# A *MURĀBAḤA* TRANSACTION IN AN ENGLISH COURT – *The London High Court of 13th February 2002 in Islamic Investment Company of the Gulf (Bahamas) Ltd. v. Symphony Gems N.V. & Ors.*

KILIAN BÄLZ*

(Gleiss Lutz Rechtsanwälte, Frankfurt/Main)

*Abstract*

Islamic finance is based on the application of *Sharīʿa* rules to modern financing transactions. The Islamic finance industry has grown considerably over the last two decades and Islamic financing transactions today often have a global reach. As a consequence, traditional Islamic contractual structures are reformulated in the language of international commercial agreements and *Sharīʿa* based transactions are adjudicated in non-Islamic jurisdictions. In examining a recent case of the London High Court dealing with an Islamic *murābaḥa* agreement this essay investigates the complex interaction between and among Islamic contractual structures, English style contractual drafting and principles of international commercial law.

## *Introduction*

Islamic law is fundamental to Islamic finance. Islamic financial institutions claim to adhere to the principles of the Islamic *Sharīʿa* and use transactions that are inspired by traditional Islamic structures.

However, Islamic financing transactions today often are implemented in a non-Islamic legal environment, i.e., a jurisdiction that is not effectively bound by and does not give effect to the principles of the Islamic *Sharīʿa*, at least to the extent commercial agreements are concerned. Although the governments of some Muslim countries, among them Pakistan, Iran and Sudan, have engaged in officially promoting Islamic banking, having in mind the "full Islamiciza-

* Author's note: I am indebted to Baudouin Dupret, Jan Goldberg, Anna Würth, the ILS editors, and the anonymous readers who, through their critical reading, helped me to improve (so I hope) the argument of this essay; needless to say the sole responsibility for any shortcomings, errors, and flaws remains exclusively mine.

tion" of the banking sector (Nienhaus, 1996: 175-85; Warde, 2000: 112-23), by far most of the Islamic finance business is transacted in jurisdictions where the relevant *Sharīʿa* principles, in particular the prohibition of *ribā*,[1] are no longer enforced and may never have been enforced as the law of the land.[2] In these jurisdictions, which include the Gulf banking hubs of Dubai and Bahrain and international financial centres that host Islamic financial institutions, such as London and Geneva, the business model of Islamic financial institutions is based on *reference to Islamic legal norms* that are *not enforced as the (official) law of the state*. Transactions guided by the principles of the Islamic *Sharīʿa* are carried out in a non-Islamic legal environment.

This raises the questions of how Islamic legal principles that are the basis of Islamic financial transactions relate to the laws of the jurisdiction in which they are implemented and how traditional Islamic contractual structures are transformed when adjudicated in a court that does not necessarily share the parties' commitment to *Sharīʿa*-rules. By examining a recent case of the London High Court, I explore a dispute based on an Islamic financing transaction in a Western court. *Islamic Investment Company of the Gulf (Bahamas) Ltd. v. Symphony Gems N.V. & Ors.*[3] is reportedly the first case heard in an English court relating to a *murābaḥa* agreement.[4] The case not only illustrates

---

[1] The predominant opinion in the contemporary Islamic banking literature holds that the prohibition of *ribā* is a prohibition of fixed interest charges (*fā'ida*). For excellent expositions of the traditional doctrine, which is slightly more complex, see Saleh, 1992: 11-61; Wichard, 1995: 180-216; on the contemporary discussions, see Mallat, 1988 and Amereller, 1995:72-96.

[2] Although the prohibition of *ribā* is, to some extent, upheld (nominally) in some Middle Eastern jurisdictions, there is a general tendency to confine its application and to exclude (international) banking transactions. For details, including a comparative discussion of relevant codes and case law, see Amereller, 1995: 133-74; Comair-Obaid 1995: 184-202; Krüger, 1997: 80 ff; Bälz, 2001b: 242-3.

[3] 13th February 2002, 2001 Folio 1226 per Justice Tomlinson, 2002 West Law 346969, QBD (Comm Ct).

[4] This is how the case was perceived in the market. To date, there are only a few (published) court decisions relating to the concrete application of Islamic financing transactions. To the best of my knowledge, the only jurisdiction where some (published) case law exists is Malaysia (see the discussion in Klötzel, 1999). The absence of case law dealing with Islamic banking transactions is a phenomenon about which one can only speculate. Generally, many Middle Eastern jurisdictions (with a few exceptions) are not good at law reporting; courts often do not publish cases on a regular basis and private law firms, accumulating precedents in connection with their practice, are not fond of publicising their business expertise *gratis*. Furthermore, financial transactions, once they exceed a certain volume,

the global reach of the Islamic finance industry and, thereby, provides an outstanding example of how the Islamic *murābaḥa* is applied in international trade finance, but also exposes the intricate interplay between Islamic legal structures, transnational contractual practices and national legal rules that is typical of today's Islamic finance industry.

### *The Facts of the Case*

Islamic finance has developed into a truly global business. While Islamic financial institutions reportedly operate in some seventy countries and administer assets in the aggregate amount of US $200 billion (Warde, 2000:1), the most important area of business remains trade financing on the basis of the *murābaḥa*, an area that accounts for more than 80% of the Islamic banking business (ibid. 133). *Murābaḥa* financing today, moreover, is not limited to the economies of the Muslim Middle East and South Asia, as demonstrated by the facts of the case in the London High Court.

The claimant, an Islamic bank incorporated in the Bahamas,[5] entered into a contract described as "Morabaha Finance Agreement" with the defendant on 27 January 2000, and brought a claim over the amount of the balance due. The defendant is a company incorporated in Belgium[6] that is active in the trade with precious gems. The co-defendants are the shareholders of the Belgian company who

---

only rarely become publicly contentious. With regard to financial innovations in particular, banks exercise great caution and shy away from the risk of establishing an inconvenient precedent. As a result, most disputes are settled amicably and out of court. All these factors may have contributed to the scarcity of relevant case law.

[5] Islamic Investment Company of the Gulf (Bahamas) is part of the "Prince Mohammed Group". The Saudi Prince Mohammad al-Faisal al-Saud (a son of King Faisal) played a major role as pioneer and proselytiser of Islamic finance. In the late 1970s and early 1980s, he established a major transnational network of Islamic financial institutions, among them the Dar Al-Maal Al-Islami Group (set up in 1981), one of the most important players in the market, if not the most important. Islamic Investment Company of the Gulf is the prototype of the modern Islamic financial institution, established off-shore in a tax efficient jurisdiction with business activities of a global reach (cf. Warde, 2000: 74-8).

[6] The domicile of the defendant is not explicitly mentioned in the judgment. However, "NV" normally is the abbreviation of *naamloze vennootschap*, a kind of joint stock company under Dutch or Belgian law. Further, a company named "Symphony Gems" with an address in Antwerpen can be traced in the *Annuaire de Belgique* (*http://page31035-31035.annuairemondial.com*, 13.02.2003).

guaranteed the amounts owed under the *murābaḥa*-agreement. The agreement, drafted in English, outlines the transaction contemplated therein as follows:

> (A) The Purchaser wishes to deal with the Seller for the purpose of purchasing Supplies ... under this Agreement in accordance with the Islamic Shariah.
>
> (B) The Purchaser wishes to request the Seller to purchase the Supplies and sell them to the Purchaser through a Morabaha arrangement and the Seller is willing to make such purchase and sell the Supplies to the Purchaser on the terms and subject to the conditions set out herein.

The legal relationship between the claimant as seller and the defendant as purchaser is further outlined in art. 2 of the agreement:

> 2.1 The Seller hereby grants to the Purchaser a revolving purchase and sale facility whereunder the Seller shall purchase supplies and immediately sell them on to the Purchaser on deferred payment terms on the terms and subject to the conditions contained in this Agreement. The maximum aggregate amount to be made available by the Seller shall not exceed ... $15,000,000 (fifteen million dollars).

On 10 February 2000 and 21 February 2000, the defendant submitted two "irrevocable purchase offers" to the claimant pertaining to "a very large quantity of rough diamonds of assorted varieties", the price of which was US $7,500,000 each. The supplier of the precious gems was a diamond broker called Precious (HK) Ltd., a company with an address in Kowloon, Hong Kong. The mechanism of purchase and re-sale is described in article 4.1 of the agreement as follows:

> (a) the Seller shall purchase such Supplies [sc. as identified by the Purchaser] from the Supplier and shall transfer the Cost Price of such Supplies on the Settlement Date to such account of the Supplier as the Purchaser shall have identified for this purpose in item 2.8 of the Offer relating to such Purchase Agreement; and
>
> (b) the Purchaser shall, immediately after the Seller has purchased such Supplies, purchase such Supplies from the Seller and be bound to pay the relevant Sale Price in relation thereto to the Seller in instalments (as specified in the relevant Offer and Acceptance), the last such instalment falling due on the Maturity Date;

As required under the agreement, the claimant transferred the purchase price of US $7,500,000 per order (referred to as Cost Price in the agreement) to an account of Precious Ltd. (HK) at a branch of Credit Swiss in Zurich, Switzerland. The purchase price due under the second sales contract, payable by the defendant to the claimant (referred to as the Sale Price in the agreement) was set at US $7,917,450 per

order, payable in two instalments of US $1,980,000 on 15 July 2000 and 15 September 2000, respectively, and a third instalment of US $3,957,450 on 15 November 2000 (referred to as the "Maturity Date"). The defendant, however, did not honour its obligations under the agreement and failed to make any payments on the instalments at any time, alleging that the supplies never reached their destination. Following an exchange of correspondence, the claimant brought the action in the London High Court.

The defendant raised several defenses which illustrate the interplay of different legal rules in the Islamic finance industry, extrapolated both from Islamic legal sources and international commercial law. First, the defendant argued that inasmuch as the transaction was a contract of sale, the obligation to pay the purchase price depended on the claimant's effecting of delivery. Second, the defendant alleged that the contract was illegal altogether and thus unenforceable in court, because it violated the principles of the Islamic *Sharīʿa*. Third, the defendant invoked the *ultra-vires* doctrine of English company law, arguing that this principle bars an Islamic financial institution—such as the claimant—from entering into a *murābaḥa* transaction of the kind at hand. In the following, I will examine each of these defenses in depth and then, in the concluding part, will then discuss the significance of the legal argumentation in this case for our understanding of the law of Islamic finance.

### *Failure of Delivery: Purchase of Goods or Trade Finance?*

Under traditional Islamic law the *murābaḥa* is defined as the "sale [*bayʿ*] of a commodity for the price for which it was acquired, with a profit [*ribḥ*]" (al-Jazīrī, 1990, II: 250). The term *murābaḥa* thus denotes a contract of sale that is based on a previous sales contract and in which the price is based on the purchase price of the previous contract, calculated on the basis of the initial purchase price plus a certain profit margin.

Medieval Muslim jurists developed complex rules for calculating the purchase price under a *murābaḥa* and for regulating the information that the seller must disclose to the purchaser (cf. Udovitch, 1970: 219-22; Wichard, 1995: 260-7). Historically such transactions were used in the context of established business relationships in long distance trade whereby a trader purchased goods through an intermediary (Wichard, 1995: 260-7). It is difficult to ascertain the precise use of the *murābaḥa* in medieval trade and the allocation of risk among

the parties, especially with regard to deterioration or loss of the goods in transit; however, one reasonably may conclude that the *murābaḥa* was principally a contract of sale and not a credit facility. The profit (or "mark-up" as it is often called today) compensated the seller for his activity in trade, not for making funds available to the purchaser.

The *murābaḥa* agreement between the claimant and the defendant in the present case illustrates a different use of this transaction in contemporary Islamic finance. First, the claimant's involvement in the selection and purchase of the supplies is marginal, as the defendant buys the supplies according to the precise designation of the defendant, without any inspection or negotiation with the supplier. Second, the purchase price under the second sales contract is deferred and payable in instalments; the deferred payment, obviously, is the true economic purpose of the transaction. The structure of the transaction thus resembles a financing agreement under which the claimant provides funds to the defendant that put the latter into a position to purchase the supplies. This also is reflected in the use of the term "facility agreement" which, in English commercial usage, normally denotes a credit transaction. Looking at the economic structure of the transaction and the definition of the payment terms, the *murābaḥa* thus resembles a conventional trade financing arrangement that involves a letter of credit.[7]

Although the economic function of the transaction at hand is reminiscent of conventional trade financing, the *murābaḥa*, from the perspective of the bank, bears peculiar risks if the supplies are lost or damaged in transit, or if, as alleged in the present case, the supplier does not deliver the supplies. The question arises: is the *murābaḥa*, pursuant to its economic function, a financing agreement, or should

[7] A conventional trade finance arrangement involving a letter of credit works roughly as follows: The purchaser (P) enters into a supply agreement with the supplier (S). P, then, would apply to its bank (B) to open a letter of credit. Under the letter of credit, B stipulates to pay the purchase price to S, normally conditional upon presentation of certain documents (providing evidence that the supplies have been shipped to P). Pursuant to the application, B has recourse to P for the amount of the purchase price (and a fee on top of it). In practice, an additional bank may be involved, either on the side of S, or confirming the letter of credit on behalf of B, so that both S and P can deal with a bank in their respective home countries (for details see Goode, 1995: 960-1029).

This arrangement, in the first place, is an instrument to secure payments in international trade (as the promise of B provides S with comfort that the purchase price will actually be paid and assures P that the supplies purchased are existent and have been shipped). However, it can also be used as a credit vehicle, when combined with a credit line which B has made available to P.

it be viewed in light of the Islamic legal principles that inspired its contractual structure, in which case the transaction must be construed as a contract of sale? In the present case, the defendant expended considerable effort to suggest the latter interpretation to the court. In that case, it may be argued that the purchase price is not due until delivery of the supplies is effected. Islamic banks normally try to mitigate this risk by means of respective contractual arrangements.[8] In the case at hand, the agreement provides:

> 4.2 When the Seller shall have purchased Supplies, the Purchaser shall be absolutely, unconditionally and irrevocably obliged to purchase such Supplies from the Seller and to pay (a) all sums as mentioned in the Acceptance relating to such Supplies and (b) all other sums expressed or agreed to be payable hereunder in respect of such Supplies, in all cases notwithstanding any defect, deficiency or any loss or any other breach of any Supply contract relating thereto by the Supplier or any other matter or thing whatsoever.

This principle is reiterated in connection with the payment conditions, which are formulated in autonomous and unconditional terms:

> 4.4 The relevant instalments of the Sale Price in respect of each Purchase Agreement shall be payable by the Purchaser to the Seller on the due dates therefore, whether or not: (a) any property in the Supplies has passed to the Purchaser under the relevant Purchase Agreement and/ or to the Seller under the relevant Supply contract ... and such payment shall not be conditional upon the happening of any event, in recognition by the parties of the facts that the source of the supply of the Supplies is selected by the Purchaser ...

In interpreting the relevant provisions, the High Court judge first highlights the choice of law clause contained in the agreement, pursuant to which the "Agreement and each Purchase Agreement shall be governed by, and construed in accordance with, English law". The choice of English law is fairly common in international finance, as London is one of the most important international financial centres and English law firms have been very successful in exporting English style contractual drafting. The choice of English law is also widespread in Islamic finance (cf. Vogel/Hayes, 1998: 50-2; Hamid, 1999: 171-4). Although at least some Islamic banks provide in their contracts that the respective agreements shall be governed by "the principles

---

[8] For a discussion of the allocation of risk among the parties in *murābaḥa* agreements and their respective contractual clauses, see: Ray, 1995: 45-50; Vogel/ Hayes, 1998: 140-3; Saeed, 1999, 84-91; Hamid, 1999: 166-8; Bälz, 2001b: 245-7.

of Islamic law", it is questionable whether such a choice of law clause is enforceable in a Western court (Bälz, 2001a: 43-5). An Islamic financial institution following a commercial agenda, thus, is well advised to opt for the choice of a particular national legal order; it seems as if the increasing global reach of Islamic financing transactions also requires provision for an internationally acknowledged mechanism of dispute resolution, to include a choice of law conforming to market practice.

Referring to the choice of law clause in the agreement, the judge holds that "it is absolutely critical to note that the agreement is not governed by Shariah law but by English law". This allows the court to disregard the expert evidence provided by Dr. Martin Lau of SOAS and Dr. Samaan of the Saudi Law Firm of Salah Al-Hejailan both of whom explained in some detail the structure of the *murābaḥa* under traditional Islamic law.[9] Instead, the court construes the agreement "according to its terms as an English law contract" and holds:

> What clauses 4.4, 5.1, 5.2 and 5.6 demonstrate is that all of the arrangements concerning the acquisition of the goods by the seller from the supplier fall to be made by the purchaser, for the very good reason that this is a financing agreement facilitating or apparently facilitating the purchase of the goods of the supplier. If therefore there has been no delivery of the goods from the supplier to the seller and thus from the seller to the purchaser, that can only be because the purchaser has not made the necessary arrangements.

The payment obligations under a trade financing transaction are typically "abstract" or "autonomous" (cf. Goode, 1995: 987-9), i.e. independent of the underlying supply relationship. As a consequence, the risk of failure of delivery is borne by the purchaser alone. The judge finds further support for this interpretation by looking at the payment conditions in the *murābaḥa*-agreement. He explains:

> Clause 4.4 provides that the instalments are payable whether or not the seller is in breach of any of its obligations under the relevant purchase

[9] In English courts, the application of foreign laws is deemed a question of fact and not of law. As a consequence, a party relying on a specific provision of foreign law in its argument must prove the content of the respective rule to the satisfaction of the court as if it was a factual statement. In particular with regard to questions of Islamic law this has been criticized, as an expert witness appointed by either of the litigants will, in effect, hardly ever act impartially (see Pearl, 1995: 9-10). In the present case no reference is made to who appointed the experts. It seems, however, as if Dr. al-Samaan supports the defendant's position, while from the passages quoted by the court it cannot be determined on which side Dr. Lau is on.

> agreement, which must include failure to deliver. Payment is not conditional upon the happening of any event.

On this basis the judge concludes that "delivery of goods is not a prerequisite to recovery by the seller of the relevant instalments of the sale price from the purchaser" because the Agreement is "no orthodox contract of sale." Also in the event of a failure of delivery, the court holds, the defendant remains under the obligation to pay the purchase price.

This interpretation is likely to have been inspired by a number of reasons, some attributable to the facts of the case, and some to the construction of contracts under English law in general. As regards the facts of the case, it is striking that the defendant never raised the non-delivery defense before the claimant actually brought the action in the High Court. The parties' correspondence preceding the court proceedings, in which the defendant refers to the first instalments "due for maturity" and asks for an "extension" in a letter dated 7th July 2000, suggests that the defendant and the co-defendants, before obtaining specialised legal advice, shared the interpretation that the defendant's obligation to pay under the agreement was legally autonomous from any delivery of the goods. Moreover, the underlying reason for the non-delivery of the goods remains ambiguous. From the facts of the case one understands that the supplier, Precious (HK) Ltd., in turn, was to acquire the diamonds from the sightholder, a company controlled by two brothers of one of the co-defendants (and shareholder of the defendant); and that due to an ongoing family dispute the sightholder did not honour its commitment to Precious (HK) Ltd. The court proceedings, so it seems, are only part of a larger dispute in which the parties are engaged.

Moreover, legal reasoning in the case also is consistent with the practice of English courts, which tend towards a literal interpretation of commercial agreements, thereby attributing particular significance to the wording of the respective contractual provisions. A seminal handbook on English contract law puts this principle of contractual interpretation as follows: "The cardinal presumption is that the parties have intended what they have in fact said, so that their words must be construed as they stand" (Chitty, 1999:604). This approach differs from that taken by French or German courts, which normally put more emphasis on the "true intentions of the parties" and the economic rationale of a transaction and, at times, tend to read into the contract what the parties should have expressed there in words (cf. Zweigert/

Kötz, 1987: 429-39). In addition, and, in the present context, more importantly, London is a leading financial centre and English courts are sensitive to upholding reasonable business practices where not otherwise constrained by the rules of mandatory legal provisions. As a consequence, the business community is granted wide discretion when establishing law through practice (Goode, 1995:162). The allocation of risk under the contract at hand reflects a widespread practice in Islamic finance, through which the *murābaḥa*, as described above, is effectively turned into a credit vehicle with autonomous payment obligations. Any different approach taken by the court, in particular one admitting the defense of non-delivery, would have seriously endangered the present practice of *murābaḥa* financing, as only very few banks would be willing to assume true commercial risks; as a consequence, the application of *murābaḥa*-structures, at least in the international arena, would have been seriously curtailed and the scope of application of Islamic trade financing considerably limited.

*Illegality: Islamic legal rules as* lois d'application immediate?

As a further defense, the defendant argued that the agreement entered into with the claimant was void, because it contradicted the rules of the Islamic *Sharīʿa*.

In light of the above, this defense may surprise at first, as the agreement, by an express choice of law, is governed by English law and not by Islamic legal principles. Furthermore, the choice of law is unrestricted and not limited to "the principles of English law to the extent they do not violate the mandatory provisions of the Islamic *Sharīʿa*", a formulation that is occasionally encountered in Islamic financing agreements. However, English courts have developed the principle that a contract governed by English law is also void for illegality in the event that the respective contractual arrangement requires an act that is unlawful at the place where it shall be performed (Chitty, 1999: 1650-1). This doctrine is part of a tendency in international contract law to enforce the mandatory principles of foreign law (often referred to by the French term *lois d'application immediate*) to the extent that they (i) have a close connection with the case and (ii) protect interests that are unanimously shared by the international community.[10] Although the precise scope of the doctrine is not easily

[10] For a discussion of the different theoretical approaches, see Habermeier,

defined, it predominantly serves to enforce rules of international economic law, such as prohibitions of constraints on competition, exchange control regulations and laws enacted to combat corruption. Scholars of international commercial law have argued that the Islamic prohibition of *ribā* can be deemed such a mandatory rule (Berger, 1997). In the present case, the defendant argued that the contract was, at least in part, to be performed in Saudi Arabia, where the *Sharīʿa* was the law of the land.

Whether the *murābaḥa* transaction under consideration here fully complies with a more rigorous interpretation of the Islamic *Sharīʿa* is questionable. Although deferred payment in *murābaḥa* schemes seems to be generally accepted by contemporary Muslim scholars and can also be supported by traditional precedents (cf. Vogel/Hayes, 1998: 140; Saeed, 1999: 78-82), other aspects of the contemporary application of the *murābaḥa* continue to be disputed (cf. Ray, 1995: 46-50). The Pakistani scholar Judge Taki Usmani, a prominent figure in the Islamic finance industry and an influential advisor to Islamic financial institutions, for example, points out critically that many Islamic banks calculate the mark-up in *murābaḥa* transactions on the basis of current interest rates as reflected in indices such as the LIBOR (2002: 48-9). Further, he defines the scope of the permissible *murābaḥa* more narrowly by requiring explicitly that "the commodity must come into the possession of the financier ... in the sense that the commodity must be in his risk, though for a short period" (Usmani, 2002: 42). This statement reflects the traditional Islamic law of sales, pursuant to which, as a matter of principle, the seller can only sell an object which he owns (al-Jazīrī, 1990, II: 148-9). It thus is not permissible for the seller to dispose of an object that he purchased before he himself acquired possession from the vendor (ibid.: 210). In similar terms, the *Sharīʿa Rules for Investment and Financing Instruments* (2001) of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI),[11] establish a clear nexus between possession and the assumption of risk, even if only for a short period. Rule 6/1 pertaining to the *murābaḥa* provides:

---

1997: 37-75 and Sonnenberger, 2003; on the application of these principles in international commercial arbitration, see, Craig/Park/Paulsson, 2000: 338-46.

[11] AAOIFI is a non-governmental organisation based in Bahrain engaged in developing legal and accounting standards for Islamic financial institutions. The *Sharīʿa* Rules aim at codifying a best practice for Islamic banks. In addition to *Sharīʿa* standards, AAOIFI is also active in developing accounting rules for Islamic financial institutions.

> It is obligatory that the [sc. Islamic financial] institution is taking possession of the item to be ascertained before its sale to the customer on the basis of the *Murābaḥa* to the purchase order, so as to fulfil the institution's assumption of the risk of the item before its sale to the customer ....

This discussion may not be fully satisfactory from a legal perspective, as title to and possession of supplies are not always clearly discerned. However, as regards the allocation of risk among the parties, these principles clearly reveal an understanding of Islamic banking as "profit banking", where there is "no profit sharing without risk sharing" and "earning profit is legitimised by engaging in an economic venture" (Al-Omar/Abdel-Haq, 1996:12). Although the more restrictive view acknowledges that the capacity of a bank to bear commercial risks, such as the failure of delivery by the supplier, is rather limited, it insists that, by way of a symbolic token, a limited risk must stay with the bank. It is questionable whether a *murābaḥa* contract under which the purchaser must bear the risk of total failure of delivery by the supplier —as in the case at hand—conforms to that view. Indeed, from an Islamic perspective, it can be argued that such a contract is illegal.

The High Court, however, elegantly avoided any engagement with this intricate discussion. First, it would have been difficult to ascertain the approach that a Saudi court would have taken to the transaction at hand. Although, as a matter of principle, contract law in Saudi Arabia continues to be governed by Islamic legal principles (cf. al-Jabr, 1994: 7-8 and 23; Vogel, 2000: 302-8; Krüger, 2002) and, furthermore, Saudi courts have, at times, upheld the prohibition of *ribā* by not allowing any claims for interest (cf. Amereller, 1995: 149-61; Comair-Obaid, 1995: 189-92; Vogel, 2000: 305-6), it is rather difficult, if not impossible, to predict how they would have ruled on the agreement at hand. Second, the judge rightly pointed out that the defendant's obligations consisted merely in the payment of moneys to bank accounts in Zurich and New York. From this the court concluded that the agreement was only peripherally related to Saudi Arabia, if at all, and, in particular, no obligations under the agreement were to be performed there. As a consequence, the court dismissed the defense of illegality.

Ultra vires*: On the restrictions of an Islamic bank to enter into Islamic financing transactions*

As a last defense, the defendant submitted to the court that the agreement was unenforceable in the light of the *ultra vires* doctrine as applied in the Bahamas.

The claimant is a company incorporated in the Bahamas. Following from this, questions relating to the claimant's capacity and due representation are governed by the law of the Bahamas under which the claimant is incorporated. This also applies in the event that the contract entered into in exercising these powers is governed by English law. The Bahamas are a Common Law jurisdiction and one of the principles of English company law that has influenced local legislation is the *ultra vires* doctrine. The traditional *ultra vires* doctrine, as developed by English Courts in the nineteenth century, holds that if a company, incorporated by or under a statute, acts beyond the scope of the objects stated in the statute or the articles of association, such acts are void as beyond the company's capacity (Gower's, 1997: 203). The capacity of a legal entity to contract is thus limited by the legal act that brought it into existence. If the company's management enters into a transaction that is outside the scope defined in the articles of association, the agreement cannot be enforced.

In order to demonstrate adherence to Islamic legal principles, Islamic financial institutions commonly include in their articles of association a provision that the company is bound to the "principles of Islamic law" and will not engage in any activities that "violate mandatory provisions of the *Sharīʿa*". In addition, most Islamic financial institutions entertain a *Sharīʿa* Supervisory Board, thereby establishing a two-tiered system of corporate governance, under which the management board, in charge of running the institution's daily business, has access to the advice of (and, conversely, is subject to the control of) a separate advisory body in charge of ensuring *Sharīʿa* compliance. The management board, often consisting of trained bankers with rather limited knowledge of Islamic legal principles, is thus complimented by a body whose members are *Sharīʿa* scholars charged to determine whether or not financial innovations conform to Islamic law and to scrutinize the institution's business operations in the light of Islamic principles.[12] In many cases, the *Sharīʿa* board also issues a "certificate",

[12] On the role of *Sharīʿa* boards see Saeed, 1999: 108-18; Bakar, 2002. The division of labour between on the one hand bankers who provide banking expertise

similar to the one rendered by chartered accountants, confirming that the business policy in a respective business year did not violate the principles of Islamic law. This certificate is then used for promotional purposes, disseminated in marketing materials and displayed on the institution's web site. The precise legal nature of the claim to abide by Islamic legal norms, and the effect of an investor's relying on the Islamic orientation of the institution, awaits detailed analysis (cf. Bälz, 2002: 450-1). In the present case, the claimant's articles of association included the limitation to carry on business only "in a manner which is consistent with Islamic law, rules, principles and traditions". Based thereupon, the defendant argued that as the transaction did not comply with the provisions of Islamic law, it was outside the scope of the transactions in which the management could validly engage. Consequently, the defendant argued, the transaction was *ultra vires* and thus cannot be enforced.

It is obvious that the *ultra vires* doctrine can be a major impediment to commercial transactions, as there can be no reliance on the capacity of a legal entity without thorough investigation into and construction of its founding documents. This led the English legislator to curtail application of the *ultra vires* doctrine with respect to third parties in the Company Act of 1985. The Companies Act of the Bahamas of 1992 followed the new English approach by providing in Art. 24:

> (1) Subject to this Act, a company incorporated under this Act has the capacity and all the rights, powers and privileges of an individual of full capacity [...].
>
> (3) Any limitations in the memorandum or articles on the objects or powers of the company or any limitations .. in the memorandum or articles ... shall not affect a third party, unless that party actually knows of such limitations or the lack of such authority relating to the relevant transaction.

---

and run the business on a day-to-day basis and on the other (external) Islamic scholars who advise on *Sharīʿa* matters and provide the institution with Islamic legitimacy is closely connected with the internationalisation of Islamic finance: on the one hand, Islamic financial institutions active in the global market depend on professional management and technical banking expertise that is rarely found among scholars of the *Sharīʿa* trained in one of the traditional faculties; on the other hand, international banks that design and market Islamic products, although possessing the required banking expertise, are not in a position to generate Islamic legitimacy themselves. The solution to this problem consists in an arrangement of corporate governance with a two-tiered system, consisting of one body competent in management matters and another advising on *Sharīʿa* issues.

The Court discusses possible constructions of this statutory provision at some length, also referring to expert advice provided by two respected Bahama law firms. In the end, however, the High Court arrives at the conclusion that the purpose of the provision is limited to protecting the good faith of third parties and shall not allow a party to avoid a contract *ab initio* by arguing that it had always been aware of the other side's limited capacity. As a consequence, therefore, the Judge also dismissed this last defense. From this it follows that there is no reliance on the fact that an Islamic financial institution will engage only in transactions that conform to the principles of Islamic law. Protection of the interests of international commerce thereby overrides the ethical concerns that, at least pursuant to the self-description of the industry, are the very basis of Islamic finance.

## *Conclusion*

As the case demonstrates, the contractual practices of Islamic financial institutions may not be reduced to the mere application (or variation) of traditional Islamic legal principles.

The application of Islamic law is fundamental to Islamic finance, as Islamic financial institutions claim to adhere to the principle of the Islamic *Sharīʿa* and engage in transactions inspired by Islamic contractual structures. The exposure to a non-Islamic legal environment and international commercial practices, however, as well as the influence of transnational contract drafting techniques, have resulted in a thorough transformation of traditional Islamic contractual structures. In Islamic finance, Islamic legal principles and concepts, English style contractual drafting and the rules of international commercial law are intertwined in a manner that cannot be reduced to a modern variation of traditional Islamic contract law. As a consequence, Islamic financing transactions should be examined not only against the background of traditional *Sharīʿa* rules but also within the legal context of international finance in which Islamic financing transactions operate today.

As regards substantive legal rules, the reasoning of the London High Court reveals a complex interaction between Islamic legal principles and rules of international commercial law: The court constructs the agreement pursuant to which the parties intend to deal "in accordance with the Islamic Shariah" by following the pragmatic approach of English commercial law, according to which, especially

to the extent that professionals are concerned, the wording of an agreement overrides the intentions of the parties, and consistency with professional practices is more important than protection of the ignorant. The defendant, on the other hand, refers to conflict rules of international economic law in order to invoke Islamic legal principles that allegedly are in force in Saudi Arabia. In the end, debate arises as to how the Common Law doctrine of *ultra vires* currently applies to an Islamic financial institution incorporated under the law of the Bahamas. Whether or not the legal reasoning of the judgment is in line with Islamic legal principles remains an open question that must be left to *Sharīʿa* scholars to decide. However, the English court gives legal sanction to a widespread practice in the Islamic finance industry and resolves the dispute in a commercially reasonable manner, an approach that is fully consistent with the long-standing tradition of English courts in commercial matters. As a result, the transaction, explicitly labelled a *murābaḥa* agreement, is effectively construed as a financing agreement with abstract payment obligations.

The transformation of Islamic legal structures is also reflected in the style of the agreement, which is obviously influenced by English legal drafting techniques. Although the idea of Islamic finance is based on reference to Islamic legal norms, and the industry has, over the last years, successfully formulated certain standards applicable to Islamic financial transactions, such as, for example, the AAOIFI *Sharīʿa* Principles referred to above, the global reach of Islamic financing transactions requires that business practices are precisely defined in formal legal terms, in particular when applied in an environment that remains happily ignorant of traditional Islamic concepts. While the structures of Islamic financing transactions, as the present case shows, are inspired by Islamic legal principles and contractual models, the concrete wording of the agreements often cannot conceal the influence of the boiler plate clauses commonly encountered in conventional financing agreements; this tendency is further enhanced by the increasing involvement of international law firms in Islamic finance and the fact that the respective agreements, as in the present case, may provide for a venue in a non-Islamic jurisdiction, applying the principles of English law (or the law of another Western jurisdiction) to its interpretation.

The product of these drafting techniques are comprehensive contractual arrangements, intelligible to the international financial community and also including detailed contractual provisions that apply in the

event in which the transaction does not develop as originally envisaged, as was the case in the High Court judgment. Such default rules that apply "when things go wrong", however, reflect the practices and standards of the international financial community, where banks tend to avoid the assumption of commercial risks under financing agreements, rather than aiming at a true reconstruction of traditional Islamic legal principles. The outcome, as the present case demonstrates, is a hybrid transaction, consisting of both Islamic and non-Islamic legal elements, reflecting both the international financial community's tribute to Islamic legal norms as well as a transformation of *Sharīʿa* principles in the light of the globalized practices of financial markets.

*References:*

AAOIFI (2001), Accounting and Auditing Organisation for Islamic Financial Institutions, *Sharīʿa Rules for Investment and Financing Instruments* (Manama).

Al-Jabr, Muḥammad Ḥassan (1994), Al-qānûn al-tijārī al-saʿûdī, 3rd ed. (al-Khubr: al-Dār al-Wataniyya al-Jadīda li'l-Nashr wa'l-Tawsīʿ).

Al-Jazīrī, ʿAbd al-Raḥmān (1990), Kitāb al-fiqh ʿalā al-madhāhib al-arbaʿa (5 vols., Beirut: Dār al-Kutub al-'Ilmiyya).

Al-Omar, Fuad and Mohammed Abdel-Haq (1996), *Islamic Banking: Theory, Practice and Challenges* (London and New Jersey: Zed Books).

Amereller, Florian (1995), *Hintergründe des "Islamic Banking". Rechtliche Problematik des riba-Verbotes in der Sharīʿa und seine Auswirkungen auf einzelne Rechtsordnungen arabischer Staaten* (Berlin: Duncker &Humblot).

Bakar, Mohd Daud (2002), "The Shariʿa supervisory board and issues of Shariʿa rulings and their harmonisation in Islamic banking and finance," in: Simon Archer and Rifaat Ahmed Abdel Karim, *Islamic Finance: Innovation and Growth* (London: Euromoney Books).

Bälz, Kilian (2001a), "Islamic Law as Governing Law under the Rome Convention: Universalist Lex Mercatoria vs. Regional Unification of Laws," *Uniform Law Review* 6, 27-49.

———. (2001b), "Islamic Banking," in: Ulf R. Siebel (ed.), *Handbuch Projekte und Projektfinanzierung* (München: C.H. Beck, 2001).

———. (2002), "Islamische Aktienfonds in Deutschland," *Zeitschrift für Bank- und Kapitalmarktrecht* 2002, 447-52.

Berger, Klaus Peter (1997), "Die Einwirkung drittstaatlicher Eingriffsnormen auf internationale Verträge dargestellt am Beispiel islamischer Zinsverbote, in: Harald Herrmann, Klaus Peter Berger and Ulrich Wackerbarth, *Deutsches und Internationales Bank- und Wirtschaftsrecht im Wandel* (Berlin/New York: Walter de Gruyter).

*Chitty on Contracts.* Vol. 1: General Principles (1999), ed. H.G. Beale, 28th ed. (London: Sweet & Maxwell.).

Comair-Obaid, Nayla (1995), *Les contrats en droit musulman des affaires* (Paris: Economica).

Craig, W. Laurence, William W. Park and Jan Paulsson (2000), *International Chamber of Commerce Arbitration*, 3rd ed. (New York: Oceana Publishing).

Goode, Roy (1995), *Commercial Law*, 2nd ed. (London: Penguin Books).
*Gower's Principles of Modern Company Law* (1997), 6th ed. by Paul L. Davies (London: Sweet & Maxwell).
Habermeier, Stefan (1997), *Neue Wege zum Wirtschaftskollisionsrecht. Eine Bestandsaufnahme prävalenter wirtschaftsrechtlicher Methodologie under dem Blickwinkel des kritischen Rationalismus* (Baden-Baden: Nomos).
Hamid, Mohamed El Fathi (1999), "Facing the challenges to Islamic Banking: an overview of the issues," in: Christian von Bar (ed.), *Islamic Law and its Reception by the Courts in the West* (Köln/Berlin/Bonn/München: Carl Heymanns).
Klötzel, Thomas R. (1999), "Islamic Banking in Malaysia," in: *Wege zur Globalisierung des Rechts. Festschrift für Rolf. A. Schütze zum 65. Geburtstag* (München: C.H. Beck).
Krüger, Hilmar (1997), "Überblick über das Zivilrecht der Staaten des ägyptischen Rechtskreises," *Recht van de Islam* 14 (1997), 67-131.
———. (2002), "Vermögensrechtliches Privatrecht und Rechtsverfolgung in Saudi-Arabien," in: *Einheit und Vielfalt des Rechts. Festschrift für Reinhold Geimer zum 65. Geburtstag* (München: C.H. Beck).
Mallat, Chibli (1988), "The Debate on *Riba* and Interest in Twentieth Century Jurisprudence," in: idem (ed.), *Islamic Law and Finance* (London: Graham & Trotman).
Nienhaus, Volker (1996), "Islamische Ökonomik in der Praxis: Zinslose Banken und islamische Wirtschaftspolitik," in: Werner Ende/Udo Steinbach/Gundula Krüger, *Der Islam in der Gegenwart*, 4th ed. (Munich: C.H. Beck).
Pearl, David (1995), "The Application of Islamic Law in the English Courts," in: *Yearbook of Islamic and Middle Eastern Laws* 2, 3-11.
Ray, Nicholas Dylan (1995), *Arab Islamic Banking and the Renewal of Islamic Law* (London/Dordrecht/Boston: Graham &Trotman).
Saeed, Abdullah (1999), *Islamic Banking and Interest. A Study of the Prohibition of Riba and its Contemporary Interpretation* (Leiden/Boston/Cologne: Brill).
Saleh, Nabil A. (1992), *Unlawful gain and legitimate profit in Islamic law. Riba, gharar and Islamic banking*, 2nd ed. (London/Dordrecht/Boston: Graham & Trotman).
Sonnenberger, Hans-Jürgen (2003), "Eingriffsrecht - Das trojanische Pferd im IPR oder notwendige Ergänzung?," *Praxis des internationalen Privat- und Verfahrensrechts*, 104-15.
Udovitch, Abraham L. (1970), *Partnership and Profit in Medieval Islam* (Princeton: University Press).
Usmani, Judge Taki (2002), *An Introduction to Islamic Finance* (The Hague/London/New York: Kluwer Law International).
Vogel, Frank E. and Samuel L. Hayes, III (1998), *Islamic Law and Finance. Religion, Risk and Return* (The Hague/London/Boston: Kluwer Law International).
Vogel, Frank E. (2000), *Islamic Law and Legal System. Studies of Saudi Arabia* (Leiden/Boston/Cologne: Brill).
Warde, Ibrahim (2000), *Islamic Finance in the Global Economy* (Edinburgh: University Press).
Wichard, Johannes Christian (1995), *Zwischen Markt und Moschee. Wirtschaftliche Bedürfnisse und religiöse Anforderungen im frühen islamischen Vertragsrecht* (Paderborn, München, Wien, Zürich: Ferdinand Schöningh).
Zweigert, Konrad and Hein Kötz (1987), *Introduction to Comparative Law*, 2nd ed., paperback (Oxford: Clarendon).