THIRTY-FIVE YEARS OF THE MALAYSIAN JUDICIARY ADJUDICATING ISLAMIC FINANCE MATTERS

Since the introduction of Islamic finance in Malaysia three and half decades ago, the Malaysian judiciary has been confronted with various legal issues involving Islamic finance. While it is not the purpose of the article to provide an exhaustive list of decided cases[1] in chronological order, the aim is to highlight the main issues impacting the practical aspects in the Islamic finance industry, namely, the issues of *ibra*' (waiver), late payment charges, reference to the Shariah Advisory Council, enforceability of non-*Shariah*-compliant contracts and *sukuk* default. This is done through an analysis of reported court cases by the Superior Courts. It is found that the courts have adopted a pragmatic approach in dealing with Islamic finance matters of practical importance, hence providing clarity and certainty to the industry players.

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I. Introduction

1 Since its introduction in the 1980s, Islamic finance[3] in Malaysia has continuously developed into a sophisticated sector, providing

1 See, for example, Mohd Johan Lee, *Islamic Finance: Recovery, Rescheduling & Restructuring of Islamic Financial and Capital Market Products and Services in Malaysia* (Malaysia: LexisNexis, 2nd Ed, 2019); Rusni Hassan, Ahmad Azam Othman & Norlizah Mokhtar, *Islamic Banking in Malaysia: Cases and Commentaries* (Malaysia: CLJ Publication, 2017); and Mohd Johan Lee, *Islamic Banking in Malaysia: Shariah Theories, the Laws, Current Structures and Practices, and Legal Documentation* (Malaysia: LexisNexis, 2017).

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3 A large number of Islamic finance definitions are found in the literature, ranging from the relatively simple definitions for specific aspects (say, Islamic banking) to more

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a competitive and resilient component of the global financial system. Founded on Shariah principles, the central feature of Islamic finance is the prohibition of payment and receipt of *riba* (interest). Other distinctive features are the prevention of ambiguity (*gharar*) in contracts, the prohibition of gambling (*masyir*),[4] the prohibition of conducting economic or investment activities which are ethically and socially unacceptable (such as casino, pornography, alcohol and prostitution), the introduction of alms-giving (*zakat*)[5] and the sharing of risk and profit by parties in the transaction.[6]

2 Compared to conventional banking and finance where the banker/financier–customer relationship is a creditor/lender–debtor/borrower relationship, the banker/financier–customer relationship in Islamic finance can take different forms based on the contracts entered into by the Islamic financial institution ("IFI") and the customer. These contracts may take the form of *bai' al 'inah* (sale and buy-back agreement), *bai bithaman ajil* ("BBA") (deferred payment sale), *mudharabah* (profit-sharing loss-bearing), *murabahah* (cost plus), *musharakah* (partnership/profit and loss-sharing), *ijarah* (leasing), *wakalah* (agency) and *sukuk* (Islamic bond).[7]

3 Such an approach, much as it might seem unsustainable in the complex world of modern finance, proves to be otherwise. According to the 10th Global Islamic Finance Report 2019, the estimated figure for the

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complex definitions covering all financial operations. Warde, for example, defines Islamic finance as follows: "Islamic financial institutions are those that are based, in their objectives and operations on Quran's principles (principles of the Muslims' Holy book)." See Ibrahim Warde, *Islamic Finance in Global Economy* (Edinburgh University Press, 2000). This particular definition suggests that Islamic financial firms are not just banks, but also other types of financial intermediaries that employ Shariah principles. The other point of departure is that the Shariah ostensibly requires the adjustment of all aspects of Muslims' lives and the formation of a complete moral system. According to Iqbal, while the prevailing Western financial system focuses on the capitalistic features of economic and financial processes, Islamic finance aims to make an actual moral and equitable distribution in resources and social fairness in all (Muslim) societies (Zamir Iqbal, "Islamic Financial System" (1997) 34(2) *Finance and Development* 42).

4 *Masyir* denotes making an easy gain in a competitive game at the expense of other participants without any effort.

5 The concept of collection of *zakat* is to promote moral values by providing financial support for the needy and poor from peoples who have greater financial abilities.

6 For details, see Mohamed Hashim Kamali & Sheila Ainon Yusuf, *Islamic Transactions and Finance: Principles and Developments* (Malaysia: CLJ Publications, 2013) at pp 16–22 ("Permissibility and Prohibitions in Islamic Transactions and Contracts").

7 For a detailed explanation of the meaning of these contracts, see International Shari'ah Research Academy for Islamic Finance, *Islamic Financial System; Principles & Operations* (Malaysia: ISRA, 2012) ch 7 (pp 244–290) and ch 10 (pp 389–446).

global Islamic financial industry at the end of 2018 was US$2.6trn after recording a growth of 6.58%.[8] Domestically, Islamic finance is reported as continuing to anchor the growth of the overall Malaysian banking sector, expanding at a much faster pace than conventional loans in 2018 at 11.0% (2017:10.3%) in contrast to the latter's 3.3% growth. As of January 2019, Islamic finance comprised some 32% of the overall system's loan.[9] In the area of capital market, Malaysia continues to be the main driver for the *sukuk* market and represented 49.7% of the total global outstanding *sukuk* which stood at US$466.8bn, as at the end of 1H2019.[10] The nation's *sukuk* market is largely driven by corporates and government-related entities at 66.8% and has been a viable funding tool for various mega infrastructure projects.[11] By numbers of funds, Malaysia ranked first (28.3%) with 430 of the total global number of funds, followed by Saudi Arabia (203), Luxembourg (202), Pakistan (180) and Indonesia (174).[12]

4 Ranked as a leader among 56 countries for Islamic finance institutions,[13] Malaysia has successfully established a mature and robust Islamic regulatory framework and pioneered the dual banking system, wherein both Islamic and conventional financial systems operate and co-exist within a single regulatory framework. This has partly generated a vibrant business environment for financial institutions, intermediaries, investors, issuers and service providers alike.

II. Legislative and regulatory framework on Islamic finance

5 There are three major categories under Islamic finance, namely, Islamic banking, Islamic capital market and *takaful* (Islamic insurance). Each of these businesses is regulated by a separate written law.

8 Cambridge Institute of Islamic Finance, "Global Islamic Finance Industry Recorded a 6.58% Growth in 2018 to Register USD2.6 trillion in Global Assets", press release (21 October 2019) <https://www.cambridge-ifa.net/pressRelease.php> (accessed 26 October 2019).

9 RAM Holdings Bhd, "Islamic Banking Insight" (26 March 2019) https://www.ram.com.my/pressrelease/?prviewid=4929 (accessed 6 October 2019).

10 Malaysia International Islamic Finance Centre, "Global Sukuk & Islamic Funds Statistics 1H2019" *Epicentre – The MIFC Newsletter* (July 2019).

11 Ng Min Shen, "Malaysia Remains Lead in Islamic finance" *The Malaysian Reserve* (5 April 2018).

12 Malaysia International Islamic Finance Centre, "Global Sukuk & Islamic Funds Statistics 1H2019" *Epicentre – The MIFC Newsletter* (July 2019).

13 Shereen Mohamed, Abdulaziz Goni & Shaima Hasan, "Islamic Finance Development Report 2018" *Thomson Reuters* (2018).

A. Islamic banking and takaful

6 The first legislation enacted to facilitate the infrastructure and operations of Islamic banking in Malaysia was the Islamic Banking Act 1983[14] ("IBA 1983"). In compliance with the interest-free principle, an amendment was also made to the Government Investment Act 1983[15] to facilitate both statutory reserve and liquidity reserve requirements, which are to be interest-free. The Takaful Act 1984[16] ("TA 1984") was enacted to allow the licensing and operation of Islamic insurance or *takaful* companies in Malaysia. In 1996, s 124 of the Banking and Financial Institutions Act 1989[17] ("BAFIA 1989") was amended to allow conventional banks licensed under the Act to introduce Islamic banking business.

7 In 2003, the IBA 1983 was amended by inserting s 13A which provided that an Islamic bank may seek the advice of the Shariah Advisory Council ("SAC") of the Central Bank of Malaysia ("BNM") on Shariah matters relating to its banking business and that the Islamic bank shall comply with the advice of the SAC. The inclusion of s 13A enables the Islamic banks to seek the advice of the SAC and it is mandatory for the Islamic banks to comply with the advice given by the SAC pursuant to such request.

8 Another important piece of legislation in Islamic finance was the Central Bank of Malaysia Act 1958[18] ("CBMA 1958"). In 2003, an amendment to the then CBMA 1958 was made and through s 16B(1), the SAC was established under the aegis of BNM. The SAC functions as a body that ascertains the matters relating to Islamic banking business, *takaful*, Islamic finance business, Islamic development finance business or any other business based on Shariah principles.[19]

9 In 2009, Parliament passed a new Central Bank of Malaysia Act 2009[20] ("CBMA 2009"). The new CBMA 2009 deals in detail with the establishment and roles of the SAC and fills the lacunae in the previous CBMA 1958 where only one section dealt with the SAC. Section 52 of the CBMA 2009 outlines the functions of the SAC when reference to it is made by bodies other than the bank, including the court and arbitrators. The new ss 56 and 57 of the CBMA 2009 substitute the word "may" with

14 Act 76.
15 Act 275.
16 Act 312.
17 Act 372.
18 Act 519.
19 Central Bank of Malaysia Act 1958 (Act 519) s 16B(1).
20 Act 701.

the word "shall" which makes it compulsory for the court or arbitrator to refer to the decision of the SAC as expert evidence in court under s 45 of the Evidence Act 1950.[21] Section 57 of the CBMA 2009 expressly provides that any ruling made by the SAC pursuant to a reference by the court or arbitrator shall be binding.

10 Further development in the legal framework of Malaysia's Islamic financial system is seen in the enforcement of the Islamic Financial Services Act 2013[22] ("IFSA 2013"). This legislation replaced the IBA 1983, the TA 1984 and the BAFIA 1989. In concert with the needs of the industry, this law provides BNM with the necessary regulatory and supervisory powers to fulfil its broad mandate within a more complex and interconnected environment, given the regional and international nature of financial developments. The law is expected to place Malaysia's financial sector on a platform for advancing forward as a sound, responsible and progressive financial system. In describing the whole idea of the IFSA 2013, Datuk Nor Shamsiah Mohd Yunus, (the then) deputy governor of BNM,[23] who was instrumental in the development of the IFSA 2013, summarised the key features of this Act as follows:[24]

> The emphasis on governance framework for an end-to-end *Shariah* compliance for Islamic financial institutions under IFSA 2013 is a key additional dimension of the regulatory framework for Islamic finance and substantially increases the level of transparency required. In particular, IFSA provides a comprehensive legal framework that is fully consistent with *Shariah* in all aspects of regulation and supervision, from licensing to the winding up of Islamic financial institutions. More importantly, IFSA provides the statutory foundation for a *Shariah* contracts-based regulatory framework in a manner that would facilitate the next level of Islamic banking business, transcending beyond financial intermediation to include real economic sector participation, complete with the consequent regulatory checks and balance. Such a distinctive regulatory approach seeks to realise further the value proposition of Islamic finance, as the industry advances towards a new level of maturity and sophistication.

11 As the primary source of legislation governing the licensing and operation of Islamic and international Islamic banking businesses conducted by financial institutions, the IFSA 2013, together with the guidelines and circulars issued by BNM,[25] contains extensive provisions

21 Act 56.

22 Act 759.

23 Note that Datuk Nor Shamsiah Mohd Yunus is now the governor of the Central Bank of Malaysia.

24 Malaysia International Islamic Finance Centre, "Malaysia Islamic Finance Marketplace Gains Clarity and Certainty through Islamic Financial Services Act 2013" *Epicentre – The MIFC Newsletter* (October 2013).

25 Central Bank of Malaysia Act 1958 (Act 519) s 59.

on end-to-end Shariah compliance, governance and enforcement, which include the following basic premises:

(a) establishing BNM as the Shariah regulator over the financial sector;

(b) providing the legal basis for the rulings of BNM's Shariah Advisory Council ("BNM SAC");

(c) prohibiting financial institutions that conduct Islamic and international Islamic banking businesses from carrying out non-Shariah-compliant activities; and

(d) empowering BNM to direct and penalise financial institutions for breaches of the IFSA 2013 and offences committed thereunder.[26]

12 Under the IFSA 2013, BNM was conferred regulatory and supervisory powers and was also empowered to issue guidelines and circulars on Shariah requirements to promote financial stability and ensure Shariah compliance. Following therefrom, the IFSA 2013 provides that the operations, structure, and the terms and conditions of Islamic financial products and services provided by financial institutions must be Shariah-compliant. Any entity that conducts Islamic banking business or international Islamic banking business must possess the licences granted by the Minister of Finance ("the Minister") on the recommendation of BNM.

13 Various measures have been taken by the authorities to strengthen consumer protection, including:

(a) the issuance of the revised BNM Rules on Prohibited Business Conduct in 2016[27] to supplement the prohibitions on financial institutions from engaging in conduct deemed to be inherently unfair to consumers under Schedule 7 to the IFSA 2013;

(b) the establishment of the Financial Ombudsman Scheme under the Islamic Financial Services (Financial Ombudsman Scheme) Regulations 2015; and

(c) the setting up of the Malaysia Deposit Insurance Corporation ("MDIC") pursuant to the Malaysia Deposit

26 Islamic Financial Services Act 2013 (Act 759) s 28(3).

27 Issued pursuant to ss 135(3) as well as 136(2) of the Islamic Financial Services Act 2013 (Act 759), superseding the previous Central Bank of Malaysia Rules on Prohibited Business Conduct issued in 2014.

Insurance Corporation Act 2011[28] ("MDICA 2011"), under which the MDIC insures consumers against the loss of their deposits (including Islamic deposits) in financial institutions in Malaysia for up to RM250,000 per depositor per financial institution in the event of loss caused by failure of a financial institution holding such deposits.

14 As for the *takaful* business, it is provided under the IFSA 2013 that any company that is in the *takaful* business or international *takaful* business must hold a valid licence granted by the Minister on the recommendation of BNM. *Takaful* operators must also comply with the relevant BNM guidelines on *takaful*[29] and have in place an effective *retakaful* management strategy that is appropriate to the overall risk profile of the *takaful* business, and ensure that risks are ceded to *takaful* or *retakaful* operators.[30] In addition, *takaful* operators shall not accept inwards reinsurance from insurance or reinsurance companies except where the risk is Shariah-compliant and the arrangement is based on Shariah-compliant *retakaful* contracts.[31]

15 In June 2019, BNM issued a new policy document[32] following a review of the former guidelines to further clarify for the *takaful* industry the application of Shariah contracts that complement the Shariah standards and operational requirements issued by BNM. The new policy shall come into effect on 1 July 2020. It provides additional guidance related to the specifics of the *takaful* business. This document also seeks to strengthen *takaful* fund management practices to ensure their sustainability, and prudent management. Collectively, these guidelines seek to spur greater innovation in the *takaful* industry while further safeguarding the position of *takaful* participants.[33]

B. Islamic capital market

16 Unlike Islamic banking and *takaful* matters which are under the purview of BNM, the Islamic capital market is under the purview of the Securities Commission Malaysia ("SC"). The Capital Markets

28 Act 720.
29 Capital Markets and Services Act 2007 (Act 671) s 10.
30 Central Bank of Malaysia, *Guidelines on Takaful Operational Framework* (BNM/RH/GL 004-22) (issued on 26 June 2013) at para 10.09.
31 Central Bank of Malaysia, *Guidelines on Takaful Operational Framework* (BNM/RH/GL 004-22) (issued on 26 June 2013) at para 10.11.
32 Takaful Operational Framework (BNM/RH/PD033-7) (issued on 26 June 2019).
33 Central Bank of Malaysia, *Guidelines on Takaful Framework (Exposure Draft)* (issued on 18 May 2018).

and Services Act 2007[34] ("CMSA 2007") constitutes a single framework regulating the licensing of both conventional and Islamic capital market services, market conduct and offering and issuances of securities, including unlisted Islamic securities or *sukuk*, with the exception of specific laws, regulations and guidelines that apply exclusively to the operation of the Islamic capital market. This marked a major milestone in the SC's continuous efforts to strengthen the capital market regulatory framework. In this regard, the CMSA 2007 provides, *inter alia*, as follows:

> (a) Islamic securities are securities for the purposes of securities laws;[35]
>
> (b) any proposal, scheme, transaction, arrangement, activity, product or matter relating to Islamic securities shall comply with the relevant requirements under securities laws and guidelines issued by the SC;[36] and
>
> (c) the Minister may, for the purposes of securities laws and on the recommendation of the SC, *inter alia*, prescribe any instrument or product or class of instruments or products to be:
>
> (i) Islamic securities;
>
> (ii) Islamic derivatives; or
>
> (iii) Islamic capital market products.[37]

17 The following features of the CMSA 2007 accord greater protection to investors in securities (including Islamic securities) in Malaysia:

> (a) the SC's power to take civil and administrative actions;[38]
>
> (b) the SC is allowed to recover three times the amount of losses through civil action for a wider range of market misconduct;[39]
>
> (c) the standards of trustees for debenture holders are enhanced;[40] and

34 Act 671. This Act repealed and consolidated the Malaysian Securities Industry Act 1983 (Act 280), Futures Industry Act 1993 (Act 499) and parts of the Securities Commission Malaysia Act 1993 (Act 498).
35 Capital Markets and Services Act 2007 (Act 671) s 316(B)(1).
36 Capital Markets and Services Act 2007 (Act 671) s 316(B)(2).
37 Capital Markets and Services Act 2007 (Act 671) s 5.
38 Capital Markets and Services Act 2007 (Act 671) s 200.
39 Capital Markets and Services Act 2007 (Act 671) ss 201(5)(a) and 201(6)(a).
40 Capital Markets and Services Act 2007 (Act 671) ss 260(1), 260(5), 378 and Schedule 9.

(d) investor protection is extended to clients of financial institutions.[41]

18 With the CMSA 2007, there are various guidelines and practice notes issued by the SC to regulate the Malaysian capital markets, including Islamic capital markets. For instance, in 2015, the SC introduced the *Guidelines on Unlisted Capital Market Products under the Lodge and Launch Framework* as part of its initiative to promote process efficiency, shorten time-to-market and provide certainty of product offering.

19 The SC too has its own SAC, established under s 31ZI of the Securities Commission Malaysia Act 1993[42] ("SCMA 1993"). Under this section, the SAC is the highest authority for the ascertainment of Islamic law for the purpose of Islamic capital market matters. Section 31ZJ spells out the function of the SAC of the SC. Sections 31ZN and 31ZO have the same wording as ss 56 and 57 of the CBMA 2009, providing room for the court or the arbitrator making reference to the SAC when there is a dispute regarding the Shariah aspect of any Islamic capital market case.

C. Collective investment schemes (funds)

20 The BNM *Guidelines on Investment in Shares, Interest-in-Shares and Collective Investment Schemes for Islamic Banks* ("BNM Guidelines") constitute the main guidelines governing all collective investment schemes ("CIS") offered by Islamic banks. The BNM Guidelines adopt a more principle-based regulatory approach to enable financial institutions to define the scope of their equity-related investments according to capacity and capability. Other than guidelines issued by BNM, the SC has also issued various guidelines governing CIS.

21 Generally, under the BNM Guidelines, there are two categories of investments that may be made by financial institutions:

(a) investment in shares or interest-in-shares of any corporation; or

(b) investment in CIS, which includes unit trusts.

22 In addition, the SC has issued various guidelines on the establishment of a variety of CIS that can be invested in by financial institutions.

41 Capital Markets and Services Act 2007 (Act 671) s 347.
42 Act 498.

D. Offshore transaction

23 All offshore transactions in the Federal Territory of Labuan are governed by a different set of laws and regulations. First and foremost, they are under the purview of the Labuan Financial Services Authority ("Labuan FSA"). This is provided in the Labuan Financial Services Authority Act 1996[43] ("LFSA 1996") whereby Labuan FSA has been entrusted to be the central regulatory, supervisory and enforcement authority of the international business and financial services industry in Labuan. All Islamic banking and finance matters are further governed by the Labuan Islamic Financial Services and Securities Act 2010[44] ("LIFSSA 2010") which details out the regulations of for all offshore Islamic banking and finance products and services. Meanwhile, all transactions in Labuan are also governed by specific offshore transaction laws such as the Labuan Business Activity Tax Act 1990,[45] Labuan Companies Act 1990,[46] Labuan Limited Partnerships and Limited Liability Partnerships Act 2010,[47] Labuan Foundations Act 2010,[48] Labuan Trusts Act 1996[49] and many others.

24 The LIFSSA 2010 provides for the establishment of the Shariah Supervisory Council ("SSC"), and for the SSC to:

> (a) ascertain Islamic law for the purposes of any business regulated or supervised by the Labuan FSA and issue rulings; and
>
> (b) advise on any Shariah issue relating to any business regulated or supervised by the Labuan FSA.

25 The SSC, however, may only make rulings upon reference being made to it by licensed or regulated entities under the LIFSSA 2010 or as determined by the Labuan FSA. While the rulings of the SSC shall, upon issuance, be binding upon the Labuan FSA and the entity making the referral, the rulings shall not be binding on any other licensed entity, entity regulated under the LIFSSA 2010 or Shariah-compliant entity unless specified as such by the Labuan FSA.

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43 Act 545.
44 Act 705.
45 Act 445.
46 Act 441.
47 Act 707.
48 Act 706.
49 Act 554.

E. Other laws

26 It is pertinent to note that Islamic finance in Malaysia needs to ensure its validity by complying not only with the Shariah principles but also other relevant legislation such as the National Land Code 1965,[50] the Hire-Purchase Act 1967[51] and the Stamp Act 1949.[52] Additionally, the requirements of procedural laws need to be adhered to before any action can be taken in the civil court. This article, however, will not discuss on the application of these Acts.

F. Court of adjudication

27 The Federal Constitution of Malaysia has uniquely provided for two separate court systems running side by side, the civil court regime and the Shariah Court regime. The Shariah Court is the court of adjudication for any Muslim personal law related matters like marriage, divorce, *etc*.[53] The civil court is the court of adjudication for the remaining matters including all commercial and banking disputes.[54] Hence, when Islamic finance was implemented in Malaysia, one of the first questions to be ascertained was with regard to the court of adjudication, the civil court or the Shariah Court?

28 The State List of the Federal Constitution provides that the Shariah Court only has jurisdiction over Muslim personal matters and as such the Shariah Court is not competent to adjudicate any disputes arising out of Islamic finance. The Federal Constitution confers jurisdiction on the civil courts to decide all commercial and banking disputes. Islamic banking and finance is but a banking and financial practice within the same banking and financial landscape of the country. The only add-on in the case of Islamic banking and finance is the Shariah-compliance characteristic. Hence, all Islamic financial disputes have been adjudicated by the civil court since 1983.

29 After 20 years of Islamic finance in Malaysia, the Judiciary decided to establish an exclusive Muamalat Court effective 1 March 2003. This Muamalat Court is to deal with all Islamic finance related matters filed within the geographical area of Kuala Lumpur and within the monetary limit of the High Court. Those filed in other courts (for example, the

50 Act 56.
51 Act 212.
52 Act 378.
53 Item 1 of List II of the Ninth Schedule to the Federal Constitution (2010 Reprint).
54 Finance, including banking, is within the federal matters under item 7 of List I of the Ninth Schedule to the Federal Constitution (2010 Reprint).

Sessions Court) or in other High Courts (for example, in Johor Bahru) will be adjudicated by the respective courts as usual.[55]

III. Landmark cases in Islamic finance disputes[56]

30 The first case involving an Islamic finance dispute that reached the civil court three years after the first Islamic bank commenced its operations in Malaysia is the case of *Tinta Press Sdn Bhd v Bank Islam Malaysia Bhd*.[57] In this case, the plaintiff bank offered an Islamic leasing facility to the defendant. After servicing the monthly payments for a while, the defendant defaulted. By way of an *ex parte* application for an *ex parte* mandatory injunction, the plaintiff sought to recover the leased asset, *ie*, the printing equipment. The High Court granted the *ex parte* injunction. The defendant then contested and applied to set aside the *ex parte* injunction. The court refused to set aside the injunction. Dissatisfied with the decision, the defendant appealed to the Supreme Court which was the apex court of the land at that time. After considering all material facts, the Supreme Court ruled that the High Court judge was right in granting the injunction. Hence the appeal was dismissed.

31 It was held that, unlike conventional banking, Islamic banking and finance was based on the underlying Shariah contract(s) between the parties. To make it permissible, the facilities granted to the customers must have one or more underlying Shariah contracts between the bank and the customer. Even though the facility may still be a home financing facility to assist the customer acquire his dream house, there must be a Shariah contractual relationship between the bank and the customer.

32 In its initial years, Islamic banks in Malaysia adopted the Shariah contract BBA whereby the bank would first purchase the property from the customer. The bank would subsequently sell the same property back to the customer. The former was to enable the bank to acquire the ownership of the property and for the customer to obtain the principal/facility sum that he needed. The latter was to enable the bank to obtain the sale price (which consists of the principal sum and the profit) from the customer albeit by way of deferred payments mode (for example, via 300 monthly instalments). This (the contract when the bank sells the house back to the customer) is in fact the cause of action for the bank when the customer defaults in the payment of the instalments. Those two contracts of "buy

55 Practice Direction 1/2003.

56 For detailed reading, see Mohd Johan Lee, *Islamic Finance: Recovery, Rescheduling & Restructuring of Islamic Financial and Capital Market Products and Services in Malaysia* (Malaysia: LexisNexis, 2nd Ed, 2019).

57 [1987] 2 MLJ 192.

and sell back" were executed to comply with the Shariah requirement for Islamic banking.

33 The question that arises is what happens if the buy and sell transaction is not permissible under the existing law? This was the question posed to the court in the case of *Dato' Haji Nik Mahmud bin Daud v Bank Islam Malaysia Bhd*.[58] In this case, the plaintiff obtained an Islamic financing facility structured using the BBA concept. Under the BBA practice, the plaintiff sold 25 lots of land ("the Properties") to the defendant bank for RM520,000. Subsequently, the defendant bank sold the Properties back to the plaintiff for RM629,200 which was to be paid by way of monthly instalments. Ten years after the execution of the buy and sell contracts, the plaintiff applied for an order from the court that all the transactions perfected were null and void. The plaintiff contended that as the Properties were Malay Reserved Land, the buy and sell transactions were in contravention of the Kelantan Malay Reservations Enactment 1938. The defendant had never been gazetted as a Malay holding to be eligible to be a Malay Reserved Land owner. However, the defendant bank had been gazetted as a qualified Malay Reserved Land chargee. Thus, the plaintiff argued that the transaction where the defendant purchased the land from the plaintiff in itself was illegal. The subsequent sale by the defendant to the plaintiff was therefore illegal as well.

34 The High Court held that it was never the intention of the parties to involve any transfer of proprietorship. The execution of the property purchase agreement and the property sale agreement was the process required by the Shariah law before the party could avail itself of the financial facilities provided by the defendant. The prerequisite was well understood by the plaintiff. Thus, the execution of the property purchase agreement and the property sale agreement had not transgressed the provisions of ss 7 and 12 of the Enactment since there was no dealing or attempt to deal in the said lands contrary to the provisions thereof. On appeal, this decision was upheld by the Court of Appeal.

A. Ibra' *(waiver) in recovery cases*

35 Many Islamic financing facilities were structured using sale contracts as their underlying Shariah contracts. Such practice involves the calculation and fixing of the total profit chargeable by the financier throughout the tenure and hence provides certainty to the customer. Thus, at the time of the contract formation, the parties have already agreed on the total amount of the sale price (which consists of the principal sum and

58 [1998] 3 CLJ 605; [1998] 3 MLJ 393.

the profit of the bank). If the payment period is 30 years, the sale price will be calculated based on 30 years' profit of the bank. However, there will be a situation when the customer would settle the facility earlier than the agreed 30-year period. In such situation, the Shariah law provides for a mechanism called *ibra*' (waiver) to discount the unearned profit of the remaining tenure from the agreed sale price. This is an incentive for the customer to settle the facility earlier than the originally agreed tenure.

36 However, while the provision of *ibra*' is definite with regard to early settlement, the mechanism for the provision of the same in cases of default was not clear initially. In fact, many were of the view that *ibra*' must not be given in cases of default. Otherwise, it would be seen as an incentive for the customers to default. With the lack of clear policy from the regulator, the courts devised an innovative approach in resolving this issue. In 2005, the then Muamalat judge took the bold move of calculating and fixing *Ibra*' at the time the judgment was granted by the court. The judgment sum would be granted using the formula of an outstanding sale price minus *ibra*' fixed by the court. This was the judgment of the Muamalat Court in the case of *Affin Bank Bhd v Zulkifli bin Abdullah*.[59]

37 For a while, this became the practice of all the courts. However, the recovery of the judgment sum may not be realised instantly after the judgment.[60] Hence, the crystallisation of *ibra*' at the time of judgment would not be suitable. In view of that, the Muamalat Court took a different approach in *Bank Islam Malaysia Bhd v Azhar bin Osman*.[61] In this case, Rohana Yusuf J (as her Ladyship then was) decided to allow the plaintiff's claim for an outstanding sum of RM391,634.66 for the first suit and RM190,476.54 for the second suit. However, in view of the facility that was yet to expire, her Ladyship further held that the judgment sums were subject to deduction of the unearned profit by the plaintiff (if any) upon full realisation.[62] As for the originating summons for the order for sale, her Ladyship adjourned the matter to a new hearing date pending the bank filing a supplemental affidavit to state the outstanding sum, after deducting the unearned profit as of the date of the order for sale.[63] This is indeed the most sensible and befitting solution and decision with regard to *ibra*' in recovery cases. Hence, not surprisingly, when proper

59 [2006] 3 MLJ 67.

60 In fact, in some cases, the judgment debtor would take more than ten years to settle the judgment sum. Some may never pay any part of it due to subsequent insolvency action.

61 [2010] 9 MLJ 192.

62 *Bank Islam Malaysia Bhd v Azhar bin Osman* [2010] 9 MLJ 192 at [33].

63 *Bank Islam Malaysia Bhd v Azhar bin Osman* [2010] 9 MLJ 192 at [34].

guidelines were issued by BNM a year later,[64] this approach by Rohana Yusuf J was incorporated into the guidelines.

38 The court had earlier in the case of *Bank Kerjasama Rakyat Malaysia Bhd v PSC Naval Dockyard Sdn Bhd*[65] clarified the confusion with regard to the provision of *Ibra*' in the event that the facility had already expired at the time of settlement. In this case, Rohana Yusof J held that if the facility had expired before the settlement, then, *ibra*' need not be calculated. This is because *ibra*' is only granted if the facility is settled before the maturity. *Ibra*' is no longer relevant if the facility has already expired.

39 In this case, a *bai' al 'inah* facility was granted. The total sale price was RM23,437,500 which was to be paid back in 60 instalments, namely, 59 instalments of RM140,625 each and the final instalment of RM15,140,625. When the customer defaulted, the bank commenced legal action to recover the sum of RM15,418,147.41 which was the outstanding sale price. During the initial summary judgment hearing, the bank lost its case. The defendant alleged that the amount claimed was excessive and exorbitant because no *ibra*' was given. On appeal, her Ladyship held that there was no need to calculate *ibra*' because the facility in this case had already expired on the day the judgment was entered. The court held further that:[66]

> In the present case, the amount claimed by the Plaintiff has already reached its maturity and therefore no issue of unearned profit could arise. Consequently, the argument that the Plaintiff had based its claim on the full purchase price so as to obtain unearned profit would not hold water. It follows further that the contention that Islamic banking is more burdensome than conventional banking remains a mere speculation.

B. Late payment charges

40 One of the terms of the agreement upon the conclusion of a Shariah contract (*aqad*) is that the customer will pay the sale price punctually according to the mechanism agreed. However, in practice, there will always be customers who delay their payment to the bank. In a conventional system, bankers could charge a pricy default interest until full settlement. However, this would not be the case for Islamic banking recovery matters. This is because the parties have already agreed on the

64 Central Bank of Malaysia, *Guidelines on Ibra' for Sale-Based Financing* (BNM/RH/GL 012-5) (first released on 1 November 2011).

65 [2008] 1 CLJ 784.

66 *Bank Kerjasama Rakyat Malaysia Bhd v PSC Naval Dockyard Sdn Bhd* [2008] 1 CLJ 784 at [7].

sale price during the *aqad*. Hence, there should not be any additional payments other than the agreed sale price. Yet, any late payment by the customer would cause losses to the bank as well as its depositors.

41 For that, the SAC has deliberated and agreed that in the case of any late payment or default by customers, Islamic banks can charge two different charges as late payment charges which are *ta'widh* (compensation) and *gharamah* (penalty). In the former, BNM has set the 1% rule during the tenure. This means that the *ta'widh* payable should not be more than 1% per annum on a daily rest basis over the arrears. It must be non-compounding. However, in the event that there is a default in payment after the maturity of the tenure, the rate applicable should not be more than the prevailing rate of the International Islamic Monetary Market ("IIMM"). This is the reference rate prescribed by BNM which must be observed by the IFIs.[67] Since it is a form of compensation, all money collected by the bank under *ta'widh* is the bank's money without any need to channel it to any third party. It is to compensate the bank for all the losses suffered due to the late payment by the customer.

42 Notwithstanding the clear ruling by the SAC and the guidelines by BNM, parties at the initial stage of implementation seemed to be confused about how much *ta'widh* they could claim. The court endorsed the guidelines of BNM on this in *Kuwait Finance House (M) Bhd lwn Teknogaya Diversified Sdn Bhd*[68] and clarified the confusion. In this case, in addition to claiming the amount in arrears, the plaintiff also claimed *ta'widh* at the prevailing IIMM rate until full settlement. After examining the clauses in the facility agreements, in particular cl 22, Mohd Zawawi Salleh J (as his Lordship then was) held that the rates chargeable for the *ta'widh* are:

(a) the 1% rate before the expiry/maturity of the facility; and

(b) the IIMM rate after the expiry of the facility.

43 In the instant case, the facility had yet to expire at the time of the judgment. Hence, his Lordship held that the bank could not claim the IIMM rate as the *ta'widh* rate. The bank only has the right to claim the IIMM rate upon expiry/maturity of the facility.[69]

67 Central Bank of Malaysia, *Guidelines on Late Payment Charges for Islamic Financial Institutions* (BNM/RH/ GL 012-6) (issued on 31 January 2013) at pp 5–6.

68 [2012] 9 MLJ 433.

69 *Finance House (M) Bhd lwn Teknogaya Diversified Sdn Bhd* [2012] 9 MLJ 433 at [20] and [23].

44 There were also some views that the practice of fixing the *ta'widh* rate in the agreement was against the Shariah law. This was due to the fact that the original Shariah ruling is that *ta'widh* should be subject to proof of actual losses. This was the thrust of the argument put forward by the defendants in *Bank Islam Malaysia Bhd v Helcom Engineering Corp Sdn Bhd.*[70] Mohd Zawawi Salleh J, adopting the provision in s 56 of the CBMA 2009, made a specific reference to the SAC of BNM in order to ascertain the Shariah position on this.

45 The court posed a few questions to the SAC with regard to *ta'widh* in this specific reference. The SAC, thereupon, replied to inform the court that under the Shariah law, the parties cannot by their own agreement contract a specific rate of *ta'widh* without proving the actual loss of the bank due to the late payment by the customer. However, they may adopt a specific rate set by the regulator. BNM, being the regulator of the banking industry, has set this as up to 1% or up to the IIMM rate as the standard rate of *ta'widh* in such a situation. Hence, the SAC opined that it was permissible for the bank to charge *ta'widh* in this case. This has clarified the issue and position of collecting *ta'widh* at a rate of up to 1% during tenure and up to the IIMM rate upon maturity under Shariah law.

46 However, the situation would be different if in the contract between the parties, the imposition of *ta'widh* is not mentioned. This was what happened in the case of *MK Associates Sdn Bhd v Bank Islam Malaysia Bhd.*[71] In this case, the main issues raised by the plaintiff were with regard to the rights of the defendant bank to charge *ta'widh* of RM10,384,262.88 against the plaintiff. One of the arguments raised by the plaintiff was that the *ta'widh* was introduced subsequent to the grant of the BBA facility and the execution of the agreements. This is because at the time the agreements were executed, the resolution pertaining to *ta'widh* had not been made by the SAC; thus, the bank was not entitled to charge *ta'widh*.

47 The main issue in this case was whether an IFI can impose *ta'widh* when the contract was silent on it and/or when at the time the parties negotiated and/or entered into the contract, the concept of *ta'widh* had not been introduced into the Islamic financial system of the country. Also, the plaintiff questioned if an IFI can impose *ta'widh* and have it backdated for almost 12 years preceding its introduction.

48 After considering the views of Shariah experts of both parties, the court held that the bank was not entitled in law to charge *ta'widh*

70 [2011] 1 LNS 1862.
71 [2015] MLJU 1954.

against the plaintiff. Asmabi Mohamad J (as her Ladyship then was) acknowledged that her decision was heavily reliant on the views given by the plaintiff's expert who, among others, argued that mutual consent is required in terms of the agreement and further consent is required for the lawful appropriation of property. Thus, her Ladyship was of the view that the bank ought to have informed the customer so that the customer was aware of the imposition of *ta'widh* and that consent might be given freely by the customer on such.

(1) Late payment charge on judgment sum

49 It is relevant to note in respect of late payment charges that it is not uncommon that judgment debtors would not usually settle the judgment sum immediately after the judgment has been entered against them. In this regard, the civil court judges are given wide powers to award interest on the judgment sum between the date when the customer defaulted and the date of the judgment.[72] To discourage the delay in payment, the Rules of Court 2012[73] ("ROC 2012") has also provided a proviso that "every judgment debt shall carry interest at such rate as the Chief Justice may from time to time determine … from the date of judgment until the judgment is satisfied".[74] Currently, the judgment interest is fixed at 5% per annum.[75]

50 Previously, there used to be confusion among practitioners as to whether an Islamic bank may collect this judgment debt "interest". To avoid any non-Shariah compliant issue, most chose not to collect it. Later, the ROC 2012 was amended to insert an additional rule exclusively for judgment debts arising out of Islamic banking transactions which has clarified the matter. Order 42 r 12A provides:

> **Late payment charge on judgment debts arising from financial transactions in accordance with Shariah (O 42, r 12A)**
>
> 12A (1) Every judgment debt arising from financial transactions in accordance with Shariah shall carry a late payment charge calculated from the date of judgment until the judgment debt is fully satisfied at the rate provided under Order 42, rule 12 and subject to the following conditions:
>
> (a) the judgment creditor shall only be entitled to *ta'widh* as a result of late payment;

72 Civil Law Act 1956 (Act 67) s 11.
73 PU (A) 205 of 2012.
74 Rules of Court 2012 (PU (A) 205 of 2012) O 42 r 12.
75 This is as set *vide* Practice Direction No 1/2012 issued by the Chief Justice. It was previously 8% per annum.

> (b) the amount of late payment charge shall not exceed the outstanding principal amount; and
>
> (c) if the amount of *ta'widh* is less than the amount of late payment charge, the balance shall be channelled to any charitable organizations as determined by the Shariah Advisory Council.

51 Unfortunately, defendants, upon default and upon such recovery action against them, tend to argue that any attempt by Islamic banks in collecting such late payment charges is *haram* (illegal) or not Shariah compliant and must be stopped. The Malaysian judiciary has on numerous occasions held that such an allegation is nothing but a sham defence. For example, in *Bank Pertanian Malaysia Bhd v United Trade Arena (M) Sdn Bhd*,[76] the court held that any allegation that such collection is tantamount to *riba*' was misconceived.

C. Reference to the Shariah Advisory Council

52 Being adjudicated in the civil court and not the Shariah Court, Islamic banking and finance matters in Malaysia are bound procedurally by the ROC 2012. However, that does not mean that the Shariah compliance framework can in any way be compromised. In fact, this Shariah compliance requirement is now even more crucial because bankers must ensure compliance under the IFSA 2013. For that reason, there are some unique requirements under the Shariah compliance framework which are applicable to the Islamic banking recovery process and procedures. These requirements will not in any way work against the existing legal system or laws. Rather, they work hand-in-hand with the existing legal infrastructure to ensure that the entire recovery process and procedure will not only be in accordance with the laws, enforceable by the civil courts, but also be Shariah compliant. In this regard, ss 56 and 57 of the CBMA 2009 and ss 31ZN and 31ZO of the SCMA 1993 have provided for the SAC of the BNM and of the SAC of the SC, respectively, to be the ultimate determiner on all Shariah issues relating to Islamic finance.

53 In the initial years, the validity of such provisions in ss 56 and 57 of the CBMA 2009 and ss 31ZN and 31ZO of the SCMA 1993 was questioned. It was argued that these provisions took away the powers of a presiding judge. However, the dust has now settled through numerous cases decided by the Malaysian judiciary. The court held that ss 56 and 57

76 [2015] 1 LNS 610.

are valid and constitutional as reasoned by Low Hop Bing JCA in *Tan Sri Abdul Khalid Ibrahim v Bank Islam (M) Bhd*:[77]

> 24 … the statutory duty and function of the SAC is to ascertain Islamic financial matters or business only. It does not hear evidence nor decide cases. …
>
> 25 Sections 56 and 57 contain clear and unambiguous provisions to the effect that whenever there is any Shariah question arising in any proceedings relating to Islamic financial business before eg any court, it is mandatory for the court to invoke s 56 and refer it to the SAC, a statutory expert, for an answer on the Shariah issue on dispute. The duty of the SAC is confined exclusively to the ascertainment of the Islamic Law on financial matters or business. The judicial function is still within the domain of the court ie to decide on the issues which the parties have pleaded. The fact that the court is bound by the answer given by the SAC under s 57 does not detract from the judicial functions and duties of the court in providing a resolution to the dispute(s) which the parties have submitted to the jurisdiction of the court. In applying the SAC ruling to the particular facts of the case before the court, the judicial functions of the court to hear and determine a dispute remain inviolate. The SAC, like any other expert, does not perform any judicial function in the determination of the ultimate outcome of the litigation before the court, and so cannot be said to usurp the judicial functions of the court.

54 The ruling issued by the SAC is an expert opinion in respect of Islamic banking and finance to:[78]

> … ascertain speedily Islamic law on financial matters which can command the confidence of all concerned in the sanctity, reliability, quality and consistency in the interpretation and applications of Shariah principles for Islamic finance transactions before the court.

55 A good illustration of how ss 56 and 57 apply in a typical Islamic banking recovery matter is the case of *Bank Islam Malaysia Bhd v Helcom Engineering Corp Sdn Bhd*. In this case, the parties had agreed to restructure the outstanding sum under a few previous facilities into a Cash Note-i Facility. The defendants failed to service the payment of the Cash Note-i Facility on a regular basis. After the defendants failed to respond to the letter of demand issued by the plaintiff's solicitor, the plaintiff brought a civil action against the defendants. In the summary judgment application, the defendants alleged, *inter alia*, that the predetermined *ta'widh* was actually interest imposed by the bank.[79]

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77 [2013] 3 MLJ 269 at [24]–[25].

78 *Mohd Alias bin Ibrahim v RHB Bank Bhd* [2011] 3 MLJ 26 at [105], *per* Zawawi Salleh J (as his Lordship then was).

79 *Bank Islam Malaysia Bhd v Helcom Engineering Corp Sdn Bhd* [2011] 1 LNS 1862 at [33].

56 The Muamalat Court noted that the SAC had resolved the issue earlier in its published rulings that *ta'widh,* as a result of the default on the part of the customers, could be claimed by the bank.[80] However, with regard to the question whether *ta'widh* can be predetermined by the parties in the agreements without proving the damage suffered by the bank, there was no published ruling by the SAC on this point. Hence, upon application by the defendants, Mohd Zawawi Salleh J formulated a Shariah issue and referred it to the SAC. The question put to the SAC was "whether the *Ta'widh* rate can be fixed/pre-determined by the parties in a contract without the proof of actual loss suffered by the Bank?"[81]

57 The SAC replied speedily (11 days later), and stated, *inter alia*, that:[82]

> (1) The parties to a contract cannot predetermine the *Ta'widh* rate adopting their own calculation.
>
> (2) However, the contracting parties may agree on a *Ta'widh* rate fixed by the authority. The authority in the banking industry is Bank Negara Malaysia ('BNM').

58 Relying on this specific answer given by the SAC, the court thus decided that the claim for *ta'widh* by the plaintiff in this case was lawful.[83]

59 In *Low Chin Meng v CIMB Islamic Bank Bhd*,[84] the court took the initiative to refer four questions to the SAC for its specific rulings. Briefly, the court sought the advice of the SAC on the validity of an asset used repeatedly through *hibah* (gift) and asset purchase and sale agreement, and whether such gift could be returned to the original owner also by way of *hibah* and subsequently used as a security in order to secure the repayment of the facility four times the original value of the asset.[85]

60 The SAC answered all the questions posed in the affirmative. In its specific rulings, the SAC opined and reasoned that the asset could be used repeatedly. Once the preconditions were fulfilled, the transfer between the vendor and the purchaser to the sale was valid. The operation of the *hibah* prior to the sale, although involving the asset of a third party,

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80 *Bank Islam Malaysia Bhd v Helcom Engineering Corp Sdn Bhd* [2011] 1 LNS 1862 at [41].

81 *Bank Islam Malaysia Bhd v Helcom Engineering Corp Sdn Bhd* [2011] 1 LNS 1862 at [42].

82 *Bank Islam Malaysia Bhd v Helcom Engineering Corp Sdn Bhd* [2011] 1 LNS 1862 at [43].

83 *Bank Islam Malaysia Bhd v Helcom Engineering Corp Sdn Bhd* [2011] 1 LNS 1862 at [44].

84 [2015] 5 CLJ 324.

85 *Low Chin Meng v CIMB Islamic Bank Bhd* [2015] 5 CLJ 324 at [32].

was also valid. The subsequent charge of the asset as a guarantee for the indebtedness was equally valid.[86]

61 In this case, the High Court judge deliberated on the rulings of the SAC at length before arriving at the decision accordingly.[87] The finding of the judge was later upheld by the Court of Appeal. It is interesting to note that in this case, the Court of Appeal acknowledged and affirmed the position of the SAC when it said that it had "referred the matter to the council for its ruling in compliance with section 56(1) which makes it mandatory for the court to do so when any question arises concerning a Shariah matter".[88] In fact, the appellate court even added that, by virtue of s 57 of the CBMA 2009, the ruling made by the SAC pursuant to the reference made by the judge under s 56 is binding on the court.[89]

62 The biggest challenge on the constitutionality of ss 56 and 57 of the CBMA 2009 was in the recent Federal Court case of *JRI Resources Sdn Bhd v Kuwait Finance House (Malaysia) Bhd*.[90]

63 In this case, Kuwait Finance House (the plaintiff) had granted various Islamic facilities to JRI Resources Sdn Bhd (the first defendant), including an *ijarah* facility. The *ijarah* facility involved the leasing of shipping vessels by the plaintiff to the first defendant. The *ijarah* facility was guaranteed by the second, third and fourth defendants. The first defendant later defaulted and failed to make payments of the sums outstanding under the *ijarah* facility. Over the course of the suit in early 2014, the plaintiff proceeded with the summary judgment against the defendants.

64 On 3 October 2014, the High Court granted summary judgment against the defendants for the outstanding amount of RM118,261,126.26. Subsequently, the first defendant appealed to the Court of Appeal against the summary judgment. At the hearing of the appeal, the first defendant submitted, *inter alia*, that its failure to derive income from the charter proceeds (from leasing of the vessels) was due to the failure of the respondent to carry out major maintenance works on the vessels. The appellant alleged that the carrying out of the major maintenance works

86 *Low Chin Meng v CIMB Islamic Bank Bhd* [2015] 5 CLJ 324 at [33].
87 *Low Chin Meng v CIMB Islamic Bank Bhd* [2015] 5 CLJ 324 at [34].
88 *Low Chin Meng v CIMB Islamic Bank Bhd* [2015] 5 CLJ 324 at [32].
89 *Low Chin Meng v CIMB Islamic Bank Bhd* [2015] 5 CLJ 324 at [34].
90 [2019] 5 CLJ 569; [2019] 3 MLJ 561. It is noted that the Malayan Law Journal and the Current Law Journal ("CLJ") have different styles of organising the sequence of the judgments of the Federal Court judges. For ease of clarity, this article adopts the sequence of the case reports in the CLJ. Hence, all paragraphs stated below are in accordance with those of the CLJ.

on the vessels was the responsibility of the respondent, as owner of the vessels. It was also submitted that the learned High Court judge had erred in not referring the Shariah issues raised by the first defendant to the SAC. The Court of Appeal allowed the appeal and remitted the case to the High Court for a retrial and ordered that there should be a reference made to the SAC by the High Court on the question, namely:

> Whether clause 2.8 of the *Ijarah* agreements is *Shariah*-compliant (the issue).

65 The Shariah issue was then referred by the High Court to the SAC.[91] Both the appellant and the respondent actively participated in the process before the SAC. Both parties submitted their expert opinions to the SAC. The opinions were in conflict.[92] Upon such reference, the SAC provided its answer to the question posed by the court. The SAC took note that the SAC's duty is merely to analyse the Shariah issues that are contained in each question posed and to state the Shariah ruling relating to the question. The SAC does not have jurisdiction to make a finding of facts or to apply the ruling to the facts of the case and to make a decision because the jurisdiction is vested in the court. The SAC took the view that the owner and the lessee may negotiate and contractually agree as to who shall bear the costs of maintaining the leased assets. Hence, the SAC opined that cl 2.8 was indeed Shariah-compliant.[93]

66 Following the ruling of the SAC, the High Court scheduled a hearing date in August/September 2016 for the trial to proceed on the respondent's claim against the appellant. However, before the trial could proceed, the appellant/first defendant filed an application for a referral of a constitutional matter under Art 128 of the Federal Constitution[94] and s 84 of the Courts of Judicature Act 1964[95] to determine if ss 56 and 57 of the CBMA 2009 under which the SAC gave its ruling was constitutionally valid. The High Court, on 22 August 2016 dismissed such application. An appeal was then filed to the Court of Appeal against the said dismissal.

67 On 15 May 2017, the Court of Appeal allowed the first defendant's appeal and ordered that the High Court make a constitutional reference as sought. Accordingly, on 20 October 2017, the High Court made

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91 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [11]–[16].

92 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [17].

93 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [18].

94 2010 Reprint.

95 Act 91.

a constitutional reference to the Federal Court[96] to answer the following questions:[97]

> (1) Whether Sections 56 and 57 of the Central Bank of Malaysia Act 2009 are in in breach of the Federal Constitution and unconstitutional by reason of:
>
> (a) Contravening Article 74 of the Federal Constitution read together with the Ninth Schedule of the Federal Constitution for the SAC having been vested with the power to ascertain Islamic law;
>
> (b) Contravening Part IX of the Federal Constitution for the said sections having the effect of vesting judicial power in the SAC; or
>
> (c) Contravening Article 8 of Federal Constitution for the said sections having the effect of denying a litigant substantive due process.
>
> (2) If the above is answered in the negative:
>
> (a) Whether the Court is nonetheless entitled to accept or consider the expert evidence in respect of any questions concerning a Shariah matter relating to Islamic finance business.

68 This being a matter involving the Federal Constitution, by the initiative of the then Chief Justice of Malaysia, the matter was fixed for a hearing before an unprecedented nine-member bench. The bench comprised the Chief Justice, the President of the Court of Appeal, the Chief Judge of Malaya and the Chief Judge of Sabah and Sarawak, together with four other judges of the Federal Court, and one judge of the Court of Appeal.

69 When the case was fixed for hearing, the president of the Association of Islamic Banking Institutions of Malaysia and BNM were allowed to intervene in the proceeding.

70 In delivering the majority decision,[98] Mohd Zawawi Salleh FCJ observed that there was a necessity for a single authority to ascertain Islamic law for the purpose of Islamic financial business. The rapid increase in the number of players in Islamic banking and finance in the country over the years has given rise to increasing complexities of Islamic finance products and the corresponding increase in disputes must be

96 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [19]–[23].

97 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [2].

98 Ahmad Maarop PCA, Ramly Ali FCJ, Azahar Mohamed FCJ, Alizatul Khair Osman Khairudin FCJ and Mohd Zawawi Salleh FCJ. Note that in dissent were Richard Malanjum CJ, Zaharah Ibrahim CJM, David Wong Dak Wah CJSS and Idrus Harun JCA.

properly managed. An unsatisfactory feature of the resolution of the disputes before the civil courts previously was due to reliance on various differing sources of Islamic principles.[99] His Lordship also reasoned that it is an acknowledged fact that diversity of opinion among so-called experts in Islamic legal principles had led to uncertainty in the Islamic banking industry that affected the stability of the Islamic financial system to the detriment of the economy.[100] His Lordship then cited various reported cases illustrating the conflicting approaches taken by the courts in the past which led to uncertainty of Shariah interpretation and disruption to the well-functioning of the Islamic finance industry. Hence, the establishment of the SAC serves the particular need for an authoritative view on Shariah matters in Islamic finance.[101]

71 His Lordship also echoed and quoted[102] a passage in the judgment of Rohana Yusuf J in *Tan Sri Abdul Khalid bin Ibrahim v Bank Islam Malaysia Bhd*:[103]

> 18 To my mind there is good reason for having this body. A ruling made by a body given legislative authority will provide certainty, which is a much needed element to ensure business efficacy in a commercial transaction. Taking cognisance that there will always be differences in views and opinions on the Syariah, particularly in the area of muamalat, there will inevitably be varied opinions on the same subject. This is mainly due to the permissive nature of the religion of Islam in the area of muamalat. Such permissive nature is evidenced in the definition of Islamic Banking Business in section 2 of the Islamic Banking Act 1983 itself. Islamic Banking Business is defined to mean, banking business whose aims and operations do not involve any element which is prohibited by the Religion of Islam. It is amply clear that this definition is premised on the doctrine of 'what is not prohibited will be allowed'. It must be in contemplation of the differences in these views and opinions in the area of muamalat that the legislature deems it fit and necessary to designate the SAC to ascertain the acceptable Syariah position. In fact, it is well accepted that a legitimate and responsible Government under the doctrine of siasah as-Syariah is allowed to choose, which amongst the conflicting views is to be adopted as a policy, so long as they do not depart from Quran and Islamic Injunction, for the benefits of the public or the ummah. The designation of the SAC is indeed in line with that principle in Islam.

99 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [64].

100 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [65].

101 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [66]–[79].

102 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [80].

103 [2010] 4 CLJ 388; [2009] 6 MLJ 416 at [18].

72 The majority of the court then held that the ruling under s 57 of the CBMA 2009 does not conclude or settle the dispute between the parties arising from the Islamic financing facility at hand. It does not "determine" the liability of the borrower under the Islamic facility. The determination of a borrower's liability under any banking facility is decided by the presiding judge and not the SAC.[104]

73 The majority of the court also opined that the SAC does not have any characteristics of judicial power as laid down by the Federal Court in *Semenyih Jaya Sdn Bhd v Pentadbir Tanah Hulu Langat*.[105] The ruling made by the SAC is solely confined to the Shariah issue. The presiding judge who made reference to the SAC will then exercise his judicial power and decide the case based on the evidence presented before the court. Since there is no judicial power vested in the SAC, the SAC does not usurp the judicial power of the court.[106]

74 The majority of the court also accepted the contention advanced by the learned counsel for the first intervener that s 56(1) of the CBMA 2009 gives the option to the court or arbitrator whether to take into consideration the published ruling of the SAC or to refer the Shariah issue to the SAC for a ruling. The word "or" in that section signifies that such option is provided to the court or arbitrator. The phrase "take into consideration" in that section implies that only the court or arbitrator has the exclusive judicial power to decide on the case by applying the ruling of the SAC to the facts of the case before them.[107] The exercise of judicial power does not exist merely because there is an adjudication of an issue.[108]

75 As regards the allegation that the binding effect of the SAC's ruling precludes the court from deciding the law applicable in the case before it, Mohd Zawawi Salleh FCJ held that the SAC does not usurp the court's power to interpret and apply the law in the case before the court.[109] In support, his Lordship quoted[110] the ratio of the High Court of

104 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [84].
105 [2017] 3 MLJ 561; [2017] 4 AMR 123.
106 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [108].
107 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [109].
108 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [113].
109 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [114].
110 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [115].

Australia in *Rola Co (Australia) Pty Ltd v Commonwealth*[111] that the usage of the word "binding" did not involve an exercise of the judicial power of the Commonwealth. His Lordship then made a comparison to the mandatory sentencing regime under various penal laws where the court is required to impose a specific term of imprisonment. After analysing various decisions of the apex courts in Malaysia and in other jurisdictions as well as the Privy Council regarding this issue, the majority of the court agreed that such practice was not in any way unconstitutional nor would such provision be against the doctrine of separation of powers.[112] The majority of the court thus held:[113]

> … by parity of reasoning that Parliament is competent to vest the function of the ascertainment of Islamic law in respect of Islamic banking in the SAC and such ascertainment is binding on the court. It was likened to the legislative power in prescribing the minimum sentence to be imposed by the court on a convicted person(s). The function of the SAC is merely to ascertain the Islamic law for Islamic banking, and upon such ascertainment, it is for the court to apply the ascertained Islamic law for banking to the facts of the case. The ascertainment of Islamic Law for banking does not settle the dispute between the parties before the court. The SAC did not determine or pronounce authoritative decision as to the rights and/or liabilities of the parties before court. It did not convert the High Court into a mere rubber stamp.

76 His Lordship also observed that in fact, as stated in BNM's *Manual for References to Shariah Advisory Council by the Civil Court and Arbitrator*,[114] the SAC does not finally dispose of the dispute between the parties. It does not engage in the judicial process of determining the rights of the parties.[115] The same can be seen in the answer given by the SAC under s 57 to the court in the present case. In the opening paragraph of the ruling, it is clear that:[116]

> In answering to the question posed by the Court, the SAC took note that the SAC's duty is merely to analyse the Syariah's issues that are contained in each question posed and to state the Hukum Syarak ruling relating to the question. The SAC does not have jurisdiction to make a finding of facts or to apply the ruling to the facts of the case and to decide whether relating to an issue or for the case because this jurisdiction is vested with the Court.

111 (1944) 69 CLR 185.

112 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [117]–[127].

113 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [128].

114 Central Bank of Malaysia, *Manual for References to Shariah Advisory Council by the Civil Court and Arbitrator* at para 7.

115 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [131].

116 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [132].

77 Hence, the SAC has no jurisdiction to enter into the dispute between the parties by itself "applying the ruling to the facts of the case" and coming to a final decision on the dispute. The duty to ascertain Islamic law is conferred on the Legislature and the SAC is the Legislature's machinery to assist in resolving disputes in Islamic banking. It does not exercise judicial power at all.[117]

78 Besides, disputes in Islamic finance and banking matters are within the jurisdiction of the civil courts, notwithstanding that Shariah law is involved. This is due to the fact that Islamic banking and finance disputes do not and cannot fall within the jurisdiction of the Shariah Courts as finance and financial institutions are matters within List I (Federal List) and outside of List II (State List). Thus, Islamic banking matters lie within the jurisdiction of the civil courts, but the civil courts are not equipped to make findings on Islamic law. The majority of the court opined further that the civil courts are not sufficiently equipped to make findings on Islamic law.[118] This can be supported by the ratio of the courts in *Bank Islam Malaysia Bhd v Lim Kok Hoe*[119] and *Tan Sri Abdul Khalid bin Ibrahim v Bank Islam Malaysia Bhd*.[120]

79 His Lordship further stressed that:[121]

> 142 … the SAC has been harmonising the proliferation of Shariah opinions in the industry since its inception. It was already accustomed to the practical considerations at hand and the need for certainty in the industry on Islamic banking principles. Therefore, the binding nature of the ruling of the SAC is justified as section 56 of the 2009 Act was enacted on the reason of conserving and protecting the public interest.
>
> 143 … the rulings of the SAC are made through the exercise of collective *ijtihad*. The SAC comprises prominent scholars and Islamic finance experts, who are qualified individuals with vast experience and knowledge in various fields, especially in finance and Islamic law, to ensure robust and comprehensive deliberation before the issuance of the rulings.

117 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [133].
118 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [137]–[138].
119 [2009] 6 MLJ 839.
120 [2010] 4 CLJ 388; [2009] 6 MLJ 416 at [18].
121 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [142]–[143].

80 Further, only highly qualified experts would be appointed by the Yang di-Pertuan Agong, on the advice of the Minister after consultation with BNM, to be the members of the SAC.[122]

81 It was also decided by the majority of the court that ss 56 and 57 do not contravene Art 8 of the Federal Constitution, which deals with equality before the law and equal protection of the law. It does not apply to all persons in any circumstances but rather it applies "alike to all persons in the same group".[123]

82 The majority of the court also reasoned that the civil courts are not in a position to appreciate and determine the divergences of opinions among the experts and to decide based on Shariah principles.[124] If the parties are allowed to lead expert evidence, civil court judges would then have:[125]

> … to ascertain what the applicable Islamic law for the Islamic banking is, and to proceed to apply the ascertained law to the facts of the case. In ascertaining the law, competing parties to the dispute will submit before the courts their own views of what the law is. In such circumstances, the practical questions that need to be addressed are:
>
> (i) to what source would a judge refer to;
>
> (ii) which mazhab should he or she adopt if there are differing opinions among the experts; and
>
> (iii) would civil law or Shariah law be the applicable law.

83 Thus, the use of expert evidence by the parties would further complicate the decision-making process as the judge would have difficulties in choosing the correct expert opinion to rely on. It is only prudent to have a body of eminent jurists, properly qualified in Islamic jurisprudence and/or Islamic finance, to deal with questions concerning Shariah validity of a contract. The majority of the court then emphasised that in Malaysia that special body would be the SAC.[126]

122 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [144].

123 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [150]–[152].

124 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [154].

125 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [156].

126 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [142]–[143].

84 In addition, Azahar Mohamed FCJ discussed the doctrine of separation of powers in his judgment. His Lordship noted that the doctrine recognises that, where necessary, one branch of the Government should be allowed to exercise part of the powers of another branch and the delegation of power by one branch of the Government to another is allowed.[127] In the context of this case, item 4(k) of the Federal List, Ninth Schedule to the Federal Constitution, vests legislative competence in Parliament to enact laws aimed at ascertaining Islamic law and other personal laws for the purposes of the federal law. Therefore, the ascertainment of Islamic law for the purposes of the federal law has been assigned by the Federal Constitution to a specific branch of government, that is to say, the legislative branch. Under the Federal Constitution, ascertainment of Islamic law for the purposes of Islamic finance business falls under the legislative power and thus, his Lordship opined that, powers and discretion on such matters are neither inherent nor integral to the judicial function.[128] The Federal Constitution does not contain any express prohibition upon the exercise of legislative powers by the Executive or of judicial powers by either the Executive or the Legislature.[129] While there are certain matters where one branch of the Government should not exercise the functions of another, other matters may be capable of assignment by Parliament in its discretion to more than one branch of government or for that matter to any administrative body.[130] Since there is no prohibition for one branch of the Government to exercise the functions of another with regard to the matter in the present case, it is up to Parliament to decide how the ascertainment of Islamic law should be put into effect.[131]

85 By enacting several pieces of legislation to establish the SAC, Parliament recognised a need for the establishment of a single point of reference for the purposes of ascertainment of Islamic laws in relation to Islamic finance business. Parliament has in effect assigned or delegated its powers to the SAC to ascertain what the applicable Islamic law for the business is.[132] The establishment of the SAC under the CBMA 2009 indicates that, under the constitutional framework, Parliament has

127 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [142]–[143].

128 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [142]–[143].

129 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [142]–[143].

130 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [178].

131 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [178].

132 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [179].

assigned the role of the ascertainment of Islamic law in resolving Islamic finance disputes in the civil courts to both the SAC and the courts.[133]

86 Further, his Lordship reasoned that:[134]

> … under this constitutional arrangement, the courts are duty-bound to refer Shariah issues arising from Islamic banking and finance to the SAC, but more importantly they are legally obliged to adopt the SAC's ruling to the disputed matters. The key point to note here is that this should be looked at as a proper constitutional mechanism in order to assist the courts in applying the correct Islamic laws to resolve Islamic financial disputes and upholding Shariah compliance in such matters, as permitted by the Federal Constitution. Within the framework of the Federal Constitution, the SAC and the courts have to operate with some level of integration if our Islamic banking and Islamic financial services are to function well.

87 Azahar Mohamed FCJ thus concluded that ascertainment of Islamic laws for the purposes of Islamic finance business is a function or power delegated by the legislative branch to the judicial branch and the SAC. As such, ss 56 and 57 of the CBMA could not and did not trespass or intrude onto the judicial power; the provisions did not violate the doctrine of separation of powers. His Lordship also stressed that the principle of separation of powers did not apply to invalidate any legislative delegation of powers to the SAC and the courts to ascertain Islamic law for the purposes of resolving disputes on Islamic finance matters. He thus held that "[t]his is not stripping the Judiciary of its powers. Neither the Executive nor Legislature usurps or intrudes the sphere of judicial powers".[135]

88 The Federal Court by a majority determined in the negative for all the questions raised. Hence, ss 56 and 57 do not violate the doctrine of separation of powers. Nor do they violate Art 74, Pt IX or Art 8 of the Federal Constitution. It was also decided that the court is not entitled to accept or consider expert evidence in respect of any questions concerning a Shariah matter relating to Islamic finance business.

89 In his dissenting judgment, David Wong CJSS referred to the judgment of Zainun Ali FCJ (as her Ladyship then was) in *Semenyih Jaya Sdn Bhd v Pentadbir Tanah Hulu Langat* and the judgment of Richard Malanjum CJSS (as his Lordship then was) in the case of *Public Prosecutor v*

133 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [200].

134 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [200].

135 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [203].

Kok Wah Kuan[136] for support on the basic structure doctrine and opined that ss 56 and 57 of the CBMA 2009 ought to be struck down.[137] It was his Lordship's considered view that all three elements of adjudication, finality and enforceability were present in these provisions.[138] Therefore, His Lordship dissented and concluded that ss 56 and 57 had violated the doctrine of separation of powers in that the aforesaid sections had clothed the SAC, a non-judicial body under the Federal Constitution, with judicial power.[139]

90 Richard Malanjum CJ concurred with this. Further, in his dissenting judgment, his Lordship also set out his reasoning in the context of the Federal Constitution on issues involving the proper understanding and interpretation of these concepts, namely, separation of powers *vis-à-vis* judicial independence, rule of law and judicial power.[140] After a lengthy elaboration, his Lordship arrived at the conclusion that s 57 of the CBMA 2009 contravened Art 121 of the Federal Constitution, in so far as it provided that any ruling made by the SAC pursuant to a reference is binding on the High Court making the reference. The effect of the section was, in his view, to vest judicial power in the SAC to the exclusion of the High Court on Shariah matters. Thus, Richard Malanjum CJ opined that s 57 must be struck down as unconstitutional and void.[141]

91 It is interesting that his Lordship also made a suggestion to the industry to achieve the same legislative purpose through other methods that do not involve an infringement of judicial power. His Lordship proposed that the parties to an Islamic finance agreement can agree to submit any questions of Shariah questions to the SAC for determination in the event of a dispute, and to be bound by the determinations of the SAC.[142] The agreement may also include a form of "conclusive evidence clause", stating that the determination of the SAC is conclusive evidence of the position of Shariah position. In such a case, the court should give effect to the agreement between the parties, and would not be at liberty

136 [2007] 6 CLJ 341; [2008] 1 MLJ 1.
137 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [235]–[243].
138 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [250].
139 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [265].
140 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [268].
141 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [347].
142 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [345].

to go behind the determination to question its correctness in the absence of fraud, *mala fides* or manifest error.[143]

D. Enforceability of non-Shariah compliant contracts

92 The question always arises as to the enforceability of the financial facilities where the underlying contract(s) is/are not in compliance with the requirement of IFSA 2013 and/or BNM's standards. The answer to this will determine whether the bank can recover the outstanding amount due and owing when the customer defaults. In most cases, the defendants (namely the customers in default) will plead that the transaction or the documents are against the Shariah and thus are not enforceable. If this defence is rejected by the court, the recovery action will be allowed. The Malaysian judiciary has delivered a clear stand on this in *Maybank Islamic Bhd v M-10 Builders Sdn Bhd*,[144] *Bank Kerjasama Rakyat Malaysia Bhd v Emcee Corp Sdn Bhd*[145] and *Bank Islam Malaysia Bhd v Lim Kok Hoe.*

93 In *Maybank Islamic Bhd v M-10 Builders Sdn Bhd,* the appellant bank granted several Islamic banking facilities to the first respondent ("first facilities"), which included a *murabahah* overdraft facility ("MOD facility") for RM3m. At the conclusion of a full trial, the High Court dismissed the appellant's claim and held that the agreement relating to the MOD facility was unlawful for failure to comply with the requirement of Shariah law as required under the guidelines issued by BNM.[146] The finding of non-compliance with the Shariah principles was on the ground that the same assets had been used under the first facilities and the second facilities. The said assets, according to the judge, were already owned by the first respondent and Shariah law prohibited the same asset from being sold and resold.[147] The judge also dismissed the respondents' counterclaim.

94 In arriving at the decision, Asmabi Mohamad J (as her Ladyship then was) observed that:[148]

> … both the contracting parties ignored the features of financing premised on the Islamic Concept termed as *murabahah* and blatantly regarded the transaction as if it was a conventional loan. By their conduct, both parties were privy to the illegality and had camouflaged the MOD facility as *murabahah* and both had

143 *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd* [2019] 5 CLJ 569; [2019] 3 MLJ 561 at [346].
144 [2017] 2 MLJ 69.
145 [2003] 2 MLJ 408.
146 *Maybank Islamic Bhd v M-10 Builders Sdn Bhd* [2017] 2 MLJ 69 at [19].
147 *Maybank Islamic Bhd v M-10 Builders Sdn Bhd* [2017] 2 MLJ 69 at [20]–[21].
148 *Maybank Islamic Bhd v M-10 Builders Sdn Bhd* [2015] MLJU 2035 at [106].

> benefitted from this illegality. Obviously, this transaction had clearly violated the basic tenets of the financing premised on the Islamic Concept. Further as I had shown above the contract involving the MOD facility, which the parties termed as *murabahah* was contrary to the basic tenets of financing based on *murabahah* as there were no fresh ASA and APA having been executed. In view of this and as both parties were privy to the illegality as illustrated above, both parties had not come to this Court with clean hands. The Court therefore would not assist the parties who had come to Court to seek relief, if they had not come with clean hands.

95 The appellant appealed and the respondents cross-appealed to the Court of Appeal. Rohana Yusuf J examined the purported non-compliance and held that the nature of the transaction of the MOD facility was a *bai' al 'inah* agreement as defined by the SAC of BNM resolution; hence, the application of the guidelines stated by the learned judge of the High Court was misplaced. Her Ladyship noted that the guidelines were specifically for *murabahah* contracts and *murabahah* purchase ordered arrangements. It did not address the *bai' al 'inah* contract. The correct approach for this case was to examine the contract on the basis of *bai' al 'inah*.[149]

96 On that basis, even if the assets used for both the transactions were the same, the same assets could be sold and purchased pursuant to an Islamic facility multiple times without affecting Shariah compliance. A transaction under the first facilities was already completed when the parties executed the sale and purchase transaction making these same assets available to be transacted.[150]

97 Her Ladyship was also of the view that, in the alternative, the purported non-compliance with the *murabahah* principles did not render the contract illegal and unenforceable. The real issue confronting the court was whether a contract which did not comply with Shariah law on one hand, but was in compliance with the law of contract on the other hand, would be legally enforceable.[151]

98 On this issue, the majority of the court examined the issue of illegality by looking at s 24 of the Contracts Act 1950.[152] The court could not find any of the circumstances listed in s 24 as having been cited by the respondents to contend a case of illegality. Thus, the sole ground for

149 *Maybank Islamic Bhd v M-10 Builders Sdn Bhd* [2017] 2 MLJ 69 at [23].
150 *Maybank Islamic Bhd v M-10 Builders Sdn Bhd* [2017] 2 MLJ 69 at [24]–[26].
151 *Maybank Islamic Bhd v M-10 Builders Sdn Bhd* [2017] 2 MLJ 69 at [28].
152 No 136 of 1950.

holding the agreement for the MOD facility a nullity was purely a failure to comply with Shariah principles that govern the same.[153]

99 Citing two English cases on the enforceability of *murabahah* contracts,[154] the court adopted the *ratio* of these cases that notwithstanding any Shariah non-compliance or any express provision that the agreement must be interpreted subject to the Shariah law, the agreements in both of these cases should be governed by and construed in accordance with the laws of England. Her Ladyship was of the view that the validity of the contract in this case should be viewed from the law that generally governs such contracts between parties in this country. This approach would be consonant with what was stated in the case of *Bank Kerjasama Rakyat Malaysia Bhd v Emcee Corp Sdn Bhd*. Hence, the provisions of the Contracts Act 1950 still govern Islamic contracts. The MOD facility agreement was not one that could be avoided under s 24 of the Contracts Act 1950 nor an illegal contract under s 25 and therefore remained an enforceable agreement and must be adhered to.[155] The appeal by the appellant bank was thus allowed and the cross-appeal by the respondents was dismissed with costs.

E. Innovative approach taken by the Malaysian judiciary with regard to sukuk *(Islamic bond) cases*

100 In recent years, in view of the increasing popularity of Islamic bonds (*sukuk*), more disputes in relation to *sukuk* default have been filed in court. Malaysian courts have taken the opportunity to clarify and adjudicate the matter in a very pragmatic way.

101 This can be seen in *Malaysian Trustees Bhd v JMT International Sdn Bhd*.[156] In this case, the plaintiff was the trustee for the holders of the underwritten commercial papers of up to RM60m ("the ICPs") issued pursuant to the Shariah principles of *murabahah* by one M-Trex Corporation Sdn Bhd ("the Issuer"). As part of the security for the ICPs, the proprietor of the land ("the Land"), one Jooei Industry (M) Sdn Bhd ("the Chargor"), charged the Land in favour of the plaintiff. The Chargor's plant and machinery on the said Land were charged to the plaintiff pursuant to a debenture ("the Debenture").

153 *Maybank Islamic Bhd v M-10 Builders Sdn Bhd* [2017] 2 MLJ 69 at [29].
154 *Islamic Investment Co of the Gulf (Bahamas) Ltd v Symphony Gems NV* [2002] All ER (D) 171; *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd* [2004] 1 WLR 1784; [2004] 4 All ER 1072.
155 *Maybank Islamic Bhd v M-10 Builders Sdn Bhd* [2017] 2 MLJ 69 at [30].
156 [2013] MLJU 17.

102 Subsequently, the Issuer defaulted in payments to the ICP holders under the ICPs. The Issuer had since been wound up by the court. Later, the plaintiff issued a letter to the Issuer declaring an event of default and that the amounts owing under the ICPs had become immediately due and repayable.

103 The Chargor was placed under creditor's voluntary winding up. A provisional liquidator of the Chargor was appointed. On 16 December 2010, the Ipoh High Court granted an order for sale and possession of the Land in favour of the plaintiff. Pursuant to the terms of the order for sale and possession, the Chargor or its nominees, agents, representatives or successor-in-title was to deliver vacant possession of the Land and the buildings thereon to the plaintiff within 14 days from the date of the order for sale and possession.

104 Pursuant to the order for sale and possession, the plaintiff filed and obtained a writ of possession for the possession of the Land against the defendant who occupied the premises, claiming itself as the lawful tenant. On 3 June 2011, however, the defendant's representative refused to deliver vacant possession of the Land when the court bailiff and the plaintiff's solicitors and agents attended at the Land premises. The bailiff filed a police report on the same day. The defendant continued to occupy the Land.

105 After perusing the tenancy agreement disclosed by the defendant, Harmindar Singh Dhaliwal J (as his Lordship then was) of the Ipoh High Court observed that far from being a tenancy, the Chargor had only granted a licence to the defendant to operate the plant and machinery for the duration of the agreement. It was also agreed between the parties in that agreement that the licence should not at any material time be deemed to confer any beneficial rights over the land assets and/or plant and machinery. The licence was also for a period of three years subject to an option at the Chargor's absolute discretion to extend the same. The so-called tenancy agreement did not provide the defendant with a right to occupy and remain on the Land. The uncontroverted affidavit evidence established that the tenancy agreement was made without the plaintiff/chargee's consent under cl 6.2(b) of the legal charge. The tenancy agreement was also made without the plaintiff/debenture holder's consent under cl 9.2(c) of the Debenture. In the absence of such consent, the court held that the so-called tenancy agreement was invalid and unenforceable. Thus, it was plain and obvious that the defendant, far from being a tenant, was in effect a trespasser. The plaintiff was therefore entitled to an order for vacant possession.

106 The leading case on the issue of the remedy available to investors in the event of a *sukuk* default is the Federal Court case of *CIMB Bank*

Bhd v Maybank Trustees Bhd.[157] This case concerned *sukuk* issued by Pesaka Astana (M) Sdn Bhd ("Pesaka"). When Pesaka was awarded three government contracts, it proposed a financing scheme to finance the contracts. The scheme involved the issuance of public Islamic *sukuk* worth RM140m. Under the terms of the subscription and facility agreement, Pesaka appointed KAF Investment Bank ("KAF") as the lead arranger, facility agent and issuing agent for the issuance of the *sukuk*. KAF was also tasked with the duty to prepare all the required documentation to obtain the necessary approval from the Securities Commission, inclusive of the information memorandum ("IM") that provided information about the *sukuk* to potential investors. In the IM, KAF included an important notice to exclude any liability arising from any claim that might arise from the IM.

107 Under the scheme, the *sukuk* were first issued to a primary subscriber, who in turn sold the same to the *sukuk* holders. The *sukuk* holders would be repaid on the maturity date. The *sukuk* funds paid by the *sukuk* holders were to be deposited into Shariah designated accounts ("SD accounts"), which Pesaka was required to open at recognised financial institutions. In order to ensure that the financial interest of the *sukuk* holders was secured as required under the law, Pesaka entered into a trust deed with Maybank Trustees Bhd ("MTB"). Under the trust deed, MTB was appointed as the sole trustee to manage and control the SD accounts. Hence, the SD accounts were to be completely ring-fenced. Instead of opening new SD accounts, Pesaka used its existing conventional accounts as the designated accounts and MTB was not made the sole signatory to these accounts. In short, the accounts were not ring-fenced when the *sukuk* were issued.

108 Having control over the accounts, Pesaka utilised the moneys in the designated accounts for its own purposes and failed to redeem the *sukuk* and repay the *sukuk* holders on the maturity date. Subsequently, the *sukuk* holders commenced an action in the High Court against the 12 defendants. A consent judgment was entered against all the defendants, except KAF and MTB. The *sukuk* holders then proceeded with the case against KAF and MTB.

109 The High Court found for the *sukuk* holders against MTB and KAF for breach of contract and negligence. The trial judge also denied KAF any indemnity against Pesaka and apportioned liability between KAF and MTB on a 60:40 basis. On appeal, the Court of Appeal affirmed the findings of the High Court but re-apportioned liability between KAF and MTB on a 50:50 basis. MTB filed a notice of contribution and

157 [2014] 3 MLJ 169.

a counterclaim against Pesaka and the directors of Pesaka claiming, *inter alia*, an indemnity in full. In addition, MTB also filed a counterclaim against CIMB Bank Bhd ("CIMB"), in the light of the accounts held by Pesaka maintained by CIMB. The Court of Appeal granted MTB an indemnity of two-thirds of the sum claimed as against Pesaka and its directors. KAF, MTB, Pesaka, the directors of Pesaka and CIMB were granted leave to proceed with the instant five appeals to the Federal Court, which were jointly heard.

110 Delivering the judgment of the bench, Arifin Zakaria CJ held that the first issue to be considered was whether KAF was entitled to include the important exclusionary notice in the IM, and if so, whether this notice operated as a disclaimer to negate KAF's duty of care. Based on the cases cited, it was clear that it was open to KAF, as the lead arranger, to include the important notice as a disclaimer in the IM. It was not contrary to law or business practice to do so. In any case, the IM contained information belonging to the issuer, Pesaka, and not that of the lead arranger and was therefore Pesaka's document. Both the High Court and the Court of Appeal fell into serious error when they held that on the facts, there existed a duty of care owed by KAF to the *sukuk* holders despite the presence of the important notice in the IM. Further, it was common ground that the *sukuk* holders were sophisticated investors and experienced financial institutions with vast experience in the capital market and not ordinary investors. They were thus expected to act on independent and professional advice from their own sources in the light of the disclaimer as contained in the IM. Thus, KAF as lead arranger was entitled to exclude liability arising from the IM through the important notice. It therefore followed that KAF could not be held liable for any information found in the IM.

111 The second issue to be considered with regard to liability was whether KAF had acted in breach of the condition precedent that required the SD accounts to be ring-fenced prior to the issuance of the *sukuk*. From the evidence adduced, namely the letter from Pesaka and the transactional letter, KAF was justified in being satisfied that the SD accounts had been opened and that MTB had been made the sole signatory to these accounts, *ie*, that the accounts had been ring-fenced. By holding that KAF had a duty to independently verify that the SD accounts were ring-fenced, the Court of Appeal had placed a much higher burden on KAF than what was required under the issue documents. In the present case, it could be reasonably concluded that when the *sukuk* were issued, KAF was fully satisfied that all the conditions precedent had been complied with and was not acting in breach.

112 Based on the evidence, the Federal Court concluded that the cause of loss was directly attributable to Pesaka, who had misappropriated

the funds. The Court of Appeal had erred in holding that the most proximate cause of the loss was the issuance of the *sukuk* by KAF without the ring-fencing in place. KAF was not a party to the trust deed, which was strictly between the issuer and MTB. MTB had wide powers and rights under the trust deed and the power of attorney, but it failed to take the necessary action to ring-fence the account before the issuance of the *sukuk* or immediately after the *sukuk* were issued. Thus, the most proximate cause of the loss was the failure on the part of MTB to ring-fence the SD accounts or alternatively to stop Pesaka from operating them. As such, MTB was wholly to blame for the loss and not KAF. As a result, MTB was 100% liable to the *sukuk* holders and its appeal against the order of the Court of Appeal in apportioning liability between MTB and KAF at 50:50 had to be dismissed.

113 However, as the total sum of moneys that was received and dissipated by Pesaka did not exceed RM107m, the judgment should not be entered for the sum of RM149,315,000, which sum represented the redemption value of the *sukuk*. If MTB were to be held liable for the full amount of Pesaka's indebtedness, it would amount to treating MTB as if it were either the primary debtor or guarantor to the *sukuk* issue, which was not the case. Accordingly, the Federal Court held that MTB was only liable for RM107m and not the full amount of RM149,315,000.

114 Although cl 14.1 of the trust deed clearly provided that MTB would be indemnified "save and except for its gross negligence, wilful default, wilful breach or fraudulent actions", the Court of Appeal found MTB to be guilty of gross negligence and only ordered Pesaka to indemnify MTB up to two-thirds of the sum claimed. However, this meant that Pesaka would stand to gain at least one-third of its ill-gotten gains. The Federal Court opined that it would not be equitable for Pesaka who had received the ill-gotten gains to be put in a position where it could retain those gains or any part of it. This was especially so since the *sukuk* holders had not taken any steps to enforce the consent judgment entered between Pesaka and the *sukuk* holders and instead focused their attention on MTB on the basis that the latter was in the position to satisfy the *sukuk* holders' claim. Thus, MTB should be indemnified in full.

115 The court further held that the directors of Pesaka had acted dishonestly when they misapplied the proceeds of the trust moneys. In the circumstances, this court had to intervene by imputing a constructive trust upon the two directors for their role in misapplying the trust moneys. The corporate veil could not be the directors' defence against MTB's claim for indemnity. With Pesaka having admitted full responsibility to the *sukuk* holders via the consent judgment, the two directors should fully indemnify MTB for the loss. On that, the court affirmed the decision

of the Court of Appeal that ordered that the directors must pay MTB two-thirds of the judgment sum.

116 In *OSK Trustees Bhd lwn Kerajaan Malaysia*,[158] the plaintiff was a trustee on behalf of the BBA Islamic securities facilities holders ("BAIS facility") and it filed this action to claim damages caused by the default of the defendant's commitment. The plaintiff submitted that the defendant (namely, the Government of Malaysia) had failed and/or refused to ensure that Malaysian International Tuna Port Sdn Bhd ("MITP") fulfilled its obligations in settling the amounts due and payable under the issued BAIS facility to finance MITP's work. MITP was a body that had carried out the upgrading work of the LKIM Complex and had managed the complex under a concession provided by the defendant's agency, namely, the Malaysian Fisheries Development Authority ("LKIM"). For this purpose, a concession agreement between LKIM and MITP had been signed while the defendant had issued a support letter through the Ministry of Agriculture and Agro-based Industry. The plaintiff argued that the support letter had assured the plaintiff that the defendant would ensure that MITP fulfilled its liabilities in full for the amount borrowed and had confirmed the continuity of MITP to bear and repay the loan. Additionally, the plaintiff alleged that the statements in the support letter were an undertaking, representation and assurance granted by the defendant.

117 After considering all the facts and documents, Mohd Zawawi Salleh J dismissed the plaintiff's claim with costs. In interpreting a supporting letter and also other contract documents, the elements to be taken into account are the background or "surrounding circumstances" such as when the support letter was issued, the contents of the document, the conduct of the parties involved and the results of previous cases. Taking into account all of these elements, the court was of the opinion that the letter of comfort issued in this case was not intended by the parties to bring about a legally binding effect. The fact that the producer of this support letter did not want to issue a letter of guarantee but instead only issued a letter of support showed that the issuer of the supporting letter did not want it to be binding in the eyes of the law.[159]

IV. Conclusion

118 While it is true that a comprehensive legal and regulatory framework governing Islamic finance has contributed immensely

158 [2012] 3 CLJ 766 (this case is reported in Malay).
159 *OSK Trustees Bhd lwn Kerajaan Malaysia* [2012] 3 CLJ 766 at [26].

to the competitiveness of the Islamic finance industry locally and internationally, the role played by the Malaysian judiciary is equally crucial and significant. In fact, on numerous occasions, the decisions of the courts were taken into consideration by the Legislature in reforming the laws. As highlighted in this article, issues such as *ibra'*, late payment charges, reference to the SAC, enforceability of non-Shariah compliant contracts and *sukuk* default are some of the many Islamic finance legal disputes of practical importance which have been clarified by the courts. These issues, as decided cases reveal, were dealt with by the courts pragmatically and in full realisation of the need to ensure compliance with both Shariah and civil law. Indeed, this is not an easy, but a challenging task. The decisions of the courts in Islamic finance matters therefore not only complement the existing infrastructure of Islamic finance in Malaysia, but also shape the direction of the industry in terms of clarity and consistency, promoting convergence between Shariah and the civil law towards a mature and stable Islamic finance industry.