Islamic Finance Dispute Resolution

By Oliver Agha

Islamic finance has come to a crossroads in its evolution. Shariah compliant financings have developed exponentially in many jurisdictions. However, there is a considerable variation in standards and wide divergence in industry practices.

The global downturn has resulted in increased levels of disputes, thus highlighting the need for an authoritative and specialist body that can adjudicate and provide reliable and specific decisions guided by Shariah in a modern commercial context.

There are many fora operating within national legal systems that deal with the adjudication of Islamic finance disputes. Such disputes can be handled by both state courts, as well as by alternative dispute resolution (ADR), as for example the Central Bank of Malaysia Shariah Advisory Board, the Kuala Lumpur Regional Center for Arbitration and the Islamic Center for Reconciliation and Arbitration in Dubai. However, existing fora face many issues on their way to becoming globally recognized centers for Islamic dispute resolution.

The first and foremost problem lies in a diversity of thought and practice of Shariah across all the Islamic countries. Besides the differences between Sunni and Shi'a Islam, there are four notable schools (madhab) within Sunni Islam itself: Maliki, Hanafi, Hanbali and Shafi'e. Although each individual is free to follow the school of his choice, certain populations in Islamic states have traditionally followed a certain Madhab.

Thus, to demonstrate the degree of fragmentation existing in the Islamic world of jurisprudence, the Hanafi school prevails in Turkey, Syria, Lebanon, Iraq, Jordan, Egypt and the Sudan; Maliki has governed the Muslim populations of North, West, and Central Africa; Shafi'e has prevailed in East Africa, Malaysia, and the southern part of the Arabian Peninsula and Hanbali is the basis for the codified law of the Kingdom of Saudi Arabia.

Such differences inevitably influence the approach to Islamic finance and related disputes. Malaysia, for example, takes a more liberal approach to the interpretation of Shariah, whilst the Gulf region's interpretation is considered more purist.

A vast amount of Islamic finance cases are adjudicated by the state courts of various countries, thus falling under the purview of national law. There are countries where Shariah is: (i) a supreme source of law, as for example, in Saudi Arabia, Iran, Sudan and Pakistan, (ii) one of the sources of law as in Malaysia, Kuwait and UAE, (iii) not part of the legal system. Naturally, the issues arising in relation to Islamic dispute resolution vary depending on the category to which the country belongs.

Of course, the majority of legal systems are not based first and foremost on Shariah and, as a result, courts will apply Shariah law in the context of its interplay with the national laws. This raises issues both in relation to the status of Shariah law within the contract, court adjudication process and also in relation to the enforcement of overseas judgments.

In the Middle East, a vast amount of Islamic finance transactions name the courts of England and Wales as the applicable forum and the law of England and Wales as the governing law. Naturally, the English courts have addressed the extent of applicability of Shariah law to certain contracts. For example, in the case of Shamil Bank of Bahrain (EC) versus Beximco Pharmaceuticals Ltd, the court considered the status of a purportedly dual Shariah and English governing law clause.

Contracts between the parties stated that they were "subject to the principles of the glorious Shariah" and would be governed by and construed in accordance with the laws of England and Wales. Beximco claimed that the dual reference to Shariah and English law meant that the contract had to be

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recognized as binding by both systems of law (and that the contract was not Shariah compliant). The Court of Appeal ruled that because Shariah law was not the law of any individual country and there was too much uncertainty as to its terms for it to be a binding system of law, English law was the sole governing law.

This case has caused controversy, given the popularity of English governing law clauses in the Islamic finance industry. Parties are now advised to make sure that any Shariah compliant arrangements and mechanisms included within their agreements also comport with the chosen national law. However, there may be circumstances where this simply is not possible and Shariah principles may be sacrificed. Whilst the Shamil case is limited to England and Wales, it is possible that other common law legal systems may apply similar reasoning.

In cases where parties are considering choosing a specific national law, the legal system of which includes Shariah law, they must ensure that there is a reciprocal enforcement treaty in place between both countries.

However, in certain circumstances, even when such arrangements are in place, a successful enforcement may be impossible. For example, if the decision of a foreign court involves payment of interest, such a decision will not be enforced in Saudi Arabia since it contravenes the basic precepts of Shariah.

Thus, submitting an Islamic finance matter to a state court of any jurisdiction may evince various issues, which include enforcement, adjudication in accordance with Shariah law, lack of competent training of judges, and conflict of laws issues, among others.

Therefore, the market has reached a point where an authoritative and specialist Islamic finance ADR institution is needed. Such a forum must draw on both Islamic academia, as well as robust commercial expertise.

ADR fora for Islamic finance matters exist in many countries in a variety of forms (arbitration, expert determination, among others). However, such fora face certain issues that impede their growth. Notwithstanding the issue with the diversity of schools of Islam, the ADR fora must be able to pass a final and binding decision. However, frequently, this is not the case.

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Until this month, under the Central Bank of Malaysia Act 1965, for instance, the court had a discretion to refer a question concerning a Shariah matter in Islamic finance to the Shariah Advisory Council.

However, the Shariah Advisory Council could only make recommendation that were not ultimately binding. That Bank Negara Malaysia Act 2009 has reformed the situation, making the Shariah Advisory Council's decisions binding is an indicator of the increasing maturity of Islamic finance ADR in Malaysia. However, the situation is not uniform.

In the Middle East, the leading regulatory body for Islamic finance is the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). It develops and publishes standards that regulate the industry. One of the standards to be issued by AAOIFI concerns arbitration and the publishing of such should assist in the development of Islamic ADR fora.

Another question confronting Islamic ADR institutions is the optimal scope of their mandate. In Malaysia, for instance, the role of a Shariah arbitrator has often been limited to that of an expert, who renders

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a judgment in terms of a discrete aspect of a case, and then refers it back to the main ADR forum.

To the extent an Islamic ADR institution attempts to undertake a scope that is all-encompassing, and therefore akin to its conventional commercial arbitration equivalent, raises the issue of competence and qualifications of the arbitrators. In a conventional context, many commercial arbitration fora are qualified to issue a ruling on all of the aspects of the issues between the parties.

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One has to query whether a sufficient number of Shariah scholars are qualified to deal with the dynamics of complex commercial arbitration and/or whether commercial arbitrators can be sufficiently expert in the intricacies of Shariah law. Another issue concerns the identity of arbitrators, that is, can non-Muslims issue binding decisions that affect Islamic parties.

In relation to enforcement of arbitral awards, Islamic ADR fora may face the same issues as the state courts. In circumstances where a party needs to enforce an arbitration decision overseas, they may find it difficult to do so under another nation's law. The parties need to ensure that there is a reciprocal enforcement treaty in place between both countries.

The New York Convention of 1958 on the enforcement of foreign arbitration awards has gone a long way to deal with cross-border enforcement of arbitral awards and most countries, under which the arbitration of Islamic finance disputes are carried out, are signatories. The convention requires that signatory states recognize and enforce arbitral awards made under the governing law of other nations.

However, there are exceptions, in particular the public policy defense, that allows a party to avoid enforcement of an award on the ground of "public policy". It could potentially be used by national courts to prevent the enforcement of Shariah compliant arbitration awards where judges consider that the arbitration award runs counter to public policy, as for example by trumping explicit national laws or jurisdictions.

In summary, the credit crunch has exposed certain practical issues vis-à-vis the workings of dispute resolution in Islamic finance. But it has also revealed an opportunity to set the policy and agenda for the development of Islamic finance. The establishment of a recognized Islamic Finance ADR forum is needed to adjudicate disputes with recognized capability and standing.

The Middle East is a strong candidate for the role owing to its rigorous approach to Shariah law and its growing Islamic finance sector.

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