

Payment default in Islamic finance

Payment default is contemplated by Islamic finance. All legal documentation in Islamic finance does provide for payment default. Perhaps what is not contemplated is the unintended consequences of a default in relation to the *shariah* contract. This is an area where there is not much case law, but the recent cases on defaults in Islamic finance products such as *sukuk* and home financing emphasise the importance of clear legal documentation, accurate appreciation of the Islamic contract and the need for an adequate legal framework to provide certainty on *shariah* interpretation and efficient recourse. Assumptions that certain Islamic contracts are similar to other common types may result in a mistaken understanding of the Islamic contract.

Generally, Islamic finance products although not based on lending still create a payment obligation. Depending on the underlying Islamic contract, debts may be created directly between the provider of funds and the obligor, for example in a sale-type contract where the debt is the purchase price payable. There are some Islamic finance products that do not create debt directly to the provider of funds but through another vehicle that the provider of funds participates in and has a right to be paid on returns earned by that vehicle. An example is a venture participatory-type of contract where the participants provide the funding to a venture medium that in turn utilises the same vehicle to acquire assets that are then leased to the party that is to carry the payment obligation. Such structures require other types of Islamic contract that can create payment obligations, for example a lease, to be entered into together. The default of the legal obligation to pay relates to the Islamic contract that creates the debt.

For home financing, it is possible to have the funding from the financial institution through a venture medium entered into with the customer to acquire the property and which the customer then leases from the financial institution. The first contract for the participation with the customer in the venture medium does not create a payment obligation, but the other contract does.

With more complicated structures such as those used for *sukuk*, understanding payment default may not only require a focus on the facts of non-payment but also on the contract that gives rise to the obligation to pay. In lending transactions, the debt simply arises from borrowing. In Islamic finance, the obligation to pay often arises from commerce-type

transactions such as lease or sales and is usually predicated on particular Islamic contracts. This explains why some *sukuk* premised on an Islamic participatory type of contract which in itself does not create any obligation to pay (as between the issuer of the *Sukuk* and the holder) have payment default scenarios, which is actually a default of payment in respect of another Islamic contract that created the payment obligation from an obligor to the issuer.

The payment obligation is thus predicated on an Islamic contract that carries the inherent legal risk of challenges on *shariah* interpretation. This can be seen in Islamic finance cases that have involved challenges on the *shariah* integrity of the contracts. This can be seen for example in the UK the cases of *The Investment Dar Company KSCC v Blom Development Bank SAL, Islamic Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems* and others, and in Malaysia *Arak-Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd & Ors*. This is in addition to the possibility of being challenged on other grounds.

In Malaysia, the recent legislation of the Central Bank of Malaysia Act 2009 has introduced a mandatory requirement for courts and arbitrators to refer to the National Shariah Advisory Council, which is a body established by the central bank pursuant to that Act on any *shariah* issue and whose decision is binding on the court and arbitration. This to a certain extent mitigates the risk of differences of views of *shariah* that may be held by different courts or arbitrators. It further provides for any limitation that a judge or arbitrator may have in the understanding of *shariah* that may relate to the dispute in question.

Payment default in Islamic finance puts to test not only the legal documentation but also the recourse avenues and proceedings. The issues that may arise may not just relate on the documentation alone, but also in the legal framework in which such contracts are to be enforced.

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