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Islamic finance: when will an English court consider *Shari'a* compliance?

As the global economic slowdown continues and more debt defaults materialise, it is inevitable that the litigation of Islamic financing structures will become increasingly common - notably in the English courts, as English law governs a significant number of cross-border Islamic finance arrangements.

Stakeholders in the Islamic finance industry will be focusing closely on the outcome of these disputes, as they look to ensure that their products remain sufficiently robust when faced with a period of continued economic uncertainty.

This briefing considers the recent TID / Blom litigation[1] and how this should be distinguished from the Shamil Bank litigation[2].

A better understanding of the Court's decision-making process will ultimately enable clients to make more informed decisions in order to ensure that their agreements remain enforceable in the manner that the parties originally intended.

Key Issues

Islamic finance transactions being litigated in the English courts.

Appeal of a summary judgment order.

Questions of capacity – *ultra vires*.

Expert evidence.

Background: appeal of summary judgment

A Lebanese bank, Blom Developments Bank SAL ("**Blom**"), provided The Investment Dar Company KSCC ("**TID**") (a Kuwaiti company) with funding totalling approximately US$10million (the "**Principal Amount**") through a *wakala* (or agency) based deposit / investment structure. This particular structure was originally put in place in October 2007.

The *wakala* (or agency) was structured as a 'master' arrangement under which Blom as *muwakkil* (or depositor) would, from time to time, deposit funds with TID as *wakeel* (or agent). TID instigated each of these investments through 'investment offers' (i.e. funding requests). TID was required to invest those funds in a pre-agreed manner, and any such investment was to be in accordance with *Shari'a*.

The intention behind this arrangement was that TID would ultimately return the Principal Amount along with an expected amount of profit based upon an anticipated profit rate for each investment transaction (the "**Expected Profit**"). The documentation was drafted so as to create – using a series of complicated contractual provisions – an unconditional obligation on TID to pay the Expected Profit and to return the Principal Amount when required, irrespective of the performance of the investments themselves. This was what Blom expected to receive, subject to non-performance by TID.

These arrangements, as is quite common for cross-border Islamic finance transactions of this nature, were governed by English law.

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When TID failed to pay the Expected Profit and to return the Principal Amount at the end of the investment period, Blom brought a summary judgment application in the English courts. Blom's application was based on two claims:

- TID had acted in breach of the terms of the *wakala* (or agency) arrangements; and, in the alternative
- TID held Blom's funds on trust for Blom.

[1] The Investment Dar Company KSCC v Blom Developments Bank SAL, [2009] EWHC 3545 (Ch).
[2] Beximco Pharmaceuticals Ltd, Bangladesh Export Import Co Ltd, Mr Ahmed Sohail Fasiuhar Rahman, Mr Ahmed Sohail Fazlur Rahman, Beximco Holdings Ltd v Shamil Bank of Bahrain, EC [2004] EWCA Civ 19.

In response to these claims, the argument put forward by TID and its legal counsel was that:

- TID was required by its constitutional documents to comply with, and conduct its business activities in accordance with, *Shari'a*;
- the *wakala* (or agency) arrangements did not comply with *Shari'a*; and
- as a consequence of the foregoing, TID did not have the proper legal capacity at the outset to enter into the *wakala* (or agency) arrangements – and that such arrangements went beyond the corporate power and authority of TID and should therefore be considered *ultra vires* (or void).

The Master hearing Blom's application found that there was an arguable defence to the contractual claim, but not to the trust claim and therefore issued a summary judgment ordering TID to pay to Blom the Principal Amount but not the Expected Profit (in respect of which the Court felt there was a case to be argued).

TID elected to appeal the summary judgment with a view to overturning the order to pay the Principal Amount to Blom.

Capacity: a question of local law?

Our view is that the TID / Blom litigation can be distinguished from the Shamil Bank litigation. In the Shamil Bank litigation, the Court refused to take into account *Shari'a* principles on the basis that enforceability should be determined solely by English law. In this case however, the decision of the Court rests upon an analysis of capacity and authority.

In order to determine whether TID had proper legal capacity, it is necessary to consider the relevant Kuwaiti laws as they apply to TID, but – given the express statements as to *Shari'a* in TID's constitutional documents – it would also be necessary to consider the underlying issue of *Shari'a* compliance. This is not something that an English court would be equipped to answer on its own.

On the basis of the evidence submitted by the parties (which included the views of an expert for each litigant), the Court agreed with the conclusion of the Master that there was "an arguable case that the transactions entered into pursuant to the master *wakala* agreement were *ultra vires* TID". Unlike the Master however, the Court also concluded that "it is sufficiently arguable... that there is no trust claim, at least in the amount claimed by Blom". As such, the appeal was allowed – the "arguable case" threshold was all that needed to be shown in order for TID's appeal to succeed. It is important to note that the Court did not need to look deeper into the substance of the arguments put forward, it was satisfied that there was a triable issue for a later hearing.

The Court did, however, note that TID had expressly undertaken in the master *wakala* agreement that: (i) the transactions contemplated thereunder were *Shari'a* compliant by reference to TID's own *Shari'a* committee; and (ii) it would not at any time assert that the arrangements contravene *Shari'a*.

Expert evidence

The Court heard expert evidence which demonstrated that this kind of *wakala* (or agency) is a common transaction in the Islamic world; it also took note of HMRC guidance[3] on *wakala* transactions. The Court, however, considered that the TID / Blom arrangements differed from a "true investment agency" approach in that, under the terms of the master *wakala* agreement, Blom (as depositor) was entitled to receive all of the Expected Profit and did not take the risk of any shortfall in (or non-performance of) the investments made by TID.

This formed the crux of TID's defence – that the commercial effect of each of the *wakala* transactions was equivalent to that of a conventional bank deposit with interest, that the master *wakala* agreement and individual contracts entered into thereunder were not *Shari'a* compliant because, in reality and substance, TID was taking deposits at interest (i.e. the unconditional obligation to pay the Expected Profit).

In order for an English court to consider the capacity issue (itself a question of Kuwaiti law), it would also be necessary to consider detailed expert evidence on this point. Although the Court in the TID / Blom litigation heard experts from both sides, it declined to consider the expert evidence in any detail – stating instead that this was a point to be considered at trial.

Limited effect?

The Court observed that TID's defence was actually not much more than a lawyers' construct, which had been presented for the first time before the Master, and accepted that a claim for restitution of the Principal Amount could be brought by Blom if TID's defence was to succeed at trial (i.e. if the *wakala* arrangements were declared *ultra vires* and no trust was

[3] VAT FIN 8500.

held to exist). Furthermore, the Court felt that TID did not have any obvious defence to the restitutionary claim. Putting this another way, the Court would not allow TID to refuse to return the Principal Amount to Blom.

However, as no claim for restitution had yet been pleaded on behalf of Blom, the Court was not entitled to issue a summary judgment on this basis.

TID's appeal was therefore allowed but made subject to the condition that TID make an interim payment of the Principal Amount to Blom. The economic effect of the earlier summary judgment order therefore remained the same – TID still had to pay Blom.

Nonetheless, the effect of the Court ordering an interim payment, as opposed to a summary judgment, is that Blom is still required to submit a claim for recovery of the Principal Amount in the main proceedings. However, it remains to be seen whether TID will see fit to submit any defence to this claim, particularly in light of the Court's clear support for the potential claim in restitution.

It is worth noting that, if the contract was to be deemed *ultra vires* TID and therefore void, it seems unlikely that Blom would be able to recover any of the Expected Profit through a claim founded upon restitution.

Analysis

It is not unusual for issues as to capacity to arise in respect of emerging market transactions (where, for example, the absence of a licence may affect the ability of a party to transact). However, whether or not something is or is not *Shari'a* compliant is a more difficult (and less clear-cut) question to answer than (say) a licensing restriction that prevents a party from conducting certain identified types of financial activity.

The TID / Blom litigation is an important and timely reminder to legal practitioners and other stakeholders in the Islamic finance industry that the importance of an obligor's own approach to *Shari'a* compliance should not be overlooked. This is particularly relevant where that obligor is an Islamic financial institution or an Islamic company which was established and/or operates by reference to *Shari'a* compliant objectives (whether or not these are expressly referred to in its constitutional documents).

In practice, it seems inevitable that this will lead banks (both Islamic and conventional) to conduct a closer examination of the capacity and authority side of transactions that they enter into with Islamic clients: authorisations, capacity opinions and other typical safeguards will come under increased scrutiny.

Practical steps

If you are entering into Islamic financing arrangements with either an Islamic financial institution or an Islamic company, the following practical steps should be considered:

- request that they provide a copy of the *fatwa* (or other relevant certificate / approval document) confirming their detailed consideration of the structure and documents and that the transactions contemplated thereby are *Shari'a* compliant;
- documents should include detailed representations regarding (i) *Shari'a* compliance and (ii) non-conflict with constitutional and other authorisation documents; and
- documents should include an express waiver of any *Shari'a*-related defences.