Guest Analysis: Shari'ah Clauses in Financial Contracts

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1. General

Islamic Finance, i.e. financial products in compliance with Shari'ah principles, is a growth market estimated at more than US$ 700bn worldwide at year-end 2009, with annual growth rates at around 15% p.a. Moreover, Islamic Finance Institutions were not much affected by the first round of the finance crisis, because, due to the Shari'ah principles, they were much less exposed to the systemic drivers of the liquidity squeeze, although they cannot escape the downturn of the real economy. The Shari'ah is not confined to a specific national jurisdiction. Nevertheless, it constitutes a corpus of rules on social conduct that is both general and abstract, and hence has to be qualified as law.\(^2\) Basically, contracts not in contravention of Shari'ah principles would be considered as Shari'ah compliant.\(^3\) Normally, Islamic finance products are approved by Shari'ah Boards, which, however, will mostly act as counsels or advisors rather than being part of the formal legal system.\(^4\) Nevertheless, there is a need to manage general legal risk and Shari'ah compliance risk as part of the operational/reputational risk of financial institutions: "a comprehensive and effective legal framework is a key component of a sound and stable Islamic financial system."\(^5\) A respective legal framework can be considered effective if it:

- provides a suitable environment to accommodate Islamic finance;

- secures the enforceability of Islamic finance contracts;

- ensures an effective legal process for the settlement of disputes re. Islamic finance contracts.\(^6\)

2. EU Law

The Rome Convention\(^7\) of 19th June 1980 entered into effect on 1st April 1991. As an agreement between the Member States, it established uniform rules concerning the law applicable to contractual obligations in the EU involving the parties' free choice of law even where such law is that of a non-contracting (non-EU) State (Art. 3). However, according to prevailing legal view, the Convention allowed only the choice of State law, although the wording of Art. 3 used the general term of "law."\(^8\) This is based on the view that only State law is precise enough. Taking effect from 17th December 2009, the Rome Convention has been replaced by the Regulation on the Law Applicable to Contractual Obligations („Rome II“).\(^9\) The Regulation is established as EU Community Law, directly applicable in Member States to contracts concluded after 17th December 2009 (Art. 28). In its recitals (13), the Regulation seems to open the door to non-State law: "This Regulation does not preclude parties from incorporating by reference into their contract a non-State body of law..."\(^10\) However, considering the history of the legislative process, this is meant to involve incorporation into a contract governed by State law rather than to allow the choice of non-State law as the governing law of contract in general.\(^11\) The Commission had initially proposed to allow the choice of non-State law such as UNIDROIT (but excluding, e.g., the lex mercatoria, which, according to the Commission, "is not precise enough")\(^11\), but failed to gather sufficient support.

Art. 3 of the Regulation allows partial choice of law. However, according to prevailing legal view, dual choice of law can only be applied to specific and clearly defined parts of

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a contract, due to certainty requirements.

The above-mentioned EU Community law only regulates the minimum freedom of the choice of law, and refers to court disputes only, but is not applicable in the case of agreed arbitration. In respect of the Shari'ah rules under the jurisdiction of an EU Member State, this means:

- The parties may choose any State law which incorporates the rules of Shari'ah as substantive law, e.g. Saudi Arabian jurisdiction. However, due to the exemption regime of the Regulation, investigation is necessary whether under the jurisdiction of the chosen court the choice of law in respect of negotiable instruments (promissory notes etc.), law of companies and constipations of trusts is permitted. In addition, many Arab civil and/or commercial codes including Kuwait and the United Arab Emirates (UAE) are hybrid, allowing interest and other instruments not permitted under the Shari'ah:

...whether a State's legal system is fully Islamised or not has little bearing on the extent to which it is able to establish a satisfactory legal framework for IIFS.  

- The parties may choose the Shari'ah as the law of contract, opt out of any national law, exclude dispute resolution before the courts and submit to arbitration.

- The jurisdiction of a Member State may allow the choice of non-State law including the Shari'ah (e.g. France).

- The parties may incorporate by reference into their contract a non-State body of law including the Shari'ah. It is doubtful, however, whether such choice is allowed by direct application of Regulation EC 593/2008, because it is contained in its recitals only. In order to ensure that the court of a Member State gives effect to such agreement, the eligibility of such reference under the relevant jurisdiction should be investigated.

- The parties may construe the contract under any State law carefully avoiding evident contradictions to Shari'ah principles. This requires a great deal of due diligence and advice by Islamic and secular experts. The obvious advantage is certainty under the chosen state law. The courts might, however, render judgements not complying with the aims of the Shari'ah even if the contract has been approved by a Shari'ah Board. Further, proper due diligence is necessary in respect of the appropriateness of the chosen jurisdiction to accommodate the typical legal structures of Islamic Finance, e.g., trust structures under English or French law might be easier to implement than under German jurisdiction. A few further general principles under EU jurisdiction might restrict the enforcement of certain provisions of a contract which complies with Shari'ah principles:

- Overriding mandatory provisions in the sense of public interests under the jurisdiction of the forum is not permitted. It is, however, is unlikely that mandatory Shari'ah principles of Islamic finance contracts would be affected in particular the ban of riba, speculation including recovery of lost profits and of the uncertainty of the contract's object. In any case, national bank supervisory regulation has to be observed.

- The choice of law may not work to the disadvantage of the customer, depriving him of the protection afforded by the law of the country in which the consumer has his habitual residence. Under this principle certain default practices might be challenged in case they are applied to Islamic retail banking. Again, however, violation of mandatory Shari'ah principles is unlikely, as demonstrated above.

3 Individual Jurisdictions of EU Member States

3.1 UK: English law

In a benchmark decision, the English Court of Appeal has refused to enforce Shari'ah principles, based on three arguments:

- The EU Rome Convention allows only the choice of State law;

- a contract can only be construed under one single jurisdiction;

- it cannot be the parties' intention to entrust an English court with the interpretation of the Shari'ah.
Related principles developed in the case of Shamil Bank of Bahrain EC vs. Beximco Pharmaceuticals Ltd. and others\(^{17}\) indicate that reference to the governing law means exclusively a reference to the law of a particular country.\(^{18}\) This decision was rendered when only the Rome Convention was applicable (and not Rome I’ including its recitals). Moreover, the choice of Shari’ah in the contract was worded ambiguously. The parties had chosen English law, whereby, Shari’ah should have prevailed according to the agreement. Nevertheless, it seems doubtful whether an English court would enforce any reference to the Shari’ah, even restricted to clearly identified sections of a contract. Hence, under English law the current practice is not to include a reference to the Shari’ah, avoiding the somewhat unpredictable potential for conflicting results.\(^{19}\) Contradictions to Shari’ah principles are avoided by seeking the approval by Shari’ah scholars, which, however, cannot deliver rulings which would be enforceable by the English courts. As an alternative, the choice of the Shari’ah would be effected when submitted to arbitration.\(^{20}\)

Otherwise, the way is being paved to accommodate Islamic Finance, in particular the tax regime, as well as financial industry regulation.

3.2 French Law

As has been demonstrated by abundant case law in respect of the choice of lex mercatoria\(^{21}\) French courts are applying non-State legal rules to international contracts. As the Shari’ah constitutes law susceptible to be enforced, it would be given effect by the French courts.\(^{22}\) Further, it seems clear that the prohibition of charging interest, of speculation and of the uncertainty of the contract’s object do not contradict the French mandatory rules.\(^{23}\) The judge would have to identify for himself the content of this law\(^{24}\) However, in order to ensure the proper and predictable application of the Shari’ah, agreement on the codifications of the Accounting and Auditing Organisation of Islamic Financial Institutions (AAOIFI) would be advisable. Experts are expecting that the AAOIFI standards may eventually play the same role as the UNIDROIT principles on international commercial contracts in addition to lex mercatoria.\(^{25}\) Further, the French courts would respect agreed mediation processes.\(^{26}\)

Under this view, the following clauses have been proposed in case of agreements on French courts:\(^{27}\)

„This agreement shall be governed by the principles of Shari’ah.“

„Subject to the principles of the Shari’ah, this agreement shall be governed by and construed in accordance with the laws of France.“

„Any dispute shall be governed by the law of France except to the extent it may conflict with Islamic Shari’ah, which shall prevail.“

Apart from that, a commission has been established to facilitate the accommodation of Islamic Finance in France. A series of tax reliefs and legislative measures have been issued or are under way.

3.3 German Law

Although the Rome Convention has been implemented by German legislation (with amendments to the EGBGB – the German civil code), the situation is characterised by the lack of case law.

It is doubtful whether the German courts would recognise the choice of the Shari’ah as the governing law of a contract.\(^{28}\) The prevailing legal view is that the relevant Art. 27 (1) of the German EGBGB allows only the choice of State law, based on the wording and the history of the legislative process.\(^{29}\) Although, considering that at least the term „Recht“ (law) is neutral and that most comments are based on the Rome Convention alone rather than on „Rome I“, the outcome of the choice of the Shari’ah seems at least very uncertain.\(^{30}\) As is the case under EU law, Art. 27 (1) EGBGB allows dual (partial) choice of law, but the nearly unanimous opinion of commentators is that it must be possible to clearly separate the related parts of the contract. Although the underlying reasoning – danger of contradicting interpretation and uncertainty – may not be compelling in every case, there is considerable risk in respect of the enforceability of such clauses.\(^{31}\)
On the other hand, the by far prevailing opinion is that the choice of the Shari‘ah would be enforceable in Germany in the case of arbitration, due to the requirements of § 1051 (1) ZPO ("choice of law or of the jurisdiction of a specific State").

Nevertheless, the prevailing view is that non-State law can be integrated into a contract by way of reference to substantive law instead of by way of choice of governing law. Hence the parties may agree to exercise or enforce their claims and other rights (under State law) exclusively subject to compliance with the Shari‘ah rules. Accordingly, mandatory rules of German law contradicting the Shari‘ah – such as riba, speculation and the uncertainty of the contract's object - may be waived. As is the case in France, the judge would have to identify for himself the content of the Shari‘ah. In this context, AAOIFI codifications could be agreed upon as a code of conduct. Another method to avoid interpretation of the Shari‘ah by a German court or by experts appointed by the court would be by agreement on a referee ("Schiedsgutachter"), who should decide with binding effect according to § 317 BGB (interpretation of the German civil code by way of analogy) in the course of the proceedings before the German court. In this case, the referee's decision could only be challenged before the courts if it is obviously incorrect.

Conclusion: contractual Shari‘ah agreements can be enforced in German courts provided the legal mechanisms are properly construed.

The German financial services supervisors (BaFin) have advised that they would welcome Islamic Finance. However, major clarifications in respect of the tax regime seem to be necessary, in particular regarding real estate finance not using SPV structures.

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3 M. Al-Jasser (supra FN 1), p.1. The burden of proof is on those parties claiming non-compliance.
4 Under the Central Bank of Malaysia Act, e.g., the National Shari‘ah Advisory Council of the BNM and the Securities Commission have the sole authority re. Shari‘ah matters of Islamic Banking.
7 Convention 80/934/EEC.
8 K. Blüts, Das islamische Recht als Vertragsstatut? IPREx 2005, p.45. This is also the view of the English Court of Appeal.
9 Regulation EC 593/2008.
12 For an overview see Nik / Alia, (supra FN 6) pp. 4 and 22.
13 Nik / Alia, (supra FN 6), p. 31.
14 The New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards has been ratified by all EU Member States. The Convention is subject to the exception of public policy. See also MönchKomm-Martin, BGB 4th ed. 2010, Vor Art.1 Rom I-V, Rn 103.
15 Nik / Alia, (supra FN 6), p. 22.
16 It has to be noted that the outcome might vary in other common law environments.
19 ibid.