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# ARBITRATION OF ISLAMIC FINANCIAL DISPUTES

DR. AIDA MAITA\*

Arbitration results were 33% faster than litigation. The median time from filing to judgment was 16 1/2 months in arbitration, while lawsuits took 25 months to conclude.<sup>1</sup>

## INTRODUCTION

Using arbitration as a means of resolving Islamic finance disputes is gaining popularity in the Middle East, as well as in other Muslim States in South-East Asia and Africa. This is evident in the number of studies and articles that have been presented on this subject by Islamic finance experts and the legal community at large.<sup>2</sup> Major arbitration institutions in the region are also positioning themselves to cater to this industry's growing demand for dispute resolutions because many of these disputes

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1. Michael Delikat and Morris M. Kleine, "An Empirical Study of Dispute Resolution Mechanisms: Where Do Plaintiffs Better Vindicate Their Rights?" 2003; *available at*, <http://www.instituteforlegalreform.com/featuredtool/arbitration-quotes>. (accessed Jul. 30, 2013).

2. For example; *see* "Dispute Resolution in Islamic Finance: A case analysis of Malaysia" by Umar A. Oseni presented in the 8th International Conference on Islamic Economics and Finance of 2011 in Qatar. Also the 3rd Annual World Islamic Banking Conference in summer of 2012 in Singapore had a full session on "Governance, Legal and Risk Management Priorities for the Global Islamic Finance Industry." Also *see* "Dispute Resolution in Islamic Finance" By Jonathan Lawrence, Peter Morton and Hussain Khan Gates LLP. Published first in the "Global Islamic Finance Report 2012," <http://www.klgates.com/files/Publication>.

tend to be of high profile and value.<sup>3</sup> While the industry historically has preferred litigation over adjudication, and non-Islamic venues and laws to govern the subject of the disputes,<sup>4</sup> there have been calls by legal and financial experts to refer more disputes to ADR methods, particularly arbitration, and provide custom arbitration clauses, procedures and practices more in line with Shari'a Law. This is similar to what has been established for arbitration of other industries such as Intellectual Property, Construction and Sports, and many others.

As part of the overall objective of this dissertation, building a successful arbitration hub in the Middle East depends to a large extent on understanding the needs and types of dispute resolutions required by potential clients. The Islamic Finance Industry (the "Industry"), which is one of the largest and fastest growing sectors<sup>5</sup> in the region's economy, will constitute a large percentage of those clients; therefore, demand for specialized dispute resolutions of Shari'a based products will increase. This chapter presents arbitration-related aspects of Islamic financial transactions; it further provides a brief overview of Islamic finance and discusses how current disputes and arbitration clauses are being handled; it further analyzes relevant court precedent and makes suggestions that encourage arbitrations that are more in accordance with Shari'a requirements and it also looks at existing centers that have published their own specialized arbitration rules that regulate Islamic finance, such as the Kuala Lumpur Regional Center for Arbitration (KLRCA), Islamic Banking and Financial Services Arbitration Rules, and the Dubai International Islamic Center for Reconciliation and Arbitration (IICRA) Arbitration and Reconciliation Procedures. This chapter also presents some of the challenges the Industry faces, particularly in regards to providing a standard legal framework across various jurisdictions regarding the governing law of Islamic financial transactions.

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3. For example, Qatar International Court and Dispute Resolution Center (QICDRC) has plans to expand its commercial court jurisdiction by resolving Islamic finance disputes through a model framework. The Peninsula News July 2, 2012, <http://www.thepeninsulaqatar.com/qatar/199730-qatar-international-court-plans-expansion.html>.

4. Most Islamic finance disputes are currently governed by the Law of England and Wales or the State of New York, *Business Islamica*: by Camille Paldi - a UAE-based Legal expert, read more, <<http://www.alfalahconsulting.com/2012/03/uae-dubai-as-dispute-resolution-center.html#ixzz2Mhc1f01o>>.

5. Global Islamic banking assets under management are currently estimated at just over \$1 trillion and are expected to reach \$4 trillion by 2020. See "The Rise and Rise of Islamic Finance" *African business Magazine* Monday, November 19, 2012. Also see 'Financing on faith: The rise of Islamic finance' Article by *Arabian Business*. March 25, 2012.

## I. AN OVERVIEW OF ISLAMIC FINANCE

Islamic finance in general, refers to financial activities that are consistent with the principles of Shari'a Law. The key feature of these principles is the prohibition of Riba (interest) and Gharar (uncertainties in contracts).<sup>6</sup> These two features provide the foundations of the Industry while taking into consideration the general consensus among Islamic scholars that the prohibition of interest is not limited to usury but refers to interest on debt in any form.<sup>7</sup> Over the years these principles, among others, have evolved into particular Islamic banking principles that control the business strategy to replicate conventional services with Shari'a compliant models in an effort to compensate for disadvantages and capitalize on advantages. These guiding principles in general are the following:<sup>8</sup>

1) PROHIBIT PURE DEBT SECURITIES FROM THE FINANCIAL SYSTEM AND REPLACE INTEREST BY THE RATE OF RETURN EARNED AFTER COMPLETION OF THE CONTRACT.

2) REQUIRE BANK DEPOSITS TO BE COLLECTED ON A PROFIT OR LOSS SHARING BASIS RATHER THAN FIXED PREDETERMINED LIABILITIES.

3) ALL FINANCIAL CONTRACTS SHOULD BE BACKED BY ASSETS OR TRANSACTIONS/ACTIVITIES IN THE REAL ECONOMIC SECTOR.

4) MANDATE FULFILLMENT AND SANCTITY OF CONTRACTS THAT DEAL WITH TRADE IN GOODS AND SERVICES, AS WELL AS THE TRANSFER OF OWNERSHIP AND HONORING OF DEBT OBLIGATIONS.

5) EMPHASIZE PRINCIPLES OF MORALITY AND ETHICS IN BUSINESS CONDUCT, AND PROSCRIBE ILLICIT ACTIVITIES ACCORDING TO SHARI'A AND MANDATE THAT ALL ECONOMIC ACTIVITIES BE GOVERNED BY RULES OF FAIR DEALING AND JUSTICE.

Within these principles, Islamic financial institutions have developed a vast range of contracts to facilitate the flow of financial transactions and

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6. The prohibition of Gharar is to discourage excessive uncertainty in contracts, enhance disclosure, and proscribe all forms of deception, El-Gamal, M., *ISLAMIC FINANCE: LAW, ECONOMICS AND PRACTICE* 58-60 (Cambridge, UK: Cambridge University Press, 2009).

7. Iqbal, Z., and A. Mirakhor, *AN INTRODUCTION TO ISLAMIC FINANCE: THEORY AND PRACTICE* 10, (2nd ed.) Singapore: John Wiley and Sons, 2011).

8. Ibrahim Warde, *ISLAMIC FINANCE IN THE GLOBAL ECONOMY* 55 (Edinburgh University Press, 2000).

serve the growing financial market. These contracts now cover housing, consumer finance, business loans, project funding, co-operative or mutual insurance (Takaful) and lately, tradable Islamic bonds (Sukuk). In addition to these developments, Islamic banking and finance is emerging on the global scene as a new reality to be reckoned with. It has grown from the small local bank of Mit Ghamr<sup>9</sup> in Egypt into a global industry that was valued at about \$1.4 trillion by the end of 2011 and is expected to reach over \$4.0 trillion by 2020.<sup>10</sup> To the credit of modern Islamic jurisprudence, Islamic financial institutions exhibit significant innovation, flexibility, and sophistication in providing the necessary religious juristic rulings by producing a broad range of investment products<sup>11</sup> that cover all aspects of modern day financial needs and encompass all services that modern conventional banks, insurance outfits and capital markets can offer.

In retrospect, the Islamic banking industry formally emerged in 1975 with the establishment of the Islamic Development Bank and the Dubai Islamic Bank; the first Takaful Company was also established in 1979.<sup>12</sup> In the 1980s, Pakistan, Iran, Malaysia and Bahrain, implemented Islamic banking within the framework of their existing system.<sup>13</sup> Through the 1990s, and after the establishment of the Accounting and Auditing

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9. In 1963, in Mit Ghamr, in Egypt, the first Islamic interest-free bank came into being. Mt Ghamr was a rural area and the people were religious. They did not place their savings in any bank, knowing that interest was forbidden in Islam. The Bank operated on profit sharing bases and provided interest free savings accounts, investment accounts and zakat (an obligatory Islamic tax) accounts.

The Mit Ghamr project was successful, as deposits increased from 1963 to 1966. The bank was cautious, rejecting about 60% of loan applications and the default ratio was zero in economically good times. But project was eventually abandoned for political reasons. Nevertheless, it had shown that commercial banking could be organized on a non-interest basis. The Institute of Islamic Banking and Insurance, [http://www.islamic-banking.com/what\\_is\\_ibanking.aspx](http://www.islamic-banking.com/what_is_ibanking.aspx).

10. Global Islamic Finance Report 2012, [http://gifr.net/home\\_ifci.htm](http://gifr.net/home_ifci.htm).

11. These products include but not limited to: Mudraba: "Trust Financing," Igra wa-igtin: "Lease/hire-purchase," Murabaha: "Cost-plus Financing," Musharaka: "Venture Capital," Bai'salam: "Transaction," Manazile scheme: "Islamic mortgage housing," Bai' bi thamin ajil: "sale by deferred payment," Al-wadiah: "non-fund transaction." Further types include Commodity Murabaha: "Money Market Instruments," Sukuk: "Fixed income bonds" and Takaful which covers many types of insurance.

12. The Fiqh Academy (Islamic Jurisprudence Academy) in 1975 set out objections to conventional insurance practice and provided the grounds for an alternative structure (Takaful).

13. Academic activities launched with the first international conference on Islamic Economics in Makah in 1976. The first specialized academic financial research institution, the King Abdul Aziz University Jeddah, established the Center for Research in Islamic Economics in 1978. In the 1980s, Islamic banking received significant recognition and progressed in several States. Pakistan, Iran, and Sudan undertook initiatives to transform their overall financial systems to comply with Shari'a. Due to these transformations and breakthroughs in economies, in March 1981 the governors of the central banks and monetary authorities of the Organization of Islamic Cooperation States jointly called for further strengthening and proper implementation of the regulation, close supervision, and monitoring of Islamic financial institutions.

Organization for Islamic Financial Institutions (AAOIFI),<sup>14</sup> the International Islamic Fiqh Academy (IIFA)<sup>15</sup> and the Shari'a Supervisory Boards (SSB)<sup>16</sup> of Islamic financial institutions began engaging in discussions and reviewing financial transactions that provided further development of financial services. As of early 1999, Islamic financial institutions were present in more than 70 States, and their assets exceeded the \$200 billion mark.<sup>17</sup> Since the turn of the century, global assets of Islamic financial institutions have increased significantly. State and corporate Sukuk bonds emerged around 2001-2002<sup>18</sup> and quickly created a large market in several States, particularly in the GCC region.<sup>19</sup>

The Sukuk bonds have been issued by many Islamic nations and are tradable in secondary financial markets with both the FTSE<sup>20</sup> and Dow Jones providing indices to monitor this market. To the Industry's credit, it has been profitable for investors. Islamic financial institutions were able to sail through the financial crises of 2008 with minimal damage,<sup>21</sup> and its ability to stay competitive compared to conventional finance is probably the overriding factor for its popularity with Muslims and Non-Muslims alike. This is evident in the consistently higher rate of return for

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14. AAOIFI was established the Islamic Financial Institutions in 1990, it prepares accounting, auditing, governance, ethics and Shari'a standards for Islamic financial institutions and the industry. Professional qualification programs (notably CIPA, the Shari'a Adviser and Auditor "CSAA," and the corporate compliance program) are presented to enhance the industry's human resources base and governance. . . <<http://www.aaofi.com/aaofi/TheOrganization/Overview/tabid/62/language/en-US/Default.aspx>>.

15. An Academy for advanced study of Islam based in Jeddah, Saudi Arabia. It was created at the decision of the second summit of the Organization of the Islamic Conference (OIC) 1974.

16. This board may have different name in different States however, Islamic financial institutions that offer products and services conforming to Islamic principles usually have a religious board that act as an independent Shari'a Supervisory Board comprising of at least three Shari'a scholars with specialized knowledge of the Islamic laws for transacting (Fiqh al mu'amalat), in addition to knowledge of modern business, finance and economics. The SSBs study proposed financial transaction, and issue an opinion as to the compliance of the transaction to Islamic law in the form of a fatwa, which is a non-binding jurist's opinion, Institute of Islamic Banking and Insurance (IIBI).

17. Ibrahim Warde, 2000, *Islamic Finance in the Global Economy*, Edinburgh University Press, p 6.

18. World's first global corporate Sukuk was by Kumpulan Guthrie Bhd (USD150 million, 2001). World's first global sovereign Sukuk was by Government of Malaysia (USD600 million, 2002). [http://www.mifc.com/index.php?ch=menu\\_foc\\_suk&pg=menu\\_foc\\_suk\\_iss](http://www.mifc.com/index.php?ch=menu_foc_suk&pg=menu_foc_suk_iss).

19. Other factors that helped the industry could be attributed to the increase in oil prices and repatriation of Arab funds in the wake of the aftermath of the terrorist attacks on US on Sept 11, 2001 when many Arab investors withdrew their funds from the US and the West in general and reinvested their fortune in the region where they favored Islamic investment. See article "Challenges facing sector's growth; Global Islamic finance" By: El Waleed M. Ahmed, Legal Consultant, Foreign Affair Department, Kuwaiti Lawyer Law Firm, Al-Jabria-Kuwait.

20. A British provider of stock market indices and associated data services, wholly owned by the London Stock Exchange.

21. No Islamic bank was bailed out.

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Islamic funds in comparison to conventional mutual funds.<sup>22</sup> On a final note, as interest in Islamic finance has grown, more infrastructure institutions have been established.<sup>23</sup> Many States have introduced legislation to better facilitate the Islamic Finance Industry<sup>24</sup> in their jurisdictions.

## II. AN OVERVIEW OF ISLAMIC FINANCE DISPUTE RESOLUTION

As the Industry becomes more complex and global, disputes among international entities arising out of Shari'a compliant agreements are becoming more common place. One of the challenges that still persist in the face of the Industry in terms of compliance with Shari'a has been the lack of a regulatory framework that deals with disputes arising from Shari'a compliant contracts. As a result, these Shari'a compliant financial transactions are governed by the national laws that the parties agreed to in the contract. These laws are typically rooted in the secular, Civil or Common Law systems,<sup>25</sup> rather than in the Shari'a Law which provides the guiding principles of the subject matter of the agreement. So far, the Industry has not been able to replicate the conventional-industry risk management practices<sup>26</sup> in times of crisis, and does not have clear and precise legal procedures for remedies to disputes when things go wrong, such as loan defaults.<sup>27</sup> Therefore, conventional remedies continue to be used for this non-conventional industry.

### A. THE MALAYSIAN EXPERIENCE

As the Industry was developing, many disputes with regard to Islamic finance compliance to principles of Shari'a were heard in local jurisdictions. Particularly, since many of these cases in Malaysia were

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22. See Exhibit 7: Average yields of Sukuk and GCC conventional bond spreads, Global Islamic Finance Report 2012, [http://gifr.net/home\\_ifci.htm](http://gifr.net/home_ifci.htm).

23. Such as the Islamic Financial Services Board (IFSB), International Islamic Financial Market (IIFM), International Islamic Rating Agency (IIRA), (General) Council of Islamic Banks and Financial Institutions (CIBAFI).

24. For a complete list see "Regulatory bodies" chapter 13 of Global Islamic Finance Report 2011.

25. English Common Law and the French Civil Law have been accepted as the most common legal systems in the world including most Middle Eastern States where Shari'a regulates limited aspects of the law. Islamic financial contracts are treated no different than any other commercial contracts which are not regulated by Shari'a in most Middle Eastern jurisdiction.

26. For example Basel III which is a global regulatory standard on bank provide a comprehensive and relevant way to deal with stress events, like the subprime crisis, for conventional banks. But, unfortunately this reform has not taken into account the specificities of Islamic Banking. Aniss Boumediene, May 25 "Basel III: Relevance for Islamic Banks" Université Paris I Panthéon-Sorbonne - Institut d'Administration des Entreprises de Paris (IAE Paris) May 25, 2011.

27. For example, a loan restructuring plan requires approval by the Shari'a board of the creditor and the Shari'a board of the obligator.

litigated and published, Malaysia, as one of the first Muslim States to commit to Islamic banking, provides an interesting case study<sup>28</sup> of how these disputes in Muslim jurisdictions developed.<sup>29</sup>

In the early phases<sup>30</sup> of Islamic banking, dispute cases were handled in a conventional manner. Malaysian courts generally decided in favor of the banks as they were more concerned with the application of the classic Common Law approach by emphasizing the civil and technical aspects, and they did not tackle the issue of Shari'a compliance. However, as the Industry diversified its products, questions were raised with regard to their compliance to Shari'a Law and courts were dragged into further examination of the practices of Islamic banking to rule on whether they were compliant or contrary to principles of Shari'a.<sup>31</sup> A particular case of interest is the case of *Arab-Malaysia v Taman Ihsan Jaya Sdn. Bhd. & Onor* [2008] 5 MLJ 631. In that case, the Appeals Court in 2009 revoked the decision made by the High Court to announce that the contract of *Bay Bithaman Ajjil*<sup>32</sup> (deferred payment sale) was null and void based on

28. Hasan, Zulkifli and Asutay, Mehmet (2011) 'An analysis of the Courts decisions on Islamic finance disputes.', *ISRA International journal of Islamic finance.*, 3 (2), pp. 41-71.

29. Malaysia was one of the first Muslim States to commit to Islamic banking and is exceptional among other Muslim jurisdictions where Islamic banking cases have been published in various law reports such as the *Malayan Law Journal* and the *Current Law Journal*.

30. Generally characterized as prior to 2002, see note 24, the cases referred to are as follows:

*Tinta Press Sdn Berhad v BIMB* (1987) 1 MLJ 474; 1 CLJ 474

*Bank Islam Malaysia Berhad v Adnan Omar* [1994] 3 CLJ 735; [1994] 3 AMR 44; [1994] 4 BLJ 372

*Dato' Nik Mahmud Bin Daud v Bank Islam Malaysia Berhad* [1996] 4 MLJ 295

*Bank Islam Malaysia Bhd v Shamsuddin Bin Haji Ahmad* [1999] 1 LNS 275; [1999] MLJ 450

*Bank Kerjasama Rakyat Malaysia Bhd v Nesaretnam Samyveloo* [2002] 8 CLJ 95; [2002] 7 MLJ 103.

31. See *supra* n. 24, some of the cases referred to are as follows:

*Tahan Steel Corporation Sdn Bhd v Bank Islam Malaysia Berhad* [2004] 6 CLJ 25; [2004] 6 MLJ 1

*Arab Malaysian Merchant Bank Berhad v Silver Concept Sdn Bhd* [2005] 5 MLJ 210

*Affin Bank Berhad v Zulkifli Abdullah* [2006] 3 MLJ 67

*Bank Kerjasama Rakyat Malaysia Bhd v PSC Naval Dockyard Sdn Bhd* [2008] 1 CLJ 784; [2007] MLJ 722

*Arab Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd & Ors (Koperasi Seri Kota Bukit Cheraka Bhd, third party)* [2008] 5 MLJ 631; [2009] 1 CLJ 419

*Bank Islam Malaysia Bhd v Lim Kok Hoe & Anor And Other Appeals* [2009] 6 CLJ 22; [2009] 6 MLJ 839

*Tan Sri Khalid Ibrahim v Bank Islam Malaysia Berhad* [2009] 6 MLJ 416

*Bank Islam Malaysia Bhd v. Azhar Osman & Other Cases* [2010] 5 CLJ 54 [2010] 1 LNS 251.

32. This concept refers to the sale of goods on a deferred payment basis at a price, which includes a profit margin agreed to by both parties. Like *Bai' al 'inah*, this concept is also used under an Islamic financing facility. Interest payment can be avoided as the customer is paying the sale price which is not the same as interest charged on a loan. The problem here is that this includes linking two transactions in one which is forbidden in Islam. The common perception is that this is simply straightforward charging of interest disguised as a sale.



a religious compliance basis. The Appeals Court held that matters of Shari'a principles are not to be decided by civil court judges, but by Shari'a judges who are experts in Islamic law.<sup>33</sup> This landmark decision contributed to the passing of the Central Bank of Malaysia Act No. 701 in 2009 which established a central bank Shari'a Advisory Council and provided that courts and arbitration tribunals shall refer to this council before giving any judgment concerning Shari'a matters.<sup>34</sup>

## B. INTERNATIONAL DISPUTE LITIGATIONS OF ISLAMIC FINANCE

For a long time in the Middle East, the practice by most parties to Islamic finance contracts has been to resort to English or New York law to govern their contracts.<sup>35</sup> In fact, this seems to continue to be the business strategy adopted by many Islamic finance institutions regarding cross-State transactions. This is mainly in line with how conventional finance has handled their disputes,<sup>36</sup> notwithstanding that both systems provide a good measure of predictability, and their respective jurisdictions are well respected for effective enforcement. Parties to Islamic finance contracts have also preferred litigation to resolve their disputes over other alternative methods such as Arbitration. This could be due to lingering skepticism toward arbitration of Shari'a related matters as a result of the old oil concession arbitration cases described in Chapter II or that parties might believe that litigation will provide them with more certainty than ADR methods.<sup>37</sup>

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33. For further reading on this case and its ramification see "SHARI'AH AND LEGAL ISSUES IN AL-BAY' BITHAMAN AJIL FACILITY IN THE CASE OF ARAB-MALAYSIAN FINANCE BHD V TAMAN IHSAN JAYA SDN BHD & ORS [2008] 5 MLJ " by Zulkifli Hasan. <http://www.kantakji.com/fiqh/Files/Fatawa/ww6.pdf>.

34. Section 56 of Central Bank 2009 Act give an important jurisdiction to Shari'a Advisory Council to refer to Shari'a Advisory Council for ruling from court or arbitrator:(1) Where in any proceedings relating to Islamic financial business before any court or arbitrator any question arises concerning a Shari'a matter, the court or the arbitrator, as the case may be, shall-(a) Take into consideration any published rulings of the SAC; or (b) Refer such question to the SAC for its ruling.

35. The Global Islamic Finance Report 2011: p. 238.

36. The International Swaps and Derivatives Association (ISDA) Master Agreement of 1992 and 2002 for (Multicurrency – Cross Border) transactions allow the parties the option to elect either English law or New York. <http://www.isda.org/publications/isdamasteragrmt.aspx>.

37. At the Asia Pacific Regional Arbitration Group Conference 2011, Hakimah Yaakob, of the International Shari'a Research Academy for Islamic Finance in Kuala Lumpur, stated that, following a survey that she conducted of 10 Islamic banks and 12 takaful operators (Islamic insurance providers) in Malaysia, she found that there was a 'credit policy' in many of these institutions not to include alternative dispute resolution clauses in their contracts, but to opt for litigation instead. This was said by the financial institutions to have been done, in many cases, in order to avoid credit risks for legal uncertainty. The preference for litigation was further confirmed by enquiries made of arbitration centers in Malaysia for the purpose of this report. See "Dispute Resolution in Islamic Finance" the Global Islamic Finance Report 2012.

In an effort to subject the agreements to principles of Shari'a, Islamic finance parties have resorted to inserting, within the contract, a reference to Islamic Law in their choice of law agreement. For example, in the celebrated case of *Shamil Bank of Bahrain v. Beximco Pharmaceuticals (the Shamil case)*<sup>38</sup> the Islamic murabahah<sup>39</sup> agreements contained the following governing law clause:

Subject to the principles of the Glorious Shari'a, this Agreement shall be governed by and construed in accordance with the laws of England.

For reasons discussed in the next section, this practice proved to be fruitless. In this case, both the High Court and the Court of Appeals dismissed the defendant's arguments, reasoning that the agreements were invalid and unenforceable due to Shari'a non-compliance. While the courts agreed with the defendant on the Shari'a non-compliance of the agreement, the court held that the principles of Shari'a could not be applied to the agreements. The approach followed in this case established the English courts' precedent on Islamic finance governing law, and it was upheld in subsequent cases, including most recently the decision of the London High Court in *Dar v. Blom*<sup>40</sup> which was rendered in 2009 and concerned a different type of Islamic finance agreement. As a result of these rulings, and others in cases that were heard in western courts, most banks in the Industry removed the Shari'a reference from their agreement clause and may now include a "waiver of Shari'a defense,"

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38. *Shamil Bank of Bahrain v Beximco Pharmaceuticals Limited and Others* [2004] 1 Lloyd's Rep 1 28. In this case the defendant Beximco Pharmaceuticals Ltd and the other borrowers entered into a murabahah agreement with the plaintiff in 1995. After the defendants defaulted and after a series of various termination events under the agreements, the plaintiff finally brought the case to court and made an application for summary judgment.

39. This is an Islamic finance concept that refers to the sale of goods at a price, which includes a profit margin agreed to by both parties. The purchase and selling price, other costs, and the profit margin must be clearly stated at the time of the sale agreement. The bank is compensated for the time value of its money in the form of the profit margin. This is a fixed-income loan for the purchase of a real asset (such as real estate or a vehicle), with a fixed rate of profit determined by the profit margin. The bank is not compensated for the time value of money outside of the contracted term (i.e., the bank cannot charge additional profit on late payments); however, the asset remains as a mortgage with the bank until the default is settled.

40. The text of the High Court decision in *The Investment Dar Co KSSC v Bloom Developments Bank Sal* [2009] All ER (D) 145, can be downloaded from, <http://www.allenoverly.com/AOWeb/binaries/55080.PDF>.

According to the settled law, the transaction is governed by what is agreed in the contract, supplemented by the State law applicable to the transaction. The compliance with Islamic legal principles — the Shari'a promise — is not enforceable in court and any defense that a transaction is not compliant with Islamic legal principles will not be heard. However, the mere fact that a debtor defends in an English court by referring to Shari'a principles seriously troubled the industry. Talk of Shari'a risk spread—as did discussion of how to deal with it. See article "Islamic Finance Litigation," by Kilian Bälz.

meaning that in case of a dispute the parties agree to waive any argument that the agreement is invalid under Shari'a Law.<sup>41</sup>

C. REFERENCE TO SHARI'A IN THE GOVERNING LAW CLAUSE FOR ISLAMIC FINANCE

From a domestic prospective, some Muslim jurisdictions have been able to create Shari'a compliance infrastructure to provide for Islamic finance dispute resolution with Shari'a Law controlling certain aspects of the governing law of the agreement. Indonesia, for example, created a specialized tribunal known as "Basyarnas"<sup>42</sup> or the National Shari'a Arbitration Body which is qualified to hear Islamic finance disputes within its jurisdiction. Malaysia, as noted earlier, created a special body, the central bank Shari'a Advisory Council,<sup>43</sup> to assist courts and arbitration tribunals in Malaysia concerning Shari'a matters.

From an international perspective, however, the question that continues to surface in every dispute with a Shari'a element is the following: can Shari'a or Islamic Law be applied to govern a contract? Past experiences from Western arbitration and court tribunals have ruled that Shari'a is incapable of being the governing law. This was the case in the early oil concession arbitrations where use of Shari'a Law was refused mainly because it is not codified and it is subject to varying interpretations.<sup>44</sup> As far as Islamic finance is concerned, the *Shamil* bank case as noted in the previous section set the precedent on Western attitude toward inclusion of Shari'a in the governing law clause of a contract. The decision document<sup>45</sup> provided the following reasoning for dismissing Shari'a as the governing law:

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41. See article "Islamic Finance Litigation," by Kilian Bälz, <http://www.qfinance.com/contentFiles/QF02/gpflqc6p/1b/0/islamic-finance-litigation.pdf>.

42. The Basyarnas was created to use "Islamic law . . . as the basic principle" in settling disputes arising from financial disagreements that also invoked the civic laws. Eventually, the competence of religious courts was increased to hear "any act or business activity which is undertaken in accordance with Islamic principles which include all Islamic finance institutions. See ABDUL RASYID, SETTLEMENT OF ISLAMIC BANKING DISPUTES IN INDONESIA: OPPORTUNITIES AND CHALLENGES, 1-2 (2008). Available at, <http://www.apmec.unisa.edu.au/apmf/2008/papers/25-abdul%20Rasyid.pdf>.

43. Malaysia Central Bank Act No. 701 in 2009.

44. Within Shari'a, some laws are immutable while others are interpreted according to the particularities of the situation, including the relative good that a specific decision may bring to the community.<sup>54</sup> This grey area is the province of *Ijtihad*, which is the use of legal reasoning to arrive at a correct opinion when there is no clear text on the issue. I. A. Al-Marzouqi, HUMAN RIGHTS IN ISLAMIC LAW, (2d ed. 2001) p 44.

45. A copy of the decision document can be downloaded from, [http://www.ipsofactoj.com/international/2004/Part12/int2004\(12\)-009.htm](http://www.ipsofactoj.com/international/2004/Part12/int2004(12)-009.htm).

1) THE WORDS “SUBJECT TO THE PRINCIPLES OF GLORIOUS SHARI’A” IN THE GOVERNING LAW CLAUSE, WERE NO MORE THAN A REFERENCE TO THE FACT THAT “THE BANK PURPORTED TO CONDUCT ALL ITS AFFAIRS ACCORDING TO THE PRINCIPLES OF SHARI’A. IT WAS NOT MEANT TO TRUMP THE APPLICATION OF ENGLISH LAW AS THE GOVERNING LAW.”<sup>46</sup>

2) THE JUDGE CONCLUDED “IT IS IMPROBABLE IN THE EXTREME, THAT THE PARTIES WERE TRULY ASKING THIS COURT TO GET INTO MATTERS OF ISLAMIC RELIGION AND ORTHODOXY. THIS IS ESPECIALLY SO WHEN THE BANK HAS ITS OWN RELIGIOUS BOARD TO MONITOR THE COMPLIANCE OF THE BANK WITH THE BOARD’S OWN PERCEPTION OF ISLAMIC PRINCIPLES OF LAW IN AN INTERNATIONAL BANKING CONTEXT.”<sup>47</sup>

3) THERE CANNOT BE TWO GOVERNING LAWS IN RESPECT OF THE CONTRACT AS PROVIDED BY THE ROME CONVENTION<sup>48</sup> [WHERE IT] IS MADE CLEAR THAT A CONTRACT SHALL BE GOVERNED BY A NATIONAL LAW OF A STATE CHOSEN BY THE PARTIES NOT BY “A NON-NATIONAL SYSTEM” OF LAW SUCH AS SHARI’A. . . THE COURT WAS PERFECTLY OPEN TO THE PARTIES TO A CONTRACT TO INCORPORATE SOME PROVISIONS OF A FOREIGN LAW INTO AN ENGLISH CONTRACT, BUT ONLY WHERE THE PARTIES HAD SUFFICIENTLY IDENTIFIED SPECIFIC PROVISIONS OF A FOREIGN LAW OR AN INTERNATIONAL CODE OR SET OF RULES. “THE GENERAL REFERENCE TO PRINCIPLES OF SHARI’A IN THE GOVERNING LAW CLAUSE DID NOT IDENTIFY THOSE ASPECTS OF SHARI’A WHICH WERE INTENDED TO BE INCORPORATED INTO THE CONTRACT. . . THOSE BASIC RULES WERE NEITHER IDENTIFIED NOR REFERRED TO IN THE CONTRACT.”<sup>49</sup> HAD THERE BEEN CLEAR AND SPECIFIC SHARI’A PROVISIONS INCORPORATED IN THIS CASE, THE BORROWERS MIGHT HAVE SUCCEEDED IN THEIR APPLICATION.

4) THE COURT CONCLUDED THAT THE RELEVANT SHARI’A PRINCIPLES ARE “CONTROVERSIAL.” “. . . IT WAS THE EVIDENCE OF BOTH PARTIES’ EXPERTS THAT THERE ARE INDEED AREAS OF CONSIDERABLE CONTROVERSY AND DIFFICULTY ARISING NOT ONLY FROM THE NEED TO TRANSLATE INTO PROPOSITIONS OF MODERN LAW TEXTS WHICH CENTURIES AGO WERE SET OUT AS RELIGIOUS

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46. *Supra* n. 37, para. 41.

47. *Supra* n. 37, para. 41-54.

48. The 1980 Rome Convention on the law applicable to contractual obligations, Art.1.1, Art.3.1. [http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:41998A0126\(02\):EN:NOT](http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:41998A0126(02):EN:NOT).

49. *Supra* n. 37, para. 52.

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AND MORAL CODES, BUT BECAUSE OF THE EXISTENCE OF A VARIETY OF SCHOOLS OF THOUGHT WITH WHICH THE COURT MAY HAVE TO CONCERN ITSELF IN ANY GIVEN CASE BEFORE REACHING A CONCLUSION UPON THE PRINCIPLE OR RULE IN DISPUTE.”<sup>50</sup>

5) THE COURT ALSO NOTED THAT THERE WAS NO SUGGESTION THAT THE BORROWERS HAD BEEN IN ANY WAY CONCERNED ABOUT THE PRINCIPLES OF SHARI'A EITHER AT THE TIME THE AGREEMENTS WERE MADE OR AT ANY TIME BEFORE THE PROCEEDINGS WERE STARTED. IN THE COURT'S OPINION, THE SHARI'A DEFENSE WAS “A LAWYER'S CONSTRUCT.”<sup>51</sup> THEREFORE THE COURT LEANT AGAINST A CONSTRUCTION WHICH WOULD DEFEAT THE COMMERCIAL PURPOSE OF THE DOCUMENTS.

As a result of the foregoing reasoning, the Supreme Court confirmed the judgment of Morrison J. of the High Court and explicitly denied that Shari'a Law could be applied to settle an Islamic finance transaction, even if so specified in the contract. The Court also emphasized that Shari'a Law is not a recognizable form of law that contains principles of law capable of governing a commercial dispute in the UK.

The Shamil bank case highlighted many of the problems that face the Industry with regard to using Shari'a as a governing law. These issues, which are also recognized by most Islamic finance advocates, are summarized as follows:

Shari'a is not the law of a nation;<sup>52</sup>

Shari'a Law is not codified in a universally accepted body of law;

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50. Supra n. 37, para. 55.

51. Supra n. 37, para. 41-55.

52. Taking effect from 17th December 2009, the Rome Convention has been replaced by the EU Regulation (EC) No. 593/2008 on the Law Applicable to Contractual Obligations („Rome I“ ). In its recitals (13), the Regulation seems to open the door to non-State law: “This Regulation does not preclude parties from incorporating by reference into their contract a non-State body of law...” However, considering the history of the legislative process, this is meant to involve incorporation into a contract governed by State law rather than to allow the choice of non-State law as the governing law of contract in general. 10.

The Commission had initially proposed to allow the choice of non-State law such as UNIDROIT or Shari'a (but excluding, e.g., the *lex mercatoria*, which, according to the Commission, “is not precise enough“ ), but failed to gather sufficient support. Art. 3 of the Regulation allows partial choice of law. However, according to prevailing legal view, dual choice of law can only be applied to specific and clearly defined parts of a contract, due to certainty requirements. “Analysis: Shari'a Clauses in Financial Contracts,” Dr. Jur. Klaus Peter Follak, Jan. 15, 2010 © Thomson Reuters 2010.

Islamic jurisdiction is not bound by precedence and legal opinions may deviate from previous decisions made by other Shari'a scholars;

Existence of different schools of thought leads to different interpretations of various Shari'a compliance-related matters;

There is lack of standard detailed Islamic finance legal procedures and provisions particular to dispute resolution and the governing clause of the agreement;

The Shari'a defense is a risk where the credibility of Shari'a Advisory Boards (SAB) is always questioned when things go wrong.<sup>53</sup>

This lack of Shari'a Law governance over cross-border disputes is considered the Achilles Heel in the global acceptance and growth of Islamic finance. To some industry advocates, it is inconceivable and unsustainable for the industry to have parties who seek to enter into a contract based on Shari'a principles. Such Parties would be subjected to remedies in contravention of Islamic jurisprudence including, paying or receiving damages that include interest payments. What could make matters worse is that a judgment obtained from a foreign court that contravenes Shari'a principles may not be enforceable in a home jurisdiction, such as Saudi Arabia, where one of the parties may be registered or where enforcement may be sought. Calls were made for harmonization between Shari'a Law and Common Law in order for the industry to have a coherent and effective dispute resolution mechanism.<sup>54</sup> The Shamil Court mentioned the lack of codification within the Shari'a Law. The following section discusses this subject.

#### D. SHARI'A CODIFICATION (STANDARDIZATION)

The Muslim world does not have a central religious authority that can provide definitive religious rulings. This is largely a result of the varying interpretations of religious principles applied by different Islamic schools of thought in different States across the world. Additionally, religious

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53. Shari'a risk meant that the opinion or fatwa of a Shari'a scholar or a Shari'a board could be challenged successfully by another scholar or board so that the claim of Shari'a-compliance cannot be upheld. This was also evident in the case of Blom Development Bank vs. The Investment Dar (TID). TID argued at court that a wakala (Agency) agreement was not in compliance with Shari'a and therefore was void because it went beyond the corporate powers of TID. The company was bound by its constitutional documents to Shari'a-compliant transactions only. What is relevant here is the fact that the Shari'a-compliance of the wakala agreement was quite successfully disputed by the management of TID although it was initially approved by the company's own Shari'a board.

54. See, "HARMONISATION OF INTERNATIONAL COMMERCIAL ARBITRATION LAW AND SHARI'A," 2009 Mary B. Ayad, Ph.D candidate, Macquarie University.

rulings on secondary issues<sup>55</sup> are not definitive in nature; for example, even a fatwa by al-Azhar,<sup>56</sup> the most recognized and respected religious body in the Middle East, is subject to discussion as it is merely considered, at least from a religious point of view, an unbinding religious opinion.<sup>57</sup> As a result, Islamic institutions employ their own Shari'a advisory boards for compliance justifications. These boards have great leeway in defining if a product or an agreement is Shari'a compliant or not, which in turn results in different transactions being interpreted differently and causes uncertainty about how to do business in the Islamic finance system; this makes accurate risk assessments for both the financial institution and the customer extremely difficult.

Many authors argue that there is an urgent need for standardization within the Islamic finance industry.<sup>58</sup> This issue, however, has proven to present a conundrum and remains one of the major difficulties facing the industry; simply put, it is the number one topic at every conference, workshop or research study that attempts to address Islamic finance. Because the core business practice of the industry is based on compliance with Shari'a principles, standardization of the industry is largely dependent on the establishment of a universally accepted interpretation and codification of the Shari'a Law. The industry has established many internationally recognized bodies that are tasked with developing such common regulatory standards such as the Islamic Financial Services Board (IFSB), the International Islamic Financial Market (IIFM), the International Islamic Rating Agency (IIRA) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).<sup>59</sup> While these bodies have had relative success in developing standards and regulations in various aspects of the industry's business, it seems they are having much more difficulty in tackling core issues that pertain to Shari'a Law. As an example, the IFSB<sup>60</sup> in 2009 issued a report

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55. These are typically details that the Qur'an and Sunna are silent on.

56. It is a religious university in Cairo, Egypt. Founded in 970 or 972 as a madrasa, or center of Islamic learning, its students studied the Qur'an and Islamic law in detail, along with logic, grammar and rhetoric.

57. For example, Islamic-oriented Sukuk has drawn controversy between the government that struggles for it and Egypt's religious authority al-Azhar, the world's reference for Sunni Muslims, which deems it against Islamic Shari'a (law). See "Odds raised as Egypt cabinet approves Draft Law on Islamic bonds," Xinhua, 28-2-2013. By Agencies.

58. Shanmugam, B. and Zahari, Z. R. (2009). *A Primer on Islamic Finance*, (Charlottesville, VA: Research Foundation of CFA Institute), p. 93.

59. Bahrain takes pride in hosting several infrastructure institutions such as AAOIFI, LMC, CIBAFI, the International Islamic Financial Market and the International Islamic Rating Agency (IIRA), which inject more robustness into the Islamic finance market.

60. The IFSB is an international standard-setting organization which was officially inaugurated on November 2002 and started operations on 10 March 2003. The organization promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking,

that contains a set of Guiding Principles on the Shari'a governance systems for the industry<sup>61</sup> that the IFSB hopes will ensure compliance with Shari'a rules and principles going forward.

In reviewing the IFSB report, we found that the focus of its guiding principles was more on the selection process of the Shari'a advisory boards, rather than on providing guidelines as to how to reach a consistent ruling on the religious compliance of financial transactions under Shari'a Law. One must keep in mind that this inconsistency continues to be one of the major challenges for Islamic finance, and this inconsistency has resulted in a lack of homogeneity in a number of the Islamic products.

The AAOIFI<sup>62</sup> has been successful to a certain degree in providing codified Shari'a standards for numerous aspects of the industry's business transactions and practices.<sup>63</sup> As of today,<sup>64</sup> the AAOIFI has published 45 Shari'a legal standards that could eventually be admitted by courts in Europe as a system of principles capable of governing parts of an Islamic finance agreement; however, these standards are far from complete and most importantly, as of now there is no standard for a governing law clause that can safely evade the scrutiny of the various review committees of the AAOIFI. Finally, adoption and implementation<sup>65</sup> of such standards has been very weak in most Muslim jurisdictions, particularly those in the Middle East<sup>66</sup> where most States lack separate Islamic finance legislations and Islamic finance transactions fall under conventional commerce regulations. The following section discusses the arbitration of Islamic finance.

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capital markets and insurance sectors. For more information about the IFSB, please visit [www.ifsb.org](http://www.ifsb.org).

61. The IFSB report "GUIDING PRINCIPLES ON SHARĪ AH GOVERNANCE SYSTEMS FOR INSTITUTIONS OFFERING ISLAMIC FINANCIAL SERVICES," SBN: 978-983-44579-5-2; *available at*, <http://www.ifsb.org/standard/IFSB-10%20Shari'ah%20Governance.pdf>.

62. The AAOIFI is supported by 200 institutional members from 45 States including central banks, Islamic financial institutions, and other participants from the international Islamic banking and finance industry, worldwide. This information was taken from AAOIFI's website: <http://www.aaofi.com/>.

63. For a complete list see the following: <http://www.aaofi.com/aaofi/Publications/KeyPublications/tabid/88/language/en-US/Default.aspx>. (Last assessed ).

64. July 6, 2013.

65. The AAOIFI has gained assuring support for the implementation of its standards, which are now adopted in the Kingdom of Bahrain, Dubai International Financial Center, Jordan, Lebanon, Qatar, Sudan and Syria. The relevant authorities in Australia, Indonesia, Malaysia, Pakistan, Kingdom of Saudi Arabia and South Africa have issued guidelines that are based on AAOIFI's standards. Please note that such adoptions alone do not have a binding nature: <http://www.aaofi.com/>.

66. Only Bahrain, Oman and the DIFC jurisdiction of Dubai have specific regulation regarding Islamic finance.



### III. ARBITRATION OF ISLAMIC FINANCE

As the Islamic finance industry grows to unprecedented levels, major arbitration institutions in different regions, expecting parallel growth in a number of disputes coming out of Islamic finance, have been positioning and promoting themselves to take advantage of this growth. Mr. Ahmed Husain, CEO of the Bahrain Chamber for Dispute Resolution (BCDR-AAA), speaking at the Third World Islamic Banking Conference (WIBC) Asia Summit in Singapore to discuss the industry's growth and the benefits of arbitration in dispute resolution offers the following observation:

. . . With this growth comes the demand for alternative solutions to traditional means of settling legal disputes. As such, arbitration and mediation have an increasingly important role to play in the financial and legal sector . . . We have already seen a shift towards using alternative solutions for dispute resolution in the region due to the considerable advantages that these solutions offer . . . The process is simple, flexible and cost effective. Furthermore, parties are able to hand pick an arbitrator or mediator with the credentials and expertise that best suit their needs. This is particularly important when considering the complexities of the Islamic finance industry.<sup>67</sup>

While many of the well-known institutes in the Middle East region (DAIC, BCDR-AAA, CRCICA, DIFC-LCIA, QICCA) and in the South East Asia region (KRCLA, SIAC, HKIAC) have promoted themselves for Islamic finance disputes using conventional rules and procedures, there were other institutions established for the purposes of performing arbitration in accordance with the provisions of Islamic Shari'a Law and catering to Islamic finance. Before we present these institutes' experiences and the different approaches followed to handle Islamic finance arbitration, it would be beneficial to provide insight on the special advantages that arbitration offers to Islamic finance and the modern trends in Islamic arbitration rules.

#### A. THE ARBITRATION ADVANTAGE

It is clear that the current practice of using litigation for dispute resolution in the Islamic finance industry is not effectively serving the

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67. BCDR-AAA press release "Increase in demand for alternative dispute resolution mirrors growth of the \$1 Trillion Islamic finance industry," June 10, 2012. <http://www.bcdr-aaa.org/en/news/press-release-increase-in-demand-for-alternative-dispute-resolution-mirrors-growth-of-the-1-trillion-islamic-finance-industry.html>.

purpose for which the industry was established. Litigation, under the foreign law of any jurisdiction, presents various challenges to Islamic finance parties, including lack of enforcement mechanisms, non-conformance with Shari'a principles and a questionable level of judicial competence with regard to the subject matter.<sup>68</sup> At the same time, religious constraints will likely continue to impede the Islamic financial development in relation to Shari'a codification, meaning the industry will continue to struggle as it attempts to harmonize the Shari'a Islamic Law with the Civil or Common Law systems that are used by most nations of the world.<sup>69</sup> Many people understand that Islamic finance has its own unique features that require someone with the proper knowledge and background to adjudicate many of its delicate issues. Therefore, many authors and legal practitioners in the industry have been recommending the use of alternative dispute resolutions to resolve international disputes emanating from Islamic finance. Dr. Engku Rabiah Adawiah of the International Islamic University, Malaysia, summarizes it best:

A sure way out of this judicial imbalance is adoption of ADR which enables the parties to appoint persons with at least basic knowledge and understanding of the guiding laws and principles to settle their disputes. The adoption is not a substitute for having competent judges of Islamic law whose conferment of powers by the appropriate authority to adjudicate on the disputes is long overdue. It is rather a viable alternative for a better administration of justice.<sup>70</sup>

As a result of such sentiments and the need for ADR as perceived by scholars such as Dr. Rabiah and practitioners, there has been active promotion of arbitration as a forum that could prove more conducive to furthering, rather than defeating, the commercial purpose of Islamic finance. Experts suggest that even London, if selected and which continues to be the favored place for Islamic finance parties to adjudicate disputes, could offer ideal opportunities to resolve Islamic finance disputes in accordance with Shari'a Law if those disputes are submitted

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68. Professor Andrew White, associate professor at the International Islamic Law and Finance Center in Singapore, recently stated at the Asia Pacific Regional Arbitration Group Conference 2011 that litigation is not geared towards solving Islamic finance disputes as judges often lack the education in many industry principles "Dispute Resolution in Islamic Finance" By Jonathan Lawrence, Peter Morton and Hussain Khan Gates LLP. Published first in the "Global Islamic Finance Report 2012." <http://www.klgates.com/files/Publication>.

69. See List of national legal systems, [http://en.wikipedia.org/wiki/List\\_of\\_national\\_legal\\_systems](http://en.wikipedia.org/wiki/List_of_national_legal_systems).

70. Engku Rabiah Adawiah, "Constraints and Opportunities in Harmonization of Civil Law and Shari'a in the Islamic Financial Services Industry," [2008] 4 MLJ i at p. iii. Also quoted by Umar A. Oseni "Dispute Resolution in Islamic Finance: A case analysis of Malaysia."

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to arbitration, rather than litigation.<sup>71</sup> A case on point is *Sanghi Polyesters Ltd. (India) v. The International Investor KCSC (Kuwait)* [2001] C.L.C.<sup>72</sup> where a dispute arising from an Islamic financing agreement utilized arbitration as the dispute resolution mechanism of choice, with London listed as the place of arbitration. The applicable substantive law provided as follows:

This dispute shall be governed by the Laws of England except to the extent it may conflict with Islamic Shari'a, which shall prevail.

The decision of the arbitrator, who was chosen as an expert in Islamic Law via expression in an ICC Arbitration Award obtained in London, gave effect to the parties' will to be governed by English law, except where this would conflict with Shari'a Law, by awarding principal and the profit claims, but disallowing additional damages claims because, although compliant with English law, these would conflict with Shari'a Law. The losing party challenged the award in English court, and the judge recognized that there was no issue regarding the law of England and Wales and that the only issue was whether the contract was "invalidated in the manner claimed . . . under Shari's Law." The judge ruled that there had been no serious irregularity or injustice and that the award would stand. The judge's ruling in this case provides a clear contrast to the *Shamil* bank case that went to litigation.

There are certainly some advantages in resorting to arbitration over litigation that are peculiar to Islamic finance. Features that have enabled arbitration to become the preferred dispute resolution method over the past thirty years have been its finality, confidentiality, speed, cost, and flexibility. Additionally, the move towards arbitration offers the Islamic finance industry parties these specific added advantages:

1) Parties can appoint the arbitrators who are proficient in the field of the subject matter such as the Shari'a Law, unlike

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71. The English Arbitration Act 1996 (which applies to all arbitrations seated in England and Wales) expressly permits the arbitral tribunal to decide the dispute in accordance with the law chosen by the parties or, "if the parties so agree, in accordance with such other considerations as are agreed by them or determined by the tribunal" (s46(1)(b)). So in English-seated arbitrations the arbitral tribunal can decide the dispute in accordance with such other considerations as are agreed by the parties, and this could include Shari'a Law. "Dispute Resolution in Islamic Finance" By Jonathan Lawrence, Peter Morton and Hussain Khan Gates LLP. Published first in the "Global Islamic Finance Report 2012," <http://www.klgates.com/files/Publication>.

72. *Sanghi Polyesters Ltd. (India) v. Int'l Investor KCFC (Kuwait)*, [2000] 1 LLOYD'S REP. 480, 480 (2000).

litigation where the dispute is determined by national judges who are experts in neither Shari'a nor finance.

2) Parties have considerable freedom to tailor their own arbitration rules and institutes in accordance with their needs and the particulars of their dispute.

3) Parties are free to incorporate Shari'a Law into the governing law clause in accordance with their needs and the particulars of their dispute. Therefore, parties of Islamic finance will have more success in having critical aspects of the dispute decided by Shari'a principles.

4) Awards are final and easier to enforce in other jurisdictions than judicial judgments. The New York Convention, which is adopted by over 144 States, has established a world-wide, harmonized mechanism for such enforcement.

5) Arbitration can be conducted in venues close to home while maintaining the seat or governing law of choice abroad. This is of particular interest for Islamic finance where most parties are in Muslim States while the seat is London or the governing law is that of England.

These additional features make the arbitration process more appealing as the natural dispute resolution mechanism for Islamic finance transactions because they enable parties to selectively incorporate Shari'a principles into the governing clause if they choose. This selective incorporation further enhances the fulfillment of the intent of the contract which is Shari'a compliance and which is a primary objective of the arbitration tribunal. Recall that compliance with Shari'a was totally ignored during the course of the *Shamil* bank litigation.

Ever since the publication of the *Shamil* bank case in 2002, the subject of arbitration of Islamic finance disputes has garnered mounting appreciation in the Middle East, as well as in other Muslim States of south East Asia and Africa. Numerous studies and articles have been presented on this subject by Islamic finance experts and the legal community at large.<sup>73</sup> Furthermore, International Law students have

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73. For example; see "Dispute Resolution in Islamic Finance: A case analysis of Malaysia" by Umar A. Oseni presented in the 8th International Conference on Islamic Economics and Finance of 2011 in Qatar. Also the 3rd Annual World Islamic Banking Conference in summer of 2012 in Singapore had a full session on "Governance, Legal and Risk Management Priorities for the Global Islamic Finance Industry." See also, "Dispute Resolution in Islamic Finance" By Jonathan

produced many dissertations on the subject of Islamic Arbitration or Arbitrations in Islamic Finance.<sup>74</sup> This attention has led many experts in the industry to consider arbitration to be a perfect fit for the industry's problem of incorporating Shari'a Law into other non-Shari'a legal systems, whether they are the Civil Law, Common Law or the dual systems that are most common in the Arab and Muslim world. Arbitration after all is deeply rooted in the Arab and Muslim traditions and has long been implemented in practice since the pre-Islamic period. In that respect, arbitration has been viewed as a gateway for the application of legal pluralism<sup>75</sup> where a State's legal system accepts and tolerates the application of Shari'a Law or a certain school of thought of Shari'a Law to dispute resolution.<sup>76</sup>

### B. MODERN TREND IN ISLAMIC ARBITRATION

In reviewing many of the articles and research papers written on this subject it is evident that, at least from a doctrinal prospective, there is no consensus on specific Islamic rules regarding arbitration within the context of resolving modern international commercial disputes. Faisal Kutty in his research paper, "The Shari'a Factor in International Commercial Arbitration,"<sup>77</sup> published in 2006, provides an excellent overview of the various classic and modern opinions of the Shari'a Law regarding many modern arbitration aspects such as choice of law, public policy, and capacity of the arbitrator. Mr. Kutty suggests the following:

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Lawrence, Peter Morton and Hussain Khan Gates LLP. Published first in the "Global Islamic Finance Report 2012," <http://www.klgates.com/files/Publication>.

74. For example: "Saudi Law and Judicial Practice in Commercial and Banking Arbitration," 2008, By A. Y. Baamir School of Law, Brunel University. "COMMERCIAL ARBITRATION IN ISLAMIC JURISPRUDENCE: A study of its role in the Saudi Arabia Context," By M.A. Al Jabra. Thesis submitted for the Degree of Doctor of Philosophy in Law of the University of Wales, Aberystwyth. 2001. "Distinction between the Concepts Mediation, Conciliation, Sulh and Arbitration in Shari'a Law, Essam A. Alsheikh, Portsmouth University, Portsmouth, United Kingdom. "HARMONISATION OF INTERNATIONAL COMMERCIAL ARBITRATION LAW AND SHARI'A," 2009 Mary B. Ayad, Ph. D candidate Macquarie University. "Choice of Law and Islamic Finance," by Julio C. Colon, J.D. candidate at The University of Texas School of Law (2011).

75. Legal pluralism is the existence of multiple legal systems within one geographic area. Plural legal systems are particularly prevalent in former colonies, where the law of a former colonial authority may exist alongside more traditional legal systems, [http://en.wikipedia.org/wiki/Legal\\_pluralism](http://en.wikipedia.org/wiki/Legal_pluralism).

76. The Global Islamic Finance Report 2011: p 237. Chapter 30.4 "Legal pluralism in the Shari's" also reflects on historical example in Islamic heritage where various Shari'a schools of thought coexisted and individuals had the opportunity to go to a judge who offered an opinion which would be aligned to their affiliation. This did not contravene the broad desire by the State and the judiciary as the chief judge retained overall responsibility for the proper functioning of the system as a whole that the schools of thought should retain uniformity in jurisprudence.

77. Kutty, Faisal, "The Shari'a Factor in International Commercial Arbitration," 2006, Loyola of Los Angeles International and Comparative Law Review, Vol. 28:565, at 623, available at, <http://digitalcommons.lmu.edu/cgi/viewcontent.cgi?article=1609&context=ilr>.

There is a need to reform Islamic law from within to deal with contemporary norms, transactions and institutions, but there is an equal need to better accommodate and address the issues of concern from an Islamic perspective.

Despite the diverse views of the different Shari'a schools of thought, which continue to persist in the Islamic world, the current trend in Islamic jurisdictions and Islamic arbitration institutes is to harmonize with international standards, particularly with the UNCITRAL rules and Model Law, both of which provide great flexibility with regard to party autonomy. New draft arbitration legislation and rules limit the role of Shari'a Law only to ensure that there is no clear violation of Islamic principles, both in the arbitration process and in the applicable law governing the proceedings, which could be any State law as agreed upon by the contracting parties.

The current trend in Muslim jurisdiction is to view Shari'a principles or Islamic law as a law of substance rather than a law of procedure because the main sources of Shari'a, the Qur'an and Sunna, are silent on many of the issues that are debated in the halls of academia regarding the arbitration process, such the place of arbitration, the procedure, the time limit, the applicable rules, remuneration, and appointment of arbitrators. Both the Qur'an and the Sunna have left these aspects within the discretionary power of the parties to decide. It is important to note that much of the past academic research was done by adopting the Saudi Arbitration Law of 1983 as a model for Islamic arbitration.

The old Saudi Arbitration Law of 1983 practically required the arbitrator to be a male Muslim with knowledge of Shari'a Law<sup>78</sup> as well as use Arabic as the language of arbitration. However, the new Saudi Arbitration Law of 2012,<sup>79</sup> as described in Chapter II, was based on the UNCITRAL model and was much more harmonized with international norms and in line with the modern trend of many Muslim jurisdictions. The 2012 law is silent as to gender, nationality, and religion of the arbitrator and only requires the arbitrators to be adults, of good conduct,

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78. Saudi Arabia Arbitration Regulation of 1983 (Royal Decree No. M/46). Article 3 of the Regulations of the Old Arbitration Law required that arbitrators had to be either Saudi citizens or non-Saudi Muslims with a professional designation. They had to be experienced, of good conduct and reputation, and be of full legal capacity. The Implementing Regulations then required arbitrators to have the same qualifications as Saudi judges which, in practice, meant that arbitrators had to be male and Muslim. For more background on the subject see "5.5. Position of Women as Arbitrator, Witness or Party in Conciliation in the Shari'a" E.A. Alsheikh / Arab Law Quarterly 25 (2011) 367-400 p. 386.

79. The new Saudi Arabia Arbitration Regulation (Royal Decree No. M/34) published in June 8, 2012.

and hold a degree in law or Shari'a science. Actually, the new Saudi law allows parties the freedom to choose both the procedural and substantive law to be applied by the tribunal, provided they do not conflict with Shari'a Law.<sup>80</sup> The new Saudi law only retains the public policy requirement that the award must not contravene Shari'a Law<sup>81</sup> which from now on should come into play in issues arising from the substance of the dispute and the applicable law that is used to resolve the dispute. This approach towards arbitration is becoming common in most Muslim jurisdictions where the mention of Shari'a is limited to public policy articles to ensure non-contravention.<sup>82</sup>

#### ARBITRATION RULES FOR ISLAMIC FINANCE

Arbitration of Islamic finance poses a unique situation where the parties of such contracts or agreements are freely willing to conduct their business in a manner that is in compliance with Shari'a Law, and naturally they would like to see their disputes handled in harmony with their intentions; therefore, it is only reasonable that such disputes be adjudicated in accordance with Shari'a Law. For that reason, specialized Islamic rules or institutes were established for the sole purpose of performing arbitration in accordance with the provisions of Islamic Shari'a Law. From a procedural prospective there have been different approaches that have been used to infuse Shari'a Law into the applicable law of dispute arbitration; these approaches are the next topic of discussion.

#### C. INTERNATIONAL ISLAMIC MEDIATION & ARBITRATION CENTER (IMAC)

This center was established in Hong Kong as an independent international institution pursuant to a resolution by the Arab Chamber of Commerce & Industry in July 2008. The center does not provide a set of its own rules on its website;<sup>83</sup> however, the site provides that arbitration proceedings administered by IMAC are governed by the arbitration rules, which essentially follow the UNCITRAL rules of arbitration. Certain

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80. The new Saudi Arbitration Regulation expressly allows the parties to choose the applicable law (Article 38), procedural law (Article 25 and Article 4), venue (Article 28), their arbitrators (Article 15), the procedure for challenging arbitrators (Article 17), the commencement of arbitration (Article 26), and whether the tribunal will be able to issue temporary or precautionary measures (Article 23). In fact, Article 25 of permits parties to use either international arbitration institutions or their procedural rules or ad hoc international arbitration rules, as long as those procedures do not violate Shari'a.

81. The new Saudi Arabia Arbitration Regulation Article 55-b.

82. See the new UAE Draft Law and unifies GCC Draft Law in Chapter II.

83. See, [http://www.arabcci.org/IMAC\\_aboutus.htm](http://www.arabcci.org/IMAC_aboutus.htm).

aspects of these rules, however, have been modified in order to take into consideration the institutional character of arbitrations that will be conducted under the Shari'a Rules of Arbitration of IMAC. The arbitrators need not be of a specific sex or nationality or religion, unless otherwise provided by agreement between the parties or by provision of law. Finally, the center's website provides a list of arbitrators who seem to be experienced in many functions including knowledge of finance and Shari'a Law. It is not clear how the center provides for Shari'a compliance in its proceedings. I could not find much material on this center's activity, and it seems to be dormant except for organizing basic training courses and seminars in Islamic arbitration and finance.<sup>84</sup>

1. The Kuala Lumpur Regional Center of Arbitration "KLRCA:" The Islamic Arbitration Rules (KLRCA I-Arbitration Rules)<sup>85</sup>

This well-established center recently launched and adopted this set of arbitration rules for Islamic arbitration at the 2012 Global Islamic Finance Forum in September 2012. The rules are based on the 2010 version of the UNCITRAL arbitration rules and are considered an expansion of the previous KLRCA Islamic Banking and Financial Arbitration Rules of 2007 that were used for domestic purposes. The rules display many modern features of party autonomy where the parties have control over the arbitration process and are free to choose their own arbitrators and applicable law. The KLRCA provides this model clause to use i-Arbitration Rules:

Any dispute, controversy or claim arising out of a commercial agreement which is based on Shari'ah principles or the breach, termination or invalidity thereof shall be settled by arbitration in accordance with the KLRCA i-Arbitration Rules.<sup>86</sup>

The rules provide modifications to the conventional international arbitration rules of the center that permit the outsourcing of Shari'a related issues to a specialized Shari'a expert or advisory council as specified and agreed by the parties. The Shari'a expert or advisory

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84. See, International Islamic Mediation & Arbitration Center (IMAC) organizes basic training courses in Hong Kong announces its president Lord Edwin E. Hitti, <http://pr.syndacast.com/gb/press-releases/2826-release.html>.

85. Rule N. 8 of the KLRCA i-Arbitration rules: "PROCEDURE FOR REFERENCE TO SHARI'AH ADVISORY COUNCIL OR SHARI'AH EXPERT" reads, subject to paragraph 2 below, whenever the arbitral tribunal has to a) Form an opinion on a point related to Shari'a principles; and b) decide on a dispute arising from the Shari'a aspect of any agreement which is based on Shari'a principles; The arbitral tribunal shall refer to the matter to the relevant Council for its decision.

86. KLRCA website, <http://www.klrca.org.my/scripts/view-anchor.asp?cat=30#291>.



council is selected from the Malaysian National Shari'a Advisory Council which was established by the Central Bank Act of 2009 and currently consists of eleven prominent Shari'a scholars, jurists and market practitioners. Rule 8.2 of the i-Arbitration rules provides the following:

Whenever the arbitration relates to a dispute on a Shari'ah aspect of a commercial agreement which is based on Shari'ah principles that is beyond the purview of the relevant Council<sup>87</sup> and the arbitrator has to form an opinion on a point related to the Shari'ah principles and decide on a dispute arising from the Shari'ah aspect, the arbitrator shall refer the matter to a Shari'ah expert or council to be agreed between the parties, setting out relevant information as the Shari'ah expert may require to form its opinion including the question or issue so the Kuala Lumpur Regional Center for Arbitration referred, the relevant facts, issues, and the question to be answered by the Shari'ah expert.

At the request of any party, the Shari'a expert, after delivery of the report, may be heard at a hearing where the parties are allowed to be present and question the expert. At this hearing, any party may present expert witnesses in order to testify on the points at issue.<sup>88</sup> While the i-Arbitration rules were established primarily for Islamic finance disputes, the KLRCA advocates their use for any dispute which arises out of an agreement that is premised on the principles of Shari'a. The publication of these i-Arbitration rules is intended to provide Malaysia with an opportunity to become a hub for Islamic finance dispute resolution. KLRCA director, Datuk Sundra Rajoo, stated in an article in the *Global Arbitration Review*<sup>89</sup> the following:

With the advent of globalization and increasing cross-border transactions, the center decided to come up with a set of rules that provide for international commercial arbitration that is suitable for commercial transactions premised on Islamic principles, and that would be recognized and enforceable internationally, . . . Many Asian arbitration centers have their

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87. 'Council': means the Shari'a Advisory Council so established by the Central Bank under Central Bank Act 2009 or the Shari'a Advisory Council established by the securities Commission under the securities Commission Act 1993. The KLRCA i-Arbitration rules p. 15. Current members have vast experience in banking, finance, economics, law and application of Shari'a, particularly in the areas of Islamic economics and finance.

88. Article 29 if the i-Arbitration rules.

89. See "KLRCA to unveil Islamic arbitration rules" by Clemmie Spalton, September 17, 2012. <http://www.globalarbitrationreview.com/news/article/30822/>.

niche— for example, Hong Kong is an obvious venue for China-related disputes, and as a plural society with a majority of Muslim citizens and a regional hub for Islamic finance, Malaysia could be an appealing neutral arbitration forum for parties who have issues with Shari'a contracts . . . .

While the KLRCA has had limited success applying these rules to domestic arbitrations since 2007, it remains to be seen how this approach will be received at the international level. The next arbitration center for discussion is the IICRA.

## 2. The International Islamic Center for Reconciliation and Arbitration (IICRA)

This center (IICRA) was established as part of an agreement between the UAE and the General Council of Islamic Banks and Financial Institutions, as a representative of the Islamic finance industry in 2004. It became operational in January of 2007.<sup>90</sup> The IICRA makes arrangements to settle any kind of financial or commercial dispute between financial or commercial institutions that have chosen to comply with the Shari'a to settle their disputes.<sup>91</sup> The Center maintains a list of arbitrators who are required to have knowledge and experience in trade, industry, and finance, as well as in the relevant principles of Shari'a Law.<sup>92</sup> The IICRA provides this model arbitration clause for Islamic arbitration:

If any dispute arising between the parties out of the formation, performance, interpretation, nullification, termination or invalidation of this agreement (contract) or arising therefore or related thereto, the dispute shall be referred to an arbitration panel constituted from uneven [group] of arbitrators for a final and binding decision in accordance with the rules and procedures specified in the statute of the International Islamic Center for Reconciliation and Arbitration in Dubai.<sup>93</sup>

The IICRA has issued the Arbitration and Reconciliation Procedures,<sup>94</sup> which are primarily derived from the UNCITRAL arbitration rules and display many modern features of party autonomy where the parties can select their own arbitrators and have control over the arbitration process.

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90. IICRA website, [http://www.iicra.com/en/misc\\_pages/detail/4c855d3580](http://www.iicra.com/en/misc_pages/detail/4c855d3580).

91. Article 2 of the IICRA Chart.

92. Article 10 of the IICRA Chart.

93. IICRA website, [http://www.iicra.com/en/misc\\_pages/detail/4beeffac0c](http://www.iicra.com/en/misc_pages/detail/4beeffac0c).

94. [http://www.iicra.com/en/misc\\_pages/detail/47025a8fda](http://www.iicra.com/en/misc_pages/detail/47025a8fda).

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Parties are free to choose their own procedural law<sup>95</sup> and substantive law, provided such law is not incompatible with Shari'a Law. In this regard, the IICRA procedures provide the following:

The arbitrators must abide by the laws chosen by the parties in the dispute. . . . In all cases, the panel shall exclude any provisions that contradict in the law that should be applied if such provisions are not in conformity with the rules of Islamic Shari'a. The Arbitration Panel may invoke for the disputed issue whatever it deems appropriate from among the viewpoints of various schools of Islamic thought, rulings of Islamic Fiqh academies, and opinions of Shari'a supervisory boards at Islamic financial institutions.<sup>96</sup>

The arbitration panel may also refer the draft ruling to the Shari'a board of the IICRA for review and may introduce amendments in form on the ruling. It may also draw the attention of the arbitration panel to substantive issues related to Islamic Shari'a.<sup>97</sup>

While this center is one of the supporting infrastructure organizations for the Islamic finance industry in the world and claims to be the only accredited body for obtaining Shari'a compliant provisions by the Islamic finance industry, the IICRA does not have any published record for their case load. The only reference I could find on the use of this Center and its rules was in its semi-annual publication of January 2012 where it referred to an obvious increase in the number of Islamic finance cases submitted to the center.<sup>98</sup> Not knowing the center's caseload size and the parties involved in the disputes, it is difficult to assess the effectiveness of these rules; in fact, we could trace not a single case to this center from external resources. This could mean that most cases handled by this center are either local or insignificant.

### 3. Conventional Arbitration Rules

At the domestic level, where arbitration is becoming standard practice, many local Islamic finance contracts include standard arbitration clauses,<sup>99</sup> and most disputes are resolved in the local chambers of

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95. Article 12 of the IICRA Chart.

96. Article 28 of the IICRA Arbitration and Reconciliation Procedures.

97. Article 37 of the IICRA Arbitration and Reconciliation Procedures.

98. "TAHKEEM" an IICRA semi-annual publication of January 2012, issue No. 7.

99. This model is from a contract by Al Baraka Bank of Sudan. "In the case of a dispute over the interpretation of different clauses in the contract, the matter is referred to a three-member arbitration committee. Each party to the contract nominates one committee representative and both parties have to agree on a third arbitrator who becomes the chairman of the committee. The arbitration committee resolves the dispute in accordance with the injunctions of Islamic Shari'a."

commerce. Internationally, all established ADR institutes around the world settle financial disputes, regardless of whether they are conventional or Islamic; these institutes use their own rules and procedures that are typically modern and closely modeled after the UNCITRAL which provides parties with a great deal of freedom in choosing their arbitrators and customizing the governing clause in the way they believe is most suitable for their dispute. Nonetheless, the well-known institutes in the Middle East region (DAIC, BCDR-AAA, CRCICA, DIFC-LCIA, QICCA) and KRCLA in the South East Asia region are considered better suited for the industry because they are located within the geographic jurisdictions of the industry and they are more familiar with local laws which helps for better enforcement, and they are better staffed with legal scholars that are well experienced in the fields of Shari'a and Islamic finance.

It is believed that these characteristics provide these centers with leverage to arbitrate Islamic finance disputes and should provide better functionality for Shari'a principles in the governing law clause.<sup>100</sup> Many Islamic finance agreements concluded within the Middle East region continue to provide for Shari'a adherence in the governing clause; however, these principles have recently been better specified by associating them to particular standards or Islamic affiliation; for example, an agreement between National Bonds Corporation PJSC, Taaleem PJSC and Deyaar Development PJSC<sup>101</sup> contained this governing clause:

This Agreement is governed by the laws of Dubai, UAE to the extent these laws are not inconsistent with the principles of Shari'a (as set out in the Shari'a Standards published by the Accounting and Auditing Organization of Islamic Financial Institutions and/or Islamic Fiqh Academy of Organization of Islamic Conference), in which case the principles of Shari'a will prevail.

This practice definitely facilitates the arbitrators and judges tasked in determining the relevant rules of Shari'a and provides better certainty on issues related to application of Shari'a. The AAOIFI, which continues to promulgate standards in Shari'a rulings to guide the growing industry,

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100. These jurisdictions are more likely to stipulate "the arbitration is governed under a national law subject to the principles of the Shari'a" as a statement of intent and binding choice of law.

101. See DIFC judgment, CA 001/2011 National Bonds Corporation PJSC v (1) Taaleem PJSC and (2) Deyaar Development PJSC, Date of Issue: 22 January 2011, [http://difccourts.complinet.com/en/display/display\\_viewall.html?rbid=2725&element\\_id=3464](http://difccourts.complinet.com/en/display/display_viewall.html?rbid=2725&element_id=3464).

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has published a Shari'a Standard Ruling on Arbitration in July 2010, which helped to reassert the binding character of arbitration and the use of international conventional arbitration centers with non-Muslim arbitrators<sup>102</sup> for Islamic arbitrations. However, lack of international or even regional conventions for Islamic finance<sup>103</sup> means that these standards could be challenged by reluctant parties and may be rendered non-binding by some courts.

With the current specialized Islamic arbitration centers lacking recognition and track records, resorting to conventional arbitration rules in the region is probably the most often-used approach by Islamic finance parties for inter-State arbitrations; however, there is a lack of published arbitral opinions and a lack of official records<sup>104</sup> regarding the number of Islamic finance cases handled by these centers as well as other well-known centers in Europe and the US. This is understandable, given that first, the use of arbitration in the industry is a new trend and second, that the confidential character of the process makes the likelihood of a published opinion in arbitration minimal, unless an award is challenged in court.<sup>105</sup>

One thing is certain, however: the major arbitration centers in Qatar, Dubai and Bahrain, and their off-shore courts, are expanding their arbitration infrastructure and competing to attract Islamic finance arbitrations. The DIFC, for example, released an updated version of its 'Guide to Islamic Finance in or from the DIFC' in 2009.<sup>106</sup> The QICDRC in July, 2012, announced plans to expand its commercial court jurisdiction by resolving Islamic finance disputes through dispute

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102. AAOIFI Shari'a standard No. 32: Arbitration, "Parties can agree to settle a dispute by agreeing on a binding arbitration. The parties may select one or more arbitrators themselves, or they can delegate this to an individual or an institution. For instance, they may agree to delegate the American Arbitration Association to appoint an arbitrator from its panel of arbitrators, who understands and has experience in dealing with the kind of issues that are the subject matter of the controversy. It is preferable to have a Muslim arbitrator. Under necessity, you can appoint a non-Muslim. Whether Muslim or non-Muslim, arbitrators must judge and should not violate the principles and rules of the Shari'a." <http://www.aoifi.com/aoifi/Publications/KeyPublications/tabid/88/language/en-US/Default.aspx#Shari'a>.

103. See ISRA research Paper NO. 29/2011. "INTERNATIONAL CONVENTION FOR ISLAMIC FINANCE: TOWARDS STANDARDISATION," Hakimah Yaacob, Marjan Mohammad & Edib Smolo.

104. In reviewing these centers records, they do not itemize Islamic finance cases separately, CRCICA reported one Islamic finance case in its 2011 report.

105. On the contrary, agreements call for litigation before national courts, as in the *Dar v. Blom* and *Shamil Bank* cases, the likelihood of a published opinion (particularly at the appellate stage) is high.

106. See, <http://www.difc.ae/news/difc-authority-releases-updated-version-guide-islamic-finance>.

resolution mechanisms.<sup>107</sup> The BCDR-AAA in Bahrain has long been regarded the leader in championing Islamic finance needs and continually explores and responds to the dispute resolution needs of the business community; for instance, it proposes to build a world-class Islamic dispute resolution center<sup>108</sup> specifically for the industry.

#### IV. A PROSPECTIVE ON ISLAMIC FINANCE

The Shamil case and the issue of Shari'a compliance have provided rich material for much scholarly research and expert commentary over the last decade or so. Many ideas and proposals have been debated regarding including Shari'a Law in the governing clause of Islamic finance contracts; this is particularly so when the contracting parties would like to subject the dispute to its principles. Some scholars have considered ways to accommodate the combined law formula in western systems as proposed by the Paris Europlace Commission on Islamic Finance (PECIF)<sup>109</sup> where the PECIF was tasked with reflecting on means of receiving Islamic finance in France.

The PECIF's efforts have led to a series of tax reliefs and legislative measures in France aimed at making the Paris financial market more attractive to Islamic capital. Additionally, many Muslim scholars have advocated for Islamic solutions by the establishment of specialized Islamic tribunals and a universal Shari'a board that encompasses all Islamic affiliations. There have also been requests to establish an international convention for Islamic finance that provides a model legal framework for the adoption of Islamic finance in participating States.<sup>110</sup>

In the midst of this debate, the Industry has been performing a balancing act. On one hand, it has needed to retain its authenticity as a Shari'a-compliant industry by adhering to Islamic law; on the other, if the industry is to be successful, it must promote its business model so that it can compete with the conventional industry by providing working and competitive models that meet all market needs. This task was best

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107. QICDRC Chief Executive Officer Robert Musgrove said: "We are currently looking at the possibility of resolving Islamic finance disputes by setting up dispute resolution mechanism." <http://www.thepeninsulaqatar.com/qatar/199730-qatar-international-court-plans-expansion.html>.

108. See, "Bahrain Champions Islamic Finance, BCDR-AAA CEO says" 20/03/2013, <http://www.bna.bh/portal/en/news/552353>.

109. "Proposal – Group on Governing Law and Dispute Resolution in Islamic Finance," G. Affaki (Ed.), I. Fadlallah, D. Hascher, A. Pézard, F-X. Train, 21 September 2009, to be published.

110. See ISRA research Paper NO. 29/2011. "INTERNATIONAL CONVENTION FOR ISLAMIC FINANCE: TOWARDS STANDARDISATION," Hakimah Yaacob, Marjan Mohammad & Edib Smolo. P. 36-37.

described by El Waleed M. Ahmed, a legal consultant in Kuwait when he compared Islamic finance to conventional finance:

Conventional finance bows to one master, 'profit'. Islamic finance however, has two masters, 'profit' as well as 'Shari'a principles'. Obedience to two masters is no easy task.<sup>111</sup>

Partly as a result of attempting to please two masters, the industry continues to face unique challenges in terms of compliance with Islamic law regarding various aspects of its business, particularly in the domain of dispute resolution.<sup>112</sup> Legal experts dealing with dispute resolutions in the industry summarize these obstacles as follows:

- 1) There is no comprehensive regulatory or supervisory framework for the industry.
- 2) There is no universal Shari'a board that encompasses all Islamic affiliations.
- 3) There is no international convention or treaty for Islamic finance that harmonizes its legal framework amongst Member States.
- 4) Shari'a supervisory boards of different institutes may have mixed opinions in interpreting Shari'a compliance issues which results in varied rulings.
- 5) There is no authoritative and specialist Islamic finance ADR institution.
- 6) There is lack of harmonization of Shari'a interpretations with other legal regimes such as the common and Civil Law will play an extremely important role in this regard.
- 7) Inadequate universal standardization and codification of Shari'a Law that could be easily applied to govern Islamic financial dealing internationally.
- 8) There is lack of local legal expertise in both Islamic and conventional finance.

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111. See article, "Challenges facing sector's growth; Global Islamic finance," By: El Waleed M. Ahmed, Legal Consultant, Foreign Affair Department, Kuwaiti Lawyer Law Firm, Al-Jabria – Kuwait, <http://www.sudaneseconomist.com/?p=270>.

112. Other challenges facing the industry in terms of compliance with Islamic law have been internationally recognized in relation to capital adequacy, risk management, corporate governance, transparency and disclosure.

While the Industry has worked hard over the past decade to tackle these challenges, which in some cases have stirred controversy,<sup>113</sup> it is inconceivable that the Industry, with its Shari'a advisors, can bridge all the rifts among Islamic Fiqh schools and meet the fundamental test of representativeness, both from a doctrinal as well as geographical standpoint; therefore, the debate over ethics and Shari'a compliance in Islamic finance will likely continue. On one side of the debate, for example, stands Dr. Al Gamal<sup>114</sup> mocking the Industry for thriving on incoherent pietism when he states,

Vying for countless billions of Arab petrodollars, unexpected champions of "Islamic finance" have emerged in unlikely places. Most recently, the growing list has included Gordon Brown, the UK's Chancellor of the Exchequer, and officers of the Monetary Authority of Singapore.<sup>115</sup>

On the other side, Kilian Bälz<sup>116</sup> speaking at Harvard Law School, in May 2008, contends that Islamic finance should not be viewed in the context of "Islamization of the law," but as part of a revival of Islamic religious ethics in international business<sup>117</sup> where Shari'a principles in Islamic finance are applied as ethical principles and not as legal principles. Bälz also contends that Islamic finance does not mean to

113. Although Sukuk represent Shari'a compliant alternatives to traditional bonds, they are widely regarded as controversial due to their perceived purpose of evading the restrictions on Riba. Conservative scholars do not believe that this is effective, citing the fact that a Sukuk effectively requires payment for the time-value of money and offer investors fixed return on their investments which is also similar in appearance to interest. <http://www.financialislam.com/controversy.html>.

114. Mahmoud El-Gamal is chair of Islamic economics, finance and management at Rice University, Houston. He served as scholar-in-residence on Islamic finance at the US Department of Treasury in 2004. His book "Islamic Finance: Law, Economics and Practice" published by Cambridge University Press.

115. See, Opinion: Mahmoud El-Gamal: Incoherent pietism and Shari'a arbitrage, By Mahmoud El-Gamal, Published: May 23 2007, Dr. Al Gamal lists The primary beneficiaries of Islamic finance as first, international law firms with rising interest in an exotic legal system. The second set of beneficiaries has been the premier multinational banks, who have driven Islamic financial innovation (re-engineering is a more apt description) in both investment and retail banking. The third set of beneficiaries has been self-styled religious "scholars" and "experts," who are retained as consultants to certify the Islamicity of re-engineered financial products. <http://www.ft.com/cms/s/1/01ccc914-0553-11dc-b151-000b5df10621.html#axzz2PzmPFtDe>.

116. A well-known scholar of Islamic finance and banking, he is a partner of Amereller Legal Consultants, a specialist law firm focusing on the MENA region, with offices in Cairo, Damascus, Dubai, Baghdad, and Erbil, in addition to Munich and Berlin.

117. See, "Shari'a Risk? How Islamic Finance Has Transformed Islamic Contract Law," by Kilian Bälz, the paper is based on a public lecture delivered at the Islamic Legal Studies Program of Harvard Law School on May, 2008. He notes that Islamic finance "thrives in jurisdictions where law and religion are separated (such as Dubai, London, Kuala Lumpur), whereas in those jurisdictions that pledge to abide by Islamic legal principles (such as Saudi Arabia, Sudan, Iran, Pakistan), Islamic finance did not really take off." <http://www.law.harvard.edu/programs/ilsp/publications/balz.pdf>.



apply Islamic law; it only employs Islamic law exclusively to ascertain the permissibility of a certain transaction: the decisive question is whether the transaction is “halal;” i.e., “permissible” (as opposed to “haram” or “prohibited”).<sup>118</sup>

Through all these debates and challenges, the industry has continued growing and evolving in services to respond to the rapidly changing regulatory requirements and operating environment brought about by globalization and competition. The industry, particularly after the introduction of Islamic Sukuk, has become increasingly more internationalized to the point where it is not catering for Muslims only, and it is attracting customers of other faiths and other jurisdictions across the world,<sup>119</sup> a phenomenon currently observed in many States. This globalization has necessitated some sort of harmonization and integration between the industry and the international conventional financial system<sup>120</sup> at large. Globalization has introduced a new element into the Shari'a compliance debate; an element that is more concerned with profitability, which attracts big businesses, than with the Shari'a compliance sought by the devout Muslims for which the industry was originally designed. With the lure of profit being such a motivating factor, it is no wonder that many industry experts have recommended recasting the industry's “brand;” one suggested name could be “Participation Banking” (used in secular Turkey). The hope is that rebranding would enhance the industry's international appeal—particularly in non-Muslim jurisdictions where the industry will retain the essence of Islamic finance models, “participatory and risk-sharing partnership.” The less than explicit motive here is that a more secular nomenclature could remove the controversies that arise with respect to the industry's close association with religion.<sup>121</sup>

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118. Ibid.

119. See report “The Globalization of Islamic Finance: Connecting the GCC with Asia and Beyond” 2012 by Standard & Poor financial services LLC.

120. For example, The International Islamic Financial Market (IIFM) and the International Swaps and Derivatives Association, Inc. (ISDA) today launched the ISDA/IIFM Tahawwut (Hedging) Master Agreement on March 2010. <http://www.isda.org/media/press/2010/press030110.html>.

121. See article, “Ramadan wish list for Islamic finance” JULY 17, 2012, by Rushdi Siddiqui, who is the global head of Islamic finance at Thomson Reuters. Siddiqui believes that rebranding will take away:

- PROMOTING (one religion over another) religion argument;
- REBUTS BACKDOOR “Islamization” argument;
- ERODES its only-for-Muslim argument; and
- REMOVES it from the political talking points (and fund raising) for those who want to divide.

## V. THE FUTURE OF ARBITRATION IN ISLAMIC FINANCE

With regard to dispute resolution in Islamic finance, the industry has long encouraged the move toward arbitration of its disputes in lieu of litigation. Furthermore, the regional ADR institutes have geared up to receive an influx of Islamic finance cases that are slowly becoming the trend amongst Islamic finance parties. This trend is likely to be solidified after the publication of the PRIME Finance Arbitration Rules,<sup>122</sup> making arbitration more attractive for dispute resolution in the conventional international finance industry, and particularly for cases with high monetary value. These rules have been inspired by the 2010 UNCITRAL Arbitration Rules and customized to accommodate the needs of world financial markets,<sup>123</sup> which could include the Islamic finance market. In view of the fact that the Permanent Court of Arbitration (PCA) has authorized the conduct of PRIME arbitral hearings at the Peace Palace, The Hague and the Law of Holland are recommended as logical choices for the seat and the governing law of arbitration in PRIME arbitration clauses. PRIME Finance has also issued a number of model arbitration clauses for use with the International Swaps and Derivatives Association (ISDA) Master Agreements<sup>124</sup> which the Islamic finance industry has been part of since 2010. In retrospect, it is significant to keep in mind that Islamic financial transactions historically have been litigated under agreements governed by English or New York law mainly in line with the 1992 and 2002 ISDA Master Agreements for the conventional industry<sup>125</sup> which provided those options; however, in more recent

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122. PRIME Finance (Panel of Recognized International Market Experts In Finance), based in The Hague, has been established to assist judicial systems in the settlement of disputes on complex financial transactions, for a copy of the rule; <http://www.primefinancedisputes.org/images/pdf/arbitration%20rules%20-%20prime%20format%20-.pdf>.

123. The Rules provide for an arbitration institute to administer the arbitral proceedings, whereas UNCITRAL Rules have been written for ad hoc arbitration. The Secretary-General of the Permanent Court of Arbitration (“PCA”) in The Hague has accepted to serve as appointing authority, if so requested by a party. Article 6. Exclusively persons identified on the panel of experts will be eligible to be appointed as arbitrator, unless otherwise agreed by the parties. See article 8. Another distinctive feature of the P.R.I.M.E. Finance Rules is that awards may in principle be made public with the consent of all parties. Also, P.R.I.M.E. Finance may publish an award or an order in its entirety, in anonymised form, under the condition that no party objects to such publication within one month after receipt of the award. Article 34.

124. ISDA is a global trade association for over the counter derivatives, and maintainer of the industry-standard ISDA documentations, it is expected to release a number of model form arbitration clauses of its own later this year for use in conjunction with the Master Agreements. ISDA has previously indicated that arbitration under the PRIME Finance arbitration rules is one of the options under consideration, but has stressed that it is neutral as to the various arbitral institutions on offer. It is therefore expected that ISDA’s model clauses will cover a number of the major arbitral institutions and venues, including arbitration under the LCIA, ICC, HKIAC, SIAC and AAA/ICDR rules. See article by Nicholas Peacock and Dominic Kennelly, Herbert Smith Freehills LLP. <http://www.lexology.com/library/detail.aspx?g=7f3393d4-66f7-4adb-9ba0-98ab826f7a94>.

125. The 2002 ISDA MASTER AGREEMENT 13.(b) “Governing Law and Jurisdiction” provides:

developments at the international level, the ISDA and experts in the conventional industry are now advocating the use of arbitration in lieu of litigation in these venues as a more viable alternative.<sup>126</sup> The PRIME Arbitration Rule and the reference to arbitration in recent ISDA master agreements could be understood as reflections on a decade-long trend in the conventional finance industry of using arbitration versus litigation as a superior legal remedy to resolve legal financial disputes.<sup>127</sup> With the demanding need for integration with the international finance industry, this trend toward arbitration is sure to spread into Islamic finance, and particularly in the Sukuk market, which has the biggest international appeal and is subjected to the ISDA master agreement.

In the face of the current environment of globalization, and its continuous search for profitable opportunities in tandem with favorable regulatory developments at domestic and international levels, the industry is bound to exhibit more flexibility in meeting expectations of all its customers whether he is a devout Muslim in Egypt, a Hindu in India, or a mutual fund in Catholic Argentina. Islamic finance has evolved into a huge business; and Shari'a-compliant business should be defined as such. It is no longer catering to only the devout Muslim, who wants to conduct himself in accordance with his religion; it also promotes itself to anyone who believes in the ethics of the "profit and risk sharing business model," which is compliant with the Islamic Shari'a principles.

In that context, we may propose that the industry move away from the religious debates over issues of Shari'a compliance and its dispensing with the various Shari'a advisory boards that usually do more harm than

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(b) *Jurisdiction.* With respect to any suit, action or proceedings relating to any dispute arising

out of or in connection with this Agreement ("Proceedings"), each party irrevocably:

(i) submits: —

(1) if this Agreement is expressed to be governed by English law, to (A) the non-exclusive

jurisdiction of the English courts if the Proceedings do not involve a Convention Court and (B) the exclusive jurisdiction of the English courts if the Proceedings do involve a Convention Court; or

(2) if this Agreement is expressed to be governed by the laws of the State of New York, to the non-exclusive jurisdiction of the courts of the State of New York and the United States District Court located in the Borough of Manhattan in New York City;

126. See, "MEMORANDUM FOR MEMBERS OF THE INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC. on The use of arbitration under an ISDA Master Agreement, Dated: 19 January 201.

127. See article, "Why the Financial Service Industry's "Arbitration Boom" is Here to Stay," by Daniel A. Dufresne as featured in the July 2004 issue of *Independents Credit Operations* - a publication by the American Financial Services Association. <http://www.adrforum.com/rcontrol/documents/articlesbyforumstaff/200407dufresneico.pdf>.

good.<sup>128</sup> This could be done through developing and publishing clear and comprehensive industry standards rather than the incomplete and vague Shari'a standards that now exist. The industry standards could be based on profit and risk sharing as sanctioned by Shari'a Law, but do not have to meet the deliberate intricate scrutiny of every Islamic Fiqh school on Earth. The leading regulatory body in the industry, the AAOIFI, would be the logical institute for this task because it only has to accelerate and complete its standardization effort by employing this approach in its review process. From a dispute resolution prospective, doing so will be a big leap in the direction of easy settlement of disputes within the industry.

## VI. CONCLUSION

For its dispute resolutions, the recent Islamic finance boom, which is based on the wide international appeal for its Sukuk market, is influencing the industry to harmonize its practices with international standards. While Islamic finance has tested the application of Shari'a Law in modern legal systems over the past decade, the issue of Shari'a compliance in dispute resolution has proven to be problematic as local and foreign court jurisdictions are mostly conventional in nature. This problem is compounded by unpredictable court decisions, non-codification of Islamic Law and varying interpretations by Shari'a boards. During this period, this Islamic finance boom has coincided with various forces of globalization, which has led to harmonization of legal practices throughout the world, including the Middle East, particularly with regard to arbitration. This is evident in the new and draft Arbitration Laws, which are based on the UNCITRAL Model Law, that are being considered by many States of the Middle East.

In the case of Islamic finance, modern arbitration rules provide added features that make the process a natural resolution mechanism for its disputes; particularly for parties who are adamant about subjecting the dispute to principles of Shari'a by enabling these parties to customize the arbitration proceedings to their liking and by choosing skilled arbitrators that understand the industry and provide functionality to governing law with Shari'a reference if they choose to subject the agreement to its principles.

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128. Considering the various conflicting Shari'a rulings and the conflict of interest accusations that are rampant in the industry. See "Prominent Saudi scholar warns on agenda against Shari'a advisories," by: Mushtak Parker, ARAB NEWS, Sunday 16 January 2011, <http://www.arabnews.com/node/365617>.

Globalization has introduced a new element into the Shari'a compliance business of Islamic finance; an element that is more concerned with profitability than the Shari'a compliance aspect of the transaction. Parties who fall under this category would likely prefer conventional arbitration rules to resolve their disputes in line with the current trend in the international finance industry which was characterized by publication of the PRIME finance arbitration rules and the use of arbitration under an ISDA Master Agreement.

In order to build a viable hub for dispute resolution in Islamic banking and finance, it is important to keep the interests of the disputing parties in mind. Whether these parties choose litigation or Islamic arbitration, where the governing clause has a reference to Shari'a or conventional arbitration, with no reference to Shari'a, the off-shore jurisdictions of Bahrain (BCDR-AAA), Dubai (DIFC-LCIA), and Qatar (QICDRC) with their respective dispute resolution centers and Common Law court systems, are in the best position to serve parties of this industry. In addition to these jurisdiction central location, many international law firms have opened offices in the region<sup>129</sup> and have started to build up Islamic finance expertise across core practice areas of banking, project development and finance, capital markets, restructuring, mergers and acquisitions and investment funds. These law firms have developed extensive Islamic finance experience drafting contracts and providing consultations to governments, banks, sponsors, export credit agencies and investment funds on Shari'a compliant transactions in the Middle East, Europe, US and Asia.

On a final note, if it provides clear and comprehensive industry standards, rather than the incomplete and vague Shari'a standards that exist now, the Industry can provide exceptional assistance in terms of quick and cost effective dispute resolutions. With respect to the aforementioned jurisdictions, which offer excellent international

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129. For example, mirroring the view of the UAE as a regional hub, and despite the general perception that Dubai (and, to a lesser extent, Abu Dhabi) is a saturated legal market, new entrants continue to establish a presence in order to support or exploit new opportunities. For example, Bird & Bird LLP opened its Abu Dhabi office in 2011. Cleary Gottlieb Steen & Hamilton LLP, which has been active in the market for some time, opened an Abu Dhabi office in 2012 and installed partner Gamal Abouali and associate Chris Macbeth to handle a broad range of corporate work. Addleshaw Goddard (Middle East) LLP also opened an office in Dubai in 2012, recruiting Andrew Greaves from Trowers & Hamlin to head up the office.

In another noteworthy move, Natalie Boyd joined K&L Gates from Simmons & Simmons Middle East LLP. Of the established international firms, Allen & Overy LLP, Clifford Chance and Clyde & Co LLP have the longest track record in the region and enjoy reputations for top-quality work. Key local firms include Al Tamimi & Company, which has benefited from its expansion into the broader GCC region, as well as Hadeef & Partners and Habib Al Mulla & Company. <http://www.legal500.com/c/united-arab-emirates>.

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expertise and legal infrastructure, it would be beneficial if the Industry adopted a version of the PRIME finance arbitration rules to fit the unique features of Islamic finance where the arbitration seat could be in one of those jurisdictions.