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A Redeeming Interest in Religious Freedom: Are Islamic Mortgage Alternatives Clogs on the Right of Redemption?

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A REDEEMING INTEREST IN RELIGIOUS FREEDOM: ARE ISLAMIC MORTGAGE ALTERNATIVES CLOGS ON THE EQUITABLE RIGHT OF REDEMPTION?

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INTRODUCTION

While the American dream is as varied as the people that comprise this nation, many would agree that one of the pillars of that dream is home ownership. In light of the Qur'an's prohibition against paying interest,[1] homeownership remains nothing more than a dream for many Muslims living in America. This Article explores how a Muslim in America can purchase a home with mortgage alternatives specifically tailored to meet his needs, and how these mortgage alternatives can be executed to avoid becoming a clog on the equitable right of redemption. While these mortgage alternatives are not without critics, courts and regulatory agencies should nevertheless encourage their development because: (1) the Islamic mortgagor's equitable right of redemption is protected, either through contract rights or through the functional equivalent to mortgages; and (2) on balance, these mortgage alternatives help a growing segment of the population realize the American dream.

To fully explore this issue, Part I of this Article begins with a thorough discussion of the equitable right of redemption, why mortgagees cannot clog that right, and how the courts of equity determine if that right should be given to a borrower. Part II explores the reasons why Muslims face difficulties in the housing market and how lending institutions are responding to meet the needs of these particular consumers. Part II also details two proposed types of mortgage alternatives available to Muslims, the regulatory responses to them, and addresses challenges from critics. Part III applies a two-step analysis to determine whether the proposed alternatives are equitable mortgages and, if so, whether they clog the borrower's equity of redemption. Lastly, Part IV highlights appropriate means to ameliorate the dangers these alternatives may pose and the benefits these alternatives offer to Islamic mortgagors.

I. THE EQUITABLE RIGHT OF REDEMPTION

The mortgage, which originated in fourteenth century England,[2] commonly consisted of a borrower ("mortgagor") giving a deed in fee

1. *Qur'an* 2:275; *see also infra* text accompanying notes 58-62.

2. JESSE DUKEMINIER & JAMES E. KRIER, PROPERTY 645 (5th ed. 2002); *see also* C.C. Williams, *Clogging the Equity of Redemption*, 40 W. VA. L.Q. 31, 32 (1933).

simple to a lender ("mortgagee"), with a condition subsequent provision ("defeasance clause") stipulating that if the mortgagor repaid the debt on the given due date ("law day"), the deed would defease and the title would revert back to the mortgagor.[3] Under the mortgage, the mortgagee was entitled to possession of the real property and he could collect any rents and apply them to the debt.[4] Ironically, the reason for the mortgagee's entitlement to rents was the Church's prohibition on paying interest during this period.[5] The harsh reality of the time was that if the mortgagor failed to repay the debt on law day, then the mortgagee would own the real property in fee simple absolute and the defeasance clause would no longer be valid.[6] Since the land was generally worth more than the debt, the mortgagee received a windfall.[7]

In response to the mortgagee's perceived unjust enrichment, mortgagors began to petition the chancery courts to use its equitable powers to permit delinquent mortgagors another opportunity to pay the debt and reclaim their real property.[8] The chancellors responded by finding "that prompt payment was not of sufficient importance to justify the debtor losing the property when the lender could be compensated by an award of money . . ."[9] and, therefore, created the equitable right of redemption to cure this disparate inequity.[10] While initially the chancellors only allowed for redemption to prevent "great injustice[s]," by the seventeenth century the equitable right of redemption was well

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3. *See* DUKEMINIER & KRIER, *supra* note 2, at 645; *see also* RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 3.1 cmt. a (1997); Ann M. Burkhart, *Freeing Mortgages of Merger*, 40 VAND. L. REV. 283, 322-29 (1987).

4. Lou J. Viverito, Comment, *The Shared Appreciation Mortgage: A Clog on the Equity of Redemption?*, 15 J. MARSHALL L. REV. 131, 144 (1982) (citing ROBERT KRAVTOVIL, MODERN MORTGAGE LAW AND PRACTICE 24 (1972)).

5. For the Biblical prohibitions against paying interest, *see Deuteronomy* 23:19-20 (stating, "Thou shalt not lend upon usury to thy brother; . . . Unto a stranger thou mayest lend upon usury; but unto thy brother thou shalt not lend upon usury"); *Exodus* 22:25 (noting, "If you lend money to my people, to the poor among you, you are not to act as a creditor to him; you shall not charge him"); *Leviticus* 25:35 (commanding, "Do not take usurious interest from him, but revere your God, that your countryman may live with you. You shall not give him your silver at interest"); *Luke* 6:35 (admonishing Christians, "Lend freely, hoping nothing thereby").

6. *See* DUKEMINIER & KRIER, *supra* note 2, at 645.

7. *Id*.

8. *Id*.

9. *Id*.

10. *See* Viverito, *supra* note 4, at 145.

established as a matter of course and right.[11] As a result of this new equitable right, the delinquent mortgagor was permitted to sue in equity to redeem his property.[12] Upon payment of the debt with interest, the chancellor would compel the mortgagee to convey the land to the mortgagor.[13]

Naturally, the mortgagee did not react favorably to the birth of these new debtor-protection rights.[14] Under the new protection scheme, the mortgagee remained in danger of losing the real property even after the mortgagor's default.[15] Once again, acting in equity, the chancellors promulgated a second new right: strict foreclosure and, later, the foreclosure sale.[16] Under the right of strict foreclosure, the mortgagee could petition the chancery court to extinguish the mortgagor's equitable right of redemption, thereby assuring the mortgagee that his real property would not be redeemed at some later date.[17] Once the chancellor granted the strict foreclosure, the mortgagor was ordered to pay the debt within a specific time frame or suffer the loss of the property forever.[18] As new equitable rights evolved, the chancellors created the judicial foreclosure sale whereby the court held a public sale to dispose of the real property.[19] Under the terms of the judicial foreclosure sale, the court paid the mortgagee from the sale proceeds to extinguish the outstanding mortgage debt and then remitted any excess to the mortgagor.[20] If the foreclosure property failed to sell for an adequate amount to extinguish the mortgage debt, the mortgagee could sue the mortgagor for the deficiency.[21]

While strict foreclosure and the foreclosure sale brought some finality to the mortgagee, it was a costly endeavor.[22] In order to circumvent the equity courts and to take advantage of their superior

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11. *See* DUKEMINIER & KRIER, *supra* note 2, at 645.
12. *Id*.
13. *Id*.
14. *Id*.
15. *Id*.
16. *See id*.
17. *Id*.
18. *Id*.
19. *Id*.
20. *See* RESTATEMENT¸ *supra* note 3.
21. *Id*.
22. *See* DUKEMINIER & KRIER, *supra* note 2, at 646 (explaining that, with the institution of new equitable rights, comes increasing costs of foreclosure for the mortgagee).

bargaining position, mortgagees began inserting waiver clauses whereby the mortgagor agreed to forego his redemption rights.[23] The chancery courts refused to enforce these clauses, however, holding that the equitable right of redemption could not be waived.[24] The first use of "clog" to describe the mortgagees' actions is found in *Bacon v. Bacon* from 1639, "where the mortgagee will suddenly bestow unnecessary costs upon the mortgaged lands, of purposes to clogg [sic] the lands, to prevent the mortgagor's redemption . . . ."[25] Thus, over time, the clogging principle established itself in the common law, ultimately migrating to the American colonies where it enjoys the same protections.[26]

The most recent version of the Restatement of Property describes the equity of redemption as "[f]rom the time the full obligation secured by a mortgage becomes due and payable until the mortgage is foreclosed, a mortgagor has the right to redeem the mortgaged real estate from the encumbrance of the mortgage by tendering payment or performance of the obligation to the mortgagee."[27] Likewise, it incorporates the prohibition against clogging in the next subsection by stating that "[a]ny agreement in or created contemporaneously with a mortgage that impairs the mortgagor's right described [in the Restatement] is ineffective."[28]

The U.S. Supreme Court highlighted similar language in the late nineteenth century: "This right [of redemption] cannot be waived or abandoned by any stipulation of the parties made at the time, even if embodied in the mortgage. This is a doctrine from which a court of equity never deviates."[29] While the Court clearly recognized the importance of the equity of redemption, it lacked subject matter jurisdiction over state mortgage law and only heard this controversy because it had appellate jurisdiction in the District of Columbia at that time.[30]

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23. *See* Viverito, *supra* note 4, at 145.
24. *Id*. at 147.
25. *Id*. at 146 (citing Bacon v. Bacon, 21 Eng. Rep. 146 (1639)).
26. *See* RESTATEMENT, *supra* note 3.
27. *Id*.
28. *See* RESTATEMENT, *supra* note 3, § 3.1(b).
29. Peugh v. Davis, 96 U.S. 332, 337 (1877).
30. *See generally* United States v. Belt, 319 U.S. 521 (1943) (discussing the jurisdiction of the U.S. Supreme Court over the District of Columbia).

For each new method mortgagees devise to emasculate the equity of redemption, the courts of equity attempt to keep pace. In analyzing whether a real estate financing arrangement is a clog on the equity of redemption, the majority of the courts of equity hold to the centuries-old maxim "once a mortgage, always a mortgage."[31] The courts generally follow a two-step analysis under this premise.[32] First, the courts of equity ask if the arrangement creates an equitable mortgage. If the chancellor determines that one exists, she examines whether the arrangement clogs the mortgagor's right to redeem the property before a valid foreclosure.[33] In answering the threshold question, the chancellors are not bound by how the parties label the transaction because "[e]quity's vision is not circumscribed by formal instruments, but extends through matters of form to the heart of the transaction."[34] They rely on multiple factors to determine whether an equitable mortgage exists; however, the principle element is whether the agreement creates an underlying debt.[35]

Generally, the existence of an underlying debt is sufficient for equitable courts to find that an equitable mortgage exists. If it is unclear whether debt exists, courts consider less prominent factors, including: (1) the relationship of the parties; (2) whether legal assistance was available; (3) the sophistication and circumstances of each party; (4) the adequacy of the consideration; (5) whether the borrower retained possession of the property; (6) the statements of the parties; and (7) whether the borrower acted as an owner (i.e., whether he paid property taxes, made improvements, etc.).[36] This is not an exhaustive list, but it

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31. Humble Oil & Ref. Co. v. Doerr, 303 A.2d 898, 905 (N.J. Super. Ct. Ch. Div. 1973); *accord* Cousins v. Crawford, 63 So. 2d 670 (Ala. 1953); Bergerding Inv. Co. v. Larson, 170 N.W.2d 322, 326 (Minn. 1969); Rice v. Wood, 346 S.E.2d 205, 211 (N.C. Ct. App. 1986); Conley v. Henderson, 75 P.2d 746, 750 (Or. 1938); Odenbaugh v. Bradford, 67 Pa. 96, 96 (Pa. 1870); Holmes v. Basham, 45 S.E.2d 252, 256 (W. Va. 1947).

32. *See generally Humble Oil*, 303 A.2d at 905 (establishing a general trend of applying a two-step analysis).

33. *See id*.

34. *See Bergerding Inv. Co.*, 170 N.W.2d at 326.

35. Grant v. Pattison, 371 P.2d 870, 873 (Mont. 1962) (citing 1 JONES ON MORTGAGES § 316, p. 386-87 (5th ed. 1894) (explaining "the existence of the debt is the test"); *see also* Flack v. McClure, 565 N.E.2d 131, 136 (Ill. App. Ct. 1990) (noting the existence of a debt as the "essential element" in determining whether an equitable mortgage exists).

36. *See Flack*, 565 N.E.2d at 136 (listing six factors that trial courts should

encompasses the majority of factors applied by courts of equity. Once a court determines that a financing arrangement is an equitable mortgage under these factors, it should ask whether the arrangement is a clog on the equity of redemption.[37]

Over the centuries, ingenious mortgagees sought means to minimize the protections of the equity of redemption. Once the equity courts struck down the mortgagee's waiver attempts, the mortgagees turned to clauses that restricted the length of time a mortgagor had to redeem.[38] The courts of equity acted decisively to invalidate these restrictions.[39] Subsequently, the mortgagees attempted to use options, which the mortgagee could exercise to take title to the real property if the mortgagor defaulted.[40] These actions were ruled as clogs for two reasons: (1) the option allowed for the mortgagee to acquire title without having to maintain a foreclosure action; and (2) the policy considerations against permitting the use of options in this manner are so strong, they are absolutely void and unenforceable, regardless of whether actual oppression exists in the specific case.[41] Similarly, chancellors prohibited practices in which the mortgagor gave an

consider to determine whether an equitable mortgage exists); *see also* RESTATEMENT, *supra* note 3, § 3.3(b)(1)-(7) (listing seven factors used to determine whether a contract for deed is an equitable mortgage).

37. *See Humble Oil*, 303 A.2d at 905.

38. *See* Viverito, *supra* note 4, at 147 (citing generally the following cases where time restrictions on mortgage redemption after default were held invalid: Frazer v. Couthy Land Co., 149 A. 428 (Del. Ch. 1929) (three years); Bradley v. Davenport, 46 P. 1062 (Cal. 1896) (four months); Stover v. Bounds, 1 Ohio St. 107 (Ohio 1853) (before a fixed date); and Floyer v. Lavington, 24 Eng. Rep. 384 (1714) (for the life of mortgagor)).

39. *See Frazer*, 149 A. at 429 (invalidating the three-year time restriction for redemption because "it appears to be settled that a right to redeem continues at all times until it is foreclosed"); *Bradley*, 46 P. at 1065 (invalidating time limit by looking to the circumstances surrounding the transaction); *see also Stover*, 1 Ohio St. at 110 (holding that an assignee of the mortgage held an equitable claim to title of the land).

40. *See* Viverito, *supra* note 4, at 147; *see also* RESTATEMENT, *supra* note 3, at cmt. b, illus. (providing several examples of clog and non-clog language).

41. *Humble Oil*, 303 A.2d at 906 (citing numerous sources concerning the history, rationale and public policy behind options as clogs on the equity of redemption); *see also* Samuel v. Jarrah Timber & Wood Paving Corp., [1904] A.C. 323 (H.L.) (affirming that an option, even if fair and taken at an arms-length transaction, was invalid as an impermissible clog); RESTATEMENT, *supra* note 3, § 3.1 cmt. d (noting that an overly dogmatic approach to options should be avoided where the option is being used to clog the mortgagor's equitable right of redemption).

absolute deed to the mortgagee with the tacit understanding that the mortgagee would only record the deed should the mortgagor default, holding such practice to be an impermissible clog on the equity of redemption.[42]

> [The] maintenance [of the doctrine] is deemed essential to the protection of the debtor, who, under pressing necessities, will submit to ruinous conditions waiving the equity of redemption allowed him or her on breach of his or her obligation, in the expectation and hope of repaying the loan at the stipulated time and thus preventing forfeiture.[43]

Two notable devices are critical to identifying clogs on the equity of redemption. First, the installment land contract is a lending device that makes time of the essence and the borrower's ("vendee") acquisition of title conditional upon full satisfaction of the debt.[44] In some jurisdictions, these distinctions have been deemed sufficient to remove these instruments from the mortgage protections and place them within the scope of contract law.[45] The installment land contract's forfeiture clause grants the vendor the power to cancel the contract, retake possession of the real property, and claim the vendee's payments as liquidated damages.[46] While the installment land contract may initially appear to be clog on the equity of redemption, it serves a valuable purpose within the housing market. Furthermore, many states' equitable courts have held that the installment land contract, because it is governed by contract law and not mortgage law, is not a clog.[47] This method of financing is exceedingly popular with low-income mortgagors who may not otherwise satisfy the traditional mortgage's

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42. *See, e.g.*, Smith v. Headlee, 183 P. 20 (Or. 1919); *see also* RESTATEMENT, *supra* note 3.

43. *Smith*, 183 P. 20 at 22.

44. GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE TRANSFER, FINANCE, & DEVELOPMENT 284 (2003); *see also* Frank R. Lacy, *Land Sale Contracts in Bankruptcy*, 21 U.C.L.A. L. REV. 477 (1973) (stating that "resort to the installment contract device is usually attributed to the unavailability of mortgage financing for very low down payment sales and to the supposed ease of terminating the purchaser's interest in the property in the event of default").

45. *See* RESTATEMENT, *supra* note 3, § 3.4 cmt. a; *see also* Roger A. Cunningham & Saul Tischler, *Disguised Real Estate Security Transactions As Mortgages in Substance*, 26 RUTGERS L. REV. 1, 7 (1972-73).

46. *See* RESTATEMENT, *supra* note 3, § 3.4 cmt. a.

47. *See* Cunningham & Tischler, *supra* note 45, at 7.

credit and down payment requirements.[48] Lenders prefer this method in states where judicial foreclosure sales are the only means of terminating a mortgagor's equity of redemption.[49] However, a growing number of jurisdictions and the Restatement view this arrangement as analogous to an equitable mortgage, with all of its protections.[50]

The deed in lieu of foreclosure is the second notable lending transaction not considered a clog on the equity of redemption[51] because it is given subsequent to the closing of the mortgage.[52] A deed in lieu of foreclosure terminates the mortgagor-mortgagee relationship after the mortgagor defaults, but before the equity of redemption is foreclosed.[53] The mortgagor conveys a deed to the mortgagee in return for the mortgagee's release of the mortgagor from the debt.[54] As a result, the defaulting mortgagor preserves his creditworthiness and avoids defense costs in foreclosure and deficiency proceedings.[55] Mortgagees seek deeds in lieu of foreclosure to avoid the expense of initiating the foreclosure proceedings.[56] Courts closely scrutinize any subsequent conveyance, however, to ensure that the transaction is adequately supported by consideration and is free from fraud and oppression.[57]

The equity of redemption has endured as one of the major pillars of mortgage law for over seven centuries. While mortgagees have striven to nullify its protections, the courts of equity have guarded this right faithfully. The doctrine reflects the equitable courts' understanding of the disparity in the parties' bargaining positions and attempts to inject a basic level of fairness into the stream of housing commerce.

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48. *Id.*

49. *See* RESTATEMENT, *supra* note 3, § 3.4 cmt. a.

50. *See id.* § 3.4 cmt. b ("Some view this right as an unconditional and the equivalent of the mortgagor's equity of redemption, while others condition the right on the purchaser's prior payments having been sufficient to create a substantial equity in the property," with the purchaser's ability to redeem dependent upon whether the payments already made exceed the fair rental value of the real estate. Those guilty of gross negligence or bad faith may be barred from redemption).

51. *See generally* DUKEMENIER & KRIER, *supra* note 2.

52. *See* RESTATEMENT, *supra* note 3, at cmt. f; *see also* John C. Murray, *Clogging Revisited*, 33 REAL PROP. PROB. & TR. J. 279, 287-89 (1998-1999).

53. *See* Murray, *supra* note 52.

54. *Id.*

55. *Id.*

56. *Id.* at 287.

57. *Id.* at 288.

II. ISLAM AND INTEREST

Home ownership remains elusive for many Muslims because Islam forbids its followers from either paying or receiving interest. This prohibition arose during the early years of the Prophet Mohammed's teaching when usurious loans were rampant and the failure to repay a debt often resulted in slavery.[58] "By outlawing interest, Islam advocated an economy based on risk-sharing, fair dealing, and equity – in both the financial and social – justice senses of the word."[59] The Qur'an clearly and simply warns its followers that "God has forbidden *riba*."[60] While the Qur'an does not expressly define *riba*, the Sunna, which is the second most influential religious authority,[61] states that "[e]very loan that attracts a benefit is *riba*."[62] Therefore, devout Muslims are unable to obtain traditional interest-bearing loans to purchase homes and must instead rely upon savings or non-interest loans from friends and relatives.

Considering that the average price of homes in 2006 was approximately $169,000,[63] the non-financing home buyer must sacrifice years of equity-building in order to save a sufficient amount to purchase property outright. Furthermore, the non-home owner loses not only tax benefits,[64] but also familial and societal advantages.[65] The Homeownership Alliance asserts essentially four primary social benefits to homeownership: (1) advantages to children, including higher

58. Jerry Useem, *Banking on Allah: Devout Muslims Don't Pay or Receive Interest. So How Can Their Financial System Work?*, FORTUNE, June 10, 2002, at 145.

59. *Id*.

60. *Qur'an* 2:275.

61. Michael Knoll, *The Ancient Roots of Modern Financial Innovation: The Early History of Regulatory Arbitrage* 13 (U. Pa. Law Sch., Scholarship at Penn Law, Paper No. 49, 2004), *available at* http://lsr.nellco.org/upenn/wps/papers/49.

62. *Id.* (referring to the passage of the Sunna that most clearly states the definition of *riba*).

63. U.S. CENSUS BUREAU, HOUSING AND HOUSEHOLD ECON. STATISTICS DIV., CURRENT POPULATION SURVEY/HOUSING VACANCY SURVEY, TBL. 11A (2008), *available at* http://www.census.gov/hhes/www/housing/hvs/historic/histt11.html.

64. I.R.C. § 163(a) (2006) (allowing home owners to deduct interest from their adjusted gross income).

65. ROBERT D. DIETZ, HOMEOWNERSHIP ALLIANCE, THE SOCIAL CONSEQUENCES OF HOMEOWNERSHIP 3 (2003), *available at* http://www.newtowncdc.org/pdf/social_consequences_study.pdf.

academic performance and lower instances of behavioral problems; (2) higher civic participation; (3) greater overall health and happiness; and (4) enhanced property values.[66] Muslims who cannot raise sufficient resources to purchase a home outright are forced to choose between rejecting piety or sacrificing the benefits of home ownership. Therefore, many Muslims are losing out on a critical aspect of the American dream.

In response to the religious barriers to home ownership for Muslims, lending institutions have begun seeking ways to meet the needs of this expanding community.[67] There are many variations of alternative lending methods; this Article analyzes two proposals submitted to the Office of the Comptroller of the Currency ("OCC"), representing the basic arrangements available.[68]

A. The United Bank of Kuwait's Net Lease Proposal

The United Bank of Kuwait ("UBK") brought the first proposal for Islamic-centered mortgage alternatives to the OCC in 1997.[69] UBK wished "to offer Net Leases to meet the special needs of its customers who adhere to the principles of Islam."[70] Under the UBK Net Lease program, the lessee will select a home and agree to a purchase price with the seller.[71] Next, the lessee will enter into a Net Lease Agreement and a Purchase Agreement (collectively "the Agreements") where the lender will agree to purchase the home and serve as landlord, and the lessee will make a monthly payment which will comprise principal, rent, taxes,

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66. *See id*. at 13.

67. While this article will focus on the United Bank of Kuwait's Net Lease Proposal in Interpretive Letter No. 806 and the *murabaha* proposed in Interpretive Letter No. 867, these are not the only lenders providing alternative mortgages to Muslims. For a discussion of alternate lending methods, *see* Bill Maurer, *Articulating Islamic Knowledge to an American Dream: Islamic Home Financing Alternatives After September 11, 2001*, 26 POL. & LEGAL ANTHROPOL. REV. 196 (2003).

68. Off. of the Comptroller of the Currency, About the OCC, http://www.occ.gov/aboutocc.htm (last visited Jan. 28, 2008). The OCC charters, regulates, and supervises all national banks and all federal branches of foreign banking institutions. *Id*.

69. Interpretive Letter No. 806, [1997-1998 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,253 (Off. of the Comptroller of the Currency Oct. 17, 1997) [hereinafter Interpretive Letter No. 806], *available at* http://www.occ.treas.gov/interp/dec97/int80 6.pdf (pagination, *infra*, consistent with URL source).

70. *Id*. at 1.

71. *Id*.

and insurance components.[72] UBK will add its cost of funds, as determined by the London Interbank Offering Rate ("LIBOR"), at the start of the lease.[73] While UBK will retain legal title, the lessee shall have the right of possession to the home for a specified number of years.[74] The lessee will be responsible for maintaining the property and paying the expenses normally associated with purchaser's responsibilities.[75] Under the payment terms, the principal amount will amortize over the term of the lease.[76] Once the principal sum is fully amortized, UBK will transfer title to the home to the lessee automatically.[77]

The Agreements also permit the lessee to prepay the principal and acquire title to the property early.[78] In the event that the lessee materially defaults under the Agreements, UBK will have remedies similar to those under a traditional mortgage.[79] UBK will provide notice to the lessee of default and allow a period to cure the default;[80] however, if the lessee fails to cure within that time frame, UBK will terminate the lease and treat the property as if it had been acquired in foreclosure.[81]

In advocating its proposal, UBK argued that the transaction would be functionally equivalent in economic substance to a secured real property transaction.[82] To support its argument that the transaction would be functionally equivalent to traditional real estate financing, UBK intended to carry the loans on its financial records as financing, rather than leasing, in accordance with Generally Accepted Accounting Principles ("GAAP").[83] Furthermore, UBK anticipated that the Internal

72. *Id*.
73. *Id*. at 2.
74. *Id*.
75. *Id*.
76. *Id*.
77. *Id*. The Interpretive Letter is silent as to how UBK will transfer title or when it would deliver the deed to the lessee. *See id*.
78. *Id*.
79. *Id*.
80. *Id*.
81. *Id*.
82. *See id*.
83. *Id*. at 1-2; *see also* INCEPTION OF THE LEASE, Statement of Fin. Accounting Standards No. 23 (Fin. Accounting Standards Bd. 1978), http://www.fasb.org/pdf/fas23.pdf (discussing the generally accepted accounting principles for leases); ACCOUNTING FOR LEASES, Statement of Fin. Accounting Standards No. 98 (Fin. Accounting Standards Bd. 1988), http://www.fasb.org/pdf/fas98.pdf.

Revenue Service would treat the transaction as a financing agreement, allowing the lessee to deduct the imputed interest portion of the lease payment on their tax filings.[84] Essentially, for accounting and tax purposes UBK would treat the transaction as a traditional interest-bearing loan, but the Islamic lessee would regard the transaction as a non-interest-bearing lease-to-own agreement, while also receiving the advantages of home ownership.[85]

In analyzing whether UBK's proposal was appropriate under the current regulatory scheme, the OCC turned to the National Banking Act ("Bank Act"),[86] which authorizes the OCC to regulate domestic branches of foreign banks and enumerates the following powers of national banks:

> [t]o exercise . . . all such incidental powers as shall be necessary to carry on the *business of banking*; by discounting and negotiating promissory notes, . . . and other evidence of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes . . . (emphasis added).[87]

In *NationsBank of North Carolina, N.A. v. Variable Life Annuity Insurance Co.*, the U.S. Supreme Court broadly interpreted the "business of banking" to extend beyond these powers[88] and added that the OCC has discretion to "authorize activities beyond those specifically enumerated."[89] In determining whether a proposed activity is within the "business of banking," the OCC relies upon three general principles: (1) whether the proposal is "functionally equivalent" or logically follows an approved activity;[90] (2) whether the proposal is responsive and/or

84. *See* Interpretive Letter No. 806, *supra* note 69, at 3; *see also* I.R.C. § 7701(l) (2006) (authorizing the Secretary of the Treasury to "prescribe regulations re-characterizing any multiple-party financing transaction as a transaction directly among any two or more of such parties where the Secretary determines that such re-characterization is appropriate to prevent avoidance of any tax imposed by this title"); I.R.C §§ 1271-1276 (2006) (discussing imputed interest for debt instruments).

85. *See generally* Interpretive Letter No. 806, *supra* note 69.

86. National Banking Act, 12 U.S.C. §§ 24 (Seventh), 371 (2006).

87. *See* Interpretive Letter No. 806, *supra* note 69, at 3 (quoting the Bank Act).

88. NationsBank of N.C., N.A. v. Variable Life Annuity Ins. Co., 513 U.S. 251, 258 (1995).

89. *Id*. at 258, n. 2.

90. Interpretive Letter No. 806, *supra* note 69, at 4; *see, e.g.*, Merchants' Bank v. State Bank, 77 U.S. 604 (1871); Am. Ins. Ass'n v. Clarke, 865 F.2d 278 (2d Cir. 1988);

beneficial to the bank's customers;[91] and (3) whether the bank is assuming new risks.[92]

In adhering to these statutory and judicial mandates, the OCC concluded that the proposal fell within the ambit of the Bank Act because it was "functionally equivalent to or a logical outgrowth of secured lending."[93] After examining the actual accounting, regulatory, and tax effects of the proposed transaction the OCC opined that:

> UBK's Net Lease proposal responds to the special issues regarding Islamic customers by providing an alternative method for a discrete group to get access to credit without forcing them to choose between their religion and home ownership. It allows followers of Islam to purchase homes without violating Islamic proscriptions on borrowing money on which interest is charged. Furthermore, UBK's Net Lease proposal is consistent with the well-established public policy of encouraging home ownership.[94]

In approving UBK's proposal, the OCC opened the door for Islamic mortgagors to remain true to their religious tenets while simultaneously enjoying the benefits of homeownership.

B. UBK's Net Lease Proposal Is a Clog of the Mortgagor's Equity of Redemption

Two years later, the OCC reaffirmed its commitment to lending flexibility when it approved a second lending institution's proposal to offer *murabaha* financing products.[95] *Murabaha* is akin to a cost-plus-profit financing arrangement where the lender essentially functions as a "riskless principal," or quasi-agent.[96] Here, the lender purchases the home on behalf of the borrower and then resells the home to the

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M & M Leasing Corp. v. Seattle First Nat'l Bank, 563 F.2d 1377 (9th Cir. 1977).

91. *See* Interpretive Letter No. 806, *supra* note 69, at 9.

92. *Id.*; *see, e.g.*, Merchants' Nat'l Bank, 77 U.S. 604 (1871); Am. Ins. Ass'n, 865 F.2d 278 (2nd Cir. 1988); M & M Leasing Corp., 563 F.2d 1377 (9th Cir. 1977).

93. *See* Interpretive Letter No. 806, *supra* note 69, at 4.

94. *Id.* at 9.

95. Interpretive Letter No. 867, [1999-2000 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,361 (Off. of the Comptroller of the Currency June 1, 1999) [hereinafter Interpretive Letter No. 867], *available at* http://www.occ.treas.gov/interp/nov99/int86 7.pdf (pagination, *infra*, consistent with URL source) (agreeing that *murabaha* financing transactions are permissible).

96. *Id*. at 1.

borrower at an agreed upon profit. Under the terms of the agreement, the borrower remits a down payment to the lender, which is not to exceed 25%, and finances the difference.[97] Using a recognized market index, such as LIBOR, the lender determines the profit by calculating the present value of the interest payments, like a traditional interest-bearing mortgage, and adds that amount to the debt.[98] The borrower makes equal installment payments based on the cost-plus-profit amount until the debt is fully amortized.[99]

Once the closing has occurred the lender records the title with a senior mortgage (or deed of trust) on the property.[100] In the event the borrower defaults under the *murabaha* contract, the lender may foreclose on the real property as it would under a traditional real estate transaction.[101] In addition to the foreclosure, the lender may seek a judgment for any deficiency between the balance due and the contract amount.[102]

The OCC determined that the *murabaha* proposal was functionally equivalent to conventional financing transactions and approved the proposal, as it had the Net Lease proposal.[103] Based largely on its earlier decision in favor of UBK,[104] the OCC found that the *murabaha* transaction would be treated as a secured lending transaction for accounting, regulatory, and tax purposes and was within the scope of the approved policies of the Bank Act.[105]

C. *Criticisms of the Islamic Mortgage Alternatives*

Even though the OCC, banks, and a growing number of consumers embrace the Net Lease and *murabaha*, these mortgage alternatives are not without their critics. Some argue that "the 'Islamic Bank' is a

97. *Id.* at 4.
98. *Id*. at 2-3.
99. *Id*. at 5.
100. *Id*. at 4.
101. *Id*. at 5.
102. *Id*. at 5. The OCC's Interpretive Letter does not discuss the applicability of any anti-deficiency statutes. The OCC may have assumed that the jurisdiction of the lender either did not have such a statute or that the statute would be inapplicable in this instance.
103. Interpretive Letter No. 806, *supra* note 69.
104. *See* Interpretive Letter No. 867, *supra* note 95, at 6 (referencing precedent decision in Interpretive Letter 806, *supra* note 69).
105. *Id.*

Trojan horse which has been infiltrated into *Dar al-Islam*[106]. . . . [It] is a totally crypto-usurious institution and like all other usurious institutions must be rejected and fought."[107] On their faces, the Net Lease and *murabaha* appear to be interest-free financing products; however, some strict interpreters argue that "the 'fees,' 'mark-ups,' and 'profit-sharing' of Islamic transactions are a thinly veiled subterfuge for interest."[108]

The assertions that these mortgage alternatives are merely "thinly veiled" interest transactions are concededly valid, and supported by traditional notions and understandings of economic thought. Interest is essentially the cost applied for borrowing money.[109] The Net Lease veils its interest charge in the term "rent,"[110] whereas the *murabaha* similarly disguises its interest in the profit tacked on to the principal amount at the start of the relationship.[111] Without these two components of the payment, however, the lenders would fail to realize a profit on the transaction and would be unwilling to lend money. While the arguments for and against Islamic mortgage alternatives are cogent, whether an interpretation is correct is a question of one's faith and is beyond the scope of this inquiry.

III. RECONCILING ISLAMIC MORTGAGE ALTERNATIVES WITH THE EQUITABLE RIGHT OF REDEMPTION

While the OCC's imprimatur went a long way in helping Muslims obtain flexible financing methods, neither it nor the proposing banks addressed what effect these proposals would have on the equity of redemption. One fundamental objective of the equity of redemption is to protect the mortgagor from the superior bargaining power of the mortgagee.[112] This basic concern is even more apposite when

106. MARSHALL G.S. HODGSON, THE VENTURE OF ISLAM, CONSCIENCE AND HISTORY IN A WORLD CIVILIZATION I: THE CLASSICAL AGE OF ISLAM 513 (1974). "*Dar al-Islam*: lands under Muslim rule . . . converse of *Dar al-Harb*, i.e., lands under non-Muslim rule." *Id.*

107. Umar Ibrahim Vadillo, The Fallacy of the "Islamic Bank," http://www.geocities.com/Athens/Delphi/6588/bfallacy.html (last visited Jan. 30, 2008).

108. Marla Dickerson, *The Price of Piety in Islam*, L.A. TIMES, Mar. 17, 1999, at A1.

109. *See* Economics A-Z: Interest, Economist.com, http://www.economist.com/research/Economics/searchActionTerms.cfm?query=interest (last visited Jan. 30, 2008).

110. *See* Interpretive Letter No. 806, *supra* note 69, at 8.

111. *See* Interpretive Letter No. 867, *supra* note 95, at 1.

112. Viverito, *supra* note 4, at 146-47.

mortgagees replace traditional mortgages—and their strong common law protections—with novel alternatives marketed toward a specific class of borrowers.

A. The Net Lease and Murabaha Are Equitable Mortgages

To determine whether these proposals satisfy this basic concern, this Article analyzes the Net Lease and the *murabaha* using the same factors that courts of equity apply in deciding whether a particular financing arrangement is an equitable mortgage.[113] Based on the information provided within the OCC's interpretative letters, the Net Lease and the *murabaha* proposal should be treated as equitable mortgages because the underlying substance of each transaction is a debt secured with real property.[114] Both agreements create an obligation for the borrower, and if the borrower defaults, the lender can seize the home to recover the loaned amount.[115] Furthermore, the lender records the transaction in conformity with GAAP, as a traditional mortgagee would, and reports the earnings as interest income for tax purposes,[116] giving credence to the contention that these transactions are mortgages. Moreover, UBK and the proposing lender in Interpretative Letter No. 867 argued that the borrowers will be able to deduct some portion of their payments as interest, as traditional mortgagors are entitled to do.[117] Thus, both the Net Lease and the *murabaha* create a mortgagor-mortgagee relationship in which an underlying debt exists.

In both the Net Lease and *murabaha*, the borrower retains possession, unless and until he defaults and the mortgagee forecloses.[118] Under both proposals, the borrower acts as a traditional mortgagor, with responsibility for the utilities, homeowner's insurance, property taxes, repairs and renovations.[119] Furthermore, the borrower may improve the

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113. *See supra* Part I.
114. *See supra* Part II.A-B.
115. *See* Interpretive Letter No. 806, *supra* note 69, at 2; Interpretive Letter No. 867, *supra* note 95, at 5.
116. *See* Interpretive Letter No. 806, *supra* note 69, at 9; Interpretive Letter No. 867, *supra* note 95, at 6.
117. *See* Interpretive Letter No. 867, *supra* note 95, at 6.
118. *Cf.* Interpretive Letter No. 806, *supra* note 95, at 2; Interpretive Letter No. 867, *supra* note 95, at 5.
119. *Cf.* Interpretive Letter No. 806, *supra* note 69, at 2; Interpretive Letter No. 867, *supra* note 95, at 4.

property, repay the debt early, and sell the property.[120] The proposing lenders, like traditional lenders, cannot regain possession of the property until the borrower's interest has been foreclosed, either by the expiration of the redemption period in the Net Lease or by way of judicial foreclosure in the *murabaha*. Lastly, the most telling similarity between the Net Lease and *murabaha* borrowers and traditional mortgagors is that the Net Lease and *murabaha* borrowers pay a premium for the use of another's capital, just like traditional interest-paying mortgagors.

The installment land contract, which the Restatement considers to be a mortgage,[121] can be analogized to the Net Lease. Under the Restatement definition, an installment land contract—also referred to as a contract for deed—entitles a purchaser to possession of the fee, but conditions the vendor's delivery of title on the successful performance of the agreement.[122] UBK's proposal achieves substantially the same outcome as an installment land contract because UBK retains title to the encumbered property until the borrower repays the debt.[123] Furthermore, UBK's proposal allows it to unilaterally determine whether the borrower has defaulted on the note; it may thus regain possession to the property without foreclosing the borrower's equity of redemption. In light of the Restatement, therefore, the Net Lease is a veritable installment land contract.

Although the 'installment land contract' label fits the Net Lease, the chancellors cannot attach the same appellation to the *murabaha*. By contrast, the *murabaha* proposal expressly states that the lender does not retain possession of the title; instead, the lender records the title in the name of the borrower and lists himself as holding a first mortgage.[124] Under the facts presented to the OCC, the vendor does not defer delivery until the successful satisfaction of the underlying debt[125] and, therefore,

120. *See* Interpretive Letter No. 806, *supra* note 69, at 2; Interpretive Letter No. 867, *supra* note 95, at 4.

121. *See* RESTATEMENT, *supra* note 3, § 3.4 (b). This alternative approach assumes the state in which the transaction occurs has adopted the Restatement's treatment of installment land contracts.

122. *See id*.

123. *See supra* Part III.A; Interpretive Letter No. 806, *supra* note 69, at 2.

124. Interpretive Letter No. 867, *supra* note 95, at 4.

125. *Cf. id*. Note, the Interpretive Letter does not expressly say the delivery would not be delayed until full satisfaction of the debt. The closest inference is that the proposal largely resembles a conventional mortgage. *See id.*

the equity courts should not designate *murabaha* as installment land contracts.

Clearly, any examination of the Net Lease or *murabaha* shows that these arrangements are tantamount to mortgages. Accordingly, these borrowers ought to be entitled to the same protections as traditional mortgagors, including the equitable right of redemption. The court of equity's next step is to determine whether either of the proposed financing arrangements are clogs on the equity of redemption. [126]

B. UBK's Net Lease Proposal May Clog the Mortgagor's Equity of Redemption

UBK's Net Lease is an impermissible clog on the equity of redemption in non-strict foreclosure states. Under the Net Lease Agreement, the lessee has a specific time frame to cure the default and, in the event the default is not cured, UBK may unilaterally treat the home as if acquired in foreclosure.[127] This situation is analogous to Illustration 2 of Section 3.1 of the Restatement (Third) of Property: "Mortgagor agrees that her right to redeem under this mortgage shall terminate four months after mortgagee declares a default under this mortgage."[128] In the UBK Net Lease, the lessee loses his right to redeem after a stated period of time without the benefit of a foreclosure.[129] Therefore, the Net Lease is an impermissible clog on the borrower's equity of redemption.

Interestingly, there is a variation of UBK's Net Lease circulating in the market called an *ijara wa-iqtina.* The *ijara wa-iqtina* is similar in all discernible respects to the Net Lease except that the borrower has an option to purchase the home at the end of the lease term.[130] At first glance the existence of the option does not exacerbate the clog problem, because it is the mortgagor—and not the mortgagee—who has the option to purchase the land. Moreover, if the roles were reversed, the transaction would clearly be an example of a clog, since the mortgagor

126. The following arguments assume that the assumption that the Net Lease and *murabaha* should be treated as equitable mortgages.

127. *See* Interpretive Letter No. 806, *supra* note 69, at 2.

128. *See* RESTATEMENT, *supra* note 3, at cmt. b, illus. 2.

129. *See* Interpretive Letter No. 806, *supra* note 69, at 2.

130. *See* Knoll, *supra* note 61, at 16 (citing Tarek Zaher & Kabir Hassan, *A Comparative Literature Survey of Islamic Finance*, *in* 5 FINANCIAL MARKETS, INSTITUTIONS & INSTRUMENTS 155, 160 (2001)).

would convey the option contemporaneously with the mortgage.[131] This Net Lease-variant is not necessarily acceptable because the *ijara wa-iqtina* turns the option on its head, however. In order to be valid, an option must have independent consideration;[132] here, the mortgagee is essentially charging a fee for the mortgagor to have the right to redeem his property at the end of the lease period. With the exception of the mortgagor's option, the *ijara wa-iqtina* is the same as the Net Lease and should be treated accordingly as an equitable mortgage. Since the equity of redemption is a fundamental right of the mortgagor and zealously guarded by the equitable courts,[133] the mortgagor should not be required to pay an additional sum for that right. By requiring an additional step of exercising the option for the mortgagor to redeem the property, the mortgagee has created an impermissible clog on the equity of redemption. Accordingly, the equity courts should invalidate the option.

C. The Murabaha is Not a Clog on the Equity of Redemption

In contrast with the Net Lease, the *murabaha* is not a clog on the equity of redemption because the lender is not entitled to take possession of the home until the equity court has foreclosed the borrower's right to redeem. The *murabaha* borrower enjoys the same property rights and responsibilities as traditional mortgagors.[134] Unlike in Net Lease transactions, the *murabaha* lender does not retain legal title to the land, but rather records the title in the land records in the name of the borrower, while listing itself as holding a first mortgage.[135] If the borrower defaults under the *murabaha*, the lender cannot reenter the property until it provides notice of default and then forecloses the equity of redemption period, either through a trustee's or sheriff's sale.[136]

The most significant difference between the *murabaha* and Net Lease lender is that the *murabaha* lender cannot act unilaterally in determining when it may regain possession of the mortgaged property. Thus, in all material respects the *murabaha* confers the same bundle of property rights as traditional mortgages and is functionally and legally equivalent to an equitable mortgage. As such, the mortgage alternative

131. *See* RESTATEMENT, *supra* note 3, § 3.1(b).
132. *See* RESTATEMENT (SECOND) OF CONTRACTS § 87 (1981).
133. *See supra* Part III.A.
134. *See supra* Part III.A; Interpretive Letter No. 867, *supra* note 95, at 4-5.
135. *See* Interpretive Letter No. 867, *supra* note 95, at 4-5.
136. *See id.* at 5.

proposed in Interpretive Letter No. 867 adequately protects the mortgagor's equitable right to redeem the property.

IV. AMELIORATING THE OBSTACLES PRESENTED BY THE NET LEASE AND *MURABAHA*

The potential danger of relinquishing common law rights is not limited to the specific instances of UBK's Net Lease or Islamic borrowers, but rather extends to all borrowers who might be attracted to "religious friendly" mortgage alternatives. A nefarious lender could peddle fallacious arrangements to low-income, unsophisticated, and divinely obedient borrowers—whether Muslim or not—in the hope that they would be unaware of the protections bestowed on them by the common law. There should be greater concern that, under the pretense of religious flexibility, inimical lenders could seek to manipulate pious borrowers out of their equity of redemption or disguise higher interest rates as "rent" or "mark up profit."

A. Saving the Net Lease Proposal Through Contract Rights

The fact that the Net Lease might serve as a clog on the equity of redemption should not be fatal to its enforceability. The Net Lease can be saved by reforming the default provision to state explicitly that the lessee has the right to redeem the property at any time before a judicial foreclosure. While it could be costly and inconvenient for UBK and other lenders to seek a judicial foreclosure, that path may ultimately prove less costly than litigating claims asserting a clog on the lessee's equitable right of redemption. Given the close judicial scrutiny of arrangements claiming to not be mortgages, the assertion that the Net Lease is not a mortgage might fall on deaf ears.

B. Adding Clarity and Finality to the Murabaha

While the *murabaha* is not a clog, it is not without its shortcomings. The OCC proposal is unclear as to what amount a mortgagor will have to pay to redeem his property from default.[137] Since the interest is tacked on to the principal amount at the start of the loan,[138] will the

137. *Cf.* Interpretive Letter No. 867, *supra* note 95, at 2-4.

138. *Cf.* Interpretive Letter No. 867, *supra* note 95, at 3 (stating that the *murabaha* profit is typically based on a recognized interest rate index, e.g., LIBOR).

murabaha mortgagor have to pay the entire remaining principal amount in the event of a default? If this is the case, he will be paying more than a traditional mortgagor who is only required to pay the amount of principal and accrued interest due at the time of default. In other words, the *murabaha* borrower will essentially be paying a substantial premium to redeem his property. Consequently, the *murabaha* changes into a partial clog and the borrower will receive a worse deal than a traditional mortgagor. Furthermore, if the *murabaha* borrower must pay the entire cost-plus-profit amount, the lender will receive a substantial windfall which has yet to accrue under traditional accounting and economic principles.

The price of piety should not require religious mortgagors to pay substantially more than secular mortgagors. The *murabaha*'s shortcomings may be corrected by attaching a schedule to the agreement that illustrates what amount would be necessary to cure a default at any given installment. It could be based on a simple amortizing schedule that would reflect the interest earned as of the date of default. The schedule adds finality to the agreement, provides the mortgagee with an equitable amount of interest, and relieves the mortgagor from shouldering a higher burden than a traditional curing mortgagor. Alternatively, the *murabaha* contract language could devise a formula that serves essentially the same purpose as the schedule to avoid the specter of interest. The notion that a defaulting Islamic mortgagor should have to pay more than a traditional mortgagor to redeem his property because of religious adherence is untenable in a nation that prides itself on free exercise of religion.

V. CONCLUSION

This Article set out to explore whether it is possible for an expanding segment of the population to remain true to their religious beliefs while living the American dream. By examining the historical aspects and rationales underlying one of the longest-standing pillars of mortgage law, this Article sought to address a subtle yet monumentally important concern with a relatively new financing vehicle. While the proposals submitted to the OCC do not perfectly meet the rigors of common law mortgage protections, courts of equity and regulators should embrace these Islamic-centered mortgage alternatives in order to encourage home ownership and maintain flexibility within the home financing market. Furthermore, the existing imperfections can be cured through minimal revision of the Net Lease and *murabaha*. Through awareness of the mortgage alternatives entering the market, courts of equity can more effectively balance their fervent safeguarding of the mortgagor's common law protections with the sound public policy of being amenable to novel approaches to allow theistic mortgagors to live the American dream.