KEY POINTS

- Neither the English nor the DIFC courts can *directly* apply Sharia principles, because the proper law of a contract is required to be the law of a country.
- An *arbitral* tribunal in England or the DIFC *can* directly apply Sharia principles, even as a non-national system of law, under the relevant UK and DIFC statutes.
- The English courts can *indirectly* apply religious law, for example: where specific provisions are incorporated into an agreement; where the parties choose a national law based on religious law; where it is used as an aid to construction; or where a justiciable issue of fact arises as a condition of the existence of a right.
- In practice, Sharia principles are indirectly applied in deciding whether an agreement was *ultra vires* a party under the law of its seat.

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The application of Islamic finance principles under English and DIFC law

Neither the English nor the DIFC courts can directly apply Sharia principles. In this article, Rupert Reed QC considers the ways in which the English and the DIFC courts can apply Islamic law indirectly.

INTRODUCTION

The total amounts of Islamic financial assets have grown exponentially in spite of the global financial crisis. An increasing number of Islamic finance (IF) instruments are being negotiated and written in the "new" IF centres of London and Dubai, including its financial "free zone", the Dubai International Finance Centre (DIFC), which has codified commercial and financial law based on English and other common law principles. Many of those instruments contain English and DIFC jurisdiction and choice of law provisions.

Neither the English nor the DIFC courts can apply Islamic law *directly*, but both can apply it *indirectly* in circumstances where they recognise it as being *"relevant"*. The English courts have shown themselves willing to apply Sharia principles, for example in assessing whether an instrument is void as having been beyond the constitutional powers of, or *ultra vires*, one of its parties insofar as it is *ribawi* or Sharia non-compliant (SNC).

NO DIRECT APPLICATION OF SHARIA PRINCIPLES BY THE COURTS

The position under English conflicts of laws principles, both at common law and under the Contracts (Applicable Law) Act 1990, which implements the Rome Convention on the Law Applicable to Contractual Obligations (RC), is that, subject to limited exceptions, parties can only provide for the application of the law of a *country* or *jurisdiction* as the applicable or "proper" law of their agreement: Art 1 RC. The applicable law, under Art 10 RC, is that which will govern interpretation, performance, the consequences of breach, and various ways of extinguishing obligations and prescribing and limiting actions. Issues such as the validity of the contract will therefore be ascertained by reference to the substantive law of the relevant *country*.

The parties therefore cannot provide for the application of a "non-national" system of law, such as Islamic or any other religious law: *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd* [2003] EWHC 2128 (Comm) [27], [35]; [2004] 1 WLR 1784 [48]; [62]-[63]; *Halpern v Halpern* [2007] EWCA Civ 291; [2008] QB 195 [20]-[29]; *Musawi v RE International (UK) Ltd* [2007] EWHC 2981 (Ch) [17]-[23]. The conventional explanation for this principle is that laws cannot exist "in a vacuum", in other words without being enforceable in the courts of any jurisdiction.

DIFC law similarly requires the DIFC courts to determine civil matters in accordance with the laws of a *jurisdiction* chosen from a "cascade" of connected jurisdictions: DIFC Law No 3 of 2004 (the Law on the Application of Civil and Commercial Laws (LACCL)), Art 8.

CONSEQUENCES OF DIRECT APPLICATION OF SHARIA PRINCIPLES

The judgment at first instance in *Halpern* suggests that an express agreement of Sharia as the applicable law may have the effect of making the contract unenforceable: [2006] EWHC 1728 (Comm) [50]. However, the Court of Appeal (CA) disagreed, taking the view that it would then be for the applicable law to decide the extent to which the agreement impliedly incorporated the relevant religious law as part of the contract: *Halpern* [36].

DIRECT APPLICATION OF SHARIA PRINCIPLES IN *ARBITRATION*

The direct application of Sharia principles was similarly excluded in arbitration, until a tribunal was permitted, under s 46(1)(b) of the Arbitration Act 1996, to decide a dispute "in accordance with such other considerations as are agreed by them or determined by the tribunal". Arbitral disputes are of course outside the RC: Art 1(2)(d). A tribunal can now apply Sharia principles and other non-national rules, where they are designated by the above choice of law rule. The CA recognised in *Halpern* that, if parties wish *non-national* systems of law to apply to their agreement, then they can do so by the inclusion of a provision for the *arbitration* of any dispute: *Halpern* [37]-[38].

The equivalent DIFC statute, Law No 1 of 2008 ("the Arbitration Law") is equally clear in providing, in Art 35(1), that the tribunal shall decide the dispute "*in accordance with such rules of law as are chosen by the parties as applicable to the substance of the dispute*".

Both the English and DIFC courts will therefore *recognise* agreements to arbitrate governed by Sharia law, both in staying actions brought in breach of those agreements and in enforcing awards made in applying the agreed Sharia "considerations": *Halpern* [37].

INDIRECT APPLICATION OF SHARIA PRINCIPLES

While the English and DIFC courts will not directly apply Sharia principles, there are ways in which they can *indirectly* apply them. In particular: they can apply Sharia principles that are incorporated in an agreement; they can apply a national law that itself applies Sharia principles; they can use Islamic law as an aid to construction; and/or they can decide a justiciable issue of IF principle on which the rights of a party are conditional.

In practice, the most common indirect application of Sharia principles occurs where a party seeks to avoid its obligations under an IF instrument on the basis of an *ultra vires* defence. By this, it contends that the instrument is SNC, therefore beyond the capacity of, or *ultra vires*, either party under the law of its place of incorporation, and therefore void and unenforceable as a matter of English law. However, the English courts, and in particular the English Commercial Court, have historically seemed uninterested in IF and Sharia compliance issues, and more concerned with enforcing IF instruments as if they were conventional finance.

In *Islamic Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems NV & Ors*, Unreported, 13 February 2002, Tomlinson J summarily rejected all of the various IF defences put up by the defendant, namely an *ultra vires* defence, an illegality defence and a defence based on misrepresentation. He did so even though the murabaha finance contract in that case presented obvious symptoms of artificiality, with the bank failing to acquire the goods and assuming no business risk, and with the purchaser assuming the entire risk, being liable to pay even if the goods were never shipped.

The Commercial Court and CA took a similarly diffident approach to issues of Sharia compliance in *Shamil Bank* [2003] EWHC 2118 (Comm); [2004] EWCA Civ 19; [2004] 1 WLR 1784. Although the issue in that case was whether the enforceability of a contract governed by English law, subject to Sharia law, was conditional upon its Sharia compliance, both the judge and the Court of Appeal approached that issue from the perspective that Sharia law raised complex philosophical issues from another period on which there was little or no firm authority.

However, in the later case of *The Investment Dar Company KSCC v Blom Development Bank SAL* [2009] EWHC 3545 (Ch), a judge of the Chancery Division took a very different approach. The defendant sought to resist summary judgment by reliance on an *ultra vires* defence in arguing that the wikala contract was SNC and therefore *ultra vires* the claimant as a matter of Kuwaiti law, and so invalid as a matter of English law. The judge found that the *ultra vires* defence had been "dredged up" late by the defendant's lawyers, and thus gave the claimant both permission to amend to plead a *restitutionary* claim and summary judgment on that claim. However, he also found that there *was* an arguable defence to the existing *contractual* claim to repayment of the USD 10.7m of principal, so that he would not have given summary judgment on that claim.

The judge in *Blom* did *not* dismiss Sharia law as medieval religious philosophy. Instead, he considered carefully the evidence of the parties' experts and their exhibited texts. He started with a standard inquiry as to whether the "profit" payable to the principal could be characterised as interest paid "indirectly". However, in doing so, he identified the key ingredient that was missing from the wikala contract in that case. There was no *risk* to the principal, who received payments of "profit" in pre-determined amounts even if the value of the investments made by the agent had in fact dropped. The judge was willing to consider the Sharia compliance of the contract even in circumstances where the defendant's own Sharia committee of Islamic scholars had approved the contract.

Certain IF instruments, notably mudaraba and wikala agreements, are often compared with appointments under English law of trustees and agents. It should therefore come as little surprise that it was a judge of the *Chancery* Division of the English High Court, with its *equitable* specialism, who first engaged with Sharia principles in finding it to be arguable that the relevant agreement was not SNC under those principles.

INCORPORATION OF SHARIA PRINCIPLES

The English CA has further reminded us that provisions of foreign law can not only be "applied to" the contract, but can also be "incorporated into" the contract, which exists as a form of private legislation: *Shamil* [49]-[51]; *Halpern* [30]-[33]. The foreign law becomes a *source* of rules and principles to be applied by the governing law.

An example given in *Shamil* is the incorporation of particular provisions from the French Civil Code, so that the relevant articles are incorporated as if terms of an English contract. The parties may accordingly choose one law to apply rules of another law incorporated in their agreement. The limits of such incorporation arise from a requirement of *certainty*, so that it will operate where the court can sufficiently identify the relevant rules to be incorporated. Where doubt remains, expert evidence can be used as an aid to the interpretation by the English court of the rules and principles incorporated.

In *Shamil*, this led to the suggestion that the relevant "provisions of foreign law or an international code or set of rules" should be specific "black letter" provisions, impliedly rules rather than principles, that may not give sufficient certainty [51]. The CA found that no terms had been identified as a "corpus" of terms apt to be implied as terms of the finance contract in that case [74]. In this regard, an English or DIFC court may be more willing to apply as incorporated terms provisions from such codifications of Islamic law as exist, most notably the *Sharia Standards* published by the Accounting and

Auditing Organisation for Islamic Financial Institutions (AAOIFI), or the *Majala*, the Ottoman civil code based on Sharia law of the Hanafi school of *fiqh*.

Clearly, the more specific the reference to rules to be incorporated, for example to a particular school of jurisprudence, the more likely it is that the court will apply them. However, the court in *Halpern* appeared to accept that "Jewish law" would be sufficiently certain to be relied on as part of the contractual framework [33]. The implication in that analysis, and in the proposed distinction with *Shamil*, is that Sharia law would similarly be sufficiently certain, as long as the relevant school of fiqh were identified.

Moreover, if the proposed incorporation was of Sharia *in general*, the court may well take the view that this was an improper attempt to make Sharia the applicable law of the contract, with the proper law being no more than a "shell" for the incorporation of Sharia: *Halpern* [32].

APPLICATION OF *FOREIGN LAW* INCORPORATING SHARIA PRINCIPLES

In *Al Midani v Al Midani* [1999] 1 Lloyd's Rep 923, Rix J found it likely that the applicable law in that case was *"either Sharia law or such law as modified by Saudi law"*, noting that he regarded Sharia law to be *"a branch of foreign law"*. In *Halpern* at [24], the CA found this to be consistent with conventional conflict of laws principles on the basis that the agreement being construed in that case was an agreement to arbitrate. However, Rix J's words remind us that Sharia law is a significant source of law in a number of jurisdictions in which it is directly enforced by civil courts, so that no "vacuum" exists.

It follows that if clients are keen for Sharia principles to be applied to their agreement, one option is to apply the law of a country whose laws are or incorporate the desired Sharia principles. The Kingdom of Saudi Arabia (KSA) would be an obvious example, with its Basic Rule of Governance (A/90) providing that the KSA's constitution is the Qur'an and Sunna (Art 1), which are the ultimate sources of law (Art 7), and that the courts shall apply the rules of Sharia according to the Qur'an and Sunna (Art 48) as the source of judicial decisions (Art 45), which are not subject to any other authority (Art 46). Sharia tends in practice to prevail even over the modern statutes of the KSA said to "supplement" Sharia where necessary. In general, the KSA courts will apply the Hanbali school of *fiqh*, and so that gives some basis for legal certainty.

Similarly, the constitutions of the UAE and Oman make Sharia the main source and the source of legislation, while those of the remaining GCC countries (Kuwait, Bahrain and Qatar) describe it *"a main source"* of legislation. Many of these countries now have significant numbers of resident commercial lawyers from common law jurisdictions and of dual-qualified local lawyers so that experts in the laws of the KSA and other GCC countries can readily be found to give evidence and otherwise assist in English or DIFC proceedings in relation to agreements that are expressly or impliedly subject to the law of those countries, and thereby Sharia.

The risk inherent in entering a contract under Saudi law is of course that issues as to its validity and enforceability will fall to be determined in accordance with that law, even if by an English or DIFC court. Under Saudi law, a contract that is SNC will be void and unenforceable without more. This invalidity will result without any intervening reference to issues of the capacity of the company or the authority of its purported agents.

AID TO CONSTRUCTION

It is clear that the English and DIFC courts may have regard to Sharia principles as an aid to the construction of an IF instrument, and that the English courts do not see such use as being contrary to the RC. In *Halpern*, the CA recognised that, although Jewish law, as a non-national system of law, could not be the proper law of a compromise agreement, it could still be relied upon as part of the contractual context as an aid to interpretation [34]-[35]. To that extent, the court recognised the *relevance* of religious law in that case.

In English law, the process of interpreting the parties' words is one of assessing *"the meaning which the document would convey to a reasonable person having all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract"*: *Investors Compensation Scheme v West Bromwich Building Society* [1998] 1 WLR 896, 912. In *Halpern*, the agreement in issue purported to be the compromise of an arbitration before religious judges to which Jewish law had applied, and so it could reasonably be assumed that the parties would not have intended to depart from Jewish law in compromising that arbitral dispute. Similarly, in the case of a financial instrument said to be Sharia compliant, the context would include the core principles of IF.

Further, where there are two possible constructions of a relevant document, the court may prefer that which is more consistent with business common sense: *Rainy Sky SA v Kookmin Bank* [2011] UKSC 50; [2011] 1 WLR 2900 [15]-[21]. In the subsequent case of *LB Re Financing No 3 Ltd v Excalibur Funding No 2 plc* [2011] EWHC 2111 (Ch), Briggs J made clear that the greater the ambiguity, the more persuasive may be any argument as to the business common sense of a particular construction. Business common sense can itself be understood in the context of Islamic finance to include compliance with Sharia principles, not least given the further canon of construction that the court should prefer

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a meaning which validates an instrument rather than one which renders it void.

Similarly, the courts will depart from the ordinary meaning of the words used where it is clear, again in the relevant factual context, that there has been some linguistic mistake: *Chartbook Ltd v Persimmon Homes* [2009] UKHL 38; [2009] 1 AC 1101. This is sometimes referred to as "corrective construction". There may be circumstances where particular wording as drafted makes an IF instrument potentially SNC, but where the court could in effect correct the drafting to ensure the Sharia compliance the parties plainly intended. Applying the logic of *Excalibur*, the more obvious the drafting error, the more persuasive an argument that it should be corrected and the less ambiguity that will be required.

Evidence of Sharia may therefore serve all of the purposes for which arguments of construction are advanced before the English courts, not least to support the validity of the instrument, to ensure its compliance with the presumed intentions and reasonable understanding of the parties, and to correct errors that may result in its being SNC.

RIGHTS OF PARTY CONDITIONAL UPON IF ISSUE

There are other cases where the relief sought is not a determination of an issue of IF principle, but the rights of a party are conditional upon a prior determination of such an issue. In English and Scots law, the necessity has arisen principally in cases of religious schism where there have been issues as to who is entitled to trust property that have required the courts to ascertain the conformity of a purported trustee to religious tenets. The rule that, on a division in a religious body, the property held on trust for its purposes will go to the party that adheres to its fundamental religious principles is sometimes called the rule in *Craigdallie v Aikman* (1813) 1 Dow 1.

The issue of conformity with Sharia principles as a necessary prior issue in determining a matter of civil right arises most commonly where the ultimate purchaser or agent under an IF instrument declines to pay the bank or principal on grounds that the instrument is SNC and therefore void as being *ultra vires* one or both of the relevant parties or beyond the authority of the directors or other agents of those parties.

JUSTICIABILITY

There was until recently real concern as to whether issues of Sharia law were *justiciable* by the English and DIFC courts. In *Shergill v Khaira* [2012] EWCA Civ 983; [2012] PTSR 1697, the Court of Appeal, in a dispute as to the trusteeship of certain Sikh temples, found that an issue as to whether a claimant was the true spiritual successor to a saint venerated within a particular Sikh sect, was *not* justiciable. That issue was neither appropriate for, not capable of, decision by judicial method, and the court should abstain from adjudicating on the truth or merits of differences in religious belief or doctrine.

Fortunately, the Supreme Court took a different view, finding that the primary issues in the case were of the English law of trusts and of the construction of the relevant deed. The court explained that it *would* address questions of religious belief where necessary to enforce private rights and obligations.

The court considered the issues arising on claims that the governing bodies of unincorporated religious communities had acted *ultra vires*, for example in seeking a union with another religious community or in their dealing with members or employees. Where the *vires* in question arise from the civil contract in the constitution of the community or by statute, the courts may need to decide issues of religious belief and practice, insofar as capable of objective ascertainment, on the basis of expert evidence.

Although the court did not refer to cases in which it was alleged that a *corporation* had acted *ultra vires* by transacting in a way that is inconsistent with the tenets of a particular religion and therefore in breach of the contract between members and the company existing in its Articles, there are no obvious grounds for distinction. In both cases, the validity of the act taken on behalf of the association or company is dependent upon its consistency with the tenets and practices of the relevant religion. There was no suggestion in that case that the tenets of Nirmal Kutia Sikhism were particularly susceptible to objective ascertainment, or indeed more so than those of any school of Islamic jurisprudence.

As yet, there is no DIFC authority on the issue of the justiciability of points of Islamic law. It can, however, be assumed that justiciability would be decided on principles of English law as found in *Shergill*, on the basis of the final default application of English law under the "cascade" of jurisdictions found in Art 8 LACCL. That application of English law was described by Justice Sir Anthony Colman in CFI 8/2007 *Ithmar Capital v 8 Investments Inc* (24.11.08) in terms of the use of English and other Common law authorities "*to add flesh to the concise bones of [the codified] provisions*" of DIFC law [112].

There are, however, a number of indicators that the DIFC courts would be *un*likely to find issues of Islamic law and Sharia compliance to be non-justiciable.

First, the DIFC courts have a number of UAE-qualified judges, willing to apply directly their own knowledge of UAE law: CFI 012/2012 *Allianz Risk Transfer v Al Ain Ahlia Ince* (24.4.13).

Secondly, issues of UAE law, and the Civil Code in particular, arise commonly in DIFC cases, and the DIFC courts have expressed some comfort in dealing with those issues, in the first procedural instance on paper and without expert evidence: CFI 014/2010 *Taaleem PJSC v National Bonds Corporation PJSC* (14.1.13).

Thirdly, the DIFC courts have recently shown greater respect for IF structures. For example, in the recent case of CFI 032/2012 *Beydoun v Daman* (10.7.14), the court found, after detailed consideration of an IF *ijara* facility that an assignment of the right to purchase an apartment would have been effective as such to deprive the assignor of its cause of action if executed *after* the relevant purchase. It was not merely the creation of a security interest.

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ISSUES AS TO CAPACITY AND AUTHORITY OF PARTIES

The court in *Blom* clearly accepted that an IF instrument could be void as being *ultra vires* one of the parties under the law of its place of incorporation. Sadly, the defendant obtained a stay under the Kuwaiti Financial Stability Law before the claimant's cross-appeal of the judge's decision on the contract claim could be heard. The case assumed particular interest because the defendant's *own* supervisory board publicly criticised the defendant's raising of IF arguments without consulting it. If the case had proceeded to trial in the Chancery Division, there would have been a very interesting debate, on the expert Sharia evidence, as to whether the hybrid elements of the contract in question, which, although a wikala, included a sale and re-purchase of goods as between the principal and agent, would have saved the contract from being SNC.

When the judgment in *Blom* was first delivered, there was controversy as to whether it had *damaged* IF by creating significant SNC risk which would be required to be priced into IF contracts. However, there is now some sense that the engagement of secular courts in issues of IF may in fact have *assisted* in deterring more extreme cases of artificiality and in ensuring that banks continue to write IF business that is properly within their powers. It is no longer unusual to see parties plead in their defence that an IF contract was void as having been *ultra vires* one or both of the relevant parties and/or outside the authority of the Board or officers who executed it.

STATUTORY INTERVENTION IN ENGLAND AND THE DIFC

Under English principles as to the conflict of laws, issues as to the capacity of a company are determined under the law of the country where the company is incorporated. If that is England, then s 39 of the Companies Act 2006 protects third parties, just as under s 40 the authority of the directors is deemed free of limitation in favour of a person dealing or presumed to be dealing with the company in good faith. The result is that the *ultra vires* doctrine has in effect been abolished for the purpose of invalidating an instrument, and an excess of authority will invalidate only where the third party has acted in bad faith.

The position under DIFC law is more complex. The *ultra vires* doctrine was excluded under Art 24(2) of DIFC Law No 2 of 2009 ("the Companies Law"). This exclusion eliminates the risk of an *ultra vires* defence where the relevant party is incorporated in the DIFC, and gives a powerful argument for dealing with and/or through such parties. However, there is no specific statutory protection for third parties where the directors were acting in excess of their authority, although that authority can be drawn widely by reference to their apparent or "incidental" authority under DIFC Law No 6 of 2004.

Insofar as English or DIFC law requires issues of capacity to be decided in accordance with the law of the place of incorporation of the relevant company, the company laws of most Arab countries have a clear requirement that a company's memorandum should specify, among other things, the objects or purposes of the company. Often these are required to be legitimate and to be in accordance with such licences as the company needs to hold under policies intended to maintain uniformity and specialisation, as under Art 13 of the UAE Companies Law. It is implicit that SNC business, likely to be outside those purposes, or illegitimate or outside the scope of relevant licences, will be void or unenforceable.

MITIGATORY STEPS

There are clearly a number of ways in which the risk of a contract being found *ultra vires* can be prospectively mitigated. The most common is the taking of warranties that the agreement is Sharia compliant and/or intra vires the relevant counterparty, and/or a requirement of express undertakings that it will not seek to argue that the agreement is SNC or *ultra vires* any party. While such warranties and undertakings are effective in English law, they face two difficulties. First, under English law, a party cannot estop itself from asserting the invalidity of a contract which is invalid, so that an issue of capacity arises regardless of whether the point is taken by any party: *Freeman & Lockyer v Buckhurst Park Properties* [1964] 2 QB 480. Secondly, it may be argued, under Sharia principles, to which recognition may be given under the law of a company's seat, that such a warranty or undertaking may itself be SNC and void or unenforceable on that ground.

Other methods to mitigate SNC risk may be to require the certification of the contract as being Sharia compliant by the Sharia supervisory board of each party, or the inclusion of an arbitration provision for the appointment of an arbitrator with Sharia expertise capable of giving a prompt interim award on any issue of Sharia compliance that may be raised against payment. To the extent that an arbitration clause is discriminatory in requiring the appointment of an arbitrator from a particular religious or racial group, such discrimination is not prohibited under the Employment Act 2010 as an arbitral appointment is not "employment", and such discrimination would satisfy a genuine occupational requirement under Sch 9 to that Act: *Hashwani v Jivraj* [2011] UKSC 40.

CONCLUSIONS

There are a number of ways in which Sharia principles can be applied indirectly by the English and DIFC courts. In many instances, the parties may wish to provide for such application. There is, however, risk that those courts will find IF transactions to be void by indirect application of Sharia principles by the laws of countries in which the parties are incorporated. There are limited ways in which that risk can be managed. ■

Further reading

- The challenge of Islamic banking disputes in the English courts: the applied law [2009] 6 JIBFL 350
- Lexis PSL: Dispute Resolution: Applicable Law
- Lexisnexis Loan Ranger: Sukuk reaches western markets