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## Dispute Resolution and Insolvency in Islamic Finance: Problems and Solutions -Workshop 19 September 2013: Report of Proceedings

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## Centre of Islamic and Middle Eastern Law (CIMEL)

### SOAS Law of Islamic Finance Working Papers Series

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#### ABSTRACT

This is the report of the proceedings of a workshop held on 19 September 2013 under the auspices of the Centre for Banking and Finance Law (CBFL), National University of Singapore at Bukit Timah Campus, National University of Singapore, and published jointly by the CBFL and the Centre of Islamic and Middle Eastern Law, SOAS, University of London.

It is a truism that Islamic finance is based on the Sharia. However, neither the Sharia nor Islamic finance has its own legal system, so the application and enforcement of Islamic finance depends on the secular law of nation states. A particularly important aspect of this situation is that disputes have to be adjudicated through a national system, which usually means the secular courts. The results of some recent cases resolved in this way have led to a considerable degree of controversy. For example, some commentators have criticised the English courts for refusing to adjudicate Sharia issues, while others have criticised the Malaysian courts for doing just that. Other solutions have been proposed, such as arbitration and alternative dispute resolution, in order to sidestep the problems associated with court-based methods. In like manner, Islamic finance transactions may also have to exist and operate within the context of conventional insolvency laws, which were not designed for Islamic finance and had not been developed with Islamic finance in mind.

In this workshop we considered the dispute resolution issue by looking at the general background to the problem, the situation in England, Malaysia and arbitration/ADR. On the question of the impact and relevance of the insolvency regime in relation to Islamic finance,

the Singaporean insolvency regime was examined. Some potential solutions were also explored and examined.

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## Dispute Resolution and Insolvency in Islamic Finance: Problems and Solutions

*A Workshop at the Faculty of Law, National University of Singapore, 19  
September 2013*

### Report of Proceedings

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**DISPUTE RESOLUTION AND INSOLVENCY IN ISLAMIC FINANCE:  
PROBLEMS AND SOLUTIONS - WORKSHOP 19 SEPTEMBER 2013:  
REPORT OF PROCEEDINGS**

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National University of Singapore  
Centre for Banking and Finance Law

*Dispute Resolution and Insolvency in Islamic Finance:  
Problems and Solutions*

Workshop 19 September 2013

## **Report of Proceedings**

Convened by:

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National University of Singapore

and

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## THE CENTRE FOR BANKING AND FINANCE LAW (CBFL)

The Centre for Banking and Finance Law (CBFL) at the Faculty of Law, National University of Singapore, focuses broadly on legal and regulatory issues relating to banking and financial services. It aims to produce research and host events of scholarly value to academics as well as of policy relevance to the banking and financial services community. In particular, CBFL seeks to engage local and international bankers, lawyers, regulators and academics in regular exchanges of ideas and knowledge so as to contribute towards the development of law and regulation in this area, as well as to promote a robust and stable financial sector in Singapore, the region and globally.

## AIMS OF THE WORKSHOP

It is a truism that Islamic finance is based on the Sharia. However, neither the Sharia nor Islamic finance has its own legal system, so the application and enforcement of Islamic finance depends on the secular law of nation states. A particularly important aspect of this situation is that disputes have to be adjudicated through a national system, which usually means the secular courts. The results of some recent cases resolved in this way have led to a considerable degree of controversy. For example, some commentators have criticised the English courts for refusing to adjudicate Sharia issues, while others have criticised the Malaysian courts for doing just that. Other solutions have been proposed, such as arbitration and alternative dispute resolution, in order to sidestep the problems associated with court-based methods. In like manner, Islamic finance transactions may also have to exist and operate within the context of conventional insolvency laws, which were not designed for Islamic finance and had not been developed with Islamic finance in mind.

In this workshop we considered the dispute resolution issue by looking at the general background to the problem, the situation in England, Malaysia and arbitration/ADR. On the question of the impact and relevance of the insolvency regime in relation to Islamic finance, the Singaporean insolvency regime was examined. Some potential solutions were also explored and examined.

## BIBLIOGRAPHY

A brief bibliography is provided at the end of this document for those wishing to delve further into the topic.

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#### THANKS TO SPEAKERS AND STUDENT ASSISTANTS

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The rights of the editors, the speakers and the editors' assistants to be identified as the authors of this work have been asserted in accordance with s 77 and s 78 of the Copyright, Designs and Patents Act 1988 (c.48, United Kingdom).

#### PERSONAL VIEWS

The views expressed herein are those of the speakers in their private capacities and do not represent the views of their employers.

## I. DISPUTE RESOLUTION AND INSOLVENCY IN ISLAMIC FINANCE: PROBLEMS AND SOLUTIONS<sup>1</sup>

*Nicholas HD Foster, SOAS, University of London*

### A. General Background

This segment is about Islamic finance in England and Wales. As a preliminary matter, one must distinguish two basic concepts: “law” and “legal system”. These terms are often used interchangeably. In some circumstances, however, one must be more precise. Islamic finance is one of those fields.

By the word “law” I mean a coherent body of rules such as that denoted by the term “English law”. By the term “legal system” I mean a coherent body of rules plus the entirety of the legal infrastructure which creates it, supports it and interprets it. The latter is made up of such things as the judicial system, the legislature and the legal professions.

It is important to take note of these concepts here because the Sharia underlies and suffuses Islamic finance. Islamic finance has to be compliant with the Sharia.

However, there is a basic problem. There is presently no Sharia legal system.

#### *The Formation of a Body of Law without a Legal System*

In the classical period of the Sharia, a legal system did exist. That concept is not much articulated when we talk about the Sharia of the classical period. It tends to be merely implicit in our discussions - it is taken for granted. Such an approach is usually unobjectionable, but in Islamic finance it is problematic. With the development of Islamic finance, the classical commercial sharia was adapted for the needs of Islamic finance. But the adaptation process was done in a new world legal architecture made up of nation states, in which the only legal systems allowed are the legal systems of nation states (municipal legal systems).<sup>2</sup>

So no Sharia legal system was, nor could be, produced to make Islamic finance operate and it has to function within national legal systems. The legal framework of Sharia-compliant products and their documentation can only, therefore, be produced and be enforced within such a system.

This is fine until something goes wrong. If one party defaults or some other serious problem arises, such as the insolvency of one of the parties, one has to use the dispute resolution systems made available by the nation-state, i.e. the courts, arbitration, alternative dispute resolution or insolvency proceedings. The result is that two legal traditions come into contact and, sometimes, they conflict.

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<sup>1</sup> The report of this presentation is based on Mr. Foster’s talk at the workshop and his handout.

<sup>2</sup> The terms “secular” and “state” are often used rather than “municipal”. However, both are seriously problematic, while “municipal” is much less so.

This is the theme of this afternoon's proceedings. What happens in Islamic finance when one of the parties is in default? What happens if one of the parties is insolvent?

## **B. Islamic Finance Dispute Resolution in England**

The situation in England is controversial. We must also bear in mind that the law has moved on in some ways, but its perception has not.

Is there a problem of Islamic finance enforcement in England and Wales? In one sense, there answer is a clear "No". In English common law anything can be enforced so long as it is not illegal or contrary to public policy. 'The starting point of our domestic law is that every citizen has a right to do what he likes, unless restrained by the common law, including the law of contract, or by statute.'<sup>3</sup> So one simply puts an Islamic finance product into an English law agreement and it will be enforced as written by an English court.

In *Islamic Investment Co. of the Gulf (Bahamas) Ltd. v. Symphony Gems N.V.* unreported [2002] All ER (D) 171 (Feb) (QBD: Comm Ct) it was argued that the contract was contrary to the Sharia and should not be enforced. However, the governing clause was clear and unequivocal. It provided: "This Agreement and each Purchase Agreement shall be governed by, and shall be construed in accordance with, English law." Tomlinson J therefore rejected the argument saying: 'in my judgment, it is absolutely critical to note — that the contract with which I am concerned is governed not by Sharia law but by English law.' In my view, this was clearly the correct decision, indeed Tomlinson J could not have found otherwise.

A subsequent case (*Shamil Bank of Bahrain EC v. Beximco Pharmaceuticals Ltd.* [2004] EWCA Civ 19, [2004] 1 WLR 1784 (CA), [2004] 4 All ER 1072, [2004] 2 Lloyd's Rep 1) went to the Court of Appeal and has become the leading case in this area. Unfortunately, it is problematic in various ways and is all too often misunderstood and misrepresented. First, it is quite technically complex, and, it seems, many people do not understand these aspects. Second, the defendants were simply attempting to evade their contractual obligations by hiding behind a Sharia-based argument. English courts are not sympathetic to this sort of lawyers' construct, saw through it and would have none of it. Third, the law has since changed.

An important difference between *Shamil Bank v. Beximco* and this case was the wording of the governing law clause. It provided: "Subject to the principles of the Glorious Sharia'a, this Agreement shall be governed by and construed in accordance with the laws of England."

At first instance, counsel for Beximco argued that the Sharia could be the governing law of the contract. However, according to English law at that time, Article 1 of the Rome Convention, referred to "any situation involving a choice between *the laws of different countries*".<sup>4</sup> It was clear law that the Sharia was not the law of a "country".

Counsel for *Beximco* therefore had to concede this point and, before the Court of Appeal, rely on another argument, that of incorporation into the contract by reference. Such incorporation is certainly possible. One can, for example, incorporate parts of the French Civil Code into an

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<sup>3</sup> *Attorney-General v Observer Ltd and Others* [1990] 1 AC 109, 178.

<sup>4</sup> Emphasis added.

English law contract. However, the Court of Appeal found that this was not possible as far as the Sharia was concerned. The reasons given by the court for this finding were: the Sharia is religion, not law; it is too uncertain; it was not the parties' intention to do so, rather, they only intended to express the Bank's effort to comply with the Sharia.<sup>5</sup>

Legal practitioners in the City of London received the decision favourably. Their view was that it is helpful to know that documents will be enforced as drafted. The Sharia aspect has become a matter of compliance.

However, as noted above, the law has since changed. Recital 13 of Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I) provides as follows: "This Regulation does not preclude parties from incorporating by reference into their contract a non-State body of law or an international convention." So, strictly speaking, *Shamil Bank v. Beximco* is irrelevant for contracts to which the Rome I Regulation applies, ie those entered into after 17 December 2009. And, in any event, it must be remembered that the case concerned the interpretation of a particular clause, drafted in a particular way.

Another case which has provoked a certain amount of discussion and concern is *The Investment Dar Company KSCC v Blom Developments Bank Sal* [2009] EWHC 3545 (Ch). The only reason I can see for this discussion is the scarcity of decisions in Islamic finance. It has no precedential value because it concerned an appeal from a summary judgment. The only matter of significance (whether the transactions were *ultra vires* The Investment Dar) was not adjudicated.

The situation is different in arbitration. Arbitration Act 1996 provides (s. 46 (1)): "The arbitral tribunal shall decide the dispute [. . .] (b) if the parties so agree, in accordance with *such other considerations as are agreed by them* [...]"<sup>6</sup> "Other considerations" includes the Sharia. So, if one wants a dispute to be subject to arbitration under the Act with the Sharia as its governing law, one can do so if the other party/ies agree.<sup>7</sup>

When reading these cases an important aspect of this subject becomes apparent. One has to take local considerations into account, and one must be very wary of generalising from the cases.

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<sup>5</sup> Note also the Court of Appeal decision in *Halpern v. Halpern* [2007] EWHC 291; [2008] QB 185, (CA).

<sup>6</sup> Emphasis added.

<sup>7</sup> Note also *Hashwani v. Jivraj* [2011] UKSC 40 (arbitration clause provided that the arbitrator had to be an Ismaili; this was held not be discriminatory); *Musawi v R E International UK Limited* [2007] EWHC 2981 (Ch); and *Sanghi Polyesters Ltd (India) v The International Investor KCSC (Kuwait)* [2000] 1 Lloyd's Rep 480; [2001] CLC 748 (QBD: Commercial Court).

## II. ISLAMIC FINANCE DISPUTE RESOLUTION IN MALAYSIA<sup>8</sup>

*Aida Othman, Zaid Ibrahim & Co, Kuala Lumpur, Malaysia*

The Islamic finance industry began in the 1980s but there was not much case law until the 1990s. In 1993 an important case, *Bank Islam Malaysia Bhd v Adnan Omar* [1994] 3 CLJ 735, caused some disquiet. Despite this, people just let it be. However, it is possible to find materials by experts already discussing the situation they could anticipate, and some of the litigation that could arise from the history. It is also possible to derive from the experts an opinion of the components of an effective legal framework for Islamic finance.

### A. Components of an Effective Legal Framework for Islamic Finance

An efficient legal framework for Islamic finance in any jurisdiction requires three components: enabling laws and regulations; the enforceability of Islamic financial contracts; and appropriate dispute resolution mechanisms.

#### 1. Enabling Laws and Regulations

In Malaysia, you cannot introduce Islamic banking transactions unless you enable Sharia contracts, so Malaysia passed the Islamic Banking Act 1983. The enabling laws imposed Sharia supervision, so if an Islamic banking institution were to be set up, a Sharia Committee would have to be set up.

#### 2. Enforceability of Islamic Financial Contracts

Parties need to know the contracts they enter into will be enforced.

#### 3. Appropriate Dispute Resolution Mechanisms

The presence of these mechanisms is necessary for the same reasons as for any other type of dispute. In addition, the Malaysian litigation led the experts to conclude that arbitration and other dispute resolution mechanisms have special significance due to the complexity of Islamic financial transactions.

There are roughly three different types of jurisdiction: Islamic; mixed; and totally secular or non-Islamic. Most of these legal systems do not easily accommodate, or even directly contradict, Sharia principles, which are the essential principles for Islamic financial transactions. Certain measures are therefore necessary to enable the introduction and implementation of Islamic finance.

Without a certain amount of “customization”, the interface between the two systems could give rise to conflicts and anomalies in laws, contracts and court decisions.

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<sup>8</sup> The report of this presentation is based on Dr. Othman’s talk at the workshop and her PowerPoint presentation. For further information on the Malaysian case law see Markom, R; Pitchay, SA; Zainol, ZA; Abdul Rahim, A and Merican, RMAR (2013) 'Adjudication of Islamic Banking and Finance Cases in the Civil Courts of Malaysia' (36) *European Journal of Law and Economics* 1.



The enforceability of the Sharia is a significant concern for Islamic financial transactions. Unlike conventional financing contracts, Islamic finance transactions require simultaneous compliance with Sharia and national law requirements, with the elements of the latter varying from jurisdiction to jurisdiction.

Whenever an Islamic finance transaction is introduced, Sharia principles (with regard to the activities of the Islamic bank and the contracts entered into with customers) and local laws on contracts must be taken into account before the execution of registrations, forms and whatever that is needed for the purpose of that transaction. Parties need to make sure that the contracts that are structured and intended to be Sharia-compliant will be enforced by the courts and other enforcement bodies in different jurisdictions in accordance with the terms of the contract as agreed.

It is very important for the Islamic banking industry to have certainty in this regard.

## **B. Islamic Finance Cases in Malaysia and Their Impact**

Structurally, Islamic financial transactions are very different from conventional financing instruments. Lending at interest is not permitted, but alternative contracts have been allowed by scholars since the beginning of the Sharia. If one looks at the eighteenth-century treatises, there are discussions on sale, leasing, partnership contracts and agency contracts, which are what the Sharia scholars use to form the basis of modern-day products.

In Malaysia, even though Sharia principles are used, disputes relating to Islamic banking facilities are decided by the civil courts (viz. subordinate courts, High Court, Court of Appeal, Federal Court), not the Sharia courts: *vide* Item 7 Federal List and Item 1 State List, Ninth Schedule and Article 121 Federal Constitution.

A string of cases from the mid-1990s arose from defaults in *Bai' Bithaman Ajil (BBA)* home financing transactions. Customers disputed the right of a bank to claim the whole of the sale price.

BBA was a widely available Islamic banking product approved by Bank Negara Malaysia's Syariah Advisory Council (BNM SAC)<sup>9</sup> and the internal Sharia Committees of banks. It involves sale and buyback of an asset between the bank and its customer, known as the *bai' inah* or '*inah* sale structure'.

In Islamic banking disputes prior to *Affin Bank v Zulkifli Abdullah* [2006] 3 MLJ 67, the courts always based their decisions on the common law principles applicable to conventional banking.

### *1. Early phase*

No reference was made in previous court decisions such as *Bank Islam Malaysia Bhd v Adnan Omar* [1994] 3 CLJ 735, *Bank Kerjasama Rakyat Malaysia v Emcee Corporation* [2003] 1 CLJ 625 and *Tahan Steel Corporation v Bank Islam Malaysia Bhd* [2004] 6 CLJ 25 to the underlying Sharia principles which applied to the Islamic banking facility in dispute.

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<sup>9</sup> Bank Negara Malaysia is Malaysia's central bank.

The fact that courts applied the common law principles applicable to conventional banking and made no reference to the applicable underlying Sharia principles had led to some debate among industry observers. Judges gave interpretations of Islamic law (as the law of the land) although they had no qualification in the Sharia and no background in Islamic finance.

In *Bank Islam Malaysia Bhd v Adnan Omar* the judge referred to the facility as a loan and held that defendants have no right to a rebate, which was practiced by the bank on a discretionary basis and not part of the contractual terms.

## 2. *The Affin Bank Case*

In the *Affin Bank* case, heard before Abdul Wahab Patail J in the High Court (Kuala Lumpur) the judicial attitude changed.

The case concerned a BBA refinancing facility in which the customer had defaulted in the payment of instalments for the asset sale price. The bank claimed the outstanding balance of the asset sale price (i.e. less the payments made by the customer).

Abdul Wahab Patail J found as follows.

The customer should not be worse off under the BBA facility than under a conventional loan facility (this would occur if the bank were allowed its claim for the whole of the sale price).

The payment obligations of the customer under the BBA (i.e. as sale price) should generally match the customer's obligations under a conventional loan, pursuant to which he would have paid the principal sum plus interest and costs.

In conventional loans, the interest paid is based on loan tenure. Thus, for a BBA facility, the bank is not entitled to claim the outstanding balance of the asset sale price, because this amount includes unearned profits.

The bank is only entitled to the following amounts: the facility amount plus earned profits plus agreed penalty charges, less the payments made by the customer.

"Earned profits" are defined as the profit for accrued tenure plus profit on a daily basis.

The certainty for BBA transactions relates to the certainty of the profit margin, so the decision of the court was in line with the certainty of the profit margin.

The judge held that *ibra'* (rebate) is not relevant. The argument that the bank can give a rebate, and that it is entirely discretionary is, in his view, irrelevant and is not an answer to the question before the court which is whether in the event of early termination of the facility upon default, the bank is entitled to the profit margin on the unexpired tenure and therefore unearned. Since the matter is disputed and is before the court, and it is a triable issue, the court cannot leave it to one party to decide at its discretion to give back as a rebate.

The matter was not referred to the BNM SAC. It was determined wholly on the basis of financing documents, as any reference to the BNM SAC would have amounted to an “abdication” of the court’s judicial functions.<sup>10</sup> (A few years before *Affin Bank*, BNM had foreseen some trouble would happen and the Central Bank of Malaysia Act 1958 was amended in 2003 to allow reference to the BNM SAC for Sharia-related issues if the parties so wish. However, there was no obligation on the part of the judge to do so and in this case the judge proceeded to give his judgment without doing so.)

The judgment caused furore in the Islamic banking industry and led to uncertainty as to what banks could claim from customers. Sharia scholars were also concerned. They felt that the judge had, in arriving at his judgment, given a flawed explanation of Islamic jurisprudential principles.

### 3. *Turn of the Tide*

Other judges adjudicating disputes on Islamic banking products took different positions. Some sought the advice of Sharia scholars and the BNM SAC, thus shifting from the position of the *Affin Bank* case.

For example, in *Malayan Banking Bhd v Ya’kup Oje & Anor.* [2007] 5 CLJ 311 (HC (Kuching)), Hamid Sultan J found as follows.

The bank was entitled to claim for the whole of the sale price.

The Court was required to apply the principles of equity, in line with Sharia principles.

In *Affin Bank* and *Malayan Banking Bhd v Marilyn Ho Siok Lin* [2006] 3 CLJ 796, the judges had attempted to achieve justice and equity between the parties and even out the imbalance customers had for a long time felt, especially after *Adnan Omar*.

The bank had to demonstrate equitable conduct by giving an undertaking to provide a rebate (*ibra’*) on the sale price upon the sale of the secured asset, and the formula for that rebate had to take into account market practice and the *Affin Bank/Marilyn Ho Siok Lin* line of cases.

The use of the concept of *ibra’* (rebate) brought the judgment more into line with Sharia principles. At the time, this concept was already approved by the BNM SAC. The judge made it very clear on a concern raised by the stakeholders that if customers were allowed to come to court and challenge the Sharia compliance of the financing, having executed the contract approved by the Islamic bank’s internal Sharia Committee on a product approved by the BNM SAC, there would be great uncertainty and this is morally unacceptable from the Sharia perspective.

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<sup>10</sup> [2006] 3 MLJ 67 at [22].

In *Bank Kerjasama Malaysia Rakyat Bhd v. PSC Naval Dockyard* [2008] 1 CLJ 784 (HC (KL)) decision, Rohana Yusuf J found as follows.

The bank is entitled to the whole of the sale price.

*Affin Bank* was distinguished – there was no unearned profit as the facility tenure had expired.

As the customer had agreed to the terms of the financing and documentation at time of execution, it cannot later challenge the terms of payment or other Sharia compliant features of the facility (i.e. there was certainty in the documentation).

The doctrine of estoppel is applied; the customer, because of its conduct, cannot raise these issues later in court.

#### 4. *The Taman Ihsan Jaya Case*

The judge in *Affin Bank*, Abdul Wahab Patail J, went a step further in *Arab-Malaysian Finance Bhd v. Taman Ihsan Jaya Sdn Bhd & 11 Ors* [2008] 5 MLJ 631. In *Affin Bank* he had held that the bank could not claim the whole of the sale price. In *Taman Ihsan Jaya* he affirmed his position in *Affin Bank* and went further by invalidating the contract.

Abdul Wahab Patail J found as follows in *Taman Ihsan Jaya*.

It is essential for banks to execute a *bona fide* sale in order that the profit or selling price should not be an element disapproved by Islam. Otherwise, deferred payment of the sale price is effectively a credit or loan extended, and any profit would be prohibited as *riba*.

The court has the authority to look beyond the words of the agreement to the actual facts of the case in order to determine the substance of the transaction before it draws any conclusions on the nature of the BBA transactions.

Where the bank purchased directly from its customer and sold back to the customer with deferred payment at a higher price in total, the sale was not a *bona fide* sale but a financing transaction, and the profit portion of such a BBA transaction rendered the facility contrary to the Islamic Banking Act 1983 (or the Banking and Financial Institutions Act 1989). The judge views as acceptable however, a “tripartite” BBA transaction involving a novation arrangement between the housing developer, a customer and the bank.

When using the terms ‘Islam’ and ‘religion of Islam’, neither the Federal Constitution, nor the Islamic Banking Act 1983, nor the Banking and Financial Institutions Act 1989 provide which interpretation of which *mazhab* of Islam is to prevail. The BBA facilities are offered as Islamic to all Muslims, and not exclusively to followers of any particular *mazhab*. The test is that there must be no element involved that is not approved by the religion of Islam under the interpretation of any of the recognized *mazhabs*.

Plaintiff banks are entitled under s. 66 of the Contracts Act 1950 to a return of the original facility amount they had extended. It was thus equitable that the plaintiffs seek to obtain a price as close to the market price as possible (if not more than the market price) and account for the proceeds to the respective defendants.

An interpretation of the selling price must also not be such as to impose a heavier burden than on a loan with interest.

The plaintiff banks had relied upon *Adnan Omar*. In this course the court had taken the classic common law approach and had held that, since the parties had agreed upon a selling price and the defendant had agreed and signed a document, there was an '*aqad* (contract), that the defendant was therefore bound and the court could look no further. Abdul Wahab Patail J rejected this approach and held that the fact that there is an *aqad* and before that an *ijab* (an offer) and *qabul* (an acceptance) does not prevent an examination of the terms as to what the transaction in fact is. He stated that:

(in *Adnan Omar*) [...] The consequence was that the defendant who sought and obtained an Islamic financing facility of RM265,000 ended up, when he defaulted not long after, with liability of RM583,000. The claim for the total of all instalment payments not yet due to be brought forward as due and payable upon termination and declaration by the bank of a default, involved an interpretation of 'selling price' that resulted in the defendant being liable to an amount far higher than he would have been liable to in a conventional loan with interest.<sup>11</sup>

He also stated:

If the civil court is not to be a rubber stamp to issue orders for sale, it must maintain curial supervision that the orders for sale are being sought upon balance sums that are not pursuant to any element not approved by the religion of Islam.<sup>12</sup>

He added:

It was evident the selling price under the bank's interpretation was the original facility amount extended, to which the bank's profit margin rate and the length of time payment of instalments was applied. [...] An equitable interpretation of the bank's selling price term is that, from the evidence, it was in fact a formula that determined the bank's selling price from the original facility amount to which was applied the bank's profit margin rate as derived from the terms of the agreement between the parties, but applied as at the time the facility is paid off, meaning that the parties had agreed to a selling price upon a formula which produced the sum to be paid at the time the facility is paid off and the total sum in the agreement only represented the selling price if the full term is utilised. The equitable interpretation took away the harsh result inherent under the plaintiff's interpretation and reduced the facility to being no

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<sup>11</sup> [2008] 5 MLJ 631 at para [36].

<sup>12</sup> [2008] 5 MLJ 631 at para [14].

worse but even so, still no better, than the liability under a conventional loan.”<sup>13</sup>

To sum up:

- Abdul Wahab Patail J went further than his own judgment in *Affin Bank*. In that case he had just rejected the bank’s interpretation of what was the ‘sale price’ and applied an equitable interpretation of the term. In this case, he invalidated the BBA transaction.
- By so doing, he created a state of flux and confusion, especially among banks, as to the way in which the courts would treat BBA transactions. There was uncertainty as to the validity and enforceability of other Islamic banking (and capital) products and instruments, especially products and instruments using the BBA and *inah* structure. The banks were concerned as to whether they could claim any portion of the profit or could only claim the principal.
- The judge stated that, if a product is not accepted by all *mazhabs*, it is not allowed. This is a departure from, and a misunderstanding of a basic principle of Islamic jurisprudence that accepts differences in opinion resulting from different interpretations of Islamic sources.
- He rejected the application of the Sharia principle of *ibra’*, already approved by the BNM SAC, and refused to follow other cases, such as *Malayan Banking Berhad v Marilyn Ho Siok Lin* [2006] 3 CLJ 796 and *Ya’kup Oje*, which utilised the principle of *ibra’* and which united two different strands, the common law and Sharia principles approved by the BNM SAC.
- He refused to refer to Sharia experts, citing no necessity or reason to refer to BNM SAC, as their decisions are not binding on the court, even though such guidance was provided for under the amended Central Bank of Malaysia Act.

The Sharia scholars, however, stated that his interpretation was flawed, as were his understanding and application of Islamic jurisprudential principles.

##### 5. *The Court of Appeal’s Response*

On appeal (*Bank Islam Malaysia Berhad v. Lim Kok Hoe & Anor and other appeals* [2009] 6 MLJ 839), the Court of Appeal overturned the *Taman Ihsan Jaya* judgment.

As regards Abdul Wahab Patail’s finding that the BBA contract was “far more onerous than the conventional loan with *riba*”,<sup>14</sup> the court held as follows.

The comparison between a BBA contract and a conventional loan agreement was not appropriate, because the two instruments are not alike and have different characteristics. The BBA contract is a sale agreement; a conventional loan agreement is a money lending transaction. The two transactions are diametrically opposed. The

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<sup>13</sup> [2008] 5 MLJ 631 at paras [43]-[44].

<sup>14</sup> [2008] 5 MLJ 631 at para [37].

profit in a BBA contract is therefore different from interest in a conventional loan transaction.

When the judge came to the conclusion that a BBA contract is in fact a loan agreement and consequently replaced the sale price under the Property Purchase Agreement with an “equitable interpretation” of the same; and substituted the obligation of customer to pay the sale price with a “loan amount” and “profit” computed on a daily basis, he was in fact rewriting the contract for the parties. It is trite law that the Court should not rewrite the terms of the contract between the parties that it deems to be fair or equitable.<sup>15</sup>

Having obtained assistance from the BNM SAC, the court held that “Islamic banking business” does not mean banking business the aims and operations of which are approved by all the 4 *mazhabs*. The religion of Islam is not confined to the 4 *mazhabs* alone. Islamic law is derived from primary sources, i.e. the Holy Quran and the Hadith, and secondary sources, including and in addition to the jurisprudence of the 4 *mazhabs*.

The Court of Appeal appeared to be disturbed by the High Court judge’s decision, and many industry observers consider that judges in civil courts with no qualifications in Islamic law should not take it upon themselves to declare whether a matter is in accordance with the religion of Islam or otherwise. Whether bank business is in accordance with the religion of Islam needs consideration by eminent jurists who are properly qualified in Islamic jurisprudence. This is a principle of Islamic jurisprudence itself. One must have the proper qualifications in Islamic finance and Islamic law before one can make pronouncements on matters regarding both. This is why arbitration is recommended for disputes on Islamic finance, as will later be explained.

Under s. 3(5)(b) of the Islamic Banking Act 1983, no Islamic banking licence can be issued unless the applicant’s articles provide for a Sharia advisory body to advise the bank. The aim of this is to ensure that transactions do not involve any element which is not approved by the Religion of Islam. Additionally, a central Sharia Advisory Council, the BNM SAC, was established in Bank Negara Malaysia in 2003 as an authority on Islamic law for Islamic banking business and other matters in accordance with s. 16B of the Central Bank of Malaysia Act 1958. Therefore, the legal infrastructure was already in place to ensure that Islamic banking does not involve any element not approved by the religion of Islam. The court has to assume that the bank’s Sharia advisory body and the BNM SAC have discharged their statutory duties. It was further noted there was no allegation by the customers that the Sharia advisory body of the bank or the BNM SAC had failed to discharge these duties.

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<sup>15</sup> [2009] 6 MLJ 839 at para [28].

## C. Legislative and Policy Measures after the Islamic Finance Cases

### 1. *The Muamalat Bench*

The moment the *Affin Bank* case occurred, there was a great deal of debate in Islamic banks and among lawyers and Sharia scholars.

Since 2007, a judge in the commercial division of the High Court (Kuala Lumpur) has been assigned to preside over cases relating to Islamic finance in the hope that such a judge would better understand the history and development of Islamic finance in Malaysia and would not resort to some of the decisions given by Abdul Wahab Patail J.

The BNM SAC felt that if there is going to be a challenge to Sharia-compliant transactions, it should be tried by experts who better understand the reasons behind such transactions and will not allow the transactions to fall apart unnecessarily. The *Muamalat*<sup>16</sup> Bench at the High Court was therefore introduced and Islamic finance disputes since then have been directed to a judge with a background in Islamic banking and finance .

### 2. *The Central Bank of Malaysia Act 2009*

The Central Bank of Malaysia Act 2009:

accords formal recognition to the dual financial system practiced in Malaysia (ss. 2 and 27);

recognises the BNM SAC as being the authority for the ascertainment of Islamic law for the purposes of Islamic finance business, and the role of the BNM SAC as a consultative body to the Malaysian judiciary (ss. 51-55);

requires judges and arbitrators to take into consideration any published rulings of the BNM SAC or refer to the BNM SAC for rulings relating to Sharia issues arising from disputes before them. Once issued by the BNM SAC upon a reference being made to them, these rulings are binding on the financial institution, court or arbitrator concerned (ss. 56 and 57) (before the coming into force of the Central Bank of Malaysia Act 2009 rulings by the BNM SAC were not binding);

provides that where the ruling given by a Sharia body or committee constituted in Malaysia by an Islamic financial institution is different from the ruling given by the SAC, the ruling of the SAC shall prevail (s. 58) in the event of a dispute.

### 3. *The Securities Commission Act and the Capital Markets and Services Act 2007*

To give Shariah certainty to disputes arising from Islamic capital market transactions, amendments were made in 2010 to the Securities Commission Act 1992 and the Capital Markets and Services Act 2007<sup>17</sup> to expand the powers of the Sharia Advisory Council (SAC) for capital market business and transactions (s. 316A(1) of the Capital Markets and Services

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<sup>16</sup> Literally “transactions”, i.e. in this context Islamic banking and finance.

<sup>17</sup> The amendments were made respectively by the Securities Commission (Amendment) Act 2010 and the Capital Markets and Services (Amendment) Act 2010. These statutes, and the amended text of both principal acts, are available on the Securities Commission Malaysia website, <http://www.sc.com.my>.



Act 2007). Courts and arbitrators are required to “take into consideration any ruling of the [SAC]” or refer the matter to the SAC (s. 316F). Any ruling made by the SAC pursuant to s. 316F is binding on the court or arbitrator (s. 316G).<sup>18</sup>

#### 4. *The BNM Guidelines on Ibra’ (Rebate) for Sale-Based Financing 2012*

In 2010, the BNM SAC issued a resolution that for sale-based financing Islamic banking products, banks are to grant *ibra’* to customers if there is early termination of the facility. The BNM SAC had not previously addressed this issue, due to the Shariah principle that *ibra’* is only granted at the discretion of a creditor. However, recent legal developments resulting in claims that Islamic financing may result in injustice to customers might have been the impetus for the BNM SAC’s decisive resolution. Not long after this resolution, the BNM Guidelines on Ibra’ (Rebate) for Sale-Based Financing 2012 were issued, making it compulsory for Islamic banks to grant *ibra’* to customers of sale-based financing facilities.

#### 5. *Strengthened Oversight by BNM*

In the past few years, the Islamic Banking Department of BNM has strengthened its oversight of banks and *takaful*<sup>19</sup> operators’ practices and adherence to BNM Sharia standards. This strengthening has been achieved through bank audits, specific directives and compliance reports on Islamic financial product structures and terms, made in line with the terms and conditions outlined by the BNM SAC.

#### 6. *The Law Harmonisation Committee of BNM*

There has been established a Law Harmonisation Committee to review existing and proposed laws applicable to Islamic banking and finance and make the necessary recommendations to harmonise them with Sharia principles. This is an on-going project of BNM.

#### 7. *Alternative Dispute Resolution (ADR) for Islamic finance*

There has been active promotion of arbitration and mediation for Islamic finance disputes. Measures taken in this regard include the following.

The Kuala Lumpur Regional Centre for Arbitration (KLRCA) has launched the KLRCA i-Arbitration Rules 2012. These rules were expanded from the first Islamic rules of 1997. They cover disputes arising from commercial transactions which may contain Sharia elements or be premised on Sharia principles.

The Chief Justice of Malaysia issued Practice Direction No. 5 of 2010 on Mediation to encourage parties to use mediation in all types of disputes in the Malaysian courts.<sup>20</sup>

The recent KLRCA Mediation/Conciliation Rules encourage parties to use mediation in the KLRCA.

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<sup>18</sup> The text of these sections is set out below in the Appendix.

<sup>19</sup> Islamic insurance.

<sup>20</sup> Text available at:

<http://library.kehakiman.gov.my/digital/Arahan%20Amalan%20Dan%20Nota%20Amalan/Practice%20Direction%20No.%205%20Of%202010.pdf> (last visited 3 January 2014).

The Bar Council has created the Bar Council Centre for Mediation to promote mediation.

#### 8. *Practitioners' Recommendations*

Practitioners recommend the use of well drafted arbitration clauses.

They also recommend the use of estoppel. If parties specifically agree that the transaction they are entering into is Sharia-compliant and that they will not challenge its validity on the grounds of non-compliance with the Sharia, this acts as estoppel, so they cannot later claim that the transaction is not compliant.

A further recommendation is that Sharia principles be incorporated as specific provisions of the contract in order to ensure that they will be enforced as drafted.

Finally, careful consideration should be given to the governing law. The Malaysian authorities are keen to promote the use of Malaysian law as the governing law of contracts, because this will give Sharia certainty. If Sharia-related issues arise in a dispute governed by Malaysian law then, by virtue of the Central Bank of Malaysia Act 2009, parties must raise them with the BNM SAC in order to obtain an authoritative and definitive *fatwa* which the judge will have to follow.

If the governing law is English law, however, an English court will implement the provisions as they are drafted and it may not consider the Sharia validity of such provisions. Everything in the contract must, therefore, be clear and precise. For example, if the dispute concerns a lease contract, and the Sharia requires that the lessor must maintain the asset, the parties should incorporate this obligation as a specific provision of the contract, and ensure that it is drafted as clearly as possible.

#### 9. *The Islamic Financial Services Act 2013*

Financial and legal practitioners concerned with Islamic finance in Malaysia are grappling with the radical Islamic Financial Services Act 2013. The Act repealed the Islamic Banking Act 1983 and the Takaful Act 1984. It came into force in June 2013. It is the most stringent statute of its kind in the world. One of its principal objectives is to promote financial stability and compliance with the Sharia.

Its effect on Sharia governance is very significant. It entrenches the role of BNM as the Sharia regulator in Malaysia, it embeds Sharia principles and BNM SAC rulings, imposes a statutory duty on Islamic financial institution to comply with BNM standards, manage Sharia non-compliance risks and ensure Sharia compliance, and imposes vigorous Sharia compliance requirements. It also imposes severe offences and penalties in the event of Sharia non-compliance or breach; it is therefore no longer possible to negotiate with BNM over such matters.

The Act confirms BNM's powers to specify standards on the Sharia, Sharia governance or matters related to Sharia compliance. Guidelines, circulars and so forth are now standards (see s. 283 (b)).

The Act also confirms the status of BNM SAC rulings as constituting the minimum Sharia requirements/standard for Sharia compliance in Malaysia, in line with the international

prudential standards for Islamic finance of the Islamic Financial Services Board (IFSB) and the BNM Sharia Governance Framework 2011.

The Act contains extensive provisions regarding the assessment and investigation of potential Sharia non-compliance and an IFI's rectification of the situation, as well as provisions regarding directives and intervention concerning Sharia non-compliance. An external auditor may be appointed to conduct an audit on Sharia compliance. Severe penalties are laid down.

Failure to ensure Sharia non-compliance is an offence.

There are some worries that the Islamic Financial Services Act has granted too much power to Bank Negara Malaysia for which there is no check, and has made the penalties for lack of Sharia compliance too severe.

#### **D. ADR from the Sharia Perspective**

From very early on in Islamic history, as garnered from eighth-century manuscripts that came to light in the early 2000s, there were discussions about what we know now as ADR. The contents of the manuscripts resonate with principles of ADR that emerged after the Pound Conference held in Minnesota in 1976 at which the seminal paper was presented by a Harvard Law School professor, Frank Sander. Particular points can be raised about ADR from the historical Sharia perspective:

Arbitration (*tahkim*) and mediation (*sulh*) are recognised in Islamic law as ADR mechanisms to adjudication (*qada'*).

Arbitration is the private, judicial determination of a dispute by an independent third party.

Amicable settlement is a process in which parties resolve their dispute in an amicable manner, with or without the assistance of a mediator. Amicable settlement is particularly encouraged. For example, in the *Quran* 4:35 (An-Nisa' (Women)) it is said that: "*Sulh* is best."

The second caliph, 'Umar ibn al-Khattab, was reported to have said: "Send disputants away (first) so that they will attempt to settle amicably among themselves; verily adjudication leads to rancour."<sup>21</sup>

Islamic sources emphasise that arbitration and amicable settlement are permissible alternatives to adjudication by a judge appointed by a ruler and whose qualifications, appointment, powers procedures and determinations are strictly guided by Islamic law. Although arbitrators and mediators have greater flexibility than judges in resolving the disputes before them, the Islamic sources stipulate that they may not lead to an outcome that contravenes Islamic teachings.

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<sup>21</sup> *Musannaf* of al-San'ani 8 (15304): 303-4; Ibn Abi Shayba, *al-Musannaf* 7 (2938): 213-4.

A report attributed to the Prophet Muhammad (PBUH) and ‘Umar al-Khattab in the seventh century states: “*Sulh* is permissible, except *sulh* that makes permissible that which is prohibited, and prohibits that which is permissible.”<sup>22</sup>

Modern experts, including Sharia scholars, generally share the opinion that the industry needs a legal framework which provides certainty and predictability to the greatest possible extent and enforces the determinations of the parties in a given transaction with respect to risk allocations, relative rights, obligations and remedies. The parties, investors, the Sharia boards of Islamic financial institutions and other stakeholders of the Islamic finance industry are not indifferent to the issue of compliance with the Sharia in Islamic financial transactions.

Litigation of Islamic finance disputes, for example in Malaysia and England, shows that although up-front compliance of a transaction with Islamic law is verified by Sharia boards and is required as a condition precedent to the validity of the contract, the role of Islamic law, which is the foundation of Islamic finance contracts, may, depending on the selected national forum, be diminished during the dispute resolution process. The outcome of litigation may be a contravention of Sharia principles, defeating the commercial purpose of Islamic finance. If parties have agreed on terms that are questionable under Islamic law but allowed under local law, the national or local legal system will almost certainly enforce them, enabling parties to evade Islamic law. For example, Islamic law does not allow recovery of lost profits, seeing such claims as both speculative and unearned, but a national law may award such damages, even against a losing party’s protest that such an award is “non-Islamic”.

Without certain “customisation”, there are limitations on the ability of national courts to give effect to Sharia principles that underpin an Islamic financial transaction during dispute resolution. Therefore, the inherent features of arbitration may provide for more flexibility in terms of rendering decisions that are in line with the expectations, intentions and will of the parties than national courts do when it comes to the application of Islamic law as an applicable law.

One of the new advantages in addition to the general advantages of arbitration is that the chosen arbitrators can be experts in the relevant area, and this expertise can facilitate a speedier and more satisfactory resolution of the dispute. This advantage is particularly important in the context of Islamic finance as arbitration allows the parties to appoint experts who are knowledgeable in Sharia and Islamic finance. Their expertise may facilitate an authoritative and satisfactory resolution. Although there are differences of Sharia opinion on some Islamic financial transactions, the Sharia experts’ reasoning and resolution will provide finality to the dispute. An example would be the outcome of the dispute arising from an *istisna*’ financing arrangement in *Sanghi Polyesters Ltd (India) v The International Investor KCSC (Kuwait)* [2001] C.L.C., as expressed in an ICC Arbitration Award obtained and reported in London. The arbitrator, an expert in Islamic law, gave effect to the parties’ will to be governed by English law except where this would conflict with the Sharia, by awarding principal and profit claims, but disallowing additional damages claims because, although compliant with English law, these would conflict with the Sharia.

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<sup>22</sup> According to Oseni, this is ‘the famous letter written by Caliph Umar b. al-Khattab directed to Abu Musa al-Ash‘ari on the latter’s appointment as a judge’ and is ‘the text of a Hadith related by al Tirmidhi, Abu Dawud, Ahmad and Ibn Majah.’ Oseni, Umar Aimhanosi, ‘Dispute Resolution in Islamic Banking and Finance: Current Trends and Future Perspectives’ (August 26, 2009). Available at SSRN: <http://ssrn.com/abstract=1461895> or <http://dx.doi.org/10.2139/ssrn.1461895>, p 11.

In general, the issues and concerns on application and enforcement for Islamic finance arbitration are similar to those for arbitrations of other types of disputes.

However, there are aspects of arbitration practice and enforcement issues that are particular to Islamic finance arbitrations.

Parties may agree to appoint an expert/s in the Sharia and Islamic finance as arbitrator/s or on the arbitration panel.

The proceedings may resort to an additional mechanism, for example to refer Sharia issues to a certain expert or council, if the parties agreed to adopt such a procedure.

Cross-border enforcement of awards is still subject to the national legal framework for arbitration. Parties need to consider factors that constitute defenses to enforcement of awards. Some jurisdictions within the Islamic economic sphere will not enforce foreign arbitral awards. In some jurisdictions, the extent and degree of enforcement of foreign judgments and awards are not clear. An award may be reviewed anew/de novo in whole or in part upon attempted enforcement. This is notoriously the case in Saudi Arabia, for example.

## **E. Conclusion**

In this presentation I have attempted to sum up what is going on in the Malaysian legal scene today from the perspectives of bankers, legal practitioners and other stakeholders.

An appendix has been included, in case of difficulty in accessing the materials set out therein, to highlight some of the issues from the presentation and for those who wish to do further research.

# Appendix

## Central Bank of Malaysia Financial Sector Masterplan 2001

### Recommendation 5.10

#### Establish an effective legal structure

One of the pre-conditions to sustain the continuous growth of Islamic banking and *takaful* is a comprehensive legal infrastructure to seek any legal redress arising from Islamic financial transactions. A sufficient number of competent lawyers and judges equipped with sound knowledge and expertise in both Syariah and civil laws is needed to handle legal matters on Islamic financial contracts to promote confidence amongst the industry practitioners and customers. In this regard, steps will be taken to:

- Form a committee to establish a Syariah commercial court dedicated to deal with legal matters on Islamic banking and *takaful*. In the interim, an Islamic banking tribunal will be formed to serve as a foundation for the ultimate establishment of the proposed court; and
- Design dedicated awareness and training programmes for judges and lawyers on Islamic banking and *takaful*, to be conducted by the industry-owned research and training institute in consultation with the Judiciary and Bar Council.

#### Amendments to the Capital Markets and Services Act 2007, gazetted in 2010

##### Establishment of Sharia Advisory Council for Islamic capital market

**316A.** (1) The Commission may establish a Sharia Advisory Council for Islamic capital market which shall be the authority for the ascertainment of the application of Sharia principles for the purposes of Islamic capital market business or transaction.

(2) The Sharia Advisory Council may determine its own procedures.

##### Reference to Sharia Advisory Council for ruling from court or arbitrator

**316F.** Where in any proceedings before any court or arbitrator concerning a Sharia matter in relation to Islamic capital market business or transaction, the court or the arbitrator, as the case may be, shall—

- (a) take into consideration any ruling of the Sharia Advisory Council; or
- (b) refer such matter to the Sharia Advisory Council for its ruling.

(2) Any request for advice or a ruling of the Sharia Advisory Council under this Act or any other law shall be submitted to the secretariat.

## Effect of Sharia ruling

**316G.** Any ruling made by the Sharia Advisory Council under section 316E or 316F shall be binding on—

- (a) the licensed person, stock exchange, futures exchange, clearing house, central depository, listed corporation or any other person referred to in section 316E; and
- (b) the court or arbitrator referred to in section 316F.

## Sharia Advisory Council ruling prevails

**316H.** (1) Where a ruling given by a registered Sharia adviser to a person engaging in any Islamic capital market business or transaction is different from the ruling given by the Sharia Advisory Council, the ruling of the Sharia Advisory Council shall prevail.

(2) For the purpose of this section, “registered Sharia adviser” means a person who is registered under any guidelines issued by the Commission under section 377.

## Islamic Financial Services Act 2013

### Duty of institution to ensure compliance with Sharia

**28.** (1) An institution shall at all times ensure that its aims and operations, business, affairs and activities are in compliance with Sharia.

(2) For the purposes of this Act, a compliance with any ruling of the Sharia Advisory Council in respect of any particular aim and operation, business, affair or activity shall be deemed to be a compliance with Sharia in respect of that aims and operations, business, affair or activity.

(3) Where an institution becomes aware that it is carrying on any of its business, affair or activity in a manner which is not in compliance with Sharia or the advice of its Sharia committee or the advice or ruling of the SAC, the institution shall—

- (a) immediately notify BNM and its Sharia committee of the fact;
- (b) immediately cease from carrying on such business, affair or activity and from taking on any other similar business, affair or activity; and
- (c) within 30 days of becoming aware of such non-compliance or such further period as may be specified by BNM, submit to BNM a plan on the rectification of the non-compliance.

(5) Any person who contravenes subsection (1) or (3) commits an offence and shall, on conviction, be liable to imprisonment for a term not exceeding eight years or to a fine not exceeding twenty-five million ringgit or to both.

## Power of bank to specify standards on Sharia matters

- 29.** (1) The Bank may, in accordance with the advice or ruling of the Sharia Advisory Council, specify standards—
- (a) on Sharia matters in respect of the carrying on of business, affair or activity by an institution which requires the ascertainment of Islamic law by the Sharia Advisory Council; and
  - (b) to give effect to the advice or rulings of the Sharia Advisory Council.
- (2) In addition, the Bank may also specify standards relating to any of the following matters which does not require the ascertainment of Islamic law:
- (a) Sharia governance including –
    - (i) functions and duties of the board of directors, senior officers and members of the Sharia committee of an institution in relation to compliance with Sharia;
    - (ii) fit and proper requirements or disqualifications of a member of a Sharia committee; and
    - (iii) internal Sharia compliance functions; and
  - (b) any other matter in relation to the business, affair and activity of an institution for the purposes of compliance with Sharia.



### III. THE RELEVANCE AND IMPACT OF INSOLVENCY IN RELATION TO ISLAMIC FINANCE TRANSACTIONS

*Andrew Chan, Allen & Gledhill LLP*

*Suhaimi Zainul-Abidin, Gulf-Asia Shari'ah Compliant Investments Association, Singapore*

#### A. Introduction

*Andrew Chan*

The general Singapore position with regard to the treatment of Islamic law was decided in the case of *LS Investment Pte Ltd v Majlis Ugama Islam Singapura* [1998] 3 SLR(R) 369. In that case, the Court of Appeal rejected the argument that Islamic law was foreign law and had to be proved by expert evidence.

This case concerned a *waqf*, which shares certain similarities with a trust. The issue was whether the property in question was property “transferred”, because if it was a *waqf*, the requisite approvals could not be obtained for the purpose of transfer. The court said: “Muslim law is part of the law of the land which the court would take cognisance of.”<sup>23</sup> The court held that there was no need for expert evidence and decided on the basis of what was put forward, such as Islamic literature. In that case, Majlis Ugama Islam Singapura took the view that the property in question was subject to a *waqf* and the court accepted that view.

Since the Singapore courts have accepted that, at least in some areas (e.g. the Administration of Muslim Law Act, matrimonial and inheritance matters), Muslim law and Syariah principles are given effect to, surely Muslim law must exist as a system of law? Thus, as far as Singapore is concerned, there should be no doubt that if parties choose Islamic law beyond where the law automatically applies it, this choice will be given effect. This includes the area of Islamic finance. It cannot be the case that Muslim law is part of our law in certain areas but not others if parties so desire.

In international arbitration, the position is even clearer. Article 28 of the UNCITRAL Model Law allows the arbitrator to decide matters *ex aequo et bono* or as *amiable compositeur* i.e. on principles of equity, fairness and justice.<sup>24</sup> There is no reason, therefore, why parties cannot choose Muslim law or principles of Sharia law.

Thus, if one goes to court with a properly drafted clause which subjects the contract to Sharia principles, it is likely that the clause will be given effect. In arbitration, the clause will almost definitely be effective.

*Suhaimi Zainul-Abidin*

By way of background, arbitration clauses are rare in both Islamic banking and conventional banking transactions. The norm for Islamic banking transactions in Singapore is to have very clear governing law clauses, usually Singapore or English law. The speaker has not come across references to Sharia law in such transactions. To the extent that there is an intention to

<sup>23</sup> [1998] 3 SLR(R) 369 at para [38].

<sup>24</sup> UNCITRAL Model Law on International Commercial Arbitration. The Model Law has the force of law in Singapore by reason of s. 3 International Arbitration Act.

give effect to a transaction that is valid under Sharia law, this is encapsulated in the terms of the contract. This makes it fairly easier to consider the repercussions in an insolvency situation.

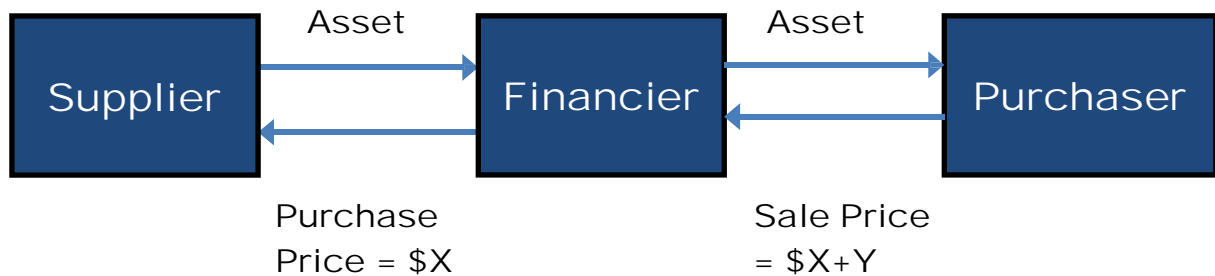
Most practitioners have quite different views on what Islamic financing means. Islamic financing can technically be very simple but it has been made very complex. If we look at transactions such as *murabaha* and *musharaka*, these are transactions that are easily understood. However, under modern Islamic financing, we have complex structures which involve a combination of Islamic principles and contracts, and which together attempt to change the true economic nature of the underlying transaction.

For instance, if a purchaser wants to buy a certain product, he can enter into an agreement with a party who procures the product for him, and who sells it to him at a mark-up. This is a simple transaction. The complexity arises when parties intend to turn the simple sale arrangement into a financing transaction which mirrors the charging of interest. In such a situation, issues relating to the value of money over time and rebates for early repayment will need to be considered. In a normal sale transaction, the sale price does not increase over time and there would not be a question of rebate for early payment.

The following sections will touch on certain Islamic finance structures and the insolvency perspectives relating to each of these structures.

## B. Sale and Finance Lease Structures

### *Murabaha* (Cost-plus Financing)



Purchase Price ( $\$X$ ) = Principal

Profit =  $\$Y$

Sale Price ( $\$X+\$Y$ ): Payable by Purchaser on deferred terms

Sale Price is similar to Principal + Interest payable on a loan

But Sale Price is payable in respect of an Asset purchase, not a Loan

*Suhaimi Zainul-Abidin*

In a simple *murabaha* transaction, there is a supplier and a purchaser. A financier steps in between them, procures the asset for  $\$x$ , and sells it for  $\$x+y$ . This is an asset procurement technique that has existed for centuries.

The problem is that banks today have used this as an Islamic finance technique replicating a loan, with  $\$x$  being the principal and  $\$y$  being the interest. In a loan transaction, the contractual relationship between parties is one of borrower and lender. In contract, in a *murabaha* transaction, the relationship is one of buyer and seller. If one party does not sell the asset to the other party, the latter does not owe the former any money. Thus, while the sale price is similar to the principal plus interest in a loan, the sale price is payable in respect of an asset purchase rather than a loan.

It should be noted that most Islamic financing transactions are based on the *murabaha* structure. While the structure is well-accepted, there has probably been insufficient consideration as to what would happen if insolvency strikes in the midst of a transaction? This would ordinarily have significant repercussions in a sale transaction, but what about a financing transaction?

*Andrew Chan*

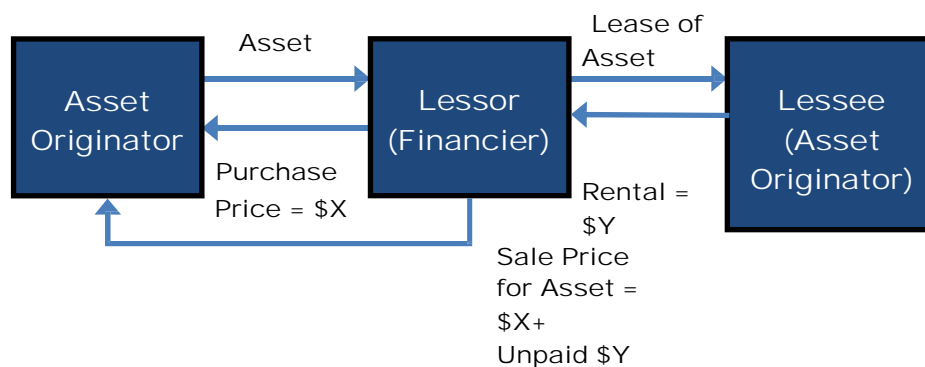
The concept of a *murabaha* transaction is different from a loan transaction. In a straight loan, the expectation is that the lender can get the loan amount back. However, in a *murabaha* transaction, if the financier buys the asset and the purchaser is insolvent, the financier cannot force the asset onto the purchaser because an obligation to purchase goods is not specifically enforceable. In the context of a *murabaha* transaction, this could mean that the bank has acquired the goods with the expectation of on-selling the same to the buyer, but finding itself

unable to complete the on-sale. The bank should therefore have considered the potential repercussions of an intervening insolvency in the sale and on-sale process, and what its recourse would be in such circumstances.

The net effect is that the financier will have to claim damages, which would be the difference between the market price and the contract price of the goods. This shows that there are difficulties in trying to use the *murabaha* transaction to replicate a loan agreement.

Furthermore, the quantification of damages for a *murabaha* transaction may be different because one is dealing with a contract of sale. Even where the purchaser has given the bank an undertaking to purchase the goods for the marked-up sale price (as is common in a *murabaha* transaction), the liquidator may ultimately prevent such an on-sale to the purchaser by disclaiming the undertaking and the *murabaha* contract. Because of the difference in the nature of the underlying sale contract (in comparison to a loan), the quantification of damages in insolvency could be different.

### ***ijara wa-Iqtina'* (Lease and Buyback)**



Purchase Price (\$X) = Principal

Rental = \$Y

Sale Price (\$X+Y): Payable by Asset Originator at Maturity / Default

Sale Price is similar to Principal + Unpaid Interest payable on a loan

Rental is payable in respect of the Lease of an Asset, and Sale Price is payable in respect of an Asset purchase, not a Loan

Sale Price is only payable if Asset is transferred back to the Asset Originator

### *Suhaimi Zainul-Abidin*

The *ijara* transaction is a lease transaction. The lessor-financier purchases the asset from the asset originator and leases it back to him. At the end of the transaction, the lessor sells the asset back to the asset originator or another obligor for the sale price. One example of such a transaction is the hire purchase of a car. In such a transaction, the asset originator is the car supplier. The bank buys the car from the supplier and leases it to the hirer. At the end of the day, the hirer purchases the car.

In the *ijara* transaction, there are two different time phases for asset transfers. The first phase is when the financier purchases the asset and leases it to the hirer. That lease will generate the

rental that the hirer is obliged to pay. The second phase is when the car is eventually transferred to the hirer, who then becomes the owner.

## **Insolvency Implications**

*Andrew Chan*

Arising from the fact that there is property passing from the originator to the lessor, and possibly back to the originator or to the lessor at the end of the transaction, there is a question of whether this is a true sale and whether, alternatively, a charge is created which requires registration under s. 131 of the Companies Act. This is an important question because a failure to register may result in the transaction being void against the liquidator and, in certain instances, the creditors.

Hence, we should ask whether the *ijara* is registrable as a secured financing transaction? As per other secured transactions, the debtor could be viewed as retaining an interest over the asset until such time as it receives repayment of the debt and, in the case of an *ijara*, the lessee is transferring title at the end of the transaction purely so that it can get its money back. The law does not allow people simply to choose structures and call them whatever they like. Ultimately, if this is properly characterised as secured financing, it has to be registered. This is an issue which often has to be dealt with in practice.

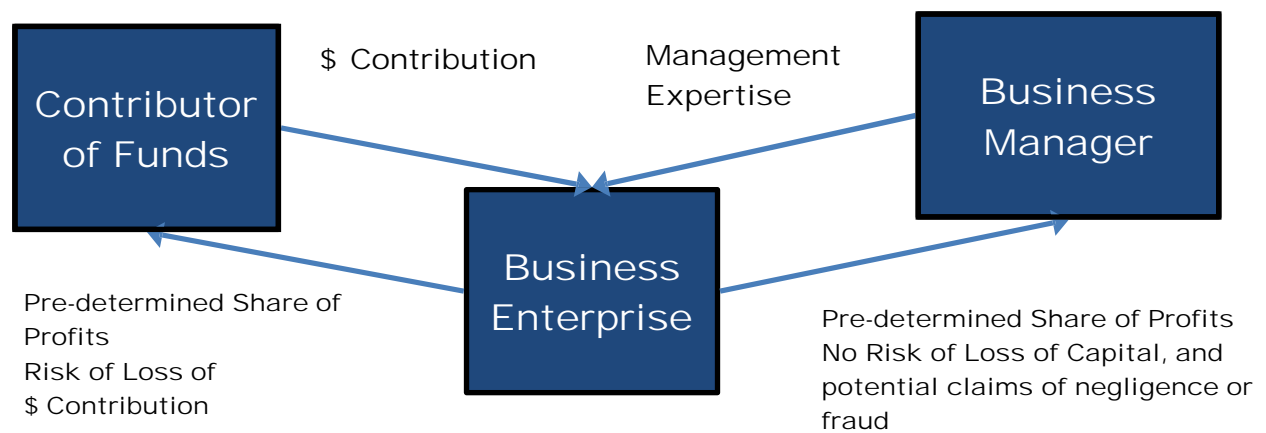
The first response to this issue is to ask: What is the purpose of this transaction? At a glance, it would appear that the purpose is not to give security, but rather to replicate the economic effects of what the financier would have been entitled to if he was entitled to interest in a financing transaction. If this is so, the issue of whether the financier gets security is secondary. Thus, in an *ijara* transaction, the proper analysis is often in practice to view it as being an unsecured financing transaction. This is also why, in such transactions, one has to look to the creditworthiness of the obligor, and not rely on the value of the asset underlying the lease. If security is necessary, it should be dealt with separately.

Another consequence of the *ijara* structure being upheld as a true sale is the risk of insolvency on the part of the financier-lessor. There is one view, supported by an Australian case decided last year, that the liquidator of an insolvent company has the power to disclaim long-term leases. In such a situation, the lessee merely has a right to claim damages. This could have severe ramifications for the lessee in terms of its expectation to receive the asset back in return for payment of the pre-agreed price.

One way of modifying the *ijara* structure is to change the final sale by the financier to the asset originator to a right of first refusal in favour of the lessee. In such a structure, the asset originator does not have an obligation to buy the asset back, but if he wishes to exercise his option and purchase the asset, he has to meet the market price.

## C. Equity Participation Structures

### *Mudharabah*



Joint Enterprise often Contractual (Unincorporated JV)

No Ownership of Shares by Business Manager, but contractually due a share of any Profits  
Business Manager has no right to liquidation proceeds of the Business Enterprise, only the Profits

### *Suhaimi Zainul-Abidin*

The first category of Islamic finance, made up of structures like the *murabaha* and *ijara*, is made up of relatively simple structures which are well-accepted in the conventional world of commercial transactions.

The second category of Islamic finance structures is made up of those with equity participation. They are often described as differing from *murabaha* and *ijara* structures because of an element of risk and profit sharing. They are also different in the sense that they are still today largely applied in ways that retain their original characteristics, unlike *ijaras* and *murabahas* which have been tailored to replicate interest-bearing structures.

The *mudharabah* is in many senses like a joint venture, with one party contributing capital to the venture and the other contributing his business or management expertise. *Mudharabah* structures are often unincorporated, meaning that they are just based on contractual arrangements, without a specific joint venture entity. Each party is contractually due his share of the profits. If there are losses, these are borne by the party that contributed capital into the venture. The party that contributed his expertise only loses his time and effort, barring instances of fraud, mismanagement or negligence.

## Insolvency Implications

The question to be asked in an insolvency situation is: Who has the right to the liquidation proceeds from the joint venture, bearing in mind the intention of the venture, which is for both parties to share the profits, but for the party contributing capital to bear the losses?

*Andrew Chan*

Several important questions need to be asked in such a situation.

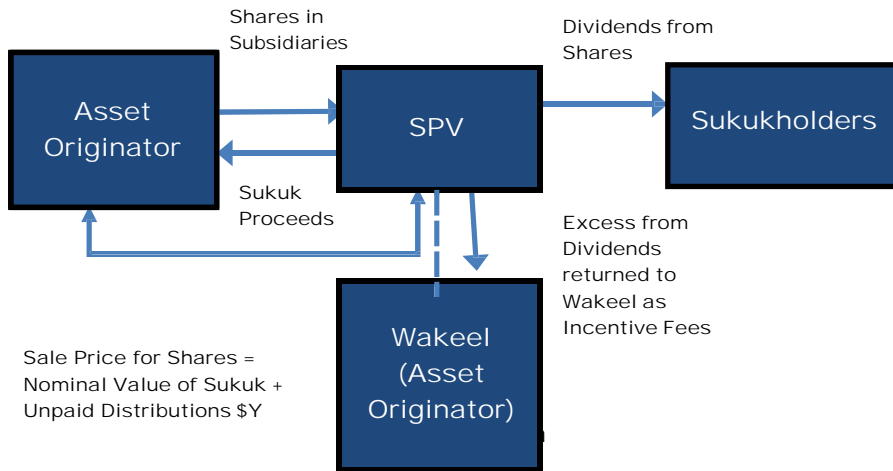
The first question to ask is whether the contribution of assets into the venture was an undervalue transaction, which could arise if the party that contributed capital into the venture did so at a time when it was known that the other party was unable to perform or that the venture was going under. Thus, one would need to ask whether the parties were solvent at the beginning of the venture and whether they became insolvent as a result of the transaction. It should be noted that the transaction will not be struck down if it can be proven that the parties were acting *bona fide* and for the purpose of carrying on their business, and that there were reasonable grounds for believing that the transaction would be beneficial to the venture. (Regulation 6 of the Companies (Application of Bankruptcy) Regulations.)

The second question to ask is whether the arrangement falls foul of the anti-deprivation rule. This may occur if there is an arrangement whereby a party owns a particular asset for as long as the venture is viable, but where he agrees to transfer part of it to another party during insolvency. Whether a *mudharabah* arrangement falls foul of the anti-deprivation rule depends on the purpose behind the arrangement and the *bona fides* of the parties. This was stated in the leading UK case of *Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services Ltd* [2011] UKSC 38. Essentially, one needs to look at general principles of law to decide the consequences on insolvency.

The last point in relation to liquidation and insolvency relates to the discretion of the courts in winding-up proceedings. In this regard, the Singapore Court of Appeal held, in *Metalfarm Asia Pte Ltd v Holland Leedon Pte Ltd* [2007] 2 SLR(R) 268, that the court will not allow the winding up of a company if there is a *bona fide* dispute. Furthermore, the Singapore Court of Appeal in *BNP Paribas v Jurong Shipyard Pte Ltd* [2009] 2 SLR(R) 949 expressed approval of the decision in *Pilecon Engineering Bhd v Remaja Jaya Sdn Bhd* [1997] 1 MLJ 808, in which the Malaysian High Court stated that the court can consider the interests of the public at large in deciding whether or not to wind up a company. If the courts can take into account considerations of wider public interest, there is no reason why principles such as justice and equity, which have been accepted as Islamic principles in the Malaysian case of *Malayan Banking Bhd v Ya'kup bin Oje & Anor* [2007] 6 MLJ 389, cannot be taken into account by the courts in their exercise of discretion, should these principles be relevant.

## D. Structured Financing

### Wakala Sukuk



*Wakala* Sukuk are typically structured as a combination between a fixed payments structure (*Murabaha/ijara*) and an investment type structure (*Wakala*). This reduces the Asset Value required to back the transaction. Repayment to Sukukholders = through sale of *Wakala* Venture to Asset Originator / Obligor. Sale Price is only payable following sale of *Wakala* Venture.

### Suhaimi Zainul-Abidin

The word “*sukuk*” can be translated as “trust certificates” i.e. certificates evidencing a trust over assets. In this traditional sense they give the holder a right to returns derived from, or based on the performance of, certain assets. However, the *sukuk* in the market today are predominantly intended to replicate what bonds do, i.e. to pay out fixed returns for the term of the *sukuk*.

In a normal *ijara-sukuk* transaction, the financier purchases the asset from the asset originator and leases it to the party requiring financing. The party requiring financing pays rent for the asset and repays the principal sum by purchasing the asset from the financier at the end of the transaction. This creates the financing mechanism. For various reasons, such as to reduce the asset value requirement of the underlying assets, a *wakala* structure is usually layered over the fixed income *ijara* or *murabaha* structure.

*Wakala* refers to an agency relationship. This typically means that there will be an SPV, in between the asset originator and the sukuk-holders, which will appoint the obligor as the *wakeel* (agent).

For example, one can imagine a structure where the asset originator is a REIT (Real Estate Investment Trust). In order to create the investment underlying the *sukuk* and make it Sharia-compliant, the SPV uses the *sukuk* proceeds to purchase certain assets from the REIT. The SPV then appoints a *wakeel* (typically the REIT itself) to manage the assets for the SPV. The



SPV, as the beneficial owner of the assets and the principal behind the agency relationship, receives the income arising from the management of the assets, and that income should flow to the *sukuk*-holders because the SPV is trustee for the *sukuk*-holders.

The repayment of principal to the *sukuk*-holders is achieved through the sale of the assets back to the asset originator for the principal amount, as per a typical *ijara* structure. Issues may however arise if the asset originator is insolvent when the SPV attempts to transfer the assets back in order to create the repayment obligation.

*Andrew Chan*

At the end of the day, if we are going to rely on the originator buying the asset back, then we should think about the contingency plans in the event that the originator may be insolvent. Additionally, if there was no true sale to begin with and the transaction is characterised as secured financing, it may be void against the liquidator etc. by virtue of it being unregistered. If the property reverts to the asset originator and the SPV has a claim as an unsecured creditor, then that may be sufficient as the structure is typically intended to be structured as an unsecured credit.

The other aspect arising from this structure is the fact that every element has a purpose. With the SPV, the intention is for it to be bankruptcy remote. The object of the SPV may be restricted in the Memorandum and Articles of Association and this limits the ability of the directors to do things which may cause the company to become insolvent. In short, these are things to think about when structuring the transaction.

#### IV. ARBITRATION/ADR IN ISLAMIC FINANCE

*Celine Chelladurai*, Zaid Ibrahim & Co, Kuala Lumpur, Malaysia  
*Nicholas Foster*, SOAS, University of London  
*KC Lye*, Norton Rose Fulbright (Asia) LLP, Singapore

*Nicholas Foster*

A few words by way of introduction. The use of arbitration in financial disputes used to be unthinkable. Lenders want to enforce the obligations due to them quickly, cheaply, and easily. Contrary to what is all too often claimed, in jurisdictions with reasonably efficient court systems arbitration is often slower, more expensive and less efficient than litigation/security enforcement. And in litigation one may well find advantages over arbitration such as summary and default judgments and interim relief procedures, as well as private, or at least out-of-court, security enforcement. In addition, if one can sue in a common law legal system, one often finds that that system is very bank friendly and, especially in England and New York, the judges are expert in financial law.

However, in Islamic finance there have recently been moves towards arbitration and ADR.

*Celine Chelladurai*

The court system has created considerable confusion. A considerable amount of effort, therefore, is now being devoted to the on-going development of a body of law which is certain. So the question is: Will alternative dispute resolutions (ADR) through arbitration and mediation provide the kind of certainty that the banking sector is seeking? Also, how do you get there? How does it fit, or does it need customization to fit Islamic financing? (The answer is yes, it does need some level of customization.) More specifically, how do you treat the concept of profits or damages?

The Kuala Lumpur Regional Centre for Arbitration Rules (KLRCA Rules) are mainly based on the UNCITRAL Model Law, but they also have a provision which ties them to the Malaysian law. If Malaysian law is used as the governing law, the arbitrator is obliged to obtain an opinion from either the Sharia Advisory Council (SAC) of the Securities Commission Malaysia or the Sharia Advisory Council of Bank Negara Malaysia) on the Islamic finance aspects, and apply that in giving the award.

But that goes against the grain of being an arbitrator and how he makes his decision, so this structure may, therefore, not sit very well in international arbitration.

The KLRCA recognize this problem. They are now moving away from a domestic outlook to an international outlook and are redrafting the rules. Two changes are of particular importance.

The first major change relates to the *choice of the scholars used*.

In the revised structure, arbitrators will no longer be bound to consult the official Malaysia SACs, but will be able to choose the most appropriate group of Sharia scholars (Sharia board).

The most significant factors in the choice of Sharia board are:

- the compatibility of the Sharia principles used by the board with those acceptable to the parties (the determining element will usually be that the board is situated in the same geographical area as the parties); and
- the suitability of the Sharia principles used by the board for the jurisdiction in which the award will be enforced.

As regards the latter issue, the main question is: Will the instrument be considered to be based on Islamic principles, and therefore valid, in the jurisdiction in which enforcement is sought? The new rules will enable the arbitrators to appoint a Sharia board where the assets are or where the award will be executed.

The second major change will allow parties to choose Sharia experts as arbitrators who will be able to *adjudicate on Sharia matters themselves*. So:

- if a Sharia board gives advice which the arbitrators do not consider correct, the arbitrators, as experts, can adjudicate the matter themselves; and
- they can make their award much more quickly.

As regards the latter issue, since they are bound by the SAC's opinion, the arbitrators currently have to wait for that opinion, but the official Malaysian SACs are overworked and obtaining their opinion can take a considerable time. This can lead to considerable delay and negate one of the principal advantages of arbitration. If, however, the arbitrators can adjudicate the matter themselves, the award can be made much more quickly.

It is important that banks realise the efficacy of this process but, despite the increased attractiveness of arbitration, many banks still do not include arbitration clauses in their documentation. Some countries now require banks to do so.

On a practical level, it is important that the arbitration clause be inserted at the outset. If, at a later state, one wishes to arbitrate but there is no arbitration clause, it is very hard to move into arbitration, as it is extremely difficult to make parties in dispute agree to anything.

It is important that the clauses be accurately drafted, and that the options be considered at the very beginning so that the bank's endgame is secure.

However, there are some disputes which still need to be dealt with in court.

*KC Lye*

Clients want certainty. They want to know what will happen if the transactions ends up in court or arbitration. They want their rights on paper. In which direction should one go, then, if one has a Sharia-compliant instrument? To court or to arbitration? It depends on the court you are competing against. The main reason why people go to arbitration is enforceability - enforceability outside of one's own country in cases of multiparty transactions involving different countries. Arbitration is chosen because one needs to enforce the award in a variety of places, and generally it is much easier to enforce an arbitration award than a court judgment.

In addition, if one goes to court, one cannot choose the judge. In arbitration, one can choose the arbitrator/s.

When choosing arbitrators, it is better to choose one who knows nothing about Sharia law. Why? What do the clients expect? They expect that the rights they will get are those that are written on paper. If an arbitrator is chosen who knows nothing, he will most probably apply the terms as written. If an arbitrator is chosen who knows Sharia law, he might try to put his own meaning into the document.

The problem with appointing an arbitrator who thinks he is a Sharia law expert is that each country has its own official view of what the Sharia is. Arbitrators will have great difficulty departing from what they think is the official view of their country, and there is a danger that this official view is different from that contemplated by the parties, because the arbitrator and the parties may come from different countries. Thus, it is better to choose an arbitrator who knows nothing about Sharia law if what is desired is for the arbitrator to enforce what is written in the instrument instead of getting involved in discussion about what the Sharia really is.

It does, of course, depend on what the clients want.

According to the KLRCA Rules, once the arbitrator receives the Sharia Advisory Council's opinion, the arbitrator shall apply that opinion. There is no discretion left for him to decide otherwise.

Lastly, note that the *Beximco* case provided a great amount of certainty to this area of law but you might end up with the arbitrator deciding what the Sharia position is for the purpose of the instrument even if he follows *Beximco*.

## V. PANEL DISCUSSION AND QUESTION AND ANSWER SESSION

Chair: *Dora Neo*, National University of Singapore, Centre for Banking and Finance Law  
All speakers

*Dora Neo*

The positions can be quite different depending on the jurisdiction the parties find themselves in. Contrasting the position of somewhere like England with somewhere like Malaysia. In England we are asking the preliminary question of whether Sharia principles can be selected as the governing law, and whether the English courts will even recognise that. The position after the Rome I Regulation came into force suggests that it may be possible in some circumstances. In Malaysia, not only is it possible to apply Sharia principles, but we have to make sure they are properly and correctly applied. There is a big difference between the two jurisdictions.

During the break, I asked Suhaimi and Andrew about the Singapore position. They both said that they thought the Sharia could be applied in Singapore. Earlier, Aida mentioned the differences in various types of jurisdiction: secular jurisdictions, Islamic jurisdictions and mixed jurisdictions. Where would Singapore fit in the scheme of things? Would Singapore ever be able to go as far as Malaysia in terms of the additional rules mentioned by Aida?

*Andrew Chan*

My proposition is that, in Singapore, we operate in a system where Muslim law is already part and parcel in certain aspects of our law. Against that background, we cannot say that Muslim or Sharia law is not law, so we have, if you like, an advantage over England insofar as this aspect is concerned.

Will we go the way of Malaysia? Again, there are competing principles because as long as there is a contest of views, there is something to be said about party autonomy. Let the parties who want Islamic law or Sharia principles to govern decide what is best for themselves, rather than necessarily impose one particular type of framework.

I am heartened to hear that in Malaysia they are exploring the possibility of giving that particular flexibility but in Singapore, as far as I am concerned, the rule is party autonomy. For those who want the views of Sharia scholars or particular standards (assuming that the relevant body is willing to give the standards on request), these can be incorporated into the contract. For those who do not wish to adopt this approach, and decide to select an expert tribunal or to enter into a particular transaction, then so be it. My views are therefore:

1. Sharia principles can and will be allowed in Singapore.
2. Party autonomy is respected.

*Suhaimi Zainul-Abidin*

Can Singapore follow the approach taken in Malaysia, where it is more regulated and certain aspects are prescribed, for example, which structures are given recognition as acceptable Islamic financial structures, meaning that other novel structures may require further approval? Yes it is possible, but I believe both approaches can work.

Malaysia is a particularly important jurisdiction in terms of Islamic finance. There are other countries, with Muslim-majority populations, that have not adopted the same level of regulation, and there are various ways to deal with this issue of Sharia standards. Much of it boils down to the intent behind the push for Islamic finance. The Malaysian government has openly declared its intention to develop an Islamic financial industry for Malaysia, and every aspect of creating, regulating and promoting that industry is thought through carefully. The intention is to create an industry that will have international scale, but at the same time is well regulated on the domestic level.

Singapore is quite different, as it is a thriving regional financial centre. Accordingly the economic basis to promote Islamic finance has been quite different. If, for instance, one could say that Islamic finance could create or bring about certain economic benefits different from those brought about by conventional finance, then perhaps there would be a better reason for Singapore to promote the growth of Islamic finance. But at the moment, it is difficult to see what that is. It appears that the Singapore government's position on Islamic finance is one of facilitation. It will allow Islamic finance to develop and thrive and, for this purpose, create a platform for it, but it is unlikely that the Singapore government will go much further than that. That means, in terms of governance from the Sharia perspective, on whether products are Sharia-compliant, we let the parties decide for themselves. The two parties, open-eyed, sign the contract and know what they are entering into. The contract provides that it is governed by Singapore law or English law, and the parties represent and agree that they will not claim that the contract is non-Sharia-compliant. Such a transaction is viewed as commercial. Singapore regulators do not want to be involved with the issue of what is Sharia or not Sharia-complaint, because that opens a can of worms in itself. Would one have to ask which *mazhab* is to be followed? Or would one go the Malaysian way, where they have a stricter approach? Both systems can work – the Malaysian system has worked really well and has set a great benchmark for everyone, but Singapore is probably going to take a different approach and will not adopt the Malaysian approach, at least for the foreseeable future.

*Dora Neo*

Thank you, and thank you also for pointing out the term in the contract which says that the parties will not challenge the product for being non-Sharia-compliant. This is an important term.

*Andrew Chan*

I'm actually very interested to see a potential debate between Celine and KC. Celine seems to be advocating the benefits of choosing an arbitral tribunal which is familiar with the Sharia, while KC seems to support a blank page. I think there are relative merits and the actual answer, I think, should be that it depends on the circumstances, but it will be interesting to see what the considerations are on this point.

*Celine Chelladurai*

I think we actually had not so much different views as different perspectives. You are right, it depends on the circumstances of the case.

If you are looking at the KLRCA i-Arbitration Rules, with strict time constraints as to when the award is delivered, you want to receive the opinion of the BNM SAC within the strict timeline. If one has an arbitrator who is a blank page as far as Sharia law is concerned, he would be reliant on expert opinion. If the expert opinion does not come in within that timeframe, you are going to get a very awkward decision.

It may be that he is just looking at the letter of the agreement and saying this is what the agreement says, but what if there were intervening facts or conduct in the transaction which altered what was in the contract? How does that put it in light of Sharia principles? How does the arbitrator deal with those facts? If it is a strict case of reading the agreement and interpreting whatever is stated within that lengthy document, all well and good, but if there were intervening factors, for example the insolvency of one of the parties or insolvency affecting an asset that underlies the transaction, how does an arbitrator with less knowledge deal with it without the expert opinion within the time stipulated by the advisory rules? Having a panel that has Sharia expertise would assist in a situation like that, compared to having someone who is blank page, is going to be guided by the BNM SAC, and who actually takes it as an expert opinion, takes it and analyses it. If he has two differing expert opinions, how does he then decide which is the correct one? An expert panel member can bring his own expertise into play and balance out the two expert opinions. It is only when you have one expert that the blank page works.

*KC Lye*

I agree that it comes down to what it is that the parties want in an arbitrator. Why does it matter how an arbitrator listens to an expert opinion on what is Sharia law?

Firstly, the arbitrator could see his role as one in which he is to find out what is truly the Sharia and to apply it, in the same way for example, as if the governing law is Singapore law, he needs to apply what is truly Singaporean law.

Secondly, consider what happens if, instead of trying to find out what is truly the Sharia, the arbitrator is trying to figure out as a question of fact what the two parties expected at the time they signed the contract. What was the deal they were trying to make? To the extent that the arbitrator is hearing Sharia evidence, he is hearing the evidence for the purpose of deciding what the two parties expect. If you want an arbitrator who is listening to the evidence for the

purpose of making up his mind on what is truly Sharia and apply it, choose an arbitrator who is greatly experienced in the Sharia, or a court from a Muslim country that is greatly experienced. (The downside is that they may have very firm views on what they think is the true Sharia.) If you want an arbitrator who is going to apply the terms of the contract as they are written, and will only listen to the evidence on the Sharia in order to try to decide what the parties truly agreed and expected when they entered the agreement, then you should choose an arbitrator who knows nothing about the Sharia, because he is more likely to receive evidence of the Sharia with that intention.

*Andrew Chan*

My view is that you should go to someone who is a Sharia expert and has an open mind.

*Nicholas Foster*

I have a structural comment that may help to explain some of the ways we are thinking about certain things. We have essentially two types of Islamic finance, one is the international, wholesale, type, and one is national. We are seeing a lot more of the national-based type of Islamic finance. One has to interpret what is going on with that fact in mind. The *Beximco* case dealt with an international wholesale transaction. The sort of considerations relevant in such a case are very much those of party autonomy and the considerations taken into account by the court are those relevant in business-to-business transactions. But in domestic circumstances we need to consider such matters as consumer protection and the regulation of everyday transactions. That is going to be dealt with in different ways in different jurisdictions with different considerations coming in. It is a very relevant consideration when you think about dispute resolution. How are you going to deal with that dispute under the differences in considerations regarding dispute resolutions on an international level and on a domestic level?

*Dora Neo*

The Islamic Financial Services Act 2013 of Malaysia has some very strict rules. Would the encouragement of arbitration in Islamic finance disputes actually facilitate the sidestepping of these rules?

*Celine Chelladurai*

If arbitration could be a sidestep, you arbitrate in Malaysia but not under Malaysian law because, if Malaysian law is applied, the regulations of the Islamic Financial Services Board, the BNM SAC, the Securities Commission and BNM would come into play. So one could sidestep the Act by having Sharia law as the governing law, but the applicable law would be non-Malaysian. In domestic arbitration, there is no reason not to use Malaysian law, so there would be no way to sidestep the constraints imposed by the new Act.



*Question from the floor*

I'd like to go back to two themes that came up in discussion – one was certainty and the other was on efficiency in terms of dispute resolution. Going back to the contract drafting of structures, are there any moves to standardise some of the drafting, as in conventional finance structures that can be replicated, to address uncertainty, for example through something similar to the ISDA for derivatives? If there is no such standardisation yet, would that take into account some of the problems that have been discussed today?

*Suhaimi Zainul-Abidin*

This issue of standardisation is one that is so commonly talked about in Islamic finance circles. In comparison to conventional financial markets, modern Islamic finance is only about 30 years old. Within this period, the breadth of instruments that Islamic finance encompasses has grown tremendously, but compared to the complexity that has grown in conventional financial markets, Islamic finance is still relatively simple. It does not have credit default swaps, collateralised debt obligations or other complex instruments that even some bankers have difficulty understanding. Nonetheless, simple as they may be, standardisation is still important and there has been great progress in standardisation. There are equivalents in Islamic finance to ISDA documentation. Initially banks came up with Islamic derivative master agreements, still different between banks but somewhat standardized in terms of the approach of trying to mirror ISDA terms, and the market is now moving on to using the standardised *Tahawwut* Master Agreement. While it has still not been adopted by many banks, there is nonetheless a gradual move towards usage of this standardised documentation. Alongside that, if you look at instruments involving loan transactions, *murabaha* transactions are fairly standardised – the majority of the boilerplate provisions that create the *murabaha* structure look similar across jurisdictions. The move towards standardisation is due to many reasons: parties and banks want certainty and efficiency so they can look at contracts that look similar to know what their rights and obligations are, and so that the asset in terms of the liability or debt can be traded. It is still a work in progress, but we'll get there.

*Question from the floor*

What happens if there is a misapplication of Islamic law or an application of only common law principle in an arbitration award regarding a dispute on Sharia-related issues and thus it is not enforceable in Malaysia? Would this cause a problem of enforceability in other countries?

*KC Lye*

The award would have the same status as any other award and it should in theory be enforceable in all countries that have signed up to the 1958 New York Convention. It is correct that if one wants to enforce the award in a Muslim country, there may be an aversion to enforcing an award with a ruling on Sharia different from the country's official view of Sharia. Under the New York Convention, one of the reasons for refusal to enforce an award is public policy. Different countries have different views of public policy. This is not limited to Muslim countries. The Indian courts have previously said that if there is a foreign arbitration award concerning a contract subject to Indian law, if the arbitrator has decided differently on

Indian law from what the Indian courts would have decided, it is contrary to public policy in India to enforce that award. If you transfer that to a ruling on Sharia, you may have the same kind of thinking, but it depends on where you want to enforce the award.

*Question from the floor*

In clarification of the previous question, if the arbitrator misapplies Islamic law and awards the claimant interest, and it happens that the respondent has an asset in a non-Islamic country, would the award not be enforceable including the interest?

*KC Lye*

Yes, the award will be enforceable in the non-Islamic country, including for interest.

*Celine Chelladurai*

Following up on that, the whole point is that one wants an enforceable award and one wants it to be enforceable in the country where the assets are. In determining the choice of arbitrator, one has to have a map available – where is he going to adjudicate on this award? If it is a country that takes Sharia principles very seriously and would consider that award as being against public policy because it does not interpret Sharia principles accurately according to their jurisdiction, then one must be careful about the choice of arbitrator and select someone who is knowledgeable and mindful about the application of Sharia principles.

*Andrew Chan*

One of the grounds of setting aside or not giving enforcement is if the tribunal did not apply the law intended by the parties. Here, it has to be shown that the tribunal has applied some of the law intended. If the contract is governed by Sharia principles but the tribunal ignores Sharia principles, there is some risk, because an award by a tribunal that ignores the law that is part and parcel of the contract will not be enforced. There is something to be said for bringing someone in with some knowledge. The other point is the concern of whether enforcement of the award is against public policy. The closest known analogy for which there is literature when it comes to the law on international arbitration awards is actually punitive damages, because the United States has phenomenal concepts of punitive damages. Punitive damages as granted in US courts taken to different countries may not be enforced because their public policy may not allow it. If a tribunal has no knowledge, there are significant risks that the award may not be enforced.

*KC Lye*

I agree that it is not a good idea to send a dispute to a tribunal with no expertise. The real question is: what expertise? My view is that it is the expertise to write an award that is not going to be set aside, not expertise in Sharia law.

*Question from the floor*

Are there different schools of thought of Islam in terms of approaches to different issues in Islamic finance? If there is, would this not mean that the choice of *mazhab* would become very important and the *mazhab* of the judge or arbitrator would also be very important?

*Celine Chelladurai*

You are always going to be coloured by your perceptions and they are going to be formulated by your personal background, your religious beliefs and a whole host of other influences in your life. You bring a wealth of information when you sit as a judge or arbitrator. There is a lot to be said for, but also against, that. How much of that is brought in in a good way and how much is brought in in a bad way? We cannot ignore the knowledge we carry with us. The practical reality is that there is going to be that element.

In Malaysia, that is why there is a move towards standardisation and certainty in how instruments are being interpreted, especially domestically, since many instruments are used in the domestic retail market to fund purchases of houses and cars. There is a huge market that affects the economy of the country, and there is a domestic agenda behind this certainty for the domestic market. Choosing a specific *mazhab* and interpretation works for Malaysia, but whether it works in other jurisdictions depends on other factors. In litigation, the need for certainty led to the rule regarding courts being obligated to follow SAC interpretations. In international arbitration, look at where you are going to execute the award, the intentions of the party and pick your expert carefully. You can mix and match your panel in arbitration for the flexibility you want when you're dealing with Sharia principles.

*Andrew Chan*

In the *Majlis Ugama Islam Singapura* case, one particular *mazhab* was specified. If one wants to ascertain the view of a particular *mazhab*, you go back to literature from the particular imam, but one of the principles of Islamic reasoning, according to some scholars, is that, if there is doubt as to what the right views are, look at the lowest common denominator. If it is common across other *mazhabs*, it is likely to be indicative of the view in this particular *mazhab*. Two principles arise:

1. Can you choose the *mazhab*? Yes.
2. If you've so chosen it, it is important to choose the arbitrator. Judges and arbitrators are humans who try to be as objective as they can, but cannot be totally objective.

*Suhaimi Zainul-Abidin*

There is no reason why in any contractual arrangement you cannot specify what type of *mazhab* you want to govern the transaction. But, in truth, it is extremely rare for parties to select a particular *mazhab*, especially in financial transactions. From a practical standpoint, the application of Sharia principles by the different *mazhabs* is largely similar, and differences are minimal. I understand that, in theory, when a Muslim is supposed to decide Sharia compliance, the *mazhab* of the judge is not intended to affect how he judges the matter. Instead, the relevant *mazhab* for the purposes of resolving the dispute should be either the *mazhab* specified to be applicable in the contract or, in the absence of such specification, the *mazhab* that is most closely connected to the parties and the particular transaction. Thus if the transaction is carried out in a particular country, and both parties are from that country, that country's *mazhab* ought to apply, if the Muslims in that country uniformly follow a single *mazhab*. This is even if the person determining Sharia compliance is from a different *mazhab*. A Sharia scholar sitting on an arbitration panel is supposed to know the different types of *mazhab* and what to apply in the particular situation.

*Aida Othman*

It is quite important to come up with a good agreement to arbitrate so that you can go for a panel of three people with Sharia and arbitration expertise. Not all agreements are perfectly drafted and the solutions may not be equitable principles that can be found in the Sharia law. You can draft into the contract several things, such as a panel of experts, or if a Sharia issue arises, it will be tried by the BNM SAC or it will be decided by the Sharia board of the bank, as it is comprised of independent experts who can then clarify why the transaction was approved in the first place. It is so important from BNM's perspective that Sharia issues are determined by the BNM SAC and not by individual Sharia scholars because:

1. If there is a Sharia *fatwa*, another qualified scholar cannot overturn it. Sharia certainty must be attained for this industry to develop.
2. The only people who understand the development of Islamic finance and take positions on Islamic finance are BNM SAC, and their resolutions are comprised of views of all the different *fatwas*.

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