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## Operating with a Truncated Legal System: Financial Law without Insolvency Law

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#### ABSTRACT

This paper is concerned with some basic legal issues underlying insolvency in Islamic finance. Modern, Western-style insolvency regimes are contrasted with the rudimentary state of the equivalent law in the classical sharia. The resultant position of insolvency in Islamic finance is then outlined. It is concluded that, for the foreseeable future, Islamic finance will have to depend on the Western-style insolvency law of nation states.

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<sup>1</sup> The rights of Nicholas Foster to be identified as the author of this work have been asserted in accordance with s 77 and s 78 of the Copyright, Designs and Patents Act 1988. This paper is a slightly modified version of the paper submitted to the Harvard/LSE Workshop 2013. This paper is intended as a basis for discussion. Its brevity, its lack of references and the absence of qualifications to simplistic statements are deliberate.

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## I. MODERN INSOLVENCY LAW

A modern insolvency law regime has several characteristics, including notably:

- a clear legal definition of insolvency, such as that contained in s 123 UK Insolvency Act 1986;
- collective procedures, ie coherent bodies of rules (eg UK liquidation or administration) which replace the rules which normally apply and enable the orderly distribution of assets of the insolvent person or, latterly, bodies of rules which can enable an insolvent business to be saved or liquidated at a better cost than in the normal liquidation procedure;
- a legally defined order of payout of the insolvent person's assets to different classes of creditors;
- a law of security and a coherent link between security law and insolvency law; and
- institutions, such as courts and organised (and regulated bodies) of specialist professionals to apply administer the system.

## II. INSOLVENCY IN THE CLASSICAL SHARIA

Some of us concerned with Islamic finance claim, implicitly or expressly, that legal mechanisms equivalent to those of modern law can always be found in the classical past or, at the very least, the classical sharia legal system always contained something of substance and relevance on every topic relevant to Islamic finance. This is, at best, misleading. The society, the economy and the financial system of the classical Muslim world, the world which existed before its Western-based transformation, had a legal system which was sophisticated for its day and, apparently, sufficient for its needs. But those needs were not our, contemporary, needs, they were much simpler. So the classical law was correspondingly simpler.

As far as insolvency is concerned, Western law did not have anything approaching modern insolvency law until, in terms of legal history, a very short time ago. Although England passed its first Act of Parliament in the area in Henry VIII's time, this was not concerned with the insolvency of companies as we know them, for such companies did not exist until the 19<sup>th</sup> century (in the United Kingdom 1844, or taking another view, 1856).

It is hardly surprising, then, that the sharia, although it had some rules relating to individual inability to pay debts (*iflas*) and some procedures to facilitate settlement between a debtor and his creditors, had no real equivalent to modern insolvency law.

### III. INSOLVENCY IN ISLAMIC FINANCE

The political, and therefore the legal, structure of the world is entirely Western. The world is divided into nation states, each of which has its own legal system or systems. Relationships between the nation states are determined by another system, that of international law.

Any other system with pretensions to being legal has to fit in with this structure. The legal (sharia/fiqh) underpinnings of Islamic finance (call this 'Islamic financial law') is no exception. Islamic financial law has to function within, and rely on, Western-style legal systems such as English, Malaysian or UAE law. Call them 'vehicular systems'. Those legal systems are of different types, especially as regards their relationship to Islamic law and their level of complexity. However, they are all indubitably nation state legal systems.

Furthermore, Islamic financial law, and the emergent parts of what may eventually become a legal system (in a rather special sense of the term 'legal system': call these parts 'the emergent IF legal system') is, for the moment at any rate, primarily concerned with legitimacy, or sharia-compliance. The emergent legal system is primarily concerned with the production of rules for the purpose of constructing *halal* products. Or, to put it another way, rules for the purpose of answering the question: is a given transaction *halal* or *haram*? The emergent legal system is not concerned with what happens on default, nor does it have a dispute resolution system, let alone rules, procedures and mechanisms to deal with what happens when a party is unable to pay its debts.

We can also see, by recalling the sketch above of what is needed for a modern insolvency law regime, that there are numerous, perhaps insoluble problems in the way of the emergent legal system producing such things.

Among the first set of problems, consider that such things are products of the nation state, and hardly any of them could be created outside it.

So the UK liquidation and administration procedures are not just complex bodies of rules, they depend on the existence of an administrative and organisational infrastructure which could not be duplicated in a non-state context.

Those procedures are the product of considered decisions, taken after much deliberation and debate, about the distribution of assets as between groups of creditors, and are deeply rooted in a particular view of world. The list of priorities is, accordingly, under the tight control of the nation state, is afforded public policy status and, with certain exceptions, is protected by the law and cannot be altered.

To put it another way, few areas of commercial law are so linked to the socio-economic ideology of a society as insolvency law, for it determines which group gets which resources when there are insufficient resources for everyone. Hence the wide divergence among legal systems in their insolvency law and the considerable difficulty in achieving any degree of harmonisation. A good example is the failure of harmonisation efforts in the European Union, and the compromise solution of the Regulation on Insolvency Proceedings.

And, just as fundamentally, the legal entities which are such important actors in the modern commercial and financial world, including Islamic finance, are products of nation states, depending entirely for their existence on municipal law, and their insolvency is inextricably linked to the nation state which gave birth to them.

Another set of problems relates to the fact, seen above, that the classical sharia contained practically nothing which could be used as a model, or even a starting point, for the construction of an Islamic finance insolvency law. Such a regime would have to be made out of whole cloth, made up from scratch - a mammoth undertaking necessitating not only the construction of insolvency law itself, but security law, the coordination of the two, and so on.

#### IV. CONCLUSION

For the future it is difficult to see how Islamic finance can do anything other than depend on the insolvency law regimes of nation states. That may give us some food for thought, such as (speculating rather wildly for a moment) choosing a vehicular law because its insolvency regime is more sharia-compliant than another, or reforming the law of a Muslim-majority jurisdiction in order to make it as sharia-compliant as possible, or creating an exceptional regime for Islamic finance.