

# **DISPUTE RESOLUTION IN ISLAMIC FINANCIAL CONTRACTS OF ISLAMIC FINANCIAL INSTITUTIONS - ISSUES**

**BY**

**MR. JUSTICE (R) KHALIL-UR-REHMAN KHAN**

## **Abstract:**

Bank entering into Islamic Financing agreements with Construction Contractors, Governing Law Clause of the contract providing for English law subject to principles of Shariah.

## **Contractor defaulting on agreements:**

How the agreements governed by English Law alone or English Law subject to Shariah Law & principles will be construed?

## **Conflict of Laws:**

Principles examined. Arbitration way out to apply principles of Shariah for determining rights & liabilities.

“IN THIS PAPER I PROPOSE TO EXAMINE THE FEASIBILITY OF ‘APPLICABLE LAW’ CLAUSES WHICH SEEK TO APPLY BOTH THE LAW OF A STATE AND SHARIAH PRINCIPLES. I BEGIN BY EXAMINING A CASE WHICH AROSE IN THE JUDICIAL SYSTEM OF THE UNITED KINGDOM.

## **Factual Background of the Dispute:**

The Bank was incorporated under the laws of Bahrain, a country which encourages Islamic Banking practices as national policy and the Bank holds itself out as applying Islamic Banking principles and uses Shariah-compliant financial products. The Bank extended finances to the Contractor on the basis of Murabahah mode of financing, and the documents executed contained a governing law clause as follows:

“Subject to the principles of glorious Shariah, the agreements should be governed and construed in accordance with English Law.”

## **Murabahah – Mode of Financing:**

The term “Murabahah” is used for a sale transaction wherein the commodity is sold for a deferred price which includes an agreed profit added to the cost. It is not a loan given on interest. The Bank provides funds for purchase of goods, machinery, and equipment etc., on

the basis of Murabahah. If the funds are required for other purposes e.g. paying price of goods already purchased, electricity, salaries of the staff or cash for payment for other utilities & services, Murabahah cannot be effected. There has to be real sale of some commodities and not merely advancing a loan. The financier must own the commodity before he sells to his client. So the Bank purchases the commodity itself or through an Agent and takes possession of the commodity physically or constructively and thereafter sells it to the client. While settling the commodity on credit, the Financier takes into account the period in which the price is to be paid by the client and increases the price accordingly. The longer the period of maturity, the higher the price. The price in Murabahah transaction as practiced by Islamic Banks is always higher than the market price. If a seller increases the price because he allows credit, it is not prohibited by Shariah if there is no cheating, there is no unconscionable gain and the purchaser accepts the price quoted with open eyes.

Originally Murabahah is a particular type of sale and not a mode of financing. The preferred mode of financing, according to Shariah, is Mudarabah, Musharakah (Partnership) (F.N.1) Diminishing Musharakah (F.N.2), Ijarah (Leasing), Salam, (Advance payment, deferred delivery of goods), Istisna (Order to manufacture goods).

**F.N.1.** *Musharakah* means a relationship established under a contract by the mutual consent of the parties for sharing of profits and losses in the joint business. It is an agreement under which the Islamic Bank provides funds which are mixed with the funds of the business enterprise and others. All providers of capital are entitled to participate in management, but not necessarily required to do so. The profit is distributed among the partners in pre-agreed ratios, while the loss is borne by each partner equally in proportion to respective capital contributions. (A sort of venture capital)

**F.N.2.** *Diminishing Musharakah* is a concept according to which a financier and his client participate either in the joint ownership of a property or an equipment, or in a joint commercial enterprise. The share of the financier is further divided into a number of units and it is understood that the client will purchase the units of the share of the financier one by one periodically, thus increasing his own share till all the units of the financier are purchased by him so as to make him the sole owner of the property, or the commercial enterprise, as the case may be.

### **Governing Law and Jurisdiction Clause:-**

Whatever may be the mode of Islamic Finance, the transaction documents contain a clause pertaining to the jurisdiction and the law which is to govern the contract.

In the case of *Shamil Bank of Bahrain v Beximo Pharmaceutical & Others* (2004) 4, All England Reports 1072 (Shamil Bank's case), the principal defence plea was that on a true construction of the governing law clause, the Murabahah agreements were only enforceable

in so far as they were valid and enforceable both (i) in accordance with the principles of Shariah i.e. rules and law of Islam; and (ii) in accordance with the English Law; and (b) in fact the agreements were unlawful, invalid and unenforceable under the principles of Shariah in that despite their form as Murabahah agreements, the transactions were in truth disguised loan at interest. As such they amounted to unlawful agreement to pay Riba, and were thus void and unenforceable.

The governing law clause in the agreement reads “Subject to the principles of glorious Shariah, the agreement should be governed and construed in accordance with English Law.”

The arguments of the counsel for Beximco, the client Company, noted in the judgment are that the governing law is English law and English law alone. However, the counsel added that this does not preclude the possibility that the principles of Shariah have relevance and that all that the parties have done is to choose English law as the governing law but at the same time to stipulate as a condition precedent that the contract is only to be enforceable in so far as it is consistent with the principles of Shariah, which principles amount to legal rules ascertainable and applicable by an English Court. The counsel for the Beximco submitted that that is something different from assertion that Shariah law governs the agreements.

It is also noted in the judgment that counsel for Beximco accepted that Convention (Rome Convention on the Law Applicable to Contractual Obligation 1980) as set out in Schedule-1 to the Contracts (Applicable Law) Act 1990, precludes the choice of Shariah as a governing law, being concerned only with a potential choice between the laws of different countries. However, the construction of the governing law clause, subject matter of the case, produces a result no different from the incorporation by reference of a codified system of rules such as the Hague Rules or the Warsaw Convention 1929 (as set out in Schedule-1 to the Carriage by Air Act 1961) into a contract governed by English law (*Nea Agrex SA v Baltic Shipping Co Ltd* 1976) 2 All ER 842. In *Baltic Shipping* case, the court rejected the

conclusion of Donaldson J. at first instance that a paramount clause was to be treated as ineffective to incorporate to Hague Rules into a charter party. Learned Counsel for Beximco relying on Baltic Shipping case argued that such a construction is fully consistent with the bank's self proclaimed mode of business as an Islamic bank carrying on an Islamic banking business.

Learned Counsel for Beximco further relied on the judgment of Tomlinson J. in Islamic Investment Co of the Gulf (Bahamas) Ltd v Symphony Gems NV (13 February 2002, unreported) in which it is clear on examining the expert evidence on record that there was no difficulty in identifying the requirements for an effective Murabahah contract under Shariah law. It was argued by the learned counsel for Beximco that the judge's conclusion that principles of Shariah law relevant to this case were controversial so as to render it improbable that the parties would have chosen the English court to resolve a dispute as to the enforceability of the agreements, was incorrect.

The following paragraphs quoted from the judgment in Shamil Bank's case reflect the conclusions of the Court of Appeal:-

- i) It is conceded by the Counsel for Beximco that there cannot be two governing laws in respect of these agreements. He further concedes that the governing law is that of England. It seems to me that he is rightly driven to this concession. The wording of Art 1(1) of the Convention ('The rules of this Convention shall apply to contractual obligations in any situation involving a choice between the laws of different countries') is not on the face of it applicable to a choice between the law of a country and a non-national system of law, such as the *lex mercatoria*, or 'general principles of law', or as in this case, the law of Sharia'a. Nevertheless, that wording, taken with Art 3(1) ('A contract shall be governed by the law chosen by the parties' (my emphasis) and the reference to choice of a 'foreign law' in Art 3(3), make it clear that the Convention as a whole only contemplates and sanctions the choice of the law of a country (cf Dicey and Morris on the

Conflict of Laws (13<sup>th</sup> edn, 2000) notes, p 1223 (para 32-079 and Adrian Briggs  
The Conflict of Laws (2002) P 159)

- ii) It does not seem to me that the passage in Dicey and Morris p 1226 (para 32-086) or the authorities referred to in the notes thereto, assist the Beximco (The Client Company). The doctrine of incorporation can only sensibly operate where the parties have by the terms of their contract sufficiently identified specific “black letter’ provision of a foreign law or an international code or set of rules apt to be incorporated as terms of the relevant contract such as a particular article or articles of the French Civil Code or the Hague Rules. By that method, English law is applied as the governing law to a contract into which the foreign rules have been incorporated. In such a case, in construing and applying those rules, where there is ambiguity or doubt as to their ambit or effect, it may be appropriate for the court to have regard to evidence from experts in foreign law as to the way in which the provisions identified have been interpreted and applied in their ‘home’ jurisdiction. However, that is still only as an aid to interpretation by the English Court in the course of applying English law and rules of construction to the contract with which it is concerned. The authority of *Nea Agrex SA v Baltic Shipping Co Ltd* [1976] 2 All ER 842, [1976] QB 933 is no more than an illustration of this.
- iii) The general reference to principles of Sharia’a in this case affords no reference to, or identification of, those aspects of Sharia’a law which are intended to be incorporated into the contract, let alone the terms in which they are framed. It is plainly insufficient for the defendants (Beximco) to contend that the basic rules of the Sharia’a applicable in this case are not controversial. Such ‘basic rules’ are neither referred to nor identified. Thus the reference to the ‘principles of ... Sharia’a’ stand unqualified as a reference to the body of Sharia’a law generally.

As such, they are inevitably repugnant to the choice of English law as the law of the contract and render the clause self-contradictory and therefore meaningless.

- iv) It seems to me that there is an appropriate alternative construction, namely that favoured by the judge, i.e that the words are intended simply to reflect Islamic religious principles according to which the bank holds itself out as doing business rather than a system of law intended to ‘trump’ the application of English law as the law to be applied in ascertaining the liability of the parties under the terms of the agreement. English law is a law commonly adopted internationally as the governing law for banking and commercial contracts, having a well-known and well-developed jurisprudence in that respect which is not open to doubt or disputation on the basis of religious or philosophical principle. I share the judge’s view that, having chosen English law as the governing law, it would be both unusual and improbable for the parties to intend that the English court should proceed to determine and apply the Sharia’a in relation to the legality or enforceability of the obligations clearly set out in the contract.
- v) Finally, so far as the ‘principles of ... Sharia’a’ are concerned, it was the evidence of both experts that there are indeed areas of considerable controversy and difficulty arising not only from the need to translate into propositions of modern law texts which centuries ago were set out as religious and moral codes, but because of the existence of a variety of schools of thought with which the court may have to concern itself in any given case before reaching a conclusion upon the principle or rule in dispute. The fact that there may be general consensus upon the proscription of Riba and the essentials of a valid Murabahah agreement does no more than indicate that, if the Sharia’a law proviso were sufficient to incorporate the principles of Sharia’a law into the parties’ agreements, the defendants would have been likely to succeed. However, since I would hold that

the proviso is plainly inadequate for that purpose, the validity of the contract and the defendants' obligations thereunder fall to be decided according to English law.

To appreciate the full impact of Shariah on business law, a visit to Clifford Chance, where Islamic finance is an important activity, would show that doing dealings that are Shariah-compliant, is a standard part of their activity. The scores of lawyers and Islamic Finance Firms are practicing Shariah. The transactions conceived in London by U.K. lawyers are being reviewed by Shariah Scholars in the Middle and Far East to judge whether or not they comply with Islamic Law. If they do not, they do not go ahead, so in practice the jurisdiction of Shariah is now well established, even in Britain. Dr. Williams, the Archbishop of Canterbury recognizing the prevalence of Shariah in business and financial dealings urged the English Judicial System to recognize Shariah as applicable law for determining the rights and obligations of the parties.

As the debate sparked by the Archbishop of Canterbury over Shariah law continues, the question is, "Is it possible for the parties to have their dispute decided in accordance with a religious, or other law or rule which is not the law of a country (non-national law)?" The answer given by Olswang in his Article published in the "International Arbitration News", is yes, if the parties submit their dispute to arbitration. In this Article, Olswang mentions that the UK Court of Appeal "refused to deem Shariah law incorporated into the contract as a contractual term, primarily on the basis that the evidence of the experts for both parties was that there is not a single, easily identifiable body of law which is Shariah law and that there are areas of considerable controversy and difficulty arising from the existence of a variety of schools of thought, both in respect of Islamic law in general and Islamic banking law in particular. The general reference in the financing agreements to Shariah law was therefore incapable of incorporating Shariah law into the contracts. It appears that incorporation may have been successful if the parties had stipulated specific "black letter" provisions of Shariah law."

(<http://www.olswang.de/newsarticle.asp?sid=858&aid=715&de=&mid=>)

The objection that the rules of Shariah, which are applicable in this case, are controversial and even these basic rules have not been identified, can be met by inserting a reference to the rules of Shariah adopted by the AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions, the Standard Setting Organization for Islamic Finance) has approved

and published Shariah Standards, 2010 and Accounting, Auditing & Governing Standards, 2010. A specific reference of these Standards in the governing law clause in a contract would thus meet this objection, as it will be sufficient answer to the objection as to the existence of divergent views of various schools of thought and of uncertainty as to applicable rules. The doctrine of incorporation can then also be relied upon as now the terms of their contract would sufficiently identify these specific “Black Letter” provisions of foreign law, that is, Shariah principles to be incorporated as terms of the relevant contract, such as a reference is made to French Civil Code or the Hague Rules. These Standards can be obtained from the Secretariat of AAOIFI. Please visit <http://www.aaofii.com/orderform2.html>

The governing law clause in an Islamic Financial Transaction (Takaful Treaty – Islamic Insurance Treaty) may be worded as under:-

“This Takaful Treaty has been framed and structured according to the established principles of Shariah as recognized in the Shariah Standards approved by the AAOIFI, Bahrain, therefore, all questions arising in respect of construction, interpretation, meaning of the terms, exclusions, limitations and conditions of this Takaful Treaty shall be resolved and determined in accordance with the principles of Shariah and as per the text in English appearing in this Takaful Treaty.”

With this wording, the application of English law simultaneously with Shariah principles is sought to be ruled out.

At this stage, a few words may be said about the scope of legislation in an Islamic State. Legislation in its present Western sense is something new to the Islamic legal traditions. If legislation means “laying down of legal rules by a sovereign or subordinate legislator” as Salmond has put it, then in that sense there has been no legislation in the history of Islam before Majallah (a civil code) of the Ottomans, that too, was not a piece of legislation in the sense that it laid down some new rules of law. What the Majallah did, was not more than the rephrasing or redrafting of the already existing legal rules and arranging them in appropriate order after reformulating them into the form of sections and sub-sections. The vast development and expansion in Islamic Law throughout the ages was never the result of any legislative exercise in the modern sense. The nature of this development and expansion in Islamic Law is essentially different from the development and expansion of Anglo-Saxon or any other contemporary legal and judicial system.



Islamic law is basically a part of a holistic system based primarily on a religious message contained in the Qur'an and the *Sunnah* (F.N.3) – the two basic and original sources for all guidance. The principles laid down in the Qur'an and the *Sunnah* are, in fact, guiding signs or 'limits' (*Hudud*) within which human beings have to work out practical details and solution for given problems. The development of law after the Holy Prophet (Peace Be Upon Him) gave rise to principles of *Ijtihad* (F.N.4) – a principle which was approved by the Holy Prophet (Peace Be Upon Him) himself towards the close of his life, *Ijma* (F.N.5) – a principle discovered by the companions of the Prophet (Peace Be Upon Him), *Qiyas* (F.N.6), *Maslahah* (F.N.7), *Istislah* (F.N.8) etc. – principles later developed by the early Muslim jurists. But the point which becomes crystal clear even by a cursory glance over the history of Islamic law that its entire development and expansion took place at the hands of non-official and private individual – at times collective – efforts.

**F.N.3** *Sunnah* - it refers to utterances of the Prophet Muhammad (PBUH) other than the Holy Qur'an known as Hadith or his personal acts or sayings of others tacitly approved by the Prophet.

**F.N.4** *Ijtihad* - it refers to an endeavour of a qualified jurist to derive or formulate a rule of law to determine the true ruling of the Divine Law in a matter on which the revelation is not explicit or certain on the basis of Nass or evidence found in the Holy Qur'an and Sunnah. Express injunctions have no room for *Ijtihad*. Implied injunctions can be interpreted in different ways by way of inference from the accepted principles of Shariah.

**F.N.5** *Ijma* - consensus of all or majority of the leading qualified jurists on a certain Shariah matter in a certain age.

**F.N.6** *Qiyas* - literally it means measure, example, comparison or analogy. Technically it means a derivation of the law or the analogy of an existing law if the basis of the two is the same. It is one of the sources of Islamic law.

**F.N.7** *Maslahah* – peace, conciliation, settlement, to foster peace between disputants.

**F.N.8** *Istislah* - reasoning based on the principle of the public good.

Before the *Majallah* there is no example in the whole legal history of Islam that a rule of law was ever laid down by a sovereign, a ruler or by an official of the State or by a person or persons appointed by a ruler or even elected by the people for that purpose. The entire exercise of law-making has been taking place at purely private level without intervention by the State or the masses. The interpretation of the Qur'an and the *Sunnah* and discovery of new rules of law in response to new situations and requirements was the job of the scholars, teachers, academicians and the jurists while the application of that store of legal rules to day-

to-day problems was the province of the judiciary and its allied agencies such as *Ifta'* (F.N.9) and *Hisbah* (F.N.10) etc.

**F.N.9** *Ifta* – an institution/Department for giving Shariah ruling.

**F.N.10** *Hisbah* - Department of Accountability.

Whenever a new situation arose, scholars and jurists of the *Ummah* (Muslim Community as a whole) addressed themselves to the task and discovered the rule of law in regard to that situation applying the principles of *Ijtihad*, *Qiyas*, *Istihsan* (F.N.11) and *Istislah* and giving arguments in favour and in defence of their conclusions. It was then up to the Judge to accept the most sound and most rational of all such conclusions and to apply that conclusion to the question in issue. In some cases – especially in the early days of Islam – where the Judge was himself a recognized, established and trustworthy scholar of the divine law, he also participated in that process of law-making. It was in this way that the law continued to develop and expand without interference or pressure from the rulers. It was an open workshop in which every one possessing the required qualification could freely partake and advance his arguments which, if sound and based on original sources, were accepted both at popular and judicial levels. It was in this very manner that all major legal schools came into existence.

**F.N.11** *Istihsan* - it is a doctrine of Islamic Law that allows exception to strict legal reasoning, or guiding choice among possible legal outcomes, when considerations of human welfare so demand.

It is not a mere coincidence that the founders of such major schools were private individuals enjoying no official position or authority. Some of the jurists whose legal opinions are still followed by large number of Muslims and applied – though on a limited scale – by some contemporary courts were even persecuted by their contemporary rulers. In this respect the examples of Imam Ahmad ibn Hanbal and Imam Zaid ibn ‘Ali can be cited; these two celebrities were *personae non gratae* in the eyes of the rulers of their respective times and were persecuted for one reason or the other; yet the legal opinions expressed by them and the legal rules framed by them had their value not only in their own lifetime but also centuries after their death. This tradition in the development of Islamic law, which originated during the early days of *Khulafa-i-Rashidin* (the four righteous Caliphs, namely, Abu Bakar, Umar, Usman and Ali), continued for about twelve hundred and eighty-five years. All the development of the law which is undoubtedly one of the richest treasuries of legal thought

ever produced by any people or civilization took place according to this tradition, i.e. with purely private and non-official efforts without any interference or pressure from the governments. Some rulers did try to influence the development of law for one reason or the other, but Muslim jurists never allowed such influence to be effective. Here, the example of the Caliph Harun al-Rashid can be cited who tried to persuade Imam Malik to let the government adopt his *Muwatta* (a compilation of Hadith/Traditions of Holy Prophet and Shariah Rulings) as the guide book for the courts. But it goes to the unrivalled credit of the great Imam that he preferred the freedom and supremacy of law to his personal acclaim and recognition. He refused to agree to the idea and saved the right of the jurists and scholars to exercise *Ijtihad* freely and independently according to their sincere and genuine understanding of the Qur'an and the *Sunnah* and the strength and soundness of their arguments without being influenced by any other force except their own conscience and fear of God.

The first outward departure from this tradition took place in 1287 A.H. 1869 A.D. when the Ottoman *Sultan* promulgated the first-ever codified piece of law in the history of Islam i.e. the second chapter of the *Majallah*. Although this was a departure from the tradition only in form and appearance and not in essence and reality, yet it paved the way for a real departure which the Muslims first tolerated and then accepted under the powerful influence of the Western legal traditions. (State and Legislation in Islam by Dr. Mahmood Ahmed Ghazi [Pages 112-113] - published by Shariah Academy International Islamic University, Islamabad)

Thus *Ijtihad* has been postulated as the function of scholars and jurists who possess required qualifications and they were under an obligation to exercise *Ijtihad* in matters not covered by the Qur'an, the *Sunnah* or the consensus of the Ummah. It has never been considered to be the job of the ruler or holder of an office or a Body or an Organization. The role of the rulers in the process of legislation in the sense of law-making was restricted to issuing of administrative orders. In case there is a valid and genuine difference of opinion among the jurists based on sound arguments, the Executive Authority may, in view of the expediency and public weal, order the court to follow one of such conflicting views provided it pertains to the province of *Ijtihad*, *Masalih-i-Mursalah* (F.No. 12), *Istihsan* etc. In that case, the opinion preferred by the Executive Authority will be the law of the land and will hold the field. This has been an accepted rule of Islamic law.

**F.N.12** *Masalih-i-Mursalah* - public good, to advance public interest and harmony.

The compilers of Majallah have put it in these words: “When the Head of the Muslims orders (the courts) to act according to one of the views in respect of the problems open to *Ijtihad*, then that particular view becomes the only accepted view and it becomes incumbent (upon the courts) to act accordingly.” (Section 1801 of the Majallah).

In view of the uncertainty as to the ability to incorporate non-national laws as contractual terms to aid the interpretation of a contract and until the English Courts accord Shariah the status of laws applicable, the way out for the parties to have certainty for having their disputes resolved in accordance with the principles chosen by them (e.g. principles of Shariah) is for them to submit their disputes to arbitration under the 1996 Act.

**Note:-** I have not checked ICC/UNCITRAL or ICSID Rules due to their non-availability with me. I have not hazard any opinion about application of Shariah rules by the Arbitrators acting under the ICC rules etc. If there is no bar for them to apply Shariah rules, may kindly include these rules along with the Arbitration Act, 1996.

It was confirmed in *Halpern v. Halpern* and also held in *Musawi v. RE International (U.K.) Ltd. & Others* (2007) EWCA Civ 2981, that an English Court would give effect to the arbitrating parties’ choice of non-national law and would for example enforce an award made by arbitrators applying any considerations agreed between the parties. The Court found that Section 46(1)(b) of the 1996 Act entitled the parties to require the Ayatollah, Arbitrator to apply Shariah law to the resolution of their disputes.

It is, therefore, suggested that Islamic Financial document (the Takaful Treaty) may contain choice of law and jurisdiction clause as follows:-

“Any difference arising out of this treaty concerning its validity or invalidity shall be submitted to the decision of a panel of arbitration as per the provisions of the Arbitration Clause. The panel of arbitration is required to decide in accordance with the established principles of Shariah and International Takaful custom as adopted in the Shariah Standards issued by AAOIFI. Notwithstanding the foregoing, each party agrees to submit to the exclusive jurisdiction of the courts of England and Wales (or state here the country where the award is sought to be enforced) for the enforcement of the award made by the Arbitrators.”

**Note-I** English Judges have been applying the Personal Law of Muslims in Privy Council for more than a century. They correctly applied the Shariah law in most of the cases except a very few cases like that of the case of Muslim Waqf. This necessitated intervention by the Parliament by enacting Waqf Validating Act, 1923.