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Arbitration as a Method of Dispute Settlement in Islamic Banking and Finance: A Perspective from Malaysian Governing Law

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ABSTRACT

Arbitration is one of the important alternative dispute resolution (ADR) methods. Being an alternative method, it has advantages over the conventional dispute resolution mechanisms i.e. court litigation. This paper examines the law governing arbitration as a method of resolving disputes in Islamic banking and finance in Malaysia. Main provisions of related statutes and rules are discussed, as well as related issues. This paper adopts library research method and analyses relevant statutory laws, decided cases, books, journals, law reports, newspaper articles, conference proceedings and other periodicals. This paper concludes that although the law related to arbitration in Islamic banking in Malaysia is already in place, improvements are needed to ensure the arbitral process is more in line with the Shariah principle.

Keywords: Arbitration, disputes, Islamic banking and finance

INTRODUCTION

Islamic banking and Islamic finance have flourished in Malaysia since the passing of the then Islamic Banking Act 1983 which paved the way for the establishment of Malaysia's first Islamic bank i.e. Bank Islam Malaysia Berhad in the same year. After more than 30 years, the country has witnessed the mushrooming of new Islamic banks, local and international, to cater to rising needs of the public. While it is good to have many Islamic banks offering a wide range of Islamic instruments or transactions, disputes and cases arising out of these transaction are also increasing. The conventional option

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is to go for court litigation in order to get a settlement. However, there is another way of having those disputes settled without having to go to court. It is called the alternative dispute resolution (ADR), of which arbitration is one of its methods. The purpose of this paper is to discuss the law governing arbitration as an alternative method of settling disputes arising out of Islamic banking and financial transactions in Malaysia. In doing so, the paper will examine the law and rules governing the arbitration process of Islamic banking and finance disputes in Malaysia. Main issues related to these will be highlighted as well as suggestions on tackling them.

ARBITRATION

Arbitration is defined as 'resolution of dispute by a person (other than a judge) whose decision is binding' (Oran, 2000). It is also referred to as '[T]he determination of a dispute by one or more independent third parties (the arbitrators) rather than by a court' (Martin, 1997). In short, arbitration is an out-of-court method of settling disputes with the help of a third party whose decisions are binding. Arbitration is regarded as one of the most referred to alternative dispute resolution (ADR) methods of settling disputes. Among the ADR methods, arbitration is known as an arbitral method because its decision is, similar to judgment in court litigation, made by a neutral third party and binding on the disputing parties.

When comparing arbitration and litigation, it is a fact that arbitration has several advantages which makes it more preferable to litigation. The advantages include, *inter alia*, party autonomy, fair settlement without unnecessary delay, cost saving, flexibility of process, full confidentiality, finality of award, and enforceability of award (Blake, Browne & Sime, 2011). These advantages may be appealing to parties to legal disputes, including those related to Islamic banking and finance matters.

RELEVANT STATUTES AND RULES

The relevant law governing arbitration of disputes arising out of Islamic banking transactions in Malaysia are the Arbitration Act 2005, Central Bank of Malaysia Act 2009 and Kuala Lumpur Regional Centre for Arbitration (KLRCA) i-Arbitration 2013. These statutes and rules are applicable as they are referred to by disputing parties in resolving their disputes in Islamic banking and finance.

Arbitration Act 2005

The Arbitration Act 2005 substitutes the Arbitration Act 1952. The repeal is due to the fact that the 1952 Act was out-dated compared with arbitration laws in neighbouring countries and other countries worldwide at that time. Because the law was not keeping up with existing trend, the approach of the Malaysian judiciary towards arbitration in Malaysia was not so pro-arbitration (Dipendra & Bashir, 2010).

This resulted in several shortcomings in the conduct of arbitration and difficulty in enforcement of awards in the country. Among those shortcomings are issues related to court's appointment of arbitrators, unenforceability of arbitral awards and the court's tendency to interfere with the findings and awards of arbitrators (Abraham, 2003, 2006). These had discouraged disputing parties from using Malaysia as the seat for their arbitration (Rajoo, 2006).

This uncompromising position had prompted some arbitral bodies to come up with proposals with the object of amending the 1952 Act (Abraham, 2003). The proposals were then submitted to the Attorney General's Chamber for further action. As a result, the Arbitration Act 2005 was enacted by the Federal Legislature and came into force on 15 March 2005. This Act repeals the Arbitration Act 1952 and the Convention on the Recognition and Enforcement of Foreign Arbitral Awards Act 1985 (Arbitration Act 2005, Section 51(1)). The ultimate purpose of the 2005 Act is to promote international consistency of arbitral bodies which are modelled according to the United Nations Commission on International Trade Law ("UNCITRAL") (Abraham, 2006). Thus, it is not surprising that most of the provisions of the 2005 Act are similar to those of the UNCITRAL model law.

The Arbitration Act 2005 has several new important features which disputing parties in Islamic banking and finance disputes must observe. First, the disputing parties have autonomy over the flexibility of the arbitration process. The court cannot freely interfere in the arbitral proceedings and awards save in accordance with the provision of the Act (Section 8). When the parties agree on the exclusion of court power to intervene, any invitation to interfere in arbitral awards shall not be entertained by the court (Mogan, 2005). This was absent in the repealed 1952 Act where the court could and had freely interfered. Now, disputing parties are given the right to choose whether they want the court intervention in their arbitration or not with regard to certain matters. These matters are determination of a point of law arising in the course of arbitration (section 41), question of law arising out of an award (section 42), taxation of arbitration costs, extension of time for commencing arbitration proceedings (section 45), and extension of time for making awards (section 46). In cases where the parties allow court intervention in any of the above matters, they may customise such intervention to be full or partial as they wish.

Second, the 2005 Act provides for a mandatory stay-of-court proceeding when there is an arbitration agreement (Section 10(1)). This replaces the discretionary power of the court to grant a stay under the 1952 Act. The mandatory stay under the present law may be able to limit court interference in arbitration process and awards, and fortify the role of the court in support of arbitration. However, the mandatory stay order will not be given

on the following grounds: the arbitration agreement is null and void, inoperative or incapable of being performed, or there is no arbitrable dispute between the parties (Section 10(a) and (b)).

The courts have duly granted the mandatory stay by virtue of section 10 of the 2005 Act in many cases. In *Albit Resources Sdn Bhd v Casaria Construction Sdn Bhd* [2010] 3 MLJ 656, the defendant was a main contractor for a construction project and the plaintiff was the defendant's subcontractor under two subcontracts - one contracted in June and another in August. The plaintiff brought a legal action against the defendant for the two subcontracts. The defendant applied for an order of stay against the plaintiff's claim in respect of the sum MYR334,273.37 for the June subcontract and for reference to arbitration on the ground that the said subcontract was subject to arbitration. The plaintiff disputed the existence of arbitration agreement in the June subcontract. Thus, the main issue in this case was whether the June subcontract was an agreement to arbitration under section 9 of the Arbitration Act 2005. At trial stage, the judicial commissioner gave a negative answer and did not grant the stay order.

However, the Court of Appeal unanimously allowed the appeal on the ground that both parties had agreed to the inclusion of PAM agreement into the June subcontract and that clause 34 of the said agreement expressly contained provision for arbitration. Thus, on the true construction of contract, the June subcontract was subject to arbitration agreement by virtue of section 9(5) of the Act which provides: "*A reference in an agreement to a document containing an arbitration clause shall constitute an arbitration agreement* provided that the agreement is in writing and the reference is such as to make that clause part of the agreement." Accordingly, the Court of Appeal held that the learned commissioner had erred in dismissing the defendant's application for an order of stay and reference to arbitration.

A similar outcome where the courts granted stay orders can also be found in *Comos Industry Solution GMBH v Jacob and Toralf Consulting Letrikon Sdn Bhd & Ors* [2012] 4 MLJ 573 and several other cases, such as *Standard Chartered Malaysia Bhd v City Properties Sdn Bhd & Anor* [2008] 1 MLJ 233 *Sunway Damansara Sdn Bhd v Malaysia National Insurance Bhd & Anor* [2008] 3 MLJ 872; *Borneo Samudera Sdn Bhd v Siti Rahfizah bt Mihaldin & Ors* [2008] 6 MLJ 817; *CMS Energy Sdn Bhd v Poscon Corp* [2008] 6 MLJ 561; and *Majlis Ugama Islam dan Adat Resam Melayu Pahang v Far East Holdings Bhd & Anor* [2007] 10 CLJ 318. This statutory position in which the courts are bound by the wishes of disputing parties to settle their disputes by arbitration must be respected by the courts. Indeed it has become an important achievement since the coming into force of the 2005 Act.

Third, the arbitration tribunal may also in its own jurisdiction, decide on matters regarding preliminary objection and validity of arbitration agreement (Section

18). Under the old law, this power was vested only in the court. However, this power is only available to the arbitration tribunal, subject to both the parties' consent in the arbitration agreement.

Fourth, the 2005 Act empowers arbitration tribunal, in addition to the existing power of the court, to issue interim orders (Section 19). Such orders are treated as awards of the arbitration panel and may cover security for costs, discovery of documents and interrogatories of witnesses, affidavit evidence, and preservation or interim custody or sale of disputed property. Under the repealed Act, these reliefs were within the prerogative domain of the court and could only be obtained after the hassles of long time and rigid procedures. This current feature of arbitration will definitely save disputing parties' time and money in order to get the same reliefs.

Fifth, not all provisions of the Act are applicable to all arbitrations. The Act has four major parts. Parts I, II and IV of the Act are applicable to all arbitrations if the seat of arbitration is Malaysia. Regarding Part III, there are two general rules to be observed: a) the Part is applicable to domestic arbitrations whose seat of arbitration is Malaysia. However the Part is not applicable when the parties mutually agree in writing to opt out of the provisions of the Part (section 3(2)(b)); b) in case of international arbitrations whose seat of arbitration is Malaysia, the Part is not applicable. But it is applicable when the parties mutually agree in writing to opt in (section 3(3)(b)) i.e. to make the Part applicable to their arbitration. Thus, Part III is in its 'default setting' applicable to domestic arbitrations but not applicable to international ones. On the other hand, it does not apply to domestic arbitration in case of 'opt out' and applies to international arbitrations in case of 'opt in'.

All the above features are meant at improving arbitration as an efficient dispute resolution method which can help parties settle their disputes without having to resort to court litigation. Does this mean that arbitration must be totally free from court intervention? The answer is negative. Although the court, by default under the 2005 Act, is not free to interfere in arbitration, total separation of the latter from the former is impossible. In fact, judicial help is still needed to support arbitration in certain situations. For instance, enforcement of arbitral award against a non-complying party, interim orders before the set-up of an arbitral tribunal, or interim orders against a third party not privy to the arbitration process (Muttath & Hwang, 2002). In those instances, the parties still need to go to court to get those remedies. In this regard, the court assumes a supportive role which is very much needed to ensure the arbitral process run smoothly and efficiently.

KLRCA i-Arbitration 2013

In Malaysia, the relevant body that has a direct connection with arbitration is the Kuala Lumpur Regional Centre for Arbitration ("KLRCA"). This body was set up in 1978 under the auspices of the Asian-African Legal Consultative

Organisation (AALCO) (Kuala Lumpur Regional Centre for Arbitration (KLRCA), 2015). It became the first regional centre that AALCO established in Asia with the aim 'to provide institutional support as a neutral and independent venue for the conduct of domestic and international arbitration proceedings in Asia' (KLRCA, 2015).

Since its birth in 1983, Islamic banking and Islamic finance in Malaysia has achieved tremendous growth and is still rapidly growing including related Islamic banking and financial products. This would also mean more disputes would arise from Islamic banking transactions. Thus, efficient arbitration rules for dispute resolution in Islamic banking and finance are important in addition to being Shariah-compliant.

In order to fulfil these two purposes namely efficient and Shariah compliant dispute resolution, the KLRCA issued a set of rules which was known as the KLRCA Rules for Islamic Banking and Financial Services Arbitration 2007 ("IBFSA Rules"). These rules have been constantly updated and the most current version is known as the KLRCA i-Arbitration Rules 2013.

As for its main features, the KLRCA i-Arbitration Rules 2013 can be divided into four main parts. Part I is KLRCA i-Arbitration Rules, revised in 2013 and has 18 rules. Part II is the UNCITRAL Arbitration Rules and has 43 articles. This part is divided into four main sections: Section I (introductory rules); Section II (composition of the Arbitral tribunal); Section III (arbitral proceedings); and Section IV (the award). Part III provides four main schedules to the rules. Lastly, Part IV outlines the guide for the rules. If there is any conflict between a provision of Part I and another of Part II, the former shall prevail (Rule 1(3)).

As regard to the types of disputes that can be referred to arbitration, the KLRCA i-Arbitration Rules 2013 are silent. However Part IV of the Rules, which represents a guide to the rules, states "[A] ny dispute which arises out of an agreement which is premised on the principles of Shariah." (Part IV, Item 4). The 2007 Rules stated such dispute was one arising out of 'any commercial contract, business arrangement or transaction which is based on Shariah principles' (IBFSA 2007, Rule 1(3)). Thus, clearly any dispute arising out of transactions based on *Mudharabah, Murabahah, Musyarakah, Ijarah* and other Shariah principles can be referred to arbitration under i-Arbitration Rules 2013. It is also worth to note that the statement on types of dispute is more general compared with the one stated in the previous IBFSA 2007 Rules. Being general in construction, item 4 of Part IV can cover all transactions or financing instruments which are based on the Shariah principles.

As such, it is important to note that the qualification of being 'based on the principles of Shariah' is the main factor to take into account before any dispute can be entertained by arbitration under the KLRCA i-Arbitration Rules 2013. The qualification would cover disputes arising out of the

present contracts or instruments of Islamic banking and finance as applied in Malaysia. On the other hand, disputes arising from conventional banking and finance contracts cannot be resorted to i-Arbitration Rules 2013. Instead such disputes should be referred to the KLRCA Arbitration Rules 2013.

In order to refer a dispute in Islamic banking and finance contract to arbitration under the KLRCA i-Arbitration Rules 2013, the contract must contain a provision to that effect. Such a provision is known as an arbitration clause. As guidance for contracting parties, the KLRCA i-Arbitration Rules 2013 provide the following model arbitration clauses for parties to adopt in their contracts.

> *"Any dispute, controversy or claim arising out of or relating to this contract or the breach, termination or invalidity thereof shall be settled by arbitration in accordance with the KLRCA i-Arbitration Rules."* (Schedule 3),

and

> "*The parties hereby agree that the dispute arising out of the contract dated _____ shall be settled by arbitration under the KLRCA i-Arbitration Rules.*" (Schedule 4).

The clause in Schedule 3 can be inserted by parties to an instrument of Islamic banking or financial services at the time of contract. For existing contracts that have no arbitration clause or contracts that have different arbitration clause, the parties may include or substitute the old one with another model arbitration clause as outlined in Schedule 4. By virtue of this clause, irrespective of Schedules 3 or 4, the parties are bound to refer any dispute, which may arise out of the contract, to the KLRCA i-Arbitration Rules 2013.

Considering the great advantages of arbitration over litigation, it is hoped that almost, if not all, Islamic banking and finance contracts contain arbitration clause or agreement so that any potential disputes may be settled without having to go to court.

An important feature of the KLRCA i-Arbitration Rules 2013 is its reference to a Shariah council or expert. Such a reference arises in two situations. The first one is when the arbitrator has to make an opinion on a matter related to Shariah principles (the KLRCA i-Arbitration Rules 2013, rule 11(1)(a)). Another is when the arbitrator has to make decision on a dispute arising from the Shariah aspect of the contract that can be subject to arbitration under the KLRCA i-Arbitration Rules 2013 (rule 11(1)(b)). When a matter or aspect in question comes under the purview of a specific Council, such a council shall be referred to (rule 11(2)(a)). In Malaysia, such a council will be the Shariah Advisory Council (SAC) of the Central Bank, or of the Securities Commission as the case may be (Section 51 of the Central Bank of Malaysia Act 2009; section 316A of the Capital Markets and Services Act 2007). However when the matter does not fall under the purview of any council, reference shall be made to a Shariah council or expert, as agreed

by the disputing parties (rule 11(2)(b)). In the second situation, the expert can be the SAC itself, Shariah Committee (of any Islamic bank), or any member thereof. In Malaysia; such an expert must be approved by the Central Bank (Para. 8 of Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions). This requirement is important to ensure integrity and independence of such Shariah council or committee or expert in Islamic banking and finance.

Before making the reference, the arbitrator may also consider the existing and published resolutions of the Council. Among them are the SAC of the Central Bank of Malaysia's *Shariah Resolutions in Islamic Finance* 2010 & 2012. If no answer can be found in these published resolutions, reference should be made to the Council or other Shariah experts, as the case may be.

An arbitral award under the KLRCA i-Arbitration Rules 2013 is final and binding on the parties and shall be carried out without delay by the relevant party (the KLRCA i-Arbitration Rules 2013, rule 12(7)). Further, the award may include late payment charge based on the principles of *gharamah* and *ta'widh* (the KLRCA i-Arbitration Rules 2013, rule 12(8)(a) and Shariah Resolutions in Islamic Finance, 2012). Should the party fail to comply with the award, the other party may enforce the award through the court (Arbitration Act 2005, s.38).

CENTRAL BANK OF MALAYSIA ACT 2009

A law which is also relevant to arbitration in Islamic banking and finance is the Central Bank of Malaysia Act 2009. This Act came into existence in 2009 which repealed the Central Bank Act 1958. Among the reasons for the promulgation of 2009 Act was to ensure judges or arbitrators make judgments or awards in accordance with the Shariah principles on Islamic banking and finance. Prior to the coming into force of the 2009 Act, the civil courts had the option to refer to the Shariah Advisory Council in deciding Shariah matters in Islamic banking and finance cases. However the option was not always exercised by the civil courts so that several cases were decided not taking into account the Shariah principles. Among these cases were: *Affin Bank Bhd v Zulkifli bin Abdullah* [2006] 3 MLJ 67 (High Court); *Arab Malaysia Finance Bhd v Taman Ihsan Jaya Sdn Bhd & Ors (Koperasi Seri Kota Bukit Cheraka Bhd, third party)* [2008] 5 MLJ 631 (High Court Kuala Lumpur); *Bank Islam Malaysia Bhd v Ghazali bin Shamsuddin & Ors* (Suit No D4-22A-215 of 2004); *Bank Islam Malaysia Bhd v Nordin bin Suboh* (Suit No D4-22A-1 of 2004); and *Arab-Malaysian Merchant Bank Bhd v Silver Concept Sdn Bhd* [2008] 6 MLJ 295. In the latter case, the learned judge made the following remark:

> *"Section 16B of the Central Bank of Malaysia Act 1958 (Act 591) however does not make reference mandatory... In the case of reference made by the court, the ruling is not binding but*

shall be taken into consideration. Given the reference is discretionary and the rulings are not binding ... the court is of the opinion reference is not necessary." (p. 299)

The Central Bank of Malaysia Act 2009 was passed to rectify the above setback. Now, the reference to the Shariah Advisory Council has been made obligatory on the court and arbitrators when the civil courts or arbitrators need to decide on Shariah matters involving Islamic banking and finance cases (section 56(1) of Central Bank of Malaysia Act 2009). The section provides:

"Where in any proceedings 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*** *(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." (Emphasis is added).*

The ruling by the Council on the reference shall be binding on the arbitrator (CBMA, s.57) who is under duty to apply the ruling when deciding the dispute and making the award. Further, the ruling of the Council shall also be binding on the parties and shall be final and not subject to appeal. The 2005 Act has also accorded the Shariah Advisory Council as the highest authoritative body to ascertain questions of Shariah law in Islamic banking and finance in Malaysia. It means the Council has the final say to make rulings in relation to Shariah matters in Islamic banking and finance in Malaysia.

The requirement of statutory reference to the Council is very important to ensure judgments in such cases are according to the Shariah principles, given the fact that judges of the civil courts are not all trained in the law of Islamic banking and finance. The weakness of the civil courts in this regard can be best illustrated by an *obiter* given by Mohd Zawawi J in *Tan Sri Abdul Khalid v Bank Islam Malaysia Berhad* [2012] 7 MLJ 597 whereby he said:

"... civil courts may not be sufficiently equipped to deal with the issue whether a transaction under Islamic banking is in accordance to the religion of Islam or otherwise. Civil courts are not conversant with the rubrics of Fiqh Al-Muamalat which is a highly complex yet under developed area of Islamic jurisprudence." (pp. 615-616)

ISSUES AND SUGGESTIONS

Based on the above discussion, there seems to be an issue as regards the status of the reference. Is it obligatory on the arbitrator to make such a reference to Shariah Advisory Council?

Clearly, the Central Bank of Malaysia Act 2009 makes such reference an obligation by virtue of the word "shall" in section 56(1). On the other hand, the i-Arbitration Rules 2013 treats the reference as an option based on the word "may" used in rule 11(1).

It is suggested that the provisions of the 2009 Act should prevail over the 2013 Rules if the seat of a particular arbitration is Malaysia. This is due to the fact that the former is a statute while the latter is a delegated legislation. As such, the law of Malaysia, including section 56(1) of the Central Bank of Malaysia Act 2005, will be applicable to any arbitral proceeding relating to disputes in Islamic banking and finance when the parties mutually choose Malaysia as the seat for arbitration. In this situation, the arbitrator is under statutory duty to make a reference to the SAC for its ruling. On the other hand, the situation would be otherwise if the seat of the arbitration is not Malaysia. Thus, the arbitrator may choose whether to make a reference, subject to the agreement of disputing parties.

Another issue relates to maintenance of deposits. It is normal that deposits must be paid by disputing parties before the commencement of arbitration proceedings. For arbitration under the IBFSA Rules 2007, the deposit paid by the parties must be maintained by the KLRCA in a non-interest bearing bank account of a financial institution (IBFSA Rules, rule 18(3)). However, the present KLRCA i-Arbitration Rules 2013 are silent on the type of account for the deposits. It is not clear why the new Rules fall short to specify the type of account. It is suggested here that the position of 2007 Rules should be read with the current 2013 Rules, since it is important that the account in which such deposits are to be kept must be Shariah-compliant. It is also submitted that the 2013 Rules be amended to include an express provision to the effect.

CONCLUSION

In Malaysia, disputes arising out of Islamic banking transactions can be referred to arbitration by virtue of several statutory laws. Although the Arbitration Act 2005 prevents the court's interference in arbitral proceedings, the role of the latter is still important and cannot be left out. In fact, the court plays a very strong supportive role to ensure arbitration as well as i-arbitration achieve their true purposes and functions. Apart from that, the existence of KLRCA as the first regional arbitration body in Asia since 1978 has helped expand the popularity of arbitration to local and international parties. With its own i-Arbitration Rules 2013, it is really hoped that most, if not all, Islamic banking transactions contain arbitration model clause so that disputes, if any, can be settled without having to go to the court. The statutes and rules governing arbitration of disputes in Islamic banking and finance are already in place in Malaysia. But there are issues which need proper attention by relevant authorities.

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