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I. Case Law Update*

A. APPOINTMENT OF ARBITRATORS IN ENGLAND SUBJECT TO ENGLISH ANTI-DISCRIMINATION LAWS (FOR NOW. . .)

In June 2010, the English Court of Appeal ruled in *Jivraj v. Hashwani* that the appointment of arbitrators by private parties must comply with the English Equality (Religion and Belief) Regulations 2003, which prohibit discrimination in employment (the "EER").[1] The decision partially reversed a 2009 judgment in the same case, in which the High Court of Justice ruled that neither arbitrators nor their appointments are protected under the EER, because arbitrators are not "employees" and the arbitrator-litigant relationship is not an "employment" relationship.[2]

Jivraj arose out of an English law-governed joint venture agreement containing an arbitration clause requiring that "all arbitrators . . . be respected members of the Ismaili [Muslim] community."[3] The parties were Messrs. Jivraj and Hashwani, both members of the Ismaili Community.[4] In 2008, Hashwani appointed an arbitrator who was not a member

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* Contribution by Hdeel Abdelhady.

1. Jivraj v. Haswani, [2010] EWCA (Civ) 712, [30] (Eng.), *available at* http://www.bailii.org/cgi-bin/markup.cgi?doc=/ew/cases/EWCA/Civ/2010/712.html&query=title+(+jivraj+)&method=boolean [hereinafter *Jivraj II*].

2. Jivraj v. Hashwani, [2009] EWHC (Comm) 1364, [38] (Eng.), *available at* http://www.bailii.org/cgi-bin/markup.cgi?doc=/ew/cases/EWHC/Comm/2009/1364.html&query=title+(+jivraj+)&method=boolean [hereinafter *Jivraj I*]. For a more detailed discussion of Jivraj I, *see* Hdeel Abdelhady, *Islamic Law in Secular Courts (Again): Teachable Moments From the Journey*, 38 INT'L L. NEWS No. 4 (2009), reprinted at Opalesque Islamic Finance Intelligence December 2009, *available at* http://www.opalesque.com/OIFI137/Industry_Snapshot_Islamic_Law_in_Secular_Teachable197.html.

3. *Jivraj II*, [2010] EWCA (Civ) 712, [2].

4. *Id.*

of the Ismaili Community, and Jivraj sought a court order declaring the appointment invalid.[5] A dispute as to the legality of the arbitration clause ensued.

The EER prohibit religion-based discrimination in employment, except where "being of a particular religion or belief is a genuine occupational requirement."[6] The appellate court construed the EER broadly to determine that "employment" encompasses any "contract personally to do work of any kind."[7] Being contract-based, the arbitrator-litigant relationship is subject to the EER, and arbitrators cannot be denied appointment based on religion.[8] The genuine occupational requirement exception was inapplicable because membership in the Ismaili Community was not required to carry out the role of arbitrator, which was to determine the dispute under English law.[9] The court invalidated the arbitration clause in its entirety.[10]

The *Jivraj* case highlights tensions between the legal and policy prerogatives to provide relative freedom, independence, and privacy in dispute settlement through arbitration, on the one hand, and stamping out unlawful discrimination, on the other.[11] In November 2010, the Supreme Court of the United Kingdom granted leave to appeal in the case.[12] The case is being watched closely by the international arbitration community, whose members have expressed concern that the appellate court decision in *Jivraj* will have adverse consequences for international arbitration in London.[13]

5. *Id.* at [3]-[4].

6. *Id.* at [5]. In *Jivraj I*, the court noted that even if the EER had applied, the requirements of the genuine occupational requirement exception would have been met, as membership in the Ismaili Community was a bona fide occupational requirement. *Jivraj I*, [2009] EWHC (Comm) 1364, [45].

7. *Jivraj II*, [2010] EWCA (Civ) 712, [9], [17] (reasoning that the EER are patterned on earlier anti-discrimination in employment legislation that defines employment broadly).

8. *Id.* at [25].

9. *Id.* at [29]-[30]. Importantly, had the arbitration clause authorized the arbitral tribunal to sit in equity, the requirement of membership in the Ismaili Community might have been justified under the *bona fide* occupational requirement exception. *Id.* at [29].

10. *Id.* at [26], [34]. The offensive language could not be severed from the remainder of the arbitration clause because it was "an integral part of the agreement to arbitrate." *Id.* at [34]. This part of the decision was in accord with *Jivraj I*. *Id.*

11. The lower court remarked that the interest in ensuring parties' freedom "to agree how their disputes are resolved, subject only to such safeguards as are necessary in the public interest" favored the application of the genuine occupational requirement exception. *Jivraj I*, [2009] EWHC (Comm) 1364, at [46] (quoting Section I of the Arbitration Act 1996).

12. UK Supreme Court, Applications for Permission to Appeal, *available at* http://www.supremecourt.gov.uk/docs/PTA-1011.pdf (last visited Dec. 2010).

13. The International Chamber of Commerce and the London Court of International Arbitration intervened in support of the application for leave to appeal to the Supreme Court. Tom Toulson, *Leave to Appeal Granted in Jivraj*, GLOBAL ARB. REV., Nov. 23, 2010, *available at* http://www.globalarbitrationreview.com/news/article/28932/leave-appeal-granted-jivraj/.

II. Corporate Governance in Islamic Finance*

A. The Front Office Generates Revenue, the Back Office Creates Value: Operational Excellence is the Key to Unlocking Lasting Value in Islamic Finance

It is not righteousness that ye turn your faces towards East or West;
But it is righteousness to believe in Allah and the Last Day,
and the Angels, and the Book, and the Messengers;
To spend of your substance, out of love for Him, for your kin, for orphans,
for the needy, for the wayfarer, for those who ask, and for the ransom of slaves;
To be steadfast in prayer, and practice regular charity,
to fulfill the contracts which ye have made;
And to be firm and patient, in pain (or suffering) and adversity,
and throughout all periods of panic.
Such are the people of truth, the God-fearing.

-The Noble Qur'an, 2:177

The quoted Qur'anic *aya* (verse) crystallizes a fundamental Islamic value: form does not trump substance, and outward adherence to religious injunctions does not, without more, equal piety.[14] Rather, piety is measured by deeds motivated by sincere faith, whether perceptible or imperceptible to others. The significance of this verse for individual Muslims is clear. Moreover, it applies to institutions that hold themselves out to the public as "Islamic," whether in the form of Islamic banks, Islamic windows of conventional banks, or other providers of Islamic financial products and services, such as *takaful* and financial advisory. Islamic Financial Institutions (IFIs) must ensure that behind the scenes, in their back offices, their operations are of a quality that ensures that representations about the nature of their business model, products, services, and commercial and legal objectives are true to the religion-derived principles to which they owe their market share. This requires operational excellence in the back offices of IFIs, which must be facilitated and reinforced at the industry level. Operational excellence is the key to unlocking lasting value in Islamic Finance.

This note discusses two published court opinions involving IFIs—*The Investment Dar v. Blom* (*Blom*) and *Shamil Bank of Bahrain EC v. Beximco Pharmaceuticals Ltd.* (*Shamil*)—and IFI Shari'ah Board Reports and their implications for governance and brand management.[15] In this note, the notions of operational quality and governance are broad, and are used interchangeably.

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* Contribution by Hdeel Abdelhady.

14. This *aya* (verse) appears in *Surat Al Baqara*, Chapter Two of the Holy Qur'an. *Surat Al Baqara*, comprised of 286 *ayat* (verses), is the longest Chapter in the Qur'an and is said to sum up "the whole teaching of the Qur'an." Abdullah Yusuf Ali, The Meaning of the Holy Qur'an 16 (Amana Publ'n, 11th ed., 2004).

15. Inv. Dar Co. KSCC v. Blom Dev. Bank SAL, [2009] EWHC (Ch) 3545 (Eng.), *available at* http://www.bailii.org/cgi-bin/markup.cgi?doc=/ew/cases/EWHC/Ch/2009/3545.html&query=title+(+blom+)&method=boolean; Shamil Bank of Bahrain EC v. Beximco Pharm. Ltd., [2004] EWCA (Civ) 19, [2004] All E.R. 1072 (Eng.), *available at* http://www.bailii.org/cgi-bin/markup.cgi?doc=/ew/cases/EWCA/Civ/2004/19.html&query=title+(+shamil+)&method=boolean.

1. *The Need for Operational Excellence in Islamic Finance is Particularly Compelling*

The financial crisis and other well-known governance failures (recall Enron) are powerful reminders of a universal truth. Rules, whatever their source, are only as good as their enforcement. Laws alone are insufficient to prevent practices motivated by short-term gain to the detriment of long-term value. This is particularly true for Islamic Finance, which operates globally without comprehensive industry-specific regulation, making external regulatory checks on governance moderate to non-existent. Further, the nature of the relationship between IFIs and consumers of their products and services, based on the Islamic profit and loss sharing (PLS) construct, requires that IFIs be operationally strong to maximize returns for consumers and shareholders.[16] IFIs, owning their existence to a religion-based ethical model, must be, and must convincingly appear to be, ethical. Vigilant self-governance is required to preserve the Islamic brand, maximize profitability, and fill legal and regulatory gaps.[17]

2. *Governance Shortfalls Revealed: Case Studies*

In the last paragraph of the well-known February 2008 Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI's) clarification on *sukuk*, AAOIFI's Shari'ah Board advised IFIs "to decrease their involvement[ ] in debt-related operations and to increase true partnerships based on profit and loss sharing in order to achieve the objectives of the Shari'ah."[18] The advice, seemingly a postscript to AAOIFI's *sukuk* clarifications, is broad in scope and applicability, and has ramifications for governance at the institutional and industry levels. Published court opinions and Shari'ah Board Reports (SBRs) issued by IFIs shed light on areas in which to improve operational quality. Although court opinions and SBRs are, by their nature, specific to institutions and situations, they have industry-wide ramifications.[19]

a. The Blom Case

In *Blom*, The Investment Dar (TID), an IFI, asserted its own failure to comply with *Shari'ah* as a defense to an apparently valid demand for payment by Blom Development Bank (BDB). TID's Memorandum of Association prohibited its engagement in "any

16. Consumers of Islamic financial products are more akin to equity investors, partners, and co-venturers than they are to consumers of conventional debt-based products. In assessing equity-based investments and ventures, the soundness of management and operations figures prominently. The quality of the management and operations of IFIs should figure equally prominently in the assessment of Islamic products.

17. A survey of Islamic Finance leaders in the Middle East revealed that sixty-six percent of survey respondents believed that the Islamic Finance industry is "under-regulated." *The Deloitte Islamic Finance Leaders Survey in the Middle East, Benchmarking Practices*, DELOITTE, 12 (2010), http://www.deloitte.com/assets/Dcom-Lebanon/Local%20Assets/Documents/FSI/DTME_IFLS_publication_23092010.pdf [hereinafter *Deloitte Survey*].

18. *Resolution on Sukuk*, ACCT. & AUDITING ORG. FOR ISLAMIC FIN. INST., (Feb. 2008), http://www.aaoifi.com/aaoifi_sb_sukuk_Feb2008_Eng.pdf.

19. Indeed, only fifty-nine percent of respondents to the Deloitte Survey stated that the entities they represented had in place "corporate governance/procedures," while thirty-nine percent did not. *Deloitte Survey*, *supra* note 17, at 11. At the same time, fifty-eight percent of survey respondents "view[ed] corporate governance and Sharia'a governance as prerequisites for best practices." *Id.*

usury or non-Sharia compliant activities."[20] In October 2007, TID and BDB entered into a *wakala* agreement, pursuant to which BDB deposited US$10 million with TID as its agent, for *Shari'ah*-compliant investment in TID's "treasury pool."[21] TID's Shari'ah Board previously approved the TID-BDB transaction and the form of the master wakala agreement.[22] TID failed in its payment obligations and BDB filed suit in English court (pursuant to English forum and governing law clauses). After an initial hearing, BDB won summary judgment for US$10 million, the principal amount deposited. TID sought permission to appeal the summary judgment, arguing, inter alia, that a full trial was required to determine whether the *wakala* was enforceable. According to TID, the *wakala* was interest-bearing, not *Shari'ah*-compliant, and therefore unenforceable because TID did not have the legal capacity to enter into the *wakala*.[23] Subsequently, TID's Shari'ah Board issued a statement asserting that the transaction was *Shari'ah*-compliant, and advised TID to abandon its appeal against BDB.[24]

b. The Shamil Case

The *Shamil* dispute arose out of two *murabaha* and related agreements between Shamil Bank of Bahrain and Beximco Pharmaceuticals, its corporate affiliates, and directors (collectively, Beximco).[25] Beximco defaulted on its obligations, and Shamil Bank brought a claim in English court, pursuant to English governing law and forum selection clauses. Shamil Bank prevailed both at trial and on appeal.[26]

Shamil Bank's Shari'ah Board certified the disputed transactions before the litigation. Nevertheless, at trial, Beximco argued that the *murabaha* and related agreements with Shamil Bank were interest-bearing loans with Islamic names. The English court appeared to accept this characterization, stating that: "if the Sharia law proviso were sufficient to incorporate the principles of Sharia law into the parties' agreements, the defendants would have been likely to succeed."[27] Due to a governing law clause that did not effectively incorporate *Shari'ah* as a source of governing principles, however, it cannot be known whether the court's prediction of a favorable outcome for Beximco would have materialized, had *Shari'ah* applied.

3. *Addressing Governance Shortfalls at the Institutional Level*

a. Instruments Susceptible to a *Shari'ah* Challenge

- **Innovation in Islamic Finance: Back to Basics**. *Blom* and *Shamil* involve agreements that were characterized by litigants as effectively interest-bearing, and repugnant to *Shari'ah*. These characterizations, accurate or not, raise a frequently asked question about whether Islamic Finance has innovated sufficiently to meet con-

20. *Blom Dev. Bank*, [2009] EWHC (Ch) 3545, [3].
21. *Id.* at [1]-[2], [5]-[6].
22. *Id.* at [16]–[17].
23. *Id.* at [16].
24. *See* Shaheen Pasha, *Investment Dar Gets Sharia Board Blow to Blom Case*, ARABIANBUSINESS, June 9, 2010, http://www.arabianbusiness.com/investment-dar-gets-sharia-board-blow-blom-case-282707.html.
25. *See Shamil Bank*, [2004] EWCA (Civ) 19, [11]-[12]; *see also* Abdelhady, *supra* note 2, at 18, 19.
26. *See* Shamil Bank of Bahrain v. Beximco Pharm. Ltd., [2003] EWHC (Comm) 2118, [58], [2003] 2 All E.R. (Comm) 849 [hereinafter *Shamil I*]; *see Shamil Bank*, [2004] EWCA (Civ) 19, [61]-[63].
27. *Shamil Bank*, [2004] EWCA (Civ) 19, [55].

sumer demand, develop and expand its market share, and bolster *Shari'ah* compliance. Much has been written on the subject of innovation, and *Shari'ah* experts, business professionals, and economists would best pave the way forward. For the purposes of Part I, it is sufficient to state that IFIs and the Islamic finance industry should revisit the issue of whether the "bank" operating model assumed by many IFIs is congruent with the Islamic PLS model.

- Owing to real commercial pressures, IFIs frequently use off-the-rack instruments (*e.g.*, *murabaha*, *wakala*, and *tawarruq*) that have been susceptible to *Shari'ah* challenges because, as implemented, they most directly compete with the term loans, fixed return investment instruments, and treasury products used by their conventional counterparts. IFIs are, after all, for-profit entities, and their responses to real commercial pressures are understandable. However, it is reasonable to question whether the continued reliance on products that are readily susceptible to accusations of *Shari'ah* violations and innovation shortcomings are in the best long-term interest of IFIs and the industry. More important, the widespread use of such instruments, to the exclusion of innovative Islamic PLS-based offerings, denies the industry the opportunity to know and capitalize on its true potential market share, as many consumers will avoid products that appear to be Islamic in name only.
- Ensuring Shari'ah Compliance, From Cradle to Grave. The *Blom* and *Shamil* cases both involved claims that "Islamic" agreements were effectively interest-bearing. Such accusations, if made frequently and publically, undoubtedly will have damaging effects for specific IFIs and the industry at large. IFIs must ensure that their instruments and transactions are structured, documented, and executed in a manner that minimizes the risk of *Shari'ah* challenges. This means that the letter and spirit of *fatawa*, forms of agreements, and transaction structures reviewed and approved by Shari'ah Boards must not be altered over the course of their lifetime, unless re-submitted and re-reviewed for *Shari'ah* compliance. Coordination and vigilance across operational units (*e.g.*, management, compliance and legal, risk management, and transaction teams) is essential to ensure that the *Shari'ah* character of instruments remains intact after Shari'ah Board approval.

b. Managing Litigation and Derivative Commercial Risk

- Legal Risk Management Should Reflect Sound Governance. Legal risk is as much a part of doing business as commercial risk, and legal risk management is part of corporate governance. IFIs (like other entities) must conduct their affairs in a manner that demonstrates an appreciation of legal risk, before legal disputes arise. As a matter of policy, legal risk and litigation management protocols should be written, periodically reviewed (internally and with outside counsel), and explained and disseminated to IFI personnel at regular intervals. Well-crafted protocols should address, among other issues: (1) internal approvals and considerations necessary when deciding to proceed with litigation (*e.g.*, based on the nature of disputes, amount in controversy, likelihood of publicity, etc.); (2) forum type (*e.g.*, arbitration, mediation, national courts); (3) jurisdiction (considering, *e.g.*, quality of courts, typical duration of litigation, expense, and ability to adjudicate substantive issues); (4) governing law; (5) likelihood and extent of commercial risk attendant to litigation strategy; (6) internal document retention and record-keeping procedures; and (7)

the ability to produce evidence.[28] Legal risk and litigation management protocols should facilitate informed decisions about litigation, including whether commercial risks outweigh the potential benefits of a legal strategy.

- **Sound Legal Risk Management Requires Coordination Across Back Office Functions**. The *Blom* case presents a striking example of the harm that can result from a lack of coordination in making litigation decisions. The assertion in court of *Shari'ah*-non-compliance by an IFI whose constitutional documents prohibit its engagement in *Shari'ah*-non-compliant transactions is remarkable, to say the least.[29] Where *Shari'ah* compliance is potentially subject to dispute, the IFI's Shari'ah Board should be asked to review, with the assistance of legal counsel and relevant departments, germane documentation and transaction history and assess *Shari'ah* merits *before* any litigation strategy is pursued. The wisdom of this approach is borne out by the TID Shari'ah Board's untimely advice that TID abandon its legal dispute with BDB.
- **Evidentiary Inadequacy of Post Hoc, Wholesale Certification of Islamic Transactions**. In the *Shamil* case, Shamil Bank submitted year-end SBRs as proof that the disputed transactions with Beximco had been "certified" by its Shari'ah Board. The certifications were not specific to the Shamil-Beximco transactions. The SBRs stated: "The Board believes that all the bank's business throughout the said year, including investment activities and banking services, were in full compliance with Glorious Islamic Sharia'a."[30] The evidentiary value of the certifications was not scrutinized because *Shari'ah* principles were not applied to decide the case. As a general matter, IFIs should be aware that such post hoc, sweeping certifications (in SBRs or otherwise), without more, might not be sufficient proof of *Shari'ah*-compliance or adequacy of *Shari'ah* oversight in litigation or in other contexts. With this in mind, IFIs should consider whether internal records of *Shari'ah* approval, review, and compliance are of a type and quality that would evidence *Shari'ah*-compliance in litigation or other contexts. A good record keeping and retention policy should address such issues.
- **Governing Law and Forum Selection Should Demonstrate Commitment to Shari'ah-Compliance**. Many parties to Islamic Finance contracts select secular (*e.g.*, English) law and courts in their governing law and forum selection clauses, for good reason. Jurisdictions outside of the Islamic Finance hub provide the transparency and predictability necessary for effective dispute resolution. At the same time, however, as was the case in *Shamil*, secular courts will often refuse to apply *Shari'ah*, apply it in a limited fashion, or are ill-equipped to interpret *Shari'ah* even if applied.[31] IFIs should draft their governing law and forum selection clauses to en-

28. Where agreements call for litigation before national courts, as in the *Blom Dev. Bank* and *Shamil Bank* cases, the likelihood of a published opinion (particularly at the appellate stage) is high. On the other hand, if parties have opted for arbitration, the likelihood of a published opinion is slim to none, depending on the terms of arbitration, *e.g.*, the forum selected, procedural rules, and confidentiality provisions, etc.

29. Note also that TID had a *Shari'ah*-based obligation to fulfill the contract that it made. *See, e.g., Surat al Baqara* 2:177.

30. *Shamil Bank*, [2004] EWCA (Civ) 19, [8].

31. In *Shamil Bank*, the disputed agreement contained a governing law provision stating that: "Subject to the principles of the Glorious Sharia'a, this agreement shall be governed by and construed in accordance with the laws of England." *Id.* at [1]. The English court did not apply *Shari'ah*, because under English law, the law

sure that *Shari'ah* principles are applied to decide the substantive elements of legal disputes. The use of governing law clauses that effectively incorporate *Shari'ah* is in the interest of IFIs and the industry generally. If Islamic Finance cases continue to be decided under secular law, to the exclusion of *Shari'ah*, legal ambiguity will continue to hinder sustainable long-term growth because of legal uncertainty. Separately, IFI-drafted governing law clauses that have the foreseeable effect of excluding *Shari'ah* suggest a lack of commitment to *Shari'ah* and its enforcement. As the trial judge noted in *Shamil*: "The English court, as a secular court, is not suited to ascertain and determine highly controversial principles of religious-based law and it is unlikely that the parties would be satisfied by any such ruling; that is not what they were wanting by their choice of law clause."[32]

c. Shari'ah Board Reports: Disclosure Quality and Brand Management

As succinctly stated by the Islamic Financial Services Board (IFSB): "Compliance with *Shari'ah* rules and principles is the *raison d'être* of the Islamic Financial Services Industry."[33] SBRs issued by IFIs should reflect this existential truth, in two ways. First, IFIs should ensure that their SBRs fully describe the *Shari'ah* governance apparatus in place, to communicate to consumers, shareholders, regulators, and the public, the importance and role of *Shari'ah* governance at the IFI level. Second, SBRs are an excellent marketing medium for IFIs, and they should be used to bolster the Islamic brand.

- **Bolster the Level of Disclosure in SBRs**. IFI SBRs tend to share a common structure. First, they state that operations complied with applicable *fatawa* and *Shari'ah* generally. Second, they assure readers that all profits derived from non-*Shari'ah*-compliant transactions were set aside and paid as *zakat* (charity). Third, SBRs usually reiterate that responsibility for governance, including *Shari'ah* governance, rests with IFI management. Fourth, SBRs typically state that the Shari'ah Board discharged its oversight functions based on information and documentation (*e.g.*, audit reports) provided by IFI management. Finally, the signatories of SBRs often are scholars known to have held multiple Shari'ah Board positions during the reporting year. These five common features highlight places where disclosure can be enhanced, along the following lines:
  - Additional details regarding the nature of the *Shari'ah* governance apparatus in place (*e.g.*, the manner in which *Shari'ah*-compliance audits are conducted and their frequency, and clarity as to whether the Shari'ah Board itself reviewed documentation [*e.g.*, by sampling] or relied on summaries of documentation).
  - More information about the human, technological, and departmental resources that are devoted to *Shari'ah*-compliance, etc., and their place in the IFI's organizational structure.

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of decision in English courts must be a law of another country, and not a "non-national" system of law. *Id.* at [40]. Therefore, the *Shamil Bank* case was decided under English law, even though, as noted, the English Court in that case commented that the outcome likely would have been different if *Shari'ah* had applied. *Id.* at [55].

32. *Shamil I*, [2003] EWHC (Comm) 2118, [36].

33. *Guiding Principles on Shari'ah Governance Systems for Institutions Offering Islamic Financial Services*, ISLAMIC FIN. SERV. BD., 1 (2009), http://www.ifsb.org/standard/IFSB-10%20Shariah%20Governance.pdf.

- The setting aside of improperly gained profits is itself an element of *Shari'ah*-compliance. However, disclosures of such instances must be reasonably explained and accompanied by details of remedial measures that were or will be implemented to avoid or reduce instances of non-compliance in the future.

- **The SBR as Marketing Tool**. SBRs serve necessary (and, in jurisdictions where they are required by regulation, mandatory) functions. They also should be used proactively as marketing tools. SBRs provide IFIs with a rare opportunity to educate a diverse pool of readers about the nature of their business model and objectives and to differentiate their brand. Using SBRs as effective marketing tools requires that they be written eloquently and thoroughly, to achieve the purpose of informing readers about the importance of *Shari'ah* governance, the *Shari'ah* governance processes in place within the publishing IFI, the commercial and ethical objectives of Islamic Finance, and distinctions between IFIs and their conventional counterparts.

d. The Role of Shari'ah Boards

- **Empowering Shari'ah Boards**. Shari'ah Boards sit at the narrow apex of the *Shari'ah* compliance pyramid. They make and interpret the rules, and they are charged with a degree of oversight. However, with few exceptions, they are not full-time employees of the IFIs that they serve. IFIs must ensure that Shari'ah Boards are equipped with the resources necessary to discharge their duties. Such resources might include assigning full-time, dedicated *Shari'ah* governance personnel (*e.g.*, legal counsel, compliance professionals, accountants, etc.) with responsibility for reviewing documentation, audit reports, and transactions on a regular basis. Such dedicated Shari'ah Board personnel should report directly to the Shari'ah Boards that they serve, and should have a meaningful degree of independence from other operating units of IFIs.

4. *Industry-Level Facilitative Measures: Building a Specialized Legal Infrastructure*

Many industry participants and observers have called for binding standardization to promote predictability and transparency in Islamic Finance. Whether standardization is a feasible and wise option in the near-term is open to debate. In the meantime, other measures can be taken to promote predictability and transparency.

- **Facilitate Development of Contemporary Islamic Economic Law**. *Shamil* and *Blom* are two of many cases involving IFIs that have been tried in secular courts. Frequent and widespread resort to secular fora, over the long term, will stunt the development of contemporary Islamic economic law. As demonstrated by the *Shamil* case, secular courts will not always apply religion-derived law to settle disputes. The result is that modern Islamic economic instruments are not being scrutinized under the laws with which they purport to comply, thus perpetuating legal ambiguity.
- **Specialized Dispute Resolution Fora**. As Islamic Finance continues to grow, so will the number of disputes. The need is clear for specialized fora to resolve Islamic Finance disputes, accommodate parties, and facilitate the transparent development of contemporary Islamic economic law. The accumulation of legal decisions through such fora would engender standardization of norms, without the potentially

negative consequences of standardizing rules based on insufficient industry experience. Of course, any such specialized fora, to be viable, must offer a degree of transparency, predictability, and efficiency on par with English and other secular systems, with the much-needed benefit of substantive *Shari'ah* expertise.

- **Shari'ah Expert Vetting, Training, and Roles**. In the *Shamil* case, as in others involving Islamic law and tried in secular fora, the services of Islamic legal experts were utilized.[34] So long as Islamic legal experts are needed, the Islamic Finance industry has an interest in ensuring that persons acting as Islamic banking and finance experts are qualified. Relatively modest measures can be taken to promote and maintain quality among experts; for example, training and certification programs, and the creation of an expert registry through such programs. Of course, oversight would be necessary to ensure that such measures do not have the undesirable effect of excluding any alternative *Shari'ah* interpretations or points of view, as long as competency is guaranteed.

B. Conclusion

Without question, contemporary Islamic Finance has grown tremendously in a short period of time. This growth and the raised visibility that has accompanied it present challenges and opportunities. Islamic Finance has reached the point of maturity at which introspective questions about its essence and place in the world of financial services must be asked and considerately answered. Unanimity of opinion among Industry participants and observers as to the future of Islamic Finance is unlikely. Whatever the outcome, the path to sustainable growth must begin with operational excellence, which is the key to unlocking lasting value in Islamic Finance.

III. Local Law Obstacles To Structuring An Islamic Financing In The U.A.E. and Saudi Arabia*

Although the United Arab Emirates (U.A.E.) is a civil code jurisdiction, Islamic *Shari'ah* is embedded in many provisions of law. Article 7 of the U.A.E. Constitution provides that Islamic *Shari'ah* is "a source" for legislation.[35] Article 2 of the Civil Code[36] provides that the principles of *fiqh* are to be utilized in understanding the underpinnings of the provisions of the Civil Code. Article 27 of the Civil Code provides that the provisions of a governing law cannot be applied if they contravene Islamic *Shari'ah*, public order, or the morals of the U.A.E.[37] However, the reality is that similar to jurisdictions in the region other than Saudi Arabia,[38] interest provisions are enforceable in the U.A.E. The Federal Supreme Court and the Dubai Court of Cassation have upheld Article 76 of the Commer-

34. *See Shamil Bank*, [2004] EWCA (Civ) 19, at [2].

* Contribution by Nabil A. Issa.

35. United Arab Emirates Const., as amended 1996, art. 7.

36. Law No. 5 of 1985 Civ. Code, art. 2 (U.A.E.).

37. *Id.* art. 27.

38. Many financings in Saudi Arabia are conventional financings that use euphemisms such as "commission" or "profit rate" rather than the term "interest." Interestingly, the more conservative *Shari'ah* Boards refuse references to the SAMA Banking Disputes Committee for fear that such tribunal will enforce interest-based provisions of a financing, even if the financing is mean to be *Shari'ah*-compliant.

cial Code[39] enforcing interest provisions in financing agreements. In Saudi Arabia, the Basic Law provides that the *Shari'ah* is the law of the country.[40] However, in both the U.A.E. and Saudi Arabia, many issues under local law do not make an exception for *Shari'ah*-compliant financings, making it more difficult to structure such financings than in jurisdictions around the world that do create such exceptions.

A. RAHN

Under *Shari'ah*, a security interest may be perfected only through possession.[41] Lenders normally wish to obtain a *rahn* (mortgage or pledge) of the real estate, movable property of the project company, and the facility to be constructed for use by the project company.

1. *Real Estate/Immovables*

Saudi Arabia, unlike the U.A.E., does not have a central registry to record real estate title deeds. To create a valid mortgage interest in real property in Saudi Arabia, the lender or other security holder and the owner must enter into a separate pledge agreement, the full text of which is then recorded on the title deed to the real property by the Notary Public. Afterward, the title deed is given to the mortgagee.

2. *Movables*

In non-recourse financings, the financiers normally wish to take a mortgage over all the movables that belong to the borrower. In Saudi Arabia, the Commercial Mortgage Regulations[42] establish a statutory framework applicable to mortgages over movable property. However, the governmental bodies tasked with recording the *rahn* on the title historically did not yet have a mechanism to do so. In December 2010, however, Saudi Arabia created the Unified Center for Lien Registration. Lenders are closely now watching to see how effectively they can enforce security registered with such center. The U.A.E., on the other hand, has historically provided for registration over movables with registrations such as over vehicles.

3. *After-Acquired Property*

In general, under *Shari'ah*, *marhoun* (assets) must be something that can be validly sold. Therefore, any *marhoun* subject to a *rahn* "must (i) be in existence at the time of the execution of the . . . *rahn*, (ii) have a quantifiable value, and (iii) be saleable and deliverable."[43] Thus, in many Gulf Cooperation Council (GCC) jurisdictions it can be argued

39. Law No. 18 of 1993 COMM. CODE, art. 76 (U.A.E.).

40. Royal Decree No. A/90 27/08/1412 H (Mar. 1, 1992) (Saudi Arabia) [hereinafter Basic Law].

41. *See, e.g.*, Michael J.T. McMillen, *Islamic Shari'ah-Compliant Project Finance: Collateral Security and Financing Structure Case Studies*, 24 FORDHAM INT'L L. J. 1184, 1205 (2001).

42. Royal Decree No. M/75 dated 21/11/1424 H. (Feb. 27, 2004), *supplemented by* Decision No. 6320 dated 18/6/1425 H., published in *Umm Al Qura* edition no. 4016 (Oct. 29, 2004) (Saudi Arabia) (consisting of implementing regulations issued by the Minister of Commerce and Industry).

43. McMillen, *supra* note 41, at 1220.

that after-acquired property is not part of the *marhoun*, unless schedules listing the *marhoun* are updated.

A form of security agreement for the region utilizes the *rahn-adl* structure, in which the *adl* is akin to the Western concept of a trustee over the assets. This is supported by a "Deed of Possession" in which the schedules to the concerned security agreement are duplicated (and, as with the Security Agreement, updated regularly), thus creating a form of "constructive possession" of the assets and subjecting them to a *rahn*. Each type of asset in a financing must be analyzed to determine the best method under local law to subject such asset(s) to a *rahn*. While the *rahn-adl* concept has not been tested before local courts, to our knowledge, such structure has been utilized in non-recourse financings in the region.

4. *Pledge of Interests in LLCs*

> To be valid, any security interest . . . must be reduced to actual or constructive possession of the subject of the pledge given. In the absence of a share certificate that can be physically delivered to the lenders or even annotated, the pledge of interests in a Saudi LLC most Emirati LLCs is not enforceable under local law. We note, however, the Emirate of Dubai instituted a procedure to register a pledge of interests of LLCs incorporated in Dubai in December 2010. To get around this, lenders will often require sponsors to form special purpose vehicles (SPVs) in offshore jurisdictions (*e.g.*, the Cayman Islands or elsewhere, including over shares of Jebel Ali Free Zone Offshore Companies or entities registered in the Dubai International Financial Center) to serve as the actual shareholders in the local project company, as the shares of such SPVs may be more readily pledged to the lenders as additional security for their loans.[44]

The lenders can then take security over the second-tier shares, which are the shares of the offshore companies established by the sponsors to hold their shares in the project company. This, however, does not always work if the company wishes to be deemed a GCC shareholder. At times, it may be possible to form the SPV in a jurisdiction such as the Dubai International Financial Centre (DIFC) or as a Jebel Ali Free Zone Offshore Company (JAFZOC) to be 100% GCC owned and still be deemed a GCC entity and pledge shares at the DIFC level or JAFZOC level.

B. Assignment of Contract Proceeds

It is possible to assign contract proceeds and other intangible rights under *Shari'ah*, subject to the caveat that it is not possible to "perfect" such assignments through recordation with a central registry. Instead, borrowers in Saudi Arabia and the U.A.E. are often asked to assign specific contract proceeds, with an acknowledgment from the payer that the assignment will remain in effect until the assignee consents to any transfer or termination of the assignment.

44. Nabil A. Issa & Patrick F. Campos, *Challenges in Structuring Non-Recourse Islamic Financing for Energy Projects in Saudi Arabia*, 2 Tex. J. Oil Gas & Energy 395, 461-62 (2007).

Under *Shari'ah* precepts as applied in Saudi Arabia and the U.A.E., however, unilateral assignments are not effective. To create an effective assignment of a contract of the relevant project company or contractual obligations of counterparties to a contract, the counterparties must be given notice of the assignment and must consent to the assignment. Thus, an assignment of amounts owed to a project company to the lenders must include a written consent of such assignment by the payer(s) in order to be a perfected interest.

C. Power of Attorney

Financiers in Saudi Arabia and the U.A.E. often rely on a *wakala*, or a power of attorney given to a designee of the lenders to exercise certain "step-in rights" if there is a default. But powers of attorney are revocable, even if the power of attorney is characterized in the security documents as an "irrevocable" power of attorney. To protect against the revocation of a power of attorney granting step-in rights, lenders often include a liquidated damages provision in the security agreement that is triggered upon premature revocation. Local courts have enforced liquidated damages where they approximate the actual damages and are not drafted as excessive financial penalties for non-performance. It would further encourage Islamic financings if local laws allowed for irrevocable powers of attorney when attendant to a *Shari'ah*-compliant financing.

D. Sukuk

Both the U.A.E. and Saudi Arabia do not permit local limited liability companies, the most common form of corporate vehicle, to issue *sukuks* because such are considered "debt" instruments. This contradicts the intended nature of *sukuk* as an undividable interest in the underlying assets and results in the need for *sukuk often* to be issued by an offshore company. Such leads to most *sukuk* being "asset-based," not "asset-backed."

E. Transfer of Land

Because no exception is made for *ijara* financings to the fees charged to transfer land, most *ijara* financings in the U.A.E. are situations in which the financing party owns the land contractually but not legally. The financing party then gets a mortgage over the land. This arrangement is technically absurd as the "owner" of the land for *Shari'ah* purposes is getting a mortgage over such land. One would expect the Land Department in the relevant Emirate to waive such fees to encourage the use of *ijaras*. In Saudi Arabia, a financial institution may not own land unless it is being used for its premises or as part of a foreclosure. Because there is currently no mortgage law in Saudi Arabia, a party other than the financial institution holds title in its name for the benefit of the financial institution. One would also expect an exception to be made in Saudi Arabia for financial institutions to be the owner of record if that financial institution is using some form of Islamic financing such as an *ijara*.

F. Dispute Resolution

1. *Issues in Relation to Governmental or Quasi-Governmental Entity*

It does not appear that, under Dubai law, a Dubai governmental entity would have the authority to give a prospective, blanket waiver of sovereign immunity in a contract or otherwise without the express prior consent of the Ruler of Dubai.

In Saudi Arabia, Article 3 of the Arbitration Regulations states that governmental departments may not resort to arbitration to settle their disputes with third parties except after approval of the President of the Council of Ministers.[45] In addition, Council of Ministers Resolution No. 58 dated 17/01/1383 H. provides that governmental departments may not agree to a foreign arbitration clause in their contracts.[46]

Finally, as in the case with foreign arbitration, a Saudi governmental department may not agree to a contract that provides for governing law other than the laws and regulations of Saudi Arabia.[47]

2. *Enforcement of a Foreign Arbitral Award or Judgment Against the Project Company*

Almost any matter involving a U.A.E. national or a foreigner resident in the U.A.E. gives the local courts jurisdiction. It is not clear to what extent such arbitral awards are enforceable without having to re-litigate the merits of the matter in a local court.

In order to enforce a judgment of a court in a foreign jurisdiction in Saudi Arabia, such judgment must be submitted to the Board of Grievances, which would have the discretion to enforce all of such judgment or such part thereof to the extent it is not inconsistent with Saudi Arabia's laws or regulations.[48]

While both the U.A.E. and Saudi Arabia are signatories to the New York Convention for the Enforcement of Foreign Arbitral Awards, it is still not clear to what extent such arbitral awards can be easily enforced.[49] Both jurisdictions, however, have enforced arbitral awards and judgments rendered in other GCC jurisdictions.

3. *Use of the SAMA Banking Disputes Committee*

The Saudi Arabian Monetary Agency (SAMA) Banking Disputes Committee has played a critical role in providing a tribunal that understands financing documents and more quickly resolves banking disputes involving Saudi Arabian parties than the Saudi Board of Grievances. Because the Committee regularly enforces the interest portions of conventional financings in Saudi Arabia, the more conservative Shari'ah Boards, fearing that the

45. Royal Decree No. M/46 12/07/1403 (Apr. 24, 1983) (Saudi Arabia) [hereinafter Arbitration Regulations].

46. *See* Issa & Campos, *supra* note 44, at 466.

47. *Id.* at 466-67 (citing Art. 3 of Council of Ministers' Resolution No. 58 17/01/1383 H. (June 25, 1963) (Saudi Arabia)).

48. *Id.* at 467.

49. *See* Convention on the Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958, 21 U.S.T. 2517, 330 U.N.T.S. 3; *see also, e.g.*, Dale E. Stephenson & Khulaif Al-Enezee, *Enforcement of Foreign Arbitral Awards in Saudi Arabia*, Financier Worldwide, Dec. 2010, at 56 (discussing the challenges to enforcement in Saudi Arabia). We also note that it is believed that courts of the Emirate of Dubai have recently begun to enforce arbitral awards rendered in jurisdictions subject to the New York Convention.

provisions may enforce interest provisions in a financing document even if it portends to be *Shari'ah*-compliant, refuse provisions in *Shari'ah*-compliant financing documents that give the Committee jurisdiction over a dispute. The Saudi Arabian authorities should address this concern by deciding that the Islamic financing industry has grown enough to eliminate the need for conventional financing in Saudi Arabia and that the Committee should not enforce interest provisions in *Shari'ah*-compliant financings.