahn* of a borrowed property.

278 With respect to the implications for loss, damage, and destruction scenarios, see sections 7.2.2(g) and 14.

- If the second secured obligation matures prior to the maturity of the first secured obligation, the encumbered asset is divided between the two secured obligations (assuming division does not reduce the value of the encumbered asset). The first secured creditor is repaid first, until repayment in full, and the excess, if any, is then paid to the second secured obligation.

The same principles apply where the encumbered asset is not divisible and must be sold as an entirety.

With respect to acquisition of security rights, the AAOIFI Standard permits a seller to stipulate a condition in a sale contract that the purchaser grant to the seller, after actual or legal possession of the asset that is sold, a *rahn* in the asset to secure payment of the purchase price. There is no special priority allocated to such a *rahn* under the AAOIFI Standard.[279]

The Shari'ah does not provide for relative differentiation in competing priorities that relate to the type of property over which the *rahn* is granted (e.g., negotiable instruments and documents, bank accounts, etc.) or the manner in which the *rahn* is made effective. This may be due to the historical focus on possession concepts.

As a generalization, all security rights over different types of property are treated equally. Previous discussions in this report have noted individual circumstances in which the rights of different parties to a transaction or series of transactions are afforded specific rights with respect to specific types of properties.

Shari'ah scholars and jurists have only recently begun considering the implications of registration regimes, and there is no developed body of interpretations regarding issues pertaining to registration concepts. For example, there are no published interpretations of the relative priorities of competing security rights where one such right is possession-based and the other is registration-based.

[279] AAOIFI Standard, *supra* note 14, at § 3/2/7.

11 SALES, TRANSFERS, LEASES, AND LICENSES

SUMMARY OVERVIEW SALES, TRANSFERS, LEASES, AND LICENSES	
SME NEED	SMEs frequently are unable to purchase essential properties that are used in the SME's business and must lease or license those properties from others who have granted security rights in those properties. If those pre-existing security rights, and their relative priorities, are defeated or diminished, the properties will not be made available to SMEs.
MODEL LAW	Registration in specialized registries or by title certificate is given preferred status. A security right in an encumbered asset that is made effective against third parties by registration in specialized registries or by title certificate has priority over other security rights in that same asset that are made effective by any other method, regardless of the order of registration. Buyers, transferees, lessees, and licensees of encumbered assets that are registered in a State-designated special registry or by title certificate are subject to that registry or title security right, with limited exceptions.
	A buyer, transferee, lessee, or licensee of an encumbered asset acquires its rights subject to a security right in that encumbered asset that is effective against a third party at the time of the sale, transfer, lease, or license, with certain express exceptions. One such exception is secured creditor authorization of the sale, transfer, lease or license free of the security right.
SHARI'AH	Registration concepts are not addressed, and the implications of registration systems are currently being considered by Shari'ah scholars. The early trend seems to be recognition of registration as a substitute for possession.
	Sales, other dispositions, transfers, leases, licenses, and similar transactions are analyzed separately where conducted by the debtor or conducted by the secured creditor. The rules in each case are detailed and factually dependent. The Malikis and the Hanafis consider these dealings by a debtor to be suspended pending secured creditor election as to whether to void the transaction or permit the transaction and void the security right so as to allow the purchaser or other recipient to take the relevant property free of the security right, although these schools differ in analytical approach. The Hanbalis and Shafi'is consider any such dealings without secured creditor consent to be invalid. Secured creditors are not permitted to conduct such dealings in encumbered assets without the consent of the grantor of the security right. The suspension and invalidity approaches of the various schools are similar to those applied to debtor actions.
AAOIFI	AAOIFI recognizes registration in a security rights registry as a valid substitute for possession. The AAOIFI Standard does not address sales, other dispositions, licenses, loans, and other dealings in encumbered assets (leaving those matters to classical principles as applied in the contemporary context).
RECONCILIATION SUGGESTION	The AAOIFI position regarding registration is a good base (this is discussed elsewhere in this Report). The Model Law provisions are largely harmonious with Shari'ah principles, especially with respect to the underlying principle of protection of any valid security right (although the suspension concepts applied by the Malikis and Hanafis are not found in the Model Law). Discussion with Shariah scholars should focus on understanding Shari'ah principles in the context of the Model Law provisions and harmonizing the two sets of rules.

11.1 Model Law Provisions

The provisions of the Model Law pertaining to the rights of buyers, other transferees, lessees, and licensees are set forth in two parts. The first part sets forth general principles. The second part sets forth principles applicable to specific categories of assets: negotiable instruments; rights to funds credited to a bank account; money; negotiable documents and tangible assets covered by those negotiable documents; certain licenses of intellectual property; and non-intermediated securities. For the most part, these are discussed separately in this section, beginning with the general principles.

A buyer, transferee, lessee, or licensee of an encumbered asset acquires its rights subject to a security right in that encumbered asset that is effective against a third party at the time of the sale, transfer, lease, or license, with certain express exceptions.[280] One such exception is where the secured creditor authorizes the sale or other transfer free of the security right.[281]

Similarly, the rights of a lessee or licensee of an encumbered asset are not affected by the security if the secured creditor authorizes the grantor to lease or license the asset unaffected by the security right.[282] The rights of a lessee of a tangible encumbered asset or a licensee of an intangible encumbered asset in the ordinary course of the lessor's or licensor's business are unaffected by the security right if the lessee or licensee, at the time of the conclusion of the lease or license agreement, does not have knowledge that the lease or license violates the rights of the secured creditor under the security agreement.[283] If the rights of a lessee of a tangible encumbered asset or of a licensee of an intangible encumbered asset are not affected by a security right, the rights of any sub-lessee or sub-licensee are also unaffected by that security right.[284]

The principles of the Model Law applicable to buyers are similar. A buyer of a tangible encumbered asset sold in the ordinary course of the seller's business acquires its rights free of the security right if, at the time of conclusion of the sale agreement, such buyer does not have knowledge that the sale violates the rights of the secured creditor under the security agreement.[285] If a buyer or other transferee of a tangible encumbered asset acquires its rights free of a security right, any subsequent buyer or subsequent transferee also acquires its rights free of that security right.[286]

Under the Model Law, registration in specialized registries or by title certificate is given preferred status. Thus, a security right in an encumbered asset that is made effective against third parties by registration in specialized registries or by title certificate has priority over each other security right in that same asset that is made effective by any other method, and regardless of the order of registration.[287] Buyers, transferees, lessees, and licensees of encumbered assets that are so registered in a State-designated special registry or by title certificate are subject to that registry or title security right, except as provided in Paragraphs 2–8 of Article 42 of the Model Law.[288] If a security right is permitted to be made effective by registration in such a State-designated special registry or by title certificate, and is not made

[280] Model Law, Article 42, ¶ 1. The Note to the Working Group for this Article clarifies that the exceptions to ¶ 1 apply only to buyers, transferees, lessees and licensees and not to domes or other gratuitous transferees.
[281] Model Law, Article 42, ¶ 2.
[282] Model Law, Article 42, ¶ 3.
[283] Model Law, Article 42, ¶¶ 5 (leases) and 6 (licenses). This statement, regarding licenses, is subject to other laws of the State, if any, relating to intellectual property (see Article 59 of the Model Law).
[284] Model Law, Article 42, ¶ 8.
[285] Model Law, Article 42, ¶ 4.
[286] Model Law, Article 42, ¶ 7.
[287] Model Law, Article 43, ¶ 1.
[288] Model Law, Article 43, ¶ 2.

effective by that permissible means, then a buyer, transferee, lessee, or licensee acquires its rights unaffected by the security right.[289]

11.2 Shari'ah Provisions

Registration concepts are not addressed in classical Shari'ah interpretations, and thus are not afforded any preferred (or other special) status. The AAOIFI Standard acknowledges the registration concept, but only within the classical possession-based paradigm. Thus, registration is recognized as possession within, and for the purposes of, existing Shari'ah principles.[290] The rules applicable to sales, other dispositions, leases, licenses, loans, and other dealings with respect to the encumbered asset are analyzed based upon whether they are effected by the debtor-grantor or the secured party, with variations by jurisprudential school also affecting the analysis. The AAOIFI Standard does not address sales, leases, loans, and gifts of encumbered assets; these matters are left to interpretations under classical principles.

11.2.1 By Debtor

As noted, the *rahn* contract becomes binding (a) upon valid offer and acceptance for the Malikis and under the AAOIFI Standard, but (b) only upon delivery and receipt of the encumbered asset for the Hanafis, Hanbalis, and Shafi'is. These positions have consequences for various dealings in the encumbered asset, including sales, leases, and gifts of the encumbered asset.

Sales prior to delivery to and receipt of the encumbered asset by the secured creditor present particular issues for Maliki jurists. Recall that the debtor can be required to deliver the encumbered asset after a valid offer and acceptance has made the *rahn* contract binding.

If the secured creditor is negligent or not diligent in demanding delivery of the encumbered asset, a sale of the encumbered asset by the debtor after offer and acceptance, but prior to delivery and receipt, will be honored as a valid sale by the Malikis and the underlying obligation is not insured by the encumbered asset. That is, the security right of the *rahn* will not attach to the sold property.

If the secured creditor is diligent in demanding the delivery of the encumbered asset, but the debtor sells the encumbered asset to a third party anyway, the Malikis take three different positions. Some jurists allow the sale to be consummated and substitute the purchase price for the sold object as the encumbered asset. Other jurists allow the third party sale, and substitution of the purchase price as the encumbered asset if the sold object was delivered to the third-party purchaser, and allow voiding of the sale by the secured creditor if the sold object is not yet delivered. A minority of Malikis allow the sale to proceed and do not substitute the purchase price as the encumbered asset (leaving the creditor unsecured). In each case, the purchaser of the property acquires the property free of any security right under the *rahn*.

If the debtor and the secured party each allow the post-offer-and-acceptance, pre-delivery sale of the encumbered asset, the Malikis hold that the sale is valid and executed, but differ in their analysis of whether or not the sale proceeds are substituted for the sold object as an encumbered asset.

The Hanafis, Hanbalis, Malikis, and Shafi'is each address issues related to sales, leases, loans, gifts, and other dealings that arise after the encumbered asset has been received by the secured creditor. The various positions are of importance in the context of contemporary commercial financial arrangements. As a general, introductory principle, a debtor sale of the object that is to become an encumbered property prior to delivery to and receipt by the secured creditor is valid because the *rahn* contract is not binding until delivery and receipt has occurred. Thus, the purchaser takes the property unburdened by the security right and the asset is not available to become subject to the security right (unless the purchaser

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289 Model Law, Article 43, ¶ 3.

290 See, e.g., AAOIFI Standard, *supra* note 14, § 3/1/2.

were to make it subject to the security right). As a general rule, sales of encumbered assets without secured creditor consent are invalid.

The rulings of the Malikis are the simplest. The Malikis rule that all unauthorized dealings (sales, leases, loans, gifts, etc.) of the encumbered asset are deemed suspended pending the election of the secured creditor as to whether (a) the dealing is voided by the secured creditor and the *rahn* is continued, or (b) the dealing is permitted by the secured creditor and the *rahn* is invalidated (even if the debtor does not in fact consummate the dealing).

The Shafi'is establish the general principle that the debtor is not permitted to deal in the encumbered asset in any manner that transfers ownership to a person other than the secured creditor without the consent of the secured creditor. This principle addresses sales, other dispositions, and gifts. The Shafi'is do not allow a *rahn* of an encumbered asset that is subject to an existing *rahn*. They do allow leasing of the encumbered asset so long as the final maturity date of the lease (*ijara*) occurs prior to the maturity date of the secured obligation. In all instances, the sale, other disposition, lease, loan, gift, or other dealing is valid if it is with the secured creditor or with the consent of the secured creditor. However, in all such cases, other than leasing of the encumbered asset, the security right is rendered void. As such, the lessee takes the property unburdened by the security right. In the case of a lease, the security right continues and the lessee takes under the lease subject to the security right.

The Hanbalis concur that dealings in the encumbered asset without secured creditor permission are invalid, and the security right stays in effect. Dealings with secured creditor permission are valid, but the security right is then rendered void, except in the case of leases and simple loans. Thus, in all "dealings" arrangements, other than leases and simple loans, the purchaser, transferee, lessee, or licensee takes the property unburdened by the security right. In the case of leases and simple loans, the lessee and borrower take subject to the security right.

The position of the Hanafis is different: it involves suspension and consent concepts. The Hanafis begin their analysis from the principle that a sale of the encumbered asset without the permission of the secured creditor is suspended. The sale becomes valid and executable if (i) the secured creditor permits the sale, (ii) the debtor repays the underlying secured obligation, or (iii) the secured creditor absolves the debtor of the secured obligation.

In the first and third of these situations, the purchase price is substituted as the encumbered asset. Therefore, the purchaser takes the property free of the security right of the *rahn*.

If the secured creditor does not give permission for the sale, the sale remains suspended (but not voided). If the purchaser under the sale arrangements was not aware of the existing *rahn*, that purchaser will be given the option of waiting until the encumbered asset is released from the *rahn* to effect the sale or asking the judge to void the sale.

Similarly, if the debtor leases, loans, or gifts the encumbered asset or subjects the encumbered asset to a second *rahn*, the dealing is suspended pending the secured creditor's permission. If the dealing is a lease, the lease is binding and the permission of the secured creditor invalidates the security right (a lease to the secured creditor also invalidates the security right). Thus, the lessee takes the property unburdened by the security right. The same invalidation of the security occurs if the dealing is a security right or gift of the encumbered asset to the secured creditor.

The security right is not invalidated if the dealing is a loan of the encumbered asset to the secured creditor. In the case of such a loan, however, the secured creditor no longer guarantees the encumbered asset. Any loss, damage, or destruction of the encumbered asset while in the secured creditor's possession for use as a borrower is treated as a possession of trust (with full value liability attaching only for secured

creditor transgression or negligence). This relief of guarantee of the encumbered asset does not apply to any period before or after the period of use by the secured creditor.

11.2.2 By Secured Creditor

A secured creditor is not permitted to deal in the encumbered asset without the consent of the grantor of the security right: that is the base principle. The Hanbalis and Shafiʻis rule that any unauthorized dealings by the secured creditor are invalid and void because the secured creditor is not the owner of the encumbered property. For these schools, the *rahn* remains valid and continues. Generally stated, the Hanafis and the Malikis adopt concepts of suspension and consent to address secured creditor dealings.

If the sale, simple loan, or gift by the secured creditor is consummated with the permission of the debtor, the security right is invalidated. If the debtor consents to the sale, loan, or gift, it is executed (and, presumably, the sale proceeds are substituted for the sold asset). Thus, the purchaser or recipient is unburdened by the security right. In the case of a lease, the lease is effected, the lessee takes the property subject to the security right, and (A) the rent belongs to the secured creditor if the debtor did not consent to the lease, and (B) the rent belongs to the debtor if the debtor did consent to the lease. As a result, the lessee or borrower takes subject to the *rahn*.

The Maliki position is that the unauthorized dealings by the secured creditor are suspended pending authorization (or denial of authorization) by the debtor.

If the debtor gives permission, the sale, lease, loan, gift, or other dealing is executed. In the case of a sale, the sale proceeds are substituted as the encumbered asset. In the case of a sale or gift, the security right becomes voided.

If the debtor consents to a lease with a maturity date after the maturity date of the secured obligation, the security right is voided.

Similarly, a consensual lease that has a maturity date prior to the maturity date of the secured obligation is voided if the lessee is not required by the lease agreement or convention to return the asset upon termination of the lease.

The security right is not voided, and remains in effect, if the lease maturity date ends prior to the maturity date of the secured obligation and the lessee is bound, by contract or convention, to return the leased asset at the end of the lease term.

For the Hanbalis and Shafiʻis, a sale, lease, loan, or gift by the secured creditor without the permission of the debtor is invalid, and the security right continues.

A sale, lease, loan, or gift by the secured creditor with the consent of the debtor is executed. In the case of a sale, the sale proceeds are substituted for the sold asset as the encumbered asset. If such a transaction involves a sale or gift, the security right is voided upon the consummation of the sale or gift.

If the transaction is a lease or a loan, the security right is not voided, and the lessee or borrower takes subject to the security right.

12 Preservation, Use, Sale, and Lease of an Encumbered Asset

GENERALIZED SUMMARY PRESERVATION OF AN ENCUMBERED ASSET AND RELATED EXPENSES	
SME NEED	
MODEL LAW	The responsible party must take reasonable steps to preserve the encumbered asset and its value. The Model Law has not yet determined which party has the preservation obligation. A secured creditor in possession of the encumbered asset has the right to reimbursement for reasonable expense incurred in connection with the preservation of the asset.
SHARI'AH	The basic principle is that the secured creditor's right to hold the encumbered asset implies an obligation to safeguard that asset in the same manner the secured creditor would safeguard its own property. The different schools of Islamic jurisprudence have different positions on responsibility where there is loss, damage, or destruction of the encumbered asset that is attributable to the secured creditor or its nominee or permissible user. These responsibility rules turn on whether the possession is one of guarantee (Hanbali, Maliki, Shafii) and thus make the secured creditor responsible for the entire value of the asset, or a possession of trust (Hanafi) and thus make the secured creditor responsible for the full value of the asset only if there has been usurpation or transgression by the secured creditor or its nominee or permissible user. See section 14 of this Report.
	Regarding expenses, there are two general principles. First, the debtor-grantor is responsible for expenses of safeguarding the encumbered asset (without reimbursement from the debtor) and the debtor is responsible for expenses relating to upkeep, preservation, and use of that asset. All four schools and AAOIFI adhere to this principle, although the Hanafis allocate expenses for safeguarding the asset to the secured creditor on an unreimbursable basis. Second, if either the debtor or the secured creditor pays expenses that the other is required to pay, the payment is considered a non-recoverable gift (this principle has exceptions). The primary differences among the schools of Islamic jurisprudence relate to situations in which the encumbered asset is lost, damaged, or destroyed, or otherwise sufferes a diminution in value.
AAOIFI	The AAOIFI Standard provides that the debtor should bear all expenses relating to preservation of the encumbered asset against decay, diminution, and reparation. Payment by the secured creditor of debtor expenses gives rise to a right of reimbursement to the secured creditor.
RECONCILIATION SUGGESTION	The AAOIFI Standard is a good base, and is consistent with the Model Law and contemporary financing practices.

GENERALIZED SUMMARY USE OF AN ENCUMBERED ASSET	
SME NEED	Use of encumbered assets by SMEs during the term of a security right(s) on those assets is critically important to SMES. In most, if not all circumstances, they have no assets other than the encumbered assets.
MODEL LAW	A secured creditor in possession of an encumbered asset has the right to make reasonable use of that asset and the right to apply monetary proceeds of the asset to payment of the secured obligation.
SHARI'AH	Only the Shafi'is allow the debtor to use the encumbered asset during the term of the security right. They permit secured creditor use only with the permission of the debtor. And they allocate benefits of use of the encumbered asset to the debtor. The Hanafis allow debtor use of the encumbered asset only with secured creditor consent. Any benefit of that asset that is taken by the secured creditor is to be applied to the secured obligation. Secured creditor use of that asset is prohibited, by some interpreations even if the debtor has consented. The Hanbalis allow debtor use only with the consent of the secured creditor. Secured creditors are not permitted to use the encumbered asset (with very limited exceptions). If the debtor and secured creditor cannot agree on use arrangements, the encumbered asset will be left unused (despite principles in aversion to waste of an asset). The Maliki positions are the strictest. They prohibit debot use of the encumbered asset entirely. If the secured creditor consents to debtor use, the security right is invalidated (even if the debtor does not actually use that asset). Secured creditor use of the encumbered asset is prohibited in all circumstances, save one (where the security right secures a sales contract, and then only subject to conditions).
AAOIFI	The AAOIFI Standard allows debtor use of the encumbered asset with secured creditor consent. The secured creditor has no right to use the encumbered asset free of charge, whether or not the debtor has consented to such creditor use. If the debtor gives permission for creditor use, the secured creditor must pay to the debtor "normal pay" for similar assets.
RECONCILIATION SUGGESTION	The AAOIFI Standard is a good base, and is largely consistent with the Model Law and contemporary financing practices (other than with respect to the "normal pay" provisions).

12.1 Model Law Provisions

As a general principle of the Model Law, the rights and obligations of the parties to a security agreement are determined by (a) the terms and conditions of the security agreement, and (b) usages to which the parties to the security agreement have agreed and practices that have been established between those parties.[291] The intention is to allow the parties to structure their relationship in accordance with their particular needs, and to "give legislative strength to trade usages agreed upon by the parties and trade practices established between them".[292]

[291] Model Law, Article 61.

[292] Model Law, Article 61, Note to the Working Group. This Notice to the Working Group indicates that the Guide to Enactment of the Model Law, when prepared, will address the burden of proof if the effectiveness of the agreement is challenged on grounds of inconsistency with these provisions. Specifically, it will place the burden of proof on the party challenging effectiveness on these grounds.

The Model Law addresses preservation of an encumbered asset and its value. The rule is that the responsible party "must take reasonable steps to preserve the asset and its value."[293]

However, no definitive determination has yet been made as to which party or parties have preservation obligations. The issue primarily depends on who has possession of the encumbered asset. Thus, the current draft of the Model Law leaves open the matter of whether preservation obligations will be imposed upon (i) the grantor in possession, (ii) the secured creditor in possession, (iii) only the secured creditor, or (iv) the grantor. Other factors affecting the ultimate form of this provision are the particular circumstances of the transaction and arrangement and whether the asset is a tangible asset or an intangible asset.

A secured creditor in possession of the encumbered asset has certain defined rights. These include rights to:

- Be reimbursed for reasonable expenses incurred for preservation of the asset;
- Make reasonable use of the asset; and
- Apply monetary proceeds of the asset to payment of the secured obligation.[294]

If the encumbered asset is in the possession of the grantor, the secured creditor has the right to inspect the encumbered asset at reasonable times and in a reasonable manner.[295]

The points to note, in terms of the comparison with Shariʻah principles and rules, are (a) that the secured creditor has the right to reimbursement for all reasonable expenses for preservation of the asset (and the concept of "preservation of the asset" is likely to be broadly construed), and (b) that the secured creditor has the right to make reasonable use of the asset. As noted in the next section, the applicable Shariʻah principles and rules are somewhat different.

12.2 Shariʻah Provisions

Not surprisingly, the four jurisprudential schools vary in their interpretations of the Shariʿah principles of relevance to (a) preservation of the encumbered asset during the term of the *rahn*, (b) expenses relating to the encumbered asset during the term of the *rahn*, and (c) use of the encumbered asset during the term of the *rahn*. This section discusses each of these topics.

12.2.1 Preservation of Encumbered Asset

The basic principle of preservation of the encumbered asset under relevant Shariʻah principles is that the secured creditor's right to hold the encumbered asset (which is property owned by the debtor or other grantor, not the secured creditor) implies an obligation to safeguard the property in the manner that the secured creditor safeguards its own property (and thus to have responsibility for expenses relating to safeguarding that asset). The nature of the possession is a critical determinant of the preservation obligation of the secured creditor. Safeguarding expenses are discussed in section 12.2.2.

Whether a debtor or secured creditor has performed the obligations for which it is responsible concerning allocable categories of expenses will influence the determination of whether safeguarding of

[293] Model Law, Article 62.

[294] Application of the proceeds to the secured obligation was previously discussed, and is further discussed in section 15, but is not discussed in this section.

[295] Model Law, Article 64.

the encumbered asset has been adequate in many circumstances and, of course, will affect the interpretations of different schools as to allocations of responsibilities and liability exposures.[296]

As discussed, for the Hanafis, a *rahn* possession is a possession of trust (as are deposits). In the normal course of events, the secured creditor will be responsible for the full value of the encumbered asset only if the secured creditor usurps or transgresses (or allows a usurpation or transgression). If, however, the secured creditor does not perform its safeguarding responsibilities in accordance with the relevant standards, the secured creditor is deemed by the Hanafis to hold as a possession of guarantee. In such a case, the secured creditor is liable for the full value of the encumbered asset.

As noted, Hanbali, Maliki, and Shafiʻi jurists and scholars rule the possession of the secured creditor to be a possession of guarantee and therefore impose a more rigorous standard in all circumstances, making the secured creditor responsible for the full value of the encumbered asset.

A secured creditor that has possession of the encumbered asset may deposit the encumbered asset with a third party depositary.[297] The rules of responsibility for the guarantee of the value of the encumbered asset, as between the secured creditor and the depositary, vary by jurisprudential school and even within each school.

The issues become apparent where the encumbered asset is lost, damaged, or destroyed while in the possession of the depositary. The Hanafis differ among themselves, and their positions are illustrative of the range of interpretations. Some Hanafis (ʼAbu Hanifa, for example) take the positon that the secured creditor remains obligated to guarantee the value of the encumbered asset, and that the depositary is not obligated for such guarantee. Others (such as ʼAbu Yusuf) hold that both the secured creditor and the depositary guarantee the value of the encumbered asset, with the secured creditor being ultimately responsible in all circumstances.

A related group of Shariʿah principles relates to the concept of debtor negligence or transgression (including willful misconduct) in connection with preservation responsibilities where that negligence or transgression causes a diminution in the value of the encumbered asset or its loss, damage, or destruction. These principles apply where the debtor has preservation responsibilities. To provide some perspective on current practice, under the Saudi Arabian mortgage law, if there is a decrease in the value or loss, damage, or destruction of the encumbered asset that is the result of the debtor's negligence or willful misconduct, the secured creditor (i) may require immediate payment of the debt in full, or (ii) may demand additional security.[298]

12.2.2 Expenses Relating to Encumbered Assets

Other fundamental principles relate to the obligations of the debtor and the secured creditor with respect to various expenses relating to the encumbered asset. The discussion begins with two general principles.

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[296] See Majelle, *supra* note 14, article 741, and al-Zuḥaylī, *supra* note 13, at 166-69, including with respect to reductions in the underlying secured obligation in certain circumstances.

[297] The deposit contract (ʻ*act al-ʼide*ʻ) and deposits are discussed in al-Zuḥaylī, *supra* note 13, volume I, at 573-600, Ibn Rushd, *supra* note 14, Book XLV, at 375, and Hedaya, *supra* note 14, Book XXVIII, at 259. In summary, it is a contract for safekeeping of an asset that can be possessed physically. A deposit is a possession of trust in which the depositary is responsible for the value of the asset only upon transgression or negligence of the depositary. There are circumstances in which the possession of trust converts to a possession of guarantee (such as where the depositary uses the asset). There are also differences of interpretation where the depositary holds the asset for a secured creditor, as discussed in the text following this note.

[298] McMillen, Saudi Rahn, *supra* note 18.

- The first principle is that the debtor-grantor is responsible for the expenses of the encumbered asset (with some exceptions).[299] This principle is accepted by the Hanafis, Hanbalis, Malikis, and Shafi'is, and is also a principle of the AAOIFI Standard.[300]
- The second principle, is that if either the secured creditor or the debtor pays expenses that the other is obligated to pay, the payment is considered a non-recoverable gift.[301] This principle has some exceptions and varies in application by jurisprudential school.

Variation in interpretation begins with consideration of the types of expenses for which the debtor is responsible.

The AAOIFI Standard provides that the debtor should bear all actual expenses relating to preservation against decay, diminution, and "reparation" of the encumbered asset.

In addition, the secured creditor should bear all expenses relating to safekeeping, documentation, and selling of the encumbered asset, unless the debtor and the secured creditor agree that the debtor should bear these expenses.[302] It is rare in contemporary financing practice for the secured creditor to bear any of the expenses allocable to the secured creditor under the AAOIFI Standard, and thus debtor and secured creditor agreement on this matter is likely to be near universal.

If the secured creditor pays the expenses allocable to the debtor under the AAOIFI Standard, whether with or without the permission of the debtor, the secured creditor has the right of recourse against the debtor for reimbursement of the amount paid by or on behalf of the secured creditor or the secured creditor may obtain such reimbursement through a period of benefit (and use?) of the encumbered asset.[303] This is contrary to the second principle stated at the beginning of this section.

Beginning with classical Hanafi interpretations:

- The secured creditor is responsible for the expenses relating to the safeguarding (including storage) of the encumbered asset, without credit against the secured debt and without reimbursement from the debtor.[304]
- The debtor is responsible for upkeep, preservation and use of the encumbered asset, including repairs, watering, feeding, grafting, weeding, wages, and taxes, without credit or deduction against the secured debt.[305]
- With respect to medical expenses for an animal given as encumbered asset, the secured creditor is responsible up to the value of the secured obligation, and the debtor is responsible for any amount in excess of the value of the secured obligation.

The Hanbalis, Malikis, and Shafi'is have a different view (as does the Saudi Arabian mortgage law).[306] The debtor is responsible for expenses relating to the benefit, upkeep, and safeguarding, and for medical

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[299] This is based upon the following *hadith*: "A pawned object does not become property of the creditor, and the pawning debtor retains rights for its output and obligations for its expenses." See al-Zuḥaylī, *id.*, at 150, including footnote 12.

[300] With respect to the AAOIFI Standard, *supra* note 14, see § 3/2/10 of that Standard.

[301] See, e.g., Majelle, *supra* note 14, article 725, al-Zuḥaylī, *id.*, at 152, and AAOIFI Standard, *id.,* at § 3/2/10.

[302] AAOIFI Standard, *id.*, at § 3/2/10.

[303] AAOIFI Standard, *id*., at § 3/2/10.

[304] This may include the rent of the place where the *marhun* is kept and of any watchmen. See, e.g., Majelle, *id.*, article 723, and al-Zuḥaylī, *id.*, at 150-51.

[305] See, e.g., Majelle, *id.*, article 724, al-Zuḥaylī, *id.*, at 150-51 and Ibn Rushd, *supra* note 14, § 37.3.

[306] See, e.g., al-Zuḥaylī, *id.*, at 150-51, and, with respect to Saudi Arabian law, McMillen, Saudi Rahn, *supra* note 18.

expenses for an animal given as an encumbered asset. The basis for this interpretation is that the debtor is the owner of the encumbered asset, is entitled to its output, and is thus responsible for its expenses.

The schools take different positions as to whether the secured obligation is reduced in circumstances involving the loss of the encumbered asset or a diminution in the value of the encumbered asset.

The Hanbalis, Malikis, and Shafiʿis take the position that there is no reduction in the underlying secured obligation, absent transgression or negligence on the part of the secured creditor in connection with such loss or diminution.

The Hanafi position is that the secured creditor's possession is one of trust with respect to the encumbered asset and a possession of guarantee with respect to the financial aspect of the encumbered asset, up to the value of the encumbered asset. Thus, if the encumbered property perishes, the secured obligation is considered repaid up to the value of the encumbered property that is lost (i.e., there is a reduction in the underlying secured obligation in that amount). The amount of the secured obligation in excess of the lost value of the encumbered asset will continue to be payable. If the value of the lost encumbered asset is greater than the amount of the secured obligation, that amount is payable by the secured creditor only in cases of transgression or negligence by the secured creditor. Three conditions apply to the foregoing rules: (a) the secured obligation must exist at the time of the loss or damage; (b) the encumbered asset must have been lost or damaged while in the possession of the secured creditor or its agent or a trustee (and not while in the possession of the debtor or a third-party usurper or transgressor); and (c) the lost or damaged property must constitute part of the original encumbered asset (and not be an increase or growth).

Where there is a loss or decrease in value of the encumbered asset that results from third-party acts that are not attributable to the debtor, the lost value must be recovered from, and compensated by, the responsible third party. That compensation will then become an encumbered asset and subject to the security right that attached to the original encumbered asset.

There is divergence among these schools if the debtor refuses or fails to pay these expenses.

The Malikis allow the secured creditor to pay the expenses that are not paid by the debtor without seeking the permission of the debtor. The secured creditor may then seek compensation from the debtor, even if the compensation exceeds the value of the encumbered asset.

Under Shafiʻian interpretations, the secured creditor must seek judicial intervention to effect payment of the expenses. If the debtor is present and can afford to pay the expenses, the judge will force the debtor to pay the expenses. If the debtor is absent, the judge may take the expenses out of the property of the debtor, to the extent property is available. If the debtor has not paid the expenses because it is financially unable, the judge may (x) borrow to pay the expenses, (y) sell a portion of the encumbered asset to pay the expenses,[307] or (z) order the secured creditor to pay the expenses and establish the amount of the secured creditor's payments as a further debt of the debtor. If the secured creditor pays the expenses in accordance with a judicial order, the secured creditor may demand reimbursement from the debtor.

The Hanbalis require the creditor to seek the debtor's permission before the secured creditor pays expenses relating to the encumbered asset. Any payment by the secured creditor without debtor permission in circumstances where the debtor's permission could be sought results in a characterization of the secured creditor's payments as a voluntary charitable contribution to the debtor. If it is not feasible to seek the debtor's permission, the secured creditor may pay the expenses and seek compensation from the debtor in an amount equal to the lesser of the amount actually paid by the secured creditor and the normal amount of expenses in such a circumstance.

[307] Note that this is a circumstance in which a sale of the *marhun* is permissible prior to or at the maturity of the secured obligation.

12.2.3 Use of Encumbered Assets

(w) General Principles

The ability of the debtor-grantor to use the movable encumbered asset (*marhun*) during the term of the security right (*rahn*) is an especially important topic in the context of financings for SMEs. SMEs usually have little or no non-movable property to use as collateral for financings. Essentially all of the assets of an SME that are available for use as collateral are movable assets. Further, it is likely that the SME will require continuing use of the assets given as collateral so that they can continue to generate revenue during the term of the financing.

As noted, the Model Law permits the secured creditor to make reasonable use of an encumbered asset that is in the possession of the secured creditor. The rule is relatively simple.

The rules pertaining to use of encumbered assets (*marhun*) under the Shariʻah are both more complicated and less favorable to the debtor (such as an SME) that desires to continue to use the assets during the term of the finance.

A fundamental Shariʿah principle prohibits allowing a usufruct of a property to go to waste. In general terms, property (including the usufruct) is to be used, not wasted, including during the term of a *rahn.* The rules pertaining to use by the debtor and by the secured creditor have been developed with this no-waste-of-usufruct principle as a background. There are different interpretations of the use rules.[308]

In considering the structure of the Model Law, as modified for a jurisdiction in which the Shariʿah is applied, careful consideration must be given to the precise interpretations that will be applied to principles regarding (a) use of the encumbered property, (b) waste of the usufruct of the encumbered property, and (c) the interplay of use and waste principles in the entire set of permutations involving debtor use, secured creditor use, and the impact of decisions to allow or prohibit each of those uses. The views of the various jurisprudential schools diverge on some of these matters.

(x) Shafiʻian Positions

The Shafiʻis stand alone in allowing the debtor to use the encumbered asset during the period of the *rahn*, without limitation, except that the debtor use may not harm the secured creditor. This would prohibit use if the use resulted in a material diminution in the value of the encumbered asset, for example.

The basis for the interpretations of the relevant principles by Shafiʿian jurists is that the debtor (or grantor, if different than the debtor) owns the encumbered property. As a result, the debtor is entitled to use and extract all usufruct from the encumbered asset, with or without consent from the secured creditor. Preservation of collateral value is ensured through application of principles to the effect that the debtor may do no harm in using and extracting value from the encumbered property, and may not do anything that decreases the value of the encumbered property, without authorization from the secured creditor.

Proceeding from the doctrinal base of debtor ownership, secured creditors are prohibited from using the encumbered asset during the term of the *rahn* and, generally, benefits from the use of the encumbered asset accrue to the debtor. The Shafiʿis provide an exception, and allow the benefit of the usufruct to accrue to the secured creditor in certain sales arrangements where the usufruct is of a known amount at the inception of the sales contract and the *rahn* is stipulated in the sales contract (e.g., where a sale and a lease are combined in one contract). A minority of Shafiʿian jurists allow secured creditor use with debtor permission if the *rahn* contract does not specify use matters.

[308] See al-Zuḥaylī, *supra* note 13, at 152-65. See, also, Ibn Rushd, *supra* note 14, § 37.1.3.

The principles of debtor use are compatible with contemporary financing practices and are favorable to the SMEs that need to use the properties constituting encumbered assets during the term of the *rahn*. The critical issues, from the secured creditor's perspective, relate to application of the revenue (or other proceeds) generated by operation of the encumbered asset during the term of the *rahn*. The proceeds will not be available to pay the secured obligation unless (a) a separate valid *rahn* can be created in those revenues or other proceeds, or (b) those proceeds are subject to the existing *rahn*.[309] Obtaining a valid *rahn* interest in unknown future properties (such as these types of proceeds) may be difficult.

The principles of secured party use, where that use is restricted and benefits may not accrue to the secured creditor, limit the ability of a secured creditor to use the encumbered asset as a remedial action and apply the revenue from operation or use of the encumbered asset to the secured obligation. Thus, sale of the encumbered asset may be the only available remedy.[310]

(y) Hanafian Positions

The usufruct of an encumbered asset is part of the encumbered asset and, as such, is subject to the security right on property constituting the encumbered asset.[311] In most instances, the debtor is permitted to use the encumbered asset only with the permission of the secured creditor. However, if the debtor can benefit from the encumbered asset without taking possession of it (e.g., a machine or land), then the benefit or output belongs to the debtor. If the secured creditor takes the benefit, it is deducted from and cancelled against the secured obligation.

If the debtor uses the encumbered asset without the permission of the secured creditor, the debtor must guarantee the value of the extracted use to the secured creditor. The debtor is considered a usurper and transgressor on the secured creditor's rights, and the secured creditor's guarantee is absolved. Among the consequences for the usurpation and transgression, the debtor could be compelled to return the encumbered asset to the secured creditor and the debtor would be liable if the encumbered asset were lost, damaged, or destroyed during the debtor possession.

Use of the encumbered asset by a secured creditor is prohibited, as a general principle, but there are variations in interpretive positions within the Hanafi school. One position (which may be the most common) is that debtor permission is required for a secured creditor to use the property. A second position is that the secured creditor is never permitted to use the encumbered asset, even with the consent of the debtor. A third, and middle, positon precludes secured creditor use if that use is stipulated in the contract but allows it if debtor permission is given but not stipulated in the contract.

The debtor-use-with-permission rule is compatible with contemporary financing practices. The debtor (e.g., an SME) will be able to use the movable asset to generate revenue for its business and to repay the secured obligation. The secured creditor will be obligated to apply any proceeds against the secured obligation.

Whether the secured creditor may use the encumbered asset in a remedies scenario will depend upon the specific Hanafi Shari'ah scholar that makes the determination regarding permissibility. Some will allow this remedy with debtor permission, while others will not.

[309] Of course, the nature of the proceeds is a critical factor. See, e.g., the discussion in section 8.2 as to whether the proceeds or accretions to the *marhun* are subject to the existing *rahn* on the existing *marhun*.

[310] See section 15.

[311] See, also, Majelle, *supra* note 14, article 715, and section 8.2.

(z) Hanbalian Positions

The usufruct of an encumbered asset is part of the encumbered asset and, as such, is subject to the security right on the encumbered asset. In most instances, the debtor is permitted to use the encumbered asset only with the permission of the secured creditor. However, if the debtor can benefit from the encumbered asset without taking possession of it (e.g., a machine or land), then the benefit or output belongs to the debtor. These interpretations are thus essentially the same as the Hanafis, with respect to debtor use.

Secured creditors are generally not permitted to use the encumbered asset, other than animals that require feeding, without the permission of the debtor. There are specific rules applicable to situations in which the secured obligation is a loan. In those situations, secured creditor use of the encumbered asset is permissible only if the secured creditor pays compensation (usually at market rates) to the debtor.[312]

In certain limited circumstances, the Hanbalis do allow the secured creditor to take the benefit of the usufruct of an animal. The compensation must be milk from the animal or riding of the animal and the value of the milk or riding must be equal in amount to the expenditures made by the secured creditor in feeding and caring for the animal.

The Hanbalis add a provision that the property will remain unused (despite the aversion to waste) if the debtor and secured creditor cannot agree on allowing one or the other to benefit from the use of the encumbered asset.

The debtor-use-with-permission rule is compatible with contemporary financing practices. The debtor (for example, an SME) will be able to use the movable asset to generate revenue for its business and to repay the secured obligation. The secured creditor will be obligated to apply any proceeds against the secured obligation. In this connection, the consequences of inability of the debtor and creditor to agree on use and allocation of benefits of use are that the encumbered asset is not used by either the debtor or secured creditor.

The Hanbali position seems to prohibit a secured party remedy that includes use by or on behalf of the secured party, except in the loan circumstance noted above (and in the case of animals that require feeding).

(aa) Malikian Positions

The Maliki school has the strictest interpretations of *rahn* principles pertaining to use of the property during the term of the *rahn*. The debtor is prohibited from using the encumbered asset in essentially all circumstances. Permission from a secured creditor allowing debtor use invalidates the *rahn,* even in circumstances where the debtor does not actually use the encumbered asset.

The analysis of rulings regarding secured creditor use of the encumbered asset provides for eight scenarios. Secured creditor use is prohibited in seven of those scenarios.[313] Secured creditor use is permitted only if the security right secures a sale contract and then only if the security agreement specifies the period of secured creditor use and the *rahn* requirement is stipulated as a condition in the sale

[312] Under the Saudi Arabian mortgage law, it is permissible for a secured creditor to be authorized, pursuant to a security agreement, to collect and receive the proceeds from operation of an encumbered asset prior to foreclosure, but the secured creditor is not allowed to retain those proceeds. Any provision authorizing the retention of proceeds by the secured creditor is null and void (although the remainder of the security agreement remains valid and binding). The provisions of the Saudi Arabian law should permit the use of lockbox structures and reserve accounts so long as the funds in those accounts are not applied to the debt except in accordance with the enforcement provisions of the law. See McMillen, Saudi Rahn, *supra* note 18.

[313] These involve different loan and sales arrangements.

agreement. In the permissible case, compensation must be paid to the debtor or deducted from the outstanding debt. Secured creditor use is always prohibited if the secured obligation is a loan.[314]

The Maliki interpretations preclude debtor use of the property and are thus most problematic in terms of correspondence with contemporary financing practices. These interpretations are particularly difficult in the context of SME financings.

Similarly, use of the encumbered asset by a secured creditor in the remedies context is problematic. Instances of Shariʻah-compliant loan transactions where secured party use is permissible are rare. *Ijara* (lease) transactions, *murabaha* (cost-plus sale) transactions, and similar transactions are used with much greater frequency. These are not within the category of transactions for which secured creditor use of the encumbered asset is permissible.

(bb) AAOIFI Standard Positions

The AAOIFI Standard allows the debtor to benefit and use the encumbered asset during the term of the *rahn* with the permission of the secured creditor.[315] The secured creditor has no right to use or benefit from the encumbered asset free of charge, whether or not the debtor has given permission for such a creditor use. If the debtor does give permission for secured creditor use and benefit, the secured creditor must pay to the debtor the "normal pay" for similar assets.[316]

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314 Ibn Rushd, *supra* note 14, at § 37.1.2, notes that a condition may be imposed prohibiting secured creditor use of the *marhun*.

315 AAOIFI Standard, *supra* note 14, at § 3/2/9.

316 AAOIFI Standard, *id*., at § 3/2/9, referencing §§ 3/3 and 4/3. The meaning of the referenced sections in this context is unclear. It seems to imply that the payment should be all income from the *marhun*. It is possible that the meaning is "market value".

13 PREPAYMENT OF SECURED OBLIGATION

GENRALIZED SUMMARY PAYMENT OF SECURED OBLIGATION	
SME NEED	SMEs need to have the ability to prepay a financing from time to time as they have available funds. The optimal prepayment may be less predictable than for more established enterprises, and cash flow scheduling is likely to be less sophisticated than for more established enterprises.
MODEL LAW	Prepayments are permissible, and are a matter of negotiation between the debtor and the secured creditor.
SHARIʻAH	Prepyaments are permissible at any time, even if precluded by the financing agreements. However, no benefit (such as reduced financing costs) is conferred on a debtor making a prepayment.
AAOIFI	No provision.
RECONCILIATION SUGGESTION	Following the lead of the Saudi law, prepayments should be permitted at any time. Creative “revolving credit” structures may assist in diminishing the impact of the Shariʻah principle that prevents a benefit for prepayment or early payment. For example, a series of shorter payment periods might be structured with a right in the debtor to extend for one or more longer periods out to the last date on which the financing would have been available without the shorter periods.

13.1 Model Law Provisions

Neither the Model Law nor secular legal principles restrict the ability of a debtor to prepay a secured obligation. Rights of redemption at times expressly allow prepayments (albeit during the course of the enforcement process). Prepayments are a matter for negotiation and determination by the parties to the transaction. Prepayment rights and restrictions are embodied in the loan or financing agreements and, in many cases, in the relevant security agreements.

It is not uncommon, particularly in commercial financing transactions, for the right of the debtor to prepay to be restricted. Prepayments may be prohibited, particularly where the receivable from the financing is sold into a securitization transaction. Or prepayments may not be permitted for a specified period of time. Or prepayments may be allowed, but only when accompanied by a prepayment premium of some type and amount. There are an unlimited number of variations of prepayment arrangements.

Frequently, a prepayment must be accompanied by a “make-whole” premium or “breakage” amount. The make-whole premium or breakage amount is calculated in various ways, and may be limited as a matter of secular law. In one common formulation, the premium or amount is calculated relative to the net present value of the interest that would have been earned on the loan or financing if the loan or financing had not been prepaid, assuming reinvestment of the prepayment, as of the date of prepayment, at then-current specified interest rates. These premiums can be significant in amount.

13.2 Shariʻah Provisions

The Shariʿah allows a debtor to prepay an obligation at any time, even if the financing arrangement expressly precludes early prepayment. It is not permissable to require that a prepayment be accompanied by a prepayment premium or penalty. This is rather direct conflict with customary practices in interest-based transactions.

Illustrating the inter-relationship between secular law and the Shariʿah, even in a jurisdiction in which the Shariʿah is the paramount law of the land, the new Saudi Arabian mortgage law allows prepayment of indebtedness prior to its maturity in accordance with the agreement of the parties (thereby allowing prohibitions on early prepayment).[317] The Saudi law does not speak to premiums upon prepayment.

The critical question in each jurisdiction in which the Shariʿah is applied is whether a dispute resolution body (e.g., a court) will enforce a contractual restriction on early prepayments of debt. Given the predominant Shariʿah interpretation, it is likely that it will not enforce that restriction (although the effect of a contrary secular law provision is uncertain) and that the debtor will be permitted to prepay the outstanding secured obligation despite the express contractual restriction.

[317] McMillen, Saudi Rahn, *supra* note 18.

14 LOSS, DAMAGE, DESTRUCTION, AND CONSUMPTION OF ENCUMBERED ASSET

14.1 Model Law Provisions

The concepts relating to loss, damage, destruction, and consumption of the encumbered asset under the Model Law are, for the most part, subsumed in the concept of "proceeds", which includes insurance proceeds and any other amount that might be derived from loss, damage, or destruction of the encumbered asset.[318] The proceeds are a substitute for the lost, damaged, or destroyed value in the asset.

State law will be determinative as to responsibility for loss, damage, destruction, and consumption of the encumbered asset. These laws vary markedly from one State to another, are dependent upon a wide range of other bodies of law, and are not addressed in this report.

14.2 Shari'ah Provisions

Some of the consequences of, and responsibilities of the debtor, grantor, secured party, *'adl,* and depositary with respect to loss, damage, and destruction of the encumbered asset are noted in previous sections of this report. As noted in section 5.2.4, those consequences and responsibilities flow directly from the nature of the possession of the encumbered asset as interpreted by the different schools.

To summarize, the Hanafis interpret the possession of the encumbered asset by the secured creditor to be a possession of trust. As such, the secured creditor is responsible for the full value of the encumbered asset only in the event of transgression or negligence by the secured creditor. In other circumstances, the secured creditor that has possession is responsible for the lesser of (a) the value of the encumbered asset and (b) the amount of the outstanding secured obligation.

The Hanbalis, Malikis, and Shafi'is interpret the possession by the secured party to be a possession of guarantee. To these schools, the secured creditor in possession of the encumbered asset is responsible for the full value of the encumbered asset, whether or not there has been transgression or negligence by the secured creditor.

Under the AAOIFI Standard, the possession by the secured creditor, its agent, or a notary is a possession of trust.[319]

Implementation of these basic principles is a bit more complicated in practice, however. This section is intended to summarize the rules pertaining to loss, damage, and destruction of the encumbered asset in different circumstances. Much of the material presented in this section has not been presented in previous sections. However, in an effort at comprehensiveness, section 14.2.2 also includes some material previously discussed. This section begins by considering loss, damage, and destruction and then turns to other situations (consumption of the encumbered asset or transgression against the encumbered asset) as those situations are addressed by different Shari'ah principles.

14.2.1 General Rules

The AAOIFI Standard provides that the *rahn* is no longer valid when the encumbered asset perishes or is lost, damaged, or destroyed in such a way that it has no value, unless proceeds are substituted for the encumbered asset.[320] The same result is likely to obtain under the classical rules, as well. In most instances

[318] See the discussion in section 8. As to a related matter of loss or damage caused by the encumbered asset, see Legislative Guide, II.A.7(e), at ¶ 71: "liability for loss or damage caused by encumbered assets (as a result of breach of contract or wrongful act) is not an issue related to secured transactions").

[319] AAOIFI Standard, *supra* note 14, at § 3/2/4. Responsibilities of the secured creditor, its agent and the notary are discussed in section 14.2.2.

[320] AAOIFI Standard, *id*., at § 3/1/6.

where the *rahn* secures a financing arrangement, there will be proceeds from insurance or other compensation (e.g., eminent domain or other governmental taking payments). Proceeds of these types will often suffice to satisfy the responsible party's obligations with respect to such perishing, loss, destruction, or damage.

Upon a loss, damage, or destruction of the encumbered asset that is not attributable to the debtor, the Hanafis consider the secured obligation to be repaid out of the secured creditor's guarantee in an amount equal to the amount of the secured obligation or, if less, the value of the encumbered asset. Any excess value of the encumbered asset over the amount of the secured obligation is considered to have vanished, with any guarantee of such excess by the secured creditor being applicable only if there is transgression or negligence by the secured creditor or its agent. If the value of the encumbered asset is less than the amount of the secured obligation, the secured creditor is permitted to demand repayment of the shortfall amount from the debtor. If the encumbered asset consisted of multiple units or elements of property and there is a loss, damage, or destruction of some, but not all, units or elements, the secured obligation is deemed to be repaid to the extent of the units or elements that are lost, damaged, or destroyed.

The Hanafis impose three conditions for these types of guarantees: (a) the secured debt must be in existence at the time of the loss, damage, or destruction; (b) the encumbered asset must have been lost, damaged, or destroyed while in the possession of the secured creditor, its agent, or an *'adl* (e.g., and not while in the possession of the debtor or a usurper or transgressor); and (c) the part of the encumbered asset that is lost, damaged, or destroyed must be part of the property originally subjected to the *rahn* and not an increase to or output of that original property or another derivative of the original possession.

Further, a diminution in the price or, assuming satisfaction of preservation and expense requirements, the value of the encumbered asset while in the possession of the secured creditor is not protected by the secured creditor's guarantee (assuming no usurpation, transgression, or negligence by the secured creditor, its agent, or an *'adl*).

The non-Hanafis possession of guarantee conception results in a guarantee of the encumbered asset for its full value.

The Malikis add another dimension to this position by ruling that the possession is one of guarantee if there is suspicion of possible usurpation, transgression, or negligence (they then specify various rules pertaining to the proof of these matters) and if the movable collateral is of a type that can be hidden (e.g., jewelry): the burden of proof shifts to the secured creditor in this circumstance.[321]

The Hanafis, Hanbalis, Malikis, and Shafi‘is all agree on the base principle applicable to consumption of or usurpation of or transgression on the encumbered asset: it is guaranteed and its value must and will replace the consumed encumbered asset. The agreement ends there. The different schools have different opinions as to determinations of who is responsible for the guarantee and the time at which the value of the encumbered asset is determined.

Consider, first, the debtor as consumer, usurper, or transgressor. The rules derived by the Hanbalis turn on whether the encumbered asset is fungible property or non-fungible property. If it is fungible property, the debtor must guarantee its replacement with an equivalent equal. If it is non-fungible property, the debtor must guarantee its value as of the date of the consumption, usurpation, or transgression. The secured creditor will then hold the replacement encumbered asset (whether equal property or value) until maturity as a substitute encumbered asset (or use it to extract repayment if the secured obligation has matured).

If the creditor consumed, usurped, transgressed, or adversely affected the encumbered asset through its negligence, the Hanafis rule that the secured creditor must guarantee its replacement by an equal if it

[321] See al-Zuḥaylī, *supra* note 13, at 167.

is fungible and must guarantee its value if the encumbered asset is non-fungible. Value in this situation is determined as of the date of the original receipt of the encumbered asset by or on behalf of the secured creditor. If a third party is the usurper or transgressor, the value is determined as of the day of the usurpation or transgression, and the secured creditor must seek compensation from the third party.

The Shafi‘is and the Hanbalis take the position that the usurper or transgressor must guarantee either the value of the encumbered asset or its replacement by an equal, in each case as determined as of the date of the usurpation or transgression. The priority of the secured creditor continues in this value or equal, even if the value or equal is not received by the secured creditor. That results in the secured creditor having a priority claim in the debtor's estate if the value or equal is not received in a timely manner by the secured creditor. A corollary to this approach is that the debtor, as owner of the encumbered asset, must seek compensation from the usurper or transgressor.

The position of the Malikis is that a usurpation or transgression by the debtor or a third party requires the debtor to provide to the secured creditor either the value of the encumbered asset as of the date of the usurpation or transgression or a replacement by an equal. If the usurpation or transgression is by the secured creditor, the secured creditor is responsible for providing such value or equal, but there is disagreement within the school as to whether the value should be determined as of the date of original receipt of the encumbered asset or as of the date of the transgression.

14.2.2 Previously Discussed Situations

The following discussion constitutes summaries of some of the more important particularized instances of loss, damage, or destruction of the encumbered asset that are provided in other sections of this report.

(cc) *'Adl* Arrangements

Loss, damage, and destruction of the encumbered asset while in the possession (or guarantee) of the *'adl* are treated in the same manner as if the loss, damage, or destruction had occurred while the encumbered asset was in the possession of the secured creditor (assuming the *'adl* is not a transgressor).[322]

If the encumbered asset provided by a grantor other than the debtor is lost, damaged, or destroyed prior to a demand for its return by the grantor,[323] then the grantor has the right to elect whether the debtor or the *'adl* is responsible for guaranteeing the value of the lost, damaged, or destroyed object (encumbered asset). If the grantor elects to hold the *'adl* responsible, the *'adl* has a right of recovery from the debtor.

Where an *'adl* has been appointed and the *'adl* places the encumbered asset in the possession of either the debtor or the secured creditor without the consent of both the debtor and the secured creditor, and the encumbered asset was lost, damaged, or destroyed while in the possession of either the debtor or the secured creditor, the *'adl* would be required to guarantee the value of the encumbered asset despite not having possession.

This possession of guarantee of the *'adl* is also continuing where the *'adl* provides possession of the encumbered asset to a third party without the consent of both the debtor and the secured creditor. In such a situation, the *'adl* guarantees the lesser of the value of the encumbered asset and the amount of the secured obligation, for the Hanafis, and the entire value of the encumbered asset, for the Hanbalis, Malikis, and Shafi‘is. In each of the foregoing examples, the *'adl* is considered a "transgressor" for not having obtained the consent of both the debtor and the secured creditor.

[322] The provisions of this section that discuss matters involving an *'adl* are discussed in section 5.2.6.

[323] See section 5.2.6, which notes that a grantor other than a debtor may demand the return of the *marhun* in cases of transgression.

(dd) Notary Arrangements

Under the AAOIFI Standard, the debtor and the secured creditor may appoint a third-party notary to hold the encumbered asset.[324] The notary (as well as the secured creditor and any agent of the secured creditor) is deemed to hold in a possession of trust, for the most part.

If the encumbered asset is lost, damaged, or destroyed in the possession of the notary and the loss, damage, or destruction does not involve the transgression or negligence of the notary, the notary does not have responsibility for such loss, damage, or destruction and the secured obligation remains valid and unaffected.[325]

If the loss, damage, or destruction of the encumbered asset is attributable to the notary, the possession of the notary becomes a possession of guarantee. The notary is then responsible for the full value of the encumbered asset as of the date of the loss, damage, or destruction. In such a case, the obligation of the notary may be offset against the secured obligation.[326]

Positions under the AAOIFI Standard vary when the encumbered asset is an asset that the secured creditor owes to the debtor.[327] A debtor may create a *rahn* in an asset that the secured party owes to the debtor (and, presumably, the obligation that obligates the delivery of the asset).[328] This is permissible whether the asset is kept by the secured party as a possession of trust (such as deposited or lent assets) or as a possession of guarantee (such as current accounts and assets retained after nullification of contracts). In the latter case, the status of the secured creditor vis-à-vis the debtor changes from one holding in a possession of trust to one holding in a possession of guarantee.[329]

The applicable rules upon loss, damage, or destruction of the asset owed by the secured creditor to the debtor are then as follows.

If the encumbered asset is lost, damaged, or destroyed in the possession of the secured creditor, and the loss, damage, or destruction does not involve the transgression or negligence of the secured creditor, the secured creditor does not have responsibility for such loss, damage, or destruction, and the secured obligation remains valid and unaffected.[330]

If the loss, damage, or destruction of the encumbered asset is attributable to the secured creditor, the possession of the notary becomes a possession of guarantee. The secured creditor is then responsible for the full value of the encumbered asset as of the date of the loss, damage, or destruction. In such a case, the obligation of the secured creditor may be offset against the secured obligation.[331]

(ee) Depositary Arrangements

A secured creditor that has possession of the encumbered asset may deposit the encumbered asset with a third-party depositary.[332] The rules of responsibility for the guarantee of the value of the encumbered asset, as between the secured creditor and the depositary, vary by jurisprudential school and even within each school.

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324 See section 5.2.7.
325 AAOIFI Standard, *id*., at § 3/2/4.
326 AAOIFI Standard, *id.*, at § 3/2/4.
327 See section 7.2.2(c).
328 AAOIFI Standard, *id*., at § 3/2/5.
329 AAOIFI Standard, *id*., at § 3/2/5.
330 AAOIFI Standard, *id*., at § 3/2/4.
331 AAOIFI Standard, *id.*, at § 3/2/4.
332 See section 12.2.1.

The issues become apparent where the encumbered asset is lost, damaged, or destroyed while in the possession of the depositary. The Hanafis differ among themselves. Some Hanafis ('Abu Hanifa, for example) take the positon that the secured creditor remains obligated to guarantee the value of the encumbered asset, and that the depositary is not obligated for such guarantee. Others (such as 'Abu Yusuf) hold that both the secured creditor and the depositary guarantee the value of the encumbered asset, with the secured creditor being ultimately responsible in all circumstances.

(ff) Leased or Borrowed Property

Where there is a grant of a *rahn* in property that is leased or borrowed by the debtor (grantor),[333] and the encumbered asset is lost, damaged, or destroyed in the possession of the secured creditor, and the grantor has violated a constraint imposed by the property owner, the property owner has the right to demand compensation from either the grantor (the borrower of the property) or the secured creditor. The grantor-borrower guarantees the value of the encumbered asset as a transgressor. If the grantor-borrower pays full compensation to the property owner, the grantor-borrower becomes the owner of the encumbered asset, in whatever state or condition it then exists. If the property owner seeks compensation from the secured creditor, and the secured creditor makes payment in full of the value of the encumbered asset, the secured creditor has the right to demand reimbursement of that payment from the grantor-borrower as a transgressor and the ultimate guarantor of the value of the encumbered asset. These are the rulings of the Hanafis, Shafi'is, and Malikis.

If a property is borrowed for the purpose of using it as an encumbered asset, and the property is lost, damaged, or destroyed in the possession of the secured creditor, the schools also have differing positions.[334] The amount to which the property owner is entitled under Hanafi rulings is the lesser of its value and the amount of the underlying secured obligation; the borrower-grantor will not be responsible for the difference if the amount of the underlying secured obligation is less than the value of the property. The Malikis allow the property owner compensation equal to the full value of the property (encumbered asset) as of the date of the loan of the property owner to the borrower-grantor. The Shafi'is and most Hanbalis allow the property owner compensation equal to the full value of the property (encumbered asset) on the day of its loss, damage, or destruction (assuming no transgression).

The Hanafis, Hanbalis, and Shafi'is rule that the property owner may demand the return of the loaned property at any time (loans are considered non-binding conditions). If the borrower-grantor is unable to return the loaned property that is being used as an encumbered asset, then the property owner may require the secured creditor to release the property to the property owner against payment to the secured creditor of some amount (usually the value of the encumbered asset) and the property owner may demand compensation from the borrower-grantor for that amount. The Malikis permit the property owner the right to recall the property in only unrestricted simple loan arrangements.

It is also permissible for a lessee to grant a *rahn* in a leased property, as grantor, assuming that such an arrangement is not prohibited by the terms of the lease and is acceptable to the property owner. Possession by a lessee is a possession of trust, and not of guarantee. The lessor has no right to terminate the *rahn* arrangement until the termination of the lease. This is a particularly helpful set of principles in the context of modern commercial arrangements in circumstances where the property owner is amenable to the arrangement. That, of course, is subject to considerable negotiation, is quite asset-specific, and may be costly.

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[333] See section 7.2.2(e).

[334] See section 7.2.2(e).

Slightly different rules apply where the AAOIFI Standard is applicable to the creation of a *rahn* by a debtor in, and use as encumbered asset of, a property that is borrowed or leased by the debtor with the permission of the owner of the property.[335]

If the borrowed or leased asset is sold in the exercise of remedies by the secured creditor, the property owner has recourse against the debtor for the value of the borrowed or leased property (the encumbered asset). The right of recourse is in-kind, if the encumbered asset is fungible property. The right of recourse is for the full value of the encumbered asset, if the encumbered asset is not fungible property.[336]

If the encumbered asset constitutes borrowed or leased property and is lost, damaged, or destroyed in the possession of the debtor during the term of the *rahn*, the obligations of the debtor vary. For borrowed property, the debtor is responsible for the full value of the encumbered asset. If the encumbered asset is leased, the debtor is responsible to the property owner only if the loss, damage, or destruction was the result of a transgression or negligence of the debtor. That is, the leasing arrangement is treated as a possession of trust.

(gg) Property of Others

As to property of others over which a *rahn* is granted which is lost, damaged, or destroyed while in the possession of the secured creditor,[337] the Hanafis rule that the property owner has the right to demand payment from the grantor of the *rahn* or, if the secured creditor knew, at any time, that the grantor did not have the legal right to grant the *rahn*, from the secured creditor. Both parties are considered transgressors, with full guarantee of the value of the property, in such circumstances. If the property owner receives compensation from the grantor, the secured creditor is considered repaid on the secured obligation to up to the value of the property serving as an encumbered asset. If the property owner seeks and receives compensation from the secured creditor, the secured creditor may demand reimbursement of that compensation from the grantor-debtor *plus* an amount equal to the outstanding secured obligation.

In interpreting these principles, the Hanbalis distinguish between situations in which the secured creditor has knowledge of the usurpation or transgression and those where the secured creditor does not have such knowledge.

If the secured creditor had knowledge and accepted or allowed continuation of the *rahn* arrangements using the property as an encumbered asset, the secured creditor is liable as a full guarantor of the value of the property. For the Hanbalis, the property owner may seek compensation from either the grantor or the secured creditor (as with the Hanafis). However, if recovery is made against the grantor (debtor), then the grantor is entitled to demand reimbursement compensation from the secured creditor.

If the secured creditor did not have such knowledge, and there was loss, damage, or destruction of the usurped property, the Hanbalis consider the cause of the loss, damage, or destruction.

If the loss, damage, or destruction resulted from the negligence or transgression of the secured creditor, the secured creditor is liable for the value of the property.

If the loss, damage, or destruction was not the result of negligence or transgression by the secured creditor, there are three differing interpretive positions.

- First, the secured creditor is liable as guarantor of the value of the property.
- Second, the secured creditor is not a guarantor of the property's value, but has a possession of trust.

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335 AAOIFI Standard, *supra* note 14, at § 3/2/6.

336 AAOIFI Standard, *id.*, at § 3/2/6.

337 See section 7.2.2(f).

- Third, the property owner has the option of demanding compensation from the secured creditor or the grantor, but the grantor is the ultimate guarantor of the value of the property.

For the Hanbalis (and the Shafiʻis), the secured obligation is not repaid out of the payment by the grantor.

(hh) Multiple *Rahn* Arrangements

Second *rahn* arrangements also raise issues relating to loss, damage, and destruction.[338] If the encumbered asset is lost, damaged, or destroyed in the possession of the second creditor, the Hanafis allow the debtor to seek compensation from either the first secured creditor or the second secured creditor. If compensation is sought from the first secured creditor, the first *rahn* is considered valid. If compensation is sought from the second secured creditor, the first *rahn* is considered invalid although the first secured creditor remains as the ultimate guarantor of the value of the encumbered asset. Thus, if the second secured creditor compensates the debtor (original grantor), the second secured creditor is entitled to compensation from the first secured creditor.

If a debtor leases, loans, or gifts the encumbered asset or subjects the encumbered asset to a second *rahn*, the dealing is suspended pending the secured creditor's permission. If the dealing is a lease, the lease (*ijara*) is binding and the permission of the secured creditor invalidates the *rahn* (a lease to the secured creditor also invalidates the *rahn*). Any loss, damage, or destruction would then be subject to rules applicable to an *ijara*. The same invalidation of the *rahn* occurs if the dealing is a *rahn* or gift of the encumbered asset to the secured creditor. The *rahn* is not invalidated if the dealing is a loan of the encumbered asset to the secured creditor. In the case of such a loan, however, the secured creditor no longer guarantees the *rahn* or encumbered asset. Any loss, damage, or destruction of the encumbered asset while in the secured creditor's possession for use as a borrower would be treated as a possession of trust (with liability attaching only for secured creditor transgression or negligence). This relief of guarantee of the encumbered asset would not apply to any period before or after the period of use by the secured creditor.[339]

(ii) Failures to Pay Expenses Relating to Encumbered Assets

Instances of loss, damage, and destruction have ramifications relating to expenses pertaining to the encumbered asset. These ramifications relate to the issue of whether the secured obligation is reduced in various circumstances involving a loss or diminution in value of the encumbered asset.

The Hanbalis, Malikis, and Shafiʿis take the position that there is no reduction in the underlying secured obligation, absent transgression or negligence on the part of the secured creditor in connection with such loss or diminution.

The Hanafi position is that the secured creditor's possession is one of trust with respect to the encumbered asset and a possession of guarantee with respect to the financial aspect of the encumbered asset, up to the value of the encumbered asset. Thus, if the encumbered property perishes, the secured obligation is considered repaid up to the value of the encumbered property that is lost (i.e., the underlying secured obligation is reduced by that amount). The amount of the secured obligation in excess of the lost value of the encumbered asset will continue to be payable. If the value of the lost encumbered asset is greater than the amount of the secured obligation, that amount is payable by the secured creditor only in cases of transgression or negligence by the secured creditor.

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338 See section 7.2.2(g).

339 See section 11.2.1.

Three conditions apply to the foregoing rules: (a) the secured obligation must exist at the time of the loss or damage; (b) the encumbered asset must have been lost or damaged while in the possession of the secured creditor or a trustee (and not while in the possession of the debtor or a third party usurper or transgressor); and (c) the lost or damaged property must constitute part of the original encumbered asset (and not be an increase or growth).

(jj) Use Arrangements

Loss, damage, and destruction considerations also arise in connection with use of the encumbered asset by the debtor or the secured creditor.[340] Debtor use of the encumbered asset without the permission of the secured creditor results in the debtor being a usurper, and liable for the value of the encumbered asset if it is lost, damaged, or destroyed during the debtor's possession.[341] Similarly, secured creditor use that is not permitted results in the secured creditor being a usurper and transgressor, and liable for the value of the encumbered asset if it is lost, damaged, or destroyed during the secured creditor's possession.

(kk) Proceeds and their Use

Finally, loss, damage, and destruction of an encumbered asset is important in considering proceeds and their use.[342] Instances of loss, damage, and destruction result in payments of amounts that constitute proceeds. This type of proceeds is substituted as the encumbered asset for the property that is lost, damaged, or destroyed, and the secured obligation may be realized out of the value of the encumbered asset, including the substituted proceeds, in situations of loss, damage, or destruction of the encumbered asset.

Whether the proceeds may be applied to the secured obligation prior to the maturity of the secured obligation depends upon the interpretations of the specific school of Islamic jurisprudence whose principles are being applied, the individual Shari'ah scholars, and the facts of the matter being considered. For example, is the loss, damage, or destruction total or partial? If it is total, most scholars will allow immediate application of the proceeds (say, insurance proceeds) to the secured obligation. Some, however, will not allow that application until the scheduled maturity of the secured obligation and will make periodic payments with respect to the secured obligation from the proceeds in accordance with the original repayment schedule on the secured obligation.[343]

[340] See section 12.2.3.

[341] See, e.g., section 12.2.3(c), setting forth the Hanbalian interpretation.

[342] See section 8.2.

[343] See the discussion of Saudi Arabian law in section 15, whereby the proceeds are placed in a bank account and distributed in accordance with the original amortization-repayment schedule for the secured obligation.

15 ENFORCEMENT AND REMEDIES

GENRALIZED SUMMARY ENFORCEMENT AND REMEDIES	
SME NEED	SMEs need the remedies process to be cost-efficient, but also need adequate debtor protections against overreaching and aggressive creditor actions. The availability of self-help remedies to the creditor increases willingness to lend or otherwise finance. This is an area of careful balancing of interests.
MODEL LAW	Self-help by a secured creditor is permissible.
SHARI'AH	Classical principles disfavor extra-judicial remedies. Usually, a secured creditor cannot sell, dispose of, lease, or license an encumbered asset in a public or private arrangement. The debtor owns the property, and the general rule is that only the debtor can sell, dispose of, lease, or license the encumbered asset (or the court will do so if the debtor fails to do so). The principles seem based on considerations of debtor protection.
AAOIFI	The secured creditor can be appointed as the agent of the debtor to effect extra-judicial sales, dispositions, leases, and licenses.
RECONCILIATION SUGGESTION	The AAOIFI Standard is a good base. It incorporates fiduciary concepts attendant upon agency doctrines. These are important protections for debtors, particularly SMEs.

15.1 Model Law Provisions

After a default, each of the grantor and the secured creditor has various rights under the Model Law. In each case, the exercise of one post-default right does not preclude the exercise of other post-default rights (assuming there is no impossibility of such exercise). The exercise of a post-default right with respect to an encumbered asset does not prevent exercise of a post-default right with respect to the secured obligation, and vice versa.[344]

The grantor has the right to:

(a) Pay and fully perform its secured obligations (and then obtain a release of all encumbered assets from the security right);

(b) Apply to the court if the secured creditor is not complying with the Model Law requirements;[345]

(c) Propose that the secured lender acquire the encumbered asset in total or partial satisfaction of the secured obligation (or reject any such proposal of the secured creditor); and

(d) Exercise any right provided under the security agreement or other applicable law.[346]

The grantor and "any other interested person" are afforded a right of redemption in the encumbered asset that is affected by payment or performance in full of the secured obligation, including payment of interest and costs of enforcement. The right of redemption may be exercised until the asset is sold, otherwise disposed of, lease, licensed, acquired, or collected by the secured creditor or until the

344 Model Law, Article 80, ¶¶ 3 and 4.

345 See, also, Model Law, Article 83.

346 Model Law, Article 80, ¶ 1.

conclusion of an agreement by the secured creditor for that purpose.[347] Any such agreement will not be effective with respect to fraudulent acts of the secured creditor or based upon the incapacity of the grantor.

The secured creditor has the right to:

(a) Obtain possession of the encumbered asset;[348]
(b) Sell or otherwise dispose of, or lease or license, the encumbered asset;
(c) if the security right covers all assets of the grantor, sell or otherwise dispose of the grantor's business as a going concern;
(d) Propose that the secured creditor obtain the encumbered assets in total or partial satisfaction of the secured obligation; and
(e) Exercise any other right provided in the security agreement or any other applicable law to the extent the same is not inconsistent with the Model Law.[349]

The secured creditor, as a unilateral right, may waive any of its rights or vary the same by agreement.[350]

The secured creditor may exercise these rights judicially or extrajudicially.[351] The Model Law encourages extrajudicial exercise of these rights.[352] Extrajudicial exercise is subject to certain constraints. These include good faith and commercial reasonableness,[353] certain conditions regarding extrajudicial repossession,[354] relatively unfettered rights to sell, otherwise dispose of, lease, or license the encumbered asset upon notice,[355] and certain requirements as to application of the proceeds of the exercise of these rights.[356]

There are three conditions regarding extrajudicial enforcement.[357]

- First, the grantor must have consented to extrajudicial enforcement in the security agreement.
- Second, the secured creditor must have provided notice of default and notice of the secured creditor's intention to obtain extrajudicial possession within a period specified by the State (e.g., 15 days after the notice) to the grantor, any person in possession of the encumbered asset, and any person owing payment or other performance of the secured obligation. There is a suggestion that the notice need not be given where the encumbered asset is perishable, may quickly decline in value, or is of a kind sold on a recognized market (a provision that is still being considered by the Working Group).

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347 Model Law, Article 82.
348 Model Law, Article 86, is also definitive as to the right of a secured creditor to possession of the encumbered asset after a default.
349 Model Law, Article 80, ¶ 2.
350 Model Law, Article 81.
351 See, also, the Note to the Working Group with respect to Article 83. That Note indicates that the Guide to Enactment, when drafted, will clarify that relief may be afforded pursuant to other mechanisms adopted by the State, including arbitral tribunals, chambers of commerce, and notary publics, if the grantor and secured creditor agree to the use of relevant State laws.
352 See, e.g., Legislative Guide, Recommendation 138, at VIII.8.C.1.
353 Model Law, Article 5.
354 Model Law, Article 87.
355 Model Law, Articles 88 and 89.
356 Model Law, Article 90.
357 Model Law, Article 89.

- Third, at the time the secured creditor seeks to obtain possession of the encumbered asset, neither the grantor nor any other person in possession of the encumbered asset objects.

Extrajudicial sales are encouraged, and relatively unconstrained, under the Model Law.[358] After a default, the secured creditor may sell, otherwise dispose of, lease or license the encumbered asset without application to a court or other authority. The secured creditor "may select the method, manner, time, place and other aspects" of the sale, disposition, lease, or license.

The Model Law does require that certain notices be provided in connection with any proposed sale, disposition, lease, or license.[359] Notice of the secured creditor's intention to effect these remedies must be given to the grantor (unless the right is in the security agreement), any debtor, any person with rights in the encumbered asset if notice of such rights has been given to the secured creditor, any other secured creditor that has registered a security right with respect to the encumbered asset, and any other secured creditor that this is possession of the encumbered asset at the time when the enforcing secured creditor took possession of the encumbered asset. The notice must be given within a specified period of time before the exercise of the extrajudicial disposition or other remedy and describe the encumbered asset, the amounts required to satisfy the secured obligations (including interest and costs), a reference to the right of redemption, and the date of the extrajudicial disposition or other remedy. No notice must be given if the encumbered asset is perishable, may quickly decline in value, or is of a kind sold on a recognized market.

Even if a competing creditor has commenced enforcement, a secured creditor with a security right that is higher in priority than that of the enforcing creditor is entitled to take over the enforcement process at any time prior to the time the encumbered asset is sold, otherwise disposed of, leased, licensed or acquired by the secured creditor or until conclusion of an agreement for the secured creditor for that purpose. The higher ranking creditor may enforce its security right by any method permissible under the Model Law.[360]

The Model Law also stipulates the application of proceeds from both judicial and extrajudicial disposition of encumbered assets.[361] As a first principle, the debtor remains liable for any shortfall if the proceeds of enforcement are insufficient to pay the secured obligation.

The basic application-of-proceeds principle is that the net proceeds (after deduction for costs of enforcement) must be applied to the secured obligations. That principle is subject to the rights of holders of preferential claims established by the State.[362]

Thereafter, amounts due to subordinate competing creditors must be paid (if that subordinated competing creditor notified the enforcing creditor of its claim prior to enforcement).

Any excess is then paid to the grantor. The Model Law provides that an enforcing creditor may pay the surplus over the payment of its secured obligation to a court or other competent authority or deposit funds for payment in accordance with the Model Law priority provisions.

A separate set of provisions applies to arrangements in which the secured creditor desires or agrees to acquire one or more of the encumbered assets in total or partial satisfaction of the secured obligation.[363]

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358 Model Law, Article 88.

359 Model Law, Article 89.

360 Model Law, Article 85.

361 Model Law, Article 90.

362 Model Law, Article 45, and the Guide to Enactment, when drafted, will provide examples of preferential claims, such as unpaid amounts to sellers of goods and claims of service providers.

363 Model Law, Article 91.

In such a circumstance, the secured creditor must provide a proposal to: the grantor; the debtor; any other person that owes payment or performance obligations with respect to the secured obligation, including guarantors; any person with rights in the encumbered asset that has notified the enforcing secured creditor of those rights; any other secured creditor that has registered a security right with respect to the encumbered asset; and any other secured creditor that was in possession of the encumbered asset at the time the enforcing secured creditor took possession of the encumbered asset. The proposal must specify the amount of the secured obligation then owed (including interest and enforcement costs), the amount of the secured obligation proposed to be satisfied by the encumbered asset, a description of the encumbered asset, a reference to the rights of redemption, and the date on which the encumbered asset will be acquired by the enforcing secured creditor.

The enforcing secured creditor is then entitled to acquire the encumbered asset unless any notice party objects in writing by a State-established cut-off date.

Where the encumbered asset is in partial (and not total) satisfaction of the outstanding secured obligation, each addressee notice party must affirmatively consent to the arrangement.

Alternatively, the grantor may make the foregoing proposal. If that proposal is accepted by the enforcing secured creditor, the foregoing provisions are also applicable.

The transferee, lessee, or licensee acquires the asset in any sale, other disposition, lease, or license arrangement in a judicial or other officially administered enforcement. The State is permitted (and expected) to specify the nature of the rights so acquired, including whether the asset is acquired free and clear or subject to other rights.[364]

The nature of the rights acquired in an extrajudicial sale, disposition, lease, or license is a bit different under the Model Law.[365] Specifically, the transferee, lessee, or licensee pursuant to a procedure not involving a court or other official authority acquires the rights free of the rights of the enforcing secured creditor and any lower priority creditor, but subject to the rights that have priority over that of the enforcing secured creditor. This is true even if the acquisition is pursuant to a sale, disposition, lease, or license that is not in accordance with the Model Law, so long as the transferee, lessee, or licensee had no knowledge of the violation of the Model Law, that lack of knowledge was not the result of reckless behavior, and the violation did not materially prejudice the rights of the grantor or another person.[366]

As with other portions of the Model Law, there are asset-specific rules regarding enforcement. These apply primarily to receivables, negotiable instruments, rights to payment of funds credited to a bank, and non-intermediated securities.[367] The secured creditor with respect to these encumbered assets is entitled to collect payment from not only the debtor, but also the debtor of the receivable, the obligor under the negotiable instrument, the depositary bank, or the issuer of the non-intermediated security, in each case if the grantor has agreed that collection may be sought prior to default by the debtor.

The secured creditor may also enforce any personal or property right that secures or supports the payment of the encumbered asset.

If the security right in funds credited to a bank account has been made effective against third parties by registration of a notice, the secured creditor may enforce such right only pursuant to a court order, unless the depositary bank agrees otherwise. Enforcement rights with respect to these instruments and

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364 Model Law, Article 92.
365 Model Law, Article 93.
366 Model Law, Article 93, ¶ 3.
367 Model Law, Article 94.

arrangements are also subject to certain other constraints and provisions.[368] Such enforcement is subject to any agreement between the grantor and the secured creditor to the effect that the secured creditor is entitled to take steps to preserve encumbered intellectual property.[369]

15.2 Shariʻah Provisions

15.2.1 Demands for Repayment: Debtor Ownership and Sale of Encumbered Assets

Enforcement and remedies are areas in which the relevant Shariʿah principles are frequently in conflict with secular legal regimes for secured transactions (such as the Model Law).[370] Before exploring some of these areas of conflict, two topics should be noted to provide context.

- The first is the Shariʻah principles relating to the nature of demands for repayment of secured obligations upon the maturity of the secured obligations. This is the step that sets the enforcement and remedies provisions in motion.
- The second is the base set of principles relating to ownership of property that constitutes an encumbered asset and the respective rights of the debtor and the secured creditor to effect sales of the encumbered asset during the term of the *rahn*.

The demand for repayment principles under the Hanafi school are illustrative. The secured creditor may first demand repayment of the matured secured obligation. If the debtor determines to repay the secured obligation, the debtor may demand that the secured creditor produce the encumbered asset to prove that it is intact and in the required state and condition. The secured creditor is obligated to produce the encumbered asset in this circumstance, unless it is too costly or cumbersome to produce the encumbered asset, in which case the secured creditor must give the debtor access to the encumbered asset so that the debtor may satisfy itself as to the condition of the encumbered asset. The secured creditor is also relieved of the obligation to produce the encumbered asset if it is held by an *ʼadl*. In that case, the debtor must be afforded access to the encumbered asset in order that the debtor may satisfy itself as to the condition of the encumbered asset.

A fundamental principle of a *rahn* contract or *rahn* arrangement is that the debtor continues to own the encumbered asset after its delivery to and receipt by the secured creditor. As such, only the debtor has the right to sell the encumbered asset.

Another fundamental set of *rahn* principles relates to the attachment of the secured creditor's right of withholding the encumbered asset from the debtor during the pendency of the *rahn* and the secured creditor's first claim to the value of the encumbered asset to satisfy the secured obligations.

The resolution of these conflicting principles, for the non-Shafiʻis, is that the right of the debtor to sell the encumbered asset is suspended during the period of the *rahn* and until the secured obligation is paid in full.

These principles are further developed so that the debtor (or the debtor's heir, agent, or permitted designee)[371] is allowed to sell the encumbered asset if the secured creditor gives permission for such a sale.

The rules pertaining to sales by an agent, including a permitted designee, which may be an *ʼadl*, a jointly appointed notary (under the AAOIFI Standard), the secured creditor, or a third person, are worthy of further consideration because of their frequent use in contemporary financing structures. In many

[368] See section 7.1.
[369] Model Law, Article 68.
[370] Enforcement of a security right is addressed in Model Law Articles 81 through 94.
[371] al-Zuḥaylī, *supra* note 13, at 171-82.

contemporary financings, particularly those involving SMEs, it is likely that some agency arrangement will be structured to effectuate enforcement and remedies. This is done to expedite the enforcement process and to achieve economies in effectuating the enforcement process (which is particularly sensitive to transaction cost considerations in the context of SMEs).

The Hanafis impose various rules on sales by an agent of the debtor. Those rules vary depending upon whether the agency is stipulated in the *rahn* contract or the right of the agent is subsequently established.

For example, an agent that is appointed in the *rahn* contract cannot be dismissed, but the agency is terminated upon the death of the debtor. The agent may be forced to sell if the agent does not sell in accordance with the terms of the *rahn* contract.

An agent appointed after conclusion of the *rahn* contact may be dismissed (and that may include dismissal by the secured creditor) and is terminated upon the death of the debtor.

If the agent or other permitted designee is jointly appointed by the debtor and the secured creditor (as with an '*adl*, and, presumably, a notary), then the agent or designee may be dismissed only by joint action of the debtor and the creditor, a rule also imposed by the Malikis.

The foregoing principles have important implications for the structuring of enforcement and remedies provisions, particularly in circumstances involving SMEs where an agency may be created to effect enforcement and remedies.

The Malikis also impose varying rules on sales by designees of the debtor with the debtor's permission. If the debtor's permission stipulates conditions to the sale by the permitted designee, then the sale may not be made, except in accordance with those conditions.

Thus, for example, if a condition is established that the sale may not be made except when the debtor does not repay the secured obligation by a specific time, then the sale may not be effected until that specific time.

If the designee is not the secured creditor and is given unconditional permission to sell the encumbered asset, then the sale may be effectuated without the permission of a judge.

If the secured creditor is the permitted designee, then the secured creditor must secure the permission of a judge before effectuating the sale of the encumbered asset.

A sale of the encumbered asset for an amount equal to its value will be valid. A sale at an amount that is less than the value of the encumbered asset allows the debtor to take the encumbered asset from the purchaser (or any subsequent purchaser) at the amount at which it was sold to the purchaser.

The Hanbalis and the Shafi'is concur as to the general principle that only the debtor has the right to sell the encumbered asset, but impose the requirement that any sale by or on behalf of the debtor may only be effected with the permission of the secured creditor. If the secured creditor refuses to give permission, the debtor may appeal to a judge to cause effectuation of the sale.

The Hanbalis and the Shafi'is take a different position regarding judicial involvement in sales by an agent: they rule that a judge cannot force an agent to sell (in direct opposition to the rulings of the Hanafis and Malikis).

The procedure is that the judge must first order the debtor to sell and, if the debtor does not sell, the Hanbalis, Malikis, and Shafi'is (and some Hanafis, such as 'Abu Yusuf) rule that the judge may then conduct or cause the conduct of the sale.

Most Hanafis rule that the judge may not conduct or cause the sale even upon debtor refusal, and that the appropriate course of conduct is coercion of the debtor (e.g., incarcerating the debtor until the debtor causes the sale).

In all cases, if the secured obligation is of the same genus as the encumbered asset, the repayment may be made from the encumbered asset. If the secured obligation is not of the same genus as the

encumbered asset or otherwise, then a sale must be made. In all cases, the expenses of the sale are for the account of the debtor (as owner of the encumbered asset).

There are special rules applicable to sales of perishable objects constituting the encumbered asset. Here, a sale may be necessary to avoid loss of value in the encumbered asset.

As a general statement, the rule is that a judge must authorize sales of perishable objects (the reasoning being that these are sales by the secured creditor). Sales of a perishable encumbered asset are permitted not only at the maturity of the secured obligation, but also in situations where it is clear that the secured obligation will mature subsequent to the perishing of the encumbered asset. The Hanafis, Hanafis, Malikis, and Shafi'is all agree with the foregoing characterizations, except that the Shafi'is take a slightly different view of situations involving sales of the perishable encumbered asset prior to actual maturity of the secured obligation. For the Shafi'is, whether a sale will be permissible prior to the actual maturity of the secured obligation depends upon whether or not such a sale was authorized in the *rahn* contract as a condition to the *rahn*. If it was not, the encumbered asset will not be sold prior to maturity of the secured obligation and, if it perishes, it will no longer constitute insurance for the secured obligation.[372]

15.2.2 Shari'ah Conflicts with Secular Law

It is important to be aware of some primary areas of coincidence and, more importantly, conflict between Shari'ah principles and secular law. A primary area of conflict relates to provisions in a security agreement that allow the secured creditor to take ownership or possession of the encumbered asset,[373] or to sell, otherwise dispose of, lease or license the encumbered asset,[374] or to otherwise exercise self-help remedies, upon non-payment of the secured obligation. As noted in section 15.2.1, the taking of possession by the secured creditor may be for the purposes of acquiring an encumbered property in total or partial satisfaction of the secured obligation, if the grantor and other secured creditors do not object, and post-default rights of the secured creditor may be exercised judicially or extra-judicially, in the discretion of the secured creditor.

The AAOIFI Standard provides for a formulation that is somewhat different than the classical interpretations, both as to the rights afforded the secured party and as to the concept of self-help by the secured creditor. These formulations are more harmonious with contemporary financing practices than most of the classical interpretations.

Specifically, the AAOIFI Standard provides that it is permissible to stipulate as a condition in the *rahn* contract that the grantor (debtor) appoint the secured party or the secured party's representative as an agent with full power to sell the encumbered asset upon a default with respect to the secured obligation and to apply the proceeds of any such sale to the secured indebtedness (all without resorting to the judiciary).[375]

372 al-Zuḥaylī, *supra* note 13, at 174.

373 Model Law, Articles 2(a), 87 and 88. The requirements for permissible secured creditor self-help possession pursuant to Article 88 are that the debtor has consented to that arrangement in the security agreement, the secured creditor has given notice of its intent to obtain possession, and the debtor or other person in possession of the encumbered asset does not object at the time of the exercise of self-help by the secured creditor.

374 Model Law, Articles 2(b) and 89.

375 AAOIFI Standard, *supra* note 14, at § 3/4/1.

If the proceeds from any such sale exceed the outstanding amount of the secured obligation, plus related expenses, the excess must be returned to the debtor (or other grantor). And if the proceeds of such sale are insufficient to pay in full the outstanding amount of the secured obligation plus related expenses, the shortfall is considered an unsecured debt, subject to Shari'ah principles applicable to debt, and the secured creditor has recourse to the debtor for such shortfall.[376]

All of these positions of the AAOIFI Standard are commonplace in contemporary financing arrangements.

It provides that a secured creditor is not permitted to require that the secured creditor be allocated ownership of the encumbered asset in default scenarios.[377] Similarly, the AAOIFI Standard would countenance a provision that allowed the secured creditor to purchase the encumbered asset at its fair market value at the time of the sale and purchase.[378]

The AAOIFI Standard is aligned, in large part, with the classical hostility to self-help arrangements and the classical favoritism for sales arrangements in default scenarios. Under classical interpretations of the relevant Shariʿah principles, provisions in a security agreement that allow the secured creditor to take ownership of the encumbered property in payment default scenarios, and similar self-help provisions, are usually are null and void. The Maliki jurists, some Hanbali jurists, and some other jurists rule that the *rahn* contract is defective as of its inception. Some Hanafi and Hanbali jurists rule that the security agreement and its remaining provisions remain valid and enforceable.

These positions are derivative of the principle that the debtor continues to own the encumbered property and thus only the debtor has the right to sell the encumbered property.[379] However, there are nuances among the different jurisprudential schools. Thus, for example, the Hanafis and the Malikis consider the debtor's sale rights to be suspended during the term of the *rahn*.

The Shariʿah favors sales of encumbered properties in virtually all debtor default scenarios. The initial preference is sale of the encumbered asset by the *debtor* (not the secured creditor), which may include sale by the *debtor's agent*.[380]

The basis for this preference is the continuing debtor ownership of the encumbered property, which leads to the principle of debtor control of the sale and substitution of the proceeds of the sale for the encumbered property.

That is not the end of the matter, however; there are further refinements. These are exemplified by the requirements of the Hanbalis and Shafiʿis that the secured creditor provide consent to the sale by the debtor.[381]

Judicial sale of the encumbered property is the second-ranking preference of the Shariʿah. The Hanafis and the Malikis take the position that the judge may force the debtor's agent to sell the property. The Hanbalis and the Shafiʿis are of the opinion that compelling the debtor's agent is contrary to agency principles and do not allow compulsion of the debtor's agent. In any event, the judge is eventually entitled

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376 AAOIFI Standard, *id.*, at § 3/4/1.

377 AAOIFI Standard, *id*., at § 3/4/2.

378 AAOIFI Standard, *id.*, at section 3/4/2.

379 al-Zuḥaylī, *supra* note 13, at 171-74.

380 al-Zuḥaylī, *id.*, at 171-72.

381 al-Zuḥaylī, *id.*, at 173. Refusal of the secured creditor to give permission allowing a debtor-grantor sale allows the debtor-grantor to appeal to the judiciary. The judge will then provide the secured creditor with two options: giving permission to the sale; or absolving the debt. If the secured creditor rejects both those options, the judge may allow the debtor to sell the encumbered property.

to order a judicial sale of the encumbered property under non-Hanafi principles. The Hanafis do not allow a direct judicial sale; the court will coerce the debtor until the debtor or the debtor's agent sells the encumbered property.[382]

As to the proceeds of a sale of an encumbered asset, the secured creditor has priority. If the sale proceeds are insufficient to pay the secured obligation in full, the secured creditor becomes an unsecured *pari passu* creditor with respect to the unpaid balance of the (formerly) secured obligation. This is quite similar to secular concepts, including those embodied in the Model Law. An important point to note here has been previously discussed: there may well be no competing secured creditors under the Shariʿah because of the principles that void the initial security right upon any grant of a further security right in the same encumbered asset.

The Saudi Arabian mortgage law illustrates the types of issues that arise under Shariʿah principles as a result of the interaction of different sets of principles.[383] To set the stage, consider three Shariʿah principles. The first is that a debtor cannot be required to make early prepayment of its debt or secured obligation.[384] The second is that a debtor-grantor continues to own the proceeds of a foreclosure sale as encumbered property that is substituted for the original encumbered asset that is the subject of the foreclosure sale. The third is that the secured obligation is repaid out of the encumbered asset only if the secured obligation has matured. If the encumbered asset is sold prior to the maturity of the secured obligation (e.g., to prevent it from perishing), then the price received from the sale is substituted as the encumbered asset and is held as the encumbered asset until the debt matures.[385]

It is this set of principles that forms the basis for the provisions of the Saudi Arabian law that require, upon a debtor default and sale of the encumbered asset, placing the sale proceeds in a bank account and dispensing those proceeds in accordance with the original payment schedule for the secured obligation.[386] This approach is designed to give effect to the aforementioned classical Shariʿah principles, including the principle that the proceeds obtained by foreclosure sale substitute for the original encumbered property, that there be no forced early payment, and that payments proceed to maturity in accordance with the original agreement.

Obviously, this introduces a host of issues, including issues pertaining to a previously unconsidered credit: that of the bank holding the funds until maturity. These credit risks may be significant, depending upon the legal and regulatory regime applicable to the bank. And this arrangement exposes the amounts in the bank account to the subsequent bankruptcy or insolvency of the debtor (although, as previously discussed, it is likely that the secured creditor's priority in those amounts would continue during the bankruptcy or insolvency). Given contemporary commercial and financial practices, legal regimes for security rights in jurisdictions that incorporate the Shariʻah into the secular law struggle mightily with systems that implement these principles rigorously.

Another set of considerations relates to whether a debtor and secured creditor may agree to arrangements allowing the secured creditor, in connection with remedial actions, to use the encumbered asset and to apply the proceeds of that use to repayment of the secured obligation. The principles that will be applicable relate to secured creditor use, as discussed in section 12.2.3, and whether the proceeds are subject to the existing *rahn* and constitute part of the existing encumbered asset or must be made subject

382 al-Zuḥaylī, *id.*, at 173-74.

383 See McMillen, Saudi Rahn, *supra* note 18.

384 The corollary is that the debtor has the option of prepaying its obligation or debt at any time, without adjustment to (reduction in) the amount being paid early.

385 See the discussion in section 7.2.2(g).

386 McMillen, Saudi Rahn, *supra* note 18.

to a new *rahn*. These are matters that contemporary Shari‘ah scholars debate, and their views are evolving. It is imperative that the Shari‘ah scholars and jurists in each jurisdiction be consulted in structuring any modifications to the Model Law with respect to these matters.

16 CONCLUSION

This report has considered select provisions of the Model Law from a Shariʿah vantage. The focus has been on comparative differences between the Model Law and the relevant Shariʿah principles and interpretations of those principles.

An implication of this examination of is that rendering the Model Law useful in jurisdictions that apply the Shariʿah is a daunting—and possibly insurmountable—endeavor. Drawing that implication or reaching that conclusion is inappropriate, however.

The bulk of the Model Law is not comprised of differences from Shariʿah; it is harmonious with Shariʿah principles and need not be modified. The Model Law is a sound, efficient, and effective base upon which to build. The modifications needed to render the Model Law efficient and effective in jurisdictions that apply the Shariʿah, while entailing significant rigor and attention to detail, seem manageable.

What is quite clear is that the game is worth the candle. Legal regimes for secured transactions in many jurisdictions that apply the Shariʿah, where they exist at all, are significantly underdeveloped in the context of modern commerce and finance. And they are notably unclear as regards their application of Shariʿah principles. That severely hampers the ability of potential and actual market participants to make risk assessments and the ability of market participants to achieve predictability with respect to, and certainty and stability in, their transactional relationships. Those factors serve as disincentives to market participation and distort market pricing functions, to the disadvantage of both commercial and financial actors in these jurisdictions and the broader populations of these jurisdictions.

Given these impediments, the accelerated growth of Islamic finance in these jurisdictions, and the progress of globalization to include both these jurisdictions and Shariʿah-compliant arrangements as well as more pervasive arrangements, a draft of the Model Law that is sensitive and responsive to Shariʿah concepts is both appropriate and timely: more, it is imperative.

APPENDIX 1

DRAFT MODEL LAW ON SECURED TRANSACTIONS
UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW

Working Group VI (Security Interests)
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A/CN.9/WG.VI/WP.63 (30 January 2015, Articles 1–25)
A/CN.9/WG.VI/WP.63/Add.1 (9 February 2015; Articles 26–60)
A/CN.9/WG.VI/WP.63/Add.2 (9 February 2015; Articles 61–94)
A/CN.9/WG.VI/WP.63/Add.3 (6 February 2015 Articles 95–116)
A/CN.9/WG.VI/WP.63/Add.4 (6 February 2015; Annex I: Regulation: Articles 1–23)