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ARBITRATION CLAUSE IN ISLAMIC FINANCE FACILITY: A NEW YORK CONVENTION AND MODEL LAW PERSPECTIVE

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Arbitration presently is a subject of great commercial and public interest. Many countries have started taking pro-active steps to encourage 'Alternative Dispute Resolution' (ADR) mechanism such as arbitration, mediation, conciliation, adjudication, etc. as viable options in contrast to litigation. Arbitration has many of the features of litigation and paves way for just, fair, efficient and economical dispute resolution mechanism with an arbitral award of equal status to a court judgment. Judgments of court can be challenged for error of fact and/or law. An award of arbitral tribunal cannot be challenged on that basis. In addition, parties to the arbitration proceedings can agree to choose the arbitrator, the rules, the law, the mode of evidence, the time frame, costs, fees, etc. which may not be an option in litigation proceedings. Further, arbitration is seen to provide commercial viability for parties as well as empowerment of arbitrators, arbitral institution, lawyers, support staffs, etc. and very importantly to the public as it reduces the government's spending on courts.

The object of this paper is to demonstrate that Islamic Finance and the law on arbitration are at an evolutionary stage. Marrying them together in the contractual documents relating to Islamic Finance Facilities will result in an efficient dispute resolution mechanism which will benefit investors as well as the public.

Introduction

First, I will briefly set out the 'broad statements':

Islamic Finance as well as Arbitration are evolutionary subjects which have commercial significance. The concepts have moved away from the embryonic stage.[1]

(i) Islamic Finance as well as International and Domestic Arbitration are growing not in arithmetical but geometrical progression generating growth and revenue. Those involved in the study, practice and administration of these concepts need to organise themselves to provide high utility to the commercial world as well as the public.[2]

(ii) The issuance of *sukuk* (Islamic bonds) related to Islamic Finance Facilities has become the most popular mode of financing infrastructure facilities, in contrast to consumer financing.[3]

(iii) Arbitration (Tahkim) is the recommended mode for dispute resolution under the Shariah. However, Islamic Finance Facilities largely does not come with an arbitration clause, and in consequence it can be argued it is not Shariah compliant.[4]

(iv) Shariah compliance is an essential feature of Islamic Finance Facility. It is purportedly achieved by the approval of the product (facility) by the Shariah Committee.[5]

(v) The importance of getting an endorsement from the Shariah Committee is extremely important to attract investment and/or depositor and/or customers, but not for the purpose of settlement of dispute by litigation. The reason being, when there is a dispute in courts as to whether a

[1] It is well established that the concept of arbitration was in vogue in the pre-Islamic era in the Middle East. See N.J. Coulson, *A History of Islamic Law*, (Edinburgh: Edinburgh University Press, 1964), p.10. Arbitration in the pre-Islamic era was related to dispute settlement by adjudication through a third party (Tahkim). The learned author Vincent Powell Smith had this to say: (i) In pre-Islamic Arabian tribal society, arbitration appears to have been the only publicly-sanctioned system of disputes settlement and was the alternative to self-help remedies; (ii) In pre-Islamic Arabia disputes concerning rights of property, succession and so on were often referred to an arbitrator (hakam) for decision; (iii) This was essentially a voluntary private arrangement, although it has been said that the awards of the arbitrators appointed in the "Ukaz - which was a fair held periodically in Mecca - were customarily binding on disputants.

[2] See Chapter 5 of: Hamid Sultan Abu Backer, *International Arbitration with Commentary to Malaysian Arbitration Act 2005* (Kuala Lumpur: Janab (M) Sdn Bhd, 2016).

[3] See Hamid Sultan (2016).

[4] See Hamid Sultan (2016).

[5] See Hamid Sultan Abu Backer and Anwardeen Hamid Sultan, *Islamic Banking Annexed With Medjelle (Civil Code of Ottoman Caliphate,* (Kuala Lumpur: Janab (M) Sdn Bhd, 2014).

product is Shariah compliant or not, the common law courts such as in England are not concerned with whether the product is Shariah compliant or not. The courts take the view that as long as the finance facility term does not breach the law of contract and/or the law of the state, it will be enforceable notwithstanding that it may breach Shariah principles.[6]

(vi) Common law courts are not concerned with Shariah law. However, if the parties have agreed for Shariah law to be the governing law in arbitration, the arbitrators will be dealt with Shariah issues. Any award they make will be enforceable under the New York Convention in all Model Law countries, which are arbitration friendly.[7]

(vii) Islamic Finance Facilities have advanced to a stage where the issuers as well as consumers may not be Muslims. Islamic Finance Facilities with an arbitration clause stating that the governing law will be other than Islamic law will be valid under the Convention and will be enforceable in the Model Law countries.[8]

(viii) The conclusion is that an Arbitration Clause in any Islamic Finance Facility is a must to truly say the product is Shariah compliant. It will also assist as an efficient dispute resolution mechanism in contrast to litigation. An arbitral award has prospect of being enforced in all New York Convention countries in contrast to judgments of courts.

Islamic Banking and/or Finance and Role of Shariah Committee[9]

It is important to appreciate that the concept of Banking and/or Finance in the conventional sense does not exist in the Quran and/or teachings of the Holy Prophet (S.A.W). There were only trading concepts to facilitate Islamic Commercial transactions.

[6] See *Maybank Islamic Berhad v M-IO Builders Sdn Bhd & Anor* [2016] MLRAU 532.

[7] Rome Convention as to governing laws which is applicable to the European Union is not applicable to arbitration. [See *Shamil Bank of Bahrain v. Beximo Pharmaceuticals Limited & Ors* [2003] EWHC 2118 HC and [2003] EWCA iv 19]. In UK, it is well recognised that Islamic Arbitration is permissible and the award is enforceable.

[8] See Hamid Sultan (2016).

[9] See Hamid Sultan (2014).

Some of the trading concepts used were *mudarabah* (partnership), *ijarah* (leasing), *murabahah* (deferred payment sale), etc.

In the last three or four decades, these trading concepts were used as financing instruments. For example, a person who has adequate capital can purchase a number of cars and lease them out to earn an income and/or sell them on deferred payment sale and thereby make a profit. For all these modes, there was no necessity for a Shariah Committee to approve the facility documents. It was purely based on willing buyer and customer basis subject to the laws of the state.

As a general rule, when financers needed capital to operate finance facilities inevitably they needed depositors to fund their activities. To do so, they needed to obtain permission from the central bank as well as comply with regulatory measures. Islamic financers also have to go through the process to attract Muslim depositors they had to assure and/or guarantee that the money received and profit earned as well as the profit given to the depositors are Shariah compliant. This is where the role of the Shariah Committee emerged and its main purpose was to endorse all financial transactions of the Financier are Shariah compliant. Thus, the endorsement of the Shariah Committee was instrumental for attracting Muslim depositors.

The Islamic Financers have also started providing other facilities which conventional banks do such as current account, withdrawal by cheques, etc. to attract depositors and thus, they have acquired the stature as bankers.

What the Shariah Committee did not ensure in the financing facilities in the early days, which largely continues, is an effective and recommended mode of dispute resolution mechanism under the Shariah. This was sadly also the case where foreign parties were involved in finance facilities such as *sukuk*.

When a dispute arose in relation to Islamic Finance Facilities, it often has to be taken to courts. The courts in common law countries were not concerned with Shariah principles when one party alleges that the facility agreement, etc. was not Shariah complaint. The courts took the position that as long as the terms of the finance facility agreement do not breach the state laws it held that the contract was valid. It effectively means that Shariah Law is not relevant in common law countries, nor had they the expertise in Shariah finance. In other words, the efforts of the Shariah Committee is only relevant for the purpose of

attracting depositors as well as customers. The expertise of lawyers was only necessary to conduct litigation arising from disputes relating to Islamic Finance Facilities. Thus, Islamic Finance Facility did not give a choice for contracting parties to choose the governing law of the dispute in particular Shariah law or any other laws when arbitration was not an option.

Sukuk and the Arbitration Clause[10]

It is now well established that Islamic Finance is in current day a global practice with wide acceptance. *Sukuk* is seen as the prime pride in the growth of Islamic Finance Facility. The facilities are offered by non-Muslim financial institution to customers who need not be Muslims. It is trite that arbitration is one of the effective modes of dispute resolution under the Shariah jurisprudence. Providing for arbitration clause in Islamic finance facilities will be an effective means of dispute resolution and will also be Shariah compliant, and awards thereunder will be enforceable in countries which has subscribed to the Convention and/or Model Law. I say so *inter alia* for following reasons:

(i) There are sufficient materials to support the proposition that arbitration clause in Islamic civil or commercial agreements will not stand as an impediment to position International or Domestic Islamic Arbitration within the parameters of the Convention as well as Model Law.[11]

(ii) The Quranic injunction as well as Sunnah of the Holy Prophet (S.A.W) also do not impinge on the concept of '*pacta sunt servanda'*, which advocates that a treaty based on the consent of the party to it, is binding and must be executed in good faith. That is to say, parties can agree to governing

[10] See Hamid Sultan (2014).

[11] The Muslim Arbitration Tribunal (MAT) which operates within the parameters of English Arbitration Act 1996 has as its core business dealing with commercial arbitration disputes. Its rulings can be enforced in England. [See also Islamic Arbitration of Family Disputes in New Zealand, dissertation Oct. 2010, by Laura Ashworth). The MAT Procedural Rules is anchored on the basis of justice, equity, good conscience and fairness. The overriding objective states that all adjudication will be based on the principles of the Quran, accepted practice of the Holy Prophet, the recognised schools of Islamic Law, the interests of the parties and the overall public interest.

It must be noted that the former Lord Chief Justice of England and Wales Lord Phillips has personally endorsed MAT and had observed that Oman's legal system is very similar to the structure in England and Wales. That is to say Western law is largely used in most matters where Syariah law, currently, is only limited to matters of personal and family law. [See www.inbrief.co.uk].

law of the dispute as well as arbitrators and/or counsel, etc. as they deem fit.[12]

(iii) The common law courts which do not recognise Shariah jurisprudence is prepared to recognise awards based on Shariah principles and have allowed enforcement of the awards.[13]

(iv) There is no impediment for non-Muslim arbitrators to sit in Islamic Finance Disputes. For example, Dubai International Financial Centre Courts (DIFC) have Muslim as well as non-Muslim Arbitrators.[14]

(v) There are a number of specialised Islamic Arbitration Institutions or regular Arbitration Institutions which are equipped to deal with Islamic civil and commercial law disputes with appropriate rules and methodology to ensure Shariah compliance. International or domestic award issued through the auspices of these institutions are enforceable.[15]

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[12] One particular maxim which is very relevant to Islamic Arbitration is related to the proposition that 'what is not prohibited is permissible'.

The Quranic injunction as well as Sunnah of the Holy Prophet also does not impinge on the concept of '*pacta sunt servanda'*.

In the often quoted case of Aramco Arbitration, *Saudi Arabia v Arabian American Oil Company (Aramco)* 27 ILR 117, the arbitral panel had taken the view that *pacta sunt servanda* is recognised in Islamic jurisprudence. [See Sangwani Patrick Ng'ambi, 'Resource Nationalism in International Investment Law', 2015].

[13] See *Beximco Pharmaceuticals Ltd & Ors v. Shamil Bank of Bahrain EC* [2004] EWCA Civ 19; and *Dubai Islamic Bank PJSC v. PSI Energy Holding Company BSC & Anor* [2013] EWHC 3781 (Comm), where the English Court did not recognise a clause prescribing the Sharīʿah as the governing law of agreement.

[14] It is pertinent to note that the Dubai International Financial Centre Courts (DIFC Courts) which deal with commercial disputes and have jurisdiction over international arbitration matters consists of judges who are Muslims as well as non-Muslims. Islamic jurisprudence promotes Islamic finance arbitration and there is no specific prohibition against arbitration in commercial disputes stated in the Holy Quran or Sunnah of the Holy Prophet, save that the commercial transaction must not breach the riba (interest) and gharar (uncertainties) rules. And even if these rules are breached and an International Islamic Arbitration award is issued, it will still be good for enforcement in most of the Model Law countries, like England, Singapore, Australia, Hong Kong, etc. with the exception of some countries in the Middle East. Paul Turner in his article 'Finding Your Path: Arbitration, Sharia and the Modern Middle East' observed some pertinent points which can be summarised as follows: (i) Islamic schools accept that commercial matters can be arbitrated, provided that parties have submitted to settle the dispute through arbitration; (ii) it has been said that Sharīʿah does not allow parties to agree to arbitrate future disputes, but this does not prevent conventional arbitral agreements being used in the Middle East, including Saudi Arabia where such clauses are explicitly allowed under Article 1 of the Arbitration Law; (iii) the conservative Sharīʿah requirement that the arbitrator must be a male Muslim is only followed in Saudi Arabia and not in other countries; (iv) tt is unlikely that enforcement of an international arbitration award will be refused in the Middle East countries on public policy grounds when it is not Sharīʿah-compliant; (v) Domestic awards must comply with domestic laws to be enforced at the seat; (vii) Award consisting of interest will be enforced as most Middle East countries have legalised interest and/or the interest part can be severed.

15 See Hamid Sultan (2016).

(vi) The peculiar benefit of the Model Law regime as opposed to the Convention is that an award cannot be challenged on the grounds of an error of fact or law. The challenge can only be related to arbitral process and not the arbitral award.[16]

Convention[17]

When Islamic Finance Facilities were introduced, the Convention was the regime for International Arbitration. International Arbitration did not progress under the Convention. The stakeholders were not attracted by the terms of the Convention and the legislations made in those terms[18], and the Islamic Finance Facility providers and Shariah Committees were not an exception to that. The Convention did not guarantee that an international award will be enforced as opposed to Model Law. The shortcomings of the Convention *inter alia* were as follows:

(a) The most important articles of the Convention are Article 1 to V. Two of the Articles are not arbitration friendly. They are Articles II and V respectively.

(b) Article II permits a party to an arbitration agreement to argue before the court that the agreement is null and void, inoperative or incapable of being performed. This is often referred to as a jurisdictional objection and courts despite the party autonomy concept of arbitration have often ruled in favour of litigation. Even if the court finds in favour the arbitration clause and refers the matter to arbitration, that does not stop the losing party from raising the same issue at the enforcement stage pursuant to Article V.

(c) Article V in principle does not guarantee an international arbitration award will be enforced as of right. The said article particularised five grounds for a party who objects to an award to rely on and two grounds for the court on its own motion to refuse enforcement.

16 See 'Birds Eye View of International Arbitral Process: Malaysian Chapter' – KLRCA Newsletter #19 / July-Sept 2015.

17 See Astro Lippo: Is 'Passive Remedy' An Anathema To The Enforcement of International Arbitration Award? Malaysian Chapter.

18 For example, in Malaysia, Convention on the Recognition and Enforcement of Foreign Arbitral Awards Act 1985 (repealed by Arbitration Act 2005).

Model Law[19]

Model Law has enabled international arbitration to grow in leaps and bounds. Its unique features are as follows:

(i) It recognises party autonomy concept in full and does not allow the court to intervene in the arbitration process or award except in very limited circumstances, notwithstanding the fact that it has largely subsumed Articles I to V of the Convention.

(ii) The role of the seat court is only to assist and supervise the arbitral process.

(iii) Issues related to Article II of the Convention earlier have to be settled before the arbitral panel with a right of appeal to the seat court. Enforcement courts which are arbitration friendly will not allow the jurisdictional issues to be relitigated again unless the award comes from a state which is not recognised for its judicial independence, etc.

(iv) Issues related to Articles II or V can largely be settled in the seat court itself and in consequence it guarantees the award from the seat court will be enforceable in other Convention or Model Law states.

Conclusion

In my view, Islamic finance facility and the law on Arbitration has evolved over the years to provide a perfect dispute resolution mechanism for Shariah Committees to take into consideration and impose an arbitration clause for all Islamic Finance Facilities to say the product is truly Shariah compliant.

The present shortcomings of arbitration proceeding may be related to the complaint of exorbitant fees, delay in arbitration proceedings, etc. These shortcomings can be addressed by way of an amendment to the Arbitration Act of the state which has subscribed to the Model Law. Recently, India has addressed these shortcomings. They have now amended their Arbitration Act i.e. the Indian Arbitration and Conciliation Act 1996 has

[19] See Birds Eye View of International Arbitral Process: Malaysian Chapter; and Astro Lippo: Is 'Passive Remedy' An Anathema To The Enforcement of International Arbitration Award? Malaysian Chapter.

been amended through Indian Arbitration and Conciliation (Amendment) Act 2015. There is no reason why other states should not follow with similar amendments as the Indian Act as Arbitration as well as Islamic Finance are subjects which are evolutionary in nature in attempting to accommodate the needs of society.

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