

## Dispute Resolution in Islamic Finance

By Jonathan Lawrence ([jonathan.lawrence@klgates.com](mailto:jonathan.lawrence@klgates.com)), Peter Morton ([peter.morton@klgates.com](mailto:peter.morton@klgates.com)) and Hussain Khan ([hussain.khan@klgates.com](mailto:hussain.khan@klgates.com))  
of K&L Gates LLP

This article was first published in the "Global Islamic Finance Report 2012"  
in April 2012

The number of Sharia compliant products that are available has grown enormously over the past few years. Many Islamic finance transactions are governed by English law or the law of another country, instead of Sharia law. Sharia is a set of moral and religious principles rather than a codified body of laws. These types of transactions often take place on a global level, with parties originating from different regions in the world. For example a Swiss bank may launch a Sharia compliant financial product aimed at investors in the Middle East using documentation governed by English law. Due to the diverse backgrounds of the parties involved, the specialist nature of the agreements and the potential variety of legal jurisdictions in play, there may be considerable benefits in having an authoritative common platform to resolve disputes as they arise in a manner that is guided by Sharia within a modern commercial context.

### *The tendency to favour litigation*

Litigation (the resolution of disputes through the courts) is the most well known method of determining disputes. Amongst some entities working in Islamic finance there is scepticism towards alternative forms of dispute resolution, such as international arbitration and mediation. At the Asia Pacific Regional Arbitration Group Conference 2011, Hakimah Yaakob, of the International Shariah Research Academy for Islamic Finance in Kuala Lumpur, stated that, following a survey that she conducted of 10 Islamic banks and 12 *takaful* operators (Islamic insurance providers) in Malaysia, she found that there was a 'credit policy' in many of these institutions not to include alternative dispute resolution clauses in their contracts, but to opt for litigation instead. This was said by the financial institutions to have been done, in many cases, in order to avoid credit risks for legal uncertainty. The preference for litigation was further confirmed by enquiries made of arbitration centres in Malaysia for the purpose of this report.

Malaysia is not the only Islamic country where there is some reticence towards non-litigation forms of dispute resolution. In Middle Eastern states, many people have also been sceptical of using alternative dispute resolution since the outcome of a series of oil concession arbitrations conducted in the 1950s to 1970s. In these arbitrations the local laws were refused and Western systems of law took priority. For example, prior to the tribunal award in *Saudi Arabia v Arabian American Oil Company (ARAMCO)* (Award of 23 August 1958, 27 ILR 117 (1963)), international arbitration was the most commonly used method of settling disputes between the Saudi government and foreign oil companies. In the ARAMCO case the tribunal stated that the law of Saudi Arabia should be "*interpreted or supplemented by the general principles of law, by the custom and practice in the oil business and by notions of pure jurisprudence*" and therefore ARAMCO's rights could not be "*secured in an unquestionable manner by the law in force in Saudi Arabia*". International arbitration was subsequently seen by the Saudi government as a tool to protect the interests of Western corporations. The Saudi Council of Ministers issued Decree No. 58 of 1963 which prohibited any government agency from signing an arbitration agreement without prior authorisation from the Council President.

In the renowned English case of *Beximco Pharmaceuticals Ltd v Shamil Bank of Bahrain EC*

[2004] EWCA Civ 19, one of the issues concerned the governing law of the contract. The contract stated that “*subject to the principles of Glorious Sharia’a, this agreement shall be governed by and construed in accordance with the laws of England*”. At trial, the judge, when dealing with the question of the applicable law, referred to the Rome Convention on the Law Applicable to Contractual Obligations 1980 and stated that the convention only made provision for the choice of law of a country, and did not provide for the choice of law of a non-national system of law, such as Sharia law. It was held that a contract can only have one governing law and that parties to a contract can only agree to adopt the law of a country as the governing law of a contract. Therefore, according to English law, as Sharia law is a non-national system of law it is not capable of being the governing law of a contract.

An alternative argument that was made to the English Court of Appeal was that, with English law being the governing law of the contract, it is possible to incorporate general Sharia principles as terms of the contract. This argument was also rejected. Lord Justice Potter found the attempt to incorporate by reference the “*principles of Glorious Sharia’a*” to be too vague to be given effect: he stated, “*The general reference to principles of Sharia in this case affords no reference to, or identification of, those aspects of Sharia 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 applicable in this case are not controversial. Such ‘basic rules’ are neither referred to nor identified. Thus the reference to the “principles of ... Sharia” stands unqualified as a reference to the body of Sharia 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.*” This case demonstrates that general references to the principles of Sharia law will not be given any meaning, at least by the English courts. This is especially so given that there is a divergence of opinions amongst scholars as to the principles in question. On this Potter LJ made the following comment: “*Finally, so far as the “principles of ... Sharia” are concerned, it was the evidence of both experts that there were indeed areas of considerable controversy and difficulty arising not only from the need to translate into propositions of modern law texts which centuries ago were set out as religious and moral codes, but because of the existence of a variety of schools of thought with which the court may have to concern itself in any given case before reaching a conclusion upon the principle or rule in dispute.*”

A further recent English Court case regarding incorporation of non-national laws was the Court of Appeal case of *Halpern v Halpern* [2008] QB 195. Although that case related to a dispute between Orthodox Jews under Jewish law, the Court stated that “*it may be that for actual incorporation it is necessary to identify “black letter” provisions, but that seems to me to be another way of saying that there must be certainty about what is being incorporated*”.

So, in summary, what these court decisions tell us is that, so far as the English Courts are concerned (i) the governing law of a contract has to be either English law or the law of a country, therefore, Sharia law cannot be the governing law of a contract; and (ii) it may be possible to incorporate as a term of the contract certain principles of Sharia law, provided there is certainty as to what is being incorporated.

The cases referred to demonstrate that, whilst there has been a tendency to favour court litigation as a means of resolving disputes in Islamic finance, the English courts have at times encountered difficulties in dealing with contracts where the parties have, at least to a certain extent, sought to have their dispute resolved in accordance with Sharia or other non-national laws or principles.

Professor Andrew White, associate professor at the International Islamic Law and Finance Centre in Singapore, recently stated at the Asia Pacific Regional Arbitration Group Conference 2011 that litigation is not geared towards solving Islamic finance disputes as judges often lack the education in many industry principles. In this context, some would say

that arbitration is well placed to deal with these issues given that in arbitration, arbitrators can be selected that have the requisite knowledge both of Sharia and the relevant commercial transactions.

Additionally, there may be less difficulties in electing to have a dispute in relation to a contract decided in accordance with Sharia law by submitting the dispute to arbitration, rather than litigation. Taking the position in England as an example, the English Arbitration Act 1996 (which applies to all arbitrations seated in England and Wales) expressly permits the arbitral tribunal to decide the dispute in accordance with the law chosen by the parties or, "*if the parties so agree, in accordance with such other considerations as are agreed by them or determined by the tribunal*" (s46(1)(b)). So in English-seated arbitrations the arbitral tribunal can decide the dispute in accordance with such other considerations as are agreed by the parties, and this could include Sharia law.

### *The key features and foundations of arbitration*

Arbitration is a non-court alternative method of resolving disputes, where a neutral, independent arbitrator or panel of arbitrators, known as a tribunal, is appointed by the parties to make a binding decision, known as an award, from which there are very limited grounds of challenge. Arbitration may be either administered (where the arbitration is conducted under the auspices of one of several arbitral institutions) or non-administered/*ad hoc* (where the parties agree between themselves the rules that will apply to the arbitration, without the involvement of an institution for the arbitration).

Further important features of arbitration include:

1. Arbitral rules and institutions – the procedural framework for the arbitration is stipulated in the arbitral rules. The arbitral tribunal obtain their procedural powers from the arbitral rules which are usually much briefer than court rules, and give the tribunal discretion on many matters unless the parties agree otherwise. Parties are able to choose which institution, if any, should administer the arbitration, and therefore which rules will be applicable to their arbitration.
2. Seat of arbitration – the seat of arbitration is typically, but not always, where the arbitral hearing is held. It is usually expressed as a city. The seat is an important choice as the law of the seat will govern the arbitral procedure. As mentioned above all English-seated arbitrations are governed by the Arbitration Act 1996. The courts of the seat will have certain powers, and the award will be treated as having been made at the seat.
3. Neutrality – arbitration in a third country is often an acceptable alternative when contracting parties are not prepared to submit to the jurisdiction of its counterparty's local court.
4. Finality – unlike a court judgment, an arbitral award is generally not subject to appeal on the merits, and may only be annulled for jurisdictional grounds or on the basis of serious procedural irregularity giving rise to substantial injustice. Whilst this is generally the position, it is always important to check the local arbitration law and practice at the seat of the arbitration to understand the scope for an award to be set aside and the likelihood of court intervention.
5. Procedural flexibility – arbitral procedures can be adapted to the circumstances of the contract or matter in dispute much more readily than court procedures. For example, the parties can agree to the location of the hearings, the language of the proceedings and the number and qualifications of arbitrators. In the absence of party agreement, the arbitral tribunal usually has a great deal of discretion on procedural matters.
6. Privacy and confidentiality – arbitral proceedings are generally private and parties

may insert confidentiality wording in their arbitration clause (if none exist in the arbitration rules) so that the contents of the proceedings and the award are kept confidential.

There are two key foundation stones upon which arbitration as a method of dispute resolution has grown. First, the United Nations Commission on International Trade Law (UNCITRAL) Model Law. The UNCITRAL Model Law is a model national arbitration law designed to assist states in reforming and modernising their laws on arbitral procedure so as to take into account the particular features and needs of international commercial arbitration. It covers all stages of the arbitral process from the arbitration agreement, the composition and jurisdiction of the arbitral tribunal, the extent of court intervention, through to the recognition and enforcement of the arbitral award. It reflects worldwide consensus on key aspects of international arbitration practice and has been accepted by states in all regions of the world.

Secondly, the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards (commonly referred to simply as the New York Convention). The New York Convention seeks to provide common legislative standards for the recognition of arbitration agreements and for court recognition and enforcement of foreign arbitral awards. The Convention's principal aim is that foreign arbitral awards will not be discriminated against. It obliges parties to ensure such awards are recognised and generally capable of enforcement in their jurisdiction in the same way as domestic awards. Grounds for non recognition of a foreign award are very limited. These include awards that are contrary to public policy; where the parties to the agreement were under some incapacity; the agreement is not valid under the law to which the parties have subjected it; or the absence of proper notice of the appointment of the arbitrator or of the arbitration proceedings. An ancillary aim of the Convention is to require courts to give full effect to arbitration agreements by requiring courts to deny the parties access to court in contravention of an arbitration agreement.

#### *Historical connection between Islam and arbitration*

Arbitration is specifically mentioned in the Quran at Surah 4, verse 35, “*If you fear a breach between them twain (the man and his wife), appoint (two) arbitrators, one from his family and the other from hers; if they both wish for peace, Allah will cause their reconciliation. Indeed Allah is Ever All-Knower, Well-Acquainted with all things.*” Although the subject matter of this quote is a matrimonial dispute, the framework of arbitration has been applied to commercial disputes for many years. Arbitration under Islamic law is known as *tahkim* where parties agree to settle their dispute by referring it to an arbitrator known as a *hakam* or *muhakkam*.

Arbitration has a longstanding history as a form of dispute resolution in Islam, and with the development of international arbitration institutions in the Islamic world, there is therefore an ideal opportunity for international arbitration to establish itself as the method of choice for the resolution of Islamic finance disputes.

#### *Development of international arbitration in the Islamic world*

The previously described reticence towards international arbitration is now changing, with many Middle Eastern countries adopting the UNCITRAL Model Law for their arbitration laws, signing the New York Convention and establishing local arbitration centres in the region.

For example, there are four arbitration centres in the United Arab Emirates:

1. the Dubai International Arbitration Centre (DIAC) which was established in 1994 as the “Centre for Commercial Conciliation and Arbitration”;
2. the DIFC LCIA Arbitration Centre which was launched in February 2008;

3. the Abu Dhabi Chamber of Commerce & Industry which was formed in 1993; and
4. the Dubai based International Islamic Centre for Reconciliation and Arbitration (IICRA) which was established in 2005 by the Islamic Development Bank and the General Council for Islamic Banks and Financial Institutions in order to provide a Sharia based arbitration facility.

Of the four UAE institutions, the DIAC is probably the best known and busiest of the Gulf arbitration centres.

In Qatar there are two institutions: the Qatar International Centre for Commercial Arbitration (QICCA) and the Qatar Financial Centre (QFC). In Egypt there is also the prominent Cairo Regional Centre for International Commercial Arbitration (CRCICA).

Arbitration institutions in Islamic countries outside of the Middle East include the Kuala Lumpur Regional Centre for Arbitration (KLRC), which has introduced specific rules to deal with Islamic banking and finance disputes. Other centres, such as Hong Kong, are also able to cater for Islamic finance disputes, with the establishment of the International Islamic Mediation & Arbitration Centre (IMAC) which was opened in 2008 by the Arab Chamber of Commerce & Industry after consultation with the International Chamber of Commerce, a pre-eminent arbitration institution. Singapore is also a major centre for international arbitration, with the Singapore International Arbitration Centre (SIAC) being its foremost arbitration institution.

However, the arbitration laws in the UAE, Saudi Arabia, and Qatar are not based on the UNCITRAL Model Law. In Egypt, Singapore and Malaysia the arbitration laws are based on UNCITRAL Model Law (albeit with the Malaysian act modelled on the 1958 UNCITRAL Model Law with some modifications, rather than the newer 1985 Model Law).

In 2010, the UAE Ministry of Economy published a draft independent Federal Arbitration Law, which is based on the UNCITRAL Model Law. This draft is currently under review and is expected to be introduced in 2012. In the UAE and Qatar there are 'free zones' for financial services. These free zones have their own legal jurisdiction and court system which is separate from the rest of the country. The DIFC and QFC are based in free zones and as such have their own distinct laws that are independent from the national laws governing international arbitration. Both the DIFC and QFC laws are based on the UNCITRAL Model Law. The parties do not have to have a connection with the jurisdiction in order to adopt these jurisdictions and their associated laws as the seat of arbitration.

All of the countries discussed above have acceded to the New York Convention. They are also contracting states to the Convention on the Settlement of Investment Disputes Between States and Nationals of Other States (the ICSID Convention). Additionally the UAE, Saudi Arabia and Qatar (along with Bahrain, Kuwait and Oman) are members of the Gulf Cooperation Council (GCC). The GCC has a unified economic agreement between member states that they will recognise and enforce judicial and arbitral awards rendered in other member states.

For the purpose of this report we contacted a range of international arbitration institutions to enquire about the number of cases that they have dealt with involving Islamic finance. We were informed that take up by parties was generally very low. This could be due to a number of factors: many of these institutions are relatively new and are currently establishing themselves; and certain regions favour litigation to settle disputes. This curious response from the institutions is all the more unexpected as arbitration has many potential beneficial features as a form of dispute resolution, especially for Islamic finance disputes. Of course another explanation might be that disputes involving Islamic finance may themselves be relatively rare or resolved by negotiation between the parties without reference to an outside

body.

The benefits and the use of arbitration have been highlighted by Peter Werner, Senior Director of the EMEA office in London of the International Swaps and Derivatives Association (ISDA) Financial Law Reform Committee. On 1 March 2010, ISDA and International Islamic Financial Market (IIFM) published the ISDA/IIFM *Tahawwut* (Hedging) Master Agreement. Mr Werner recognised a marked increase in the use of arbitration in the financial sector, and particularly in relation to ISDA Master Agreements involving parties established in or operating from emerging market jurisdictions.

The factors for this growth in the use of arbitration include globalisation, the increased involvement of parties from emerging markets in international finance and the clearing rules of most, if not all, of the world's clearing houses providing for disputes to be resolved by arbitration. The main reasons for using arbitration were stated to be the unattractiveness of litigating in the courts of many jurisdictions, particularly emerging markets, and the enforcement advantages of the New York Convention. If a party succeeds on the merits of a dispute that may prove to be a pyrrhic victory if it is not possible to enforce the resulting judgment. Leading international arbitrators are familiar with complex transactions, are able to get to grips with issues outside their core expertise and are likely to be much better able to deal with derivatives disputes than the courts of many jurisdictions. Arbitration agreements also provide for the parties to be able to nominate members of a tribunal whose main expertise is in derivatives.

#### *Drafting the arbitration clause*

In cases where arbitration is the chosen method of dispute resolution it will be necessary to include in the contract a suitably drafted arbitration clause. Parties and their counsel should consider carefully, as a minimum: the seat of arbitration and the laws which would be applicable due to this choice, and importantly whether the seat of arbitration and the anticipated jurisdiction for enforcement are signatories to the New York Convention; the rules of any institution they wish to use; the categories of dispute covered; the method of appointment and number of arbitrators; the language of the arbitration; and the governing law of the contract, which should preferably be stated outside of the arbitration clause. Legal advice should be taken to ensure that the proposed choice of governing law will be respected in the arbitration. For example, whilst an election by the parties to have their dispute referred to arbitration and decided in accordance with Sharia law should be respected for arbitrations seated in England (per s46(1)(b) of the Arbitration Act 1996), that is not necessarily the case in all seats of arbitration. Special care should be taken in seeking to draft arbitration clauses for multi-party arbitrations and multi-contract arbitrations. Optional provisions which may be considered for inclusion in the arbitration clause include, for example, making provision for: a specific procedure to be followed relating to the disclosure of evidence; allowing for remedial powers, such as interim relief; rights of appeal; confidentiality; and the qualifications of the tribunal.

In order to avoid ending up with an ill-suited arbitration procedure, it is very important that the arbitration clause is given careful consideration at the time of contracting, and appropriate legal advice is taken. It is unfortunately the case that all too often the arbitration clause is very much the "midnight clause" thrown in at the last minute without due consideration. This can have very serious time and cost consequences if a dispute should arise and can seriously hamper a party's ability to obtain a fair and efficient resolution of a claim.

#### *Mediation*

Mediation is another important method of alternative dispute resolution. Mediation is a flexible process conducted confidentially in which a neutral person (the mediator) actively

assists parties in working towards a negotiated agreement of a dispute or difference. The parties are in ultimate control of the decision to settle and the terms of any resolution. Mediation can be used alongside litigation or arbitration at any stage.

As with arbitration, mediation (which is known as *sulh*) is also a traditional method of reconciliation in Islam and is mentioned in several verses of the Quran. *Sulh* is usually conducted in an informal manner, but can be facilitated by an institution. Unlike in international arbitration or litigation, mediation does not result in a binding award or judgment. At the conclusion of the mediation process if the mediation has been successful, the parties draft and sign a contract that reflects the settlement terms.

Not all mediations result in a settlement being concluded, and for that reason, mediation is not a standalone means of dispute resolution. However, it is commonly used alongside, or to prevent, litigation or arbitration.

A form of facilitated negotiation, mediation can have considerable benefits in terms of saving time and costs. Parties may also wish to select the mediator based on their expertise in Islamic finance. However, mediation may not always be suitable, for example where there is a need for a precedent or a binding award or judgment or the same issue arises in related agreements or matters.

### *Conclusion*

The Quran and Sunnah repeatedly stress the importance and benefits of settling disputes quickly and discreetly. International arbitration is a method that can be used to achieve this. When parties have carefully considered and drafted international arbitration clauses in their Islamic finance agreements, they can have greater confidence that any disputes which may arise will be handled in an equitable, confidential and, importantly, Sharia compliant manner.