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# The Origin of Non-Recourse Mortgage Financing: How Ancient Is This Seemingly Modern Financing Technique and Is It Perhaps Sha'ariah and Halachically Compliant?

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**This article explains the modern non-recourse mortgage financing structure, traces its origins, and suggests that, conceptually, the non-recourse financing format bears more than a passing resemblance to three financing forms in use in medieval times, known as the Iska, Qirad, and Commenda. These forms enabled the financing of trade and business. They also provided for an interest-like return to the financier, in many cases, without falling astray of the Biblical prohibition against making interest-bearing loans.**

It is common practice to finance commercial real estate transactions through an interest-bearing mortgage loan. At its most basic level, the loan is typically evidenced by a note that is secured by a mortgage[1] against the real estate and an assignment of the rents. This structure underlies the financing of office, retail, industrial, hotel, multi-family, healthcare and other types of income producing real estate. It is one of the structural components of the financial product known as commercial mortgage backed securities ("CMBS").[2]

## Introduction

The modern CMBS loan is formulated based on a so-called non-recourse mortgage loan structure. The term non-recourse is somewhat of a misnomer, however, since it does not mean that there is no liability at all. Rather, the term denotes that there is, generally, no personal liability for repayment of the loan. Instead, the sole recourse is against the real estate, encumbered by the mortgage, which secures repayment of the loan. This non-recourse nature of CMBS financing distinguishes it from other types of mortgage financing, where the borrower is personally liable under the note for the debt.

How did non-recourse financing come into practice? Was it invented as a part of the CMBS phenomenon or is it an older formulation? Indeed, could it be ancient in origin?

This article suggests that, conceptually, the non-recourse financing format bears

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more than a passing resemblance to three financing forms in use in medieval times, known as the Iska,[3] Qirad,[4] and Commenda.[5] These forms enabled the financing of trade and business. They also provided for an interest-like return to the financier, in many cases, without falling astray of the Biblical prohibition against making interest-bearing loans.

This is interesting on a number of levels. Of course, knowing when and where a useful idea was first formulated is noteworthy from an historical point of view. But, this analysis may also yield a result that is most useful, in terms of modern financing techniques, as well. Understanding why these medieval financing structures were permitted despite the dominant culture disdaining interest-bearing loans might help us adapt existing financing products to meet similar present day concerns. Imagine having a universal CMBS-like financial product that permits the free flow of capital, through the capital markets, from sources of capital adhering to the Halacha[6] and Sha'ariah[7] to those in need.

There are non-recourse financing techniques significantly more ancient in origin than the medieval forms noted above. One of the earliest recorded non-recourse financing structures is reported in the second century Mishna.[8] Limited recourse financing forms[9] are also discussed in the Mishna. Both non-recourse and limited recourse structures are described in the Jerusalem Talmud,[10] which was compiled during the fourth century. The limited recourse model of the Mishna is reflected in the form of Iska reported in the Babylonian Talmud[11] of the sixth century. However, there are non-recourse versions of the Iska, as well. There are also other limited or non-recourse financing models discussed in the Jerusalem Talmud and Babylonian Talmud, as summarized below.

It was after this period that the Islamic form known as a Qirad (or Mudarabah) likely made its appearance. Christian Europe later adopted a similar format, known as the Commenda, in the medieval period. The Iska format also continued to develop.

In the global economy of the medieval period, the Iska and Qirad enabled business to be done among lenders and borrowers from different countries and seemingly disparate systems of law and culture. As evidenced by documents found in the Cairo Geniza[12] and elsewhere, there was a commonality of approach to dealing with lender and borrower concerns. This was, likely, because of shared values and similar supervening religious considerations about charging interest, among individuals of the Jewish, Christian and Muslim faith. These medieval financing forms successfully embraced the purely financial demands of the marketplace in a manner that also accommodated the religious sensitivities of the participants. It is not suprising then that these financing forms were similar in conceptualization; even if not in every detail of execution?

The non-recourse and limited recourse financing structures noted above were an integral and essential part of medieval commerce. As market conditions have changed in the centuries since that time, so have the terms of financing. However, it appears we have now come full circle and re-engaged with ancient financing concepts that flourished in the medieval period.

The Iska, Qirad, and Commenda address the kind of issues covered by modern financing forms in similar fashion. Concepts of risk of loss, the apportionment of risks, exculpation from personal liability and carve-outs to exculpation (providing for full or limited liability), appear to have developed early on.


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These forms sought to accommodate and balance both the needs of the lender securely to deploy capital and those of the borrower to obtain funding, without requiring either to take unreasonable risks. As might be expected, the terms of financing appear to have changed over time, in response to the ebb and flow of demand in the marketplace.

The religious principles and practices, which drove these financing structures, served to enable business, rather than proscribe it. Medieval religious authorities paid a great deal of attention to the fundamental concerns of how lenders might employ capital to make a reasonable and secure return and how borrowers might access needed capital to finance trade and commerce. What emerged were financing forms that were functional and did not fall astray of religious mandates forbidding the making of interest-bearing loans. As noted above, conceptually, these forms bear a striking resemblance to modern non-recourse financing techniques. This is most refreshing given the absolute pronouncements by some denouncing[13] the charging of interest, no matter what the circumstances. These purported religious spokesmen are often so doctrinaire in their approach that they fail to address these permitted financing forms used since medieval times. While some seek to use religion, as a divisive force, this article finds that shared values and similar financing concepts were employed to break down barriers and foster trade and could do so again. Expressing these ancient concepts in modern terms will hopefully shed light on just what is prohibited and what is not and will put seemingly modern non-recourse financing in a new perspective.

To better appreciate the nature of these medieval financing forms, it is important to understand the religious principles, which prohibit a loan on interest and yet permit these financing forms. In a classical Biblical loan, the borrower bears all of the risks and must repay the funds advanced under all circumstances. The return earned by the lender in this kind of a loan transaction is deemed prohibited interest. However, if the borrower is not personally liable and lender bears all of the risk of loss, then the financing is usually not considered a traditional loan transaction. As a result, the return earned on the money advanced by the lender is often not considered prohibited interest. There are also intermediate positions, where the risk of loss is shared on some agreed upon basis by the parties. The details of when and to what extent each party bears some of the risks of loss are cogent. There are also differences among and within the body of religious laws embodied by the Halacha, Sha'ariah and medieval Christian[14] thought. A careful analysis of what risks may be borne by the borrower and the extent of liability can yield insights into the very essence of why one type of financing form may be permitted, while another one is deemed a prohibited interest-bearing loan. A review of the documentary forms extant, referenced by religious authorities, provides insights into the nuances of just what is permitted or prohibited. Thus, a borrower may properly agree to a variety of terms, conditions and obligations. Violating them might convert an otherwise non-recourse financing into a recourse loan. The menu of permitted covenants in the medieval financing forms is similar, in many respects, to the carve-outs to exculpation in CMBS financing forms.

The current CMBS non-recourse financing structure, like the medieval and more ancient forms before it, was designed to accommodate prevailing business and financing


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practices. It is suggested that, conceptually, much like the antecedent medieval financing forms, the CMBS format may similarly be exempt under the Halacha, Sha'ariah and Canon law[15] from concerns about the charging of interest (whether termed Ribit,[16] Riba[17] or Usury,[18] respectively).

## The CMBS Non-Recourse Financing Structure

The modern CMBS mortgage structure is reported to have originated in the late 1980s and the issuance of CMBS began in earnest in the early 1990s. However, there were antecedents,[19] dating back to the beginning of the 1980s, including the syndication of interests in mortgages, pioneered by the investment firm Drexel Burnham.[20]

As noted above, CMBS mortgages are often characterized by the term non-recourse. The concept of non-recourse mortgage financing was developed before CMBS made its debut. However, prior to the 1980s, it was often accomplished using other formats and techniques that were not as elegant as those used in CMBS financings.

In 1975, achieving a non-recourse mortgage was viewed as a structural exercise. It was not just a matter of drafting an exculpation clause; it was more complicated than that, at the time.

Real estate is a unique asset category under the law. It has many benefits as compared to other asset classes; but it is also burdened with certain complications. In dealing with real estate, there is so called privity of estate and privity of contract. These two existential states can sometimes be in conflict.

Being a party to a contract creates privity of contract with the other parties to the agreement. When real estate is sold subject to a mortgage, there is no privity of contract between the mortgagee and the new owner, unless there is an assumption by the new owner of the mortgage encumbering the property.[21] Nevertheless, because of the concept of privity of estate, the new owner takes title to the real estate, subject to the terms and conditions of the mortgage. This means if the mortgage payments are not made, then the mortgagee can foreclose against the property. However, absent an express assumption of the mortgage and underlying debt obligation represented by the note, the mortgagee cannot sue the new owner personally to enforce the note. It may only proceed against the mortgaged property. Functionally, this is the equivalent of a non-recourse mortgage financing.

It should also be noted, when it comes to a mortgage and real estate, contract rights may not necessarily be enforceable in quite the same manner as is the case with other agreements. In the real world of real estate, including matters of title, mortgage liens, possessory rights, the New York rule of election of remedies[22] and the equitable remedy of foreclosure,[23] there may be intervening or other factors that qualify the kind of relief that can be obtained.[24] In order to access the value of the real estate that is the security for a non-recourse mortgage financing, the lender is sometimes required to foreclose against the property. This is the legal process whereby the borrower's rights, as the owner of the real estate (including the so-called equity of redemption[25]), as well as, any other subordinate claims to and liens encumbering title to the real property, are cut off. This is also a necessary prelude to obtaining possession of the real estate, subject to the usual non-borrower tenants' rights.[26]

The concepts of privity of contract and


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privity of estate were used to good effect in constructing what amounts to a non-recourse mortgage financing, prior to the advent of CMBS. Under this structure, title to the real estate was first conveyed to a corporation, newly formed for that purpose. The corporation entered into the mortgage loan, which did not contain the exculpatory provisions[27] typically found in a CMBS financing. The loan was fully recourse against the corporate borrower. However, the newly formed corporation had only one genuine asset; the real estate encumbered by the mortgage. Next, title to the property was then usually transferred to a limited partnership, owned by the actual principals in the transaction. A limited partnership entity[28] was typically used to achieve both limited liability and the benefits of a pass-through of income[29] and depreciation deductions.[30] These are important features that characterize the ownership of commercial real estate. The partnership, as the new owner of the real estate did not expressly assume the mortgage. It was, in effect, burdened with responsibility for repayment of the mortgage; but only to the extent of the real estate itself. There was no personal obligation because there was no contractual assumption of the mortgage and the underlying debt obligation. The net result was a non-recourse mortgage financing that burdened the real estate; but not the other assets of the ownership entity or the personal assets of the principals.

As time went on, borrowers demanded and lenders accommodated the need to have an express exculpatory provision in the mortgage documents.[31] I remember well having to adjourn a closing in the early 1980s, because the exculpation language was not quite right. As a young attorney, I was concerned that I may have made the wrong judgment call. When I returned to the office, I was gratified to learn that the bank had called and agreed to the needed changes.

At the time, non-recourse financing was not a financial product prevalent at banks, generally; especially, non-money center banks. Indeed, in the late 1980s, I was involved in working out non-recourse mortgage loans that had been syndicated by Drexel Burnham to banks and other financial institutions, nationwide. Meetings were held with groups of lenders holding interests in the morgages to review the status of the mortgages and the workout strategy. At one such meeting, with representatives of approximately two-dozen banks, I was asked to explain the meaning of a non-recourse mortgage. Many in attendance were astonished that the borrowers were not personally liable for the debt. The concept was foreign to their experience.

While the unique characteristics of the asset class of real estate are sometimes burdensome to a lender, they are generally most beneficial. The lender may realize a secure and priority first mortgage lien on the real estate and, by extension, the rents derived from the property. Other debts incurred by the borrower, with limited exceptions,[32] are subject and subordinate to the lien of the first mortgage financing. This despite the fact that these very debts[33] may have been incurred in providing services to tenants needed to yield the rent. Indeed, the ability to compartmentalize the real estate has powered an entire real estate finance industry. It is not a typical loan to a business, with all of the attendant underwriting concerns about other intervening creditors and the complications of running a business. Legally, the real estate asset (and, by extension, so too the rents) can be segregated from the business of the tenants at the property paying the rent.


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As a corollary to this financing structure, the need for personal liability of the borrower is diminished. Indeed, it may even complicate what, at its very essence, is a simple financial model. It is an asset-based loan and the asset is unique because it can continue to generate its own income, even if the borrower is no longer there. Indeed, if the borrower's personal net worth is needed to support the underwriting of the loan, then it probably is not the sort of loan that should be pooled with others and made a part of a CMBS financing. Each commercial mortgage loan is required to stand on its own and be underwritten based on the real estate securing the loan; not some outside credit. Loans comprising a CMBS offering are also, generally, supposed to be underwritten in accordance with the same standards. This process of standardization is intended to make these otherwise complex financial products resemble commodities. If a personal guaranty is required, financially, to support a mortgage loan, then the loan is inconsistent with the general underwriting standards. Moreover, all sorts of entanglements could occur. For example, the guarantor's credit may be impaired for reasons having nothing to do with the property encumbered by the mortgage. This would violate one of the sacrosanct principles of CMBS financing, so called bankruptcy remoteness.

This focus on the asset that is the object of the loan, to the exclusion of other sources of credit support, distinguishes the CMBS format from a typical bank financing of a relationship borrower. In essence, when a local bank underwrites a loan to one of its customers, it usually intends to retain the loan as an asset of the bank.[34] Since the bank is not underwriting the loan for resale in the capital markets, it is often more concerned about entangling the borrower in a financial relationship with the bank. After all, when a bank has a relationship with its customer, then why not seek to be as secure as possible. Bank culture, therefore, often demands that a personal guarantee of the customer be obtained, even when it's not necessary, financially, as credit support for a fully secured first mortgage loan. Why artificially exculpate the customer from personal liability for a loan; it's all part of the overall relationship. This is unlike an originator in the CMBS market, which is vitally interested in disentangling the mortgage loan from the borrower's other financial affairs.

The exculpation from personal liability of the borrower, with the sole recourse being against the real estate securing the mortgage loan, is an essential feature of non-recourse financing. This same conceptual approach underlies the the other, more ancient, financing techniques, noted above. It may also help explain why the interest-like return earned by lenders using the Iska or Qirad was not viewed as prohibited interest.

The depth, strength and efficiency of the capital markets has helped achieve one of the lowest interest rate environments in history. The CMBS financing model is a part of the reason for this success. Its re-emergence as a financing alternative, after the debacle of 2008, is a testament to its resiliency. It remains one of the preferred financing techniques including for the reasons noted above. However, despite its usefulness in making low cost financing available to so many borrowers for the betterment of society, is it nevertheless forbidden under the Halacha or Sha'ariah? The answer may be a qualified no. It may well be that the CMBS format, if properly drafted, yields permitted return and not prohibited Ribit or Riba, as more fully discussed below.


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## The Biblical Prohibition Against Making Interest-Bearing Loans vs. Other Financing Techniques

The Bible prohibits the making of an interest-bearing loan[35] by one individual to another.

However, financing structures have since been developed that are exempt from the Biblical prohibition, because they differ in one or more material respects from the original Biblical construct. Of critical importance is the fact that the Biblical prohibition involves the making of a loan.[36] But just what is a loan? How does it differ from a partnership, lease or other financing device?

Maimonides[37] codified the classical definition of a partnership under the Halacha. At its most basic level, it involves two people who contribute capital and their services in furtherance of a common enterprise.[38] The sharing of profits and losses is typically based on the relative amounts of their capital contributions to the partnership. If both contribute equally, then they share in the profit and losses equally. But what if only one of the parties contributes capital and, furthermore, that party does not work[39] in the venture financed by his capital. Does that mean that there is no partnership? The simple answer is yes.

Maimonides expressly deals with this construct. He posits that if money comes from one party and the other party is designated to deal with the money, then the relationship is called an "esek."[40] The financier advancing the funds is called the "Baal HaMaot" (owner of the money) and the borrower is called the "Mit'asek" (businessman or user of the money). This is because the borrower alone is involved in the business that is financed with the money advanced by the financier. The borrower cannot bind the financier and the liabilities incurred by the borrower are not attributed to the financier. The financier's risk on the transaction is limited to the principal advanced. This is unlike a traditional partnership relationship, where one partner is responsible for the liabilities incurred by the other in furtherance of the partnership business. Whatever the relationship may be between the moneyman and the user of the funds advanced, it is not a partnership. Religious law views their arrangement as a financing structure. Whether it is deemed to be a loan and, hence, any profits derived by the lender from the financing are prohibited as Ribit, is dependent on a number of factors. It is not obvious from the simple fact pattern described above. Further analysis is required to establish whether the financing structure is a loan or something else.

Just what are the defining characteristics that establish a particular financing form as a loan or not? This is a threshold question. If the particular financing structure is not a loan, then the gain realized by the financier may not be prohibited Ribit or Riba.

It appears that the conceptual basis for distinguishing a loan from other financing structures that do not yield prohibited Ribit or Riba involves, at its most basic level, an apportionment of the risk of loss on the transaction.

At one end of the continuum is a loan transaction, where the borrower assumes all of the risk of loss and is personally liable to repay the loan. At the other end of the continuum is a permitted financing structure, where the financier assumes the risk of loss. If the borrower has no personal liability to repay the funds advanced by the financier,[41] then it is not considered to be a loan. This


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construct has many labels,[42] but, at its essence, it is a financing. In between are a variety of financing structures, where the risk of loss on the transaction is apportioned on some basis that may, or may not, yield prohibited Ribit or Riba. It depends on the particulars of the transaction and not everyone agrees on what does or does not work, as more fully discussed below.

Consider, for example, a lease of property under a rental arrangement.[43] In essence, the property is being loaned to the tenant and yet the rent paid is not considered Ribit[44] or Riba. A distinguishing characteristic between a Talmudic lease and a loan is that the landlord, unlike a lender in a loan transaction, bears some of the risk of loss. At a minimum, the landlord retains the risk of depreciation of the property, both physically and financially (in terms of any dimunition in value). The landlord also typically bears the risk of loss due to fire or other casualty.[45]

Consider also one of the permitted financing structures discussed in the Jerusalem Talmud.[46] A lender provides a borrower with produce, on credit, for transport to and sale in a remote locale, where the price is higher. The lender is to be paid the higher price, but only upon return by the borrower from the trading mission. Ostensibly, there is a higher credit price charged for the privilege of deferred payment of the purchase price.[47] This is, generally, deemed to be prohibited Ribit. Yet in this context, the transaction is permitted, provided that the lender bears the risk of loss during the trip to the remote locale.[48] The financing would then convert into a straight loan in the total amount of the higher sales price. The borrower could then use the financing proceeds to buy goods for sale locally and would be entitled to all the profits earned on the return trip. Similarly, the borrower would bear all the risks of loss in connection with those subsequent transactions and the return trip.

There are a number of other permitted non-recourse and limited recourse financing techniques described in the Mishna, as well as the Jerusalem Talmud and Babylonian Talmud, as summarized below.

It is important to dispense with labels. Calling something a loan, lease or sale does not necessarily make it so, for Riba and Ribit purposes. The reason why one type of transaction might yield prohibited Ribit or Riba and another similar transaction yield permitted return is primarily a function of how the risk of loss is apportioned in the particular transaction.

### Early Forms of Non-Recourse Financing described in the Mishna, Jerusalem Talmud, and Babylonian Talmud

The Jerusalem Talmud[49] describes a simple, straightforward, non-recourse approach to financing that solves the problem of Ribit. The financing transaction involves an advance of funds to purchase fruits in a place where the price is lower and the transport of the fruits to another locale for sale, where the price is higher. The borrower is the fruit dealer and the financier is known as the purchaser. The arrangement provides for a sharing of profits by the borrower and financier, equally. The text explicitly provides that if the financier bears the risk of loss,[50] then the financing transaction is permitted. It goes on to say that if the borrower bears the risk of loss, then the financing transaction is prohibited.

Another useful non-recourse financing structure discussed in the Jerusalem Tal-


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mud[51] is ascribed to Rav Leyzer.[52] Under this financing technique, a sum was advanced to the borrower to do business with for a specified term. All of the profits earned during an initial period during the term belonged to the financier. The financier also bore the risk of loss during that initial period. Thereafter, the principal amount plus profits earned, during the initial period, was automatically converted into a loan in that aggregate sum. The borrower could then use the loan proceeds to do further business, for balance of the term, on the conditions agreed to by the parties. Any profits earned during the later part of the term belonged to the borrower. Concomitantly, any losses suffered during the later period were also borne by the borrower. This non-recourse financing structure[53] may be the basis of the Medieval financing form described by the Tur,[54] discussed below. It is also described favorably in an earlier work of Tannaic literature known as the Tosefta.[55]

The Mishna[56] also describes a form of non-recourse financing that does not violate the rules prohibiting Ribit. Under this permitted structure, a financier may loan calves or colts to a borrower. The borrower is to raise them until an agreed upon time, when they are to be sold. Under this financing arrangement, the financier and borrower split the profits from the sale, one-half each. It is referred to as a "half of the profits" financing arrangement.

In contrast to this permitted financing structure, there is a nearly identical financing form described in a subsequent Mishna in the same Chapter of the text;[57] but that form is prohibited. Both transactions involve a loan of calves or colts to a borrower. The financier is to receive one-half of the profits in each case as the return on his investment in the calves or colts. However, in the prohibited case, the text speaks of an assessment being made of the value of the calves or colts, at the inception of the financing transaction. This is the distinguishing characteristic between the two otherwise identical transactions. The underlying assumption is that the valuation is done in order to fix the amount of the principal obligation that the borrower undertakes, by entering into the prohibited financing format.[58]

In the prohibited form, the borrower is personally liable to the financier for the value of the calves or colts, no matter what happens. If, the ultimate sale of the calves or colts yields less than the amount of the initial value, then the borrower is liable to the financier for the deficiency. If the colts or calves die during the course of the transaction, then the borrower is, nevertheless, liable to pay the original value. No matter how the transaction is labeled, in substance, it's a loan. Thus, the Mishna concludes that this type of a financing structure would yield Ribit[59] and, therefore, is prohibited.

This is in stark contrast to the virtually identical financing form previously discussed, where there is no assessment of value of the calves or colts borrowed at the inception of the financing transaction. The valuation is not necessary because the borrower is not personally liable to the financier for the principal amount of the financing (i.e., the original value of the colts or calves).

Under the permitted form of the financing structure, the borrower is, generally, not liable for any losses (including if the animals perish during the course of the transaction). The sole recourse is against the property that is the subject of the financing (i.e., the calves or colts). The borrower would, however, be personally liable for violating the stipulations made by the parties regarding the use and


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care of the animals. Since, it is the financier who, generally, bears the risk of loss on the transaction, it is not a traditional loan transaction. The Mishna, therefore, raises no issue of prohibited Ribit. Said another way, the Mishna presents a non-recourse financing[60] structure with certain carve-outs to exculpation.

The Mishna[61] also reports a limited recourse structure. Under this financing technique, the financier advances funds to a storekeeper to purchase goods on the basis of sharing the profits, equally. Rashi[62] and other commentators[63] interpret this structure as the limited recourse form of Iska, where the risk of loss is apportioned equally between the parties. Hence, the key proviso that the borrower must be compensated for the work involved in effectuating the financed transaction. Absent this provision for compensation, the financing form would be proscribed, as yielding prohibited Ribit, as more fully discussed below.

This innovative financing structure is analyzed in the Babylonian Talmud.[64] The text begins by citing a statement of the Nehardeans[65] to the effect that there is a financing structure known as the Iska. It goes on to report that the Rabbis reformulated the Iska in a manner that benefited both lenders and borrowers. The Iska was a financing structure in use at the time and prior thereto.[66]

The risk of loss in the basic Iska financing structure, prior to the Rabbinic intervention, likely mirrored some of the non-recourse forms[67] described in the Mishna and Jerusalem Talmud. The format, however, was restructured.[68] As a result, it better protects the interests of lenders.[69] Thus, instead of lenders bearing all the risk of loss (with limited exceptions), the risk was divided; one half to the lender and one-half to the borrower.[70]

At the same time, as the Talmud points out, it favored the interests of borrowers, generally, by enabling the freer flow of money from capital sources to borrowers. It is suggested that this may have been a time when lenders were less willing to risk their capital and hence money was tight.[71] The Rabbis formulated this sharing of the risk arrangement to incentivize financiers to part with their cash because they were better secured.

The Iska arrangement encumbered the money advanced and anything purchased with the funds.[72] When reduced to writing in a document known as a Shtar,[73] this innovative Iska structure not only encumbered real property (because of its debt component), it was also able to encumber[74] specified personal property. Nevertheless, it was unlike a pure loan, where the borrower bears all of the risk of loss. Furthermore, unlike a traditional loan (and despite the borrower bearing one-half the risk of loss), Rava[75] notes in the text, all of the monies advanced (including the portion deemed a loan) could only be used for the transaction or business that was the object of the financing.[76] Rava goes on to state that the borrower cannot use the proceeds of the financing for drinking beer (i.e., personal use), as would be the case with a traditional loan. Rava also notes that the merchandize purchased with the proceeds of the financing stands as security for repayment.

This innovation of the Rabbis analyzed in the Babylonian Talmud represents one of the limits of how much risk of loss may be borne by the borrower and still qualify the financing as a non-loan, for Ribit purposes. This favorable apportionment of risk of loss is condi-


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tioned on the borrower receiving some compensation for his efforts on behalf of the venture. The amount that must be paid is the subject of discussion in another part of the Talmud.[77] It ranges from a nominal amount[78] to the equivalent of full wages on prevailing market terms.[79] However, this is only required where the losses and profits are shared equally. If the lender bears an appropriately greater percentage of the losses than his share of the profits (for example: 2/3 of the losses vs. 1/2 the profits[80]), then no separate compensation need be provided to the borrower.

This essential element in the Iska, distinguishes it both contractually and philosophically from other Sha'ariah compliant and Christian financing forms. The Qirad and Commenda view the borrower's efforts, acumen and contacts, as his or her contribution to the venture with the financier. The Halacha takes a different view. In a pure investment context, where the financier takes all the risk of loss, the borrower is using his labor, talent and contacts to achieve profit for both parties. It is not very different from an incentive compensation arrangement in an employment context.[81] However, where the borrower has a personal debt obligation to the financier, then it might appear that the borrower was working for the financier, without compensation, as payment in kind to the financier for the loan. This otherwise uncompensated effort[82] could then be deemed to be prohibited Ribit. Although, this is not a genuine employer/employee relationship,[83] there is still an appearance issue. The answer of the Talmud was to pay the borrower something for these efforts. This served to dispel any appearance that the borrower contributed these efforts for the benefit of the financier solely in order to secure the loan and, hence, any issue of Ribit.

The Talmud explores the nature and extent of risk of loss a borrower can assume and under what circumstances, before the financing transaction is deemed a loan, yielding prohibited Ribit. At one end of the equation is the innovation to the Iska reported by the Nehardeans in the Babylonian Talmud noted above. It is unique among these religiously orientated financing forms. This Iska format, adapted to meet the needs of borrowers and lenders, permits the sharing of the risk of loss, equally. It is truly a creative restructuring of a most useful financing form. Its continued use in modern times is a testament to its inherent fairness and functionality. At the other end of the equation are the non-recourse financing forms that are recorded in the Mishna, Tosefta and Jerusalem Talmud. To be a loan, the borrower must be personally liable for repayment of the full principal amount advanced, under all circumstances. However, can a non-recourse loan be converted into a recourse one under certain circumstances, without violating the strictures against Ribit? The answer is a qualified yes, because the borrower must honor the stipulations agreed to by the parties and a breach results in personal liability by the borrower.[84] What are the kinds of obligations and liabilities that a borrower may undertake and under what circumstances, without falling astray of the prohibition against Ribit? How about the typical carve-outs to exculpation under a CMBS type mortgage loan; would they be acceptable under the Halacha? The answers to these questions require a deeper analysis of the relevant Halachic precedent on the subject.

There are some risks that the borrower can bear without issue. Thus, even an agent must follow the principal's instructions and would incur liability for defaulting in these duties.[85] The Sha'ariah follows a similar path,


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as reflected in the Qirad. In essence, the borrower is liable only if the borrower violates the duties or other stipulations agreed to under the financing arrangement. As a result, they are not subject to the strictures against Ribit or Riba.

The texts in the Mishna, Tosefta, Jerusalem Talmud, and Babylonian Talmud are among the earliest recorded discussions of the nature of non-recourse financing. Interestingly, the Jerusalem Talmud text cited above[86] also discusses what happens if the borrower fails to purchase the goods that are the object of the financing or sell them. It concludes that the financier cannot hold the borrower liable for the profits that would have been earned, had the borrower accomplished the purchase and sale of the goods as intended. The financier however can recover the unused funds. Similarly, the financier can recover any goods purchased that are unsold.

The non-recourse financing structures discussed in the Jerusalem Talmud, as well as, the earlier presentation of the structure in the Mishna and Tosefta would appear to presage, by hundreds of years, a later financing form known as a Qirad or Mudaraba under the Sha'ariah. The non-recourse financing form was already in use by the time of the Mishna.[87]

The limited recourse evolution of the Iska financing arrangement, discussed in the Talmud, was a standard practice[88] until the 11th century. There appears to have then been a shift back to the earlier form of non-recourse Iska, reported in the Mishna and Tosefta and discussed in the Jerusalem Talmud. This was a time when trade was international in scope and was conducted not only on land and by sea.[89] These were perilous trading missions. Besides the danger of ships sinking and pirates, crossing the borders of the many nations along trading routes was also no easy feat. Imagine the money, effort and contacts it took to mount a successful trading mission from the interior of Germany or France, to the coast of Spain or Italy and then to India or China and back. With no direct sea route, the trip involved movement on land in Europe, a sea journey to the Middle East, a trip over land to the Persian Gulf and then a sea voyage to India and back again, along a similar combination of sea and overland travel. Few people had the means or acumen and contacts to accomplish this kind of international trade.[90] The Jews were well placed to do so because of their presence in many of the locations mentioned above.[91] It is speculated that there was a greater supply of money and substantial demand for the products of trade. Entrepreneurs who could successfully accomplish these kinds of trade missions were in more limited supply. Moreover, because of the inherent risks of sea voyages many entrepreneurs were unwilling to bear all of the risks involved in these ventures.[92] The successful entrepreneur, with contacts in far ranging places and the apparent ability to accomplish profitable transactions, was able to obtain more favorable terms of financing. Hence, it is believed that borrowers involved in sea trade were able to demand financing without affording the lender the protection of a full recourse loan (or even the more limited recourse provided under the Babylonian Talmud's form of Iska financing arrangement). They could demand and obtain what amounts to non-recourse financing.

This was also a time when the Qirad was in common use and the Commenda financing arrangement began to appear. Some of the contemporaneous Halachic discussions of


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these various financing arrangements are summarized below. Needless to say, there was much business interaction among members of all three major monotheistic religions at the time, in Europe, North Africa and the Middle East. This is documented in the forms of written agreements entered into by the various parties that have survived to our times.[93] These financing structures are also the subjects of contemporaneous discussions in Rabbinic texts. Thus, for example there is the decision rendered by the Rambam dealing with a Qirad.[94] There are also references by Rabbinic authorities to other financing forms then in use. In this regard, I note in passing the reference by Rav Yosef Karo[95] in his monumental work, the Bet Yosef[96] on the Tur,[97] in which he states that the seemingly non-recourse financing form[98] used in Lombardy[99] is not permitted. He notes that this is because the borrower's liability under that format was too extensive.

### Other Non-Recourse and Limited Recourse Financing Techniques Discussed in the Talmud

The Jerusalem Talmud and Babylonian Talmud[100] analyzed a variety of financing structures that were not purely non-recourse and nevertheless did not fall astray of the strictures against Ribit. The nature and extent of the limitations on recourse or the conditions that might create liability for the borrower, in an otherwise non-recourse structure, are recorded in various Talmudic texts. The Talmudic discussions engendered an entire body of Rabbinic literature, as well as, the creation of various documents embodying these limited recourse and non-recourse financing concepts. How the risk of loss is apportioned between the borrower and lender[101] is a key element in distinguishing whether a particular financing arrangement is prohibited or not. This is the grey area in the continuum between full recourse and non-recourse financing. The Talmud examines a number of different financing structures,[102] including those summarized below.

#### *A Technique Akin to the Modern Deed of Trust Mortgage Form*

Under this structure,[103] the borrower makes a conditional sale of a piece of land to the financier in connection with a loan. The loan amount and purchase price of the land are the same. The term of the loan is three years. The sale is deemed to occur as of the inception of the financing, provided the loan is not repaid on or prior to the maturity date. The fruits derived from the land, in the interim, belong to the financier, if the sales condition is satisfied (i.e., the borrower defaults in payment). If the borrower repays the loan amount, then the sale is voided and the fruits derived from the land belong to the borrower. The fact that the financier receives the fruits derived from the land is not deemed to be prohibited Ribit. This was said to be the financing device used by Boethus[104] ben Zonin, that he used on the advice of the Rabbis.[105] The Jerusalem Talmud reports that Rav Yuda[106] found this financing structure to be permissible. This is because the interest-like yield was, in fact, only earned conditionally. It was contingent on there being a payment default. Hence, it was deemed not to be Ribit. The borrower could avoid any such charge merely by making timely payment of the loan. This concept of conditionality is an underlying theoretical basis applicable to many of the permitted springing recourse provisions noted below.

#### *A Technique for Financing the Aging of Wine*[107]

The basic structure is similar to financing


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techniques used in the liquor business today. A distiller's investment in barrels of scotch left to age over periods of upwards of 18 years or more can be enormous. By entering into a buy-sell arrangement with a distributor, the distiller was able to obtain an immediate advance of cash, thereby financing its investment in the scotch. Under this financing program, the distiller kept possession of the spirits and had the right to buy back the spirits at the expiration of the term of the financing. The price yielded a healthy return to the distributer as the financier. In the modern financing form, the distributor also had the right to put the spirits to the distiller at the same price. It was a loan in all but name. Under the Talmudic structure described by Abaye[108] the financier similarly advanced a sum, denominated as the purchase price, to a wine dealer. It is styled as a purchase, but like the modern form, it is essentially a financing device. Unlike, the modern form,[109] the Talmudic financier took the risk of a loss that, when the aging process was completed, the price of wine may have declined.[110] The financier also benefited if the wine was worth more upon completion of the aging process. The Talmudic wine dealer, as the borrower, similarly kept possession of the wine. The dealer received the immediate benefit of a cash advance, instead of tying up capital, long term, while the wine aged. However, under the Talmudic form, the dealer, as borrower, bore the risk of loss that the wine turned into vinegar.[111] Rav Sherevya challenged this apportionment of risk formulation of Abaye,[112] because he viewed it as being akin to a loan. Thus, Rav Sherevya asserted the expected appreciation in the value of the wine, when fully aged and earned by the financier, was prohibited Ribit. In response, Abaye demurred and concluded that the financing form was permitted. He reasoned that it did not violate the prohibition against Ribit, because the financier also assumed the risk that the wine might, instead, depreciate in value, over the course of the financing transaction,[113] as noted above. Thus, while the borrower bore some of the risks on the venture, nevertheless, the financier took on sufficient risk to distinguish this financing structure from a prohibited interest-bearing loan transaction.

### *Another Useful Method of Non-recourse Financing Known as the Tarsha[114] of Rav Hama[115]*

Under this structure the financier provided merchandise to the borrower on credit. The market price for the merchandise in another remote locale was higher than the price in the local marketplace. The credit price for the goods was based on this higher price. It was not due and payable until the goods arrive for sale in the destination marketplace. At that time, the principal amount (representing the value of the goods in the home market) plus interest (representing the agreed upon premium over the local price) was transformed into a loan. The borrower could then use the monies so advanced to finance the purchase of goods in the remote locale for sale at a profit in the local home marketplace. Why, though, was this Tarsha[116] transaction not prohibited by reason of the prohibition against Ribit? Consider, there is the higher credit price that is usually considered Ribit under the Halacha. Then there is also the issue of the work done by the borrower in transporting the goods and then selling them at the higher price. Isn't this uncompensated effort also a form of prohibited Ribit? It would appear that the only reason the borrower exerted all these efforts and used his contacts and acumen to achieve the higher price was the loan that resulted. As to


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the former concern, the answer is that the financier assumed the risk of loss[117] on the goods furnished until they were sold in the remote location. Thus, this apparent credit sale was not viewed as a loan and, therefore, the yield to the financier derived therefrom was not prohibited Ribit. As to the later concern, it appears to be a valid one. Indeed, the medieval financing formats[118] based on this Talmudic structure, do require some form of compensation to the borrower.[119] This is so, notwithstanding that the Tarsha financing was initially a non-recourse form, as opposed to a limited recourse structure. The Talmud responds to the issue by noting that Rav Hama provided the borrower with the benefit of his exemption from taxation and a priority position in the marketplace. These benefits, derived from Rav Hama's position, were viewed as emolument to the borrower. The profits made by the borrower on the return trip accrued fully to the borrower. Correspondingly, the borrower was personally liable for payment of the full derivative loan amount. This financing form was expressly recognized by the Rambam as the basis of a non-recourse financing structure of the 12th century. It is also believed to be a precedent for a similar form described by the Tur in the 13th century.

### *The Leasing of Money Financing Structure of Rav Hama*[120]

A lease can be a financing tool. In modern finance, a lease of real estate coupled with an option to purchase has even been found to be an equitable mortgage.[121] However, the Talmud rejected this leasing of money financing technique. The Talmud reports that it is unlike a genuine lease, because money is fungible. Thus, the original coins leased are not returned; rather it is the monetary equivalent. In contrast, leased real property is returned at the end of the term of a lease. Said another way, the landlord, in a leasing arrangement, bears the risk of physical (and financial depreciation) of the property leased. A Talmudic lease structure also requires that the landlord bear some risks, such as fire or other casualty. If the landlord bears no risk of loss (as in a triple net bondable lease[122]) then the lease is nothing more than a loan of the property and the rental prohibited Ribit. In deference to Rav Hama, he apparently believed that if the landlord bore the risk of loss arising out of acts of G-d or other such events outside the control of the borrower,[123] then that was sufficient to establish the financing arrangement as outside the ambit of a traditional loan and the prohibition against Ribit. After all, in a true loan the borrower was personally liable no matter what the circumstances. However, his colleagues disagreed and the form was viewed as nothing more than a disguised loan.[124]

### *Rav Nachman's Technique*[125] *of Financing Tenant Improvements to Real Estate*

Under this structure, a storekeeper, who leased a store, borrowed money from the landlord for the purpose of painting a mural on the wall of the store. The landlord made the loan and increased the rent accordingly. It was reasoned that this was a beneficial tenant improvement because customers liked to shop in a well-decorated store. Thus, as a result, the rental value of the store could be said to be higher because of the improved condition. Hence, more rent could be charged. Similarly, if a ship owner loaned the lessee of the ship money to install a new mast, then the rent for the ship could be commensurately increased. The reasoning once again was that, with the improvements to the leasehold, the rental value increased. There was, there-


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fore, no concern about Ribit. A true rental arrangement is also distinguished from a loan, because there is no personal responsibility for the value of the property rented. The physical and financial depreciation of the property, if any, upon expiration of the lease, are borne by the landlord.

### *Increased Rental Rate for Real Estate if Paid Over Time*[126]

This is a unique aspect of a Talmudic lease of real estate. The guiding principal is that rent is actually set by the market based on its being due and payable in full at the end of the term of the lease. Thus, when rent is payable up-front or over time in monthly installments, it is, in effect, being offered at a discounted rate for early payment. Similarly, if goods are generally offered for a given price set by the market that accounts for payment being made on a deferred basis, with no spot price, then the seller is permitted to offer a discount for cash.

### *The Sale of a Borrower's Promissory Note at a Discount*[127]

The premium earned by the purchaser of the note is not considered Ribit.

### *The Eshoel*[128] *Financing Structure Described in the Jerusalem Talmud*

The entire discussion in the Jerusalem Talmud of this particular financing form takes all of 16 words.[129] It begins with a recitation that an individual who is "Eshoel" (loans) money to another individual. The use of the term in this context in the Talmud is unusual. The term Eshoel is derived from the word Shoel (borrow). Generally, the term is used to denote a casual loan of a household item or tool to a neighbor; not a monetary loan. The term Loveh is normally used when describing a loan of money. It is believed that the use of the term Eshoel in the text is not accidental and that it is intended to portray a particular type of financing structure. Consider, a Shoel/borrower does not bear the risk of loss by reason of depreciation, physically or financially, or use of the borrowed item for the intended purpose. Furthermore, if the lender is present with the Shoel/borrower when an event causing a loss occurs, then the borrower is not liable for the loss. These characteristics distinguish the Shoel transaction from an ordinary loan. The text goes on to provide for a specified amount of compensation for the borrower.[130] It concludes with a statement that the borrower and lender divide the profits; but no mention is made of the precise terms of division. This is unlike the other examples of financing structures described in proximity to this form in the text, where the sharing percentage is expressly specified as being one-half the profits to the borrower. This does not appear to be a lacuna; rather, it is proposed it is intentional. It is suggested, the Shoel structure described in this text is not an equal sharing arrangement. As a fully non-recourse financing form,[131] there is no substantive reason to limit the parties ability to agree to an unequal profit sharing arrangement. Yet, there may still be a problem of appearances. Consider, if sharing the profits, equally, is the accepted norm, then reducing the profit share of the borrower may imply that the work of the borrower is not fairly compensated. The difference may appear to be Ribit.[132] Therefore, the Talmud may be specifying that separate compensation be provided for the borrower to avoid this issue. This would then be much like the formulation of the Tur, discussed below, which was designed, in part, to avoid this very issue of appearances. In any event, whether it is a non-recourse or limited re-


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course form, it is another example of a financing structure that does not yield prohibited Ribit.

### *The Surean Pledge*[133]

Under this structure, the financier advances funds to the property owner, as borrower. In return, the lender receives a so-called Surean Pledge of the real estate and is entitled to all the avails from the property for a term of years. Although, nominally referred to as a pledge (or mortgage, in modern terminology), it is, in effect, a lease of real estate for a term of years. At the maturity date, the loan is deemed paid and unencumbered title to the property reverts back to the borrower.[134] Conceptually, the principal amount of the loan is viewed as a pre-paid rent under what is, effectively, a lease of the mortgaged real estate. In substance, though, it is a financing device, where the borrower is not personally liable and the sole recourse is against the real estate. Indeed, the real estate is used to repay the principal sum together with permitted return over the term of the Surean Pledge. The duration of the term of the Surean Pledge is designed to permit the financier ample opportunity to earn these sums; but the financier takes the risk that this result in fact occurs.

## Maimonides' Consideration of Non-Recourse Lending Structures in the 12th Century, Including the Islamic Qirad

The Rambam[135] describes a non-recourse financing format that is based on the Tarsha of Rav Hama, summarized above. The structure begins with an advance of funds from the financier to the borrower. The terms include a requirement that the borrower use the funds for an investment or presumed profitable activity. All of the profits from the venture, up to a fixed amount agreed to by the parties, accrue to the benefit of the financier.[136] Upon paying over the fixed sum to the financier, the borrower has use of the original principal amount. Any profits yielded by the venture thereafter belong to the borrower and similarly, any risk of loss is borne by the borrower.

There are two important provisos that animate this financing form and distinguish it from a prohibited interest-bearing loan. The first is that the financier bears the risk of loss until the fixed amount noted above is earned. Thereafter, the borrower assumes the risk of loss. The second is that there must be some compensation provided for the borrower until the fixed sum is earned. This is said to deal with the appearance issue of Ribit. Otherwise, it would appear that the only reason the borrower worked in the venture and used his contacts and acumen to achieve realization of the fixed sum of profits due to the financier was the prospect of then obtaining a loan of the funds. The payment of some compensation, even nominal,[137] is designed to resolve this concern.

The Rambam also considered other non-recourse financing structures.[138] In his Responsa,[139] he dealt with what he referred to as the Iska in accordance with the form used by non-Jews[140] or the "Jewish form of contract in the format of the Iska of the non-Jews.[141] The Judeo-Arabic text of the Responsa refers to the Iska as a "Qiratz."[142]

The Rambam defines these financing forms by explaining they provide that the borrower does not have personal responsibility for losses. The transactions described involved a variety of locales, including Tunis and India.

In one of the Responsa,[143] the Rambam dealt with two types of Iska forms. One form


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Iska[144] provided for the profits to be shared by the financier and borrower equally and losses to be borne two-thirds by the financier and one-third by the borrower. The other form provided for the borrower to receive only one-third of the profits; but the borrower had no personal liability for losses. While the Rambam preferred the former financing format he raised no issue of Ribit as to the later form.

### The Tur's 14th Century Structure for a Non-Recourse Financing

Rav Jacob ben Asher describes a permitted non-recourse financing structure, in his seminal code of Jewish Law known as the Arba Turim[145] or Tur. It is similar to the Rambam's form, based on Rav Hama's Tarsha, summarized above.[146]

Under the Tur's format, the financier advances a sum of money to the borrower. The borrower agrees to do business with the funds so as to yield profit until an amount equal to double the sum advanced is realized. The borrower is then to pay over that amount to the financier. The Tur specifies that the risk of loss be borne by the financier until this condition is achieved. Thereafter, any further profits earned belong to the borrower and correspondingly, the risk of loss shifts to the borrower.

Once again, the critical factor distinguishing this permitted financing structure from a prohibited loan structure seems to center on who bears the risk of loss in the financed venture. If the lender bears the risk of loss then, subject to the separate compensation provision noted below, the loan structure does not violate the prohibition against Ribit. On the other hand, if the borrower assumed the entire risk of loss of the transaction, from the inception of the financing, then the financing structure is nothing more than a loan and, by extension, the interest-like return payable to the financier, prohibited Ribit.

The Tur also requires that the borrower be provided with separate compensation[147] during the period until the profit condition is satisfied. Rav Yosef Karo discusses this requirement of compensation of the borrower.[148] He reports that if agreed to at the time of entering into the Iska then the compensation can be nominal. Otherwise, Rav Karo requires that the borrower be paid the market wage standard for so-called idle laborers.[149] This proviso seems to deal effectively with any concern about appearances.[150]

### The Trumat Hadeshen's 15th Century Non-Recourse Financing Structure

Rabbi Israel Isserlein[151] in his seminal work, the Trumat Hadeshen,[152] begins his discourse by setting forth a question of religious law dealing with lending and Ribit. He posits that the lender desires to loan money with a fixed rate of interest that is virtually secure as to principal. The question posed is how to do so, without falling astray of the prohibition against Ribit.

The answer provided by the Trumat Hadeshen is most interesting. He begins by analyzing the leasing of money arrangement posited by Rav Chama[153] that was rejected by the Talmud, as summarized above. He concludes that it was insufficient for the lender just to take the risk of loss by reasons of acts of G-d or other such events outside the control[154] of the borrower. To be exempt from the prohibition against Ribit, the lender had to assume the risk of loss,[155] generally. This included losses incurred by reason of theft or destruction of the property, not just acts of G-d.


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However, the Trumat Hadeshen goes on to note, the lender could agree with the borrower to certain stipulations, which, if violated, would shift the risk of loss to the borrower. Thus, for example, the parties could agree that the borrower's own testimony as to the occurrence of a loss of principal would not be probative. To establish a loss of principal would require the testimony of two specified witnesses, to wit: the Rabbi of the community and the Cantor. Unless these two specific witnesses came forward and testified, of their own personal knowledge, to an actual loss of principal, the borrower would be required to repay the principal amount. With regard to interest, the borrower would have to take a solemn oath that there were no profits. Otherwise, the specified rate of interest would be due and payable.

There could also be other stipulations made by the parties that were difficult or well neigh impossible for the debtor to satisfy. For example, the borrower could agree that the sole use of the funds advanced would be to make secured loans that were fully cash collateralized. If used for any other purpose, then the borrower would be personally liable to repay the loan. Similarly, extensive security provisions could be made dealing with the funds advanced. For example, the borrower could be required to bury the funds advanced under the floor in his or her home.

This opinion of the Terumat Hadeshen has been cited as a source of the non-recourse form Iska[156] in use today. It is a non-recourse financing structure, with carve-outs to exculpation. It is similar in conception to the modern non-recourse mortgage-financing format. This Iska format was further developed over time, as summarized below.

### A Non-Recourse Iska Document,[157] Following the Trumat Hadeshen's Formulation, with an Amendment to the Terms, Known as the Tikun Maharam, Found in a Documentary Formbook, Originally Published in 1625, Entitled Nahalat Shiva

The Tikun Maharam form of Iska was developed by Rabbi Mendel ben Avigdor[158] of Cracow. It was reportedly adopted by the Council of Four Lands[159] at the Kreminitz Fair, in the vicinity of Lublin,[160] in 1607.

Under this document, the borrower acknowledges receipt of the money advanced and agrees it is an Iska financing. The document provides that as soon as the profits earned reach the fixed return[161] amount, the entire principal sum plus the fixed return will be deemed a pure loan until the maturity date. From that point forward, the borrower is required to sell all assets acquired with the monies advanced to repay the debt in full. In this regard, the document specifies that even if this requires a distress sale at half price, the borrower is still required to do so.

The borrower also agrees that the principal amount will be a priority against any profitable venture entered into by the borrower. In essence, money is fungible. If the borrower makes a profit anywhere in the world then it is counted for purposes of determining whether the lender's principal was lost. This is not a net income concept, where losses incurred in one venture can be offset against a profitable one. It is a measuring device for determining whether the borrower, prima facie, can assert any loss of principal. Thus the principal is not deemed lost to the extent of any profits earned by the borrower in any endeavors, any where in the world. This is also the measure for determining whether the specified fixed return has been earned on the principal amount.


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The document also stipulates that the testimony of the borrower that there was a loss of principal is not probative. Two kosher witnesses are required to establish that there was a loss of principal. This is the major change initiated by Rabbi Mendel to the prior version of the Trumat Hadeshen. Hence the term "Tikun," meaning correction. It modified the requirement that only the testimony of the Rabbi and Cantor would be acceptable to evidence a loss of principal; a provision that was viewed as impossible of performance. After all how could the Rabbi and Cantor of a community personally know all of a borrower's worldwide income and business affairs? Frankly, even the lesser requirement of any two kosher witnesses is still nearly impossible to satisfy. Indeed, can anyone know the business of another so intimately and completely, so as to be able to testify of his own personal knowledge? Unless the borrower can actually present this testimony, it is presumed there was no loss of principal. As noted above, the borrower can still assert a prima facie defense to the payment of the fixed return, based on the borrower's own testimony accompanied by a solemn biblical oath.[162] The fact that the document does not bar the borrower from asserting there was a loss is significant. The borrower cannot covenant there will absolutely be a profit and be personally liable for a braech of this provision. That would be nothing more than a disguised loan. Rather, the document provides a precise and exclusive mechanism for when and how a defense of loss can be established. The burden of proof is on the borrower. Otherwise it is presumed that there was sufficient profit earned to warrant payment of both principal and interest. This conditionality feature helps ameliorate any concern that the non-recourse nature of this Iska form is illusory. Although, it may be very difficult for the borrower to assemble the proof needed to meet the burden, the fact is, the borrower can satisfy this condition and, therefore, have no personal liability for repayment of the loan.

The Tikun Maharam Iska is one of the most prevalent forms still in use to this day. Many Iska forms incorporate its terms by reference. It represents a milestone in the development of the non-recourse form Iska.

## Trade vs. Loan, a Re-Analysis of Koranic, Sunnah and other Relevant Texts and Definitions and the Qirad (or Mudarabah) Financing Structure

By way of background, it is important to note that the Koran[163] provides that trade (Bey) is like Riba. However, trade is permitted and Riba is not. The Koran does not define these terms or otherwise differentiate them. Indeed, it is not immediately clear from the text what distinguishes transactions that are prohibited because they yield Riba[164] and those that do not labeled trade.

The difference between the two is not just a matter of form or context; it goes to the substance of two types of financing techniques. Riba is associated with a loan where the borrower is personally liable to repay the loan no matter what the circumstances. In essence, the borrower assumes personal responsibility for any risk of loss, whatever the use of funds or cause of the loss. Another important factor is that the lender is not actively involved in the venture being financed by the loan. It is the borrower who does the work. Thus, it is asserted, in connection with a loan, it is the money that is working;[165] not the lender. Any gain earned by the lender on money advanced as a loan is viewed as subject to the prohibition against Riba.[166]


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However, trade can also involve a non-working party who finances the venture. Consider the not unusual situation of a person of means who financed an entrepreneur in a trade transaction. Imagine the discussion in a local café in Naples or Cairo, in the 14th century. The entrepreneur proposed chartering and provisioning a ship to sail to India. The purpose was to acquire spices and to return home to sell them locally. A successful venture of this sort could be very lucrative. The entrepreneur had the acumen and contacts to accomplish the transaction. However he was missing the cash to finance the venture. The financier had the money but this was not charity. To induce the financier to part with his cash required that he too profit from the venture. The simplest way of accomplishing the financing was for the financier to make a personal loan to the entrepreneur and receive a return called interest on the money advanced. However, that was wrong religiously, both in Naples, a part of the Christian world, and Cairo, a part of the Muslim world. Moreover, the entrepreneur may well have been unwilling to borrow the money if he took all of the risks of the venture. It is understandable that an entrepeneur might be unwilling to assume personally liablility to pay principal and interest, under all circumstances. There were too many genuine risks associated with a sea voyage to so distant a place as India. The ship could sink or pirates could attack the ship and steal the money or merchandise. There was also the risk that the venture might fail because of market conditions.

Under these circumstances, the entrepreneur was often able to negotiate a non-recourse or limited recourse sharing of risk arrangement.[167] These kind of financing structures had names like the Iska, Qirad, or Commenda.

Why was a Qirad that financed trade and was structured much like a loan transaction, permitted under the Sha'ariah and not deemed a loan yielding prohibited Riba? Both a loan and trade financing (under a Qirad,) involved an advance of funds by a non-working financier. Yet, in one case, the gain earned on the funds advanced was permitted and in the other it was prohibited. What distinguished these two otherwise similar transactions? Indeed, in reflecting on the Koran verse noted above, there are allusions to the fact that there is no genuine difference between a loan and what is referred to in the Koran as trade. Nevertheless, one is prohibited and one is permitted.

The essential distinguishing characteristic between a loan earning prohibited Riba and one earning permitted return involves the sharing of the risk of loss on an agreed upon and permitted basis. Thus, notwithstanding that the lender in a trade transaction does not work in the venture (only the borrower does) and, furthermore, notwithstanding that the non-working party is the only one advancing funds for the venture, the gain earned on the funds advanced is not prohibited Riba. The document embodying this permitted form of financing of trade is the Qirad or Mudarabah.[168] Under the Qirad, the financier[169] advances the money needed by the borrower to accomplish one or more transactions. The financier is not actively involved; rather, the borrower does all the work. The borrower also provides the contacts and talent in what is hoped will be a profitable venture. Unlike the Iska, the borrower receives no separate compensation for his efforts.

The Qirad is a non-recourse financing device, with some carve-outs to exculpation. Thus, except for the borrower's negligence


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or failure to fulfill his duties, in accordance with the agreement of the parties, it is the financier who bears the risk of loss on the venture. Borrower's obligations can include a variety of covenants, so long as they are not otherwise prohibited under the Sha'ariah.

Profits may be divided as the parties agree. Unlike the Iska financing structure, the borrower is not entitled to receive separate compensation for his efforts. In effect, the financier contributes the capital and the borrower contributes his time, contacts, skill and efforts.

Despite the fact that the money advanced under a Qirad arrangement can be said to be working for the financier, a condition otherwise frowned upon in the Sha'ariah,[170] nevertheless, this financing structure is permitted. This is supported by various sources in the Koran,[171] Sunnah,[172] and Hadith.[173] Indeed it is reported that Mohammed himself entered into a Qirad financing arrangement with a wealthy Jewish woman financier, who would later become his wife.[174]

Under the Qirad, the borrower is liable for losses arising out of the borrower's negligence. There is a duty of due care and diligence. There is also a duty to maintain confidentiality. This would include concealing material information about the investment or activity to be financed. Specific stipulations can also be made. This might include traveling by a specific sea route or not traveling overland through a dangerous valley. The parties are free to make other stipulations between them. Thus, the parties may also agree the borrower will only do certain transactions with the funds advanced[175] that are less risky. It would be misconduct by the borrower to do a prohibited investment or transaction. The parties may also prescribe specific security arrangements.[176]

Commingling of funds with the borrower's other activities is also be prohibited. Furthermore, the borrower is required to provide proper management and execution of the contemplated transansaction intended to yield a profit. This includes the borrower's acumen, contacts and work, which are deemed the borrower's contribution to the venture. The borrower is not supposed to delegate management. If the borrower breaches any of these provisions then the borrower is liable for the loss.

At the conclusion of the Qirad transaction, there must be an accounting by the borrower in the presence of the financier and the principal amount must be repaid first before any division of profits.[177]

The financier is not liable for the acts or debts of the borrower, including in connection with the venture being financed by the financier. In this regard, it is important to note, that under the Sha'ariah, the funds advanced and the property it purchases are technically still owned by the financier.[178] From a legal point of view, under the Sha'ariah, the borrower is not deemed to be the agent or partner of the financier. Furthermore, neither is a joint venture or entity created by virtue of the parties entering into a Qirad. The liabilities of the borrower are not generally imputed to the lender. The financier places only the monies advanced at risk. In effect, they are still considered to be the property of the financier. Like the Iska, the Qirad has its own structure. While it may have some analogous provisions, a Qirad is not a partnership, agency, lease or loan. It is a financing form that appears to have existed before the emergence of Islam.[179]

The basic structure, underlying the Qirad and the Iska before it, seems to have origi-


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nated in ancient times. Some of the terms and conditions may have changed over time. However, the basic conceptual arrangement, whereby risk of loss is shared, seems to have existed in Mishnaic times and perhaps even earlier. This is the essential characteristic that distinguishes the Qirad and Iska from a traditional loan. It is the primary reason why the return earned by the financier is permitted as opposed to being prohibited Riba.

### A Comparison of the Commenda, Qirad and Iska, Including an Analysis of the Carve-Outs to Exculpation under Each Form

The Commenda, Qirad, and Iska have much in common, conceptually. All three of these financing forms are based on a non-recourse or limited recourse financing structure. They each require that the principal be paid back to the financier, first, before any sharing of the profits. However, each form also has unique elements that distinguish one from another.

Scholars have addressed the question of the origin of these financing forms. As to the western Commenda, some argue that it is based on the Qirad.[180] Others argue it may be based on the Byzantine Chreokoinonia[181] or the Roman Societas. It is also argued by some[182] that all of these forms, as well as, the Iska may have influenced the development of the Commenda. It is respectfully submitted that the earliest such financing structure was probably the original non-recourse financing format embodied in the Iska. The limited recourse Iska structure discussed in the Babylonian Talmud was described as an innovation[183] promulgated by the Rabbis that benefited lenders. The earlier incarnation was, therefore, perforce not as beneficial to lenders. The earlier form was likely the non-recourse[184] version of the Iska,[185] which pre-dates the Qirad and Commenda by many centuries.

The particular terms and conditions of the risk sharing arrangement, qualifying the financing form as permitted, differ under Christian, Sha'ariah and Halachic[186] systems of law and thought. However, there seems to be a common underlying conceptual approach that distinguishes a prohibited interest-bearing loan from a permitted financing under these legal traditions, even if they differ in detail. Part of the reason for this common approach is shared values, originating from the Bible that are venerated by all three religions. The surviving documents also indicate a prevalence of Jewish parties to the trade transactions, which may also be a common denominator. After all, Jewish merchants played a significant role in international trade at the time. It is reported[187] that Jewish merchants spoke Arabic, Persian, Roman (Greek and Latin), and Frankish, Spanish, and Slavonic languages. They participated in the silk, fur, aloe and spice trade. This involved travel to and from the lands of the Franks, the Western Sea, ports along the Mediterranean (including Italy, Spain, North Africa, and the Middle East), by camel to the Eastern Sea and then to and from India, as well as, China. They crossed the countries of the Slavs, Khazars, and the Caspian Sea and traveled via the overland silk route to China. The dispersal of the Jews throughout the Diaspora created a natural natural network of local contacts necessary to sustain international trade.[188] Indeed, it is asserted that because of their presence and contacts in France, Germany, Byzantium, and Muslim territories, they had a virtual monopoly on this aspect of international trade at the time.

This was further enhanced because of the difficulty of safely moving money (in the form


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of gold or specie) over these distances and especially across borders. The ability to have reliable, trustworthy and proven trading partners was a significant advantage. Thus, instead of moving money, payments were often made by bills of exchange. This early informal payment by exchange system presaged the modern international banking system by centuries. It is no surprise then that the financing structures used to finance international commerce, as embodied in the Qirad, Commenda, and Iska, are similar in many respects. Some of the relevant distinguishing characteristics are discussed below.

The Iska financing structure can accommodate the lender receiving a specified sum (whether fixed or based on a percentage of the principal amount) under certain circumstances.[189] Similarly, the Commenda form,[190] where the financier first receives a specified share of the profits and then the remaining share of the profits would go to the borrower.[191]

The Qirad structure, according to Ibn Malik,[192] appears to prohibit assigning to the financier a fixed amount of profits ahead of the borrower. His view is that any percentage can be specified for the borrower so long as there is a sharing of profits and neither the lender nor the borrower receives a sum outside of the sharing of profits arrangement. He explains[193] this is because in a Qirad, there is no sale, rent, work, advance, or convenience, which either party can specify he or she receive, without the other party sharing in it. Remember that in a Qirad,[194] as opposed to the Iska, the borrower receives no separate compensation for his efforts on behalf of the venture. However, Malik does permit the financier to have more than a one-half share of the profits. He notes that the borrower may receive only a third or a fourth of the profits or even less. Indeed, Malik states that so long as a percentage of profits is specified, whether great or small, anything agreed to by the parties is permitted.[195]

One of the primary differences between the Iska, on the one hand, and the Qirad and Commenda on the other hand, relates to whether a provision for compensation of the borrower is required. The Iska mandates that the labors of the borrower be separately compensated, on some basis, even if the amount is nominal. This might include awarding the borrower a disproportionately greater percentage share of the profits as compared to the losses. This is a key element, in order to avoid even the appearance of an issue of Ribit. The Qirad and Commenda do not make such provision because it is antithetical to these structures. The labor of the borrower is deemed to be a contribution to the venture. Yet all three forms do not view the financing structure as a genuine partnership because, as discussed above, the financier only contributes money to the venture; not labor.

An Iska can accommodate a loan of money or goods. A Qirad can only be based on a loan of money. This is because according to Malik, if goods are loaned, then there is the problem of fluctuation in values before the intended transaction can be accomplished. In addition, there are the costs of sale. In his view, the Qirad does not begin until the goods are converted into cash and the culmination of the Qirad is also in cash.

In the Commenda[196] the borrower is obligated to go through with the venture that is the object of the financing. This differs from an Iska and Qirad, where the borrower can elect not to proceed and just return the funds advanced. The Commenda also limited the risks borne by the lender. Typically, the lender assumed only the risk of loss by rea-


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son of the ship sinking or attack by pirates.[197] Casualty loss, generally, was borne by the borrower. The borrower also assumed personal liability for a breach of the express covenants,[198] as well as, implied covenants in accordance with custom and usage among merchants.[199] Other provisions might be made, including for personal liability by the borrower for fraud, as well as, assessing penalties (equal to two times the sum of principal plus profit[200]), if the borrower asserted defenses or counterclaims. Once the ship docked, all of the risks of loss were borne by the borrower. This is unlike the Qirad or Iska, where casualty or other matters outside of the control of the borrower were borne by the lender, whether at sea or on land.[201]

The procedural rules and standard of evidence required to establish a loss, embodied in the Tikun Maharam Iska, are unique among these three medieval financing forms The Iska can also contain a provision that conditions any claim of loss by the borrower on there being delivered to the lender periodic accountings, sworn to by the borrower.[202] If borrower fails to honor these covenants then the borrower is barred from claiming a loss. The Iska also may provide that, in essence, if the borrower earns profits anywhere in the world,[203] then the borrower would be liable to pay the principal plus interest.

The security measures required by the Iska can include provisions dealing with the storage and use of the funds. The Iska can also require armed guards, as well as, restrict the means of transport of the funds. This can include only traveling by prescribed routes and to specified locations. The Commenda and Qirad also permit these kinds of security covenants.

The innovation to the Iska structure, reported by the Nehardeans in the Talmud,[204] is also unique. In essence, the Babylonian Talmud permits an apportionment of the risk of loss equally between the borrower and the lender. This limited recourse structure is brilliant in its conceptualization.

Each of the three medieval financing forms provide for recourse events. Many of the provisions are similar although some are unique to the particular financing structure. Summaried below are some of the typical carve-outs to exculpation in each of the forms, respectively.

The Qirad, may, for example, include the following recourse events:[205]

- If the borrower takes any of the monies before a final accounting, in the presence of the financier. Under a Qirad, the principal must first be repaid and then only are the profits to be divided.
- If the borrower violates a provision that only certain goods[206] should be purchased with the financing proceeds or an express prohibition against buying certain named goods.
- If the borrower uses the principal or profits for his own purposes and not in furtherance of the venture. Malik describes a number of different examples of this kind of misconduct, including, using principal or profits to buy a slave girl. The borrower is also prohibited from entering into a Qirad with another, doing other business for himself, buying himself clothing, making charitable contributions, hiring others to do his work or paying for travel and entertainment outside of what is necessary, in the ordinary course and in furtherance of the venture.


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- If the goods are sold on credit. If the borrower violates this prohibition then he is liable for any ensuing losses.

- If the borrower violates security provisions agreed to by the parties. The Qirad may require that a particular sea route not be taken or that the money or goods be protected in accordance with specified procedures while in transport. If the borrower does not follow the agreed upon arrangements, then the borrower is liable for any loss.

- If the borrower violates any other customary provisions designed to protect the investment against physical loss, akin to waste.

- If a loss results from the borrower's own negligence.

The Iska, may, for example, include the following recourse events:

- Failing to account on a regularly prescribed basis.[207]

- Failing to follow prescribed security measures.

- Using the proceeds of the financing for a purpose not expressly permitted under the particular Iska agreement.

- Not obtaining adequate collateral in connection with the use of the proceeds of the financing, in order fully to secure the repayment of the funds advanced.[208]

- Using means of transport or travel routes that are other than as may prescribed in the Iska agreement.

- Purchasing goods that are other than those permitted.

- Not obtaining the approval of a given number of noted experts as to the quality of the merchandize purchased and that an advantageous purchase.[209]

Halachic literature is replete with examples of these kind of covenants. Rav Moses ben Joseph D'Trani,[210] known as the Mabit[211] permitted provisions to the effect that the money could not be released by the borrower to anyone except as against a pledge of gold or silver of at least equal value. Furthermore, either the money or the pledge had to be in the exclusive possession and control of the borrower and stored underground in the borrower's house in complete secrecy. No one, other than the borrower or his spouse, was to be privy to the location of the funds. The borrower was also required to station guards at his home if he wasn't there. If the borrower traveled with the funds, then he was required to have four archers accompany him as security guards. Any violation of these provisions imposed liability on the borrower for any resulting loss. The borrower was also charged with responsibility if he delayed in making advantageous trades. Thus, if the market took a downturn and losses were suffered because the borrower didn't act immediately to take best advantage of market conditions, then the borrower was liable. The Mabit also included other provisions, such as a requirement for an accounting every three months during the term. His Iska format also specified a fixed return payable to the financier of 10% per year,[212] if there were profits, consistent with the non-recourse nature of the financing.

The recourse events in a Commenda are more extensive than in a Qirad or Iska, as noted above.[213] Thus, the borrower was not liable if, while at sea, the ship sank or was attacked by pirates. However, if losses occur for other reasons, then the borrower was


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liable. For example, if the money was stolen before the purchase of goods was made or there was a fire that destroyed the money or goods, then this was the responsibility of the borrower. The borrower was similarly liable if losses occurred after the ship docked at port or if the venture was unsuccessful financially, because of market conditions. It might be said that the Commenda was a financing arrangements that had two carve-outs to liability; but was otherwise recourse to the borrower.

### An Analysis of Carve-Outs to Exculpation Under the Basic Non-Recourse CMBS Mortgage Form, Including from an Halachic and Sha'ariah Prospective

There are two broad categories of carve-outs to exculpation. A default in one category triggers liability for the full amount of the loan, together with interest (typically at the default rate), plus any costs associated with enforcement. The other category limits liability to the extent the lender suffers any actual loss as a result of the borrowers default. The placement of the carve-out event in one category or the other is somewhat negotiable in certain instances. The purpose of this article, though, is not to differentiate among the various carve-out events. Rather it is to explore them conceptually and compare them to the three medieval forms of non-recourse financing noted above. Thus, the usual carve-outs to exculpation are summarized below, without categorization as whether a default there under will result in full recourse for the full loan amount or just limited recourse as to the actual loss incurred:

- *Violating the special purpose entity-bankruptcy remote provisions of the mortgage.*

There is usually an extensive set of covenants set forth in the mortgage documents that are designed to limit the possibility of a bankruptcy by the borrower being triggered by some event outside of the mortgaged real estate or the single purpose borrower entity. These can include provisions limiting the business of the borrower to owning just the mortgaged real estate and no other properties or businesses and not entering into any other debt. This also usually includes entering into any loans besides the mortgage loan or precipitating a lien against the property, albeit subordinate to the mortgage.

The key is separateness and no outside entanglements. In essence, the covenants are designed to isolate the mortgaged property and the rents it generates, so that they are available to service and repay the mortgage loan. Compliance with these provisions will hopefully avoid substantive consolidation with a bankrupt affiliate of the borrower arising out of financial issues of an affiliate or another property or business.

The prohibition against entering into other loans, even if not directly secured by the mortgaged property, is also intended to lessen the possibility of outside events (such as a default under another loan) triggering a bankruptcy of the borrower. Sometimes, the mortgage lender may permit certain subordinate loans; but only if the holder enters into a complete subordination agreement with the mortgagee. This kind of an agreement would typically limit the subordinate lender's right to enforce or even default the subordinate debt, while the first mortgage debt is outstanding. There is also often a somewhat higher


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cost associated with CMBS mortgage financing that permits subordinate debt.

At first glance, these kinds of provisions would appear to be more detailed versions of the categories of covenants discussed below under a Qirad or Iska structure. Nevertheless, there have been some cases in Michigan[214] and other jurisdictions that have interpreted these types of provisions to mean that a mere payment default could trigger full recourse. It's one thing to say that not paying the debt service under the mortgage when there is sufficient net cash flow at the property might trigger a recourse event. This is especially so if the borrower is diverting monies earned at the property for other purposes. It's another thing to say that the inability to pay should result in full recourse because the borrower thereby violates the covenant not to be insolvent. The effect of this interpretation would be to trigger full recourse against the borrower and the guarantors under the so-called good guy[215] guaranty. This interpretation is not only antithetical to the entire concept of non-recourse financing it would also undermine any chance that the loan could be deemed to be Sha'ariah and Halachically compliant. This is because it converts what is styled a non-recourse loan into a full recourse one. There have been courts in other jurisdictions that have also dealt with the issue and the results are not uniform. Frankly speaking, insolvency should not arbitrarily be deemed to be a recourse event. Rather, a more nuanced approach is required, which explores the basis for the insolvency.

The legislature in Michigan responded to the Michigan court decisions by amending the law, in effect, to overrule the court decisions; as did Ohio. The answer for the industry, though, is to negotiate these complicated provisions of the mortgage documents in a manner that delivers genuine non-recourse, as intended. There is a difference between intentional bad acts of the sort that were intended to cause full recourse and market conditions and circumstances outside the control of a good borrower that were never intended to cause full recourse.

Clarity is required to distinguish between them. Thus, there are a variety of so-called pre-bankruptcy defaults covered in the typical covenants and conditions in a non-recourse mortgage that may result in acceleration and foreclosure against the property. These were designed to enable the lender to access the security for the loan in time to avoid an even more serious decline in the value. However, there is a genuine difference between permitting a foreclosure and triggering a carve-out to exculpation. All of these financial issues are not the result of intentional violations of the separateness and isolation of the real estate that are the conceptual basis for non-recourse financing. It is critical to distinguish among the various categories of default and the remedies available under the particular circumstances. The documents can and should be negotiated accordingly to avoid the vagaries of court decisions that might lead to unintended consequences.

From a Sha'ariah and Halachic point of view, the Michigan cases and similar decisions on the subject are problematic. It's good the industry[216] is responding appropriately to mitigate the issue.


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- *Transferring the mortgaged property or ownership of the borrowing entity in violation of the no transfer provisions agreed to in the mortgage*.

  A CMBS mortgage, typically, is due on sale. It also, generally, prohibits a borrower from doing so without first obtaining the consent of the mortgagee. If consented to, then there are usually other conditions that must be satisfied. For example, the issuance of a new non-consolidation opinion of counsel satisfactory to the lender is usually a condition to transfer. Needed licensure or other approvals are usually also conditions.

  Notwithstanding that the borrower covenants not to transfer, there is no effective remedy to prevent the same. In essence, the only remedy is to accelerate the mortgage loan because of this default and foreclose. Hence, the concept of using the good guy guaranty as a means of deterring such a default because it will trigger full recourse under the mortgage.

  These kinds of provisions deal with intentional acts of the borrower in contravention of obligations that are both reasonable and customary in the marketplace. They appear to be, conceptually, consistent with the kind of limitations on borrower's use of the funds advanced found in the Qirad and Iska, as summarized below.

- *Failure to provide required periodic accountings and other information or to allow inspections of the property*.

  These are important because the lender has a genuine interest in monitoring the performance of the property. After all, the ultimate security for the loan is limited to the property itself; not the borrower. It would appear that the Iska may contain, conceptually, similar provisions. The Qirad, would appear to be more stringent than either the Iska or CMBS structures. Under the Qirad, no distributions are permitted to the borrower until the final accounting at the end of the term of the financing and then only after the principal amount has first been repaid. The waterfall provisions under some CMBS mortgages might represent a more modern iteration of this Qirad conception of how distributions should be made.

- *Committing Fraud or making a material misrepresentation*.

  These provisions deal with a variety of issues. They include representations as to solvency at the time of the making of the mortgage loan. This would be an exception to the Michigan remedial. Conceptually, these kinds of provisions appear to be consistent with the requirements of the Halacha and Sha'ariah. However, it should be noted that a representation or warranty that the venture will be profitable is not permitted under either the Halacha or Sha'ariah. This would be wholly inconsistent with the nature of non-recourse financing and the apportionment of risk of loss. The borrower cannot assure the financier that there will be no losses. It would effectively convert what is purportedly a non-recourse loan into a full recourse loan. As such, the details of the covenants must be examined to determine whether this is the case.

- *Committing waste*.

  This might include specific provisions dealing with removal of equipment or


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other property from the premises, unless it is replaced with equal or better property.[217] It also includes such notorious acts as unilaterally knocking down the building improving the property. While land may have an intrinsic value, it usually does not generate the kind of income or value that a tenanted high-rise building on the site does.

Imagine a situation where a hotel borrower starts emptying the rooms of furniture and sells them privately for personal gain. The value of the hotel is premised in no small measure on being fully equipped and fitted out. Often this is also a requirement of the franchise agreement benefiting many hotels. This kind of action impairs the value of the mortgaged real estate. This concern is amplified in regulated properties like skilled nursing facilities, where the specialized patient beds and other equipment are an essential part of the valuation.

It is no wonder that there is a carve-out to exculpation for waste. Of course, in the properties noted above, there are particular concerns that are usually expressed in detail. The concept though is grounded in waste, where the borrower intentionally damages the lenders security in the mortgaged property.

While intentional acts that cause physical waste are reasonably included in this carve-out to non-recourse, some courts have expanded the provision to include even non-payment of real estate taxes.[218] This is another one of the decisions that have yielded surprising results to many in the CMBS industry. The provision can, however, be negotiated.

In essence, experiencing what is referred to as economic or physical waste, because the net cash flow derived from the property is insufficient to pay for debt service on the loan and all of the costs of operating and improving the property (including, proper maintenance, repair and capital improvements so as keep the property a first class facility and in compliance with leases with tenants at the property,) would be grounds for acceleration of the loan and foreclosure. However, it would not trigger full recourse.

On the other hand, not employing the net cash flow of the property to pay for these items and instead diverting the funds for other purposes, like distributions to the principals of borrower or for other ventures might properly be the basis for asserting full recourse. Often, these concerns are expressed in detail, as a part of the carve-out to non-recourse, especially after the occurrence of a default under the mortgage. This is so that there is no question as to what is intended, thereby avoiding any theoretical concerns about just what constitutes waste or not.

With the proviso's noted above, and assuming that limited to intentional acts of the borrower and not as a result of fire, casualty or other events outside the control of the borrower, these kinds of provisions would appear to be consistent, conceptually, with a Qirad or Iska structure. However, it is all about the details.

- *Violation of applicable environmental laws or cleanup requirements*.

These conditions directly affect the value and marketability of the property. Imagine if a borrower sought to frustrate


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a lender's foreclosure against the property by dumping asbestos in the basement of a building on the property. Consider also that the intended use of the property may be materially impaired by environmental contamination. These kind of intentional or willful acts should trigger personal liability by the wrongdoer. Amelioration of existing adverse physical conditions is a matter of underwriting and assuring remediation. On the other hand, there are a myriad of environmental regulations that are no different in concept from other legal requirements, some are genuinely attributable to the tenants, which occupy the premises. Compliance with environmental requirements is similar to compliance with law, generally and should not be an automatic exception to exculpation. Distinguishing among the various categories of environmental concerns is a matter of negotiation and drafting of the particular document.

If the matters noted above are not caused by the intentional acts of the borrower, but, rather, are the result of events outside the control of the borrower then that would likely be problematic under the Sha'ariah and the Halacha. Similarly, if the net cash flow from the property was insufficient to deal with these matters, then that would also be an issue.

- *Misappropriation, misapplication or conversion of rents, security deposits, insurance proceeds or condemnation proceeds.*

This provision, in the case of rents, can often be negotiated to limit it to post-default occurrences. This is important, because as discussed lenders might try to reach back and seek to recover against distributions that were made prior to any default. These provisions also typically deal with the borrower not accepting prepayment of more than one-months rent by tenants, without the consent of the lender.

There are also sometimes more insidious misapplications of funds. Thus, for example, if the borrower's affiliates own other properties and ventures and expenses of an affiliate are paid or improperly allocated to the borrower. This might also be a problem in terms of bankruptcy remoteness, because of the commingling of funds. There are generally express covenants that forbid these kinds of activities.

Both the Qirad and Iska can contain conceptually similar provisions, especially in terms of misapplication of funds. Under the Qirad, distributions to the borrower are not permitted until the final accounting and only after principal is first repaid. Thus, the concept of recovering distributions, even prior to any default, would be consistent with the Sha'ariah. If the agreement permitted the borrower to obtain interim distributions, as is the case in mortgage financings generally, then it might also be permitted under the Sha'ariah for the lender to receive interim payments of debt service, during the term. On the other hand, recourse by reason of insolvency of the venture may be a genuine issue. However, if the loss arises out of the borrower's wrongdoing (including withdrawing funds for personal use or use in other businesses or violating other covenants), then triggering personal recourse under these circumstances would appear to be Sha'ariah


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compliant. Once again, it's all about the details.

- *Failure to maintain required insurance.*

The failure of the borrower to purchase reasonably required third party insurance coverage against certain appropriate risks, out of the rents derived from the real estate, could be an exception to exculpation. The borrower is not liable for the loss, per se; but rather the losses resulting from failure to purchase the required coverage.

The Sha'ariah seems to be more flexible on this point. Under an Ijara type of financing arrangement, the lessee/borrower can agree in a separate agreement to reimburse the lessor/financier for losses resulting from fire or other casualty. However, under the Halacha, the separate agreement and lease financing transaction would be integrated. This would result in the lease being deemed nothing more than a disguised loan of the property, as noted above. Nevertheless, it would appear that separate insurance is permitted to be purchased from a third party insurer.[219] To make this a covenant of the borrower is problematical, unless the obligation is limited to payment of the insurance premiums out of available net cash flow and, of course, only if such insurance is, in fact, available on commercially reasonable terms and conditions. These are usually negotiated changes to these provisions, in any event.

- *Filing of a voluntary bankruptcy.*[220]

This may also include just being insolvent. Thus, if the borrower's assets are less than its debts or the borrower is unable to pay its debts as they come due, then that might become a recourse event. However, this kind of provision can be negotiated. Thus, it may be a default; but it would not be a recourse event. Involuntary bankruptcy might also be included as a recourse event. However, if it is defended against by the borrower, then it typically would not trigger a recourse event. What is intended is to avoid a collusive involuntary bankruptcy.

There have been a number of cases dealing with this provision.[221] Of particular concern are the ones that appear to impose liability for insolvency even when it is not directly caused by misconduct by the borrower. After all, if the mortgage is not paid, because the property does not generate sufficient net cash flow to do so, this inability, in and of itself, creates a problem of insolvency.

If that is all it takes to trigger recourse, then it may also be a genuine issue in terms of compatibility with the Sha'ariah and Halacha. It should be noted however, that the Michigan Legislature responded by passing a law that, in effect, overturned the court decision.[222] The law prohibits a mortgage lender from seeking recourse (in a non-recourse mortgage) against a borrower or guarantor by reason of the borrower becoming insolvent post-closing and thereby violating a solvency carve-out to non-recourse. Any inconsistent provision in the loan documents is deemed invalid. Ohio has since passed a similar law, entitled the Ohio Legacy Trust Act.[223]

- *Wrongfully seeking to defeat, impair, impede or interfere with the enforceability of the mortgage or lender's rights or remedies thereunder.*

This kind of a provision, like the one


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about insolvency, can be problematic. The concept of the borrower not asserting specious defenses is consistent with the Sha'ariah and the Halacha. A borrower should not be asserting defenses solely to hinder or delay enforcement of the mortgage. Some forms of Qirad and Iska even provide for penalties in the event. However, not having the right to challenge whether the principal sum is in fact due is an issue. The Iska addresses this problem by establishing an enhanced level of proof (i.e., only the testimony of two kosher witnesses is acceptable on this issue). Both the Qirad and Iska do not permit the borrower to challenge the validity of the financing. The only issue is whether the money was lost (due to no fault of the borrower, as provided under the express terms and conditions of the document). Otherwise, the borrower cannot be heard to say that the financing amount is not due and payable. Provisions dealing with cooperation by the borrower, in connection with the turn-over of the mortgaged property, after the occurrence of an event of default, and providing for liability by the borrower for losses incurred as a result of the borrower's failure to cooperate, may also be consistent, conceptually, with the Sha'ariah and the Halacha. Similarly, as to distributions made after a default, while at the same time not paying real estate taxes that would prime the mortgage.

- *Completion Guaranties*.

  Some loans require that certain work be done at the property. The funds needed to accomplish this work are usually set-aside in a reserve. Other reserves may be established to deal with rent up of the property, including for the projected cost of tenant improvements and leasing commissions. Interest reserves may also be established to deal with negative cash flow projected during the expected rent-up period. There are also typically personal guaranties associated with the obligation to complete and pay for the work. While these kinds of provisions are certainly appropriate from an underwriting and business point of view, there may be some difficulties with the guaranty provisions. If the guaranties are limited to the available funds set aside in reserves for these purposes, then this might be acceptable. On the other hand, if the guaranties are unlimited until the intended results are achieved, then this may be problematic under the Sha'ariah and the Halacha. As is the case with many of the matters discussed above, it's ultimately all about the details.

The carve-outs to the exculpation provision in the mortgage are usually coupled with a so-called good guy guaranty signed by principals of the borrower. Thus individuals or other net worth entities would guaranty the debt or loss, as the case may be, in the event of a default by the borrower that triggers any of the carve-outs to exculpation. It is important to note, that these are matters that are, generally, within the control of the borrower. The borrower is fully exculpated from personal liability unless the borrower violates these provisions.

As discussed above, there are a number of carve-outs to exculpation permitted under the Qirad, Iska and Commenda forms. From a Sha'ariah[224] and Halachic[225] point of view, the parties can enter into such business terms and conditions as they desire, so long


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as they are not expressly prohibited under the applicable legal system. However, there are genuine concerns under both these legal systems if the borrower is personally liable for events that are outside the control of the borrower. This would likely result in the financing instrument being deemed a disguised loan and, therefore, being prohibited as yielding Ribit or Riba, respectively. Many in the industry share these concerns about these kind of provisions, although strictly from a business point of view. The objectional provisions can and should be negotiated and adapted to meet these concerns.

## Conclusion

The CMBS non-recourse mortgage financing structure may, for the most part, be Sha'ariah and Halachically compliant, at least conceptually. Details, though, do matter. Thus, some court interpretations of particular carve-outs to exculpation may be troublesome. However, the applicable provisions can be negotiated so that they do not vitiate compliance. The CMBS format is structurally sound and robust enough to accommodate the foregoing and to make the adaptations that may be necessary to assure Sha'ariah and Halachic compliance.

The benefits of employing the CMBS format are manifold. The existing so-called Sha'ariah compliant financing forms have not achieved market acceptance, generally, because they are not compatible with capital markets requirements.[226] As a result they cost more than competitive capital markets products.

Embracing the CMBS non-recourse financing form, as outlined above, will permit a whole range of borrowers, now effectively barred by misperceptions of religious impediment, to access one of the most efficient and lowest cost financing sources in history.

## NOTES:

[1]In some states, instead of a mortgage, there is a deed of trust.

[2]The term CMBS is used to denote a class of securities derived from the securitization of a portfolio of mortgages against income producing real estate. This asset class usually includes multi-family rental apartment buildings, office buildings, industrial or warehouse buildings, shopping centers, hotels or skilled nursing facilities. The senior mortgage debt is typically placed in a trust and various classes (known as tranches) of participation certificates are issued. That's particular portion of the overall debt is then artificially segregated into classes representing the most senior in priority to the junior-most, within this mortgage pool. The various tranches within this senior mortgage debt are then rated by rating agencies and graded in a range that can sometimes reach as high as AAA (the highest grade under the S&P rating system) to as low as BBB (the lowest investment grade rating). Portions of the overall debt that do not merit at least an investment grade rating are separated from the senior mortgage debt included in the trust. This is because this portion of the overall offering includes only the tranches of the overall debt rated investment grade or above. Any portion of the debt that is below investment grade is further separated into separate tranches, which may also be rated. They are often classified as mezzanine or sub debt. The benefits of this kind of structured finance are manifold. On the lenders' side of the equation, those interested in the more secure portion of the debt (i.e., with a lower loan to value ratio and, therefore, more coverage) can buy the higher rated securities. However, the interest yield they receive is usually correspondingly lower than that applicable to the lower rated securities and a comparable bank financing of the entire debt. On the other hand, the lower rated portions (i.e., with a higher loan to value ratio and, therefore, less coverage) usually yield a higher rate of interest. The blended rate, though, is generally competitive when contrasted with comparable bank financing. The terms of CMBS mortgage financing may also be more favorable, including that formulated on a non-recourse basis.

[3]A type of financing form that if properly structured does not violate the prohibition against Ribit. It is discussed in the Babylonian Talmud. However, it likely existed by Mishnaic times and, possibly, well before that as well. The terms of the Iska, in its various incarnations, are more fully discussed in this article.

[4]A financing form in use in the Middle East (including prior to the advent of Islam) and elsewhere that does not violate the prohibition against Riba under the Sha'ariah, as more fully discussed in this article. The Qirad is also known as a Mudarabah.

[5]A financing form in use in Europe, during the medieval period, that appears not to violate the prohibition


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against Usury, under Christian legal traditions and practice.

[6]A term used to denote the body of Jewish Law, derived from the Bible, as elucidated in the Mishna, Jerusalem Talmud, Babylonian Talmud and various codes of law, as well as, by commentators and later religious authorities. It literally means the way.

[7]A term used to denote the body of Islamic law, derived from the Koran and elucidated by later religious authorities and scholars. It too literally means the way.

[8]The Mishna is an authoritative written code of the oral Torah, edited by Rav Yehuda HaNasi (an appellation, meaning the leader). It together with the Torah (Five Books of Moses), Neviim (Prophets) and Khetuvim (Writings), comprise a written statement of Jewish law. The Torah, Nevium and Chetuvim are also, collectively, known by the acronym Tanakh or the Bible, The word Mishna may be defined as to study or review. It may also be defined as a recapitulation. The later definition, in contemporary terms, might better be described as the Restatement.

[9]Where there is some apportionment of the risk of loss and, hence, limited personal liability, as more fully discussed below.

[10]The Talmud is a seminal encyclopedic work of Jewish law, traditions and lore. The word Talmud literally means teaching or study. The Talmud contains the Mishna and additional notes on the Mishna, known as Gemara (meaning to study or derive logically). It provides a critical analysis of the Mishna, including the provenance of the laws reported as a part of the oral tradition. Variant or other texts or reports are examined and inconsistent legal traditions or positions are discussed. Further explanations of and glosses on the subject matter of the Mishna or in general may be noted. Other materials within the oral tradition are also included. It represents the next stage in the written codification of Jewish Law. The appellation Jerusalem Talmud refers to the Talmudic text compiled in Israel during the fourth century. The editing process may not have been fully completed and the version we have likely represents only a part of the work done. It is distinguished from a later work known as the Babylonian Talmud, discussed below. The printed text of the Jerusalem Talmud referenced in this article is known as the Zhitomir Edition (1965).

[11]The Babylonian Talmud was compiled by Ravina and Rav Ashi, the leading Amoraim (literally, spokesman) of their generation, by the beginning of the 6th century. The editing process, though, continued for another approximately 200 years. The Babylonian Talmud, like the Jerusalem Talmud, contains both the Mishna and a further analysis of the matters covered by the Mishna. It also includes discussions of Biblical texts, recitations of other parts of the Oral Torah and subsequent Rabbinical enactments, as well as, a host of other materials. It is a more complete and robust work than the prior Jerusalem version noted above. The printed text of the Babylonian Talmud referred to in this article is known as the Vilna Shas.

[12]The Cairo Geniza was located at the Ben Ezra Synagogue in Fustat (Old Cairo), Egypt. It contained a collection of hundreds of thousands of fragments of Jewish manuscripts and documents. In Jewish tradition, holy books and documents containing the sacred name of G-d are not discarded. They are stored in a Geniza (literally, hidden place) until they can be properly buried. The Cairo Geniza reportedly contained documents dating back, more than a thousand years, to the ninth century.

[13]*See, for example,* the Fatwa of Osama bin Laden, dated August 23, 1996 and reproduced by PBS Newshour online. There are numerous Sha'ariah scholars who disagree with this extremist approach. For a fuller discussion, *see* article by the author entitled: "Interest, Ribit and Riba: Must These Disparate Legal Concepts Be Integrated or Is a More Nuanced Approach Appropriate for the Global Financial Community?" in the May, June, and September issues of *The Banking Law Journal* (2014).

[14]Although current Catholic Church Canon Law no longer expressly prohibits the charging of interest, it did proscribe it in the medieval period. However, *see* the discussion below, of Thomas Aquinas' view on non-recourse types of financing of the sort described in this article. Protestant practice is to permit reasonable interest charges, as noted below.

[15]A term used to denote the code of religious law of the Catholic Church and affiliated Christian Churches. In this regard it should be noted that Protestant Church doctrine, as formulated by Calvin, views the matter of charging interest differently. Beginning in 1547, Calvin spoke of reasonable interest charges for money being acceptable. Only excessive interest was wrong. After Henry the VIII broke with Rome, England, in 1545, passed a law permitting interest to be charged, up to a maximum of 10 percent per annum. In the 19th century, the Roman Catholic Church acknowledged that moderate rates of interest were not to be disturbed. As, noted above, Canon Law no longer contains an express prohibition against charging interest.

[16]The term for prohibited return under a loan as proscribed by the Halacha. It literally means increase.

[17]The term for prohibited return under a loan as proscribed by the Sha'ariah.

[18]The term for prohibited interest under a loan as proscribed by medieval Christian doctrine, as opposed to the modern usage, denoting excessive interest.

[19]Referred to as syndications of mortgages, as opposed to the term securitization of the CMBS era.

[20]It is also credited with pioneering the so-called junk bond.

[21]*See* New York General Obligations Law, Section 5-705, which requires an executed and acknowledged assumption of the mortgage, at the time title is conveyed subject to the mortgage. Otherwise, the new owner of the property encumbered by the mortgage is not personally liable for the debt and no deficiency judgment can be obtained against the new owner. However, this does not affect the liability of the new owner, if it subsequently enters into an extension or


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modification of the mortgage and assumes the mortgage debt obligation in connection therewith.

[22]*See* New York Real Property Actions and Proceedings Law, Section 1301. In New York, a mortgagee, generally, can either sue to enforce the note (and by extension, the guarantors(s) of the note) or foreclose the mortgage; but not both at the same time. This is known as an election of remedies. This is not a universal requirement and in New Jersey, for example, there is no requirement of election of remedies.

[23]Foreclosure is an equitable remedy. Not every default under a mortgage will necessarily permit the mortgagee to sustain a mortgage foreclosure proceeding in court. *See, for example*, *Loughery v. Catalano*, 117 Misc. 393, 191 N.Y.S. 436 (Sup 1921), aff'd, 207 A.D. 895, 201 N.Y.S. 919 (1st Dep't 1923), dealing with an attempted foreclosure by the mortgagee because of alterations made by the borrower without the consent of the mortgagee. *See also Rockaway Park Series Corp. v. Hollis Automotive Corp.*, 206 Misc. 955, 135 N.Y.S.2d 588 (Sup 1954), judgment aff'd, 285 A.D. 1140, 142 N.Y.S.2d 364 (1st Dep't 1955), dealing with an attempted foreclosure by the mortgagee because of building violations in existence at the time the mortgage was first entered into and known to the mortgagee. In each of these cases the respective courts denied foreclosure because it was inequitable.

[24]Sometimes, foreclosure is not a genuine option because of inter-creditor, bankruptcy or other concerns. *See, for example*, In re General Growth Properties, Inc., et al, (Bankr. S.D.N.Y., Case No. 09-11977).

[25]The right to repay the loan prior to the sale of the real estate at a foreclosure sale and thereby, in effect, cancel the foreclosure process.

[26]These rights are usually expressly subordinated in the lease with the tenant. However, tenants are often protected by a separate subordination and non-disturbance agreement that preserves the tenant's right to possession in accordance with the terms of the lease. As a condition thereto, the tenant is required to attorn and pay rent to the new owner pursuant to the foreclosure sale and otherwise perform its obligations under the lease.

[27]At the time, there was a concern that somehow a provision, which exculpated the borrower from liability, might somehow impair the note.

[28]This was before the statutory creation of the limited liability company (LLC) in common use today. The limited partnership structure provides for limited liability for the limited partners. However, the general partner is still generally liable for the liabilities of the partnership and, hence, the use of a corporate general partner. The LLC form, however, provides for limited liability for the members and managers, much like a corporation; but with the added benefit of permitting an election to be treated as a partnership for tax purposes.

[29]Hence, there is no double taxation, as is typically the case in Sub C Corporation under the Internal Revenue Code. While a Sub S Corporation, at first glance, appears to offer the tax efficiency of no double taxation, nevertheless, it suffers from disadvantages in the more complicated world of real estate and its taxation. This is because the shareholders in the Sub S Corporation cannot receive a pass-through of the tax benefit of non-recourse mortgage debt in their basis for depreciation purposes. The fact that non-cash deductions for depreciation and amortization can be passed through to the principals of the Limited Liability Company or Partnership is a fundamental element of real estate investment in income producing properties. It often shields the income of the venture that otherwise might be taxable. In effect, all or part of such income can be said to be tax deferred. This deferral can continue so long as the property is not sold and, even thereafter, if there is a tax-free exchange properly effectuated in connection with the sale.

[30]Non-recourse mortgage debt is an extremely important component of the depreciation equation, in that it yields basis that can be depreciated. These tax benefits can, in effect, be made available, pro rata, to all the partners in a partnership (and members in a limited liability company that elects to be treated as a partnership), for tax purpose. Recourse debt is not treated the same way under the tax code. Thus, those partners or members who are not personally liable for recourse debt cannot include that debt in basis for purposes of depreciation.

[31]The substantial increase in transfer taxes due in connection with the multiple transfers of the real estate may have been a motivating factor at the time. With the advent of CMBS, bankruptcy remoteness is a critical factor, which might militate against the use of intervening entities and transactions that can complicate the issue. Moreover, having a uniform exculpation provision, not subject to the vagaries of local law, is also important. Indeed, uniformity of mortgage documents, generally, is a significant element in the securitization process. The fact that the mortgage provisions may not necessarily be uniformly interpreted or enforced locally is an emerging concern in the world of CMBS, as summarized below in this article.

[32]Real estate tax liens generally prime the mortgage lien.

[33]While not a legal concern in terms of the priority of the mortgage, nevertheless the business of running the property is important. If the real estate is not properly maintained or services are not provided to tenants, as required under the leases, then tenants may, under certain circumstances, assert defenses to or offsets against the payment of rent. Thus, in practice, lenders often make deals with contractors and other service providers in order to have continuity and no interruption in the flow of rent.

[34]For this reason, the term, portfolio lender is often used to describe these kind of bank lenders.

[35]*See* Exodus, Chapter 22, Verse 24; Leviticus, Chapter 25, Verses 35–37; and Deuteronomy, Chapter 23, Verse 20. *See also* Ezekiel, Chapter 18, Verse 13; Psalms, Chapter 15, Verse 5; Nehemiah, Chapter 5 Verses 1-13; and Proverbs, Chapter 25, Verse 8. The Biblical terms for interest are "Neshech (literally, biting; as in the bite of interest) and "Marbit" (literally, increase; another synonym for interest). The Halachic term Ribit


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is derived from the Biblical term Marbit.

[36]This article focuses on the nature of the loan transaction and not on the distinction between an individual party and one that is an entity. For a discussion of Ribit and Riba and whether it applies when non-individuals (i.e., corporations) are a party to the loan transaction, *see* article on Interest, Ribit and Riba, by the author, published in *The Banking Law Journal*, as noted above.

[37]Rabbi Moshe ben Maimon (known by the acronym Rambam), a 12th century Halachic scholar and codifier of Jewish Law. He is the author of the Mishne Torah, a comprehensive code of Jewish law, known as the Mishne Torah (or Yad Chazaka). The Mishne Torah is organized, topically, instead of in the order of the Talmud from which it is derived. This distinguishes it from prior codes of Jewish law. Subsequent codes of Jewish law, like the 14th century Arba'ah Turim (literally, the Four Rows, referring to the four categories of law embodied in the work), authored by Rav Jacob ben Asher and the 16th century Shulchan Aruch (literally, the Set Table) authored by Rav Yosef Karo, followed the Rambam's format. In modern legal terms, the title of Mishne Torah might be loosely translated as the Restatement of Jewish Law.

[38]Rambam, Mishne Torah — Laws of Agency and Partnership — Chapter 6 Section 1, where the Rambam notes that if only one of the parties works in the venture then it is not a partnership; it is an esek (i.e., Iska relationship). *See* Chapters 4 and 5 for a discussion of the meaning and terms of partnership. This is in contrast to the discussion of the Iska financing form in Chapter 6, noted above.

[39]Ibid.

[40]The term literally means a business or commercial transaction. *See* Rambam, Mishne Torah, Book Of Acquisition-Laws of Agency and Partnership, Chapter 6, Section 1. In subsequent sections of this Chapter, the Rambam makes it clear that he is referring to the Iska financing form reported in the Babylonian Talmud, as more fully discussed below. The use of the term esek appears to be derivative of the term coined by Rava in the Babylonian Talmud in the description of the Iska. *See* Babylonian Talmud, Bava Metzia, page 104b, as summarized below.

[41]The term financier is used to distinguish this source of financing from a lender in a traditional loan setting, where the borrower is personally liable.

[42]*See supra* note 40. In the midst of his discussion of the Laws of Agency and Partnership, in Chapter 6, the Rambam uses the term esek to define a financing structure.

[43]Called "Sechirut" in the Talmud and other Halachic literature and "Ijara" under the Sha'ariah. *See* the discussion below concerning charging a higher rental rate, if the rent is paid over time.

[44]Under a Talmudic form lease, it is also permitted to charge a higher rent if paid over time. This construct is distinguished from a higher deferred purchase price, which is deemed to be prohibited Ribit. The Talmud explains that the increased rent is not considered prohibited Ribit because rent, under a lease described in the Talmud, is normally due at the end of the term of the lease. Hence, what is being offered is a discount for early payment; not a higher deferred rent. In this regard, it should be noted that, even in the case of a purchase transaction, if the general price is fixed based on a deferred payment arrangement, then it is not considered Ribit when a discount is offered for immediate payment. On the other hand, if the price is fixed based on immediate payment, then a higher credit price, charged for a deferred payment arrangement, would be considered prohibited Ribit.

[45]*See* Babylonian Talmud, Bava Metzia, at page 69b.

[46]*See* Jerusalem Talmud, Bava Metzia, at page 17a.

[47]The Halacha, generally, prohibits charging a premium credit price (for the privilege of deferring the payment of the lower purchase price otherwise applicable for immediate payment,) as Ribit. The Sha'ariah, however, does not consider a premium price charged for the benefit of deferral of payment to be Riba. This despite the fact that the premium paid is the equivalent of interest for the period of the delay in receiving payment for the goods. In contrast, Thomas Aquinas, a preeminent medieval Christian authority, also objects to charging a higher credit price, as noted below.

[48]This reading of the text is in accordance with the view of the Pnei Moshe. Rav Margolies corrects the text to read that if the lender (i.e., giver of the fruits) bears responsibility for loss during the trip to the remote locale, then it is permitted. However, if the borrower (i.e., recipient of the fruit) bears responsibility for the risk of loss during that trip, then it is prohibited. The text appears to have been corrupted and stated in the reverse. As printed, it is also inconsistent with a similar text in the Tosefta (Bava Metzia, Chapter 4, Section 5). The Tosefta (literally, addition) is a body of Tannaic writings that was collected; but which was not included in the Mishna, edited by Rav Yehuda HaNasi. It is helpful, in terms of aiding in the understanding of the content of the Mishna (as a contemporary expression on the same subject matter of the Mishna); but it is not itself as authoritative as the Mishna.

[49]Jerusalem Talmud, Bava Metzia, at page 17a.

[50]The term used in the text to describe the risk of loss is "Achrayut." The term may be defined literally as responsibility.

[51]Jerusalem Talmud, Bava Metzia, at page 19b.

[52]The name "Leyzer" is believed to be a shortened version of Elazar or Eliezer. The Mareh Panim commentary adjoining the text of the Jerusalem Talmud refers to Rav Leyzer as Rav Eliezer. Rav Leyzer is not otherwise specifically identified in this text. However, at the end of page 19b of the text, there is a reference to Rav Leyzer ben Azaria, who is then subsequently referred to as Rav Elazar ben Azaria. Could this be the Rav Leyzer referred to in the text? If so then he would be a first century Tanna (literally, teacher). He was not only a preeminent scholar of impeccable lineage; he


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was also reputedly very wealthy. The Tosefta of Avoda Zarah, Chapter 5, Section 1, reports that he was a dealer in wine and oil. Thus, he was likely familiar with commercial financing devices, like the one ascribed to Rav Leyzer in the text. He was elevated to the position of Patriarch by his colleagues at a young age. The Haggada of Passover describes an incident where he notes that he was like 70 years old, because in fact he wasn't. Rather he was a young man who became prematurely grey, as is befitting the occupant of so lofty a leadership position. This might help explain his concern with appearances, in terms of ultimately refusing to accept the profit derived from the permitted financing structure ascribed to him in the text.

[53]Interestingly, the Jerusalem Talmud reports that Rav Leyzer balked at using his own lending device. Nevertheless, it appears that others accepted it. The phraseology in the text is noteworthy. It suggests that structure which is said to be close to profit (because of the risks borne by the borrower) and close to loss (because of the risks assumed by the lender) is acceptable. It is respectfully suggested that this means it is a financing structure, which has an appropriate apportionment of the risk of loss. This concept is reflected in the Tosefta, as well. (*See* Tosefta, Chapter 4, Section 9.) It also expresses the conceptual basis of Abaye's position, in support of the wine financing structure, described in this article.

[54]*See* Mareh Panim commentary by Rabbi Moses Margolit (who also authored the Pnei Moshe), adjoining the text of the Jerusalem Talmud, Bava Metzia, on page 19b, which makes this assertion. *See also* the Bach (an acronym for Bayit Chadash), a commentary on the Tur, by Rav Joel Sirkis (a late 16th-early 17th century Halachic authority,) adjoining the text of the Tur, at Section 167, noted above. He makes a similar assertion. *See* further the discussion of the Vilna Gaon, summarized below.

[55]*See* Tosefta, Chapter 4, Section 9. The Tosefta is a second century compilation of laws that, as its name implies, is composed of additional materials beyond that reported in the more authoritative Mishna.

[56]Seder Nezikin, Bava Metzia, Chapter 5:4. Also found in Jerusalem Talmud, Bava Metzia, Chapter 5, Law No. 3, at page 16b. Also found in Babylonian Talmud, Bava Metzia at page 68a. Interestingly, the Babylonian Talmudic discussion reports the view of Rabbi Yonatan (A First century Tanna), on an unrelated subject. Rabbi Yonatan's position, though, is grounded in the non-recourse nature of the financing structure under discussion. This would seem to establish that the non-recourse financing structure noted in the Mishna dates back at least to the first century.

[57]Jerusalem Talmud, Bava Metzia, Chapter 5, Law No. 5, at page 18a.

[58]Interestingly, a subsequent Mishna, in this Chapter of the Tractate, speaks of what is referred to as a Tzon Barzel (literally, Iron Sheep) financing structure. Under this arrangement, the profits are shared equally. However, the borrower is personally liable for any losses. It is referred to as "Iron" because the financier is insulated from loss because of the ironclad security for the loan, including the borrower's personal liability. The reference to "Sheep" may be because this structure was typically used to finance the raising of sheep. The Mishan expressly prohibits this financing structure because of the law against Ribit. As Rashi (Rav Shlomo Yizchaki, an 11th century, leading Talmudic commentator) explains, this is because, under the Tzon Barzel financing arrangement, the borrower assumes the entire risk of loss. *See also* Yoreh Deah, Chapter 173 in the seminal code of Jewish Law, known as the Shulchan Aruch, by Rav Yosef Karo, a 16th century Halachic authority. Rav Karo distinguishes Tzon Barzel from a permitted non-recourse financing structure. He notes that if the financier takes the risk the livestock may die and also the risk the price, ultimately achieved on sale, may not yield a profit, then the financing form is permitted. In essence, the livestock is deemed to be in the control of the financier for risk of loss purposes. Rav Karo also notes that under this kind of a financing form, the sharing of profits formula does not have to be equal. The parties can agree that the borrower would receive a lesser percentage share, such as one-third or one-quarter the profits. In essence, where the lender takes the risk of loss, the sharing of profit arrangement is pretty much up to the parties. Malik has a similar point of view under the Sha'ariah, as discussed in this article.

[59]I.e., the one-half of the profits yielded to the financier under the arrangement.

[60]In a parallel text in the Babylonian Talmud, Bava Metzia, at page 70b, Abaye notes that the financier takes the risk of loss on "zula" (i.e., a lesser price being achieved on the ultimate sale of the livestock and, hence, the success of the transaction) or by reason of "Onsin" (i.e., casualty or other events outside the control of the borrower). The Tzon Barzel financing transaction is also discussed in the Babylonian Talmud at page 69b. It is defined as a loan of an asset. It is distinguished from a lease of the cow. In the case of a lease, a rental is paid, but the lessee is not liable for depreciation, physically or in the value of the cow. Similarly, if the cow dies during the term of the lease, the lessee is not generally liable for the loss. However, in a Tzon Barzel transaction, the borrower is liable for the originally assessed value, no matter what happens to the cow or the price. It is a loan substantively, no matter how denominated. The borrower is liable personally to the lender for the original value (i.e., the principal amount). In addition, the borrower is required to pay to the lender one-half of any profits. Thus, as noted above, it is deemed to be a prohibited Ribit bearing loan.

[61]Jerusalem Talmud, Bava Metzia, at page 16b.

[62]*See* Rashi, Babylonian Talmud, Bava Metzia, at page 68a. Rashi reports that this is an Iska-Palga Malveh, Palga Pikadon, where the risk of loss is borne equally by the parties.

[63]*See* Pnei Moshe, Jerusalem Talmud, Bava Metzia at page 16b. The Pnei Moshe also reports that this is an Iska-Palga Malveh, Palga Pikadon, where the risk of loss is borne equally by the parties.

[64]Babylonian Talmud, Bava Metzia at page 104b.


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[65]An authoritative group of Talmudic scholars or school of thought that originated in Nehardea, a town in what was once the Babylonian or Persian empire. It was a center of Jewish learning until it was destroyed in the third century. Thereafter, the main centers of Jewish learning in this area of the world were said to be Sura and Pumbidita. Some say that the citation in the Babylonian Talmud to "the Nehardeans say" dates to the early fourth century period. In any event, the reports themselves may be of traditions and views first expressed during much earlier periods. *See* The Legal Methodology of Late Nehardean Sages in Sasanian Babylonia by Barak S. Cohen (Brill of Leiden-Boston-2011).

[66]*See* Rashi commentary on the text of the Mishna in Babylonian Talmud, Bava Metzia, at page 68a. *See also* discussion of Assyrian Iska-Larim in article by author on Interest, Ribit and Riba, published in *The Banking Law Journal*, noted above.

[67]*See* discussion by Rav Betzalel Ashkenazi, a 16th century Talmudic scholar, in his work, the Shita Mekubetzet (commentary on Babylonia Talmud, Bava Metzia, page 104b), on the origin of the limited recourse structure reported by the Nehardeans. He cites the teachings of Rav Yehonatan to explain the reasoning behind this particular limited recourse structure. In essence, he posited that because of the inherent risks of the perilous times and dangers of transporting goods from place to place, whether by sea or land, the lender did not want to take on the risk of loss. Thus, financing sources would have dried up if this were required. Similarly, borrower/businessman were unwilling to take on all the risks. Therefore, the Rabbis instituted the innovation of apportioning the risk of loss.

[68]The language used in the text is interesting. It states literally that the sages did something that was good for the borrowers and good for the lenders. Rav Issac ben Jacob Alfasi, an 11th century Halachic authority. In his work, known as the Rif (an acronym of his name, Rav Issac of Fez), summarizes the Halachic portions of much of the Babylonian Talmud. In his commentary on Bava Metzia, at page 62a (corresponding to the discussion of the Iska in the Babylonian Talmud, Bava Metzia, at page 104b), the Rif describes the innovation of the Rabbis embodied in the limited recourse version of the Iska described above and the underlying reasons for the enactment. He reports it is good for the lender because there is at least partial recourse against the borrower personally (for one —half of the principal amount of the financing). It is good for the borrower, because in the event of a total loss, the borrower is only liable for one-half the principal and not the full amount.

[69]The Babylonian Talmud makes a conclusory statement that it benefits the lender; but does not explain how it does so. As noted above, the Rif fills in the blanks. He states that, under this form, the borrower was personally liable to repay one-half of the principal amount, under all circumstances. Logically, then it may be surmised, that, otherwise, the borrower would not have been personally liable for repayment of any of the principal amount advanced. Rav Menachem H'Meiri, a 13th century Halachic authority, in his monumental work on the Talmud, known as the Bet HaBechirah (literally Chosen House) also comments on the text. He notes in his Bet HaBechirah (Mossad H'Rav Kook-Jerusalem-1963) commentary, at page 388, on this text of the Babylonian Talmud, Bava Metzia, at 104b, that it refers to one-half the sum financed as being deemed a Malveh (loan). This is so as to confer personal liability on the borrower for that half of the principal sum advanced. He goes on to say that the funds could not be sourced if the borrower's had no personal liability, at all. On the other hand, if borrowers were required to be fully liable, personally, then no borrowers would accept money on these terms. The Meiri then goes on to discuss various aspects of risk of loss and how it is apportioned among the parties. Thus, he notes that the Rambam requires that the risk of loss arising out of theft or other loss of the goods purchased with the funds advanced be borne by the financier and not the borrower. He goes on to cite the Ra'avad in opposition to this position. He notes the Ra'avad permits the financier to shift the risk of loss on these items to the borrower, if the borrower is paid to assume this risk. However, both agree that the financier must retain the risk of loss due to Onsin (i.e., casualty or other circumstances outside the control of the borrower, sometimes referred to as acts of G-d). The Meiri cites Rashi for the proposition that if don't expressly stipulate otherwise, as a result of the enactment of the Rabbis reported by the Nehardeans in the Babylonian Talmud noted above, the presumed agreement between the parties is to share the risk of loss equally (i.e., the one-half loan, one-half investment formulation, noted above).

[70]This limited recourse version of the Iska is commonly referred to as being Palga (half) Malveh (loan) and Palga (half) Pikadon (investment). The non-recourse version of the Iska is commonly referred to as being Kulo (all) Pikodon. Under the Babylonian Talmud's limited recourse version of the Iska, one-half the funds advanced are deemed to be a loan and there is absolute personal liability by the borrower to repay this loan amount. The lender is not deemed to earn income on the loan portion of the financing. The other half of the financing is deemed to be an investment. The borrower has a number of trust-like duties as to this investment portion (*See* Tosafot adjoining text of Babylonian Talmud, Bava Kama at page 102b). If the borrower defaults in any of these duties, he or she is personally liable. Some, like Tosafot, assert the borrower is liable for the whole financing amount. Others, like Rashi assert the borrower is only liable for any losses incurred as a result of borrower's default. The net effect of these provisions is to apportion the risk of loss between the lender and borrower. As noted above, other apportionments may be made, so long as there is an appropriately proportionate relationship between the lender's share of profits versus the share of losses. If separate compensation is provided for the borrower's work then identical percentages of profits and losses can be provided to the lender. If, there is no separate compensation provided to the borrower for the work, then the borrower is to receive an appropriately disproportionately larger share of the profits, as compared to losses, to compensate the borrower for


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taking on this additional risk.

[71]*See* summary of reports of Josephus on the economy of the period, as noted below. It is respectfully suggested that the forms used were a functional response to the actual business practices, at the time. In essence, over time, what may have been a fully nonrecourse financing structure of the sort recorded in the Mishna, morphed into the more limited recourse structures discussed in the Babylonian Talmud, in response to changing financing conditions. The ebb and flow of supply and demand of money and good investment opportunities may have accounted for the changes. For example, in difficult financial times, when money was tight and demand for money exceeded supply, lenders had the upper hand. The great innovation of the Babylonian Talmud, discussed above, may have occurred during this kind of a period, in order to stimulate the flow of funds. Indeed, it appears that the discussion of a limited recourse financing structure that did not yield prohibited Ribit may have originated in the first century. This was a time of political, social and economic unrest. Even before the actual destruction of the Temple in Jerusalem in the Year 70 CE, the yoke of Roman domination was particularly heavy on the people of Israel. (*See* Josephus, Jewish Antiquities, Book 20, beginning at Chapter 11, *et seq.* and also The Jewish War, Book 2, beginning at Chapter 15, *et seq.*). After the destruction of the Temple in 70 CE and, thereafter, at the beginning of the second century, with the unsuccessful revolt of Bar Kochba, the conditions were even more difficult. The Rabbi's, in an effort to incentivize those with money to free up and deploy capital with those who could make use of it and revitalize the local economy, conceived of a way to apportion risk in a manner favorable to both, as described above. In good times, when those with money sought profitable investment opportunities, which were in limited supply, borrowers with the right contacts and acumen may have had the upper hand. This was not a static condition; it varied with the interplay of supply and demand, at the time. The parameters of religious observance, discussed in the Babylonian Talmud, defined the upper limits of how risk of loss could be properly apportioned, without falling astray of the strictures against making a loan on interest. Thus, while making a traditional personal loan was also a possibility, earning any return on the monies advanced was precluded because it would constitute prohibited Ribit. How to earn a profit on monies advanced, without falling astray of the applicable strictures against earning prohibited interest, was an integral requirement of these transactions.

[72]*See* discussion of Rava in the Babylonian Talmud, Bava Metzia, at page 104b and the discussion of Rashi on the text.

[73]A Shtar is a written document attested to by at least two witnesses that evidences the agreement between the parties.

[74]Pledge language could be inserted in support of the debt portion of this innovative Iska structure. Moreover, if a full recourse event were triggered, because the borrower violated a financing covenant, then the pledge would secure the entire financing amount.

[75]A fourth century Amora (literally, one who says) in the Babylonian Talmud.

[76]Conceptually, it was viewed as if the financier loaned the borrower one-half the capital to invest in the deal and charged no interest for the sum loaned. Therefore, as to this loan amount (i.e., one-half the total amount advanced by the financier), the borrower was personally liable to repay the loan, under all circumstances. The other half was the lender's investment for which the borrower, generally, had no personal liability. The lender was, therefore, entitled to make a return on this money, if the transaction was successful. Those earnings would not constitute Ribit, subject to certain conditions. While this analogy is useful in terms of analyzing this model, it does not fully explain the structure. Consider, these are not genuinely two separate financing transactions; they are integrated. As Rava points out, all the money advanced by the financier was required to be used to accomplish the object of the overall financing. It was, therefore not a purely separate loan transaction. Moreover, there was also a disparity between the contributions of each of the two parties to the transaction. The borrower was the only one actually actively pursuing the transaction for the benefit of both parties. It might be said that the only apparent reason the borrower would work for the benefit of both parties was to recompense the financier for providing the loan portion of the financing noted above. Why is this financing form then permitted? Doesn't it yield a disguised return to the lender equal to the value of the work performed by the borrower, which is prohibited Ribit? To address this appearance issue, compensation was provided to the borrower to make it clear that this was not the case. The amount of the compensation (be it nominal or otherwise,) is the subject of much discussion in the Babylonian Talmud and, elsewhere, as noted above. The Iska financing structure does not require a sweat equity contribution by the borrower, as is the case with the Qirad, as more fully discussed below. Indeed, in the limited recourse Iska arrangement it is prohibited. It would appear that even in the non-recourse Iska format, under certain circumstances, the absence of some separate compensation for the borrower's work may also constitute an appearance issue, as more fully discussed in this article.

[77]Babylonian Talmud, Bava Metzia, at page 68b.

[78]It is sufficient that the lender permit the borrower to dip into the lender's fish sauce or to share consumption of a dried fig. (*See* Babylonian Talmud, Bava Metzia, at page 68b.)

[79]Interestingly, the Babylonian Talmud (Bava Metzia, Page 69a) also discusses the Mishna, noted above, that describes a financier advancing funds to a storekeeper or dealer, as borrower, to buy fruits for sale in the ordinary course. A similar limited recourse financing arrangement is also discussed in the Jerusalem Talmud (Bava Metzia at page 16b). The basis of the financing arrangement is that the profits derived from this activity are to be shared by the parties, equally. Once again the Talmud notes that this is a permitted financing arrangement, provided the borrower is compensated as a worker. Rashi, in commenting on the text, notes that this financing arrangement de-


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scribed in the Mishna is an Iska, where profits and losses are shared equally. In terms of the compensation required for the borrower, Rashi specifies that the going rate for workers is divided in half. In essence, as to the so-called loan part, the borrower is, in effect, working for his own benefit. It's only as to the one-half investment part that there is an issue of the borrower working for no apparent compensation. This might create a substantive issue of Ribit. At the very least, it creates an appearance issue, since, as noted above, the only reason the borrower would be doing this work, for no compensation, is to receive the interest free loan portion of the financing. Hence, Rashi suggests that, while compensation must be set-aside for the borrower, only half the going rate is required to avoid the issue of Ribit.

[80]*See* Babylonian Talmud, Bava Metzia, at page 68b.

[81]It should also be noted the fact that the borrower bears some of the risk of loss is another factor, which distinguishes this sort of a transaction from a typical agency or employment relationship.

[82]The loan financier made to the borrower is ostensibly otherwise interest free; hence the appearance issue.

[83]For example, the financier is not responsible for the acts of the borrower under some theory of respondeat superior.

[84]The extent of this liability is the subject of discussion among the commentators on the Talmud. Some argue it is only the damages suffered by reason of the breach. Many, though, hold the borrower thereby incurs liability for repayment of the loan. *See* discussion of Trumat Hadeshen and Tikun Maharam below.

[85]*See* Babylonian Talmud, Bava Kama, at page 102a and discussion by Tosafot on the text. *See also* Tosefta of Bava Metzia, Chapter 4, Section 11.

[86]Jerusalem Talmud, Bava Metzia, at page 17a. The Talmud notes that although it constitutes wrongful conduct, it is not actionable.

[87]*See* prior discussion of Mishna above. *See also* Iska-Larim discussion in article by author on Interest, Ribit and Riba, in *The Banking Law Journal*, as noted above.

[88]*See* the Iska form, attributed to Rav Hai Gaon, set forth as Document 15, in the Book of Documents of Rav Hai son of Shreira Gaon, compiled by Simcha Assaf (Jerusalem-1830).

[89]*See* Medieval Trade in the Mediterranean World, Illustrated Documents, translated by Robert S. Lopez and Irving W. Raymond (Columbia University Press-1955).

[90]Ibid.

[91]Ibid, beginning at page 29.

[92]*See, for example,* Shitah Mekubetzet (by Rav Bezalel ben Abraham Ashkenazi, a leading 16th century Talmudic Authority,) commentary on Babylonian Talmud, Bava Metzia, page 104b.

[93]Cairo Geniza.

[94]*See* discussion of Responsa 26, among others, in the Responsa of the Rambam (Blaue edition), summarized below.

[95]A 16th century Halachic Authority, who, among other things, authored the Code of Jewish Law, known as the Shulchan Aruch, as well as, a commentary on the prior Code of Jewish Law by the Tur and on the Rambam's Mishne Torah Code, before it.

[96]Ibid.

[97]Ibid.

[98]Although not specifically referred to as a Commenda, it is likely one, based on the description in the text of the Bet Yosef. As Rabbi Yosef Karo notes, it only exculpates the borrower from losses due to the ship sinking or the cargo being stolen by pirates. It does not exculpate the borrower from all losses due to Onsin (i.e., casualty or other losses, generally, as a result of any events outside the control of the borrower). This limited assumption of certain risks by the financier is a feature common to Commenda Contracts, as more fully discussed below.

[99]Bet Yosef on the Tur, Yoreh Deah, Section 176, at page 502, in which Rav Karo notes that it is insufficient for the lender to bear just losses occasioned by fire or theft, as provided in the financing structure used in Lombardy. The lender must bear the risk of loss of Onsin (acts of G-d and other events outside the control of the borrower), generally; not just these specific instances.

[100]The financing forms summarized below are for the most part permitted by some, except for Rav Hama's lease of money structure. This particular example is used in order to differentiate it from a permitted type of lease financing transaction. Examples of financing structures prohibited by the Talmud, include the three summarized below. Thus, the Tarsha of Rav Papa (Babylonian Talmud, Bava Metzia, at page 65a) is prohibited as discussed below. So too are the so-called Mechozan Documents (Babylonian Talmud, bava Metzia, at page 68a). Under this structure, the financier accepted a specified sum, in lieu of a half share of the projected profits. The Mechozan debt instrument would set forth a total debt sum equal to the original principal amount plus the projected share of the profits projected attributable thereto. The borrower waived the right to be believed that less was made than the specified sum. It was viewed, in effect, as a sale by the financier of the profit expectation for a lesser fixed sum. The Talmud prohibited this financing structure. This despite the protestations by the financier's son that his father had orally waived the provision prohibiting testimony by the borrower as to losses actually incurred. The so-called Narashan Leases are also mentioned as a prohibited financing form in the Babylonian Talmud (Bava Metzia, on page 68a). The structure is configured as a mortgage-leaseback of the property. The rent under the lease of the borrower's property back to the borrower yields an interest like return to the financier on the underlying loan. It is prohibited because it is nothing more than a disguised loan on interest. The lender does not actually acquire title to or even possession of the property; rather, it is


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only a security interest. Contrast this with the immediate sale of the property, in the case of the Boethus ben Zunin structure summarized in this article. Under that structure there is also no lease-back to the borrower. Rashi appears to view the Mechozan Documents as an integrated transaction that yields actual prohibited Ribit. Others though view it as an appearance issue. Interestingly, the Talmud goes on to posit an example of this financing structure that was permitted. Thus, the Talmud notes if there was an interval of time (Rashi noted for a period of three years), during which the lender took actual possession and operated the real estate and only later leased the field back to the borrower then this structure was permitted. The Talmud notes that the document then in use recited this state of facts and was permitted. It goes on to note that this was important so as not to close the door on borrowers.

[101]There are other permitted financing forms, which are based on other considerations. For example, when interest is not payable by the borrower directly to the lender. This includes the sale of a borrower's interest free note at a discount. The purchaser can collect the full amount of the loan, even though a premium is being earned. Thus, notwithstanding that the premium earned is, in effect, interest, it is not deemed Ribit. As the Tosefta states so pithily, there are some things that look like Ribit; but are not. *See* the Teshuvot Rashi, Section 177. *See also* Sefer Mitzvot Gedolot, by Rav Moses ben Jacob of Coucy (a 13th century Halachic authority, known as the SM"G, after the initial letters of the name of this Halachic treatise), Section 193; and Tosefta, Chapter 4, Section 2.

[102]Not everyone agrees that this is permitted, as noted below.

[103]Mishna recorded in the Jerusalem Talmud, Bava Metzia, as Halacha 2, on page 16a. *See also* Babylonian Talmud, Bava Metzia, at page 65b, where the same Mishna is also set forth in the text.

[104]A wealthy and respected resident of Lydda in second century Israel, whose home was a meeting place for scholars.

[105]*See* discussion of Mishna, as noted above. *See also* discussion in Gemorah text following the Mishna in the Jerusalem Talmud, Bava Metzia at page 16b. The Pnei Moshe on this text notes that the fruits of the three year loan period were held in escrow, with a third party, during the loan term. They were then turned over to the ultimate recipient, as noted above.

[106]Jerusalem Talmud, Bava Metzia, at page 16b.

[107]Babylonian Talmud, Bava Metzia, at page 64a.

[108]An early fourth century Amora.

[109]The financing program summarized above provided for protection against this risk of loss, by way of a put, under the buy-sell arrangement, as noted above.

[110]In the modern form, the financier has the right to put the scotch to the distiller/borrower at a fixed price. This mitigates against the risk of a loss of value due to market fluctuations in the price. The distiller/borrower also has a call, at a fixed price, so that it can earn any excess premium in the price. The buy/sell price is formulated to yield to the financier an agreed upon return on its investment.

[111]*See* discussion of Tosafot on the text of Babylonian Talmud, Bava Metzia, at page 64a. Tosafot views this provision as the equivalent of a warranty of merchantability or fitness for a particular purpose. In essence, if the warranty is violated, then the financier is entitled to rescission (i.e., repayment of principal). The Tosafot (literally, additions) are a collection of the writings of various commentators on the Talmud, following the era of Rashi. They were among the Halachic authorities known as the First Ones, who lived during the period beginning with the end of the Geonic Era (approximately, the middle of the 11th century) and ending in the 16th century, during the time of the great codifier of Jewish law, Rav Yosef Karo and his contemporaries.

[112]He was a disciple of Rava. Abaye and Rava, were contemporaries, who were often mentioned as holding opposing positions in discussions of law in the Talmud.

[113]*See* Rambam, Mishna Torah, Laws of Lender and Borrower, Chapter 8, Section 10. *See also* Shulchan Aruch, Yoreh Deah, Laws of Ribit, Section 173, Sub-Section 13.

[114]The word in Aramaic reportedly means silent. It is used to describe the financing technique summarized above.

[115]Babylonian Talmud, Bava Metzia, at page 65a.

[116]This is in stark contrast to the Tarsha of Rav Papa discussed in the Babylonian Talmud, Bava Metzia, at page 65a. The Papaen Tarsha is deemed to be just a higher credit price under a deferred payment arrangement. The deferred purchase price was determined based on an estimate of what the price of beer might be approximately six months later, in the spring, when the seasonally adjusted price of beer was generally higher. However, the conclusion of the Talmud is that this is a credit financing arrangement yielding prohibited Ribit. This is not intuitively obvious given that the pricing was not strictly speaking phrased as being higher because of deferral of payment. However, once again the key distinguishing element appears to be whether or how the risk of loss is apportioned. In the Papaen Tarsha, the borrower must pay the higher purchase price, no matter what happens in the interim. There is no apportionment of risk of loss. The borrower bears the entire risk of loss and it is, therefore, a pure loan transaction. The difference in the purchase price is thus prohibited Ribit. In the Tarsha of Rav Hama, there is an appropriate apportionment of the risk of loss, as more fully discussed in this article. *See* discussion of this financing form in Shulchan Aruch, Yoreh Deah, Laws of Ribit, Section 173, Sub-section 15.

[117]Ibid.

[118]*See* discussion of the Rambam's Responsa on the matter, as well as, the Tur's financing form, summarized below.

[119]*See also* Tur, Yoreh Deah, Chapter 173.


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[120]Babylonian Talmud, Bava Metzia, at page 69b.

[121]*See, for example*, *United Airlines, Inc. v. HSBC Bank USA, N.A.*, 416 F.3d 609, 45 Bankr. Ct. Dec. (CRR) 1, Bankr. L. Rep. (CCH) P 80322 (7th Cir. 2005), a relatively recent case that illustrates this point.

[122]I.e., that can be the basis of a bond financing, underwritten wholly on the quality of the rent flow from the tenant. The landlord, generally, has no real responsibilities to the tenant under this type of a leasing structure. To qualify for this kind of financing, there cannot be any impediments to the payment of rent. The rent must be paid no matter what the circumstances.

[123]*See* Tosafot adjoining text of Babylonian Talmud, Bava Metzia, at page 69b. Tosafot explains Rav Hama's view was based on the belief that the lender taking on the risk of loss of "Onsin" was sufficient to avoid the prohibition against Ribit. The term Onsin may be defined as acts of G-d or other events outside the control of the borrower. This was deemed to be an insufficient apportionment of risk of loss to the lender so as to constitute the transaction as something other than a loan, subject to the prohibition against Ribit. One key distinction between a genuine lease and a loan is that the lessor takes the risk of loss of physical and financial depreciation of the property that is leased. Rabbi Moshe Isserles (known as the Rema, an acronym of his name), a 16th century Halachic authority and author of the glosses on the text of the Shulchan Aruch of Rav Yosef Karo (generally included in the text of this monumental code of Jewish law,) describes how the lessee under a genuine lease cannot assume all of the risk of loss. Thus, he notes, the lessee may be required to assume the risk of loss of theft or negligence; but not losses resulting from Onsin. *See* the discussion below on the treatment of various categories of risk and whether an assumption of those risks by the lessee would recharacterize a lease as a loan transaction.*See* Jerusalem Talmud, Bava Metzia, at page 19b.

[124]*See* Babylonian Talmud, Bava Metzia, at page 69b. To be a genuine lease and not a loan, the lessor must take the risk of loss of damages due to Onsin, physical and financial depreciation (including reasonable wear and tear). Otherwise, the lease is nothing more than a disguised loan, as noted above. The lease, however, may impose certain duties and obligations on the lessee. This would include, for example, liability for negligence.

[125]Talmud Bava Mezia at page 69b.

[126]Talmud Bava Metzia at page 65a.

[127]Tosefta, Chapter 5, Section 1 and Jerusalem Talmud, Bava Metzia, at page 16a, *See* Babylonian Talmud, Tractate Taanit, at page 10b, which describes a written document attesting to a debt (Shtar Hov) as merchandise (Prakmatia). *See also* Shulchan Aruch, Section 173. Sub-section 4, which provides that a sale of a note at a discount is permitted, so long as the seller of the note is not personally liable as guarantor of the borrower's obligations under the note.

[128]The Bible and Talmud (including the Jerusalem Talmud, Bava Metzia, at page 17a) also use another term to describe a type of borrowing structure that is not a pure loan associated with Ribit. We colloquially use the term borrow or loan when referring casually to lending an item for use by another for no charge. Thus, we might say that a tool was borrowed by a neighbor. In this kind of a transaction, the borrower is generally referred to in the Talmud and Halachic literature as a "Sho'el," as opposed to a "Loveh." The distinguishing characteristic may once again center on how the risk of loss is shared by the parties. The lender in the Sho'el arrangement bears the risk of loss of depreciation, including both physical depreciation and in terms of dimunition in value. The borrower in the Sho'el arrangement often bears the risks of casualty, theft or other loss, but not always. Thus, if the loss occurs while the Shoel is using the borrowed object for the intended purpose, then the Shoel is not liable. In that event, it is the lender who would bear the risk of loss (*See* Rambam, Mishne Torah, Laws of Borrowing and Entrustment, Chapter 2, Section 1). By implication, it is suggested that (by analogy to the rule of use for the intended purpose, noted above) the borrower, in the Shoel financing arrangement, is not liable for losses, so long as the monies advanced are used for the intended purposes. Furthermore, if the loss occurred in the presence of the lender, the Shoel/borrower would not be liable. Rather it is the lender who would bear the risk of loss under these circumstances (*See* Rambam noted above). Rav Yonatan (a first century Tanna) is cited for the proposition that a lender may be present with the borrower by way of an agent. (*See* Babylonian Talmud, Bava Metzia at page 96a; *See also* Exodus, Chapter 22, Verses 13–14.). In this regard, one cannot help but wonder whether the borrower (who is working for the benefit of the lender and borrower under this financing structure) might not be deemed to be the lender's agent, for these purposes. Be that as it may, in a traditional pure loan transaction, the borrower is personally liable to return the money loaned and bears all of the risk of loss, as noted above. In line with the foregoing, it is suggested that the reason the Jerusalem Talmud uses the term Sho'el is to describe, in shorthand, a permitted financing arrangement, where the risk of loss is apportioned differently than would be the case in a typical pure loan transaction. I propose that the Shoel financing structure discussed in the cited text is a non-recourse (Kulo Pikadon) Iska form. Rav Moshe Margolies (an 18th century Talmudic scholar), in the Penei Moshe (a seminal work on the Jerusalem Talmud he authored, printed alongside the text of the Jerusalem Talmud noted above) asserts it is a limited recourse financing structure. The Pnei Moshe notes that the Jerusalem Talmud text referred to above must refer to a Palga Malveh (one-half loan), Palga Pikadon (one-half investment) financing structure, along the lines described in the Babylonian Talmud. He bases this thesis on the fact that the financing device requires that there be provision for compensation for the borrower's work in the venture. He posits that otherwise why the need for this separate compensation. In essence, if the lender bore all the risk of loss, as in a Kulo Pikadon Iska financing structure, then there would not be any requirement, per se, for this kind of a provision for the borrower. However, this presumes a 50/50


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sharing of profit arrangement. This is not obvious from the text. Indeed, it is arguable that this particular financing structure is not necessarily a 50/50 relationship. The text merely speaks of the profits being divided between the borrower and financier without specifying the actual percentage sharing arrangement. In contrast, other examples in the text specifically reference the fact that they are based on a one-half of the profits arrangement. It is suggested that this is because when the lender has the risk of loss, the sharing arrangement with the borrower does not have to conform to the 50/50 structure of the Neardean Iska. It can be whatever is agreed to by the borrower and financier. Since it departs from the customary equal sharing arrangement, some compensation may be required to avoid an appearance of Ribit issue, as discussed below. Thus, the agreement between the parties might also conform to the non-recourse financing structures reported by the Tur and Rambam, noted above. Under these non-recourse financing structures, some compensation for the borrower is, nevertheless required. (*See* the discussion of the Bet Yosef on the Tur text summarized below.) This approach suggests another possible understanding of the Jerusalem Talmud text noted above, as an alternative to that of the Pnei Moshe. Under this interpretation, the financing form reported would be a non-recourse structure, rather than a limited recourse one. The provision for separate compensation is a matter of appearance; not substance. In essence because the financing structure may appear to yield prohibited Ribit, instead of permitted return, separate compensation is set-aside for the borrower to avoid even the appearance of charging Ribit. This concern is also expressed in the discussion in the Jerusalem Talmud of the Tarsha of Rav Chama, as more fully discussed below. In this particular case, it is proposed that the appearance issue arises because the structure eventually yields a debt, personally owed by the borrower to the financier, even if the structure does not initially begin that way.

[129]Counting a contraction in the printed text as two words.

[130]By reason of this requirement, the Pnei Moshe views this as a limited recourse financing structure (i.e., where the borrower receives one-half the profits and bears one-half the losses), of the sort described by the Nehardeans in the Babylonian Talmud. *See* discussion above of this text. *See also* Babylonian Talmud, Bava Metzia, at page 104b.

[131]Ibid.

[132]Inasmuch, as the borrower would presumably not work for less, for no reason. Hence, by implication, it may appear that the borrower is working, at reduced rates so as to recompense the financier for the loan made to the borrower of all the funds needed for the venture. Under these circumstances, it may appear that this is a Ribit bearing loan.

[133]BabylonianTalmud, Bava Metzia, at page 67b.

[134]*See* Shulchan Aruch, Yoreh Deah, Law of Ribit, Section 172, Sub-section 1.

[135]Teshuvot Maimonit, Book of Mishpatim, Chapter 52.

[136]The example of the fixed sum given in the Responsa of the Rambam is double the original principal amount. The structure is similar to the one described by the Tur, as discussed below.

[137]*See* discussion above of what constitutes adequate compensation in the Talmud. The Rambam notes in his Responsa (as summarized below) that the compensation can be nominal.

[138]*See* A Mediterranean Society-The Jewish Communities of the World Portrayed in the Documents of the Cairo Geniza, by S.D. Gotein, Volume I (University of California Press-1967).

[139]These documents were found in the Cairo Geniza, in Judeo-Arabic print (Arabic written in Hebrew characters). Yehoshua Blaue edited a compilation of these important documents authored by the Rambam (with accompanying Hebrew translation), published under the title, Teshuvot HaRambam (the Blaue Edition-1948).

[140]*See* Volume I, Responsa Number 26 at page 38 of Blaue Edition.

[141]*See* Volume II, Responsa 276, at page 676 of Blaue Edition.

[142]*See* Volume I, Responsa 26, at page 38 of Blaue Edition. It is likely a reference to a Qirad. *See also* Responsa 32 at page 45 of Blaue Edition, involving a voyage to India. Under this financing structure, the financier bore all of the risk of loss and was entitled to two-thirds of the profits. The borrower was correspondingly entitled to one-third of the profits.

[143]*See* Volume I, Responsa 78, at page 120 of Blaue Edition.

[144]The Rambam, in his response to the question posed, cited with approval the first Iska structure. This structure is consistent with the example he provided in the Mishne Torah (Laws of Agency and Partnership, Chapter 6, Section 2) of methodologies of properly apportioning risk of loss. It is also the Iska structure described in the Babylonian Talmud, Bava Metzia, at page 104b, noted above. However, he does not disapprove of the second Iska structure.

[145]Literally, the Four Rows, which encompasses four broad areas of law. One of the areas of law covered is entitled Yoreh Deah. The discussion of the non-recourse financing structure referenced above is set forth in Section 167.

[146]Unlike the Rambam's Responsa, there is no express citation to the source in the Talmud for this permitted financing form.

[147]*See* discussion above of the Teshuvot Maimonit on the subject. *See also* the discussion below of the Bet Yosef commentary (authored by Rabbi Yosef Karo) on the Tur text. Rabbi Yosef Karo distinguishes between setting compensation at the very outset of the financing and doing so thereafter. Thus, the parties can agree on nominal compensation, as a part of the original financing arrangement. On the other hand, if this is not initially done, then the compensation must be at the


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rate payable to an idle worker and paid daily. It should be noted that this sum is a base measure of compensation. It is not market rate for the kind of talent and efforts expected of the entrepreneur borrower. Rav Karo also codified the same financing structure as the Tur, in his Code of Jewish Law, the Shulchan Aruch, in Yoreh Deah, Laws of Ribit, Section 167. The Vilna Gaon (Rav Eliyahu ben Shlomo Zalman of Vilna), an 18th century Halachic authority, notes (in his commentary, the Biur H'Gra, adjoining the text of the Shulchan Aruch,) this structure is similar to that of the Tarsha of Rav Hama. However, The Vilna Gaon goes on to point out that it is similarly based on the financing structure of Rav Eliezer (i.e., Rav Leyzer), reported in the Jerusalem Talmud, as summarized above. Rav David HaLevi Segal (the author of the Turei Zahav, known as the Taz), a 17th century Halachic authority, explains the difference between this structure and an ordinary loan. His focus is on whether the lender bears the risk of loss or the borrower. Therefore he posits that the practice of paying the borrower compensation to assume all the risk of loss is problematical, because it is, in effect, nothing more that a disguised loan. See, however, the discussion below concerning whether the parties can agree, in effect, to apportion some of the risk of loss (such as fire or other casualty) to the borrower, by paying the borrower separate compensation to do so. The underlying conceptual basis for this kind of arrangement is derived from the differing responsibilities of a paid agent, as compared to an unpaid gent. Thus, the theoretical possibility of converting the borrower from what is referred to as a Shomer Chinum (unpaid agent) to a Shomer Socher (paid agent). If this were permitted, then the borrower could, in effect, be paid to assume certain risks, such as theft or casualty loss. However, this practice was frowned upon by the Taz, as noted above. Some would permit this kind of apportionment of some of the risk of loss. Thus, for example, the Tur, in Yoreh Deah, Laws of Ribit, Section 177, cites the Raavad (Rav Abraham ben David Posquieres), a 12th century Halachic authority, for the proposition that can compensate the borrower to take on the responsibilities of a paid agent. Thus, the borrower, in exchange for the payment, would, in effect, become the insurer against loss by reason of theft or other casualty. Others though prohibit it. For example, the Tur cites the Rambam for the proposition that even if the borrower is paid compensation, he still may not assume the responsibilities of a paid agent. Rather, the borrower remains, for these purposes, an unpaid agent, who is only liable for negligence; but not theft or casualty. The Tur, though, also notes that the Rivan (Rav Yehuda ben Natan, a son-in-law of Rashi), a 12th century Halachic authority, held that a lender could even shift to the borrower, the risk of loss of Onsin (i.e., acts of G-d or other events outside the control of the borrower), by agreeing to pay the borrower something for this undertaking. However, the Tur goes on to note that the Ri (Rav Yaakov of Orleans), another 12th century Halachic authority and Tosafist, prohibited this practice. In any event, one of the key risks that had to be borne by the lender under this permitted financing form, even according to the Rivan, was as to the ultimate value of the merchandise purchased with the funds advanced. Thus, the Tur cites Tosafot for the proposition that the Iska may specify that only certain merchandise may be purchased with the funds advanced. If the borrower defaults by varying from this requirement, the borrower thereby assumes all of the risk of loss. Similarly, the Tur notes, the parties may make all manner of stipulations under the Iska, including as to security measures to be taken to protect the funds advanced.

[148]Interestingly, the Raavad, in his Responsa, Section 133, deals with whether it is permitted to convert a limited recourse financing structure into a non-recourse form. Under this sequential Iska structure, a term of two years duration is provided. The firstyear of the term is structured as a limited recourse Iska. During this initial period, the borrower and lender share the profits and losses, equally (i.e., Palga Malveh, Palga Pikodon, as in the Nehardean Iska). After a year's time the principal plus profit share due to the financier would then be converted into a non-recourse financing. The financier then assumes the risk of loss, generally (i.e., Iska Kulo Pikadon), and reaps any and all profits for the second year of the term (*See also* the Meiri commentary on Talmud Bava Metzia page 105a. in the Bet HaBechirah at page 391). The Raavad concludes that this form would be prohibited because it appears like Ribit. He reasons that it appears that the borrower is working for the lender during the second year of the term for no compensation, in order to pay, in effect, Ribit for the one-half loan portion of the original financing amount that is required to be interest free. The Bet Yosef on the text of the Tur, noted above, cites this proposition of the Raavad and proposes a solution that would enable this particular financing form to be permissible and avoid any appearance of Ribit concern. In essence, he suggests, much like the Tur financing structure, that the Iska stipulate the borrower receive some compensation for his work. He concludes that this would dispose of the appearance issue raised by the Raavad.

[149]This is wage rate standard that is, conceptually, similar to the minimum wage rate in the U.S. It is an objective standard. It is the prevailing wage rate in effect for an unemployed laborer seeking employment. It is not a subjective standard. Under this principle of compensation, no assessment is required of the actual market value of borrower's work.

[150]The Beit Yosef commentary on the text of the Tur, Yoreh Deah, Laws of Ribit, Section 167.

[151]Rabbi Isserlein ben Petachia, a 15th century Halachic authority.

[152]The name of the Halachic work compiled as Responsa, authored by Rav Isserlein. *See* Responsa 302.

[153]*See* the discussion of this text in the Babylonian Talmud, Bava Metzia, at page 69b, noted above, as well as, the commentary of Tosafot on the text summarized above.

[154]The term used is Onsin, as discussed above.

[155]*See* the discussion of the Ritva, Rav Yom Tov Assevilli (of Seville), a 13th to 14th century commen-


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tary on the Babylonian Talmud, Bava Metzia, page 68a. The Ritva describes how if the lender bears the risk of loss, in what he refers to as "B'Torat Pikudon Gomer" (literally in the category of an investment, entirely), then it is not a loan. He concludes the prohibition of Ribit applies only to a loan and not to this type of a non-recourse financing structure.

[156]Sometimes referred to as the Iska-Kulo Pikadon.

[157]There are other non-recourse (Kulo Pikadon) and limited recourse (Palga Malveh, Palga Pikadon) forms extant. A limited recourse form is attributed to Rav Hai Gaon, the 11th century head of Acadamey in Pumbedita. (*See* Document 15 in the Book of Documents, attributed to Rav hai Gaon, compied by Simcha Assaf and published in Jerusalem in 1930). An interesting non-recourse form is attributed to Rav Yackov of Orleans, a 12th century Tosafist and Halachic authority. It is found in the Glosses of Rav Mordechai ben Hillel HaKohen, a 13th century Halachic authority, who wrote the commentary on the Babylonian Talmud (known as the Mordechai, after his name). It is found at the back of the Otzar HaSeforim Edition (S. Goldman-Ireland-1973) of the Babylonian Talmud, Bava Metzia, on page 172. It provides for a regular payment of a fixed sum, on a weekly basis, until the principal amount is repaid in full. It states that the testimony of the borrower is not accepted to establish a loss or any other defense to payment of the debt. This form does not, however, provide for an alternative, express means of establishing that a loss did in fact occur, as noted in the formulations of the Trumat Hadeshen and Tikun Maharam, described below. Rav Yosef Karo is reported to have rejected this format, because of a concern that it appeared like Ribit. Others raised issues concerning this form, as well. Another useful non-recourse Iska form is the non-recourse Iska document, generally following the Tur's format, found in a documentary formbook, entitled Tikun Shtarot. published in Amsterdam in 1721. This Iska document is most interesting because it follows neither the earlier formulation reported by the Nehardeans in the Babylonian Talmud (*see* the form Iska attributed to Rav Hai Gaon noted above), nor the later one of the Trumat Hadeshen (*see* the Tikun Maharam form document, based on the formulation of the Trumat Hadeshen, discussed below). It appears to be based on the structure set forth in the Tur, as summarized above. It provides that the borrower acknowledges receipt of 2,000 gold pieces. It describes the relationship as an Iska financing. However, it goes on to say that until there is a profit of 200 gold pieces earned, the lender shall bear the risk of loss. Once the profit of 200 gold pieces is earned, the Iska financing will convert into a pure loan of 2,200 gold pieces (i.e., principal plus interest). From that point on, the borrower will have all the risk of loss and personal liability for the payment of the stipulated sum (the principal and interest) of 2,200 gold pieces. The term of the loan is until the specified trade fair occurs. Once again, the key element of this form that distinguishes it, from a traditional pure loan on interest that yields prohibited Ribit, is the provision apportioning the risk of loss to the financier. It should be noted that unlike the Tur, this form does not specify compensation for the borrower. Query, is this a lacuna? Be that as it may, to my knowledge, this specific form is not generally used. The form also does not contain other covenants and conditions, including as to the kind of proof that is necessary in order to establish a loss. However, unlike other forms of Iska, this document does not expressly exclude the testimony of the borrower on the issue of whether there was a loss of principal (c.f. the Iska form of the Ri, noted above, as well as, the Tikun Maharam Iska form discussed above). This might help explain why it is that the Tikun Maharam form (or a derivative thereof[157]), based on the formulation of the Trumat Hadeshen, noted above, is the prevailing non-recourse form Iska still used to this day. Indeed, many modern forms incorporate the terms of the Tikun Maharam Iska by reference.

[158]A 16th century Halachic authority.

[159]An organization of Rabbis and other representatives of Jewry in four lands (inclusive of Poland) that constituted a form of Jewish self-government during the late 16th century and through the mid 18th century, It met from time to time to deal with issues of taxation and other legal, economic or community issues. It is reported that it adopted the Tikun Maharam form Iska. *See* www.YIVO Encyclopedia.org, subject heading, Credit. *See also* Encyclopedia Judaica (second edition), Volume 20, under the subject heading, Usury, at page 442.

[160]Ibid. *See also* Nahalat Shiva, Document 40 at page 592.

[161]The Tikun Maharam Iska provides for a fixed amount of return payable to the financier, which is consistent with the Tur's formulation (as well as that of the Rambam described above). The concept of specifying a priority fixed amount of return vs. a share of the profits is not accepted by all Halachic authorities, under all circumstances. Thus, for example, Rav Yosef Karo in his Shulchan Aruch (Section 177 at page 110b) does not permit specifying a fixed amount of return. However, Rav Moshe Isserles, a 16th century Halachic authority in his renown glosses on the Shulchan Aruch (set forth in the printed text noted above) states that many permit specifying a fixed amount of return in a non-recourse financing structure. Similarly, Rav David HaLevi Segal, a 17th century Halachic authority in his seminal work the Tureh Zahav (known by the acronym Taz), that is printed adjacent to the Shulchan Aruch text cited above. The Taz notes that so long as structured as a non-recourse financing, where the fixed return would only be payable if and to the extent of a profit, then permitted. Rav Yoel Sirkis, a 16th century Halachic authority, in his commentary on the Shulchan Aruch, the Bayit Chadash (known by the acronym Bach), that is also printed adjacent to the Shulchan Aruch text cited above, adds a further qualifier. He would permit a specified fixed return only if there was no requirement in the Iska that the only acceptable proof of loss was the testimony of two kosher witnesses, as set forth in the Tikun Maharam form. Absent removal of that condition, the Bach would only permit a formulation based on a sharing of the profits, if any. Rav Moshe Sofer, an 18th century Halachic authority, in his Responsa, known as the Chatam Sofer (in Volume 5, Choshen Mishpat, Responsa 63, at page 142) would appear to permit a


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stated percentage interest rate, if the non-recourse Iska format of the Tikun Maharam is used. *See also*, the Responsa of the Mabit (Rav Moses of Trani, a 16th century Halachic authority), Volume I, Responsa No. 244 (Grossman Publishing-1961). Reference should also be made to the Ginat Veradim, a Halachic work by Rav Abraham ben Mordechai HaLevi, a 17th century Halachic authority. The Ginat Veradim (in the Volume on Yoreh Deah-General Rule 6, Section 8) deals with the drafting of a form Iska, using the format of the Tikun Maharam, including the matter of a fixed rate of return payable to the lender.

[162]Rabbi Shabbatai Cohen (known as the Shach), a 17th century Halachic authority, notes in his commentary on the Shulchan Aruch (in the text adjoining the Laws of Usury, Section 167,) notes that the practice of requiring two kosher witnesses so as to establish that no profits earned (as opposed to a loss of principal) is inappropriate.

[163]Koran, Chapter 2:275. *See also* Koran, Chapter 3:130, regarding the basic prohibition against Riba. The term Riba is not defined in the Koran. *See* article by author on Interest, Ribit and Riba, in *The Banking Law Journal*, noted above.

[164]Ibid.

[165]The concept of a financier's money working and earning profits, without his personal labor, was also condemned in western culture, including by such personage as Aristotle. *See* Aristotle's Politics, Book I, at the very end of Chapter 10 (in Vol. 9 of the Britannica Great Books series, at page 452 referencing page 12589b of the text). He condemns making money on money, as opposed to the natural object of it. He goes on to say that money was intended as a means of exchange and not to increase at interest. He defines interest as the birth of money from money. However, it appears Aristotle also condemned making money on trade itself (i.e., by way of a middleman), which he also viewed as unnatural. According to Aristotle, it's one thing for the producer to sell the product of his or her labor to the consumer, directly. It's another thing, though, for an intermediary to make an independent market in the goods produced by others, according to Aristotle. This appears to be a point of departure by later religious Islamic and Church thinkers. They may have cited Aristotle for the proposition that charging interest was wrong. However, they distinguished this from trade, which they considered to be a permitted function. The distinction is fundamental. The intermediary trade function required both credit (money) and work to succed. The profits of trade are derived from the sale of the object purchased with the money. Is there really a difference between dividing up the profits of the sale and paying the money-man a return, only if there are profits made on the underlying transaction (funded with the money) and out of those profits. This might help explain the logic used by Sha'ariah and Christian scholars to permit the financier make money (without working) in a Qirad or Commenda structure; but not in a loan format. The distinction seems to be whether the lender bears any risk. If the loan is fully recourse to the borrower, no matter what happens in the underlying transaction funded by the money, then it is the money, making money. On the other hand, if the lender bears at least some or all of the risk of loss, as to the underlying venture's success, in order to get paid, then money doesn't itself make money, it is the underlying venture that yields return or not. How much risk must be assumed by the lender in order to constitute the financing as trade, as opposed to a pure loan, is a subject discussed in this article. It varies, depending on the particular religious law and tradition and sometimes on the scholar interpreting the same. Medieval Church leaders, such as Thomas Aquinas (a 13th century Christian Theologian) railed against usury employing arguments advanced by Aristotle. Interestingly, unlike the Sha'ariah, but much like the Halacha, Aquinas objected to a higher credit price. However, even Aquinas distinguished between a loan of money and a loan of real property (i.e., a lease), which yielded rent and not prohibited Usury. Furthermore, Aquinas described a financing structure that resembled the Iska and Qirad forms described above. *See* Summa Theologica, Volume II, part II, Question 78, including Article I-Answer (discussing a lease vs. a loan), Article 2-Reply to Objection 5 (discussing an Iska or Qirad type of financing structure) and Reply to Objection 7 (discussing a higher credit price).The reasoning used by Aquinas to permit a non-recourse financing structure, is very similar to that of Malik, in his Muwatta, as summarized below. Thus, if the financier advanced money to the borrower for use in a trade transaction, but did not convey title to the money, then technically speaking the money still belonged to the financier. He distinguishes between entrusting the money to the borrower and transferring title to the money to the borrower. When title to the money is transferred to the borrower, he deems that a loan of the money. He goes on to say that when title to the money is transferred in a loan transaction, the borrower bears the risk of loss of the money. On the other hand, when money is advanced and is said to be entrusted to the borrower, it is the lender who continues to bear the risk of loss on his money. In essence, according to Aquinas, the lender is deemed to continue to own the money and a form of society is formed. The lender bears the risk of loss on his money, even as the merchant/borrower speculates with it or the craftsman/borrower uses it in his or her craft. According to Aquinas, the lender may therefore properly demand and receive a share of the profits derived from his money.

[166]Similarly, it may also be considered Ribit under the Halacha, as noted above.

[167]Under the Commenda, there was a different sharing of risk arrangement. Thus, as more fully discussed below, the entrepreneur, as borrower, took the market risk of fluctuations in demand and price. However, the financier, as lender, took the risk that the merchandise was lost because the ship sunk or because it was stolen by pirates.

[168]As noted above, the terms describe similar financing structures and are used interchangeably.

[169]Much like the term used by the Rambam, the financier is known as the owner or provider of the money or, as the financier is sometimes colloquially referred to in modern parlance, the money-man.


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[170]*See, for example,* Koran Chapter 3, Verse 130, which forbids Riba. *See also* Chapter 2, Verse 76; Chapter 2, Verses 278–9; and Chapter 30, Verse 39.

[171]*See* Koran, Chapter 2 Verse 275, which states: "Trade is just like usury, whereas Allah permits trading and forbids usury." Aristotle might disagree; since he apparently considers both trade and interest to be unnatural, as noted above. *See also* Chapter 20, which speaks about traveling throughout the land seeking the bounty of G-d. This is interpreted to mean traveling to buy and sell goods on favorable terms with funds provided under a Qirad type of trade financing arrangement. Similarly, *see* Koran Chapter 10, which expresses a similar theme. These are the kind of financing arrangements that were prevalent in the Arabian peninsula at the time, as well as earlier. *See also* the Mishnaic and Talmudic discussions noted above.

[172]Sunnah are teachings or practices of Mohammed, not expressly set forth in the Koran, as reported by those in proximity to him. Sunnah are more authoritative than Hadith. *See* Sunnah of Abdullah ibn Abbas (i.e., the son of Abbas, who was an uncle of Mohammed) reporting about a Mudarabah. In this case, stipulations were made that the moneys advanced under the Mudarabah not be transported by sea or by crossing a valley. The funds were also not to be used to purchase livestock. It was further stipulated that if these conditions were violated then the borrower would guarantee the loss. It was reported that these conditions were brought to the attention of Mohammed and he approved them.

[173]Hadiths are later reports of the deeds or sayings of Mohammed. *See* Ibn Majah, who reported that Mohammed said that a Muqaradhah (another name for a Qirad or Mudarabah) was one of three types of blessed transactions. *See also* Al-Muwattah by Malik ibn Anas (an eighth century compiler of Hadiths and what is reputed to be the oldest surviving compendium of Islamic law), Book 32.

[174]*See* Fatwa on Banking by Umar Ibraham Vadillo (October 2006) at page 74.

[175]*See* discussion of the form Qirad described in Malik's book of laws concerning the Qirad, entitled the Muwattah, noted above.

[176]Ibid.

[177]Ibid.

[178]*See* the discussion above of a similar concept expressed by Thomas Aquinas.

[179]*See* Fatwa of Vadillo noted above. *See also* text cited in the Fatwa, quoting Ibn Rushd, from his work, Bidayat Mujtahid wa Nihayatul-Muqtasid (Cairo, 1329) at page 205, on the legality and pre-Islamic origin of the Qirad. Reference should also be made to At the Origins of the Western Commenda: Islam, Israel, Byzantium? By Abraham L. Udovitch (Spectrum, Volume 37, No. 2 (April, 1962).

[180]*See* Udovitch, At the Origins of the Western Commenda, noted above. *See also* John H. Pryor in The Origins of the Commenda Contract, published in Spectrum, Vol.52, No.1 (January, 1977). It is respectfully suggested, as more fully developed in the text of this article, that these scholars may not have considered the non-recourse financing forms described in the Jerusalem Talmudic and Mishna that predated the Baylonian Talmud. They focus only on the limited recourse Iska form reported by the Nehardeans and cited in the Babylonian Talmud. Thus, Udovitch analyzed the Palgah Malveh Palga Pikodan innovation by the Rabbis, reported by the Nehardeans in the Babylonian Talmud. He concluded this could not be the basis of the Qirad and by extension the Commenda. This is because neither of these financing forms contain the unique sharing of risk formulation embodied in the Nehardean form of Iska. However, as shown in this article, there are earlier texts that discuss a fully non-recourse financing format that may be the source of the source of the Qirad and, by extension, the Commenda.

[181]Ibid.

[182]Ibid.

[183]The language in the text is D'Ovid L'Hu Miltze, an Aramaic phrase meaning they did something to it. This phrase may be interpreted, in the context, to mean they restructured the financing form known as Iska.

[184]In this regard, the statement, in the text of the Babylonian Talmud cited above, to the effect that it was good for lenders, makes logical sense, if the prior form was non-recourse. The innovation produced an acceptable form of limited recourse. It would not be good for lenders if full recourse were reduced to limited recourse. It should also be noted that the Babylonian Talmud in Tractate Bava Metzia at page 104b, also discusses that the Iska structure does not necessarily mandate an equal sharing of profits and losses. Indeed, in the discussion by Rava of the case of Rav Illush, it concluded that the Iska arrangement, attributed to Rav Illush, provided for the lender to bear a 2/3 share any losses and receive a1/2 share of the profits. The Rambam (Mishne Torah, Laws of Agents and Partnerships, Chapter 6) describes how the lender's share of profits and losses is a matter of agreement between the borrower and lender. So long as the share of losses borne by the lender is inversely proportionate to the share of profits, there is no issue of Ribit. This suggests that if the lender bears all of the risk of loss, then the lender could be entitled to most of the profits. This conceptual analysis of the Rambam precedes the financing form of the Tur, noted above, which takes this formulation to its logical conclusion. Similarly, the Rambam in his Responsa, discussed above.

[185]Consider, a fully recourse version of this kind of a financing structure is nothing more than a prohibited interest-bearing loan. For example, the Mishnaic textual counterpoint of the iron-clad (Tzon Barzel), fully recourse and prohibited financing form. As discussed above, it is juxtaposed in the text of Chapter 5 (of the Jerusalem Talmud, Bava Metzia,) with the permitted non-recourse version of otherwise the same form.

[186]And within each legal tradition, according to some.

[187]In the Book of the Routes and Kingdoms by Abu al-Qasum (a ninth century work) a document


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translated in Gotein, Medieval Trade, at page 31.

[188]*See* discussion in Chapter on Jewish Role in World Trade, in Gotein, Medieval Trade, beginning at page 29.

[189]*See, for example,* the formulations of the Tur, Trumat Hadeshen and Mabit, discussed above.

[190]*See* discussion of Commenda documents, found in Gotien, Medieval Trade.

[191]Ibid.

[192]Muwattah, Book 32, Number 32.3.5.

[193]Muwattah, Book 32, Number 32.4.6.

[194]Similarly, in the Commenda arrangement.

[195]Some modern Sha'ariah scholars, such as Dr. Tantawi, the Grand Mufti of Egypt and Shaykh Shaltut, the Grand Imam of the Al-Azhar University of Egypt, permit the pre-fixing of the share of profits in the case of bank accounts or government bonds, respectively. *See* The Riba-Interest Equation and Islam: Reexamination of the Traditional Arguments by Dr. Mohammad Omar Farooq (2005). *See also* Part II of Interest Ribit and Riba, by author, in The Banking Law Journal (June-2013), beginning at page 549. Consider also that in a typical CMBS mortgage financing, the borrower may make distributions of profits monthly, with the payment of monthly debt service. Furthermore, the borrower, through an affiliate, often earns management fees. Thus, it may be argued that this criteria of Malik is satisfied in a typical CMBS financing.

[196]*See* The Commenda Contract, by John H. Pryor in Speculum, Vol. 52, No. 1 (January, 1977), at pages 20 and 33.

[197]*See* The Institutional Dynamics of Early Modern Eurasian Trade: The Commenda and the Corporation, by Ron Harris, in the Journal of Economic Behavior and Organization (2009). These risks were often separately insured. This may help account for the growth of third party insurers like Lloyd's, which began as a syndication market among investors willing to take on these risk of sea voyage for a healthy premium.

[198]Document 82 (Venetian Commenda-covering a voyage from Genoa to Thebes), translated in Gotein, Medieval Trade, at page 176.

[199]*See* Gotien, Medieval Trade, at page 9.

[200]*See* Document 86, translated in Gotein, Medieval Trade, at page 180. This particular Commenda covered a voyage from Pisa to Sicily.

[201]*See* Document 91 (a Marseilles Land Commenda) translated in Gotein, Medieval Trade, at page 188. This Commenda also included a provision for accounting by the borrower.

[202]Ginat Veradim, Yoreh Deah, Principle 6, Section 8. *See also* Blaue, Brit Yehuda, Chapter 37, Section 10 (discussed below), which notes that can even require weekly accountings, sworn to by the borrower.

[203]*See* discussion of Tikun Maharam Iska above.

[204]*See* discussion of the Iska in the Babylonian Talmud, Bava Metzia, at page 104b, summarized above.

[205]*See* Book 32 of Malik's Muwatta.

[206]However, the financier cannot specify that the goods be purchased solely from a specified supplier. This is because then, according to Malik, the borrower would, in effect, be the financier's hireling for a wage. This would then not be a genuine Qirad arrangement.

[207]Accountings can be required weekly and also may stipulate that will be sworn to by the borrower, according to Rav Yackov Blaue, a 20th century acknowledged expert in the area of Ribit and Iska and author of the Brit Yehudah-Laws of Ribit and Iska (Chapter 37, Section 10, at page 596 of Second Printed and Redacted Edition-Jerusalem-1979). *See also* discussion of Mabit's non-recourse Iska financing form, in this article.

[208]*See* Mabit noted above, as well as, Ginat Veradim noted below. *See also* Tosafot, in Babylonian Talmud, Bava Kama, at page 102a.

[209]A requirement noted by Rav Abraham ben Mordechai HaLevi, a 17th century Halachic authority, in his Responsa, known as the Ginat Veradim, Yoreh Deah, Rule 6, Section 8.

[210]A 16th century Halachic authority.

[211]An acronym of his name and the title of his book of responsa. *See* Responsa No. 244 of the Mabit.

[212]The formulation used by the Mabit provided that if there were profits, then $10 for every $100 of principal per year would be payable to the lender. *See also* discussion in Ginat Veradim, noted above, in Section 8, regarding fixing return out of profits. Reference should also be made to the Shulchan Aruch HaRav (Yoreh Deah, Laws of Ribit and Laws of Iska, Section 41), by Rav Shneur Zalmi of Liady, the 18th century Halachic authority, Hassidic Master and founder of Chabad Hassidism. He was also the author of the Tanya, a classic work of Hassidic literature.

[213]*See* the discussion of the Bet Yosef above.

[214]*See, for example,* the *Cherryland* decision, summarized below.

[215]Also referred to as a bad boy guaranty.

[216]*See, for example,* reports in "Carve-outs: Bad-boy Guarantees have Borrowers Spanked," by Guelda Voien in the September 8, 2014, edition of the Mortgage Observer.

[217]This is especially important in hotel or health care facilities, where movable property used in connection with the mortgaged real estate, such as the furniture, fixtures and equipment, is an essential part of the operation of the real estate, so as to generate the underwritten net cash flow needed to service the mortgage loan. Even computer software, such as an online reservation system in a hotel, can be a valuable asset.

[218]*See The Travelers Ins. Co. v. 633 Third Associates*, 14 F.3d 114 (2d Cir. 1994). In the *Travelers* case, the Federal Court was acting based on having diversity jurisdiction. The court therefore was applying New York Law. The Second Circuit noted there was no New York State Court of Appeals decision on point. The court


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went on to hold that a cause of action for waste could lie where there was an intentional failure to pay real estate taxes, despite an obligation to do so or where the failure was fraudulent. However, as the court pointed out this was a narrow ruling. Not every failure to comply with a loan obligation would constitute waste. The failure also had to impair the mortgage. This was axiomatic with real estate taxes in New York, which primed the mortgage lien. (*See* New York State Real Property Tax Law Section 902.) In the *Travelers* case, the court was presented with a claim that the borrower willfully failed to pay real estate taxes. Indeed, the borrower not only defaulted in paying the real estate taxes when due, as well as, the mortgage debt service that month (resulting in a payment default under the mortgage), it, instead, made a substantial distribution to the principals of borrower.

[219]*See* Blaue, Brit Yehuda, Chapter 37, Section 5 (at page 583).

[220]*See, for example, GCCFC 2006-GG7 Westheimer Mall, LLC v. Okun*, 2008 WL 3891257 (S.D. N.Y. 2008), Memorandum and Order of Judge Buchwald, dated August 20, 2008). In this case, Greenwich Capital, as lender, pursued the guarantor under a good-guy guaranty. The basis of the claim was that the borrower had filed for bankruptcy, after the lender accelerated the mortgage for a payment default and began to foreclose against the mortgaged property. The defendant guarantor caused the borrower to file for bankruptcy in response to the foreclosure, a clear violation of an express provision that triggered full recourse against the guarantor. The court agreed and granted summary judgment. This case was cited in "Enforceability of Carve-outs to Nonrecourse Loans: An Update," by John C. Murray of First American Title (2011), which also summarizes other cases on the issue in various jurisdictions. *See also ING Real Estate Finance (USA) LLC v. Park Ave. Hotel Acquisition LLC,* 26 Misc. 3d 1226(A), 907 N.Y.S.2d 437 (Sup 2010) and *Branch Banking and Trust Co. v. South Fork Resources LLC*, 32 Misc. 3d 1243(A), 938 N.Y.S.2d 225 (Sup 2011).

[221]*See, for example, Wells Fargo Bank, NA v. Cherryland Mall Ltd. Partnership*, 295 Mich. App. 99, 812 N.W.2d 799 (2011) and *51382 Gratiot Ave. Holdings, LLC v. Chesterfield Development Co., LLC*, 835 F. Supp. 2d 384 (E.D. Mich. 2011). *See also* "The Enforcement of Non-Recourse Carveouts in CMBS Loans: A Recent History," by Gary A. Goodman and Sabrina J. Khble in the May/June 2012 issue of *Pratt's Journal of Bankruptcy Law* for an analysis of these cases and the Legislative response in Michigan. *See also* the Headnote to the issue, entitled "Carveouts, Redux," by Steven A. Meyerowitz, in which he notes that the *Cherryland* and *Chesterfield* cases should serve as a wake-up call to negotiate and draft the nonrecourse provisions to reflect the parties' exact intentions and expectations.

[222]The Michigan Nonrecourse Mortgage Act (2012 PA 67, MCL 445.1591 et. seq.), passed by the Michigan Assembly and Senate in March 2012 and signed into law by the Governor of Michigan on March 29, 2012. The Michigan Supreme Court in *Wells Fargo Bank, N.A. v. Cherryland Mall Ltd. Partnership*, 493 Mich. 859, 820 N.W.2d 901 (2012), remanded the Cherryland case to the Michigan Court of Appeals, which upheld the new law and found it to be constitutional. It then dismissed the *Cherryland* case based thereon, in a decision rendered on April 9, 2013, under index No. 304682, *Grand Traverse Circuit Court LC* No. 2010-028149-CH.

[223]Chapter 5816: OHIO LEGACY TRUST ACT, Added by 129th General Assembly-File No.201, HB 479, § 1, eff. 3/27/2013.

[224]*See* Book 32 of Malik's Muwatta.

[225]*See* Shulchan Aruch, Yoreh Deah, Chapter 167, Paragraph 5. *See also* Blaue, Brit Yehuda, Chapter 37, Section 8 (at page 585). However, as noted in the Ginat Veradim (Yoreh Deah, Principle 6, Section 8), covenants that no reasonable businessperson would perform are not permitted. *See also* discussion of Tikun Maharam above that deals with provisions that are impossible of performance.

[226]For a fuller discussion of the subject, *see* article by the author on Interest, Ribit and Riba in *The Banking Law Journal*, noted above.


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