

## Islamic Law and Modern Guarantees in Malaysia

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### ABSTRACT

The guarantee is regarded as the most common instrument used in the business of commercial banks. Being simplest and least expensive, it is regarded as the most acceptable form of security in the banking lending transactions. However, due to the ‘unfettered discretion’ that the law gives to the creditor banker upon defaults, the reception of the instrument has decreased. This paper seeks to discuss the above issue in the light of Islamic legal point *vis-à-vis* the current position of Malaysian law of guarantee. The paper suggests that amendments should be made to the existing laws and this could be made through the process of harmonization of Islamic and Malaysian laws.

**Keywords:** Guarantees, Classical Interpretation, Contracts aCt 1950, Islamic law, Harmonization of laws.

### INTRODUCTION

Commercial banks as financial intermediaries are the mobilizer of funds from those with surplus to those who is lacking. These banks receive funds as deposits from customers or capitals from shareholders and lend these out as loans and advances to persons and business units who need them. This practice has become

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common in the business of banking and is regarded as one of its highest priorities.

As this practice become 'bread and butter' of the banks, it is of critical and paramount importance that the banks exercise prudence and care in the business. The bank is facing the risk of loss if due diligence has not been taken; credits extended may not be returned to its account. Thus, a precautionary step should be taken to avoid the risk; and the acceptance of the guarantees in the banking lending transactions may serve the above purpose.

### **THE GUARANTEES AND ITS ROLE IN MODERN ECONOMIC DEVELOPMENT**

Modern laws define guarantees as a promise to answer the debt, default or miscarriage of another.<sup>1</sup> In relation to this, Jordan CJ in *Jowitt v Callaghan* (1938) 38 SR (NSW) 512 said;

*The contract of guarantee or suretyship is a contract between two persons which is intended by them to secure the performance of the obligation of a third person to one of them. The existence, present or future, of the obligation of a third person, and an intention in the parties to the contract to secure the performance of that obligation, are essential features of a contract of guarantee. If these elements are present, the contract is one of guarantee whether the promise be collateral to the promise of a principal obligor and in the nature of a distinct and separate promise to perform the principal obligation if it does not:*

<sup>1</sup> See, for further reference, section 4 of the Statute of Frauds 1677; In Fell's Treatise on the Law of Mercantile Guaranties and of Principal and Surety in General, a 'contract of guarantee' is defined as a promise to answer for the payment of some debt, or the performance of some duty, in case of the failure of another person, who is, in first instance, liable to such payment or performance; In De Colyar on Guarantees, a 'contract of guarantee' is defined as a collateral engagement to answer for the debt, default or miscarriage of another person; In Smith's Mercantile Law, a 'contract of guarantee' is defined as a promise to answer for the payment of some debt, or the performance of some duty, in case of the failure of another person, who is himself, in the first instance, liable to such payment or performance. See *Re Conley* [1938] All ER 127 at pp. 130-1. These common law definitions on the guarantee have been adapted to be the law of Malaysia. In the Malaysian Contract Act 1950 (Act 136) section 79 provides, a 'contract of guarantee' is a contract to perform the promise, or discharge the liability, of a third person in case of his default. The person who gives the guarantee is called the 'surety'; the person in respect of which default the guarantee is given is called the 'principal debtor', and the person to whom the guarantee is given is called the 'creditor'.

*Inland Revenue Commissioners v Holder [1931] 2 KB 81 at 101-102; Elder v Northcott [1930] 2 Ch 422 at 430; or whether it be a joint promise with the principal obligor by virtue of which an immediate obligation is assumed to the obligee which is joint with that of the principal obligor: Permanent Trustee Co. of New South Wales Ltd. v Hinks (1934) 34 SR (NSW) 130.*

The guarantee has also been described as a contractual obligation undertaken by one person (known variously as the ‘guarantor’ or the ‘surety’) in which he promises that a second person (known as the ‘principal’) shall perform a contract or fulfill some other obligations and that if the principal does not, the surety will do it for the principal (McGuinness 1986; Lord Reid in *Moschi v Lep Air Services Ltd.* [1972] 2 All ER 393 at 398).<sup>2</sup> Therefore, one could suggest that the guarantee is a promise to ensure the creditor that obligations owe to him will be satisfied. At this point, if the principal does not perform, the guarantor will do it for the principal. Thus, the guarantee presupposes a valid principal obligation in which case if the promise is not collateral to this principal obligation, the arrangement shall not be regarded as a guarantee. In practice, the question as to whether a particular promise is a guarantee or otherwise is left to the court to determine. At this point, the court will construe the promise in the light of the words and circumstances of the agreement.<sup>3</sup>

In the banking lending transaction, the guarantee contributes a significant role in the economic development of a nation. A vast amount of credit has been successfully extended to capital users through the strength of the guarantee. Credit, which will be used as working capital, investment and business enterprise, not only generate profits but also contribute to the economic development of a nation. Here, the guarantee forms a useful instrument to secure the loans offered to its

<sup>2</sup> It is submitted that this approach to the guarantee needs an in-depth analysis since it is almost impossible for the guarantor to compel the principal debtor to perform, unless the guarantor has an actual control over the conduct of the principal debtor.

<sup>3</sup> See, for example, *Merit Properties Sdn Bhd v Aktif Lifestyle Stores Sdn Bhd & Anor* [2007] 5 MLJ 28. In *Golden Vale Golf Range & Country Club Sdn Bhd v Hong Huat Enterprises Sdn Bhd (Airport Auto Centre Sdn Bhd & Anor as Third Parties)* [2005] 5 MLJ 64, Low Hop Bing J states that in the construction of contracts, the court is not bound by the labels that parties choose to affix onto the particular document, and that the clear duty of the court is ‘to construe the document as a whole and to determine from its language and any other admissible evidence its true nature and purport’.

customers. The readiness of a guarantor to undertake the liability of a principal debtor could save the creditor banker from suffering loss. In this context, the guarantee as personal security stands as an alternative recourse to the debts advanced to the customers. McGuinness (1986, p.2) said;

*[I]n most cases obligations of this sort are meant to provide the person for whose benefit they are intended with a secondary source of performance. If a person guarantees the debt of another, in most cases the creditor to whom that guarantee is given will still look to that other for payment. It is only when the principal debtor defaults that the creditor will normally look to the guarantor for performance. Thus a guarantee is usually a form of performance security. However, unlike other forms of security such as mortgages, guarantees provide security by providing the creditor with an alternate source of performance, rather than with a specific property to which resort may be made to obtain compensation in the event that there is a default.*

The guarantee is not only considered as economical and efficient but also simple in terms of both its execution and enforcement. As Abdul Latiff (1988, p.37) remarks;

*[The] guarantee is a good security document because it can be realized by making a simple demand on the guarantor provided care has been taken when executing the document to maintain its validity.*

On the part of the capital users, a legal recognition to the scheme is more than welcomed; it helps capital users to obtain loans from financial institutions. Since the guarantee involves no asset from the capital users the practice is common in banking lending transactions. People like those who are involved in the Small and Medium Enterprises (SME's) find it a very useful instrument especially when their credit history has yet to be established.

The importance of the guarantee would be more appreciated when the value of the asset, which was at first created as collateral, begins to depreciate. At this point, the guarantee, which was created as a 'double protection', acts as a 'contingent' instrument to rescue the creditor banker against a possible irrecoverable debt. When there are two collaterals provided, the creditor banker has the choice

to enforce the one s/he desires. Siti Norma Yaakob J in *Kwong Yik Finance Bhd v Mutual Endeavour Sdn. Bhd* [1989] 1 MLJ 135 said;

*The plaintiff [i.e. the creditor banker] has the option to exercise which of two securities it wishes to enforce. It may even enforce both securities, as is done in this case, if it found that one security is insufficient to settle the debt and it was to meet this eventuality that the plaintiff had in its wisdom insisted upon two forms of security, the charge as well as the guarantee.*

Such high value of the guarantee has made it significant in the transaction of loans. The importance of the guarantee is apparent when it accords with a commitment to the success of a business. An example of this is when the guarantee is taken from directors of private companies. Jaginder Singh *et al.* (1980, p.145) confirmed;

*Banks often like to obtain a personal guarantee from directors of private companies, even though substantial collateral for the indebtedness has been obtained, to commit them to the success of the enterprise.*

In this instance the guarantors not only have a direct interest but their advantage of a limited liability has also been reduced through the production of the guarantee. Therefore, under the guarantee, the guarantors will put their full commitment to the success of the business of the companies and thus contributing to the nation's economic development.

On another point, the guarantee also accords with moral obligation on the part of a guarantor to 'advise' the principal debtor to commit to the success of a business. It is the cardinal principle of the law of the guarantee that if the principal debtor fails to perform, the guarantor has to bear the burden of the principal debtor. Thus, it is desirable for the guarantor to commit himself and advise the principal debtor to perform well in the business so that the debt could be recovered from the profit of the business.

In modern interpretation the failure of the principal debtor could mean the failure of the guarantor to perform his promise. Lord Reid in *Moschi v Lep Air Services* [1973] AC 331 stated;

*A person might undertake no more than that if the principal debtor fails to pay any installment he will pay it. That will be a conditional agreement. There would be no prestable obligation unless and until the debtor failed to pay ... On the other hand, the guarantor's obligation might of different kind. He might undertake that the principal debtor will carry out his contract. Then if at any time and for any reason the principal debtor acts or fails to act as required by his contract, he not only breaks his own contract but also puts the guarantor in breach of his contract of guarantee. Then the creditor can sue the guarantor, not for the unpaid installment but for damages.*

Hence, it is construed that under the contract of the guarantee a guarantor is held responsible for the conduct of a principal debtor. Therefore, he is bound to observe the conduct of the principal debtor so as to ensure that the principal debtor will perform his promise.

In short, the combination of the above functions of the modern contract of the guarantee reveals that the guarantee has an important role in the economic development. Such an important role of the guarantee has been well recognized in the business of the Islamic banking. Thus, a similar devise has also been adopted to realize its banking businesses.

## **GUARANTEES UNDER THE ISLAMIC LAW**

In Islam guarantees is not a new devise of law. In fact, it has been practiced among the Arabs even before the advent of the new religion. However, when Islam was established in Arabia, the ancient concept of the guarantee was refashioned to suit the will of the Islamic Shari'a. In relation to this, rules that govern the guarantees were also modified and developed to accommodate basic requirements of the Islamic Shari'a.

The scheme of the guarantees was called *al-kafala*. The rules of *al-kafala*, which was developed upon the principles of Islamic Shari'a, was constructed through the use of the method of interpretation during the classical period.

### **Guarantees in the Qur'an and the Sunnah**

There are several provisions, which deal with the guarantees in the Qur'an and the Sunnah. In surah Yusuf, for example, the Qur'an reads, 'They said: "We have

missed the (golden) bowl of the king and for him who produces it is (the reward of) a camel load; I will be bound [*zaim*] for it' (The Qur'an, 12:72). According to al-Tabari ([n.d], p.20), the word '*zaim*' implies the meaning of a guarantor, which is *kafil* in the Arabic term. On another occasion we found the Qur'an reads, 'He (Jacob) said: I will not send him with you until you swear a solemn oath to me in Allah's Name, that you will bring him back to me unless you are yourselves surrounded (by enemies, etc.)' (The Qur'an, 12:66). According to al-Qurtubi ([n.d], p.231) although the verse neither mentions the word *kafalah* nor *zaim*, it implies the meaning of the guarantees. In this case Jacob had asked for the guarantees as security for the performance of a promise made by Joseph's brethren to bring Benjamin back to him.

In the Sunnah it was reported that the Prophet has been brought with a dead man to be offered a funeral prayer. When the body was brought in, the Prophet said, 'Did he has any debt?' The people replied, 'Yes two Dinars'. Then the Prophet said, 'Offer yourselves the special funeral prayer to your friend'. Abu Qatadah stood up and said, 'O the Messenger of Allah I take the responsibility [of suretyship] for the payment of the two Dinars'. The prophet then offered a special funeral prayer for the dead man (Sahih al-Bukhari, [n.d] vol. 3, p.276).

### Classical Interpretations on the Guarantees

Classical interpretation on the guarantees was made upon two main bases, i.e. first, historical development of the guarantee; and second, basic requirements of the Islamic Shari'a. When the two are combined we will find a hybrid of law which suggests that the guarantee should also emphasize on moral obligation. Thus, instead of being a device to secure the performance of future obligation, the guarantee was also meant to help others.

Therefore, if a reference is being made to the classical manuals, one would find that the guarantee has been classified as a gratuitous contract. The aim of the guarantee was to provide assistance to the people who are in need. In the context

<sup>4</sup> In the Qur'an, [5:2] Allah enjoins the Muslims to help each other for good things. This has been regarded a general order (rule of the Islamic Shari'a) that has been put upon the Muslims to extend their assistance to others.

of creditor-debtor relationship, the guarantee will provide assistance to a prospect debtor in obtaining loan from the creditor. The presence of a guarantor is important, and his willingness to help others is absolutely encouraged in Islam.<sup>4</sup> In connection to this the Prophet said;

*Whoever relieves a believer from a difficulty in this world, Allah will relieve him from his difficulty and Allah will facilitate him in this world and the world hereafter (Hadith Muslim).*

According to al-Zuhaili (1985, p. 131), the assistance that has been extended by the guarantor is regarded as a good deed and subservience to God and therefore he shall be rewarded in the hereafter. It is upon this notion that classical guarantee was interpreted to be one of the devices for helping others. Thus, similar to gift *inter-vivos*, the aim of the classical guarantee was to provide assistance to the people who are in need. At this point, the guarantee has been interpreted on the basis of *ta'awun*, i.e., mutual assistance and the legal consequence of such an interpretation would be that the guarantee will be regarded as a gratuitous contract; a contract that requires no consideration.

### **Some Intriguing Features of Classical Guarantees**

As mentioned above, one of the distinct features of classical guarantee is that it was considered as one of gratuitous contracts.<sup>5</sup> A legal explanation for this is that the instrument has been constructed upon the concept of *ta'awun*, i.e., mutual assistance. One of the effects of such interpretation is that a guarantor will not be allowed to ask for, neither from the creditor nor the principal debtor, any pecuniary payment in return for his undertaking. At this point, al-Hattab ([n.d], p.112), one of the Malikis jurists pointed that the asking for the reward is not permissible.

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<sup>5</sup> A gratuitous contract is a contract whereby one person enters into an arrangement unilaterally for no rewards. The basic characteristic of such arrangement is that only the person who undertakes the obligation will be bound. As such the Islamic law has stipulated that the person should be capable enough (*ahliyya al-tabarru'*) to fulfill his obligation as the whole transaction is relied on him. A further consequence of the gratuitous contract is that the element of consideration is not a motive. In other words, as far as the Islamic law is concerned the contract would be valid even though there is lack of consideration on the part of the acceptor.



Further, due to the gratuitousness of the instrument, the guarantee also requires no consideration to conclude a valid contract.

The classical guarantee is also distinct in the sense that it necessitates no acceptance to conclude a valid contract. The Malikis, Hanbalis and Shafi'is suggested that a mere offer on the part of a guarantor suffices to render the guarantee valid and enforceable (al-Musi [n.d], p.331; al-Dayyib [n.d], p.96; al-Zuhaili 1985, vol.5, p.134; al-Salus 1987, p.69; 'Amer [n.d], p.185-6). These classical jurists maintained that due to the gratuitous nature of the guarantee, i.e. to help others and not to gain benefits, consent and acceptance are not essential (al-Ramli [n.d] vol.4, p.438). Thus, the arrangement is valid even it was made without the knowledge of either the principal debtor or the creditor.

Another distinctive feature of the classical guarantee could be referred to its definition. At this point, the classical jurists provide different definitions of the guarantee. The Hanafis, for example, defined the guarantee as the amalgamation of one obligation or *dhimma* into another *in respect of demand* (Ibn al-Humam [n.d] vol.5, p.389; al-Kasani [n.d] vol.6, p.2; Ibn al-'Abidin [n.d] vol.4, p.260). The Malikis, Shafi'is and Hanbalis, however, defined the guarantee as the amalgamation of one obligation or *dhimma* into another *in respect of debt* (Ibn al-Qudamah [n.d] vol.4, p.534; al-Shirbini [n.d] vol.2, p.192).<sup>6</sup> These two definitions of the guarantee have given us with different outlooks on the effect of the guarantee. Hence, according to the Hanafis the right of a creditor to sue the guarantor does not arise unless and until a proper demand has been made upon the guarantor. This is because 'demand' is the essence of the instrument. Therefore, a proper demand has to be made in order to claim his right over the guarantor. The Malikis, Shafi'is and Hanbalis however have a different view. The three schools of thought did not see demand as an essential element to establish the right of the creditor. Therefore, the right to claim can arise even a proper demand has not been made.

<sup>6</sup> Note that the only difference between these schools of thought and the Hanafis is the objective of the arrangement. In this regard, the three schools of thought held that the objective of the arrangement is the debt itself while the Hanafis held that the objective of the arrangement is the accommodation of necessary protective measurement i.e. be ready for the creditor. This different doctrine of the Islamic guarantee arrangement has given rise to a great implication in respect of right to claim on the part of the creditor as well as the commencement of the guarantor's liability.

Another issue, which worth for discussion is ‘the process of amalgamation’ of two obligations; one is the guarantor’s and second is the principal debtor’s. Indeed, the process of amalgamation has created a right upon the creditor to claim his debts from the guarantor. The process however does not mean that the obligation of the principal debtor will be relinquished but rather to reinforce the right of the creditor in respect of his credit. At this point, it is submitted that under the classical guarantee the principal debtor has not been freed; his obligation is not being relinquished and he is still rendered liable to his own debts.

This legal interpretation is different if a reference is being made to the Zahiris and some of the Shi’as (Ibn Hazm, [n.d] vol.8, p.111; al-Hilli [n.d] vol.1, p.142). According to the Zahiris, the guarantor will be primarily liable for the debts; and therefore the creditor will have the right to call upon the guarantor regardless of the above issue of demand. This view has been made upon the fact that according to the Zahiris the guarantee is essentially the ‘transfer’ of the principal debtor’s obligation to the guarantor’s obligation (Ibn Hazm, [n.d] vol.8, p.111). Thus, once the guarantor undertakes the guarantee, he is supposed to be liable primarily, as the liability of the principal debtor will be relinquished. With regard to this, Ibn Hazm ([n.d] vol.8, p.527) said;

*This view has been held by all of our companions including Ibn Abi Layla, Ibn Shibrimah, Abu Thawr and Abu Sulayman. All of us agreed that the obligation of the principal debtor would be totally relinquished and that the creditor has no right to claim from the principal debtor. Instead, the guarantor would be liable for what he has undertaken.*

However, it should be noted that this principle applies only in cases where the guarantor voluntarily assumes the obligation of the principal debtor. Thus, if the guarantor were required to assume such obligation either from the principal debtor or the creditor, a different principle applies (‘Amer [n.d] p.178). At this point, the principles that govern the Islamic guarantee might be the same as the four Sunni schools.

## GUARANTEES UNDER THE MALAYSIAN LEGAL FRAMEWORK

The legal system of Malaysia is based upon the English common law. However, before the arrival of the British in 1826, classical Islamic law was one of the main legal sources of the country. Islam had arrived in Malaysia by around 1303. Since then the teachings of Islam have been translated into the local people, and classical Islamic law has come to be in force in the region. At this point, classical Islamic law has been accepted through the process of the validation of some established local rules and the imposition of the Shafi'i's classical precepts (*fiqh*) (Hooker 1988, pp. 8-9). Accordingly, classical Islamic law developed and the climax of which was the codification of the law in the Malacca Empire (Hooker 1970, pp. 71-90; Ibrahim 1987, pp. 47-52).

Nevertheless, with the introduction of the English common law, this development was stunted and some of the principles have been abandoned. It is observed that while introducing the English common law, judges have always endeavoured to restrict the application of the classical Islamic law. In *Baker Ali Khan v Anjuman Ara Begum* (1903) 30 I.A. 94 at 111-112, for example, there was a great concern among the judges with regard to the application of the classical Islamic law in the region. Hence, the influence of the classical Islamic was reduced and a vast portion of the precepts have been abandoned.

### Legal Issues on the Guarantees in Malaysia

In Malaysia, the main law governing the guarantees is the Contract Act 1950 (Revised 1974). In the Act, there are about 22 sections that deal directly with guarantees. These sections are outlined from section 77 to section 100. The other laws that support the Act are the judicial precedents and the English common law.<sup>7</sup>

<sup>7</sup> The Application of the English common law is made through sections 3 and 5 of the Civil Law Act 1956 (Revised 1972). In respect to this, sections 3 and 5 of the Act provide that in the event of *lacunae*, the court of Malaysia shall apply the common law of England and the rules of equity as administered in England while deciding an issue or a question thereof.

Ironically, however the application of both common law and rules of equity is limited to a certain period. In west Malaysia, for example, the application is limited up to the 7<sup>th</sup> day of April 1956. In East Malaysia, the application of both common law and rules of equity in Sabah is limited up to the 1<sup>st</sup> day of December 1951 whilst in Sarawak the application is up to the 12<sup>th</sup> day of December 1949.

Section 79 and section 81 of the Act provide the nature of the guarantees in Malaysia. At this point, section 79 states that a guarantee is a contract whereby one person agrees to perform the promise, or discharge the liability, of a third person *in case of his default*.<sup>8</sup> Section 81 provides that the liability of the surety [i.e., the guarantor] is co-extensive with that of the principal debtor, *unless it is otherwise provided by the contract*.<sup>9</sup>

These two provisions suggest that the liability of a guarantor under the guarantees is 'co-extensive' with that of a principal debtor.<sup>10</sup> This means that:-

- i. A guarantor will not be liable unless the principal debtor is liable at the first instance, i.e., dependent upon the exigibility of the principal obligation *ab initio* (*Lakeman v Mountstephen* (1874) L.R. 7 HL 17).
- ii. A guarantor will not be liable unless a default occurs on the part of the principal debtor.
- iii. The liability of a guarantor is the same as the liability of a principal debtor.
- iv. The liability of a guarantor is no more than that of the principal debtor.

A creditor in Malaysia has a complete freedom of recourse in the event of default. In *Bank Bumiputra Malaysia Bhd. v Esah binti Abdul Ghani* [1986] 1 MLJ 16 it was held that a creditor has an unfettered discretion to choose the security s/he wishes to enforce. In this case, the appellant bank lent money to the principal debtor and as security took a charge over land belonging to the principal debtor and two others. The respondent was a guarantor for the loan. The principal debtor failed to pay the loan. The appellant bank took foreclosure proceedings on the land, but before the issuance of an order of sale, one of the owners died. The

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Similarly, in commercial matters, the common law and the rules of equity is applied in the Malaysian courts up to the 7<sup>th</sup> day of April 1956 for the states of West Malaysia other than Malacca and Penang. In this context, it seems that for the states of Malacca, Penang, Sabah and Sarawak, the law to be administered shall be the same as would be administered in England in the like case at the corresponding period.

<sup>8</sup> Emphasis added by the author.

<sup>9</sup> Emphasis added by the author.

<sup>10</sup> For detail discussion on the principle of co-extensiveness, a reader can refer to Steyn, J., (1974) Guarantees: The Co-Extensiveness Principle. *The Law Quarterly Review*, 20, 246; see also Mitchell, R.E., (1947) Is A Surety's Liability Co-Extensive With That Of The Principal Debtor? *The Law Quarterly Review*, 63, 355

foreclosure was not proceeded with instead the appellant bank took proceedings against the principal debtor and the respondent as guarantor. Judgment was entered against both and, based on the judgment, a bankruptcy notice was issued calling on the respondent to pay the amount owing. The respondent failed to do so. The appellant bank therefore filed a creditor's petition. The respondent failed a notice of intention to oppose the petition. The learned judge stayed the creditor's petition pending the decision of the petition against the principal debtor. The appellant bank appealed.

Among the issues to be decided was whether the guarantor has the right to compel the creditor banker to go after the principal debtor before going after him.<sup>11</sup> At this point, Lee Hun Hoe CJ (Borneo) in *Bank Bumiputra Malaysia Bhd. v Esah binti Abdul Ghani* [1986] 1 MLJ 16 remarks;

*It must be pointed out that we are not concerned with moral but legal problems. The bank has obtained a proper judgment against the surety [i.e., the guarantor], and is entitled to enforce the judgment ... The guarantor has no special right to demand that the creditor call upon the principal debtor to pay off the debt before asking the guarantor to pay.*

This statement of Lee Hun Hoe was quoted with approval in a later case. Thus, in *Bank Bumiputra Malaysia Bhd v Doric Development Sdn. Bhd.* [1988] 1 MLJ 462, Peh Swee Chin J said;

*The Federal Court's decision in Bank Bumiputra Malaysia Berhad v Esah bt Abdul Ghani [1986] 1 MLJ 16 has made it abundantly clear that, for the purpose of the instant case, in the absence of any express condition requiring that 'foreclosure proceedings' be proceeded with and completed first before suing the guarantor, the bank could not be*

<sup>11</sup> Before the present case, it was suggested that a guarantor has the right to require a creditor to have first exhausted his recourse from the principal debtor before going after the guarantor. Thus, in *Ng Yik Seng & Anor v Perwira Habib Bank Malaysia Bhd.* [1980] 2 MLJ 83, the application of the guarantors was accepted to be reasonable and valid. In this case, the guarantors contended that 'in law and equity' they should only be called on to meet their guarantee if there should be any deficit after the sum to be realized from the sale of the charged property had been determined. However, in the present case, it was stated that *Ng Yik Seng's* case should not be quoted with approval since it is regarded as a mere obiter dictum.

*compelled to sue the principal debtor, i.e., the company, first. Such being the case, counsel's submission that Esah bt Abdul Ghani's case [1986] 1 MLJ 16 was distinguishable from the instant case because of foreclosure proceedings not being proceeded with therein at all could not possibly achieve the desired result intended by counsel.*

In *Kwong Yik Finance Bhd v Mutual Endeavour Sdn. Bhd.* [1989] 1 MLJ 135 the High Court of Malaysia has decided that a guarantor has no obligation to exhaust the recourse from a principal debtor before going after the guarantor. Thus, instead of relying upon one source, the creditor has also the right to call upon the guarantor to satisfy his debt. In disposing her judgment, Siti Norma Yaakob J said;

*Just as the guarantors have no right to demand that the plaintiff creditor calls upon the first defendant, as the principal debtor, to settle the debt before asking them, the guarantors, to pay, they too have no right to insist that the plaintiff sell off the charged property first to offset the debt before suing them on the guarantee. The plaintiff has the option to exercise which of two securities it wishes to enforce. It may even enforce both securities, as is done in this case, if it is found that one security is insufficient to settle the debt and it was to meet this eventuality that the plaintiff had in its own wisdom insisted upon two forms of security, the charge as well as the guarantee (*Kwong Yik Finance Bhd v Mutual Endeavour Sdn. Bhd.* [1989] 1 MLJ 135).*

This right remains with the creditor even though there is enough collateral to cover the debt. Indeed, a creditor has the right to call upon a guarantor even there is a principal debtor who is able to make the debt good.

The above situation of the law however does not please the public. On the basis of the 'unfettered discretion' that has been bestowed upon the creditors, the law has been suggested to be in favor to the creditors (Berita Harian 1994). There are cases where the principal debtors are available but the creditor bankers are still chasing the guarantors to recover their debts (Utusan Malaysia 2001; Berita Harian 2000; Utusan Malaysia 2000). It happens that some of the guarantors' salaries are deducted from their accounts (Utusan Malaysia 2000) even without a prior notice (Utusan Malaysia 2001). It also happens that some of the guarantors have received a notice of bankruptcy from the creditor banker's solicitors (New Straits Times 2001) while at the same time the principal debtors live in a luxurious fashion

(Utusan Malaysia 2000; Berita Harian 2000). Therefore, to most of the guarantors the above state of the law should be revised<sup>12</sup> so as to make the creditor to have first exhausted the remedies from the principal debtor before going after the guarantor, especially when it proves that the principal debtor is available and capable enough to satisfy the debt (Berita Harian 2003).

At this point, the position of the modern law of guarantee in Malaysia could be explained in the manner that while it attempts to make the guarantee as a simple contract, i.e., no specific form is required, the law also seems to lack of certain protective measures to the guarantors. It is observed that in most of developed countries,<sup>13</sup> the law either cautioned the guarantor by the introduction of a requirement as to the form of the contract or provided remedies for him, which lightened his burden to a very considerable extent. This, however, does not happen in Malaysia as the guarantor's liability is 'co-extensive' with that of the principal debtor (Section 81 of the Malaysian Contract Act 1950), that is, there is no *beneficium excussionis personalis* and no *beneficium excussionis realis* or *divisionis*; and still the law does not require as to the form of the contract.

<sup>12</sup> Some revisions have been made but the problem is still not solved. In 2001, for example, an amendment has been made to the Central Bank's Guideline so as to give more protection to the guarantors. In connection to this, in 1995 a guideline has been made where a creditor bank shall use its best endeavour to recover the debts from principal debtors, provided the loans advanced not exceeding RM 200,000; the loans are not granted to a spouse of a guarantor; and the guarantor not waives his rights which are provided under the guideline. In 2001, the 1995 Guideline has been amended where the amount of the loans has been increased to RM 250,000 and the creditor bank is no longer allowed to obtain a waiver of a guarantor's rights. In a similar vein, the Bankruptcy Act 1967 has also been amended where under section 33(a) the Official Assignee is given the power to discharge a bankrupt when a period of five years has lapsed. The 2003 amendment also provide a limited protection for the guarantors as against bankruptcy actions. At this point, under the new section 5(3) of the Act the law endeavour that a bankruptcy proceeding cannot be taken against the guarantors unless all endeavours has been made to recover the debts from principal debtors. It should be pointed that the above provision applies only to social guarantors who are defined in section 2 as those who give the guarantee not for the purpose of making profit, such as a guarantee for a scholarship; a guarantee for a hire-purchase transaction of a vehicle for personal or non-businesses use; and a guarantee for a housing loan transaction solely for personal dwelling.

<sup>13</sup> This includes the United Kingdom, which requires that the guarantee be made in a written form, and most of continental Europe such as the France, which provides for the rules of *beneficium excussionis personalis*, *beneficium excussionis realis* and *divisionis*.

### The Malikis Solution

The Malikis has a special treatment to this problem. The Malikis like others uphold the intrinsic object of the guarantees where they maintain the principle that a creditor banker shall have the right to call upon the guarantor if the principal debtor fails to satisfy his debt. However, the Malikis also maintain that if it is evident that the principal debtor is sufficient, and is able to set off the debt by him self, this right shall be suspended. At this point, the creditor banker shall not be allowed to call upon the guarantor unless and until he has exhausted the recourse from the principal debtor. In the *al-Mudawana al-Kubra*, Sahnoun (n.d, p.131) said;

*When I asked Imam Malik about the right of a creditor to call upon a guarantor while at the same time the principal debtor exists and is able to set off the debt by himself, he replies that the creditor does not have such a right. Imam Malik accordingly pointed out that the creditor should have first exhausted the recourse from the principal debtor; and if the creditor did not obtain a full remedy, then he is allowed to call upon the guarantor.*

In another classical manual, al-Azhari (n.d, vol.2, p.111) emphasized that in cases of defaults, a creditor should not be given the right to call upon a guarantor if it is proven that the principal debtor exists and has sufficient sources to make the repayment.

It appears that the basis of the Malikis argument is the ability of the principal debtor to meet the payment. Therefore, in a situation where the principal debtor exists and it is proven that he is able to settle the debt, the following questions would be why should the guarantor be liable?. Why should the guarantor shoulder the burden of the debt, which he gets no benefit from?. The creditor banker should have claimed his debt from the principal debtor himself. In fact, the original purpose of the guarantee is to provide a 'second pocket' to the creditor, hence if the principal debtor fails, then the 'second pocket' can be used to save the situation. However, if the 'first pocket' is readily available and sufficient to pay off the debt, the 'second pocket' should not be touched in any case.

The Malikis however stipulated that in certain cases the creditor banker can have the right to call upon the guarantor without first going to the principal debtor. These cases include:-



- i. where it is proven that the principal debtor has made an unnecessary delay in paying off his debt;
- ii. where it is proven that the principal debtor is missing and he does not leave enough property to be used for the purpose of the payment;
- iii. where the principal debtor has been declared bankrupt, and;
- iv. where there is prior agreement that gives the creditor the right to call upon the guarantor.

Thus, unless and until the creditor has proven that at least one of the above conditions is satisfied, he cannot directly call upon the guarantor without having first exhausting all the remedies from the principal debtor.

## HARMONIZATION OF ISLAMIC AND MALAYSIAN LAWS

Harmonization is perceived to be one of the practical methods in order to make the classical rules applicable in the modern legal practices. Having seen that the pressure on the reassertion of the Islamic Shari'a could also mean to reinstate the classical rules in the modern life, the call for harmonization is perceived to be the modest approach.<sup>14</sup> The process would involve the submergence of the classical rules into the modern common law practices after an in-depth comparison has been made.

In Malaysia the process of harmonization of the classical rules and the Malaysian law is perceived to be an urgent appeal. The proposal for remolding the existing legal system, which shall be based upon both local and Islamic values (Utusan Malaysia 2007; Utusan Malaysia 2005; Bari 2003; Bari 2001), has made this call as a valid plea. In addition, the setting up of the Islamic banks, which at all times shall abide by the principles of the Islamic Shari'a, also made the call as an urgent appeal. Having aimed to be the leader in the International Islamic Financial Market, Malaysia is expected to have a comprehensive law that is based upon

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<sup>14</sup> Harmonization is different to Islamicisation since harmonization allows compromise and reciprocity. See Mohammad Hashim Kamali, 'Shariah and Civil Law: Towards a Methodology of Harmonisation', a paper presented at the *International Conference on Harmonisation of Shari'ah and Civil Law*, organized by Ahmad Ibrahim Kulliyah of Law, Hotel Legend, Kuala Lumpur, 20-21 October 2003.

workable Islamic principles. Further, the process is also important if a reference is being made to current legal issues that pertain to commercial transactions of the Islamic banking. At the moment, though the granting of finance is based on the principles of the Islamic Shari'a, the transaction is regarded as one of commercial transactions and therefore it comes within the jurisdiction of the civil courts.<sup>15</sup>

In the field of the guarantee the process of harmonization however shall be looked not only to win the Muslim hearts but also to bring back the confidence within the general public. As suggested elsewhere, the classical rules of the Malikis that relate to the right of a creditor to call upon a guarantor when a principal debtor defaults is hoped to be able to serve the purpose. It is hoped that the process will not only correct the situation but also provide a legal platform that is based upon acceptable legal values. It is interesting to note at this point that to date the law that governs the guarantee in Islamic banking is still referred to the principles of the English common law (*Bank Islam Malaysia Bhd v Adnan bin Omar & Ors* (1994) 3 CLJ 735).

The Islamic Banking Act 1983 does not have a comprehensive provision on the Islamic business practices. In fact, the Act limits its scope to the manner in which the Islamic bank could be established and managed. It neither provides the details of the commercial transactions that are allowable to the Islamic Shari'a nor the statement of the applicable substantive law for the resolution of disputes. Thus, when dispute arises the matter will be referred to the civil courts rather than the Shari'a courts. The cases will be dealt with according to common law principles (See, e.g., *Tinta Press Sdn. Bhd. v Bank Islam Malaysia Bhd.* (1984) 2 MLJ 192; *Bank Islam Malaysia Bhd. v Adnan bin Omar & Ors* (1994) 3 CLJ 735; *Dato' Haji Nik Mahmud bin Daud v Bank Islam Malaysia Bhd.* (1996) 1 CLJ 576) unless proper amendments are made to the existing laws. Dispute on Islamic financing transactions have to work in the context of English principles, as they are applicable in Malaysia. Thus, contracts like the guarantee have to be viewed in line with the equivalent relevant legislation and those applicable English law principles, to

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<sup>15</sup> Under List I of Ninth Schedule of the Federal Constitution the federal courts, i.e. the civil courts in Malaysia are given the powers to entertain cases that involve the Islamic commercial transactions.

interpret or supplement the legislation. In view of this, the insertion of the classical rules in the existing laws through harmonization seems to be desirable.<sup>16</sup>

On the issue of the right of a creditor to call upon a guarantor when a principal debtor defaults, the author feels that the Maliki doctrine on the guarantees can be the alternative solution to the modern legal stumble. It is submitted that when the existing law is not conducive to the public interest then the law should be reviewed in the light of modern circumstances where some modifications might involve. This development is inevitable as to meet the social needs and perhaps to correct the perceived injustice of the law.

At this point, the process could begin with the borrowing of some foreign legal principles and for this purpose the doctrine of the Maliki that is embodied in the classical texts shall be the main reference. It should be pointed out however, that the process does not mean that the existing legal principles will be demolished at all costs. In fact, the principles should be retained through the submergence of new principles, which are perceived to be helpful in meeting the social needs. In connection to this, the researcher would like to quote the words from Glass JA as guidance. In *Allen v Snyder* [1977] 2 NSWLR 685 at 689 the learned judge said;

*It is inevitable that the judge made law will alter to meet the changing conditions of society. That is the way it always evolved. But it is essential that new rules should be related to fundamental doctrine. If the foundations of accepted doctrine be submerged under new principles, without regard to the interaction between the two, there will be high uncertainty as to the state of the law, both old and new.*

<sup>16</sup> A general discussion on legal issues that pertain commercial transactions of the Islamic banking in Malaysia can be found in Ibrahim, A., (1987) *The Shariah and Codification: Malaysia Experience. Shariah Law Journal* 59; Mohd. Awal, N.A., (1989) *Banking System: Legal Impediments Towards its Islamization in Malaysia. Jurnal Perundangan*, 1, 26; Illiyas, M., (1995) *Islamic/Interest-Free Banking in Malaysia: Some Legal Considerations. MLJ*, 3, cxlix; Jamaluddin, S.Z., (1996) *The Islamic Financial System in Malaysia: The Legal Questions*, in *A Collection of Socio-Legal Essays*, (Ed.) Majid, M.K., Universiti Malaya; Buang, A.H., (1998) *Muamalah Islam di Mahkamah-mahkamah Malaysia in Undang-undang Islam di Mahkamah-mahkamah Syariah di Malaysia* (Ed.) Buang, A.H., Universiti Malaya; Bidin, A., (2000) *Islamic Banking in Malaysia: Reconciling Religious Law and the Common Law. The Journal of International Banking Regulation* 75; Mohamed Shariff, M.I., (2001) *Is the Law Equipped for the Development of Islamic Banking? Juridical and Practical Issues*. In: *11<sup>th</sup> Malaysian Law Conference*, 8-10 November 2001, Kuala Lumpur; Mohamed Shariff, M.I., (1994) *Conveyancing, Banking and Commercial Practice: An Islamic Perspective*. 4 *BLJ* lxxi

The existing Malaysian legal rules on the guarantees could be developed through this process. In fact, law should be perceived as a coherent and dynamic whole, which is always alterable to development. The law is always subject to a constant reevaluation and adjustment, sometimes culminating in the birth of new principles and doctrines. Foreign laws including the classical Islamic law could be the subjects for the purpose of legal development. Thus, in the context of Malaysian law of guarantees, it is proposed that classical Islamic law could be a useful contribution for such development. In relation to this, a continuous process of remolding the classical precepts should be seen as an essential part of the overall process of legal development.

It is worth stating at this point that although equity could be perceived as one method of remedy for the extremity of the law, it seems however that there is no sufficient ancestry in the principles and precedents owing to the rules. There have been several attempts to put equity in the place but the effort has not been a great success (See, e.g., See for example in *Ng Yik Seng & Anor v Perwira Habib Bank Malaysia Berhad* [1980] 2 MLJ 83; see also *Tengku Farid Bin Tungku Hussain & Ors v United Asian Bank Berhad* [1985] 2 MLJ 200, *Bank Bumiputra Malaysia Berhad v Esah Binti Abdul Ghani* [1986] 1 MLJ 16, and *Re Hong Huat Reality (M) Sdn Bhd United Asian Bank Bhd v Hong Huat Reality (M) Sdn Bhd* [1987] 2 MLJ 502). The strict adherence to the principle of precedent was perhaps the main reason for the difficulty to apply the rules of equity in the transaction of the guarantee.

In fact, it is observed that the flexible nature of equity itself has become rigid in practice. The original creativity of equity to redress hardship in law has become stagnant, as this has been circumscribed through the doctrine of precedent. It is not surprising therefore that almost a century ago the 'new model' of constructive trust that was developed by Lord Denning has been rejected.<sup>17</sup>

<sup>17</sup> The Court of Appeal had rejected the idea on the grounds that it did not have sufficient ancestry in the principles and precedents of equity. See *Grant v Edwards* [1986] Ch 638, per Nourse LJ., see also *National Provincial Bank v Ainsworth* [1965] AC 1175

## CONCLUSION

Under the guarantees there has been a discussion with regard to the right of a creditor to choose a course of action in cases of defaults. The most prevalent rule was that the creditor has an absolute right to choose a course of action, i.e. to sue the debtor or to sue the guarantor even the debtor is available and sufficient. Under the Islamic law, the Malikis however has an alternative view where the creditor can only call upon a guarantor if there is evidence that the principal debtor is in exile and s/he is not able to meet the due debt. The basis the Malikis propounds this solution was made upon the doctrine of *istihsan*, a principle of equity, and *istislah*, a principle of the general interest.<sup>18</sup> The two doctrines are comparable to the English common law of equity. While the English common law inspires equity as a separate system of law, *istihsan* and *istislah* are the modes to expand the law based upon the general practice of the Islamic Shari'a. In other words, the new rule that is being constructed should be consonant with the general practice of the Islamic Shari'a.

*Istihsan* and *istislah* are the modes that can be used to mitigate the hardships of the law.<sup>19</sup> Sometimes enforcing existing law may prove to be detrimental in certain situations, and a departure from it may be the only way of attaining a fair solution to a particular problem. The jurist who resorts to *istihsan* may find the law to be either too general, or too specific and inflexible. In both cases, *istihsan* may offer a means of avoiding hardship and generating a solution which is harmonious with the higher objectives of the Shari'a.

In Islam, avoidance of hardships is a cardinal principle of the Islamic Shari'a (The Qur'an; 2: 185). In one hadith the Prophet was reported to have said that the

<sup>18</sup>The Malikis also based their proposition upon the analogical deduction from the doctrine of *al-Rahn*, which emphasizes upon the doctrine of contingency, i.e. the secured property could only be realized if the author fails to pay the debt, to validate their argument.

<sup>19</sup>According to Kamali, *istihsan* is a method of exercising personal opinion in order to avoid any rigidity and unfairness that might result from the literal enforcement of the existing law. See Mohammad Hashim Kamali, *Principles of Islamic Jurisprudence*, p. 246 (1991). In short *istihsan* is a departure from existing rules to a more compelling reason. This departure, however, should be made on the basis of the Islamic Shari'a. Thus, the departure to an alternative ruling may be from an apparent analogy to a hidden analogy, or to a ruling, which is given in the *nass*, (i.e. the Qur'an or the Sunnah) consensus, custom, or public interest.

best of your religion is that which brings ease to the people. In this context, *istihsan* could be an exception to the general rule, which aims at alleviating the hardship that poses the people. It is not surprising therefore that the Malikis have suggested that there should be an exceptional case in the guarantees. A creditor should not be allowed to call upon a guarantor if the principal debtor is available and able to meet the due debt. Here, the application of *istihsan* is meant to be an exception to the general rule of the guarantees. This is done when one is satisfied that the alternative rule would lead to fairness and justice.

The law should have the ultimate aim to secure the public interest; and with regard to the guarantees the law should be made in a manner that helps mobilizing the surplus funds available in financial institutions.

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(n.np) refer to nonname publisher  
(n.pp) refer to nonplace publicatin

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