



Dispute Resolution & Shariah Governance in Islamic Finance: Malaysian Developments

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- Proposals to strengthen the Malaysian Shariah governance framework.
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Challenges against Islamic financing contracts in the Malaysian courts

- Disputes relating to Islamic banking facilities are decided by the civil courts (see Item 7 Federal List & Item 1 State List, Ninth Schedule and Article 121 Federal Constitution).
- A string of cases since the mid-1990s arose from defaults of Bay' bi-Thaman Ajil (“BBA”) home financing transactions, with the customers disputing the bank’s entitlement to claim the whole sale price.
- In 2008, the judge in *Arab-Malaysian Finance Bhd v. Taman Ihsan Jaya Sdn Bhd & 11 Ors* held that BBA financing transactions, which comprise sale and buyback agreements between the bank and customers, are contrary to the Islamic Banking Act 1983 as it involves an element not approved by Islam.



Challenges against Islamic financing contracts in the Malaysian courts 2

Concerns raised by these cases:

- Courts apply common law principles applicable to conventional banking and make no reference to applicable underlying Shariah principles.
- Judges give interpretations of Islamic law (as law of the land) without qualifications in Islamic law and background in Islamic finance.
- Flawed judicial interpretations and application of Islamic jurisprudential and fiqh principles by the judges, leading to anomalies and conflicts between Shariah principles and the law.
- The judgments have led to legal uncertainty and debate among stakeholders and the consumer public, and erosion of confidence in the industry.



Challenges against Islamic financing contracts in the Malaysian courts 3

Litigation of Islamic finance disputes show that although up-front compliance of a transaction with Islamic law is verified by Shariah boards, and is required as a condition precedent to contract, the role of Islamic law, which is the foundation of Islamic finance contracts, may, depending on the selected forum, be diminished during the dispute resolution process.

Without certain “customization”, there are limitations on the ability of national courts to give effect to Shariah principles that underpin an Islamic financial transaction during dispute resolution.



Amendments to the Malaysian legal framework to create greater Shariah certainty

An efficient legal framework for Islamic finance in any jurisdiction would require these components:

1. enabling laws and regulations;
2. enforceability of Islamic financial contracts; and
3. appropriate dispute resolution mechanisms.

Enabling legislations:

- authorize the creation of Islamic financial institutions and instruments;
- establish appropriate Shariah governance processes;
- address legal and tax impediments and barriers;
- address anomalies and conflicts between the existing law and Shariah principles;
- implement international prudential standards.



Amendments to the Malaysian legal framework to create greater Shariah certainty 2

- It is a fact that most legal systems around the world do not easily accommodate or even directly contradict Shariah principles, and the requisite measures are necessary to enable the introduction and implementation of Islamic finance.
- The interface between the two systems could give rise to conflicts and anomalies in:
 - laws;
 - contracts; and
 - court decisions.
- Legislators need to ensure that laws applicable to financial services must be harmonized with Shariah principles.
- Lawyers and Shariah advisors need to ensure that legal documentation for Islamic financial transactions comply with both Shariah principles and legal requirements.



Amendments to the Malaysian legal framework to create greater Shariah certainty 3

- Since 2007, a judge in the commercial division of the High Court has been assigned to preside over litigated cases relating to Islamic finance.
- Recently the Central Bank of Malaysia Act 2009 was enacted which:
 - accords formal recognition to the dual financial system practised in Malaysia (Sections 2 & 27);
 - formally recognizes the Syariah Advisory Council of Bank Negara (“SAC”) as being the highest authority on Shariah issues in Islamic finance transactions, and the role of the SAC as a consultative body to the Malaysian judiciary system (Sections 51-55);
 - requires judges and arbitrators to take into consideration any published rulings of the SAC or refer to the SAC for rulings relating to Shariah issues arising from disputes before them. These rulings shall be binding on the financial institution, court or arbitrator concerned (Sections 56 -57);
 - provides that where the ruling given by a Shariah 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 (Section 58).



Amendments to the Malaysian legal framework to create greater Shariah certainty 4

- Bank Negara recently set up the Law Harmonization Committee to create a credible and reliable forum or settlements disputes arising from Islamic financial transactions.
- Its task is to review existing and proposed laws applicable to Islamic finance and make the necessary recommendations to harmonize them with Shariah principles.
- This Committee comprises members from key government stakeholders, including the Attorney General's Chambers, industry players and experienced Islamic finance legal practitioners.
- The chairman is Tun Abdul Hamid bin Mohamad, former Chief Justice and member of Bank Negara's Shariah Advisory Council.
- The Committee will be engaging with the industry and general public for feedback on the laws which require harmonization.



Proposals to strengthen the Malaysian Shariah governance framework

Bank Negara has reviewed its Shariah governance framework for the Islamic financial institutions and made proposals to strengthen regulations on Shariah governance structures and processes:

1. Oversight by and accountability & responsibility of the board of directors, Shariah committee and management;
2. Independence of the Shariah committee in ensuring sound Shariah decision, and emphasis on the role of the board of directors in recognizing the independence of the Shariah committee.
3. Competency requirements and expected competencies to ensure key functions are capable of implementing Shariah governance.
4. Confidentiality & consistency rules on the importance of observing and preserving confidentiality and improving consistency by the Shariah committee.
5. Shariah compliance & research functions including internal Shariah review, Shariah audit, Shariah risk management process and the Shariah research functions.



Alternative dispute resolution for Islamic finance disputes in Malaysia

- Arbitration (“tahkim”) is the private, judicial determination of a dispute by an independent third party.
- Amicable settlement (“sulh”) is a process in which parties resolve their dispute in an amicable manner, with or without the assistance of a mediator.
- Both arbitration (“tahkim”) and amicable settlement (“sulh”) are recognized in Islamic law, and the latter is particularly encouraged.

As a comparison, the following is the outcome for two contracts concerning Islamic financial transactions, similar governing law clauses, but differing forums.

The first provided for dispute resolution by arbitration, while the second selected the English courts.

Juxtaposing the outcomes of the resolution of these two disputes highlights the flexibility of arbitration in addressing disputes arising under Islamic finance agreements and the limitations in the ability of the English courts to apply Islamic law.



Alternative dispute resolution for Islamic finance disputes in Malaysia 2

Case 1: dispute arising from an Istisna financing arrangement between *Sanghi Polyesters Ltd (India) v. The International Investor KCSC (Kuwait) [2001] C.L.C.* Arbitration was the dispute resolution mechanism of choice, and the terms of reference of the arbitration confirmed the place of arbitration as London.

The “applicable substantive law”: “This dispute shall be governed by the Laws of England except to the extent it may conflict with Islamic Shariah, which shall prevail”.

The decision of the arbitrator, an expert in Islamic law, as expressed in an ICC Arbitration Award obtained in London, gave effect to the parties’ will to be governed by English law except where this would conflict with the Shariah, by awarding principal and the profit claims, but disallowing additional damages claims because, although compliant with English law, these would conflict with Islamic Shariah.



Alternative dispute resolution for Islamic finance disputes in Malaysia 3

Case 2: dispute arising from a *Murabahah* financing agreement between *Shamil Bank of Bahrain v. Beximco Pharmaceuticals Limited and Ors* [2004] 2 Lloyd's Rep 1.

The governing law clause stated: “Subject to the principles of Glorious Shariah this agreement shall be governed by and construed in accordance with the laws of England.”

The English court found the proviso “Subject to the principles of the Glorious Shariah” to be inadequate to fulfil the purpose of incorporating the principles of Shariah into the parties’ agreements, that the governing law of the contract was simply English law and held accordingly.

- There are limitations on the court to consider Shariah principles which was the apparent intention of the parties.
- The English courts are well established forums of choice in international financial transactions for legal certainty and speed, but their limitations lead to the trading off of “certainty of Shariah compliance” for “financial commercial certainty”.



Alternative dispute resolution for Islamic finance disputes in Malaysia 4

- 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 do national courts when it comes to the application of Islamic law as an applicable law of contract.
- Note also that if parties have agreed on terms that are questionable under Islamic law but allowed under local law, the local legal system will almost certainly enforce it, 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 the contract is 'Islamic'.
- Malaysia has enacted specific arbitration rules for Islamic banking and financial services to compliment the court system and enable Arbitration of Islamic Financial Sector services disputes at the Kuala Lumpur Regional Centre for Arbitration.
- The Rules for Arbitration of KLRCA (Islamic Banking and Financial Services) 2007 are applicable for the purposes of arbitrating any commercial contract, business arrangement or transaction that is based on Shariah principles.



Conclusion

- Recent litigation of Islamic financial transactions which saw parties disputing the Shariah-compliance of agreements they entered into have put the spotlight on:
 - the Shariah and legal risks of Islamic financial products;
 - the need for strong Shariah governance processes at the level of Islamic financial institutions and
 - how Shariah advisors carry out their duties and the extent of their communications with management; and
- The Malaysian authorities intend to enhance the Malaysian legal framework for Islamic finance to encourage parties to select Malaysian law as the law the applicable law governing Islamic finance transactions; and arbitration in Malaysia the dispute resolution process of choice.



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