

## **Arbitration Clause in Islamic Banking Contracts: A Contractual Necessity**

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### **Abstract**

The authoritative tribunal for the settlement of banking and financial disputes in most jurisdictions is the civil law court. However, the practices of the civil law court are repugnant to Islamic Commercial law and its judges lack the appropriate knowledgeable. More so, the jurisdiction of the Shariah court in most countries is restricted to the cases of Islamic family law. It does not cover the cases of the Islamic commercial transaction which includes, the Islamic banking, Islamic insurance, Islamic financial market and etc. This problem leaves arbitration as the only process for the settlement of Islamic commercial dispute. Nevertheless, arbitration cannot be resorted to, except if an arbitration clause is inserted in the respective commercial agreement. This article expounds the importance of the arbitration clause to the Islamic commercial contracts. It proposes arbitration as the panacea for court jurisdictional logjam.

**Keywords:** *Islamic Commercial Transaction, Arbitration Clause, Civil Law Court*

### **1. Introduction:**

An arbitration clause is a mutual term in a contract or agreement that binds the parties to resolve any dispute that arises in such contract through the alternative process of arbitration. It allows the parties to settle their disputes out of the courts and without the process of adjudication or litigation. The term may specify the settling of the disagreement through a certain type of law, such as Islamic law, English common law or civil law. It may include the specification of the forum and jurisdiction of where the dispute will be settled. This paper seeks to discuss the importance of the insertion of arbitration clause in the contracts of the Islamic banking and finance which is herein refers to as Islamic commercial contracts. This is due to the absence of competent court for the settlement of the disputes that arise from Islamic commercial contracts, the divergence of opinions among jurists of the various schools of Islamic Law and the rapid dispute resolution nature of arbitration.

### **2. Basis of Arbitration in Islamic Law**

To start with it, under Islamic law, arbitration is known as al-Tahkim. The institution of al-Tahkim as a means of dispute resolution under Islamic law is established by the primary sources of Shariah law which are the holy Quran and the Hadith, as well as the custom and the practices of the transactions of the earlier Muslims. Establishing the platform for arbitration, the holy Qur'an provides for matrimonial dispute that, *"If you fear a breach between them twain (the man and his wife), appoint (two) arbitrators, one from his family and the other from her's; if they both wish for peace, Allah will cause*

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*their reconciliation. Indeed, Allah is Ever All-Knower, Well-Acquainted with all things*”.<sup>3</sup> In another verse, the Qur’an further says; “*nay, by your Lord, they can never be believers, until they appoint you the arbitrator in all the disputes between them, and find in themselves no resistance against your decisions, and accept (them) with full submission.*”<sup>4</sup> It further says; “*Verily! Allah commands that you should render back the trusts to those to whom they are due; and that when you judge between men, you judge justly. Verily, how excellent is the teaching which He (Allah) gives you! Truly, Allah is Ever All-Hearer, All-Seer.*”<sup>5</sup>

The above verses of the holy Qur’an shows that arbitration, under Islamic law, is not restricted to only the family dispute. Rather, it extends to commercial and other civil and financial disputes. More so, the verses are explicit in stating the effect of an arbitration award. It is clear from the verses that the award is binding on the parties. However, in practice before it can become binding, it has to be filed in a court in order to be recognized and enforced, after being verified that it is not in conflict with the laid down procedure and statute, it will acquire the force of bindingness on the parties.<sup>6</sup> Some of the known cases where arbitration was used for dispute settlement in the pre-Islamic era are the dispute on the replacement of the Black Stone of the Kaaba to its position amongst the tribes of Quraish after the reconstruction of the Kaaba. The arbitrator in the case was the holy Prophet Mohamed (S. A. W). Another case is that of a political case between Ali Ibn Abi Talib (R.A) and Muawiyah Ibn Abi Sufian (R. A), and the appointed arbitrators were Amur Ibn al-Aass and Abu Musa al-Asha’ari (R. A.).<sup>7</sup> ‘Thus, under Islamic Law, the position of an arbitrator is similar to that of a *qadi* (judge).’<sup>8</sup> That was the position of the holy Prophet among the people.

Thus, since arbitration has long gained recognition in the Islamic law for more ten centuries nearly ago, even before its introduction to the French law, and its modern<sup>9</sup> adoption in the UNCITRAL Model Law, it will be logical to mandate the inclusion of its clause in the contracts of the modern Islamic financial to resolve the problem of court jurisdiction whenever there is dispute among parties. Such is necessary for the efficacy of the contract and it is beneficial to the parties even if it restricts courts’ jurisdiction.<sup>10</sup>

### 3. Arbitration Clause in Islamic Commercial Contracts

The insertion of arbitration clause is generally defined as a ‘provision, included in certain construction, insurance, labor, sale or other types of contracts, requiring settlement of disputes through arbitration instead of litigation,’<sup>11</sup> in Islamic commercial contracts for the purpose of the settlement of any disputes that arise from the contract is imperative due to the

<sup>3</sup> Qur’an, al-Nisā’: 35.

<sup>4</sup> Qur’an, al-Nisā’: 65.

<sup>5</sup> 34 Qur’an, al-Nisā’: 58.

<sup>6</sup> Umar Oseni,, *Dispute Resolution in Islamic Banking and Finance: Current Trends and Future Perspectives, at 11.*

<sup>7</sup> Ali Khalil Al-Hudaithi (PhD), investment and technology transfer contracts counselor of Ajman Chamber of Commerce and Industry.

<sup>8</sup> Md. Zahidul Islam, Provision of Alternative Dispute Resolution Process in Islam, *IOSR Journal of Business and Management (IOSR-JBM) ISSN: 2278-487X. Volume 6, Issue 3 (Nov. - Dec. 2012), PP 31-36, see, < www.iosrjournals.org>*, at 3.

<sup>9</sup> Syed Khalid Rashid, PECULIARITIES & RELIGIOUS UNDERLINING OF ADR IN ISLAMIC LAW, Mediation in the Asia Pacific: Constraints and Challenges, Organised by Harun M. Hashim Law Centre, IIUM & Asia Pacific Mediation Forum, Australia, Venue: IIUM, Kuala Lumpur, 16-18 June, 2008, at 6.

<sup>10</sup> Sayid Khalid Rashid, *Alternative Dispute Resolution in Malaysia*, (Malaysia: Kulliyah of Laws, IIUM, 2006), at 41.

<sup>11</sup> Business Dictionary, see,

<<http://www.businessdictionary.com/definition/arbitration-clause.html#ixzz2Rwhl11nk>>, (29/04/2013).

dichotomy in the law and court jurisdictions. The authoritative forum for the settlement of commercial disputes, including that of the contracts of the Islamic commercial law in most jurisdictions is the civil law court which is repugnant to Islamic law. More so, the judges of the civil law courts lack the knowledge of Islamic law, hence, the necessity for the insertion of an arbitration clause in the contract, to pave way for the appointment of an arbitrator that is knowledgeable in the Islamic commercial law for the settlement of the disputes that arise from it. Meanwhile, some notable countries have tried to solve this problem by establishing arbitral form for the disputes of the Islamic commercial contracts.

Malaysia takes the lead in this regard. Thus, in order to solve the problem of civil court jurisdiction over the Islamic commercial contract, the Kuala Lumpur Regional Centre for Arbitration provides a mechanism for Shariah based arbitration for the disputes that arise from the Islamic financial institutions. To that effect, the KLRCA developed a Guideline for the Islamic contract arbitration.<sup>12</sup> That is, 'The *Rules for Islamic Banking and Financial Services Arbitration 2007*'.<sup>13</sup> The 'Rules' include a model clause for arbitration of the Islamic financial institutions. The model clause state that; "Any dispute, controversy or claim arising from Islamic banking business, Takaful Business, Islamic financial business, Islamic development financial business, Islamic capital market products or services or any other transaction or business which is based on Shari'ah principles out of this agreement/contract shall be decided by arbitration in accordance with the Rules for Arbitration of Kuala Lumpur Regional Centre for Arbitration (Islamic banking and Financial Services)."<sup>14</sup> Thus, 'The Centre makes it possible to obtain rulings by Islamic finance experts conforming (legally) and substantively) to the provisions of Islamic Law.'<sup>15</sup>

Moreover, another example of this initiative, that is arbitration center for the settlement of the dispute of Islamic commercial contract is that of 'Ajman Center for Reconciliation and Commercial Arbitration,' which was established under decree number 6/2004 as issued by the ruler of Ajman, His Highness Sheikh Humaid Bin Rashid Al-Nuaimi, The Center plays a vital role in providing investors in the UAE with a forum for the settling of their Shariah dispute, in the region.<sup>16</sup> Thus, other jurisdictions of Islamic banking and finance need to borrow a leaf from this initiative to solve the potential disputes of the Islamic commercial contracts in their various jurisdictions. In short, both KLRC and Ajman Center for Reconciliation and Commercial Arbitration are good platform that can serve as model for other jurisdiction of Islamic banking and finance and Islamic Commercial Law as a whole.

Thus, unlike court system, the mechanism of arbitration is simple and sophisticated.<sup>17</sup> Its major conditions are; the agreement between the disputing parties for the appointment of an arbitrator for the resolution of their disagreement and the acceptance of the arbitrator to assume the position of a neutral third party between them. However, arbitration is of two categories. That is, the free arbitration; where the disputants can select one or two qualified arbitrators to preside over the process of the arbitration exercise, and institutional arbitration which is a tribunal that will subjugate the disputants to a

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<sup>12</sup> Jasri Jamal, Nor Aziah Mohd & Kamal Halili, ALTERNATIVE DISPUTE RESOLUTION IN ISLAMIC FINANCE: RECENT DEVELOPMENT IN MALAYSIA, INTERNATIONAL JOURNAL OF SOCIAL SCIENCES AND HUMANITY STUDIES, Vol 3, No 1, 2011 ISSN: 1309-8063, at 10.

<sup>13</sup> Rules for Islamic Banking and Financial Services Arbitration 2007

<sup>14</sup> Ibid.

<sup>15</sup> Jasri Jamal, Nor Aziah Mohd & Kamal Halili, 'Alternative Dispute Resolution in Islamic Finance: Recent Development in Malaysia,' International Journal of Social Sciences And Humanity Studies Vol 3, No 1, 2011 ISSN: 1309-8063.

<sup>16</sup> Ali Khalil Al-Hudaiithi (PhD), investment and technology transfer contracts counselor of Ajman Chamber of Commerce and Industry.

<sup>17</sup> Musa Furber, alternative dispute resolution, *Arbitration & Mediation in non-Muslim Regions*, Tabah Analytic Brief | no. 11 | 2011, at 9.

specified arbitration center that is relevant to their dispute. Examples of these are KLRC and Ajman Center for Reconciliation and Commercial Arbitration as mentioned in the above. Others are Hague (Permanent Court of Arbitration)<sup>18</sup>, Stockholm center,<sup>19</sup> the French ICC<sup>20</sup>, and etc.<sup>21</sup> Thus, the difference between arbitration and judicature is that in judicature, the authority of the judge is very wide while the authority of the arbitrator is limited. He is only allowed to handle the cases that are assigned to him. He and exceed it.<sup>22</sup> ‘The arbitrators must be person of excellent character, superior caliber and meritorious record.’<sup>23</sup>

#### 4. Why Arbitration clause is a Necessity

The necessities for the insertion of arbitration clause in Islamic commercial contract emanates from the fact that the contracts lack the appropriate forum for the settlement of its dispute due to the following reasons:

##### a. The Absence of Competent Court:

The jurisdiction of the dispute of the banking system as a whole, regardless of whether it is Islamic or conventional is under the civil court in most countries of the world. For example, this is very clear in the Appeal case of *Bank Kerjasama Rakyat Malaysia v Emcee Corporation*.<sup>24</sup> The learned judge in his judgment stated that,

The law was mentioned at the beginning of this judgment; the facility is an Islamic banking facility, but that does not mean that the law applicable in this application is different from the law that is applicable if the facility were given under the conventional banking.

Here the judge stated that the applicable law to the Islamic banking matter is not different from that of the conventional banking, whereas, the governing contract of the Islamic banking is Islamic law, not civil law. In addition, the judges in the civil court to a certain extent do not have competence in Islamic law matters. More so, in the civil law court, not every presiding judge is equipped with the knowledge of Islamic law. This is observed in the case of *Arab Malaysian Merchant Bank Bhd v Silver Concept Sdn Bhd*,<sup>25</sup> where the learned judge himself observed that in the civil court not every presiding judge is a Muslim and, even if so, may not be sufficiently equipped to deal with matters which Muslim jurists take years to comprehend. This matter gives the necessity for the insertion of arbitration clauses in the Islamic commercial contract as a way out of the competent court logjam. More so, fortunately, ‘court does not have jurisdiction to set aside or remit an arbitration award.’<sup>26</sup>

##### b. Divergence of opinions among jurists:

Even in the situation where there is a competent Shariah court to adjudicate on the disputes that arise from Islamic commercial contracts, if the parties belongs to different jurisdiction of the Islamic schools of law, the problem of appropriate court forum will arise. For instance, in the case of *Arab Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd &*

<sup>18</sup> See, < [http://www.pca-cpa.org/showpage.asp?pag\\_id=363](http://www.pca-cpa.org/showpage.asp?pag_id=363) >, (30\04\2013).

<sup>19</sup> See, < <http://www.scc1.se/> >, (30\04\2013).

<sup>20</sup> See, < <http://www.iccwbo.org/Worldwide-Membership/National-Committees/ICC-France/> >, (30\04\2013).

<sup>21</sup> Ali Khalil Al-Hudaithi (PhD), investment and technology transfer contracts counselor of Ajman Chamber of Commerce and Industry, at 3.

<sup>22</sup> Ali Khalil Al-Hudaithi (PhD), investment and technology transfer contracts counselor of Ajman Chamber of Commerce and Industry.

<sup>23</sup> Ali Khalil Al-Hudaithi (PhD), investment and technology transfer contracts counselor of Ajman Chamber of Commerce and Industry.

<sup>24</sup> *Bank Kerjasama Rakyat Malaysia v Emcee Corporation*.

<sup>25</sup> *Arab Malaysian Merchant Bank Bhd v Silver Concept Sdn Bhd*.

<sup>26</sup> Hjh Nor Hashimah Hj Mohd Taib, Alternative Dispute Resolution In ASEAN: Brunei Darussalam, Attorney-General Chambers, Brunei Darussalam, at 7.

*Ors*,<sup>27</sup> the learned judge interpreted the concept of *riba* 'usury' by integrating it based on the understanding of the common law which is 'equity.' This may also occur in a Shariah court as the jurists of the various school of law have their interpretation of usury. For instance, some contemporary jurist such as al-Tantawi of Egypt does not agree that the banking interest is synonymous to bank interest.

Thus, in the situation whereby a judge with this type of inclination presides over a case where the disputed matter is *riba*, his judgment will certainly lead to discontent in the majority opinion which sees interest as *riba*. Although, in the said case, the judge held that the parties are bound by the terms of the contract regardless of whether it involves a usurious element or not. That is, as a way of invoking equitable principle to remove injustice. Nevertheless, the fact remains that there is a need for a forum which can amicably settle the dispute. This is where the insertion of the arbitration is important.

Another example of what may lead to disagreement in decision on the basis of school of Islamic law is that of the Kingdom of Saudi Arabia where the applicable law in the arbitration is that of jurisprudence of Imam Ahmad Bin Hannibal, while the rest of the world is now turning toward the application of the UNISTRAL rules, which was issued and approved by the United Nations.<sup>28</sup> In short, the divergent of opinions between the Islamic schools of law and the differences of legislations is a clear indication for the necessity of arbitration clause in the Islamic commercial contracts.<sup>29</sup>

### c. General Advantages of arbitration

The other general importance of arbitration is that it is not limited to the Islamic commercial contracts include; rapid dispute resolution and settlement. This is given the fact that the arbitrator will dedicate him\herself to the case at hand. In extremely difficult cases, an arbitrator will try to accomplish the settlement in a six month period. More so, the cost of arbitration is meager as compared to litigation. In another word, the cost and expenses of arbitration are much lesser that adjudication which includes court fee, lawyers' fees and the execution charges.<sup>30</sup> In addition, arbitration procedure is characterized by simplicity. The arbitrator is at liberty to adopt the most suitable method of reaching agreement. Moreover, 'there may be fewer difficulties in electing to have a dispute in relation to a contract decided in accordance with Sharia law by submitting the dispute to arbitration, rather than litigation.'<sup>31</sup> Finally, since arbitration is an amicable and mutual settlement, it creates a platform for avoiding spitefulness between the disputing parties. Since, the parties have confidence in the arbitrator the decisions are gladly accepted and friendship returns, while disagreements and conflicts disappear.<sup>32</sup>

## 5. Conclusion

To sum up, the UNISTRAL law which was issued by the United Nations issued is now applicable to most of the world's countries including the Islamic and the Arab countries where is Islamic commercial contracts vis-à-vis Islamic banking and finance are rooted. At the international level it can be observed that the insertion of arbitration clause in most commercial contract is now a requirement that is imposed by the international commerce law. For instance, in the fourth international

<sup>27</sup> *Arab Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd & Ors*.

<sup>28</sup> Ali Khalil Al-Hudaithi.

<sup>29</sup> Mathias Rohe, Alternative Dispute Resolution in Europe under the Auspices of Religious Norms, RELIGARE Working Paper No. 6 / January 201, DG Research of the European Commission's Seventh Framework Research Programme, art 9.

<sup>30</sup> Syed Ahmad Idid, ALTERNATIVE DISPUTE RESOLUTION (ADR)AN ALTERNATIVE ACCESS TO JUSTICE, Kuala Lumpur Regional Centre for Arbitration, at 7.

<sup>31</sup> Jonathan Lawrence, Peter Morton & Hussain Khan, Dispute Resolution in Islamic Finance, K&L Gates LLP, The article was first published in the "Global Islamic Finance Report 2012" in April 2012, at 3.

<sup>32</sup> Ibid

conference for arbitration held in Moscow 1972 and the fifth international conference held in London during October 1974, it was resolved that 'arbitration is an effective tool that should be used to avoid disputes during international negotiations for long term commercial contract ratification that related to technology transfer and/or joint projects as well as during the implementation of these contracts. This is in addition to the earlier New York agreement 1958 regarding recognition and accomplishing foreign arbitration decisions. The eleven Arab countries and most Islamic and Muslim countries are signatory to the agreement.<sup>33</sup> Therefore, arbitration clauses can be inserted in the Islamic commercial contracts on the basis of the model law. The insertion of the clauses will save the Islamic banks and its customers from the problem of the civil courts which laws and procedures are not relevant to Islamic law, while an arbitrator who is knowledgeable in Islamic will be appointed whenever disputes surfaces in the contracts. It believed that policy maker on the Islamic commercial law will take this into consideration.

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<sup>33</sup> Ibid.