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## The Standardization of Islamic Financial Law: Lawmaking in Modern Financial Markets†

*The project to standardize the commercial elements of the sharia as undertaken by standard-setting bodies, such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), is a lawmaking effort that is incentivized by market forces and the interaction of municipal legal systems. This Article examines the ways in which these factors contribute to the development of private Islamic legal standards, and in doing so, contribute to an emergent legal architecture that is integrated within the global economy. Contrary to the primary role assigned in existing analyses to sharia scholars and sharia supervisory boards, the Article shows that the processes that determine the composition of Islamic financial law (IFL) highlight the starkly reduced role of jurists in developing law in accordance with the traditional methodology (usul al-fiqh). Such analyses have failed to consider the standardization effort as a lawmaking project driven by market forces, which must be realized if authentic sharia principles are to be given effect. Therefore, examination of these market-led processes and their contribution to the creation of Islamic standards is essential for understanding what standardization means in relation to the fulfillment of Islamic principles and whether a high degree of standardization is desirable. First, the Article examines the role of interpretation, which highlights the methodological challenges of the standardization project. Second, the Article investigates the AAOIFI's standard-setting efforts, including the methods of standardization, its market- and law-driven incentives, and the status of standardization efforts including the madhahib (schools of law)'s differences of legal thought. Third, an analysis of the interaction of IFL and the law of municipal legal systems (the United Arab Emirates, England and Wales, and Malaysia) highlights the legal incentivization for developing sharia standards. Finally, an analysis of the commercial practice of IFL, particularly in*

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*retail markets, demonstrates commercial law's trend toward standardized contractual practices. Market forces compel the use of standard-form documentation, comprising standards that reflect the commercial practice of law firms and corporations.*

## INTRODUCTION

The long and rich tradition of Islamic jurisprudence is no stranger to commercial and financial transactions. Yet the sharia, in particular its commercial and financial rules (*fiqh*), has not been consistently practiced in any municipal legal system since the dissolution of the Ottoman Empire. Furthermore, the sharia, in its uncodified form, is arguably the governing legal system in only one modern nation-state: Saudi Arabia.<sup>1</sup> The reasons for the diminished role of this ancient legal system are multifaceted, but the impact of the West, including its “legal colonialism,” which Muslims refer to as *isti'mar qanuni*, has been perhaps the most consequential factor.<sup>2</sup>

Therefore, it is not surprising that the Islamic finance industry's facilitation of sharia-compatible financial services in mostly secular legal systems is a major challenge. Both the form and the substance of these transactions differ markedly from the fairly simple classical contracts of the past but, until recently, have not been catered to in the legal and regulatory systems of modern states. The role of market forces in shaping these legal forms so that the financial result and risk profile resembles conventional ones is unmistakable. Yet the legal structures of Islamic finance products often reflect disparate patterns of legal interaction both domestically and across borders.

The reintroduction of sharia-compliant transactions in mostly secular legal systems has resulted in an emergent legal system,<sup>3</sup> which is now commonly referred to as Islamic financial law (IFL). IFL is a hybrid legal transplant, which, with modification for municipal regulatory law, can be transplanted across the globe in jurisdictions wishing to facilitate Islamic finance. However, considerable legal and

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1. One of the most prominent and influential scholars of Islamic law of our time even concludes that “traditional sharia can surely be said to have gone without return.” See Wael Hallaq, *Can the Sharia Be Restored?*, in *ISLAMIC LAW AND THE CHALLENGE OF MODERNITY* 21, 42 (Yvonne Y. Haddad & Barbara F. Stowasser eds., 2004). See also WAEL B. HALLAQ, *Hegemonic Modernity: The Middle East and North Africa During the Nineteenth and Early Twentieth Centuries*, in *SHARI'A: THEORY, PRACTICE, TRANSFORMATIONS* 396 (2009).

2. Aharon Layish, *Islamic Law in the Modern World: Nationalization, Islamization, Reinstatement*, 21 *ISLAMIC L. & SOC'Y* 276, 277–78 (2014).

3. The idea that Islamic financial law (IFL) has developed sufficiently to be considered an emergent legal system was first proposed by Nick Foster. See Nick Foster, *Islamic Finance Law as an Emergent Legal System*, 21 *ARAB L.Q.* 170 (2007). Subsequent research developed this concept further by illustrating IFL's hybrid nature as a legal transplant, generated in modern financial markets. See JONATHAN G. ERCANBRACK, *THE TRANSFORMATION OF ISLAMIC FINANCIAL LAW IN GLOBAL FINANCIAL MARKETS* (2015).

regulatory reform is necessary to do so as the legal aspects of Islamic finance differ markedly from conventional finance.<sup>4</sup>

IFL is an amalgamation of legal inputs, including the commercial principles of the sharia, English law, international financial services law, and modern Islamic financial standards such as those of the Accounting and Auditing Organization for Islamic Financial Institutions (the AAOIFI), among others. The particular composition of IFL varies according to the municipal legal system that has chosen to facilitate and regulate the Islamic finance industry. For example, Malaysian IFL incorporates Malaysian common law, Malaysian financial services law, and central bank-issued Islamic standards, which are premised on *fiqh* and market practice. Cross-border transactions often comprise a more diverse body of legal influences including classical sharia, English law, the municipal law of the originator, market-developed Islamic financial structures, and global Islamic standards. The variation of legal influences is greater in these cross-border transactions because they must be facilitated and regulated in multiple legal systems.

Islamic finance is facilitated to varying extents in more than sixty countries. The International Monetary Fund (IMF) considers the industry systemically important in more than fourteen jurisdictions.<sup>5</sup> Yet the industry is relatively young. The first Islamic commercial bank, the Dubai Islamic Bank, was established in 1975.<sup>6</sup> Since then, approximately 360 financial institutions have gone on to offer sharia-compliant financial services.<sup>7</sup> An important aspect of this rapid development has been made possible by establishing international standard-setting bodies for the industry. For example, in 1990, the industry's diverse range of financial and auditing practices incentivized the establishment of the AAOIFI. The AAOIFI's early objective was to develop accounting and auditing standards for the integration of the industry into the global economy. Subsequently, governance and sharia standards for Islamic financial institutions (IFIs) were developed.

The standardization project, in particular the production of sharia standards, is a legal undertaking designed to produce standard forms

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4. Fitch, the international rating agency, recently stated that "as well as sharia, we see product structure and documentation, supervisory and regulatory frameworks, law and dispute resolution, and financial and accounting reporting the main areas where standardization would be advantageous." See *Fitch: Islamic Finance Standardisation Will Be Slow*, REUTERS (Oct. 25, 2017), [reut.rs/2NLGKXe](http://reut.rs/2NLGKXe).

5. Ghiath Shabsigh et al., *Ensuring Financial Stability in Countries with Islamic Banking*, IMF Country Report No. 17/145, at 1 (Jan. 5, 2017).

6. The first Islamic savings institution was established in Mit Ghamr, Egypt, in 1963, by Dr. Ahmed Al-Najjar.

7. Joseph DiVanna & James King, *The Banker's Top Islamic Financial Institutions Ranking: A Bump on a Path of Progress*, THE BANKER (Nov. 2, 2015), [www.thebanker.com/Reports/Special-Reports/Top-Islamic-financial-institutions-2015/The-Banker-s-Top-Islamic-Financial-Institutions-ranking-a-bump-on-a-path-of-progress?](http://www.thebanker.com/Reports/Special-Reports/Top-Islamic-financial-institutions-2015/The-Banker-s-Top-Islamic-Financial-Institutions-ranking-a-bump-on-a-path-of-progress?).

for the nascent legal system so that states and courtrooms are able to facilitate and regulate Islamic finance transactions. The process, although historically not unprecedented, represents a break with classical norms of sharia, since it endows jurists with the authority to determine a singular version of the law.<sup>8</sup> Historically, diversity in the law is commensurate with the derivation of God's law from the holy sources according to the best of a jurist's ability.<sup>9</sup> Yet *ijtihad* was recognized as fallible since it represented a jurist's interpretation of the law. As a result, the resulting *fatwa* was not absolute; it merely represented a jurist's best efforts to discern God's law. Standardization, on the other hand, empowers jurists and others to create standard forms from the great diversity of law (*fiqh*) that has been derived over centuries. In contrast to the traditional methodology for deriving law (*usul al-fiqh*), standardization is driven solely by market forces and the exacting demands of modern legal systems.

The standardization of the commercial elements of the sharia has received only cursory attention.<sup>10</sup> Few analyses have been undertaken, and most focus solely on the diversity of classical sharia (and its multiple schools of law) and the inherent difficulties of reconciling an ancient legal tradition with modern financial practices.<sup>11</sup> Such analyses do not recognize IFL as a legal system that is markedly different from classical sharia. These analyses do not consider the

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8. Ibn al-Muqaffa' (d. 759) was a high government official during the Abbasid Empire, who proposed to the caliph that the sharia should be standardized. His proposal was not accepted, and the development of distinctive doctrines of sharia ensued. Historically, the *mejelle*, a civil code of the late nineteenth and early twentieth centuries, was the first attempt to codify a part of the sharia. It was premised on Hanafi *fiqh* but comprised law from other legal schools too.

9. This Article does not grapple with religious or theological considerations of standardization or with the distorting effects of sharia codification in general. Many authors have addressed the latter topic. See, e.g., Ann Elizabeth Mayer, *The Sharia'ah: A Methodology or a Body of Substantive Rules?*, in ISLAMIC LAW AND JURISPRUDENCE 177 (Nicholas Heer ed., 1990); NORMAN ANDERSON, *LAW REFORM IN THE MUSLIM WORLD* (1976); Joseph Schacht, *Problems of Modern Islamic Legislation*, 12 *STUDIA ISLAMICA* 99 (1960); J.N.D. ANDERSON, *ISLAMIC LAW IN THE MODERN WORLD* (1959).

10. The only strictly legal analysis dealing with private law issues (as opposed to several analyses that deal with sharia-related issues) that I have been able to locate is Rahail Ali & Mustafa Kamal, *Standardising Islamic Financing: Possibility or Pipe Dream?*, 10 *BUS. L. INT'L* 19 (2009) (discussing the commercial aspects of standardizing Islamic financial contracts. It does not deal holistically with the topic of standardization, nor does it deal with the application of the law, which is the final determinant of legal similarity).

11. Several publications are notable: M. Fahim Khan, *Setting Standards for Shariah Application in the Islamic Financial Industry*, 49 *THUNDERBIRD INT'L BUS. REV.* 285 (2007) (dealing mostly with the diversity of the *fiqh* and ways of reconciling this diversity with modern markets); Jamal Abbas Zaidi, *Shari'a Harmonization, Regulation and Supervision* (Nov. 2012) (unpublished paper presented at the AAOIFI-World Bank Islamic Banking & Finance Conference) (on file with author). The paper deals mostly with sharia-related issues and possible avenues for regulating sharia supervisory boards (SSB). See also Amir Shaharuddin, *Defining Harmonisation of Shariah Rulings in Islamic Finance*, 30 *ARAB L.Q.* 292 (2016) (discussing the meaning of harmonization from the perspective of reconciling diverse interpretations of the sharia at the level of the SSB).

nature of the endeavor contextually, and thus neglect, in particular, the role of market forces and municipal legal and regulatory challenges as driving forces of standardization. The limited remit of these analyses results in a failure to consider the standardization effort as a lawmaking project driven by forces that must be recognized if authentic sharia principles are to be given effect. The interpretational complexity of the standardization effort is neglected, as are the ways in which the AAOIFI standards, among other industry standards, fall short in reflecting these challenges. This has limited their adoption and enforcement in municipal legal systems. In sum, there is a paucity of research concerning the driving forces behind the standardization project and therefore only a very partial picture of the complex challenge has been studied.

This Article begins to fill these gaps. It demonstrates that the standardization of sharia standards is a lawmaking process that is incentivized by market forces and the interaction of municipal legal systems. The Article examines the ways in which these mechanisms compel the development of Islamic private law standards and other Islamic financial practices, and in so doing, contribute to an emergent legal architecture that is integrated within the global economy.<sup>12</sup> Contrary to the primary role assigned to sharia scholars in earlier analyses, the Article shows that the processes that determine the composition of IFL highlight the starkly reduced role of jurists in developing law in accordance with the traditional methodology (*usul al-fiqh*). Therefore, examination of these market-led processes and their contribution to the creation of Islamic standards is essential for understanding what standardization means in relation to the fulfillment of Islamic principles and whether a high degree of standardization is desirable.

A comparative legal analysis produces some useful insights for understanding the nature of standardization efforts and in clarifying the particular objectives and legal trajectory of IFL. Islamic finance is facilitated in municipal legal systems across the globe. Most of these are civil law systems, some are common law, and many are hybrid legal systems. The nature of these systems differs from country to country and, indeed, from continent to continent. Comparative law, including the conceptual tool known as legal pluralism, is therefore a

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12. This Article is primarily concerned with the private law aspects of the AAOIFI standardization process. An analysis of the standardization of regulatory law must take into consideration a wider view of factors impacting the process, such as a state's pursuit of economic power, issues of political economy, and societal preferences. There are numerous theories concerning the harmonization of international financial law, but few, if any, that can explain its complexity. See, e.g., DAVID ANDREW SINGER, *REGULATING CAPITAL: SETTING STANDARDS FOR THE INTERNATIONAL FINANCIAL SYSTEM* (2007); Chris Brummer, *How International Financial Law Works (and How It Doesn't)*, 99 *Geo. L.J.* 257 (2011); Beth Simmons, *The International Politics of Harmonization: The Case of Capital Market Regulation*, in *DYNAMICS OF REGULATORY CHANGE* 42 (David Vogel & Robert A. Kagan eds., 2004).

useful methodology for examining the market, the legal mechanisms of the standardization challenge, and the particular municipal contexts in which IFL is facilitated.

The Article takes on this task in the following way: Part I of the Article deals with the interpretive nature of the standardization effort, highlighting the centrality of context. This is followed in Parts II and III by an analysis of the purpose, function, and nature of AAOIFI sharia standards as well as the market-driven interpretation of these standards, including any differences of interpretation. Parts V–IX of the Article provide practical examples of the direct impact that interactive legal systems and market forces comprise in the formulation of sharia standards. Case studies of the United Arab Emirates, England and Wales, and Malaysia are presented. Finally, some concluding remarks are provided.

### I. THE ROLE OF INTERPRETATION

An examination of the role of interpretation underscores the importance of investigating the legal and market mechanisms, i.e., the context that determines the meaning of the standardization process. The interconnected, dynamic relationship between the law and market forces provides the contextual background to the standardization endeavor that must be understood if the framers of such efforts wish to achieve their desired results.<sup>13</sup>

The AAOIFI, the most authoritative standard-setting organization in the Islamic finance industry, is an important part of an emerging global legal architecture for the Islamic finance industry. The AAOIFI defines its mission as the “standardization and harmonization of international Islamic finance practices and financial reporting in accordance to Shari’ah.”<sup>14</sup> The AAOIFI does not distinguish between the concepts of standardization and harmonization in relation to Islamic finance practices and financial reporting. The lack of differentiation between these terms would suggest that “standardization” and “harmonization” mean the same thing. The AAOIFI is hardly alone in this practice. Many writers consider these terms to be interchangeable, sometimes using “unification” or “harmonization” in lieu of “standardization,” without concern that the meaning or objective of each concept may be different or that each term reflects a certain historical context.<sup>15</sup> Arguably, such usage indicates a failure to conceptualize the standardization effort as an interpretive one, which requires the contextualization of law. The standardization of IFL or any other effort aimed at minimizing legal differences is largely an interpretive endeavor that engages with several areas of the law and does so in many

13. Many authors focus on the role of the SSB in standardization efforts but neglect the many lawmaking activities that take place in markets. An example is Zaidi, *supra* note 11.

14. *Mission*, AAOIFI, [aaofi.com/our-mission/?lang=en](http://aaofi.com/our-mission/?lang=en) (last visited July 8, 2016).

15. Shahrudin, *supra* note 11, at 295.

different municipal legal systems. Yet the words alone used to describe the minimization of legal differences are insufficient. They only become meaningful when applied to a particular legal context. This is because it is in the application of rules that any definition of such concepts can be found. A drafted text, which claims to have standardized legal rules, becomes meaningful when it is applied uniformly in law. Standardized conceptions of law represent reconciliations of disparate legal traditions. But these conceptions remain just that until they can be shown to have achieved applied legal similarity.<sup>16</sup>

Among several detailed objectives, the AAOIFI seeks to:

Achieve conformity or similarity—to the extent possible—in concepts and applications among the Shari’ah supervisory boards of Islamic financial institutions to avoid contradiction and inconsistency between the fatwas and the applications by these institutions, with a view to activate the role of the Shari’ah supervisory boards of Islamic financial institutions and central banks through the preparation, issuance and interpretations of Shari’ah standards and Shari’ah rules for investment, financing and insurance.<sup>17</sup>

This passage distinguishes between conformity and similarity, omitting the earlier reference to standardization and harmonization. This language is given a particular context, that of the shariah supervisory board (SSB). This allows the reader to understand in far greater detail what approximate objective the writer has in mind, even if the employed terms have changed. This example hints at another important effect of the way in which humans understand language. Namely, in the absence of closely considering the specific context in which terms such as standardization are used, the objectives of such endeavors will almost certainly not be met. This is a particularly important insight in relation to IFL because of the religious and ethical nature of the sharia. In the absence of closely examining the context in which legal rules are conceptualized, the ability to develop IFL so that it reflects classical legal principles will be curtailed.<sup>18</sup>

16. Camilla Baasch Andersen, *Defining Uniformity in Law*, 12 UNIFORM L. REV. 5, 41 (2007).

17. *Objectives*, AAOIFI, [aaofi.com/objectives/?lang=en](http://aaofi.com/objectives/?lang=en) (last visited Aug. 17, 2016).

18. The historical record of international “unification” efforts provides a vivid depiction of the way in which context has informed the usage of varying terms. The most famous of the unification efforts include the International Institute for the Unification of Private Law (UNIDROIT) and the United Nations Commission on International Trade Law (UNCITRAL). The goal of these international organizations was to develop uniformity in commercial law. (For more on the history of these endeavors, see JAN H. DALHUISEN, *DALHUISEN ON INTERNATIONAL COMMERCIAL, FINANCIAL AND TRADE LAW* (2000)). Initially, the goal of the “unification” movement was to create uniform legislation via the adoption of model codes and statutes. This involved an international agreement between states to replace national rules and to adopt a uniform set of rules.

But it is not enough to consider the context in which law is applied. The interpretive aspect of the standardization of law also presents methodological challenges that both relate to context as well as to the nature of human language and communication. One concerns the historical consciousness that the interpreter brings to the act of interpreting a text or speech. While historical baggage does not necessarily determine the meaning of the text for the interpreter, it cannot be disregarded. It embodies the opportunities and opinions that may in fact help the interpreter to understand a particular text.<sup>19</sup> A further consideration involves the mechanics of interpretation. Interpretation concerns the understanding of both texts and speech but in both cases the medium of understanding is language. However, the language of a text differs from the language of the interpreter, and the gulf between the two is not inconsequential. The object, which the interpreter attempts to describe in language, is the language of the interpreter.<sup>20</sup> It is a universal rule that language cannot be understood apart from the context in which it is used, because the meaning of words is not transparent.<sup>21</sup>

## II. AAOIFI STANDARDS: PURPOSE, FUNCTION, AND NATURE

The AAOIFI's sharia standards are designed as rules and principles, which private parties, financial institutions, and governments

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(See Emanuela Carbonara & Francesco Parisi, *The Paradox of Legal Harmonization*, 132 PUB. CHOICE 367, 368 (2007)). After recognizing that unification remained elusive, however, the terminology shifted to a comparative law notion of "harmonization" or "legal convergence." (See Martin Boodman, *The Myth of Harmonization of Laws*, 39 AM. J. COMP. L. 699, 708 (1991)). Harmonization is a less ambitious concept since it allows states to agree on a set of objectives or targets. Each state is charged with subsequently adapting its domestic law to fulfill the objectives. The difference between these concepts concerns the degree to which legal systems are homogenized, with harmonization indicating a lesser degree. The conscious decision to use "harmonization" to describe these types of legal efforts reflects an acknowledgement that circumstances did not permit the "unification" of the law.

19. 1 HANS-GEORG GADAMER, WAHRHEIT UND METHODE: GRUNDZÜGE EINER PHILOSOPHISCHEN HERMENEUTIK 392 (2010).

20. *Id.*

21. Johan Steyn, *The Intractable Problem of the Interpretation of Legal Texts*, in COMMERCIAL LAW & COMMERCIAL PRACTICE 123, 124 (Sarah Worthington ed., 2003). Steyn goes on to argue that the central hermeneutical problem of the social sciences and humanities has centered on the way in which the interpreter approaches the past, in the form of historical texts. The interpreter's own thought process, specifically his own thought horizon or consciousness, determines the revived meaning of a historical text. According to Ronald Dworkin, ultimately, all interpretation is constructive in that the interpreter "imposes purpose on an object or price" so as to make an object "the best it can be." Value is attributed to "some scheme of interests or goals or principles," which the subject matter is said to exemplify or represent. Different contexts require different forms of interpretation because different subject matters entail different standards of value. Consider, for example, the different standards applied to the interpretation of art as opposed to those applied to the natural sciences. And yet both subject matters require intention, a purpose, which is the formal structure of interpretation. An intention relates to a way of seeing a particular subject matter, a decision to pursue one aspect, one particular angle, rather than another. See RONALD DWORKIN, LAW'S EMPIRE 52–59 (1986).

may adopt and implement in municipal legal systems. A number of countries have adopted the AAOIFI standards.<sup>22</sup> However, their adoption has remained partial or merely a matter of guidance, as the legal and regulatory infrastructures of such countries rarely are reformed to strictly enforce the use of these standards. The result is that the impact of the AAOIFI standards as a means of creating a standardized version of IFL has been limited.

In general, there are various methods of harmonizing law: international conventions, bilateral treaties, model laws, codifications of custom and usage (international trade terms) promulgated by international standard-setting bodies, model contracts, and general contractual conditions.<sup>23</sup> The AAOIFI sharia standards are primarily used as general contractual terms (and regulatory standards), and to some extent represent codifications of custom and usage as promulgated by an Islamic standard-setting organization. As such they must be adopted by states, municipal legal systems, or financial institutions. These entities primarily comprise the membership of the AAOIFI.

Standards foster certainty, transparency, and predictability in Islamic financial markets with respect to a number of overlapping issues, including accounting requirements, auditing requirements, regulatory requirements, legal documentation and action, public transparency, sharia compatibility, and marketing purposes.<sup>24</sup> Standards help IFIs to reduce transaction costs, improve legal documentation, and mitigate legal challenges; reduce the time and effort required of sharia scholars; and reduce the time necessary to market new products.<sup>25</sup> Consumer confidence in the industry is improved considerably as a result.

The AAOIFI has issued fifty-four sharia standards dealing mostly with the contractual aspects of Islamic financial transactions.<sup>26</sup> Sharia standards undergo an extended development and revision process. Initial committees discuss standards extensively before submitting a base set of proposals to the AAOIFI's sharia committee.<sup>27</sup> Scholars

22. According to the AAOIFI, Bahrain, Jordan, the Kyrgyz Republic, Mauritius, Nigeria, Qatar, the Qatar Financial Center, Oman, Pakistan, Sudan, Syria, the United Arab Emirates, and Yemen have adopted them in full, partially, or as guidance. See *Adoption of AAOIFI Standards*, AAOIFI, [aaofi.com/adoption-of-aaofi-standards/?lang=en](http://aaofi.com/adoption-of-aaofi-standards/?lang=en) (last visited Dec. 23, 2018).

23. Roy Goode, *Reflections on the Harmonization of Commercial Law, in* COMMERCIAL AND CONSUMER LAW: NATIONAL AND INTERNATIONAL DIMENSIONS 1, 6–7 (Ross Cranston & Roy Goode eds., 1993).

24. Mohd Daud Bakar, *The Shari'a Supervisory Board and Issues of Shari'a Rulings and Their Harmonisation in Islamic Banking and Finance*, in ISLAMIC FINANCE: INNOVATION AND GROWTH 88 (Simon Archer & Rifaat Ahmed Karim eds., 2002).

25. HER MAJESTY'S TREASURY, *THE DEVELOPMENT OF ISLAMIC FINANCE IN THE UK: THE GOVERNMENT'S PERSPECTIVE* 19 (2008).

26. See Ibrahim Warde, *Status of the Global Islamic Finance Industry*, in ISLAMIC FINANCE: LAW AND PRACTICE 1 (Craig B. Nethercott & David M. Eisenberg eds., 2012).

27. Kristin Smith, *Islamic Banking and the Politics of International Financial Harmonization*, in ISLAMIC FINANCE: CURRENT LEGAL AND REGULATORY ISSUES 174 (Syed Nazim Ali ed., 2005).

representing both Sunni and Shia schools of law agree on a draft of a standard and the draft is revised many times in a process in which the standard is sent out to industry practitioners and submitted to technical workshops or public hearings for comments and suggestions. These changes are then incorporated until a final consensus emerges on the draft standard.<sup>28</sup> Issued standards include rules for guarantees, assignment (*hawala*), contractual conditions such as those pertaining to possession (*qabd*), and prohibitions (*gharar*). But the rules also deal with other topics that extend beyond contract law, including arbitration, redistributive taxes (*zakat*), the hiring of persons, charitable foundations (*waqf*), and profit distributions in profit- and loss-sharing partnerships premised on the *mudharabah* partnership contract. As standards, they are not meant to provide a full spectrum of contractual rules. For instance, standards do not deal with contract formation, factors that defeat contractual liability (mistake, misrepresentation, frustration, etc.), or remedies for contractual breach.

Islamic finance is subject to a wider range of legal challenges than the conventional finance industry, with its considerably longer history of practice and embedded infrastructure. Perhaps the most important of these challenges is investors' lack of familiarity with Islamic financial practices. Legal documents and the terms that comprise them are typically standardized in conventional markets as they have been the subject of extensive interpretive litigation over many years. Litigation helps to clarify the parameters of financial transactions with respect to the rights and remedies of the parties, the terms of many financial and commercial risk allocations, and the legal documentation. There is a good deal of certainty with respect to the way a court will interpret a contractual term as well as to how the court will implement the rights, obligations, and remedies of the parties in relation to the contract. As a result, standardized documentation leads to fewer transaction costs. However, only on rare occasions have Islamic finance transactions been the subject of litigation and, although some valuable principles have been established, market practitioners still have little experience with these transactions.<sup>29</sup> The parameters of certainty and predictability that courts establish in their judgments are not as readily available with respect to Islamic finance transactions. This adds uncertainty to the market and can discourage investment.

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28. AAOIFI, SHARI'AH STANDARDS (2015).

29. There is a relative scarcity of case law concerning Islamic financial transactions in most jurisdictions. Many Middle Eastern jurisdictions do not report their judicial decisions and private law firms are not inclined to disseminate the results of cases in which they have been involved. The most important industry-wide decision to date was decided by an English court in *Shamil Bank v. Beximco Pharmaceuticals Ltd.* [2004] EWCA (Civ) 19, which is discussed in detail below. However, there is a considerable body of Malaysian case law, some of which is discussed below.

Conventional efforts aimed at minimizing legal differences are generally focused on minimizing the differences between national contract laws. Such legal differences can act as a barrier to trade because contracting parties are less inclined to enter into a transaction when it is governed by the law of another state. Standardization of these differences helps to alleviate the uncertainty that legal practitioners associate with foreign states' conflict of law rules. An internationally agreed set of rules or standards is considered to be neutral and conducive to freeing up the flow of trade. Parties can adopt and use agreed standards to govern their transactions.<sup>30</sup>

Unlike model law legislation, international conventions, or bilateral treaties, the development of standards as nonbinding rules or guidelines is generally aimed at generating partial standardization.<sup>31</sup> This is due to the fact that standards are nonbinding and as such take the form of a recommendation addressed to the members of the organization, like in the case of the AAOIFI. This gigantic effort necessarily represents a lowest-common-denominator approach to standardization. The problems of particular legal orders are avoided, and, theoretically speaking, the lowest common denominator will be compatible with general concepts and rules. The downside is that standardization will be limited, since the agreed minimum standards do not preclude diversity in different jurisdictions. However, the standards may establish a higher level of standards in those jurisdictions, which previously did not meet the standard or which simply did not adhere to any standard.<sup>32</sup>

The AAOIFI sharia standards can primarily be categorized as a type of facilitative law. This is an area of private law designed to facilitate mutually desired outcomes. It includes contract law, corporate law, and other forms of property-related law. Market actors are considered fairly homogenous in their preferences for legal products that minimize legal costs, including the cost of enforcement. Reforms designed to lower legal costs in these areas of the law and generate gains for market actors without producing any losers (other than lawyers and, in the field of Islamic finance, sharia scholars, who are incentivized to maintain higher priced law).<sup>33</sup> As a result, competition between

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30. Ewan McKendrick, *Harmonisation of European Contract Law: The State We Are in*, in *THE HARMONISATION OF EUROPEAN CONTRACT LAW: IMPLICATIONS FOR EUROPEAN PRIVATE LAWS, BUSINESS AND LEGAL PRACTICE 14* (Stefan Vogenauer & Stephen Weatherill eds., 2006).

31. Clive M. Schmitthoff, *The Unification or Harmonisation of Law by Means of Standard Contracts and General Conditions*, 17 INT'L COMP. L.Q. 551, 554 (1968).

32. Katharina Pistor, *The Standardization of Law and Its Effect on Developing Economies*, 50 AM. J. COMP. L. 97, 109–10 (2002).

33. However, even in the area of facilitative law, standardization imposes a set of risk allocations that shifts the balance of costs and benefits between the parties. The allocation of risks, including their costs and benefits, must be taken into consideration if the objectives of sharia are to be met. See Michael McMillen, *Redefining and Retaining Shari'ah Compliance in Islamic Finance*, in *CHALLENGES OF RETAINING SHARI'AH COMPLIANCE IN ISLAMIC FINANCE 38, 42–43* (Jonathan G. Ercanbrack ed., 2019).

jurisdictions is thought to lead to the minimization of legal differences in this area of the law. Although systematic evidence for this assertion is not available, there are many indicative examples that tend to support it.<sup>34</sup>

Organizations such as the AAOIFI deal mostly with private law standards, that is, standards that address private economic exchanges. Companies and firms adopt standards from the bottom up, and lobbying efforts are undertaken for their adoption in municipal legal systems.<sup>35</sup> However, AAOIFI sharia standards can also be used as regulatory standards. Few states, most notably Bahrain, have adopted the AAOIFI sharia standards in full, while most other states have implemented them partially or merely as guidance. When implemented in full, standards compel IFIs to adhere to detailed regulatory rules in the intermediation of Islamic products and services. Yet regulatory implementation is not enough. In most cases, standards will need to be legislated so that courts are willing and able to enforce them in the adjudication of disputes. This is by far the most effective means of achieving standardization. As mentioned above, a top-down dissemination of Islamic finance standards is rare. Most AAOIFI members are private parties, such as IFIs and other financial institutions. These members' adoption of standards can be described as a bottom-up dissemination of standards because dissemination takes place through firms' voluntary adoption and commercial practice. In practice, this does not seem to have taken place to a recognizable extent.

The AAOIFI has also issued governance standards for sharia supervisory committees, which Bahrain, for example, has made an integral aspect of its regulatory law. The Islamic Financial Services Board (IFSB) was also established to deal with these types of regulatory standards. The IFSB promulgates and disseminates regulatory standards for IFIs including capital adequacy standards and governance standards relating to sharia supervisory committees. Unlike the IFSB, the AAOIFI sharia standards comprise both facilitative and interventionist legal aspects, and this distinction proves to be essential in understanding the legal and market mechanisms by which legal differences can be minimized.

Interventionist law is more closely associated with the legal architecture of a municipal legal system because regulation (in relation to finance, this is more specifically termed "financial services law") determines the ways in which contracts facilitate and distribute scarce resources. This type of law is known for its protection of defined interests, and it may supersede voluntary transactions. Interventionist law concerns tort and regulatory law but it may also include aspects of contract, property, and corporate law, particularly those aspects that

34. Anthony Ogus, *Competition Between National Legal Systems*, 48 INT'L COMP. L.Q. 405, 410 (1999).

35. Pistor, *supra* note 32, at 101–02.

confer protection on parties considered to be disadvantaged in the bargaining process. Consumers, employees, tenants, and even shareholders, in some instances, are examples.<sup>36</sup> Interventionist law is diverse, since countries and their respective municipal legal systems differ in their preference for the levels of legal intervention they wish to establish, and these preferences entail different costs. Generally, the expectation is that interventionist law will not converge due to the maintenance of these preferences and, generally, this seems to have been borne out in practice.<sup>37</sup>

Therefore, efforts to standardize Islamic law (*fiqh*) are designed to meet the legal and commercial demands of modern financial markets. Yet the standardization effort to date has fallen short in meeting these demands.

### III. THE MARKET-DRIVEN INTERPRETATION OF ISLAMIC LAW

The nature of the standardization process examined above illustrates the reductionist nature of the AAOIFI's work in relation to the formulation of standards from classical law (*fiqh*). It highlights the implicit demands of modern legal systems and financial markets that law be uniform, efficient, and hierarchical. These demands are the determining factors in the conceptualization of sharia standards. Islamic jurists' interpretation of ancient rules from the *fiqh* is contextualized in modern markets and legal systems. However, the *fiqh* is not the decisive factor in what becomes a sharia standard. Market practice plays this role. The fact that IFL jurisprudence embodies the contextual influences and practices of conventional financial markets, despite jurists' claims that it represents classical sharia, is controversial.<sup>38</sup>

The sharia is not a polished, unequivocal statement of law. It may be more easily understood as a method. It differs from the Christian and Jewish traditions in which there is a final arbiter of religious law. The Islamic legal tradition is nonhierarchical, and thus there is no final authority to oversee the determination of a legal ruling. Instead, a legal ruling's authority is closely associated with the erudition

36. Ogus, *supra* note 34, at 413.

37. *Id.* at 414. Ogus notes that even within the European Union there are many examples of countries with widely diverging levels of legal protection in various areas of law. In relation to Islamic finance, the diversity of regulatory approaches towards the industry is remarkable. For an examination of the ways in which the United Kingdom, Bahrain, the United Arab Emirates, and the Dubai International Finance Center deal with the Islamic finance industry, see ERCANBRACK, *supra* note 3.

38. It is controversial because of what many authors describe as its penchant for sharia arbitrage. It is a jurisprudence designed to circumvent sharia principles. Yet the fact that IFL embodies the practices of modern markets is necessary for the survival of the industry. Therefore, the question that must be dealt with is whether ancient prohibitions need to be reinterpreted so that a jurisprudence develops that is not comprised of legal ruses. Haider Hamoudi's work is particularly forceful in this regard. See Haider Ala Hamoudi, *The Muezzin's Call and the Dow Jones Bell: On the Necessity of Realism in the Study of Islamic Law*, 56 AM. J. COMP. L. 423 (2008).

and religious authority of jurists (*mujtahid*) who issue such rulings. Because the role of a jurist is pivotal to the law's determination, the sharia has often been described as a jurist's law. It requires jurists to apply their intellect to extract the law from the holy sources (the Quran, *sunna*, *ijma'* (consensus), and *qiyas* (analogical reasoning)) in a manner that later came to be described as the methodology of Islamic law, the *usul al-fiqh*. Jurists' individual determination of the law from the primary and secondary holy sources represents a probable assessment of what God's law is. A jurist does not claim to make law himself; rather, his analysis of what God's law is represents his best judgment as to what the holy sources decree. As long as the method or process of extracting the law from the holy sources is undertaken with utmost effort (*ijtihad*) according to the practice of a particular school's doctrine, the legal ruling (*fatwa*) is considered valid.<sup>39</sup> A *fatwa* is nonbinding, paving the way for great dynamism and diversity of legal opinions. Traditionally, a *fatwa* is given greater weight according to the proximity in which the issuing jurist was to the Prophet Muhammad and his "rightly guided" caliphs (*khulafa'u rashidun*).

The majority of lawmaking comprises the issuance of *fatawa* (the plural form of *fatwa*). Although they address private legal circumstances, *fatawa* are public in nature. This means that although the requestor may choose not to accept the *mufti* (jurist)'s legal advice, others may wish to do so. The *fatwa* could then be employed in a number of situations, taking on a life of its own.<sup>40</sup> The *fatwa* becomes part of the public record. It is integrated into the doctrine according to its authority and the school of law to which the *mufti* adheres.

The complexity of modern markets requires jurists to reinterpret the law (*fiqh*) so that it can be applied in a modern context. Rules must be given a different meaning that reflects the modern context. This has been task of jurists for centuries as society has changed and law has needed to adapt, lest it wither. Jurists possess a large toolkit of legal instruments such as *maslaha* (consideration of public interest), *istihsan* (juristic preference), *talfiq* (the patching together of rules from different *madhahib*), and *darura* (doctrine of necessity), which they can use to adapt the law to novel circumstances.<sup>41</sup> These tools assist jurists in modifying the meaning of rules determined many centuries ago so that they reflect the functional demands of modern legal systems and competitive forces.

39. For a more in-depth discussion of this aspect of Islamic law, see ERCANBRACK, *supra* note 3, at 30–32.

40. FRANK VOGEL, *ISLAMIC LAW AND LEGAL SYSTEM: STUDIES ON SAUDI ARABIA* 19 (2000).

41. Modern reformers of Islamic law have been, in particular, advocates of using these legal principles to adapt the sharia to the modern world. See MALCOLM H. KERR, *ISLAMIC REFORM: THE POLITICAL AND LEGAL THEORIES OF MUHAMMAD 'ABDUH AND RASHID RIDA* (1966).

Furthermore, the jurisprudential material that standardizing committees draw from is diverse and often conflicting. The Sunni sect comprises four active schools (*madhab*) of thought—the Hanafi, Hanbali, Maliki, and Shafi'i—and each *madhab* has its own legal tradition. The Shia sect may be even more diverse, as it comprises many schools as well as their sub-denominations. The principal ones are the Twelvers (Imami) from which the Jafari jurisprudence is derived; there are other smaller Shia sects including the Ismaili, the Druze, and the Zaidi. A final sect is the Ibadī movement or school of thought, which is said to have been founded prior to the Sunni and Shia denominations, in 650 C.E. The Ibadīs are predominant in Oman but are also active in parts of Algeria, Tunisia, Libya, and East Africa.

Sharia scholars, economists, lawyers, and others who comprise standardizing committees at the AAOIFI and other standard-setting organizations determine Islamic rules from a highly diverse tradition of Islamic legal scholarship and commercial practice that in large part no longer governs modern polities. Furthermore, it is unclear whether scholars' understanding of the *fiqh* recognizes actual commercial practice in premodern societies. There is, indeed, an enormous paucity of historical records with regard to Islamic commercial transactions, which would indicate that their understanding of the sharia is premised almost solely on jurists' premodern treatises.<sup>42</sup>

Therefore, sharia standards, including the AAOIFI standards, are not merely modern variants of ancient rules for the conduct of finance. Such standards are newly created, synthesized concepts, based on the use of innovative structures that adhere to the rules of classical *fiqh* in form (albeit tenuously). The modified meaning of these rules, reflecting the wholly novel context, is designed to replicate conventional market practices. Reducing the IFL's legal development or character to classical or even contemporary juristic discourse alone does not reflect the hybrid legal system's primary determinants. Such a discourse obfuscates the many possibilities of developing or standardizing IFL in a way that could reflect modern Islamic values. It prevents us from understanding the demands of modern legal systems and the corresponding ways in which these demands can be met in an authentic manner.

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42. The Cairo Geniza records are a rare occurrence of discovered records from the early Islamic era. They contain documentary material describing classical Middle Eastern civilization from the fourth/tenth to the tenth/sixteenth centuries (the Fatimid and Ayyubid dynasties) and comprise the largest single store of records concerning premodern Islamic life of this period. See S.D. Goitein, *The Cairo Geniza as a Source for the History of Muslim Civilisation*, 3 *STUDIA ISLAMICA* 75 (1955). Many prominent scholars argue that there is no sensible approach to developing modern rules on the basis of classical rules, since the "past becomes no more than an invention of the present, a means to validate an approach rather than any true reflection of the practices and norms of a previous era." See Hamoudi, *supra* note 38, at 469.

## IV. DIFFERENCES OF OPINION

There is some disagreement in relation to permissible transactions, which reflects jurists' normative understanding of *fiqh*. Malaysian jurisprudence is more permissive, which may account, in part, for the innovative nature of their central bank-mandated standards. Gulf jurisprudence, which seems to predominate in the formulation of AAOIFI standards, is less so. This may account, in part, for the low and patchy adoption of such standards, since they tend to impose greater normative restraints on market practice. Differences concerning the validity of various transactions are often theoretical while market practice tends to ignore legalistic arguments that would endanger IFIs' ability to compete in the market.

Malaysian regulatory authorities have created an industry-specific regulatory system in which sharia standards incorporate many of these practices. Malaysian Islamic finance markets are the most standardized in the world and yet are also the most innovative,<sup>43</sup> likely as a result of the permissive attitude toward commercial *fiqh*. Gulf scholars, however, take a more conservative approach and have outlawed many of these same practices. Scholarly differences center on a number of contracts used in the industry, including the *bay' al-'inah*, the *bay' al-dayn*, the *tawarruq*, the *murabaha* via double agency, charges for late or default payment, fees for letters of guarantee, linking the profit rate to industry benchmarks such as the Libor, and many others.<sup>44</sup>

Perhaps the most fundamental differences relate to Malaysian scholars' recognition of the *bay' al-'inah* (a legal stratagem in which a person sells an asset to another for a deferred payment; thereafter, the seller buys back the asset for a cash payment before having made full payment of the deferred price) and the *bay' al-dayn* (the sale of a debt) as valid contracts of sale, whereas Middle Eastern scholars typically do not. In fact, the majority of classical jurists forbade the *bay' al-dayn* to a third party on the basis that the transaction was characterized by uncertainty (*gharar*) as to whether the obligations would be fulfilled and that it led to *riba* (interest). The fundamental issue is whether a debt (*dayn*) is an asset (*mal*), capable of being owned and traded. Classical jurists typically viewed a debt as a *dayn* or an outstanding obligation, which was not capable of being traded. It had no intrinsic value and thus could merely be transferred from creditor to debtor at par value. However, a small minority of jurists, amongst them the famous Hanbali jurist Ibn Taymiyyah and his disciple, Ibn al-Qayyim, permitted the sale of a debt at a discount because their understanding of *riba* related to something that increased whereas a discount was not mentioned in the sources. The majority of contemporary scholars

43. Fitch: *Islamic Finance Standardisation Will Be Slow*, *supra* note 4.

44. Bakar, *supra* note 24, at 87.

now permit a discounted debt to be transferred from the creditor to the debtor but do not permit the trade of a discounted debt to a third party. Again, the issue is whether the debt can be considered an individual asset or property capable of generating profit. The Malaysian Sharia Advisory Council of the Malaysian Securities Commission does just that, considering a debt a financial right that is capable of being bought and sold.

In practice, differences concerning various transactions are premised on legalistic arguments that ignore the identical economic substance of putative differences. The *bay' al-'inah* mentioned above was held to be a legal ruse by the majority of classical schools. Only the Shafi'is and the Zahiris found it lawful, since the sale contracts involved in the structure fulfilled the requirements of valid sales contracts. For these schools of thought only God could know of any ulterior motive or intent of the transacting parties.<sup>45</sup> The Sharia Advisory Council of the Malaysian Securities Commission and the National Sharia Advisory Council of Bank Negara Malaysia—the central bank—have made the *bay' al-'inah* a lawful Islamic standard. The AAOIFI, on the other hand, has forbidden the *'inah*.<sup>46</sup> Yet both the AAOIFI and the Sharia Advisory Council of the Bank Negara Malaysia (BNM) have issued a standard on *tawarruq*.<sup>47</sup> *Tawarruq* simply adds a third party to the *'inah*.<sup>48</sup> It allows a financial institution to extend credit for a deferred payment with an increase (benchmarked against an interest rate such as the Libor) and for the customer to sell the commodity for a lower spot price in cash. The majority of classical jurists allowed the transaction due to its tripartite structure although the Maliki considered it reprehensible (*makruh*) and Ibn Taymiyyah and Ibn Qayyim even deemed it impermissible. The latter jurists dismissed it as a *hiyal* or legal ruse, akin to the *bay' al-'inah*. It remains a controversial contract. The Muslim World League and the *Fiqh* Academy of the Organization of Islamic Cooperation have deemed the *tawarruq* impermissible. The controversy concerns the differentiation between so-called organized *tawarruq* and the “spontaneous” or classical *tawarruq*.<sup>49</sup> The organized

45. Engku Rabiah Adawiah Engku Ali, *Bay' al-'Inah and Tawarruq: Mechanisms and Solutions*, in *ESSENTIAL READINGS IN ISLAMIC FINANCE* 137 (Mohd Daud Bakar & Engku Rabiah Adawiah Engku Ali eds., 2008).

46. SHARI'AH STANDARDS ss. 8 (AAOIFI 2015) (*Murabahah*).

47. *The Shariah Advisory Council of Bank Negara Malaysia (the SAC) 151st Meeting*, BANK NEGARA MALAYSIA (Sept. 30, 2014), [www.bnm.gov.my/index.php?ch=en\\_about&pg=en\\_sac\\_updates&ac=299](http://www.bnm.gov.my/index.php?ch=en_about&pg=en_sac_updates&ac=299). See also SHARI'AH STANDARDS ss. 30 (*Monetization (Tawarruq)*).

48. Another example is the *murabaha*, which comprises up to 80% of IFIs' balance sheets. It is widely agreed that IFIs transact in the *murabaha* in ways that flout Islamic financial standards, particularly regarding the assumption of risk. IFIs take constructive possession of the asset for a matter of seconds—literally—which undermines their legal justification for profit making according to Islamic commercial principles (*al-kharaj bi al-daman*).

49. In Arabic, the *tawarruq masrafiy* (bank or organized *tawarruq*) and the *tawarruq haqiqi* (literally, real *tawarruq*).

structure comprises preplanned legal steps and thus resembles the forbidden *'inah*. This type of structure reflects market practice. The original or classical *tawarruq*, which seems to have been fictionalized as a spontaneous transaction, is widely seen as permissible.<sup>50</sup>

Therefore, quite fundamental theoretical differences concerning the interpretation of the sharia remain in Islamic financial markets. However, the practical impact of such differences is much less severe due to the demands of the market. This fact bodes well for increasing standardization as long as standard-setting bodies are prepared to issue standards that reflect market practice in full.

To the extent that differences of legal opinion result in practical differences, regular dialogues aimed at building compromise have been established. Over the past decade Malaysia's central bank (the BNM) has reached out to Arab sharia scholars in an effort to strengthen its Islamic financial center. The bank initiated an ongoing "sharia dialogue" in which sharia scholars from around the world were invited to collaborate with Malaysian scholars. In 2002, Malaysia launched a sovereign *sukuk* (Islamic bond) in which both Malaysian and Arab sharia scholars gave their endorsement of the structure. Subsequent *sukuk* issuances employed this template, which was based on an *ijara sukuk*, to great effect. Thereafter a number of cross-selling initiatives were started, highlighting a new web of connections between institutions of the Malaysian and Arab states. In the regulatory field, the BNM began to work with Arab state regulatory authorities, particularly those of Bahrain and the United Arab Emirates (including the Dubai Financial Services Authority).<sup>51</sup> The following Part deals with the lawmaking feature of sharia standards in detail.

## V. THE INTERACTION OF LEGAL SYSTEMS

The interaction of IFL and the municipal legal systems that facilitate Islamic finance highlights the legal incentivization for developing sharia standards. Yet the process of standardization cannot alone result in a high level of standardization. For that to happen, the municipal legal systems in which Islamic finance is facilitated and enforced must be reformed in order to eliminate legal and regulatory gaps that exist between IFL and municipal legal systems.

It has been argued that legal transplants or the transfer of a legal rule from one jurisdiction to another is impossible or simply ineffectual. The argument is that a rule embodies a particular socio-cultural understanding, such that its transplantation to a foreign jurisdiction ignores the language, tradition, and culture of the legal system in which the rule was conceived.<sup>52</sup> Other scholars suggest that

50. Engku Ali, *supra* note 45, at 143.

51. Warde, *supra* note 26, at 12.

52. See Pierre Legrand, *The Impossibility of Legal Transplants*, 4 MAASTRICHT J. EUR. & COMP. L. 111, 115 (1997).

transplants and the law, more generally, have a life of their own, “no extremely close, natural or inevitable relationship exists between law, legal structures, institutions and rules on the one hand and the needs and desires and political economy of the ruling elite or of the members of the particular society on the other hand.”<sup>53</sup> Scholars of this persuasion argue that problems with transplants do arise but that, by and large, transplants can be used to great effect.<sup>54</sup> Finally, transplants can also act as legal irritants, which “triggers a whole series of new and unexpected events” and creates “wild perturbations in the interplay of discourses within these arrangements and forces them to reconstruct internally not only their own rules but to reconstruct from scratch the element itself.”<sup>55</sup>

Two elements underlying this discourse seem certain. First, the standardization of “best practice” or “efficient” law—which, in general, characterizes the effort to promulgate AAOIFI sharia standards—may prevent the jurisprudence from developing organically via commercial practice. The development of an optimal set of rules may prevent the Islamic finance industry from developing a jurisprudence premised on innovation and institutional adaptation that occurs in a dynamic, competitive environment.<sup>56</sup> This is due to the cognitive nature of law, which, for it to be effective, must be fully understood by those enforcing the law and, equally, by its users. The transplantation of law is an old experience for most developing countries. It is a history in which users’ knowledge of a living legal system has been routinely ignored.<sup>57</sup> A lack of knowledge of the way in which newly conceived standards actually function in a living legal system impedes a high degree of standardization, and, in fact, may produce an unforeseen hybrid variant of the law. There are alternative choices for the way in which any particular standard is to be implemented, and perhaps more importantly, to be enforced. A high degree of standardization presupposes knowledge of a living legal system, which provides a template for the endeavor.<sup>58</sup>

Second, legal systems are characterized by an interdependence of legal rules and concepts. This means that rules generally can only be understood in reference to other rules or concepts. It also means that standards require already existing bodies of law in the receiving legal systems so that they can be realized and enforced. Alternatively,

53. Alan Watson, *Comparative Law and Legal Change*, 37 CAMBRIDGE L.J. 313, 315 (1978).

54. O. Kahn-Freund, *On Uses and Misuses of Comparative Law*, 37 MOD. L. REV. 1, 3 (1974).

55. Gunther Teubner, *Legal Irritants: Good Faith in British Law or How Unifying Law Ends up in New Divergences*, 61 MOD. L. REV. 11, 12 (1998).

56. Pistor, *supra* note 32, at 98.

57. *Id.* at 99.

58. *Id.* at 102–03.

receiving legal systems will need to undergo reform so that complementarity exists between the new law and preexisting legal institutions.<sup>59</sup>

Most countries, which facilitate Islamic finance, have adopted civil or common law legal systems, and do not possess the legal and regulatory infrastructure to adequately regulate and enforce Islamic finance transactions. Even sharia or sharia-based legal systems such as Saudi Arabia require considerable judicial and regulatory reform because the IFL differs from classical interpretations of the law (in the case of Saudi Arabia, Hanbali *fiqh*). A number of systemic legal issues originate from these gaps. These tend to undermine investors' confidence in the industry and impede sustainable development. These include enforceability issues, a lack of clarity in relation to the role and effect of the sharia in municipal legal systems, and undeveloped securities laws, among others. More generally, the highly complex legal environments of the Middle East and North Africa (MENA) region,<sup>60</sup> where the majority of Islamic finance assets originate, are associated with a reduced flow of information (lack of transparency). This results in diminished legal certainty and foreseeability.<sup>61</sup> An example discussed below is the United Arab Emirates (U.A.E.), which recently adopted the AAOIFI sharia standards.

## VI. U.A.E. LAW AND THE DISJUNCTURE BETWEEN IFL AND SHARIA

The hybridized system of U.A.E. law, which comprises elements of the sharia, requires considerable reform if a high degree of standardization is to take effect. A default involving Dana Gas, a U.A.E. energy company, and its investors in relation to a 700 million USD *muduraba sukuk* issuance highlights the disjuncture between IFL and U.A.E. law, and how this pluralistic legal interaction incentivizes full standardization.

In the aftermath of the Dana Gas *sukuk* default, the U.A.E. central bank adopted the AAOIFI sharia standards, illustrating an important example of legal borrowing but also one which still represents partial standardization. From September 2018, all Islamic banks, Islamic windows (of conventional banks), and finance companies offering sharia-compliant products and services are required to comply with AAOIFI sharia standards.<sup>62</sup> This is an important step, but it gives effect to partial standardization as the standards have not yet been

59. *Id.* at 98.

60. In 2016, the MENA region consists of 72% of all Islamic finance assets (measured in U.S. dollars). See ISLAMIC FIN. SERVS. BD., ISLAMIC FINANCIAL SERVICES STABILITY REPORT (2017).

61. Shabsigh et al., *supra* note 5.

62. The regulation excludes *sukuk* issuances, as long as these are not issued by Islamic financial institutions or companies dealing in Islamic financial products or services. See AAOIFI Welcomes U.A.E.'s Adoption of Its Standards, AAOIFI, [aaofi.com/announcement/aaofi-welcomes-U.A.E.s-adoption-of-its-standards/?lang=en](http://aaofi.com/announcement/aaofi-welcomes-U.A.E.s-adoption-of-its-standards/?lang=en) (last visited Oct. 16, 2018).

implemented in legislation, which would require U.A.E. courts to apply AAOIFI standards when adjudicating Islamic financial disputes.<sup>63</sup>

The conventional knowledge is that the sharia will not prevail in a dispute involving Islamic finance in a U.A.E. court.<sup>64</sup> Even if the contract purports to be governed by the sharia, the laws of the United Arab Emirates will decide the issue. The court is unlikely to deal with an Islamic finance dispute in a manner that is different than its approach to conventional finance. This conclusion is premised on the general pattern of conduct of U.A.E. courts as opposed to the Union's commercial and civil codes, which, in various instances, is influenced by or reserves an interpretational role for the sharia.

The 1971 Constitution of the United Arab Emirates established a legal system that comprises a federation of seven emirates. Individual emirates retain sovereignty over their own territories in relation to matters not provided for in the Constitution. U.A.E. federal law is applicable throughout the seven emirates. It is modeled on Egyptian, Sudanese, and other Arabic countries. Egyptian law too derives from Napoleonic or French civil and penal codes but retains elements of the sharia as well. Sudanese law also comprises legal transplants. In its case, a mixture of the sharia and English common law represents the governing legal system.<sup>65</sup>

Islam is the official religion of the union and the sharia "shall be a main source of legislation in the Union," according to the Constitution.<sup>66</sup> This provision indicates that the sharia is only one source among others including federal law, general legal principles, and customary rules. However, article 2 of the 1985 federal Civil Code takes a different position in relation to the sharia: "The rules and principles of Islamic jurisprudence (*fiqh*) shall be relied upon in the understanding, construction and interpretation of these provisions."<sup>67</sup> The article elevates the role of the sharia from a source of interpretation to the source of civil law interpretation. Article 27 buttresses this role by providing that "it shall not be permissible to apply the provisions of a law specified by the preceding articles if such provisions are contrary to Islamic Shari'a, public order, or morals . . ."<sup>68</sup> These articles create legal uncertainty because of their potential conflict with the

63. This topic is dealt with in greater detail in Jonathan Ercanbrack, *Islamic Financial Law and the Law of the United Arab Emirates: Disjuncture and the Necessity for Reform*, 33 ARAB L.Q. 1 (2019).

64. Case law seems to confirm this. For examples of cases in which the sharia—albeit in a roundabout way—was circumvented in favor of U.A.E. law, see *Al-Mahkama Al-Athadia Al-'Alia* [F.S.C.] [Federal Supreme Court], decision No. 176/2008 of June 15, 2009; F.S.C., decision No. 591/2012 of Sept. 24, 2013.

65. CENT. INTELLIGENCE AGENCY, *THE WORLD FACTBOOK* (2017), [www.cia.gov/library/publications/the-world-factbook/geos/su.html](http://www.cia.gov/library/publications/the-world-factbook/geos/su.html).

66. DUSTUR DAWLAT AL-IMARAT AL-'ARABIYA AL-MUTTAHIDA [CONSTITUTION OF THE UNITED ARAB EMIRATES] art. 7 (1971) (translated by author).

67. Law No. 5 of 1985 on the Civil Transactions Law (Civil Code) art. 2 (1985) (U.A.E.) (translated by James Whelan).

68. *Id.* art. 27.

Constitution, the supreme source of law, and the way in which a court may apply them. This legal hybridity is not made simpler by the fact that U.A.E. lawmakers have chosen to selectively apply the sharia as evidenced in article 1 of the amended Civil Code, which excludes the applicability of the sharia in the Commercial Code. Yet the Civil Code comprises the law of obligations, including contract and tort, which cannot be excluded from the purview of commercial law. Specifically, the Civil Code comprises numerous so-called nominate and innominate contracts including the *ijara*, *istisna*, *salam*, and *mudaraba* contracts.<sup>69</sup> Parties who elect to use a nominate or innominate contract in their commercial dealings would be subject to *fiqh* as a basis of legal interpretation. Divergences exist between the Civil Code's provisions for Islamic contracts and the AAOIFI standards regarding the same. This is an important regulatory gap, which requires the legislative adoption of the AAOIFI standards if the implementation and enforcement of standards is to be effective.

The Commercial Code indicates that the sharia will not play a role in commercial matters unless commercial custom reflects sharia principles. Article 2 provides that in the absence of agreement and relevant law, commercial custom and practices are to apply to the matter. Specific customary practices are to have precedence over general custom and where custom is absent, civil law applies so long as it does not contradict general commercial principles.<sup>70</sup>

Practically speaking, the Federal Supreme Court, the highest court of the United Arab Emirates, as well as the Dubai Court of Cassation, have upheld article 2 by enforcing commercial practices that are widely viewed as contraventions of the sharia.<sup>71</sup> The courts regularly enforce interest provisions, which are lawful according to the

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69. Modern Islamic contract law is organized according to nominate and innominate contracts. Nominate contracts are a set of contracts in which jurists created specific names and organized these according to specific rules. The jurist takes a case-by-case approach to deriving Islamic law (*fiqh*), which produces subtle rules pertaining to specific contracts. It is not a theorization of broad formulas for contract making. There is no general theory of obligations, for example. The contract of sale functions as a type of template or model for nominate contracts. It is generally defined as an immediate exchange of counter-values by words or deed. The focus is on the subject matter of the contract as opposed to any obligation to which the contract gives rise. In practice, however, the system is not nearly as streamlined. Exceptions and qualifications far outnumber the rule as these reflect the exigencies of trade and commerce. Such exceptions are known as innominate contracts. An important early example is the *bay' al-salam* or forward sale in which the subject matter does not yet exist. The seller undertakes to make it available at a later date to the purchaser. The nonexistent subject matter is a promise given in exchange for immediate payment. According to the rules of sharia, this kind of sale is unlawful as the seller sells what is not in existence. See Nabil Saleh, *Definition and Formation of Contract Under Islamic and Arab Laws*, 5 ARABIC L.Q. 101 (1990). See also NAYLA COMAIR-OBEID, *THE LAW OF BUSINESS CONTRACTS IN THE ARAB MIDDLE EAST* (1996).

70. Law No. 18/1993 Issuing the Commercial Transactions Law (Commercial Code) art. 2 (U.A.E.).

71. See F.S.C., decision No. 591/2012; F.S.C., decision Nos. 436/24 & 440/24 of Oct. 11, 2005 (U.A.E.).

Commercial Code.<sup>72</sup> An interest rate of up to 12% is lawful according to article 76. The court construes interest charges as compensation for delay rather than acknowledging the lawfulness of interest. This would seem to reflect the religious sensitivity concerning the charging of interest.

Therefore, under foreseeable circumstances, U.A.E. law is the applicable law in relation to commercial matters, irrespective of whether these relate to Islamic finance or conventional transactions. However, the Dana Gas default illustrates the legal chasm between IFL (a *mudaraba sukuk* issuance reflecting market practice) and U.A.E. law, which, as noted, comprises provisions derived from the sharia. Paradoxically, legal uncertainty is not associated with whether the sharia will be used as an interpretational guide as discussed above. Rather it relates to elements of the sharia that are embedded in the U.A.E. Civil Code.

Dana Gas filed a motion in the U.A.E. courts which sought to declare its 700 million USD *mudaraba sukuk* unlawful under U.A.E. law. The company claimed that the structure had become unlawful “due to the evolution and continual development of Islamic financial instruments and their interpretation.”<sup>73</sup>

*Mudaraba sukuk* represent ownership of units of equal value in the equity of the *mudaraba* investment partnership. In this type of partnership, the owner of capital (*rab al-mal*) extends capital to an investment agent (*mudarib*) in order to trade on their behalf. Profit ratios are agreed in advance. Should any losses arise, these are borne by the investor. The *mudarib* loses only her time and effort if profits do not materialize. A fixed amount of profit is not permissible because it establishes a fixed return, which is generally viewed as being commensurate with *riba*.

The Dana *sukuk* structure included a scheduled redemption or purchase undertaking in which the *mudarib* liquidates the *mudaraba* assets and repays *sukuk* investors. This contractual step, the purchase undertaking, contravenes the rules of the *mudaraba* structure since investors will be compensated in full irrespective of the assets’ performance (in addition to the regular profit distributions). The issuance offers a similar risk and reward profile as a conventional bond.<sup>74</sup>

U.A.E. law, in articles 693 to 709 of the U.A.E. Civil Code, provides rules that reflect the classical sharia interpretation of the *mudaraba* contract. Article 704 of the U.A.E. Civil Code provides:

- (1) The owner of the capital shall alone bear any loss, and any provision to the contrary shall be void.

72. Commercial Code arts. 76–79.

73. DANA GAS, DANA GAS OUTLINES BROAD TERMS FOR SUKUK DISCUSSIONS (June 13, 2017), [bit.ly/2KnqRnU](http://bit.ly/2KnqRnU).

74. DANA GAS SUKUK LTD., OFFERING CIRCULAR 18 (May 8, 2013), [www.londonstockexchange.com/specialist-issuers/islamic/danagas-prospectus.pdf](http://www.londonstockexchange.com/specialist-issuers/islamic/danagas-prospectus.pdf).

- (2) If any of the capital in the *mudaraba* is lost, that shall be accounted for out of the profits, and if the loss exceeds the profits the balance shall be accounted for out of the capital, and the *mudarib* shall not be liable therefor.<sup>75</sup>

The Dana Gas *sukuk* prospectus is clear that “the *Mudarib* shall not be entitled to liquidate the *Mudarabah* Assets unless the proceeds of such liquidation, when aggregated together with the amounts standing to the credit of the Transaction Account and the Reserve Account, is equal to or greater than the Redemption Required Amount.”<sup>76</sup> The *sukuk* issuance, which reflects market practice in Islamic capital markets,<sup>77</sup> directly contravenes article 704(1)–(2) in that it requires the *mudarib* to repay *sukuk* holders their investments in full.<sup>78</sup> Given the interpretational role of *fiqh* in relation to the Civil Code, it seemed likely that the transaction would be invalidated by a U.A.E. court.<sup>79</sup>

The U.A.E. central bank’s adoption of AAOIFI standards is only a partial and as yet ineffective step in standardizing Islamic financial law. The adoption of standards is not sufficient to guarantee full standardization. The AAOIFI standards, as argued above, do not cater to the types of market practices that comprise most investment *sukuk* issuances. In the case of the Dana Gas *sukuk* issuance, for example, AAOIFI Standard No. 17 on investment *sukuk* states that

[t]he prospectus must not include any statement to the effect that the issuer of the certificate accepts the liability to compensate the owner of the certificate up to the nominal value of the certificate in situations other than torts or negligence nor that he guarantees a fixed percentage of profit.<sup>80</sup>

The standard reflects the classical rules for liability in relation to profit making as per the *mudaraba* contract. It is a reflection of jurists’ normative aspirations conflicting with market demands for fixed-price investment *sukuk* resembling the payment and risk profile of a bond.<sup>81</sup>

75. Civil Code art. 704 (translated by author).

76. DANA GAS SUKUK LTD., *supra* note 74, at 6.

77. Neil D. Miller, *Some Considerations When Islamic Transactions Default*, 7 CORP. RESCUE & INSOLVENCY 44, 48 (2014).

78. In May 2018, Dana Gas agreed to a restructuring of the \$700 million *sukuk* issuance, which brought an end to the litigation. See Andrew Torchia, *Update 1—U.A.E.’s Dana Gas Agrees \$700 mln Sukuk Restructuring Deal*, REUTERS (May 13, 2018), [reut.rs/2piCk0u](https://www.reuters.com/article/uk-dana-gas-sukuk-restructuring-idUKKBN180001).

79. This seemed very likely until the legal proceedings were brought to an end with the settlement between Dana Gas and its investors. The English Court weighed in on the matter in relation to the purchase undertaking as the issuance was governed by multiple laws. See *Dana Gas PJSC v. Dana Gas Sukuk Ltd.* [2017] EWHC (Comm) 2928 (Eng.).

80. SHARI’AH STANDARDS SS. 17, at 5/1/8/7 (AAOIFI 2015) (Investment Sukuk).

81. Fitch recently stated that “in some cases, there is still little standardization even at a local level, while in others, progress would be needed on a regional, or international basis.” The conflict between normative aspirations and market practice may be an important reason for the lack of standardization. See *Fitch: Islamic Finance Standardisation Will Be Slow*, *supra* note 4.

The standardization of actual market practice (as is the case in Malaysia) is an option that would bring about a high degree of standardization. However, it concretizes financial practices that are similar to conventional finance. The other option is to give full effect to the AAOIFI standards in municipal regulatory and legal systems. However, this is not a straightforward proposition: it may be possible in relation to retail markets (for reasons discussed below), but in relation to *sukuk* and other wholesale markets, the market may not be willing to go along.

## VII. ENGLISH LAW AND SHARIA AUTHENTICITY

The development of Islamic standards is incentivized in Islamic finance cases in the courts of England and Wales for the reason that the sharia authenticity of Islamic finance transactions is undermined in the way in which English law deals with IFL. Because of the prominent international role of English law in Islamic finance, reference to Islamic standards in the terms and conditions of Islamic finance transactions would facilitate the adjudication of disputes according to such terms and thereby instill confidence in the sharia authenticity of the market.

English courts' objective interpretational approach gives effect to the contractual provisions of Islamic finance transactions without consideration of sharia principles or AAOIFI sharia standards. The legal gap, in this functional sense, does not exist because the IFL is enforced under English law without modification. However, because English courts will not base their judgments on the interpretation of the sharia, the authenticity of transactions is undermined. English law's hands-off approach to IFL creates a credibility gap.<sup>82</sup>

Parties will choose the governing law and the law of the jurisdiction they wish to use to resolve the dispute in order to avoid complexity. The law of some jurisdictions, such as England and New York, is often chosen as the governing law in international commercial contracts because there is a substantial body of sophisticated case law dealing with issues arising in conflicts over commercial or financing contracts. This leads to greater legal certainty for the parties. Furthermore, investors demand a formal forum for dispute resolution that is not imperiled by weak regulatory and legal infrastructure. Often, investors require the use of English law in the belief that it will lessen the risks of the transaction. Islamic financial transactions, particularly wholesale, cross-border transactions are often governed, at least in part, by English law.

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82. The hands-off approach to Islamic finance is also prevalent in legislation that facilitates and regulates the industry in the United Kingdom. See Jonathan G. Ercanbrack, *The Regulation of Islamic Finance in the United Kingdom*, 13 *ECCLESIASTICAL L.J.* 69 (2011).

In the cases examined below, the defaulting party argued that the agreement was invalid due to sharia noncompliance. English law's unwillingness to decide these cases on the basis of this argument has proved to be an important reason for the industry's preference for English law as the governing law of cross-border Islamic finance contracts.<sup>83</sup> But the industry cannot remain immune indefinitely to the perceived lack of sharia authenticity in these types of transactions. Standardization buttresses the sharia authenticity of disputed transactions that are litigated in English courts.

The first Islamic financial dispute in a Western court was *Islamic Investment Co. v. Symphony Gems N.V.*<sup>84</sup> The case was important to the Islamic finance industry because it demonstrated that English courts would uphold parties' contractual agreements, even those that flouted generally accepted rules of the sharia such as the prohibition of *riba*, which the industry equates with interest. The case involved a *murabahah* financing agreement in "accordance with the Islamic Shariah," which was nonetheless governed by English law. The court upheld the parties' agreement and did not decide the case in relation to arguments concerning the sharia compliance of the *murabahah* agreement. The financial and legal practices of the Islamic finance industry were not jeopardized or thrown into question.

*Shamil Bank v. Beximco Pharmaceuticals Ltd.*<sup>85</sup> was a considerably more important case in English law and also one which reaffirmed the fact that English law would not decide the case on the basis of the sharia. It concerned a governing law clause of finance agreements. It read: "Subject to the principles of the Glorious Sharia'a, this Agreement shall be governed by and construed in accordance with the laws of England."<sup>86</sup> The case demonstrates two important principles for the way in which English law will deal with Islamic finance contractual disputes. First, a contract governed by a nonstate law or body of principles such as the *lex mercatoria* is not permitted under English law. This is due to the United Kingdom's membership in the European Union in which the Convention on the Law Applicable to Contractual Obligations (the Rome Convention)<sup>87</sup>—an EU treaty—forbids the use of a nonstate law as the proper law of a contract. Second, Islamic rules

83. Historically, the interpretational modus of English common law takes a characteristically literalist approach to contractual interpretation. This is illustrated in the well-known case of *Lovell & Christmas Ltd. v. Wall* [1911] 104 LT 85 (CA) (Eng.). Lord Hoffmann enunciated the decisive shift towards a contextual approach to contractual interpretation in *Investors Compensation Scheme Ltd. v. West Bromwich Building Society* [1998] 1 WLR 896 (HL) 912–13. Lord Hoffmann outlined what earlier courts had already set in motion, namely, Lord Wilberforce in *Prenn v. Simmonds* [1971] 1 WLR 1381, 1381–86, and in *Reardon Smith Line Ltd. v. Hansen-Tangen* [1976] 1 WLR 989.

84. [2002] All ER (D) 171.

85. [2004] EWCA (Civ) 19.

86. *Id.* [1].

87. Convention on the Law Applicable to Contractual Obligations, 1980 O.J. (L 266) 1.

or principles such as the AAOIFI sharia standards can be incorporated into a contract governed by English law. Such rules would be construed according to the methodological approach of English law. If such rules were routinely incorporated into Islamic finance agreements by public mandate, sharia invalidity arguments in which the defaulting party uses sharia compliance as a defense, would be reduced. Islamic standards, such as the AAOIFI standards, when mandated by law, have been shown to result in the highest degree of standardization. This is exactly what Malaysia has done.

### VIII. MALAYSIA'S STATE-CENTRIC APPROACH TO STANDARDIZATION

The standardization of IFL in Malaysia represents a state-led, top-down approach to standardization, which has made Malaysia the most standardized Islamic finance jurisdiction in the world. Despite its state-centered model, the premise that the standardization of Islamic standards is driven by interactive legal systems and market forces is applicable there too. Malaysia provides a remarkable example of the ways in which the state has responded to these factors as part of its strategy to develop a specialized legal and regulatory system for Islamic finance. The state has crafted a distinctive Malaysian version of IFL, which reflects the complex Malaysian legal environment and the demands of global financial markets. Notably, the state's top-heavy role in this process highlights the minimal role of traditional jurists.<sup>88</sup>

Malaysia is a multiethnic country with a majority Muslim population. It is comprised of thirteen states and three federal territories. Article 121 of the Constitution of Malaysia delineates a clear distinction between federal jurisdiction and the jurisdiction of sharia courts.<sup>89</sup> Furthermore, Article 74 provides that parliament may make laws with respect to matters enumerated in the so-called Federal List, which gives the federal courts jurisdiction over civil law, criminal law, and procedural law, comprises a wide range of civil law matters including finance and contract law.<sup>90</sup> The same article empowers state legislatures to make laws with respect to matters listed in the so-called State List.<sup>91</sup> The State List gives state courts jurisdiction over Islamic law, including Islamic personal and family law.<sup>92</sup> Islamic

88. Emma van Santen, *Islamic Banking and Finance Regulation in Malaysia: Between State Sharia, the Courts and the Islamic Moral Economy*, 39 *COMPANY LAW* 21, 26 (2018).

89. CONSTITUTION OF MALAYSIA art. 121 (1957).

90. *Id.* sch. 9, list I, item 4(a)(i) (Federal List).

91. *Id.* sch. 9, list II, item 1 (State List).

92. A former colony of Britain, the formalized regulation of Islamic personal and family law dates from the Muhammadan Marriage Ordinance issued in 1880. Courts for Muslim subjects were established in 1900 but these were subject to appeal before the common law high courts. For more on the history of Malaysian legal development, see Tamir Moustafa, *Judging in God's Name: State Power, Secularism, and the Politics of Islamic Law in Malaysia*, 3 *OXFORD J.L. & RELIGION* 152 (2014).

financial disputes, although comprising Islamic legal elements, are dealt with in secular, civil law courts. As is the case in other Muslim majority jurisdictions, the jurisdiction of sharia courts in Malaysia is limited. Malaysia distinguishes itself from Muslim majority states, however, in relation to the clarity of its constitution and legal framework concerning the role and effect of the sharia.

Malaysia inherited the common law from its former colonial ruler, Britain.<sup>93</sup> But the country's system of law, including its statutory law, is more accurately described as "Anglo-Muslim" law since it is characterized by a peculiar mix of common law and Islamic legal principles. The concepts, categories, modes of analysis, and hierarchies reflect English law, while aspects of *fiqh* are applied to Muslim subjects in relation to Islamic personal and family law and now Islamic financial matters.<sup>94</sup>

Malaysia's industry-specific regulatory system for Islamic finance reflects its Anglo-Muslim legal heritage. The Islamic Banking Act of 1983 was the first piece of legislation that created a financial services framework for the industry. The Act, however, which has now been replaced by the Islamic Financial Services Act 2013 (the IFSA 2013), did not provide guidance concerning Islamic financial structures nor did it refer to any other aspects of the sharia. The IFSA 2013 represented a considerable advancement. It provided for modernized prudential regulation of the industry and a modernized sharia governance framework. Specifically, the Act refers to the interpretation of the sharia, which is determined by the Shariah Advisory Council of Bank Negara Malaysia (the SAC), and the duty of financial institutions to ensure compliance with the sharia.<sup>95</sup> The SAC was introduced in the Central Bank of Malaysia Act 1958,<sup>96</sup> which has now been superseded by the Central Bank of Malaysia Act 2009. In the meantime, however, a contestation of legal systems took place that determined the nature and structure of the Islamic financial regime in Malaysia. Specifically, the 1958 Act provided that Malaysian courts were to be given the option to consult or take into consideration the rulings of the SAC in relation to legal proceedings involving Islamic finance.<sup>97</sup> The optional, nonbinding nature of SAC guidance paved the way for considerable litigation concerning the interpretation of the sharia.

93. Britain established a formal Crown colony comprising the port cities of Penang, Singapore, and Malacca in 1867.

94. Moustafa, *supra* note 92, at 157.

95. Remarkably, the Islamic Financial Services Act 2013 provides that any person who contravenes the SAC's interpretation of the sharia is liable to eight years' imprisonment or to a fine not exceeding 25 million MYR (6.275 million USD) or both. Therefore, the legislator employed the highest degree of regulatory intervention, ensuring a high level of standardization amongst financial institutions. See Islamic Financial Services Act 2013, No. 759, art. 28(5).

96. Central Bank of Malaysia Act 1958, No. 519, art. 16b(1) (repealed 2009). There is also a Shariah Advisory Council at the Malaysian Securities Commission.

97. *Id.* art. 16b(8).

Not unlike English case law, most Malaysian litigation involving Islamic finance transactions has involved contractual disputes in which defaulting parties seek to invalidate the agreement due to contravention of the sharia. The *bay' bithamin ajil* (BBA) structure or the *bay' al-'inah* contract has been the subject of contestation most often.<sup>98</sup> A case that highlighted the High Court of Malaysia's common law interpretational modus is *Bank Islam Malaysia Berhad v. Adnan Omar*.<sup>99</sup> The Court enforced the contract according to its terms and conditions without examination of the sharia compliance of the BBA facility, indicating the court's assertion of common law jurisdiction over the case. In this period, this approach to Islamic finance disputes characterized Malaysian jurisprudence.<sup>100</sup> Gradually, however, the courts began to take a more circumspect approach to these types of cases by examining the underlying principles of the Islamic financial structures.<sup>101</sup> In *Affin Bank Berhad v. Zulkifli Abdullah*, Justice Abd Wahab Patail rejected the notion that the dispute should involve the SAC "since the question before the court is the interpretation and application of the terms of the contractual documents between the parties . . ." and "not a question of sharia law."<sup>102</sup> The court then proceeded to analyze the BBA facility in relation to the profit payable upon default, determining "that profit margin that continues to be charged on the unexpired part of the tenure cannot be actual profit. It is clearly unearned profit" and contradicts the principle of BBA.<sup>103</sup> Therefore, the court, albeit indirectly, examined Islamic principles in relation to their ethical import, in contrast to the classic common law modus of interpretation in which parties' contractual undertakings are enforced irrespective of whether the transaction was a bad deal. The decision highlights a more intensive engagement with the sharia, albeit under the auspices of the common law.

In *Arab-Malaysian Finance Berhad v. Taman Ihsan Jaya Sdn Bhd*,<sup>104</sup> Justice Abd Wahab Patail, on behalf of the High Court of Malaysia, broke ranks with the common law in the court's renunciation of the BBA structure. He held that the structure had to be tested according to the interpretations of the five main schools (*madhahib*) of Islamic *fiqh*, and, therefore, the substance of the BBA, rather than its form, was important. To proceed otherwise would constitute

98. From 2003 to 2009, 90% of litigation involving Islamic finance was related to the BBA structure. See Zulkifli Hasan & Mehmet Asutay, *An Analysis of the Courts' Decisions on Islamic Finance Disputes*, 3 ISRA INT'L J. ISLAMIC FIN. 41, 46 (2011).

99. [1994] 3 CLJ 735.

100. As highlighted in *Bank Kerjasama Rakjat Malaysia Berhad v. Emcee Corp.* [2003] 2 MLJ 408.

101. Hasan & Asutay, *supra* note 98, at 45.

102. [2006] 3 MLJ 67, at 75.

103. *Id.* at 77. A similar examination of sharia principles was undertaken in *Malayan Banking Berhad v. Ya'kup bin Oje & Anor* [2007] 6 MLJ 389. The judge in this case examined both the common law and sharia principles of the BBA facility.

104. [2008] 5 MLJ 631.

circumvention or a legal fiction, which the Quran condemns.<sup>105</sup> The transactions in the case were said to have violated the prohibition of levying interest (*riba*). Justice Abd Wahab Patail's conservative interpretation of the sharia "sent out a shock wave within the Islamic financial establishment" because the decision undermined the validity and sharia authenticity of Malaysian IFL.<sup>106</sup> Further, Justice Patail cast doubt on the judicial authority of the SAC, which the learned judge subsequently referred to as an arm of the government in *Arab-Malaysian Bank Berhad v. Silver Concept Sdn Bhd*.<sup>107</sup> Although the Court of Appeal overturned the High Court's decision and upheld the validity and enforceability of the BBA, the viability of Malaysian Islamic finance had been thrown into doubt.<sup>108</sup>

Almost immediately, the Malaysian government sought to shore up its Islamic financial system by effectively endowing the SAC with judicial authority.<sup>109</sup> Therefore, legal contestation incentivized the promulgation of the Central Bank Act 2009, which included provisions that would bind the courts to the IFL guidelines and rulings of the SAC. Article 56(1) provides that

[i]n any proceeding relating to Islamic financial business before any court or arbitrator, any question arises concerning a Shariah matter, the court or the arbitrator, as the case may be, shall—

105. The learned justice failed to highlight the fact that the different *madhahib* have quite different approaches to legal interpretation. The Hanafis and Shaf'is were less concerned with the substance of contracts. They stressed that only God could know parties' intentions. As long as the letter of the law was valid, the transaction was valid. Further, the Hanafis developed a vibrant literature of legal ruses or stratagems known as *hiyal*, which were employed in nearly all facets of life. The Shaf'is were known to have utilized them too. See JOSEPH SCHACHT, *DAS KITAB AL-HIJAL FIL-FIQH (BUCH DER RECHTSKNIFFE) DES ABU HATIM MAHMUD IBN AL-HASAN AL-QAZUINI* (1924); Joseph Schacht, *Die Arabische Hijal-Literatur: Ein Beitrag Zur Erforschung Der Islamischen Rechtspraxis*, 15 *DER ISLAM* 211 (1926); Satoe Horii, *Reconsideration of Legal Devices (Hiyal) in Islamic Jurisprudence: The Hanafis and Their "Exits"* (Makharij), 9 *ISLAMIC L. & SOC'Y* 312 (2002).

106. Barry Rider, *The Virtue of Certainty*, 30 *COMPANY LAW* 225, 225 (2009). Zulkifli Hasan and Mehmet Asutay mistakenly cite the "conservative common law approach" in relation to this case. But the common law approach does not deal with the ethical or substantive principles of transactions (see Hasan & Asutay, *supra* note 98, at 52). The sharia is the legal system, which determined this case.

107. [2008] 6 MLJ 295.

108. Subsequent decisions upheld the validity and enforceability of the BBA, *bay' al-inah*, and *murabahah* contracts. See *Light Style Sdn Bhd v. KFJ Ijarah House (Malay.) Sdn Bhd* [2009] CLJ 370; *Bank Islam Malay. Bhd v. Lim Kok Hoe* [2009] 6 CLJ 22; *Majlis Amanah Rakyat v. Bass bin Lai* [2009] 2 CLJ 433; *Bank Islam Malay. Bhd v. Azhar Osman* [2010] 5 CLJ 54.

109. The constitutionality of sections 56 and 57 of the Central Bank Act 2009 were contested in *Mohd Alias Ibrahim v. RHB Bank Bhd* [2011] 4 CLJ 654. The judge held that the Act was constitutional on rather legalistic grounds. In *Tan Sri Abdul Khalid Ibrahim v. Bank Islam Malaysia Bhd* [2012] 7 MLJ 597, the appellant also sought unsuccessfully to challenge the constitutionality of sections 56 and 57, applying a similar rationale.

- (a) take into consideration any published rulings of the Shariah Advisory Council;  
or
- (b) refer such question to the Shariah Advisory Council for its ruling.<sup>110</sup>

Furthermore, article 57 provides that “any ruling made by the Shariah Advisory Council pursuant to a reference made under this Part shall be binding on the Islamic financial institutions under section 55 and the court or arbitrator making a reference under section 56.”<sup>111</sup> Disputes involving questions related to the sharia will be decided by the SAC and the court is bound by the SAC’s ruling. Subsequent decisions have upheld the validity and enforceability of controversial contracts such as the BBA, *bay’ al-‘inah*, and *murabahah* by referring to the authority of the SAC or SAC sharia guidelines.<sup>112</sup>

This dual financial system, which is the result of considerable lawmaking, results in the highest degree of standardization and the industry’s most innovative version of IFL. But it has also helped to concretize a state-mandated version of IFL that has been criticized as a conventional clone.<sup>113</sup> It is unlikely to satisfy those who long for a more ethical, distinctively Islamic version of IFL. Yet it has enabled Malaysia to distinguish its cultural brand in the global economy.<sup>114</sup>

#### IX. MARKET FORCES AND STANDARDIZATION

The economic nature of commercial law suggests that the tendency to minimize legal differences is particularly evident where market forces provide a strong incentive for doing so. Market forces compel the use of standard-form documentation, comprising standards that reflect the commercial practice of law firms and corporations.<sup>115</sup> These legal practices are integral aspects of Islamic financial transactions. They illustrate the market’s pull toward standardization as well as the ways in which Islamic standards are modeled on conventional standard documentation. This aspect of standardization should be treated as an important aspect of the endeavor, since it underscores the ways in which Islamic standards are formed in the market.

Commercial law tends to converge for commercial reasons. In other words, the degree of similarity tends to narrow in the commercial field

110. Central Bank Act 2009, No. 701, art. 56 (Malay.).

111. *Id.* art. 57.

112. *See, e.g.*, Bank Islam Malaysia Bhd v. Lim Kok Hoe [2009] 6 CLJ 22; CIMB Islamic Bank Bhd v. LCL Corp. Bhd [2011] 7 CLJ 594.

113. Van Santen, *supra* note 88, at 27.

114. Malaysia is one of twelve systemically important Islamic banking jurisdictions. The country has the third largest share of Islamic banking assets, totaling 9.3%. *See* ISLAMIC FIN. SERV. BD., ISLAMIC FINANCIAL SERVICES INDUSTRY STABILITY REPORT (2017).

115. Andersen, *supra* note 16, at 30–31.

even if some differences inevitably remain.<sup>116</sup> There are a number of contextual factors that lend credibility to this assertion. Namely, healthy, flourishing markets demand transparency, stability, and predictability. Clear contractual terms indicating the rights and remedies of the parties as well as the financial and commercial allocation of risks are conducive to fostering economic growth, the creation of jobs, investments, and so forth. Globalization has increased the importance of these parameters as the volume of cross-border transactions has grown exponentially. The need to understand foreign states' legal systems has grown in proportion. Lawyers, who often are unsure about a foreign state's conflict of law rules or other foreign laws and regulations, are ethically and professionally obliged to minimize the risks and associated expenses of such transactions.<sup>117</sup> Therefore, the development of an internationally recognized set of rules may lend such transactions the appearance of neutrality, since they are not directly associated with any particular state.<sup>118</sup> Further, uncertainty as to the application of the rules is minimized when an internationally recognized set of rules can be implemented. Such rules generate an extensive track record so that the consequences of their application can be easily ascertained. Take, for example, the Vienna Convention<sup>119</sup> and the United Nations Convention on Contracts for the International Sale of Goods (CISG) (1980).<sup>120</sup> CISG rules are widely recognized and tested, and considerable academic commentary on the Convention has taken place. There is little difficulty in determining the legal consequences of the application of the CISG in a contract.<sup>121</sup> The market incentive to lessen differences in private commercial transactions tends to be high, whether such transactions are conventional or Islamic.

Legal practice, particularly in trade and finance, uses standard-form contract documentation, which includes two different types of contracts: (1) a model contract form is a type of template used by lawyers and businesspersons in order to draft a contract according to the circumstances and needs of the transaction; and (2) a contract of adhesion is a contract form that has been proposed by one of the parties as the definitive form. This must be accepted or rejected, but cannot be modified except in some very small details.<sup>122</sup> This latter type of contract is often imposed on one of the parties in ways that reflect the superior bargaining power of the imposing party. Many objections to these types of contracts are dealt with in municipal legal systems, particularly with regard to the use of onerous exemption clauses.<sup>123</sup>

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116. ERCANBRACK, *supra* note 3, at 107.

117. *Id.*

118. McKendrick, *supra* note 30, at 14.

119. Vienna Convention on the Law of Treaties, May 23, 1969, 1155 U.N.T.S. 331.

120. April 11, 1980, 1489 U.N.T.S. 3.

121. McKendrick, *supra* note 30, at 18.

122. Schmitthoff, *supra* note 31, at 19.

123. See, e.g., Ole Lando, *Standard Contracts: A Proposal and a Perspective*, 10 SCANDINAVIAN STUD. L. 129 (1966).

Model contracts, on the other hand, generally require the addition of supplementary clauses or an appendix. They are thus subject to negotiation between parties of more or less equal bargaining power and used to fulfill mutual economic interests.

Both contracts of adhesion and model contracts comprise standard terms and conditions sometimes known as “boilerplate” clauses. These refer to clauses, which are common to nearly all contracts and are generally derived from legal precedents, that law firms have acquired from legal practice. Law firms and commercial parties guard such hard-won precedents jealously (if they are not reported) since they reveal how courts may construe a particular term.<sup>124</sup> Terms generally deal with the way a contract operates, but they can also deal with substantive legal issues and issues of legal enforcement. Common examples include clauses dealing with matters of jurisdiction, arbitration, choice of law, retention of title, *force majeure*, and exclusion.<sup>125</sup>

Standard terms and conditions, such as the AAOIFI standards, are embedded in standard documentation that law firms develop in order to save time and to deal with the relevant issues. Law firms and commercial parties develop their own terms, and differences in a given industry tend to be quite small. Many standard terms are used on an industry-wide basis, so that most parties in a particular industry will make use of them.<sup>126</sup> Many standard terms are used both domestically and in cross-border transactions. If parties’ understanding of these terms differ from jurisdiction to jurisdiction, agreeing on an international transaction becomes considerably more difficult. Many contractual disputes concern the proper interpretation of the terms of the contract, highlighting their legal significance.<sup>127</sup>

The use of standard documentation, whether presented as a model contract or a contract of adhesion, contributes significantly to the minimization of legal differences. Standardization may be more likely to take place as a result of the consistent use of standard contract terms in commercial contracts than would be the case if the standardization of black-letter rules were sought. This is because most black-letter rules of contract law found in municipal legal systems are default rules. Default rules apply unless they are excluded by the terms of the contract. Yet mandatory rules are few in a commercial context. Many rules can be and frequently are displaced by the agreed terms of the contract. Therefore, “it is the terms of the contract, rather than the rules of law, that play the principal role in the regulation of the relationship between the parties.”<sup>128</sup>

124. RICHARD CHRISTOU, *BOILERPLATE: PRACTICAL CLAUSES 1* (4th ed. 2005).

125. McKendrick, *supra* note 30, at 15.

126. *Id.* at 5.

127. *Id.* at 16.

128. *Id.*

Investors show a strong preference for the use of standard-form documentation comprising well-known legal usage and contractual terms. Even if the content of transactions differs, the inclusion of well-known standard terms and conditions is expected.<sup>129</sup> Investors are familiar with these contractual characteristics and likely feel that they accurately reflect the risks and rewards of a particular transaction. In fact, the role of human perception and our innate cognitive bias for familiarity may play a role in our approach to minimizing legal differences.<sup>130</sup>

English law firms, which play an outsized role in structuring Islamic finance transactions, show a particular fondness for using standard documentation. English firms' consistent usage of standard documentation minimizes the differences between transactions, even those of a wholesale nature, which tend to evince greater divergences. The documentation for Islamic finance transactions, including its format, layout, and presentation of terms, reflects English usage for conventional finance transactions.

A good example concerns the standard documentation (here such documentation refers to a model contract as distinguished above) developed and used by one of the most important standard-setting organizations for international finance in Europe and the Middle East, the London-based Loan Market Association (LMA). English law firms drafted the *Users' Guide to Islamic Finance Documents*, a document that provides guidance to lawyers in drafting sharia-compliant syndicated lending facilities. LMA primary documents are standard documentation for the syndicated lending market. The *Users' Guide* provides guidance on the ways in which terms located in LMA primary documents can be used in an Islamic-syndicated financing facility. As a result, Islamic financing agreements developed pursuant to the *Users' Guide* differ from conventional standard-form documentation in a very limited way.<sup>131</sup> They reflect English legal practice in the syndicated lending market.

Another example concerns the International Islamic Financial Market (IIFM), whose objective is to "harmonize" Islamic capital and money markets by achieving uniformity in documentation for cross-border transactions. The IIFM has partnered with conventional standard-setting organizations to create a total of nine standard-form contracts to date. Examples are the master agreement for treasury placement (MATP) and the interbank unrestricted master investment *wakala* agreement. The IIFM's collaboration with the International Capital Markets Association (ICMA) and the International Swaps and

129. E-mail from David Eisenberg, Partner, White & Case, to author (Sept. 11, 2016) (on file with author).

130. DANIEL KAHNEMAN, THINKING, FAST AND SLOW 60–61 (2011).

131. ERCANBRACK, *supra* note 3, at 124.

Derivatives Association (ISDA) is reflected in the documentation itself. While both the definitions and contractual steps of transactions mirror the Islamic structure, the agreements reflect a relatively conventional set of conditions and warranties relevant to the wholesale market. It is difficult to assess accurately the uptake of the IIFM's particular documentation. It is certain that the standard terms and conditions found in this documentation reflect widespread commercial practice in the finance industry.

Standard documentation is generally expedient in both retail and wholesale Islamic financial markets, but the level and type of standardization in these markets differs considerably. Wholesale markets such as those in which LMA standard documentation is used, are "standardized" to a great extent, due to the fairly straightforward type of transaction as well as the model contract in which it is housed. But other more complex over-the-counter wholesale markets are less amenable to standard-form documentation. These include the derivatives and *sukuk* markets. There are a number of reasons for this. First and foremost, financial institutions and law firms do not favor standardization since bespoke financial products can be priced more expensively. Commodification does not benefit financial intermediaries or law firms.<sup>132</sup> Furthermore, firms prefer their own standard-form documentation, which they have spent many years developing. That being said, parties will almost certainly include the types of terms and conditions found in standard-form documentation since these reflect commercial practice in a particular jurisdiction.

*Sukuk* are a good example of this practice. The AAOIFI provides sixteen different standards for *sukuk* issuance but the market is generally seen as one, which is not easily standardized. The importance of variability when conceptualizing standardization is relevant here. *Sukuk* issuances are structured around the assets, risks, and the credit structure of the transaction and these vary from transaction to transaction. Complete standardization or uniformity would almost certainly cripple a necessarily dynamic industry. Yet *sukuk* documentation evidences an unmistakably close adherence to the types of documentation used in international bond offerings. Even the sections that deal specifically with *sukuk* issuances (as opposed to bond issuance) display a high degree of legal similarity.<sup>133</sup> In 2008, similar commercial practice led the then-chairman of the AAOIFI's sharia committee, Sheikh Mohammed Taqi Usmani, to question the sharia compliance of almost all *mudaraba*- and *musharaka*-based *sukuk*. Standardization must be balanced with what is widely viewed as sharia authenticity. Standardization is viewed positively when it reduces costs and

132. E-mail from Eisenberg to author, *supra* note 129. For an in-depth analysis of why lawyers are motivated to engage in complexity in both language and concepts, see Anthony Ogus, *The Economic Basis of Legal Culture: Networks and Monopolization*, 22 OXFORD J. LEGAL STUD. 419 (2002).

133. E-mail from Eisenberg to author, *supra* note 129.

increases volume, but it can be viewed negatively when it leads to financial practices that resemble conventional ones.

Despite the lack of across-the-board standardization in wholesale markets, investor preferences and industry commercial practices help to minimize legal differences. Again, variability is the keyword. Retail markets are different in the sense that volume is the determining factor, since these transactions are considerably smaller and thus on an individual basis less profitable than wholesale ones. Credit card issuers or mortgage providers are not willing to provide customized contracts. Instead, banks use contracts of adhesion, a “take it or leave it” contract. If the customer wishes to do business with the bank, the conditions must be accepted in full. These contracts, like model contracts, facilitate standardization because of their “cookie cutter” format, which can easily be adopted in full or in part. There are many examples of contracts of adhesion in Islamic retail markets since almost all transactions offered by Islamic retail banks belong to this category. The restricted *mudharaba* (profit- and loss-sharing investment contract) is an exception. Retail Islamic products display more similarities in their contractual terms and conditions than wholesale markets do.

#### CONCLUDING REMARKS

The project of standardization is driven by the market. Yet the academic and scholarly focus on reconciling classical legal interpretations obfuscates this fundamental fact. It has led to the erroneous notion that IFL reflects the practice of classical law, albeit in modified form, in modern financial markets. In fact, IFL is a modern Islamic hybrid, which embodies contemporary market practice and legal realities.

The sharia comprises a toolkit that allows for the adaptation and extension of the law. But in the absence of recognizing the lawmaking project that standardization embodies, the use of these tools has only served to hide the fact that classical law is no longer relevant in modern markets, or for that matter, in most areas of modern life. The unwillingness to relinquish the past and to rediscover the law in the present prevents IFL from becoming the legal system that its early theorizers had hoped it could be.