CHAPTER 28

Islamic finance: when things go wrong

28.1 Introduction

In order to put into context the disputes that arise out of Islamic finance transactions, it is necessary to first understand the rules and principles that Islamic finance instruments and transactions are based on.

The basic principle of Islamic finance is the prohibition of investment in interest-based ventures and businesses that provide goods or services contrary to Islamic principles, such as tobacco, alcohol, gambling, and prostitution.

Islamic finance instruments should function in conformity with the principles of Islamic law (Shari'a). Shari'a is based upon the rules and principles found in its primary sources the (i) Quran and (ii) Hadith (teachings of the Prophet Muhammad (may peace be upon him)), and further clarified by secondary sources such as Ijma (scholarly consensus over the interpretation of the primary sources) and Qiyas (similarities drawn through analogy between modern day issues and those mentioned in the primary sources). Islamic finance instruments must, therefore, avoid:

• the payment or receipt of interest (riba)

• unconditional reward (some risk must be assumed)

• gharar (excessively tenuous/uncertain transactions); e.g. sale of an unborn calf, or items not in possession or not specified, or agreeing to a contract without specifying material terms of the contract

• maisir (speculative transactions); e.g., enrichment without labor (gambling), or possibly, hedge funds

• transactions involving haram (forbidden) goods or activities; e.g. illegal drugs, alcohol, pork, gambling, etc.

28.2 Popular Islamic finance products in the market

Some of the more popular Islamic finance products in the market are outlined below.

28.2.1 Musharaka

Musharaka is a partnership between two entities or persons whereby each contributes assets to a venture. Profits are shared by pre-agreement and generally cannot accord a higher share to the silent partner than his contribution of assets warrants. Losses must be shared pro-rata to the share of assets contributed. One partner may not guarantee the return or the capital of another.

28.2.2 Murabaha

In murabaha, under current market constructs, the customer identifies goods, which the bank purchases from the seller at the market price. The bank then sells the goods to the customer at a mark-up (disclosed to the customer); the deferred purchase price and mark-up is paid back by the customer to the bank in instalments over a period of time.

28.2.3 Mudaraba

Mudaraba is a limited partnership where one partner (rab al maal) injects capital in a business whilst the other (mudarib) runs the business. The partners share in the profits derived from the business, in a pre-determined manner based on profit not capital, but the mudarib does not bear any losses, unless he is negligent.

28.2.4 Ijara

Ijara, meaning "to rent" in Arabic, involves selling the right to use an asset for an agreed upon lease period, during which the lessor retains ownership of the underlying asset. This is a common underlying construct employed in large project and property financing transactions.

28.2.5 Istisna

An istisna is a procurement agreement in which the price of the purchased goods or property (while agreed at the outset) may be paid up front, according to a schedule in instalments, in stages or at completion.

28.2.6 Wakala

Wakala is an Islamic agency agreement, and is jurisprudentially quite malleable to achieve varied commercial ends. In some cases, the bank, as its customer's agent, invests funds in Shari'a-compliant assets for the purpose of generating returns for its customers.

28.2.7 Sukuk

Sukuk, wrongly called Islamic bonds (an oxymoronic term), refer to derivative ownership certificates. sukuk are issued with respect to an underlying asset and various constructs, such as musharaka, ijara or istisna. Holding a sak (the singular of sukuk) represents ownership in the underlying assets and revenues generated from such assets.

Most market sukuk are structured so that at the end of the term, the issuer must either repay the original amount invested or, if this cannot happen (i.e., the Nakheel potential default), then either the issuer renegotiates with the owners of the trade certificates, or sells the underlying asset and divides the proceeds amongst the owners of such certificates in amounts proportionate to their holding. Inevitably, this will result in a loss in the face value of the holder's certificates. Naturally, any guaranteed price redemption feature raises enforceability issues as, at its core, a sak is not meant to be a capital guaranteed product.

28.3 Shari'a in the United Arab Emirates (UAE) and the Kingdom of Saudi Arabia (KSA)

The law in Saudi Arabia is largely derived from the Shari'a, and generally based on the Hanbali school of jurisprudence. In the event that a dispute arises by virtue of a conflict between the law of the state and the Shari'a, generally the latter will prevail. The Saudi government also promulgates, from time to time, rules and regulations in order to conform the laws of the state to the Shari'a.

In addition to the courts, dispute resolution fora in Saudi include the Banking Disputes Settlement Committee of the Saudi Arabian Monetary Agency ("SAMA"), the Commercial Paper Committee, the Grievances Board, and special committees formed by the Ministry of Commerce and Industry. SAMA's Banking Disputes Settlement Committee assumes jurisdiction over disputes of a banking nature, and the Commercial Paper Committee assumes jurisdiction over disputes involving promissory notes. The Grievances Board has jurisdiction over bankruptcy issues, and commercial disputes not related to banking, and also has exclusive jurisdiction over claims against the Saudi government. Prior judicial decisions are not legally binding on courts and other judicial and quasi-judicial authorities in Saudi, which, coupled by the fact that Saudi courts do not have a system of publicly reporting judgments, renders it difficult to conclusively determine the interpretation and application of the law by the courts and judicial committees.

It is notable that the SAMA Committee, in informal conversations, has indicated that it would assert jurisdiction over Islamic finance disputes. This is remarkable because the SAMA Committee's traditional jurisdiction extends to disputes of a banking nature involving banks and their customers. In its discretion, the SAMA Committee has read its jurisdictional ambit broadly to include disputes of an Islamic financing nature e.g., disputes that stem from ijara-based transactions. How the SAMA Committee actually adjudicates such disputes and the interpretation of constructs will be very important and instructive for the industry going forward. As yet, there is insufficient information to come to any considered position on this point.

UAE legislation expressly recognizes the Shari'a, and the UAE Civil Code requires that courts be guided by the Shari'a in the absence of legislation on point: "If the judge finds no provision in this Law, he has to pass judgement according to the Islamic Shari'a." See UAE Civil Code, Article 1. The Code also delineates the order in which the four schools of thought will be referred to by the UAE courts, and requires that the judge search for "… the most appropriate solution from the schools of Imam Malik and Imam Ahmad bin Hanbal, and if none is found there, then from the schools of Imam al Shafi' and Imam Abu Hanifa as most befits." Moreover, the UAE Civil Code expressly addresses certain Shari'a-based transactions and legislates on the rules, procedure and remedies relating to such transactions. See e.g., UAE Civil Code at Articles 568 to 579 (forward sales (istisna)), Article 582 (sale of unascertained goods (juzaf)), Article 583 (deferred sales), Articles 597 to 601 (sales by a terminally ill person), and Articles 614 to 653 (gifts (hiba)). However, whilst the basic structure of UAE legislation incorporates the Shari'a, both expressly and by reference in the absence of an express law, it is well understood that each jurisdiction has its respective interpretation as to what is or is not Shari'a-compliant. The dearth of case law does not lend itself to broad conclusions with respect to the UAE courts' approach to commercial disputes. In a dispute subject to the UAE's jurisdiction, we envision that the UAE courts will strive to ascertain the intent of the parties and give effect to substance over form with respect to the transaction under review. Indeed, such is the approach taken by at least one UAE court as noted below.

28.3.1 Judgements issued by the Dubai Courts

Traditionally, market structures incorporating the ijara construct are agreements of lease to purchase. The customer identifies a property that the bank or financial institution purchases and then leases out to the customer. The rental payment constitutes a progressive payment of the capital amount and a variable component that covers the profit element for the finance institution. Along with the ijara agreement, the customer signs a purchase undertaking whereby he agrees to purchase the property at the end of the lease term and at certain other pre-agreed events. In some circumstances, the bank enters into a sale undertaking.

We understand that recently there has been a case litigated in the Dubai Court of First Instance with respect to a matter involving default of an ijara transaction.[2] While details are still forthcoming, to the extent that the case was based on the traditional ijara structure described above, we understand that the court took an approach of applying substance over form. The court ascertained that the true intent of the parties, and the real objective of the transaction, as a whole, was for the customer to eventually buy the property. Thus, the court held that the transaction was in essence "a contract for sale of property on deferred payment terms, rather than a lease. Accordingly, all payments of rental under the ijara are treated as payments by the customer towards the purchase of the property."[3] This was because the customer had identified the property and the transaction was structured towards an eventual sale of the property from the finance institution to the customer. The court granted the finance institution the remedy of specific performance of the purchase undertaking and the customer was ordered to purchase the property for the outstanding loan amount.

In upholding the intent of the contractual arrangements, and deviating from the form, the court adhered to the Shari'a principle that substance transcends form. As such, the ijara agreement was deemed to be a sale and purchase agreement, rather than a lease to purchase arrangement. This judgement, while reaffirming the Shari'a principle of substance over form, may implicate other Shari'a issues as such agreements generally also envision the parties creating an interim lessor/lessee relationship during which time the risk of loss sits with the financier. Naturally, registering a lessee's name with the Dubai Lands Department further muddies the structural waters, as from a clear Shari'a analytical perspective, such registration ought not to occur until the substantive ownership has passed between financier and customer. We surmise that there is much more development to occur in this area of the law with a multitude of cases that are making their way to the courts on the back of the economic downturn and resultant defaults.

28.3.2 Sukuk and the potential Nakheel default

Sukuk have become the flagship Islamic product of the Islamic finance industry, and the markets have an estimated USD 100 billion in sukuk issuances. Sukuk are considered the most significant mechanisms for raising Islamic finance in the international capital markets.

However, given that these are nascent structures in a developing and evolving marketplace, there is uncertainty surrounding how sukuk transactions will be finally adjudicated in the Gulf jurisdictions. Sukuk defaults have not yet been brought before the courts – so there is little indication as to how courts may approach such instruments. Many of the sukuk documents are drafted in accordance with and governed by English law. English courts have, in the final analysis, balked at effecting parties' choice of law provisions when they elect to apply Shari'a principles. English courts have questioned whether Shari'a is definitive enough to apply; even if it were considered to be sufficiently definitive (and discrete provisions were incorporated into the contract by reference), it would not likely be enforced if it were to conflict with English law. Therefore, enforcement of English judgements in relation to Islamic products/transactions would invariably require a de novo review to determine whether the English judgement was congruent with Shari'a.

A case in point is the Nakheel sukuk – a sukuk that garnered the world's attention when it became apparent that Nakheel may be unable to repay its holders.

In the Nakheel case, holders of the subject trade certificates believed that they were guaranteed the return of their premium on maturity and a profit rate of 18.89% for the period of the sukuk issuance. They also believed that, in the event Nakheel was unable to pay its debts, Dubai World, and therefore by implication the Dubai Government, would guarantee the payments (including the premium). However, the Dubai Government had publically announced that it had never guaranteed the debts owed by the Dubai World to its creditors. As the development of Islamic finance is novel globally, the UAE had no established legal precedent on which the investors could rely on to make a claim over the sukuk assets, which are largely located in the UAE. For now, Nakheel has gained a temporary reprieve due to the Dubai Financial Support Fund making available sufficient funds to repay the first sukuk that matured on 13th May 2010. In December 2009, the Chairman of Dubai's Supreme Fiscal Committee, during the announcement of the Dubai bailout, also announced a new bankruptcy law, stating that "the law will be available should Dubai World and its subsidiaries be unable to achieve an acceptable restructuring of its remaining obligations."

While the Nakheel default has not yet been adjudicated before the courts, the problems posed by this default serve as a case study of the issues that the Islamic finance industry must address. At present, via Dubai Decree No. 57 of 2009, all disputes relating to Dubai World and its subsidiaries must be heard by a Special Tribunal that has been formed, rather than being referred to the Dubai Courts. Therefore it is with great anticipation that we wait to see if any action will be referred to the Tribunal and how the Tribunal, which does not comprise of Shari'a experts, will deal with such a dispute. Naturally, for the Tribunal to have the requisite standing, it will need to consult with Shari'a experts that bring in relevant background to assist the Tribunal in weaving its way through the labyrinthine maze of issues at play that include choice of law issues, interplay between Shari'a and English law, as well as jurisdictional law considerations.

[2] Ijara Enforcement Judgements in Dubai, Al Tamimi & Company Banking & Finance Update, August 2010.

[3] *See id.*

Deeper questions that are posed by market structures that depart from accepted Shari'a wisdom or contain conventional bond defaults in sukuk garb, including whether such would be enforced in certain fora, are addressed in greater detail in "sukuk: default or no default?," Legal Spotlight, Jan. 2010, Oliver Ali Agha and Claire Grainger.

28.4 Disputes before the English Courts

28.4.1 Shamil Bank of Bahrain EC v Beximco Pharma Ltd and Others[4]

The Shamil case is representative of the courts' approach toward the conflict of laws that arises when parties select, as the governing law, both English law (or a national system of law) and Shari'a. In the Shamil case, Shamil Bank of Bahrain extended finance to various pharmaceutical companies in Bangladesh under a murabaha arrangement. Shamil Bank of Bahrain took the Bangladeshi companies and their directors (in their capacity as guarantors) to court because the companies failed to meet their payment obligations. The court found in favor of the Bank, and the Beximco defendants challenged the decision in the Court of Appeals on the basis of the governing law provision of the murabaha contract:

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

The defendants argued that the intended effect of this clause was to (i) choose the laws of England and Wales as the governing law, and (ii) subject the enforceability of the terms of the contract to conformity with Shari'a principles. The defendants further argued that the murabaha contracts that formed the subject of the dispute were in fact "unlawful, invalid and unenforceable" under Shari'a principles since the contracts were in fact "disguised loans" for interest. Since riba is universally accepted as unlawful under the Shari'a, the contract would fail the test of validity under the Shari'a. The Shamil court reasoned that it has been well-established that a contract cannot be governed by two separate systems of law concurrently. Whereas parties to a contract may import specific provisions of a law from other than the system of law that they select as the governing law of the contract, a general reference to the principles of the Shari'a is not an incorporation of a distinct set of rules. The court went on to reason that under the Rome Convention 1980, scheduled to the Contracts (Applicable Law) Act 1990, the reference to the choice of governing law for the parties must be to the law of a country, not to a "non-national system of law." The Shari'a is not the law of a country, but a collection of principles. Therefore, the court held that, irrespective of the election of the parties to subject English law to Shari'a, English law nonetheless applied because Shari'a was not a governing body of law, but merely embodied the Islamic religious principles to which Shamil Bank held itself out as doing business.

The court's conclusion reflected an interpretation that leaned towards effecting the commercial purpose of the parties (as it ascertained from its reading of the documentation). The court asserted that it is "improbable in the extreme" that the parties intended for an English court to determine a dispute as to the compliance of a contract (based on Islamic finance constructs) to the principles of the Shari'a when the Shari'a contains opposing points of view. The court noted that, while it was possible to incorporate specific provisions of foreign law into a contract governed by English law, in this case no specific rules/principles were so identified. Implicit in the court's holding was the suggestion that even where foreign law is so referenced, naturally, at most one could expect such provisions to become part of (rather than trump) an English law contract. The court noted, "it was plainly insufficient to contend that the basic rules of the Sharia were not controversial. Such 'basic rules' were neither referred to nor identified. Thus the reference to the "principles of . . . Sharia" stood unqualified as a reference to the body of Sharia law generally. As such, they were inevitably repugnant to the choice of English law as the law of the contract and rendered the clause self-contradictory and therefore meaningless."[5]

The court further noted that, for the purposes of the bank's own regulation, the views of the bank's own regulatory board are sufficient to monitor its compliance to its internal policy and mandate. Since the defendants did not concern themselves with the Shari'a-compliance of the form of the contract at the time of signing, or at any time prior to the proceedings in court, it was held that Shari'a-compliance was not of the essence from the perspective of the defendants and therefore not a valid defense to failing to meet their contractual obligations.

28.4.2 Islamic Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems N.V. and others[6]

This case is of significance because it is the first instance of an English court ruling on a transaction based on Islamic finance constructs. In this case, the Islamic Investment Company of the Gulf (Bahamas) Ltd. entered into a murabaha financing agreement with Symphony Gems N.V. Under this agreement, Symphony would identify a supplier for the precious stones and gems that it intended to purchase for its inventory, and Islamic Investment would then buy these stones and gems from the supplier and sell them to Symphony at an agreed mark-up. Symphony would pay Islamic Investment the marked-up price in instalments. However, under the agreement, Symphony agreed to make the payments regardless of whether or not delivery of the stones and gems was ever made or whether there was a defect, loss or breach; such payments were guaranteed by two guarantors from Symphony. Further, delivery of the purchased stones and gems was to be made directly to Symphony. Thus, even though Islamic Investment was buying the stones and gems and then selling them on to Symphony, it did not at any point undertake any of the risks associated with the transaction. It was agreed that the agreement was to be governed by English law.

The dispute under the agreement arose when one of the suppliers failed to deliver diamonds that Islamic Investment had bought pursuant to a request from Symphony. Symphony then failed to make payments to

[4] [2004] EWCA Civ. 19 Court of Appeals, [2004] ALL ER 1072.

[5] *Id.*

[6] 2002 WL 346969 (Q.B. Com. Ct. Feb. 13, 2002).

Islamic Investment in respect of the transaction. Islamic Investment sought to enforce the guarantee by filing for a summary judgement.

In its defense, Symphony claimed that since the subject agreement was a sale and purchase contract, the absence of delivery amounted to a breach on the part of Islamic Investment, due to which it could not make a claim for non-payment from Symphony. However, the court rejected this on the basis of the clear wording of the agreement, which did not make payment subject to delivery. Symphony argued that the agreement suffered from illegality under the laws of Saudi Arabia, where part of the transaction took place, and it further argued that since Islamic Investment's charter prohibited it from entering into contracts that were not compliant with the Shari'a, the agreement was ultra vires and thus unenforceable. The court rejected both these arguments on the basis that the transaction did not have a sufficient connection with Saudi Arabia for it to be rendered unenforceable under the principle of illegality. The court further held that the agreement was not ultra vires under the law of the Bahamas, where Islamic Investment had been formed. The court did not examine whether or not the agreement was a valid murabaha, but ruled that even if the agreement was beyond the scope of the stated objects of Islamic Investment, it was not void ab initio. Symphony further invoked the Shari'a to defend against a claim for liquidated damages on the basis that such would amount to the payment of interest. However, the court held that the claim had been brought before an English court and by a company operating under the laws of the Bahamas, and as such, the grant of the remedy would not be subject to the laws of the Shari'a.

While this judgement, naturally, is relevant in the jurisdiction of decision, it may well suffer enforceability issues in Islamic fora because Islamic courts, e.g., in the Kingdom of Saudi Arabia (when they assert jurisdiction over a case) are likely to ascertain compliance with the law of the land before giving effect to foreign judgements that rule on matters that posit Shari'a arrangements at their core.

28.4.3 The Investment Dar Company v. Blom Developments Bank Sal[7]

In the Dar case, pending trial as of the date of this publication, Investment Dar Company ("Dar"), a bank incorporated in Kuwait, entered into a wakala agreement with Development Bank SAL ("Blom Bank"). Under the agreement, Dar guaranteed to Blom a specified rate of return on the capital investment at the end of the investment period, characterized as "anticipated profit," payable regardless of whether or not the capital sum generated a profit in the hands of Dar. The investments made by Dar were not successful, and Dar failed in meeting its payment obligations under the wakala arrangements. Blom Bank sued Dar for repayment of the capital invested as well as the specified rate of return. In its defense, Dar argued that the wakala agreement was not Shari'a-compliant, and that under its constitutional documents, Dar was prohibited from engaging in non-Shari'a-compliant activities, thus rendering Dar's assent to the wakala agreement an ultra vires act not binding on Dar. The governing law provision of the wakala arrangements provided that English law will be applied, and placed a condition that Dar will use the funds only for Shari'a-compliant investments.

Dar claimed that a guaranteed rate of return is essentially riba and based the ultra vires argument on Article 5 of its memorandum of association:

"The objectives for which the company is established shall be Shari'a-compliant. None of the objectives shall be construed and interpreted as permitting the company to practice directly or indirectly any usury or non-Shari'a-compliant activities."

Dar survived Blom Bank's summary judgement motion on the ultra vires defense. The court held that the case would proceed to trial (despite expressing some skepticism on the soundness of the ultra vires argument). However, the court awarded summary judgement to Blom Bank for the capital sum, reasoning that, even if Dar's ultra vires defense prevailed, such would only apply to the fixed rate of return (i.e., the anticipated profit), and Blom Bank would still be entitled to restitution and thus the original capital sum. The main questions for the trial court to consider are (i) whether the wakala agreement was ultra vires; i.e., whether Dar lacked the legal capacity to enter into the wakala agreement, and (ii) whether to enforce a contract on the basis that it is not Shari'a-compliant, although the non-enforcement of the contract would ironically inure to the benefit of a party whose Shari'a board initially (and subsequently) affirmed the Shari'a-compliance of the contract.

28.5 Conclusion

The foregoing analysis shows that some of the most significant issues involving Islamic finance transactions are rooted in (i) the governing law and dispute resolution clause of the underlying transaction and (ii) the shortfalls of the structure from a Shari'a-compliance standpoint.

In the cases that have been examined here, the English courts have approached the cases with English law only and have set aside Shari'a law. This opens the door to several issues; most notably, parties that sought to enter into a contract based on Shari'a principles will be subject to remedies that may be in contravention to Islamic jurisprudence, including paying or receiving damages that include interest payments. Further, a judgement obtained by an English court that contravenes Shari'a principles will not be enforceable in an Islamic jurisdiction such as the Kingdom of Saudi Arabia, where one of the parties may be registered or where enforcement may be sought. Thus, the parties that sought to conduct business in compliance with the Shari'a but chose English law/courts as the preferred forum of dispute resolution may, if matters went to court, end up with remedies that are neither in line with the Shari'a nor enforceable in the home jurisdiction.

Where disputes are adjudicated in Islamic fora, judges are likely to examine the underlying construct through a critical lens, and where structures are found to have been developed outside of accepted parameters and

[7] [2009] EWHC 3545 (Ch).

established Shari'a principles (e.g., AAOIFI guidelines), judges may, per their judicial prerogative, apply substance over form.[8]

Therefore, when structuring Islamic finance instruments, any provisions that run afoul of the law of the jurisdiction may render the instrument of tenuous enforceability, and the form of a product may well be unravelled to effect substance over form. Notably, even where the law of the jurisdiction has been followed, to the extent the instrument posits a structure that runs afoul of core Shari'a principles, an Islamic adjudicative forum may still treat the instrument as a conventional instrument (and therefore undo the transaction, reverting parties to status quo ante, pre-transaction).

Whilst entering into Islamic finance transactions, it is thus imperative to (i) ensure that the contract is based on a sound structure that does not suffer from inherent flaws from a Shari'a perspective and (ii) avoid selecting a governing law and dispute resolution forum that reaches a result that may contravene core Shari'a principles. Otherwise, the parties to the contract may have, for at least one of the parties, unexpected and unpleasant surprises at adjudication.

[8] Judges in Islamic *fora* have broader discretion to exercise than their common law counterparts and have a duty to effect justice rather than give due effect to the strict construction of the contract when doing so would have problematic or impermissible results. From a *Shari'a* perspective, a judge is to lean towards effecting justice between parties and lean away from the strict construction of a contract when giving effect to it would result in an egregiously unfair or impermissible result.