The Choice of Law and Dispute Settlement Resolution in Islamic Cross Border Finance Transactions

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As the Islamic financial market becomes increasingly global, financial participants from multiple jurisdictions are taking opportunities to gather their resources and form alliances to jointly participate in the global business. As a consequence, and given that the cornerstone of Islamic finance transactions are the application of Shariah principles, such principles are being adapted into international commercial agreements and assimilated into a non-Islamic legal environment. Attempts are being made to implement Islamic finance transactions in jurisdictions which are not bound to give effect to Islamic principles, at least where commercial agreements are concerned.

Most countries have adopted either the common law, or civil law system, and there is a lack of a comprehensive legal system to support the application of Islamic principles in Islamic finance transaction documents. Even if market participants agree to use contracts based on Shariah principles, most laws and the courts lack the sufficient and specific legal backdrop, infrastructure, resources and expertise to interpret and enforce the transaction documents Islamically.

In certain countries like Pakistan, Egypt and Malaysia, despite the existence of Shariah judicial systems, the application of Islamic laws are limited to traditional areas of law such as family laws, marriage and inheritance. Even where some countries have successfully established separate Islamic statutes such as Islamic banking laws passed by Kuwait and Malaysia, its applications in the respective judicial systems are limited and are still the subject of debate.

The issues which arise as a result of the increasing participation of financial institutions and other market players from multiple jurisdictions in a single Islamic finance transaction in light of the above mentioned scenario are mainly two-fold — firstly, the choice of governing law which will govern the Islamic finance transaction documents and extent to which Islamic law principles are applied within the chosen governing law framework, and; secondly, given the lack of an Islamic legal system, the proper forum of dispute resolution for disputes under the Islamic finance transaction documents. This article attempts to outline the challenges surrounding both issues.

Role of Shariah principles vis-à-vis the choice of governing law

All finance transaction documents have a governing law clause. Although rarely the primary concern of the parties, the choice of governing law can be a point of confusion for cross-border finance transactions involving parties from multiple jurisdictions. For a conventional cross-border finance transaction, although still an important point, there is less complication as there is no requirement to consider the application of Islamic principles. Rather the issues revolve around the applicability of the choice of law in the jurisdiction where a party contemplates a legal action in other jurisdiction and the enforcement of a foreign judgment in the jurisdiction where the obligor resides and/ or where the assets of the obligor are located.

With Islamic finance transactions, the choice of law is more delicate given that the parties will naturally want to opt for Islamic law as the governing law of the finance documents. As Shariah is not a national system of law and there is no one standard codified Islamic law to be used as guidance and reference,

parties cannot merely adopt Islamic law as the governing law without reference to the law of a particular jurisdiction. Therefore, a national law system is often used as the governing law to provide more certainty on the rights and obligations of the transacting parties.

The reference to Shariah principles is embedded in the provision on the governing law, often drafted in such a way that the governing law will be used subject to the Shariah principles. Such provision gives rise to the question as to the extent of applicability of Shariah principles in the law of a chosen jurisdiction. In practice, English law is widely chosen as the governing law of Islamic cross- border finance transactions.

There is ample evidence to suggest that the reference to Shariah rules and principles amid the choice of law clauses such as illustrated above are included in the Islamic finance transaction documents with no particular thought of the effect or implementation of the provision by the judicial system. Therefore, it is not surprising for the parties to provide for the Shariah principles the law of a specific domestic jurisdiction, only to discover later in litigation that the courts lack the expertise or resources to implement the Shariah rules.

There have been a number of cases litigated in the English courts involving Islamic finance agreements, where the courts examined the issue of the governing law in such agreements.

One of such case, Shamil Bank of Bahrain v Beximco Pharmaceuticals, illustrates this point very well. The case was significant because for the first time, the questions of the validity, interpretation and scope of the English law vis-à-vis Islamic principles were considered by a secular court.

In that case, Shamil Bank of Bahrain (Shamil Bank) claimed that certain monies were outstanding from Beximco Pharmaceuticals (Beximco) under a Murabahah agreement. The governing clause in the Murabahah agreement stated that “subject to the principles of the glorious Shariah”, the agreement would be governed by and construed in accordance with the laws of England. Beximco argued that the agreement was contrary to Shariah law and therefore was not enforceable.

The judge in the first instance held that English law was the governing law and there was no scope for the Shariah law to apply as there could not be two separate law systems governing a transaction. Further, it would be highly impossible that an English secular court would apply religious principles in making the determination of a dispute. The appeal by Beximco against the decision of the first instance judge was dismissed along the same arguments. The judge in the English Court of Appeal case further argued that the general reference of the Shariah law in the agreement did not identify any specific Shariah principles to be applied and further ruled that the reference to Shariah law is repugnant to English law.

The above case illustrates two main challenges, first, the reluctance of a secular court to admit the application of Shariah principles and second, the scope for potential abuse by defaulting obligors to use Shariah invalidity arguments to avoid making payments under the Islamic documents. Due to the various interpretations of Islamic finance structures, defaulting borrowers have the opportunity to ‘shop around’ for the Shariah view which favors their argument of Shariah invalidity which will absolve them from the responsibility of payment of amount owing, which is why in the above case, the judge determined that the sole intention of Beximco was to obtain financing from Shamil Bank. Therefore the form of the agreements and the impact of the Shariah law on the validity of the agreement were not points of contention.

The judgment of the Court of Appeal relating to 11 separate cases involving Bank Islam Malaysia and Arab Malaysian Finance confirmed the validity of certain Islamic finance structure in Malaysia. Similarly, the Michigan district court has recently dismissed a case alleging that AIG’s Shariah compliant financial services violated the constitution of the US; however the interpretations of the Islamic principles are still being debated. In the Malaysian case, the judge stated that the notion that the question of whether an Islamic finance transaction is Shariah compliant is finally determined by the Shariah board is flawed. While the courts will take into account the views and opinions of the Shariah scholars, the final decision maker on making a determination of such issue will be the court. Arguably, these two cases opened up the acceptability and recognition of Islamic principles in the secular judicial systems although its application is

still vague and unclear.

Choice of dispute resolution

There is also the question to the choice of forum. If there is a legal dispute, where will the dispute be resolved? As discussed in the preceding section, there is an absence of judicial systems capable of litigating and enforcing Islamic finance documents. Secular courts do not have the capability to ascertain and determine what does or does not comply with Shariah. Even among Shariah experts there can differences in matters of interpretation of Islamic law.

In light of the above, the question is whether a dispute resolution through arbitration over the judicial courts is able to resolve the issue of application of Shariah principles in Islamic finance documents.

Arbitration is recognized under the Shariah. The advantages of arbitration are that the parties can participate in the process; work and decide on the outcome together, as opposed to against each other. This can help maintain, restore or rebuild their relationship and save costs and time. The alternative dispute resolution approach is generally more efficient, private and more flexible for both parties as compared to litigation. The parties are able to emphasize that the aim of the arbitration is to have disputes resolved in accordance with Shariah principles.

Arbitration provides an avenue to bring in and appoint Shariah scholars as arbitrators, which could issue an arbitration award which is a binding decision on the parties. However, the arbitrators or other persons involved in arbitration procedures also need to have some familiarity with financial, commercial and legal issues and not just the Shariah issues. The arbitration award, however, still requires enforcement in the secular courts. This requires the determination as to whether the arbitration award is enforceable in the relevant jurisdiction.

Conclusion

For a conventional cross-border finance transaction, the choice of governing law and dispute settlement resolution constitutes important sections of the document. The parties have to consider the legal consequences stemming from choosing a law of a particular jurisdiction, such as the issue of the applicability of such governing laws in the jurisdiction where a party chooses to bring a legal action, conflicts of law rules and enforcement of foreign judgments in a local jurisdiction.

When the parties use Islamic finance structure, another layer of governing law or principle is referenced to the finance document which adds to the complexity of the existing issues. It seems to be easy enough for the parties to merely include in the finance documents a clause that the governing law is subject to Shariah principles without giving much thought to the legal consequences. In a legal environment where there is an absence of a judicial system that can uphold and implement Islamic principles in Islamic finance documents, a governing law clause with a reference to Shariah principles seem to be irrelevant and has no particular effect.

The best practice which has been increasingly adopted by legal practitioners in Islamic cross border finance documents is to include a representation that the parties are satisfied that the agreement complies with the Shariah and a provision whereby the parties agree not to seek to challenge the enforceability of the agreement in the future on the basis of non-compliance with Shariah principles.

Consequently, the governing law clause only provides for the choice of law and without reference to Shariah. In addition, parties involved in Islamic cross border finance transactions have increasingly opted for arbitration as the choice of dispute resolution to take advantage of the flexibilities it offers and the opportunity to bring in Shariah and financial experts as arbitrators. For example in Kuwait, the court is more willing to enforce a foreign arbitration award.

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