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ENFORCEABILITY OF ISLAMIC FINANCIAL CONTRACTS IN SECULAR JURISDICTIONS: MALAYSIAN LAW AS THE LAW OF REFERENCE AND MALAYSIAN COURTS AS THE FORUM FOR SETTLEMENT OF DISPUTES

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ABSTRACT

This research paper examines the enforceability of international Islamic financial contracts in secular jurisdictions with a specific reference to England and Malaysia. English law and court are commonly categorized as the law of choice and court of choice preferred by the contracting parties in cross-border transactions due to their reputation for integrity and the resultant respect they enjoy. However, past experience shows that English courts are reluctant to recognize the underlying Shari'ah nature of Islamic financial contracts. The paper will discuss relevant cases in which these issues have been raised with a view of finding a viable solution. Furthermore, the paper will explore relevant Private International Law principles with a special reference to a "proper law of contract" principle, as well as the Rome Convention and Rome I Regulation. One of the solutions could be found in "doctrine of incorporation" where clearly identified Shari'ah principles of a contract could be enforced as contractual terms. Alternatively, the paper is proposing the Malaysian law and court as the law of reference and the forum for settlement of disputes where effective legislative and judicial mechanisms have been developed for the recognition and enforcement of both conventional and Islamic aspects of the contracts.

Keyword : Islamic finance, cross-border transactions, disputes, law of choice, doctrine of incorporation

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1. INTRODUCTION

Islamic financial transactions are based on contracts that need to be in line with two systems of law, i.e., the Sharī'ah as well as the municipal laws of the country in which the dispute, if any, is adjudicated. A “law of choice” clause mutually agreed by contracting parties will determine governing law for Islamic financial transactions. In most cross-border Islamic financial transactions, the law chosen by contracting parties is English law due to many reasons, which will be explained subsequently in the research. At the same time, the underlying Sharī'ah aspect of the transaction must not be neglected. Ideally, both laws should be duly respected and enforced. However, a problem arises when these laws are inconsistent with each other and when they provide different outcomes. The paper concentrates on English experience in dealing with these issues, as international Islamic financial cases have already been referred to their courts and duly adjudicated. The English court approach is quite reflective of the position that would be adopted by other secular jurisdictions, especially in Europe, because of Rome I Regulations, adopted to harmonize the conflict of laws throughout Europe.¹

If English law is the “law of choice” mentioned in an Islamic financial contract, then the question posed is, which law should the court apply? Generally, a contract cannot be governed by two different systems of law. The private international law “doctrine of incorporation” allows only clearly identified provisions of foreign law to be incorporated into a contract, but not the whole system of law. Could this be a solution? This problem, which could happen in any secular jurisdiction, if unsolved, would give rise to legal uncertainties and could adversely affect the Islamic financial industry. However, one may pause for a moment and ask: why do the parties choose English law and court as their preference when that choice bears a significant risk that the underlying Sharī'ah aspect of a contract will not be recognized? After all, the “doctrine of incorporation” does not override the law of choice. It only creates a platform for Sharī'ah principles to be recognized by the court as contractual terms and not as a combined-choice-of-law clause. So, is there any alternative way of having the Sharī'ah nature of a contract recognized and enforced, not as an ancillary, but rather as the main component of the Islamic financial facility, the same way that the conventional principles of the contract are?

¹ See Rome I Regulation, European Parliament and Council Regulation No. 593/2008 of June 17, 2008 on the Law Applicable to Contractual Obligations (Rome I), Regulation (EC) No. 593/2008, OJ L 177 of 4.7.2008.

This paper proposes, as an alternative to the English law and court, that Malaysian law be the law of choice and Malaysian court the court of choice. There are many advantages that this preference of Malaysian over English law could bring to the contracting parties and the industry as a whole, but two are the most obvious, namely, a contract being governed by the Common law system, which is the source of the Malaysian law, and the recognition and enforcement of the Sharī'ah aspect of a contract by the Malaysian National Sharī'ah Advisory Councils (SACs). With the enactment of the new Central Bank of Malaysia Act 2009 (CBMA), civil courts and arbitrators are obliged to refer Sharī'ah issues to the SACs for their ruling, and their rulings are binding on judges and arbitrators.²

2. ENFORCEABILITY OF ISLAMIC FINANCIAL CONTRACTS IN SECULAR JURISDICTIONS: THE ENGLISH COURT APPROACH

When the contracting parties, whose places of business are very often in different countries, enter into cross-border Islamic financial contracts, they have certain legitimate concerns in relation to the enforceability of the agreed terms. Those contracts would identify, in most cases, the law of choice and court of choice agreed to by the parties in a contract. Since the parties are from different countries, they would most likely prefer their contracts to be governed by reliable, independent laws and courts. Therefore, in most cases, the parties to cross-border Islamic financial transactions would identify English law as the governing law and English court as the court of choice. This English law is mostly chosen by the parties because of London's unique financial reputation and the international community's respect for English judges and the integrity of their judicial decisions.³ However, since the transactions are of an Islamic nature, certain underlying Islamic principles must be observed.

This is the initial presumption under which both parties enter into those contracts. Otherwise, they could have entered into a conventional financial transaction. However, when those cases are brought before the secular courts, in this case English courts, Islamic principles governing the transaction are not enforced, and the courts apply only English law, despite the fact that the Sharī'ah is mentioned in the law of choice clause

² See Part VII of the Central Bank of Malaysia Act 2009 (Act 701).

³ See Abdul Karim Aldohni, "The Challenge of Islamic Banking Disputes in the English Courts: The Applicable Law", *Journal of International Banking and Financial Law*, Vol. 24, Issue 6, (2009) 6 JIBFL 350.

together with English law. Therefore, it is essential to analyze, in a detailed manner, some of those crucial judicial decisions and to find the viable solutions so that, in the future, both Islamic and conventional aspects of the transaction can be recognized and enforced as agreed by the parties. This paper will discuss only two, arguably, the most prominent judicial decisions on this matter.

2.1 Islamic Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems N.V. and others⁴

The Islamic Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems N.V. and others was the first Islamic finance case heard and decided by the English courts. In fact, it is one of the first Islamic financial cases decided by a secular court. In this case, *Islamic Investment Company of the Gulf (Bahamas) Ltd* (IICG), the claimant, entered into a *murābahah* financing agreement (mark-up sale transaction), an Islamic financial facility, with the first defendant, *Symphony Gems N.V.* (Symphony), in which Symphony requested IICG to purchase a large quantity of precious gems and stones from the Hong Kong based supplier, “Precious (HK) Ltd.”, for USD \$15,000,000, and then to sell it to Symphony by way of instalments, as mutually agreed in the agreement, for USD \$15,834,900. The *murābahah* financing agreement contained the English “law of choice” and “court of choice” clause. Apparently, the supplier of the diamonds faced some problems in supplying them. Since no delivery of diamond had been made to Symphony, it rejected to pay instalments. On the other hand, IICG applied for the summary judgment before the English Queen’s Bench Division against Symphony in order to recover the sums owed to it.

Symphony raised a few defences, i.e., non-delivery, illegality and *ultra vires*. The defence counsel for Symphony contended that the sale price is not payable if the goods have not been delivered. Symphony never received the goods and thus, the sale price should not be payable until goods are received by the buyer. Furthermore, the defence counsel also argued that the *murābahah* financing agreement was not Sharī’ah compliant. In fact, this is one of the most important issues that the researcher would like to concentrate on and relate to the current discussion. In principle, *murābahah* consists of two promises, i.e., a promise by the customer to purchase the goods and a promise by the bank to sell the goods.⁵ The transaction is concluded when the goods are placed in the possession

⁴ [2002] WL 346969 (Queens’s Bench Division, Commercial Court, 13 February, 2002).

⁵ See Hakimah Yaacob, “A Critical Appraisal of International Islamic Finance Cases, and the Way Forward”, International Shari’ah Research Academy for Islamic Finance (ISRA), Research Paper (No. 19/2011), p. 5.

of the customer. Furthermore, before the goods are placed in the possession of the customer, risks associated with the goods are with the bank.⁶ However, the bank had expressly protected itself from the *murābahah*-associated risks, which should normally be borne by the seller, by inserting a few clauses into the agreement. For instance, Clause 4.4 of the agreement provided the following, “The relevant instalments of the Sale Price in respect of each Purchase Agreement shall be payable by the Purchaser to the Seller on the due dates thereof, whether or not: (a) any property in the Supplies has passed to the Purchaser under the relevant Purchase Agreement and/or to the Seller under the relevant Supply contract...”

This clause of the *murābahah* agreement clearly does not fulfil the necessary requirements of a *murābahah* facility permitted in the Sharī‘ah as it expressly states that the agreement comes into existence “whether or not” the goods are transferred to the purchaser, and that the purchaser is obliged to carry out his promise without the seller fulfilling his promise (i.e., promise to place the goods in the possession of the buyer). Furthermore, Clause 5.7 stated, “In particular, the seller shall have no liability in respect of loss, damage or deterioration of the supplies in transit...”

This clause also goes against the spirit of a *murābahah* agreement because it transfers risks in relation to the goods from the seller (IICG) to the buyer (Symphony) before the goods are placed in the possession of the buyer. Therefore, Symphony argued that the *murābahah* agreement in question is not Sharī‘ah compliant.

Furthermore, two expert witnesses were called by the court to determine the validity of the *murābahah* agreement from the Sharī‘ah point of view. The expert witnesses confirmed that the *murābahah* agreement, in this case, was not Sharī‘ah compliant. However, the judge of the Queen’s Bench Division, Tomlinson J., rejected all the defences presented by Symphony’s counsel. The judge observed that there is nothing in the agreement to indicate that the defendant is not obliged to pay the instalment if the goods are not delivered. The payment of the instalments is not conditional upon the delivery of the goods. This contention in itself goes against the Sharī‘ah law, which requires a seller to fulfil his promise, i.e., to deliver the goods to the buyer. The judge rejected any consideration of the underlying Sharī‘ah basis of the *murābahah* agreement. Tomlinson J. clearly observed that the court would apply English law explicitly. Although it is clear from the law of choice clause that English law is applicable, the transaction in

⁶ Ibid.

question is still an Islamic financial transaction, which must be Sharī'ah compliant. Furthermore, it is ironic that the court called the expert witnesses to elaborate on the *murābahah* agreement from the Sharī'ah point of view and yet completely disregarded the expert evidence given by the expert witnesses. Why then did the court call the expert witnesses in the first place if their evidence “has no bearing whatsoever”?⁷

This is one of the problems that can arise when Islamic financial transactions are decided by secular courts. The fact that a secular court is dealing with Islamic financial transactions does not change anything. In fact, for secular courts Islamic financial transactions are the same as conventional transactions because the law applied by the courts to all disputes is the conventional law of that country. This outcome has been contributed to by the parties' choice-of-law clause.⁸The contracting parties have expressly chosen English law as governing law when it could be foreseen that the English court would not venture into the Sharī'ah aspect of the finance facility but, rather, strictly adhere to English law.

2.2 Shamil Bank of Bahrain E.C. v Beximco Pharmaceuticals Ltd and others

[2004] 4 All ER 1072

Unlike the *Symphony Gems* case, where the governing law clause explicitly stated that only English law shall apply, in *Shamil Bank of Bahrain E.C. v Beximco Pharmaceuticals Ltd and others*, the governing law clause was English law but subject to the principles of Sharī'ah. In this case, the respondent, Shamil Bank of Bahrain (the bank), entered into several financing agreements with the appellant, Beximco Pharmaceuticals and other defendants (the borrowers). In 1995, the bank agreed to provide the borrowers with working capital based on the Islamic contract of *murābahah*. The *murābahah* agreements provided the governing law clause as follows: “Subject to the principles of the Glorious Shari'ah, this Agreement shall be governed by and construed in accordance with the laws of England.”⁹

⁷ See Dr. Norhashimah Mohd Yasin, “Islamic Commercial Contracts Cases Heard in Civil Courts under Common Law: A Case Study of Malaysia and England”, *Journal of Islamic Law Review*, Vol. 3 (2007), p. 104. For the exact phrase, refer to footnote 21 of the article.

⁸ See Dr. Engku Rabiah Adawiah bt Engku Ali, “Constraints and Opportunities in Harmonization of Civil Law and Shari'ah in the Islamic Financial Services Industry”, *Malayan Law Journal*, [2008] 4 MLJ i.

⁹ *Ibid*, paragraph 1.

However, after the borrowers' defaults in payment and the occurrence of several terminating events, the bank brought an action against the borrowers before the English High Court. The bank applied for summary judgment. However, counsel for the borrowers contended that the true construction of the governing law clause needed to be properly construed. In other words, the borrowers questioned the validity of the *murābahah* financing agreements. The financing agreements, according to them; "*were enforceable only in so far as they were valid and enforceable both (i) in accordance with the principles of Sharia'a, and (ii) in accordance with English law; and that in fact the agreements were invalid and unenforceable under the principles of Sharia'a.*" In addition, they argued that the *murābahah* financing agreements were not Sharī'ah compliant, and thus void, because they were, in principle, loan transactions disguised as sale transactions in order to get around the explicit prohibition of interest.

Both parties called their expert witnesses to present expert opinions about the validity of the transactions in Sharī'ah. The bank's expert witness, Dr. Lau, explained that the Sharī'ah compliance of the bank's transactions was approved by the Sharī'ah Advisory Board of the bank, and as such they are valid. However, an expert witness for the borrowers, Mr. Justice (retired) Khalil-Ur-Rehman Khan, disagreed stating that the financing agreements were void because they did not comply with the Sharī'ah requirements of *murābahah*. In addition, he stated that the proclamation of the bank's Sharī'ah Advisory Board about the validity of the transactions should not be conclusive proof of their validity; rather, the court should decide whether they are valid or not.

The trial decision was delivered by the Queen's Bench Division judge, Morrison J.,¹⁰ who despite listening to the expert evidence of the expert witnesses, refused to take into consideration the Sharī'ah nature of the agreements and said,

In my view, if the court were to be concerned with the application of Sharia'a law and its impact on the lawfulness of the agreements, I would conclude at this stage that it was arguable which of the two parties' experts is right and that it would offend the principles underlying CPR Pt 24 to seek to resolve them before a trial.¹¹

¹⁰ See the Queen's Bench Division decision by Morrison J., [2003] 2 All ER (Comm) 849.

¹¹ Ibid, paragraph 32.

Furthermore, the learned judge observed that the contracting parties could not have intended the English court to elaborate on Sharī'ah issues. He said, "Looking at the background, it seems clear to me that it cannot have been the intention of the parties that it would ask this secular court to determine principles of law derived from religious writings on matters of great controversy...."¹²

On the issue regarding the governing law clause, Morrison J. explained that a contract could not be governed by two separate systems of law, i.e., Sharī'ah and English law. Moreover, the governing law clause agreed to by the parties does not make Sharī'ah law the governing law, according to the judge. This is because Article 3(1) of the Rome Convention on the Law Applicable to Contractual Obligations 1980, which has force of law in the UK by virtue of Schedule 1 to the Contracts (Applicable Law) Act 1990, emphasizes that a contract "shall be governed by the law chosen by the parties", and Article 1(1) of the Convention states that the law chosen by the parties refers to the law of a country. The judge observed that the Convention does not refer to a "non-national system of law such as Sharī'ah law".

Subsequently, the case was appealed before the Court of Appeal. The main issue in the appeal was concerning the proper construction of the law of choice clause. The defence counsel, Mr. Hacker, agreed with the contention that English law should be the law of choice, but that certain Sharī'ah rules governing the agreements should be recognized by the English court by virtue of "the doctrine of incorporation", which allows foreign laws to be incorporated into a contract and to be enforced as contractual terms. As authority, the defence cited the passage from Dicey and Morris on page 1226 (paragraph 32–086). The Court of Appeal decision was delivered by Potter LJ, who refused the arguments put forward by the defence counsel. Potter LJ said:

It does not seem to me that the passage cited, or the authorities referred to in the notes thereto, assist the defendants. The doctrine of incorporation can only sensibly operate where the parties have by the terms of their contract sufficiently identified specific 'black letter' provisions of a foreign law or an international code or set of rules apt to be incorporated *as terms of the relevant contract* such as a particular article or articles of the French Civil Code or the Hague

¹² Ibid, paragraph 36.

Rules. By that method, English law is applied as the governing law to a contract into which the foreign rules have been incorporated.¹³

Furthermore, the learned judge observed:

The general reference to principles of Sharia'a in this case affords no reference to, or identification of, those aspects of Sharia'a law which are intended to be incorporated into the contract, let alone the terms in which they are framed. It is plainly insufficient for the defendants to contend that the basic rules of the Sharia'a applicable *in this case* are not controversial. Such 'basic rules' are neither referred to nor identified. Thus the reference to the 'principles of...Sharia'a' stand unqualified as a reference to the body of Sharia'a law generally. As such, they are inevitably repugnant to the choice of English law as the law of the contract and render the clause self-contradictory and therefore meaningless.¹⁴

Therefore, the Court of Appeal firmly rejected the argument of the defence counsel, but it indicated that there is a possibility of Islamic laws being recognized under the "doctrine of incorporation" if they are incorporated into a contract as "specific black letter provisions".¹⁵ The decisions in the *Shamil Bank of Bahrain* case were subject to many scholarly discussions. For instance, an interesting contention was raised by Julio C. Colon, who argues that the Court of Appeal in *Shamil Bank of Bahrain*, in interpreting the obligation of the parties, should have looked at their prior negotiations, motives, and the common practice adopted in the Islamic finance industry.¹⁶

Dr. Engku Rabiah Adawiah explains that the refusal by the courts in both the *Symphony Gems* and *Shamil Bank of Bahrain* cases is not surprising as the English courts apply Common law.¹⁷ The main fault, according to her, lies with the parties' choice of jurisdiction as in both cases the parties were not British, and what is more, the transactions were not concluded in Britain, yet they willingly chose English law as a

¹³ [2004] 4 All ER 1072, paragraph 51.

¹⁴ Ibid, paragraph 52.

¹⁵ For further details see Adnan Trakic, "Europe's Approach towards Islamic Banking and Finance: A Way Forward", a paper presented at the International Islamic Banking, Finance and Investment Conference, held in Kuala Lumpur, Malaysia, 19-20 December 2011. Organized by the World Business Institute, Australia.

¹⁶ See Julio C. Colon, "Law of choice and Islamic Finance", *Texas International Law Journal*, Vol. 46, Number 2 (Winter 2010), pp. 412-434, pp. 426-427.

¹⁷ See Dr. Engku Rabiah Adawiah bt Engku Ali, "Constraints and Opportunities in Harmonization of Civil Law and Shari'ah in the Islamic Financial Services Industry", *Malayan Law Journal*, [2008] 4 MLJ i.

governing law.¹⁸ Furthermore, she contends that even if the jurisdictions which do not apply Islamic law in commercial and financial transactions wish to do so, the absence of substantive codified code on Islamic banking law would render any incorporation of Islamic principles into the transactions difficult.¹⁹ The issue of whether or not Islamic commercial laws should be codified is a matter for scholarly discourse. However, the utilization of “doctrine of incorporation” would arguably be futile without a codified substantive code on Islamic banking law.

It can be concluded from the decided cases discussed above that, if the contracting parties wish their contract to be governed by English law, and at the same time, to recognize the underlying Islamic nature of the contract, they should expressly state in the law of choice clause that English law is the governing law, but at the same time, they should incorporate certain Sharī‘ah rules into their contract as contractual terms by virtue of “the doctrine of incorporation”. Therefore, it will not be necessary to mention, besides the governing law (English law), that an agreement is subject to the Sharī‘ah. On the contrary, the specific provisions, rules and regulations of the Sharī‘ah which the parties intend to uphold must be incorporated into a contract as contractual terms and, as such, could be recognized and enforced by a court. In other words, rules of foreign law could be enforced as contractual terms only if they are incorporated as such, and if they are identified clearly.

3. LAW OF CHOICE AND INTERNATIONAL ISLAMIC FINANCIAL CONTRACTS

Islamic banking and finance is a global industry, and entry into cross-border transactions has become a standard practice. It is very often the case that contracting parties from different countries enter into Islamic financial agreements that are governed by foreign law, in most cases English law, for the abovementioned reasons. The existence of a foreign element in a contract would raise a conflict of laws issue. Furthermore, whenever the conflict of laws issue is raised, a “proper law of the contract” that governs the rights and obligations of the contracting parties must be ascertained.

¹⁸ Ibid.

¹⁹ Ibid.

3.1. Common Law Approach

“Proper law of the contract” is an English common law rule, developed during the nineteenth and twentieth centuries by English courts to govern the rights and duties of the contracting parties whenever the conflict of laws issue is raised.²⁰ The “proper law of the contract” rule was defined by Lord Simonds, a member of Judicial Committee, in *John Lavington Bonython and Others v Commonwealth of Australia*,²¹ as follows: “...the system of law by reference to which the contract was made or that with which the transaction has its closest and most real connexion.”²² In other words, “proper law of the contract” is the system of law that governs a contract either because the contracting parties have referred to it in the contract, or if no reference has been made to it, then because a contract is most closely connected with that system of law. From the definition of it, we can see that there are two underlying elements contained in this rule, i.e., party autonomy and closest and most real connection factor.

Party autonomy refers to the freedom of the contracting parties to choose the law that will govern their contractual rights and obligations. The contracting parties choose the law of their choice by inserting an express law of choice clause in their contract. In this way, they assist a court in determining what law shall govern a contract when the issue of conflict of laws arises. Generally, courts would enforce the law chosen by the contracting parties unless certain irregularities are present in drafting of the law of choice clause.²³ The express law of choice clause, in which the intentions of the parties are expressly stated as to which law shall govern their contractual obligations, is also known as “subjective theory”.²⁴ Besides the express law of choice, the subjective theory would also cover an implied law of choice, which a court may imply from the form of a contract, from the arbitration clause, or from jurisdiction agreement.²⁵

²⁰ See C.M.V. Clarkson and Jonathan Hill, *The Conflict of Laws*, third edition, (Oxford: Oxford University Press, 2006), pp. 170-171.

²¹ [1951] A.C. 201. (Appeal from the High Court of Australia).

²² Ibid, p. 220. See also David McClean and Kisch Beevers, *Morris: The Conflict of Laws*, (UK: Sweet & Maxwell, 2009, seventh edition), p. 353.

²³ Some of the irregularities in relation to drafting the law of choice clause could be as in the case of *Shamil Bank of Bahrain E.C. v Beximco Pharmaceuticals Ltd and others* [2004] 4 All ER 1072, whereby the law of choice clause identified two separate systems of law to govern the contract, i.e., English law and Shari’ah. The court only applied English law for the reasons explained in this paper.

²⁴ For a detailed explanation of “subjective theory” and its distinction from “objective theory” see James Fawcett and Janeen M. Carruthers, *Cheshire, North & Fawcett: Private International Law*, fourteenth edition, (Oxford: Oxford University Press, 2008), pp. 666-667.

²⁵ For more details about the implied law of choice, see C.M.V. Clarkson and Jonathan Hill, *The Conflict of Laws*, third edition, (Oxford: Oxford University Press, 2006), p. 171.

However, if the contracting parties have not identified the governing law, then a court will have to ascertain the proper law of the contract by looking at the system of law with which the contract has the “closest and most real connexion”.²⁶ This is known as “objective theory”, which tends to “localize” the contract by this criterion.²⁷ As Lord Denning mentioned in the House of Lords decision in *Re United Railways of the Havana and Regla Warehouse Ltd*: “In the absence of an express clause to this effect, the test is simply with what country has the transaction the closest and most real connection.”²⁸ Earlier on, the Court of Appeal judge, Jenkins L.J., delivering judgment of the Court of Appeal in *Re United Railways of the Havana and Regla Warehouse Ltd*,²⁹ pointed out several factors that need to be taken into consideration in ascertaining the proper law of contract in the absence of the law of choice selected by the parties:

In an inquiry as to what is the proper law of a contract in which the parties have not expressed their own selection of the law to be applied, **many matters have to be taken into consideration.** Of these, the principal are the place of contracting, the place of performance, the places of residence or business of the parties respectively, and the nature and subject-matter of the contract (Dicey, pp. 719, 720, citing Falconbridge, *Selected Essays on The Conflict of Laws*, 2nd ed., p. 378). But, as the editor points out, the most satisfactory formulation is that the proper law is the one “with which the transaction has its closest and most real connection” (*per* Viscount Simonds in *Bonython. v. Commonwealth of Australia* 17.³⁰

Amongst the factors mentioned by the learned judge, two are very prominent, i.e., *lex loci contractus* (the law of the place in which the contract was made) and *lex loci solutionis* (the law of the place of performance). However, a mere reliance on these two factors in ascertaining the proper law of the contract has been the subject of criticisms as the proper law of the contract should be the one chosen (intended) by the parties

²⁶ See McClean and Beevers, *op. cit.*, p. 353.

²⁷ See James Fawcett and Janeen M. Carruthers, *Cheshire, North & Fawcett: Private International Law*, fourteenth edition, (Oxford: Oxford University Press, 2008), p. 666.

²⁸ [1960] 2 All ER 332, p. 356.

²⁹ [1960] Ch 52.

³⁰ *Ibid*, pp. 91-92.

expressly or impliedly.³¹ Lord Wright, delivering the judgment of the Privy Council in *Mount Albert Borough Council v Australian Temperance and General Mutual Life Assurance Society Limited*,³² observed:

The proper law of the contract means that law which the English or other Court is to apply in determining the obligations under the contract. English law in deciding these matters has refused to treat as conclusive, rigid or arbitrary, criteria such as *lex loci contractus* or *lex loci solutionis*, and has treated the matter as depending on the intention of the parties, to be ascertained in each case on a consideration of the terms of the contract, the situation of the parties, and generally on all the surrounding facts. It may be that the parties have in terms in their agreement expressed what law they intend to govern, and in that case *prima facie* their intention will be effectuated by the Court. But in most cases they do not do so. The parties may not have thought of the matter at all. Then the Court has to impute an intention, or to determine for the parties what is the proper law which, as just and reasonable persons, they ought or would have intended if they had thought about the question when they made the contract. No doubt there are certain *prima facie* rules to which a Court in deciding on any particular contract may turn for assistance, but they are not conclusive. In this branch of law the particular rules can only be stated as *prima facie* presumptions...”

3.2. The Rome Convention and the Rome I Regulation

Proper law doctrine was used in England until 1991, when due to practical needs of having harmonized law of choice rules throughout the EU countries, the Rome Convention on the Law Applicable to Contractual Obligations of 1980 came into existence.³³ The implementation of the Convention in the UK was enabled by the Contracts (Applicable

³¹ For examples where the application of *lex loci contractus* and *lex loci solutionis* was not appropriate, see Hakimah Yaacob, A Critical Appraisal of International Islamic Finance Cases, and the Way Forward, International Shari'ah Research Academy for Islamic Finance (ISRA), Research Paper (No. 19/2011), pp. 20-21.

³² [1938] A.C. 224.

³³ See Rome Convention on the Law Applicable to Contractual Obligations of 1980, Convention 80/934/EEC, OJ L 266 of 9.10.1980.

Law) Act 1990, which came into force on 1 April 1991.³⁴ From that date onwards, the proper law doctrine in England was replaced by the Convention, while in many other English-speaking countries this doctrine still forms the foundation of the law.³⁵ As such, we may say that the doctrine still has its relevance in the Malaysian context. The Convention has since been superseded by the Rome I Regulation, European Parliament and Council Regulation No. 593/2008 of June 17, 2008 on the Law Applicable to Contractual Obligations (Rome I).³⁶ The Rome I Regulation applies to contracts concluded after December 17, 2009.³⁷

Article 1(1) of both the Rome Convention and Rome I Regulation articulates their scope. Article 1(1) of the Rome Conventions states: “The rules of this Convention shall apply to contractual obligations in any situation involving a choice between *the laws of different countries*.”³⁸

The article clearly provides that the law governing contractual duties of the contracting parties in conflict of law situations must be the law of a State and cannot be a non-State legal system such as Shari‘ah, customs of international trade (*lex mercatoria*), nor the rules of international convention.³⁹ The applicable governing law is not only limited to the law of Member States or Contracting States to the Convention, but rather any State, as long as it is a state legal system.⁴⁰ This article is one of the reasons why the Court of Appeal in *Shamil Bank’s case*⁴¹ refused to refer to the principles of Shari‘ah because this article requires the governing law to be the law of a State and not a non-State legal system.

Article 1(1) of the Rome Convention has since been revised by Article 1(1) of the Rome I Regulation, which omits the words “the laws of different countries”. Article 1(1) of the Rome I Regulation provides: “This Regulation shall apply, in situations involving a conflict of laws, to contractual obligations in civil and commercial matters...”⁴²

³⁴ See Contracts (Applicable Law) Act 1990 at <http://www.legislation.gov.uk/ukpga/1990/36/contents>.

³⁵ See C.M.V. Clarkson and Jonathan Hill, *The Conflict of Laws*, third edition, (Oxford: Oxford University Press, 2006), p. 172.

³⁶ See Rome I Regulation, European Parliament and Council Regulation No. 593/2008 of June 17, 2008 on the Law Applicable to Contractual Obligations (Rome I), Regulation (EC) No. 593/2008, OJ L 177 of 4.7.2008.

³⁷ See Article 28, Rome I Regulation.

³⁸ See Article 1(1) of the Rome Convention. (Italic text emphasized by the author).

³⁹ See McClean and Beevers, *op. cit.*, pp. 355-357. See also Colon, *op. cit.*, pp. 424-425.

⁴⁰ *Ibid.*

⁴¹ [2004] 4 All ER 1072.

⁴² See Article 1(1) of the Rome I Regulation.

However, Article 3(3) of the Rome I Regulation confirms that the old Rome Convention's position remains unchanged by stating the following: "Where all other elements relevant to the situation at the time of the choice are located in a country other than the country whose law has been chosen, the choice of the parties shall not prejudice the application of provisions of the law of that other country which cannot be derogated from by agreement."⁴³

Therefore, Article 3(3) still refers to the "country whose law has been chosen" and "provisions of the law of that other country" implying that the applicable law must be a State law and not a non-State legal system.

Furthermore, David McClean and Kisch Beevers argue that Regulation did not alter the position of the Convention when it comes to the applicable law.⁴⁴ Nevertheless, according to them, Recital 13 of the Regulation allows the contracting parties to incorporate by reference a non-state body of law or international convention into their contract.⁴⁵ Recital 13 of the Rome I Regulation states as follows: "This Regulation does not preclude parties from incorporating by reference into their contract a non-State body of law or an international convention."⁴⁶

The recital, in fact, reiterates the application of "doctrine of incorporation" whereby the parties are allowed to incorporate laws of a non-State legal system into their contract and have them enforced as contractual terms. But even this incorporation must be specific in nature, and only clearly identified "black letter" provisions of a non-State legal system can be incorporated, not a non-State legal system as a whole, as mentioned by Potter LJ in *Shamil Bank's* case.⁴⁷

Articles 3 and 4 of the Convention and the Regulation are very essential. In principal, Article 3 of both statutes embodies the "party autonomy" principle, whereby the contracting parties are allowed to choose the law that governs their contractual rights and obligations. Either they can choose the governing law by inserting the express law of choice clause into their agreement, or the law of choice could be implied by a court

⁴³ See Article 3(3) of the Rome I Regulation.

⁴⁴ See McClean and Beevers, *op. cit.*, p. 356.

⁴⁵ *Ibid.*, pp. 356-357.

⁴⁶ See Recital 13 of the Rome I Regulation.

⁴⁷ [2004] 4 All ER 1072, paragraph 51.

from a contract, arbitration clause, or a jurisdiction agreement with the assumption that it represents the implied law of choice clause of the contracting parties. Article 3(1) of the Convention states: “A contract shall be governed by the law chosen by the parties. The choice must be *expressed* or *demonstrated with reasonable certainty* by the terms of the contract or the circumstances of the case. By their choice the parties can select the law applicable to the whole or a part only of the contract.”⁴⁸

Similarly, Article 3(1) of the Rome I Regulation states: “A contract shall be governed by the law chosen by the parties. The choice shall be made *expressly* or *clearly demonstrated* by the terms of the contract or the circumstances of the case. By their choice the parties can select the law applicable to the whole or to part only of the contract.”⁴⁹

The only difference that appears is in relation to the implied law of choice. The Rome I Regulation requires the contracting parties to *clearly demonstrate* a choice of applicable law while the level of demonstration of the parties’ law of choice in the Convention is perhaps not as strict as the Regulation because the Convention only requires the demonstration with reasonable certainty.⁵⁰ Furthermore, Julio C. Colon observes that the wordings in Article 3(1) of the Rome Convention “a contract shall be governed by the law chosen by the parties” remain unchanged in Article 3(1) of the Rome I Regulation.⁵¹ The word “law” is used in the singular, and according to him, this explicitly disapproves a combined-law approach.⁵² Therefore, there could be only one governing law (law of the State) and it cannot be applied subject to the principles of other laws such as Shari’ah. Applying Article 3(1) of the Rome I Regulation, the law of choice clause in *Shamil Bank’s* case stating that: “*Subject to the principles of the Glorious Shari’ah, this Agreement shall be governed by and construed in accordance with the laws of England*”,⁵³ would still not be upheld, and only one law would be the governing law, i.e., the law of England.

If the contracting parties did not specify the law of choice that will govern their contract in accordance with Article 3 of the Rome Convention and Rome I Regulation, then the

⁴⁸ See Article 3(1) of the Rome Convention. (Italic text emphasized by the author).

⁴⁹ See Article 3(1) of the Rome I Regulation. (Italic text emphasized by the author).

⁵⁰ See McClean and Beevers, *op. cit.*, p. 360.

⁵¹ Colon, *op. cit.*, p. 425.

⁵² *Ibid.*

⁵³ [2004] 4 All ER 1072, paragraph 1.

governing law will be determined by Article 4 of the Rome Convention and the Rome I Regulation. Since the rules stated in Article 4 are quite complex and not the same in the Rome Convention and the Rome I Regulation, we will just elaborate the current applicable rules on this matter as stated in Article 4 of the Rome I Regulation. This precisely articulates the rules that will apply in case the parties did not insert a law of choice clause. It states as follows:

1. To the extent that the law applicable to the contract has not been chosen in accordance with Article 3 and without prejudice to Articles 5 to 8, the law governing the contract shall be determined as follows:
 - (a) a contract for the sale of goods shall be governed by the law of the country where the seller has his habitual residence;
 - (b) a contract for the provision of services shall be governed by the law of the country where the service provider has his habitual residence;
 - (c) a contract relating to a right *in rem* in immovable property or to a tenancy of immovable property shall be governed by the law of the country where the property is situated;
 - (d) notwithstanding point (c), a tenancy of immovable property concluded for temporary private use for a period of no more than six consecutive months shall be governed by the law of the country where the landlord has his habitual residence, provided that the tenant is a natural person and has his habitual residence in the same country;
 - (e) a franchise contract shall be governed by the law of the country where the franchisee has his habitual residence;
 - (f) a distribution contract shall be governed by the law of the country where the distributor has his habitual residence;
 - (g) a contract for the sale of goods by auction shall be governed by the law of the country where the auction takes place, if such a place can be determined;
 - (h) a contract concluded within a multilateral system which brings together or facilitates the bringing together of multiple third-party

buying and selling interests in financial instruments, as defined by Article 4(1), point (17) of Directive 2004/39/EC, in accordance with non-discretionary rules and governed by a single law, shall be governed by that law.⁵⁴

In the situations where a contract is not covered by abovementioned points (a) to (h), or in situations where the contract would be covered by more than one of those points, then the contract will be governed by the law of the country where the party required to effect the characteristic performance of the contract has his habitual residence.⁵⁵ However, if all circumstances of the case point out that the contract is manifestly more closely connected with a country other than that indicated in the above provisions, then the law of that other country shall be the governing law.⁵⁶ Lastly, if the applicable law cannot be determined by the above provisions, then the applicable law will be that of the county with which the contract is most closely connected.⁵⁷

4. COMBINED LAW OF CHOICE CLAUSE IN ISLAMIC FINANCIAL CONTRACTS

Julio C. Colon argues that the law of choice doctrine should allow the court or arbitration tribunals to recognize the combined law of choice clause, which provides that a contract be governed by national laws of one country subject to Shari‘ah.⁵⁸ Furthermore, he opines that the rejection of the combined-law approach by the Court of Appeal in *Shamil Bank of Bahrain* case, and the Rome Convention on the Law Applicable to Contractual Obligations (Rome Convention) 1980—which states that a contract can be governed only by one system of law, which must be the law of a certain country—might not be the best way of dealing with Islamic financial transactions. The combined-law approach was used before the *Shamil Bank* case, and there were no issues regarding it. For instance, in *Sanghi Polysters Ltd. (India) v The International Investor KCFC (Kuwait)*,⁵⁹ where the law of choice provided that the contract of *istiṣnā‘*

⁵⁴ See Article 4 of the Rome I Regulation.

⁵⁵ See Article 4(2) of the Rome I Regulation.

⁵⁶ See Article 4(3) of the Rome I Regulation.

⁵⁷ See Article 4(4) of the Rome I Regulation. For further details about the applicable law where the contracting parties did not specify the choice of governing law see *Halsbury's Laws of England*, “Conflict of Laws”, Vol. 19, 5th edition, 2011.

⁵⁸ See Colon, *op. cit.*, p. 413.

⁵⁹ [2001] 1 Lloyd’s Rep. 480. See also Colon, *op. cit.*, pp. 423-424.

would be “governed by the Law of England except to the extent it may conflict with Islamic Shari’ah, which shall prevail”.⁶⁰ The English court upheld the arbitral award, and the validity of the combined-law clause was not questioned. In other words, this case shows that there is nothing there to prevent tribunals in Western jurisdictions from using the combined-law approach, according to Julio C. Colon.⁶¹

Furthermore, he explains that most contracts, especially cross-border international Islamic financial contracts, contain the arbitration clause, and so far most of the arbitration has been done using this combined-law approach.⁶² To prove his contention, he provides several examples of arbitration centres which recognize and apply the combined-law approach, such as the Philippines Monetary Board, the National Shari’ah Arbitration Body in Indonesia, the Kuala Lumpur Regional Centre for Arbitration (KLRC) in Malaysia, Dubai International Arbitration Centre (DIAC), Abu Dhabi Commercial Conciliation and Arbitration Centre (ADCCAC), the International Islamic Centre for Reconciliation and Commercial Arbitration (IICRCA) in the United Arab Emirates, and the Muslim Arbitral Tribunal (MAT) in the United Kingdom.⁶³

Having heard the above arguments, one may ask what would be the correct position to adopt, i.e., whether to opt for one law of choice clause, which is the national law of a certain country, or to opt for a combined law of choice clause which will still identify one governing national law of a country, but at the same time, will apply the Shari’ah principles when necessary to uphold the underlying Shari’ah nature of the agreement? Arguably, a stronger case would be in favour of a law of choice clause that contains only one national law of a country, because scholars, as well as the courts, in secular jurisdictions, have adopted the idea that the contract cannot be governed by two different systems of laws. The authority for this argument is Article 3(1) of the Rome Convention and the Rome I Regulation, which observes that “*a contract shall be governed by the law chosen by the parties*”.⁶⁴ Julio C. Colon argues that because of the use of the word “law” in a singular form, the combined-law approach cannot be applied.⁶⁵ The disapproval of the combined-law approach has been reiterated in *Shamil*

⁶⁰ See Colon, *op. cit.*, pp. 416-417.

⁶¹ *Ibid.*, pp. 419-423.

⁶² See Article 3(1) of the Rome Convention and Rome I Regulation.

⁶³ Colon, *op. cit.*, p. 425.

⁶⁴ See the High Court decision [2003] 2 All ER (Comm) 849, and the Court of Appeal decision [2004] 4 All ER 1072.

⁶⁵ See Article 3(1) of the Rome Convention and the Rome I Regulation.

Bank of Bahrain case.⁶⁶ Therefore, for those who insist to use English law as the law of choice, a safer approach perhaps would be to incorporate the principles of Islamic law into a contract as contractual terms, which is allowed by virtue of “the doctrine of incorporation”, instead of trying to incorporate the whole Islamic law system into a law of choice clause to operate in parallel with the national legal system of a country (i.e., English law).

5. APPLICATION OF SHARĪ‘AH PRINCIPLES THROUGH “DOCTRINE OF INCORPORATION”

As seen earlier, Article 3(1) of both the Rome Convention and the Rome I Regulation does not allow a combined-law approach, and thus, there can be only one governing law of choice, which must be the law of a State.⁶⁷ Therefore, the issue is how to ensure that the underlying Islamic nature of an agreement is recognized and enforced by courts in secular jurisdictions. One of the obvious answers is “the doctrine of incorporation”. The doctrine of incorporation is a Private International Law doctrine that allows the contracting parties to incorporate the provisions or principles of the Sharī‘ah or another non-State legal system into a contract. In fact, the Rome I Regulation allows the provisions or principles of the non-State legal system to be incorporated into a contract and enforced as contractual terms. Recital 13 states: “This Regulation does not preclude parties from incorporating by reference into their contract a non-State body of law or an international convention.”⁶⁸

An incorporation of Sharī‘ah principles into a contract through this doctrine, as a viable option, was acknowledged by the Court of Appeal judge Potter LJ in the *Shamil Bank of Bahrain* case,⁶⁹ but it must be done in an appropriate manner. In other words, only specific provisions or rules of the Sharī‘ah can be incorporated, not the Sharī‘ah as a whole. A certain degree of certainty of incorporated laws must be present. Otherwise, the incorporation would be unenforceable and futile. That is why Potter LJ refused to agree that the Sharī‘ah governing principles have been successfully incorporated into the contract. He said as follows:

⁶⁶ See the High Court decision [2003] 2 All ER (Comm) 849, and the Court of Appeal decision [2004] 4 All ER 1072.

⁶⁷ See Article 3(1) of the Rome Convention and the Rome I Regulation.

⁶⁸ See Recital 13 of the Rome I Regulation.

⁶⁹ [2004] 4 All ER 1072.

The general reference to principles of Sharia'a in this case affords no reference to, or identification of, those aspects of Sharia'a law which are intended to be incorporated into the contract, let alone the terms in which they are framed. It is plainly insufficient for the defendants to contend that the basic rules of the Sharia'a applicable *in this case* are not controversial. Such 'basic rules' are neither referred to nor identified. Thus the reference to the 'principles of...Sharia'a' stand unqualified as a reference to the body of Sharia'a law generally. As such, they are inevitably repugnant to the choice of English law as the law of the contract and render the clause self-contradictory and therefore meaningless.⁷⁰

There are a few points that can be highlighted in relation to the doctrine of incorporation:

1. There can be only one governing law of choice, which must be the law of a State. The law of choice clause in *Shamil Bank's* case demonstrates the so-called combined-law approach, whereby the application of English law was subject to the principles of Shari'ah.⁷¹ In other words, English law would be applied to the extent of its consistency with Shari'ah, and in case of any inconsistency, the Shari'ah should prevail. However, Article 3(1) of both the Rome Convention and the Rome I Regulation does not allow the combined-law approach.
2. A non-State legal system, including Shari'ah, can be incorporated into a contract through the doctrine of incorporation by virtue of Recital 13 of the Rome I Regulation and the judicial decisions. The incorporated provisions or principles of Shari'ah would be enforced as contractual terms.
3. A non-State legal system cannot be incorporated into a contract as a whole, but only certain relevant provisions or principles of it. Therefore, the incorporation can only be effected where the contracting parties have clearly identified "black letter" provisions of a foreign law or code, as mentioned by Potter LJ in *Shamil Bank's* case. The requirement for a clear and unambiguous identification of provisions of a foreign law impliedly

⁷⁰ Ibid, paragraph 52.

⁷¹ [2004] 4 All ER 1072, paragraph 1. The law of choice clause in the agreement was as follows: "Subject to the principles of the Glorious Shari'ah, this Agreement shall be governed by and construed in accordance with the laws of England."

presumes that they are codified and as such incorporated. However, most of the substantive Islamic commercial law governing Islamic banking and finance agreements is not codified. In fact, there is a considerable discourse among the Muslim scholars about whether Islamic commercial laws should be codified or not.

4. The contractual incorporation of Sharī'ah can also be done by incorporation of Islamic principles as substantive law, as discussed by Dr. Andreas Junius.⁷² There is nothing wrong in incorporating a non-State legal system into a contract in most of the European countries, but one of the questions that may be asked is, to what extent may a non-State legal system be incorporated, i.e., in whole or only certain provisions of it? Dr. Andreas Junius disagrees with Dr. Killian Balz's contention that the clause "*subject to the principles of the Glorious Shari'ah*" means that the parties have contractually agreed that the relevant principles of Islamic law shall be applied as a substantive law and that their rights exercised must be Sharī'ah compliant, and that by this contractual reference, the Sharī'ah as a whole becomes incorporated into a contract.⁷³ This, according to Dr. Andreas Junius, goes against the principle of determinability, which is applicable in contract law in the German context.⁷⁴
5. Incorporation of foreign law into a contract enhances the degree of certainty of law. Incorporated foreign laws are enforced in the form of contractual terms and will not be affected by legislative changes made to the law between the time of making the contract and its performance. On the other hand, an express choice of the applicable law is "living law" and the latest amendments to it will have to be endorsed. Thus, it might affect the contractual obligations, for instance, reducing the rate of interest, because the applicable law at the time of conclusion of the contract might be different from the applicable law at the time of the contractual performance.⁷⁵

Many authors, when commenting on the abovementioned English cases, have said that the parties need to be careful when drafting the governing law clause. They argue that the governing law clause needs to be drafted "appropriately". What does the word

⁷² See Dr. Andreas Junius, "Islamic Finance: Issues Surrounding Islamic Law as a Law of choice under German Conflict of Laws Principles", *Chicago Journal of International Law*, 7 *Chi. J. Int'l L.* 537, p. 548.

⁷³ *Ibid.*, pp. 548-549.

⁷⁴ *Ibid.*

⁷⁵ See McClean and Beevers, *op. cit.*, p. 364.

“appropriately” indicate here? This is a very important question to be considered. We argue that mentioning the Sharī‘ah aspect together with English law in the governing law clause, whereby the English court is identified in the court of choice clause, is unnecessary. The English court will not venture into the Sharī‘ah aspect of the agreement as the court is bound to follow English law in deciding the case. This contention has been proven by the decisions in both the *Symphony Gems* and *Shamil vs. Bank of Bahrain* cases. Therefore, the authors opine that emphasis should not be placed on the governing law clause if the case is adjudicated before the secular courts; rather, the parties should strive to incorporate into a contract relevant Sharī‘ah principles that could be enforced and recognized by the secular courts as contractual terms by virtue of “the doctrine of incorporation”.

6. MALAYSIAN LAW AS THE LAW OF REFERENCE AND MALAYSIAN COURTS AS THE FORUM FOR SETTLEMENT OF DISPUTES

6.1. Islamic Finance in Malaysia

In Malaysia, Islamic finance began as an industry in 1983 with the enactment of the Islamic Banking Act 1983, followed one year later by the Takaful Act 1984, both of which form the foundations of the Islamic finance industry in Malaysia as we see it today. These Acts paved the way for the licensing of the first Islamic bank and the first *takāful* operator. Subsequently, in 1993, the Securities Commission Malaysia was established. The development of the Islamic capital market was one of the items on the Commission’s developmental agenda.

From just one bank and one *takāful* operator back then, Malaysia now has 16 Islamic banks, 5 international Islamic banks and 11 *takāful* operators, with another *takāful* operator underway. In addition, there are 16 Islamic fund management companies licensed under the Capital Market and Services Act 2007. As at June 2011, the Islamic banking assets have grown to almost RM393 billion, accounting for 21.6% of the total banking assets of the country. Deposits stand at RM296.8 billion or 22.79% of the total deposits in the country. Islamic financing amounts to RM 240.6 billion or 23.8% of total financing in Malaysia.⁷⁶ As for *takāful*, the industry assets amount to RM16.3

⁷⁶ Bank Negara Malaysia.

billion or 8.66 % of *takāful* and insurance total assets. Market penetration has increased to 12.1%. In the area of the Islamic capital market, Malaysia is the largest *ṣukūk* market in the world with USD112.3 billion or 62% of outstanding global *ṣukūk* as of the second quarter of 2011.⁷⁷ As of June 2011, 89% of the securities listed on Bursa Malaysia were Shari'ah compliant, and there are 160 approved Islamic unit trust funds currently in the market.⁷⁸

In terms of product offerings, Malaysia offers a comprehensive range of Islamic financial products, from a plain *wadī'ah* savings account for the man on the street, to more complex financing structures, such as Islamic structured products and *ṣukūk*, for multi-national companies. There are also ranges of family and general *takāful* products as well as investment products such as the Islamic real estate investment trust.

Malaysia has attracted international institutions to set up their operations here. Al-Rajhi, Kuwait Finance House, Qatar Islamic Bank, HSBC Amanah, Standard Chartered Saadiq and Deutsche Bank are among the well-known international institutions that have set up their Islamic banking business in Malaysia. Renowned international fund managers like Franklin Templeton, Amundi, Nomura and BNP Paribas have also established their Islamic fund management companies in Kuala Lumpur. In the *takāful* industry, leading international companies such as Prudential, American International Assurance, Friends Provident Group UK and Great Eastern Life Assurance Limited have taken steps by partnering with local institutions to establish their *takāful* operations in Malaysia.

The Government, particularly through Bank Negara Malaysia and Securities Commission Malaysia, is also facilitating the development of Islamic finance. One of PEMANDU's Entry Point Projects under Financial Services is to "*position Malaysia as the indisputable global hub for Islamic finance*" and to create approximately 12,000 jobs under the sector. Malaysia currently hosts two leading international Islamic financial organizations, namely the Islamic Financial Services Board (IFSB), a standard setting organization, and the International Islamic Liquidity Management Corporation (IILMC), a corporation established to facilitate global Islamic financial institutions in managing their financial liquidity.

⁷⁷ Total outstanding global *ṣukūk* as of 2nd quarter of 2011 was USD179 billion – Bloomberg/MIFC Promotions Unit, Bank Negara Malaysia.

⁷⁸ Malaysian ICM, 2nd Quarter 2011, Vol. 6 No. 2 (Quarterly Bulletin of Malaysia Islamic Capital Market by Securities Commission Malaysia).

To support the growth of the industry, it is essential to have human capital development. Towards this end, substantial resources have been spent by Malaysia to develop talents for the Islamic financial industry. The biggest commitment by Bank Negara Malaysia is the establishment of the International Centre for Education in Islamic Finance (INCEIF). INCEIF, a university recognized by the Ministry of Higher Education, has the objective of developing talent not only for Malaysia's Islamic finance industry but also globally. It now has *"approximately 2,000 students from over 75 countries."*⁷⁹

In addition, the International Shari'ah Research Academy for Islamic Finance (ISRA) is spearheading global research initiatives for Islamic finance. The effort by Bank Negara Malaysia is complemented by the effort of the Securities Commission of Malaysia through its training arm, the Securities Industry Development Corporation, to undertake programs catering for the development of talent for the Islamic capital market. These initiatives are to complement the already existing efforts by leading universities such as the International Islamic University Malaysia in developing the much needed talent for the industry. Malaysia's focus is not limited to developing the business aspect of the industry but its human capital developments as well.

In the words of Tan Sri Zeti Akhtar Aziz, the Governor of Bank Negara, *"Malaysia is currently supplying world class talent for the fast-growing Islamic finance"*.⁸⁰ In addition, to borrow the words of Dato' Muhammad Ibrahim, the Deputy Governor of Bank Negara, *"...the market has been supported by a robust regulatory and supervisory framework, reinforced by the legal and Shari'ah framework."*⁸¹

The Global Islamic Finance Report (GIFR 2011), in the chapter on The Malaysian Model, under the heading "Strength and Advantages of the Malaysian Model" on page 165 to 166, has this to say:

The strength and advantages of the Malaysian model are numerous and deserve an analysis on their own. However, in summary, amongst the obvious advantages of the Malaysian model are the following:

⁷⁹ Handbook on the visit by Tun Abdul Hamid Mohamad to INCEIF on 2 November 2011.

⁸⁰ Malaysian National News Agency (BERNAMA), 15 October 2011 – 3rd Convocation of INCEIF.

⁸¹ Dato' Muhammad Ibrahim, Deputy Governor, Bank Negara Malaysia, Luncheon Address 21st Conference of Presidents of Law Associations in Asia: "Islamic Finance and Malaysia's Role" 27 July 2010. Kuala Lumpur Convention Centre.

- (i) Sound and clear Sharia-compliance and governance framework;
- (ii) Tax accommodations;
- (iii) Certainty and predictability of dispute resolution outcomes;
- (iv) Talent enrichment and thought leadership infrastructures;
- (v) Depth and width of its capital market;
- (vi) Deposit insurance protection.

6.2 Malaysian Law as the Law of Reference - Role of the SACs in Settling Shari'ah Issues in Islamic Financial Contracts

Malaysia has taken measures to ensure that its products comply strictly with Shari'ah requirements. New products are only issued with the approval of either the Shari'ah Advisory Council ("SAC") of Bank Negara or of the Securities Commission, respectively, the two highest authorities on Shari'ah issues in Islamic finance in the country. Additionally, every Islamic financial institution and *takāful* company is required to have its own Shari'ah committee whose members have to be approved by the SAC of the Central Bank. Since November 2009, Malaysia has gone further by making it compulsory for the court and the arbitrators to refer Shari'ah issues arising before them to the respective SACs and that the rulings of the SACs are binding on them.

The advantages of having a central authority to decide on the Shari'ah issues are as follows:

- (i) It enables a product to be thoroughly screened to spot the Shari'ah issues, if any. This is the most difficult part. Each SAC has a Secretariat manned by officers who not only have Shari'ah backgrounds but also have been exposed to Islamic finance. The officers in the Secretariats are assisted by their colleagues from other departments, Islamic or conventional, when the need arises. Other institutions under Bank Negara, like ISRA and INCEIF are also there to assist. The Secretariats have access to the industry. The officers are in a position to call on the people in the industry for consultation and feedback. Bank Negara and the Securities Commission have regulatory and supervisory powers over the banking institutions, insurance companies, *takāful* operators and capital market

institutions under their respective jurisdictions. Bank Negara and the Securities Commission are in a position to ensure that the rulings are complied with. No other religious department, religious council or fatwa committee has such power and expertise. With such expertise and facilities, the Secretariats are able to present very comprehensive papers for consideration of the respective SACs. Whenever there is a common issue, the two SACs hold a joint meeting.

- (ii) Having the SACs at the national level enables speedy ruling on an issue. The Secretariat has to prepare and present the case for deliberation and ruling to one council only. Otherwise, it would have to do it at least fourteen times, at fourteen different Fatwa Committees in the thirteen States and Federal Territory. That would take time, and the rulings could differ from one state to another. (This is not taking into account the issue of jurisdiction). The chosen model promotes consistency of rulings on Sharī'ah issues. It would be difficult to achieve consistency in the rulings if the issues were decided by fourteen different Fatwa Committees in the States or the issues were left to be decided by the Sharī'ah Committees of the respective Islamic financial institutions.

6.2.1 Why Not the Civil Courts?

Civil courts do not have the expertise to decide Sharī'ah issues. Indeed, from our observation, we have reached a stage now that even an *ʿālim* or a mufti is not in a position to make a proper ruling on a Sharī'ah issue in Islamic finance by himself. In their case, it is not due to lack of knowledge of the Sharī'ah or Islamic jurisprudence; rather, it is due to the difficulty of understanding the complexity of the products. Judges, sitting alone or even in threes, are in no better position. They lack the knowledge of the Sharī'ah and Islamic jurisprudence.

In the case of common law, civil court judges are in a position to look for the law. They may even find that the submissions of both counsels are wrong. However, they are unable to do the same in the case of a Sharī'ah issue. In the end, they would just listen to the submissions of the two opposing, partisan and, with respect, equally “unlearned” lawyers, and choose which submission to accept. The judges may not even be Muslims. The Sharī'ah is a religious law for the Muslims, the breach of which results in the commission of a sin punishable in the hereafter. Islamic banking was born out of

the desire of pious Muslims to avoid committing a sin in their financial transactions. Throughout the history of Islamic jurisprudence, only pious experts of high moral standing (*mujtahids*) were considered qualified to issue Sharī'ah rulings; not just any Muslim. It is for this reason that Malaysian law provides for the establishment of a Fatwa Committee in every State for the purpose of issuing Sharī'ah rulings on Islamic matters within the State jurisdiction. Clearly, it is not acceptable to a vast majority of Muslims for non-expert non-Muslims of questionable moral standard (according to Islamic values) to make Sharī'ah rulings binding on them and that if they breach such rulings they would commit a sin and may even end up in hell for it! Some may even see it as Islamic banking and Sharī'ah being "hijacked" by non-Muslims who joined the bandwagon not out of fear of committing a sin, but to make money. The faith factor is absent. This is a serious matter for Muslims.

In this respect, expert witnesses do not help. This is because, first, they are partisan; otherwise, they would not be called by the party to give evidence in its favour. Secondly, the judge hearing their conflicting testimony is not in a position to make an independent evaluation for the same reason that I have mentioned in respect of the submissions of opposing counsels.

6.2.2 Why Not the Sharī'ah Courts?

In Malaysia, Sharī'ah courts do not have jurisdiction over finance, banking and insurance, nor over limited companies and banks, they not being "*persons professing the religion of Islam*". Companies law, bankruptcy law, contracts law, land law and a host of other laws relevant and applicable to Islamic finance are outside the jurisdictions of Sharī'ah courts. Neither Sharī'ah judges nor Sharī'ah lawyers, unless they are also members of the Bar, have expertise in those laws.

Legal documents are in English, and common law lawyers who draft those documents could not appear in the Sharī'ah courts. The law is in English. The witness, local and more so foreigners, give evidence in English. Moreover, there are fourteen Sharī'ah Courts of Appeals as against one Federal Court. That could lead to inconsistency in the rulings on a particular issue.

In reality, Sharī'ah issues are very rare issues in court. In 2009 the Mua'malat Division of the High Court in Kuala Lumpur alone disposed of 940 cases as against 691

registered in that year. In 2010, 1270 cases were disposed of as against 1260 registered. Up to September 2011, 1033 cases were disposed of as against 1020 registered. So far only one Shari'ah issue has been referred to the SAC of Bank Negara Malaysia. Those thousands of other cases were decided on issues of land law, law of contract, companies law and others in which the Shari'ah courts have no jurisdiction and Shari'ah judges have no expertise. Shari'ah courts do not even have rules to cover those actions. Lastly, the Reciprocal Enforcement of Judgments Act 1958⁸² does not extend to the judgments of the Shari'ah courts.

It is interesting to note that what Malaysia has done has received very favourable reports from other countries. We will only quote two passages. The first is from the book *"The Art of Islamic Banking and Finance"* by Yahia Abdul Rahman on page 79, discussing the Malaysian approach:

This approach saves a lot of confusion and conflicts within different Shari'aa Boards. The involvement of the Central Bank adds credence and weight to the rulings. In addition, because the Shari'aa Board is operated and supervised by the Central Bank, there is no potential for conflict of interest because the individual banks are not paying their own hand-picked scholars for their services.

The second is from GIFR Report 2011, on page 165:

The existence of a structured and powerful National Supervisory Advisory Council (NSAC) was originally intended to ensure clarity in terms of fiqh muamalat practices, but today it also has the power of final arbiter on Shari'a issues in any IBF dispute. By having legal authority, there will be coherence and assurance of validity of pronouncements by Shari'a scholars. In most other jurisdictions, the status of Shari'a pronouncements for IBF contracts remains vague and ambiguous when it comes to enforcement under the law.

Malaysia's view is that producing the highest standard of Shari'ah-compliant products is not the end of the matter. It is equally important that the implementation and the settlement of disputes, if they arise later, be done in a Shari'ah compliant environment.

⁸² Malaysian National News Agency (BERNAMA), 15 October 2011 – 3rd Convocation of INCEIF.

Therefore, Malaysian laws, insofar as they are applicable to Islamic finance, should be Shari'ah compliant. Nevertheless, Malaysia is going one step further: it wants to give legal effect to Shari'ah principles which are applied in the practices, services and products of Islamic finance in the market. A good example is *wa'd*. This is to ensure the legal certainty of those principles.

6.3 Malaysian Courts as the Forum for Settlement of Disputes

First, we shall look at the role of lawyers in the settlement of disputes. In any legal system in the world now, lawyers play a very important role in finance, conventional or Islamic. They are the ones who advise the financial institutions when issuing a product; they are the ones who advise customers on the legal aspects of the product. They are the ones who draw up the contracts; they are the ones who advise the parties when there is a dispute. They are the ones who appear in court when there is a case; they are the ones who make the submissions on the facts and the law for the judge to decide, in reality, trying to persuade the judge to decide in their clients' favour. They have to know Islamic finance to be able to do all those things. Otherwise, they would be misleading everybody who seeks their advice, including the court that hears the case.

However, even here, we believe that Malaysia has an advantage. Most of the lawyers in Malaysia who specialize in Islamic finance are Muslims. The faith factor is there. Secondly, Malaysia has many institutions of higher learning that offer courses in Islamic finance, fulltime or part-time. The lawyers may enrol themselves in such institutions. In fact, many have done so. This argument could be extended to judges and arbitrators.

Let us now look at the courts. First, the court system is based on the common law system. The system has the advantage of oral and documentary evidence, oral and written submissions by counsels, full written and reasoned judgments instead of mere orders. All these lead to transparency and reduce the incidence of corruption. What is important is that the judgments and the reasons thereto are open to scrutiny by everybody, forever. Next, following the common law system, the courts abide by the doctrine of precedent, which leads to consistency and certainty of the law. In this respect, we have an edge over countries with Muslim majority populations that practice the continental system.

In this regard, another point in Malaysia's favour is that the lawyers and judges speak English, proceedings in the superior courts (where these cases go) are in English, and judgments are written in English.

Malaysian courts now stand among the best in the world in terms of speedy disposal, after a fair trial. In the *Mua'malat* Division of the High Court in Kuala Lumpur (where most of the Islamic finance cases go), for writ actions, most of the cases that go for trial, are disposed of within six months. For summary judgment and Originating Summons, it is three months. The World Bank in its Progress Report titled *Malaysia: Court Backlog and Delay Reduction System*, published in August of 2011, has given a very favourable report on the achievement of the Malaysian judiciary in its reform to reduce backlog and delays in court. What is left is for our lawyers and judges, at least some of them, to specialize in Islamic finance. That would put them ahead of their counterparts in other common law countries.

A word about arbitration; most of what has been said about the court applies to arbitrators. This is what the GIFR Report says:

[T]he Kuala Lumpur Regional Centre for Arbitration (KLRCA) provides a convenient alternative resolution platform by having a specific rule to govern disputes, including IBF matters. The Rules for Arbitration (Islamic Banking and Financial Services) 2007 were specially drafted and introduced to provide a customized platform and mechanism for the resolution of disputes in the Islamic financial services sector.

We agree, in theory, but let us look at the reality. As of 7th December 2011, there was only one case registered and heard in KLRCA. However, a beginning has been made. It is interesting to note that, in that case, a *Shari'ah* issue was referred to the SAC of Bank Negara Malaysia, it was duly answered, and effect was given to it. At least we have seen the system working.

We will end the discussion of this part by quoting from the GIFR Report 2011 again, on page 167:

It is observed that...English law has been the preferred law of reference for international Islamic finance transactions; therefore the objective of the Committee is arguably very ambitious. Considering that English law has a long tradition of being the reference law for international contracts, and English courts command enormous respect in the international arena for their impartiality and independence, there are many reasons for people to be skeptical. However, if we consider that Malaysia is simply offering a value proposition whereby parties to an international Islamic finance contract are comfortable that

- The jurisdiction is neutral to all parties to the contract;
- The Malaysian law offers absolute certainty and predictability with regard to Shariah issues as the NSAC is the final arbiter on such matters—which no other jurisdiction can offer;
- The Malaysian courts and arbitration are competent in dealing with disputes arising from IBF contracts,

then there is no reason to reject the possibility of making Malaysian law as the reference law for IBF contracts.

The points explaining why Malaysian law should be chosen as the law of reference and Malaysian courts as the forum for settlement of disputes for international Islamic finance contracts can be summed up as follows:

1. Malaysia, in the eyes of the world, is an Islamic country. Internationally, it is seen as a model Islamic country. It is only natural for Malaysia to want to be the hub for Islamic finance.
2. Malaysia is already the leader in Islamic finance.
3. No other government in this world has done more than the Malaysian government for the development of Islamic finance.
4. Malaysia already has a pool of Shari'ah scholars who have specialized in Islamic finance. Some of them are sitting on Shari'ah Committees all over the world.
5. Malaysia has the Shari'ah Advisory Council of the Central Bank of Malaysia (SAC, BNM) and the Shari'ah Advisory Council of the Securities Commission of Malaysia (SAC, SC) at the national level to make Shari'ah

rulings on Islamic finance. Hopefully, the two could be merged into one in the near future.

1. Malaysia already has the common law system in place, and it is working comparatively well.
2. Malaysian lawyers and judges speak English, Malaysian laws are in English, and the judgments of the superior courts are in English.
3. Malaysian courts and arbitrators are comparatively efficient, competent and independent. After all, the cases are purely civil cases based on contracts involving companies and individuals. There is no politics in that. Negative perception should not be an issue. In terms of knowledge in Islamic finance, Malaysian judges, arbitrators and lawyers, taken as a whole, are at par with their counterparts in other countries, if not better.
4. Malaysia has the infrastructure. Courtrooms are among the best in the world, transportation and communication are good, streets and hotels are free from suicide bombing (so far), cost of living is comparatively cheap, and it is summer throughout the year with the temperature around 30°C. All these factors are conducive to foreign lawyers doing litigation in Malaysia.

7. CONCLUSION

All in all, English law and courts remain the most common law of choice and court selected by the contracting parties in international Islamic financial contracts, despite the attendant uncertainties that may arise in relation to the enforceability of the underlying Sharī'ah nature of those contracts. English courts, as is the case for many other secular jurisdictions (especially in continental Europe), are bound by the Rome I Regulation and the common law principles in deciding Islamic financial contracts. As a result, the Sharī'ah principles of the contracts are not taken into consideration, and that in itself has an adverse effect on the contracting parties and the Islamic finance industry. However, the paper has argued that contracting parties who insist on having both English law as a law of choice and Sharī'ah principles recognized as underlying principles of the contract can still have certain provisions and principles of Sharī'ah, incorporated into their contract and recognized by the courts as contractual terms through the “doctrine

of incorporation”. Alternatively, the paper has suggested that the contracting parties in international Islamic financial contracts should choose Malaysian law as the law of reference and Malaysian courts as the forum for settlement of disputes. The advantages are numerous; one of the most obvious being that besides having a contract governed by common law (which is one of the sources of Malaysian law), Shari‘ah issues of contracts would be referred by the civil court to the national SACs for their ruling, which is binding on it.

Notes



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