

Sardar Law Firm Special Bulletin Partnership to Ownership in a Credit Crunched Economy

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

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Structuring Business in a Credit Crunch: PARTNERSHIP TO OWNERSHIP

By:
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January 26, 2010—Islamic finance is a parallel system that will supplement, and be supplemented by, a deeper knowledge and experience of conventional financial systems.

As the market strives to recover, entrepreneurs are still searching for funding avenues. With angel investors few and far between, it is imperative that entrepreneurs look to build partnerships that will provide them with creative mobility, without strict and impracticable restraints.

Using Islamic Financing concepts to structure a business does not imply that your business must be “Shariah Compliant” or so certified. It is a structuring tool that should be taken advantage of by companies looking to finance.

An untapped source for a partnership or LLC structure is one promoted by Islamic financing principles. In our last piece, we discussed the Mudaraba concept of a joint venture, with a three part process: (1) investors; (2) funds; and (3) the business entity. **Here, we discuss another principle, Musharaka Mutanaqisah, which is applicable to partnerships and start-ups, allowing for a “diminishing” partnership agreement. This allows the Entrepreneur to eventually have full ownership of the business.**

Diminishing Partnerships

An oft-ignored feature of Islamic banking is that it promotes risk-sharing between the provider of funds—the Investor, and the user of funds—the Entrepreneur. By contrast, conventional banking structures place all the risk on the Entrepreneur, cocooning the Investor with an assured, predetermined rate of interest. Whether the project succeeds or fails, the Investor is guaranteed a return on investment, through interest payments. In the Musharaka system, the risk is allocated in an equitable manner: you lose only what you invest—whether it be labor or monies—and you reap through a pre-arranged manner agreed upon by both parties.

Musharaka Mutanaqisah refers to a joint partnership where two or more persons combine capital and/or labor, forming a business. Under this variant, the share of the capital provider in the business diminishes over time as the entrepreneur/labor-providing partner makes regular payments to the capital provider. This variant is often used in home financing, however it is just as applicable to partnership agreements and start-ups.



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Structuring the Business

As with all business deals and structuring agreements, the Musharaka system is best implemented through a contract between two or more parties, or through the creation of a comprehensive Operating Agreement that embodies the concept of Musharaka.

Under this variant, there are three contracts: (1) partnership agreement for joint ownership of the financed business; (2) the Investing partner lease, whereby the partner invests its share in the asset ownership to the Entrepreneur at an agreed upon percentage; and (3) the final signing over of the business from the Investing partner to the Entrepreneur upon completion of all payments agreed upon by the parties.

Example: Entrepreneur pays 20% of the asset cost as the initial share to co-own the business while the Investor provides for the balance of 80%. The Entrepreneur agrees to gradually buy back the Investor's 80% share at an agreed portion until the asset is fully owned by the Entrepreneur.

Eventual Ownership

The Entrepreneur's share ratio in the business would increase after each payment, which would be a combination of lease payments and the repayment of the capital contribution. Unlike conventional bank repayment set-ups, these agreements are often based on the amount the business is earning. For example, the repayment amount is not an exact number, but a percentage of the business's earnings for the repayment period.

These repayment plans allow flexibility for both parties, and it encourages Investors to take interest in the business itself. Unlike banks, who have little or no concern for the development of a business, the Investor in a Musharaka Mutanaqisah structure reaps the benefits of a blossoming business, and suffers a loss when the business suffers as well – as does the Entrepreneur.

Further, upon repayment, the business is no longer a partnership – it will be fully owned by the entrepreneur.

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