Shariah Non-Compliance Issues and Defence of Illegality in Islamic Finance Litigation [2017] 2 ShLR xxxiii

Shariah Law Reports Articles (ShLRA)

SHARIAH NON-COMPLIANCE ISSUES AND DEFENCE OF ILLEGALITY IN ISLAMIC FINANCE LITIGATION

Hizri Hasshan

Fellow, Faculty of Law, Universiti Kebangsaan Malaysia (UKM)

LLB (Hons), LLM (UKM)

Executive Diploma in Islamic Law (Islamic Banking) IIUM

Advocate & Solicitor (Malaya)

Senior Associate Member of Chartered Institute of Islamic Finance Professionals (CIIF)

INTRODUCTION

The Islamic Financial Services Act 2013 ('the IFSA') gives great emphasis on Shariah compliance aspect whereby all Islamic banking and financial institutions are duty bound to ensure their aims, operations, affairs and activities are in compliance with Shariah.[1] In the event that any party contravenes the statutory requirement on Shariah compliance, such person shall commit an offence and shall, on conviction, be liable to imprisonment for a term not exceeding eight years or to a fine not exceeding 25m ringgit or to both.[2] The severe penalty imposed by the statute is a reflection of the seriousness of the Shariah non-compliance issues under the IFSA.

Shariah compliance encompasses three stages namely (a) the product development stage; (b) product application stage; and (c) enforcement and/or dispute resolution stage.[3] At the first stage, Shariah compliance is ensured through deliberation and approval by the Shariah Committee of the Islamic financial institutions and followed by vetting and approval by the Shariah Advisory Council of Bank Negara Malaysia ('SAC').[4] At the product application stage, Shariah compliance will undergo several processes such as Shariah review, Shariah risk management and Shariah auditing.[5] Finally, at the enforcement and/or dispute resolution stage, Shariah compliance will be scrutinised by the court and/or arbitrator with assistance from the SAC.

In this article, the author will focus on Shariah non-compliance issues at the third stage: the dispute resolution in litigation proceedings at court. The reported case laws dealing with Shariah non-compliance issues and defence of illegality will be discussed in this article, allowing readers to observe the common defences raised by Islamic banking consumers and the attitude of courts towards such Shariah non-compliance issues. Further, the author will also look into the legal effect of Shariah non-compliance ie whether such non-compliance shall render Islamic banking and finance transaction illegal and unenforceable.

ILLEGALITY OF CONTRACTS UNDER THE MALAYSIAN LAW OF CONTRACTS

Before going into the issue of illegality and Shariah non-compliance in Islamic banking and financial transaction, this article will first discuss the general approaches taken by Malaysian courts in dealing with illegality under the conventional contractual transaction.

Illegality under the Contracts Act 1950

In discussing the issue of illegality of contracts, reference shall be made to s 24 of the Contracts Act 1950 which reads as follows:

The consideration or object of an agreement is lawful, unless —

(a) it is forbidden by a law;

(b) it is of such a nature that, if permitted, it would defeat any law;

(c) it is fraudulent;

(d) it involves or implies injury to the person or property of another; or

(e) the court regards it as immoral, or opposed to public policy.

In each of the above cases, the consideration or object of an agreement is said to be unlawful. Every agreement of which the object or consideration is unlawful is void.

The aforesaid section provides that the object of an agreement will be unlawful if any of the elements stated above exists and such agreement shall be accordingly rendered void. In litigation practice involving the conventional commercial transaction, it is quite common for litigants to invoke s 24 of the Contracts Act 1950 in order to challenge the validity of a contract with intent to frustrate the claim by a party seeking enforcement of such contract. As long as the party can prove that the object or consideration of the contract is forbidden by law, fraudulent, immoral or against public policy, they may succeed in defending the suit and simultaneously frustrate such contractual claim or alternatively mitigate their contractual liability.

Approaches adopted by courts in dealing with illegal contracts

In dealing with issues of illegality of contracts, it is observed that there are several approaches adopted by the Malaysian courts, inter alia, as follows

Approach 1: Courts shall not be party to the enforcement of an unlawful agreement

Under this approach, the courts take a very strict attitude whereby the courts will not recognise and enforce contracts which are tainted with element of illegality. In the case of *Lim Kar Bee v Duofortis Properties (M) Sdn Bhd*,[6] the Supreme Court decided that the

courts should always set their face against illegality in any contract. It is very well settled that the courts can take judicial notice of such illegality at any stage of the proceedings and refuse to enforce the contract irrespective of whether illegality is pleaded or not where the contract is ex facie illegal.

In the case of *Thong Foo Ching & Ors v Shigenori Ono*,[7] the Court of Appeal in dealing with issue of illegality has also re-affirmed the similar position by adopting the Privy Council's decision in *Keng Soon Finance Bhd v MK Retnam Holdings Sdn Bhd & Anor*.[8] Siti Norma Yaakob JCA (as she then was) in *Thong Foo Ching*'s case agreed that once it is apprised of facts tending to support the illegality, the court is obliged, to take notice *ex proprio motu* and no court could knowingly be party to the enforcement of an unlawful agreement.

This approach originates from the maxim of *ex turpi causa non oritur actio*, a well-established doctrine in common law. Justice Kang Hwee Gee in the case of *Tay Kian Hock (t/a Hock Yen Co) v Kewangan Bersatu Bhd*[9] has explained this doctrine by referring to the description provided by Lindley LJ in *Scott v Brown Doering McNab & Co*[10] as follows:

> Ex turpi causa non oritur actio. This old and well-known legal maxim is founded in good sense, and expresses a clear and well-recognised legal principle, which is not confined to indictable offences. *No Court ought to enforce an illegal contract or allow itself to be made the instrument of enforcing obligations alleged to arise out of a contract or transaction which is illegal*, if the illegality is duly brought to the notice of the Court, and if the person invoking the aid of the Court is himself implicated in the illegality.

The cases cited above are among the leading authorities which are frequently relied on by parties who wish to invoke defence of illegality. Once illegality has been discovered by the court even though it is not sufficiently pleaded, the court will not enforce such contract on the basis that the court's facilities should not be used to enforce such illegal transaction and unravel the mess which was caused by and carried out by the parties in

clear contravention of the law.[11] In the case of *Norman Disney & Young (suing as a firm) v Afifi bin Hj Hassan*[12] the court struck out the plaintiff's claim on the grounds that there was an attempt to circumvent the requirements under the Registration of Engineers Act 1967. The court further held that the plaintiff's true intention was to create an 'Ali Baba' type of company where control of the company was still vested in the hands of the foreigners. The establishment of 'Ali Baba' type companies was held to be illegal because it is against Malaysian public policy.

Norman Disney's case also indicates that the defence of illegality is not limited to breach of statutory provision but also includes any element which is contrary to public policy. Over the years, the concept of *ex turpi causa non oritur actio* was not restricted to illegality but the courts on public policy grounds had also disallowed the plaintiff from recovering anything stemming from the plaintiff's own wrong doing.[13] Despite the absence of statutory definition of the phrase 'public policy' in the s 24(e) of the Contracts Act 1950, 'public policy' has been defined by many common law countries, including India whose Contract Act has provision which is *para materia* with our s 24 of the Contracts Act 1950.[14]

A contract which has a tendency to injure public interest and public welfare is one against public policy.[15] In the case of *Monkland v Jack Barclay Ld*[16] Asquith LJ said:

> Certain specific classes of contracts have been ruled by authority to be contrary to the policy of the law, which is, of course, not the same thing as the policy of the government, whatever its complexion — for example, marriage brokerage contracts, contracts for the sale of honours, contracts in unreasonable restraint of trade and so on.

Based on the foregoing discussion, it is evident that courts under this first approach will not enforce contractual transaction if such transaction is proven to be illegal, against public policy, immoral and/or in contravention of the law or statute.

Approach 2: Not every breach of a statutory provision would render an agreement illegal even though such breach attracts criminal penalty

However, under the second approach, the courts in some cases seem to affirm validity of contract notwithstanding the fact that such contract contravenes certain legislations and statutory provisions. The Federal Court in the case of *Kin Nam Development Sdn Bhd v Khau Daw Yau*,[17] in dealing with non-compliance with housing legislation held that although the appellant may well be guilty of an offence under r 17 for contravening r 11(1) of the Housing Developers (Control and Licensing) Rules 1970 such breach would not affect the validity of the contracts which the developer has signed with the purchasers.

In another case of *Beca (Malaysia) Sdn Bhd v Tang Choong Kuang & Anor*[18] the Supreme Court, inter alia, stated:

> ... *Not every breach of a statutory prohibition would render an agreement illegal or void though such breach may attract criminal penalty*. The fundamental question is whether the Enactment means to prohibit the agreement. It is important that the courts should be slow to imply the statutory prohibition of agreements, and should do so only when the implication is clear. Whether an agreement is implicitly forbidden depends upon the construction of the statute, and for this purpose no one tests is decisive. Persons who deliberately set out to break the law cannot expect to be aided in a court of justice. It would be a different matter when the law is unwittingly broken. An agreement for the sale of, say, frozen food, is not to be considered illegal or void merely because the premises in which the frozen food is sold does not comply with the law. *We recognise that each case must be decided by reference to the relevant statute*.

The *Tan Choong Kuang*'s case above appears to give emphasis on the intention of the statute ie whether such statute intends to prohibit such agreement. The mere fact that there is penalty imposed for non-compliance of a statute will not necessarily render the agreement invalid and the court will look into this issue on a case to case basis. In the case of *Tham Kut Cheong & Anor v Mohd Pancha Abdullah*,[19] the Court of Appeal ruled that s 32B of the Securities Commission Act 1993 is not designed to prohibit contracts as much as punish persons who act in contravention of the same. In arriving at the said

decision, the Court of Appeal has followed the decision of the High Court of Australia in *Yango Pastoral Co Pty Ltd v First Chicago Australia Ltd*[20] whereby it was held by the Australian High Court:

> *It is often said that a contract expressly or impliedly prohibited by statue is void and unenforceable. That statement is true as a general rule, but for complete accuracy it needs qualification,* because it is possible for a statue in terms to prohibit a contract and yet to provide, expressly or impliedly, that the contract will be valid and enforceable. However, cases are likely to be rare in which a statute prohibits a contract but nevertheless reveals an intention that it shall be valid and enforceable, and in most cases it is sufficient to say, as has been said in many cases of authority, that the test is whether the contract is prohibited by the statute. *Where a statute imposes a penalty upon the making or performance of a contract, it is a question of construction whether the statute intends to prohibit the contract in this sense, that is, to render it void and unenforceable, or whether it intends only that the penalty for which it provides shall be inflicted if the contract is made or performed.*

The above Australian case suggests that the court may need to interpret whether the intention of the statute is to prohibit such contract by rendering it void. In Malaysia, the Supreme Court in commenting to the above passage in *Yango*'s case in the case of *Chung Khiaw Bank Ltd v Hotel Rasa Sayang Sdn Bhd & Anor*[21] was of the following view:

> Thus, in our view, it may be stated as a general principle that a contract the making of which is prohibited by statue expressly or by implication, shall be void and unenforceable unless the statue itself saves the contract or there are contrary intentions which can reasonably be read from the language of the statute itself.

Hence, under this second approach, it may be concluded that the courts are vested with the power to interpret whether the intention of the Parliament is to invalidate transaction which contravenes the statutory provision. If there is clear intention that such contract should be invalidated, then the court will not enforce such contractual dealings.

Approach 3: Invalidity of certain contractual clause will not render the whole agreement invalid

Under the third approach, the court may adopt the doctrine of severability whereby illegality will only be recognised to a certain extent but will not invalidate the whole

agreement. In the case of *Prudentdeals Sdn Bhd v YM Tengku Abdul Halim Ibni Almarhum Sultan Ibrahim*,[22] the rationale of the doctrine of severability was explained as follows:

> The primary purpose of the doctrine of severability is to separate that portion in a document deemed to be void ab initio from the part or portion considered being of a valid nature. However, it is important that with the severance and invalidation of some section or clause in a document, it will not affect the validity of the remaining sections or clauses.

However, Justice Lee Swee Seng in the case of *Norman Disney & Young (suing as a firm) v Afifi bin Hj Hassan*[23] has a different view whereby he opined that the severability clause is bad device which contravenes s 25 of the Contracts Act 1950. His reasoning was stated as follows:

> Would the presence of a severability clause in the agreement help the plaintiff? I do not think so. To allow the severability clause to save the agreements would be scandalous! The plaintiff would have the best of both worlds in that if the agreements were bad in law, they would still be able to enforce the agreements. *This device of detaching the unlawful and illegal from that which is not appears under the Contracts Act 1950 to have been totally disabled by virtue of s 25 thereof* which reads:
>
> > If any part of a single consideration for one or more objects, or any one or any part of any one of several considerations for a single object, is unlawful, the agreement is void.

Despite the reasoning given by Justice Lee Swee Seng in the above case, the doctrine of severability has been recognised by the Federal Court in the case of *Badiaddin bin Mohd Mahidin & Anor v Arab Malaysian Finance Bhd*.[24]

Approach 4: The law leans in favour of upholding bargains and preserving sanctity of contract between contracting parties

The fourth approach appears to suggest that the court will not invalidate contract and will

construe intention of parties with a view to uphold the bargain between the parties. This approach is relevant to maintain the sanctity of a contract.

The Federal Court in the case of *Charles Grenier Sdn Bhd v Lau Wing Hong*[25] held that:

> The law leans in favour of upholding bargains and not in striking them down willy-nilly. And its declared policy finds expression in the speech of Lord Wright in *Hillas & Co v Arcos Ltd.* [1932] All ER (Rep) 494, where he said:
>
> > Businessmen often record the most important agreements in crude and summary fashion; modes of expression sufficient and clear to them in the course of their business, may appear to those unfamiliar with the business far from complete or precise. *It is, accordingly, the duty of the court to construe such documents fairly and broadly, without being, too astute or subtle in finding defects; but, on the contrary, the court should seek to apply the old maxim of English law, verba ita sunt intelligenda ut res magis valeat quam pereat.* That maxim, however, does not mean that the court is to make a contract for the parties, or to go outside the words they have used, except in so far as there are appropriate implications of law, as, for instance, the implication of what is just and reasonable to be ascertained by the court as matter of machinery where the contractual intention is clear but the contract is silent on some detail.

This approach was also adopted by the Supreme Court of India in the case of *Central Bank of India v Hartford Fire Insurance Co Ltd*[26] whereby it was held that it is the duty of the court to give effect to the bargain of the parties according to their intention and when that bargain is in writing, the intention is to be looked for in the words used unless they are such that one may suspect that they do not convey the intention correctly. The court must give effect to the plain meaning of the words however much it may dislike the result.

Under this approach, the court will also not allow a party to invoke its own wrongdoing and illegality caused by the said party to be used as a ground to rescind or invalidate a contract. In the case of *Gimstern Corporation (M) Sdn Bhd & Anor v Global Insurance Co Sdn Bhd*,[27] the Supreme Court held that:

> The rule is that if a stipulation in a contract be that the contract shall be void on the happening of an event which one or either of the parties can by his own act or omission bring about, then the party who by his own act or omission brings that event about, cannot be permitted either to insist upon the stipulation himself or to compel the other party who is blameless, to insist upon it, because to permit the blameable party to do either would be to permit him to take advantage of his own wrong to put an end to the contract, vide the judgment of Lord Atkinson in *New Zealand Shipping Company Ltd v SDAECD France* [1919] AC 1.

This decision clearly demonstrates that court will not allow a party to take advantage or benefit from its own wrongdoing. Sometimes, in litigation, a litigant may invoke issue of illegality which was caused by his own wrongdoing in order to avoid liability or gain benefit. Adopting this approach, court will not allow such situation to happen. The principle laid down in *Gimstern*'s case has been adopted in several Court of Appeal's cases such as *Ezzen Heights Sdn Bhd v Ikhlas Abadi Sdn Bhd (Soh Yuh Mian, intervener)*[28] and *Golden Vale Golf Range & Country Club Sdn Bhd v Hong Huat Enterprise Sdn Bhd*[29] where courts have affirmed the established principle that a party cannot rely on its own wrong to defeat its opponent's claim.

Now, it appears that the courts may adopt any of the four main approaches in dealing with issue ofillegality. The approach taken by court will be based on facts of each case, terms of contract, intention of parties, interpretation of the relevant statutes and equitable consideration. All the above approaches may also be used in dealing with issue of illegality and Shariah non-compliance arising from Islamic financial contract.

DOES SHARIAH NON-COMPLIANCE AMOUNT TO ILLEGALITY UNDER THE MALAYSIAN LAW?

Does Shariah non-compliance amount to illegality under the Malaysian law? This is indeed a very difficult question to answer as there is no judicial precedent or clear position under the Malaysian law. Based on the relevant legal provisions appeared in the statutes and case laws, this issue is still arguable. However, this article will analyse the

issue by examining the position in Shariah as well as under the Contracts Act 1950 and IFSA.

Effect of the Shariah non-compliance to the Islamic banking contracts: Shariah perspective

Shariah compliance is the essence of Islamic banking and financial contracts as it distinguishes Islamic finance from the conventional counterpart.[30] According to the majority of Islamic jurists, there are two rulings on status of a contract namely a valid (*sahih*) contract and invalid (*ghayr sahih*) contract.[31] The latter category is also called as *batil* or *fasid* contract.[32] In order to determine whether a contract is valid or not, majority of Islamic jurists will look at the fulfilment of the essential elements (*arkan*) of the contracts such as contracting parties, subject matter, and offer and acceptance.[33] A contract will be rendered invalid if one of the pillars of contract is violated.

Despite the practice of majority of jurists not distinguishing between *batil* (void) and *fasid* (irregular) contract, the Hanafi jurists have a different interpretation between the effect of void contract and irregular contract. According to the Hanafi school of thought, a *batil* contract is a contract that is invalid due to a defect in any of the essential elements of the contract.[34] On the other hand, a *fasid* contract is a contract whereby the essential elements of contract are present but it is tainted by a defect in an accessory attribute (*wasf*).[35] A *fasid* contract therefore may be rectifiable and will be treated as valid once the intolerable elements are eliminated.[36]

According to Asyraf Wajdi *et al* (2012), the Hanafi's differentiation between *batil* and *fasid* contract is more practical and relevant to modern Islamic financial transaction.[37] As such, when the defects are minor and can be rectified, the contract will not be invalidated and there is no necessity to ask contracting parties to re-execute the financing agreements. Hence, from the Shariah perspective (relying on Hanafi's view), it appears

that non-compliance with main elements of contract will render the contract invalid whereas non-compliance with minor elements which is rectifiable cannot be used as ground to invalidate the contract.

Effect of Shariah non-compliance to the Islamic banking contracts under the Contracts Act 1950

In the case of *Bank Islam Malaysia Bhd v Lim Kok Hoe & Anor and other appeals*,[38] the Court of Appeal has ruled that the same contract law shall apply to Islamic banking cases. Raus Sharif JCA (as he then was) held:

> [27] Similarly, the law applicable to BBA (*Bai' Bithaman Ajil*) contracts is no different from the law applicable to loan given under the conventional banking. *The law is the law of contract and the same principle should be applied in deciding these cases*. Thus, if the contract is not vitiated by any vitiating factor recognised in law such as fraud, coercion, undue influence, etc. the court has a duty to defend, protect and uphold the sanctity of the contract entered into between the parties.

The above remarks were quoted with approval in the case of *Kuwait Finance House (Malaysia) Berhad v AC Property Development Sdn Bhd* [39] whereby it has been expressly recognised that the law governing Islamic banking contracts is the Contracts Act 1950.

Due to the aforesaid position, the author is of the opinion that the Shariah non-compliance may be invoked and argued as a form of illegality within the ambit of s 24 of the Contracts Act 1950. The Islamic banking consumers should not be estopped from relying on Shariah non-compliance as a defence in Islamic banking litigation. The court will then need to assess the arguments put forth by the parties and determine whether or not such defence is a mere afterthought. If such defence has merits and involves Shariah arguments where no published rulings of SAC are available, then it is mandatory on the court to make reference to SAC for ruling in accordance with the provisions of the Central Bank of Malaysia 2009.

Effect of Shariah non-compliance to the Islamic banking contracts under the IFSA 2013

Despite the fact that defence of Shariah non-compliance may be invoked under s 24 of the Contracts Act 1950, the court may also need to look at the position under IFSA in order to ascertain the intention of Parliament. It must be noted that Shariah compliance is not only a contractual requirement but also a statutory requirement by virtue of s 28 of the IFSA. In the event that Islamic banks fail to comply with Shariah, the consumer may invoke statutory non-compliance as a ground to invalidate such contract. But, based on provisions in the IFSA, is the court empowered to declare such contract as illegal? This issue seems still uncertain.

Under s 281 IFSA, it is provided that:

> Except as otherwise provided in this Act, or in pursuance of any provision of this Act, *no contract, agreement or arrangement, entered into in breach or contravention of any provision of this Act shall be void solely by reason of such breach or contravention:*
>
> > Provided that nothing contained in this section shall affect any liability of any person for any administrative, civil or criminal actions under this Act in respect of such breach or contravention.

The above provision appears to suggest that no contract can be invalidated despite any breach of provision in the IFSA (including provision relating to Shariah non-compliance). By adopting the approach by Federal Court in *Kin Nam Development Sdn Bhd v Khau Daw Yau*[40] as discussed earlier in this article, it may be argued that non-compliance with Shariah will not invalidate the Islamic financial contract even though the Islamic banks and their officers may be liable for criminal penalty. Notwithstanding the aforesaid, it is the author's view that if the Shariah non-compliance is very serious and not rectifiable,

the court is not bound by s 281 of the IFSA and may invoke s 24 of the Contracts Act 1950 to invalidate such contract with a view to preserve the sanctity of Shariah law.

Rectification of Shariah non-compliance at dispute resolution stage

Based on s 28(3) of the IFSA, it appears that Shariah non-compliance is treated as non-compliance where it is curable by way of rectification. Once the Islamic financial institutions are aware of existence of Shariah non-compliance, they need to inform Bank Negara and submit a plan for rectification of the non-compliance. But, it is not certain whether rectification can still be allowed when the non-compliance issue reaches litigation stage. Can the court allow rectification on Shariah non-compliance?

From the author's observation, the Malaysian court (prior to the coming into force of the IFSA) has dealt with the issue of rectification of contract relying on equitable principle. In the case of *Malayan Banking Bhd v Robiah Endot*,[41] the plaintiff bank has filed application for rectification to change the profit margin in *Bai' Bithaman Ajil* facility from 0.85%–8.5% on the grounds that there was a mistake on the plaintiff's part. The plaintiff's counsel relied on the case of *A Roberts & Co Ltd v Leicestershire Country Council*[42] arguing that Justice Pennycuick said:

> ... a party is entitled to rectification of a contract on proof that he believed a particular term to be included in the contract, and that the other party concluded the contract with the omission or a variation of that term in the knowledge that the first party believed the term to be included ... The principle is stated in *Snell on Equity* (25th Ed, 1960, p 569) as follows: 'By what appears to be a species of equitable estoppels, if one party to a transaction knows that the instrument contains a mistake in his favour but does nothing to correct it, he (and those claiming under him) will be precluded from resisting rectification on the ground that the mistake is unilateral and not common.

However, Justice Zawawi has dismissed the plaintiff's application to change the profit rate on the ground that it will not be equitable to do so as the defendant has signed the contract and agreed with the profit rate of 0.85%. There was no convincing evidence to

prove both parties intended to fix profit rate at 8.5%. The court also referred to the passage by Lozen Hardy MR in *Lovell and Christmas Ltd v Wall*[43] where it stated:

> The essence of rectification is to bring the document which was expressed and intended to be in pursuance of a prior agreement into harmony with that prior agreement. Indeed, it may be regarded as a branch of the doctrine of specific performance. It presupposes a prior contract and its requires proof that, by common mistake the final completed instrument as executed fails to give proper effect to the prior contract. For this purpose, evidence of what took place prior to the execution of the completed document is obviously admissible and indeed essential.

Based on the foregoing, even though rectification is permissible under the IFSA, it seems that the court will not simply allow rectification since it will not be proper for court to interfere with commercial bargains between contracting parties. In addition, the Court of Appeal in the case of *Bank Islam Malaysia Bhd v Lim Kok Hoe & Anor and other appeals*[44] has already held that it is trite law that the court should not rewrite the terms of the contract between the parties that it deems to be fair or equitable. Hence, if the Shariah non-compliance issues were brought to court and one of the parties seek rectification to regularise the non-compliance, the court must look at all factors in order to achieve just and equitable decision. In the alternative, the court may propose to the litigants to consider court-annexed mediation to amicably resolve their disputes.

Remedies available to contracting parties in dealing with illegal contracts

In the event that rectification is not allowed and the Islamic financial contract is declared void by the court due to Shariah non-compliance, does that mean that Islamic financial institutions have no remedies to recover the amount of financing? For these circumstances, if the contract is rendered void due to illegality and Shariah non-compliance, it may be argued that the consumer is still liable to refund the amount of financing by virtue of s 66 of the Contracts Act 1950 which reads as follows:

> When an agreement is discovered to be void, or when a contract becomes void, any person who has received any

advantage under the agreement or contract is bound to restore it, or to make compensation for it, to the person from whom he received it.

In the case of *Arab-Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd & Ors (Koperasi Seri Kota Bukit Cheraka Bhd, third party)*,[45] the High Court in invalidating some *Bai' Bithaman Ajil* transaction has allowed the banks to seek refund of amount of financing pursuant to s 66 of the Contracts Act 1950. Justice Wahab Patail J held that:

[69] This court holds that where the bank purchased directly from its customer and sold back to the customer with deferred payment at a higher price in total, the sale is not a bona fide sale, but a financing transaction, and the profit portion of such Al-Bai' Bithaman Ajil facility rendered the facility contrary to the Islamic Banking Act 1983 or the Banking and Financial Institutions Act 1989 as the case may be.

[70] Acting upon the basis that the bank's action resulted more likely from a misapprehension rather that of intent aforethought, *the court holds the plaintiffs are entitled under s 66 of the Contracts Act 1950 to return of the original facility amount they had extended.*

However, on appeal to the Court of Appeal,[46] the above decision was reversed and the legality of the *Bai' Bithaman Ajil* facility was affirmed.

APPROACHES TAKEN BY MALAYSIAN COURTS IN DEALING WITH SHARIAH NON-COMPLIANCE ISSUESAdjudication of Shariah non-compliance issues by Malaysian courts

In dealing with issue of illegality or Shariah non-compliance under s 24 of the Contracts Act 1950, Malaysian courts generally have taken two approaches namely the *non-interventionist approach* and *interventionist approach*.[47] In the *non-interventionist* approach, the court will not interfere with the Shariah issues but only to give effect to the terms of contract between parties.[48] This approach is similar to the position taken by the English court in *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd and others*.[49] However, for *interventionist* approach, the court will recognise the Shariah issues and if

necessary, deal with the aspects of liability and quantum of claim.[50] This article will discuss selected cases in Malaysia which deal with the two main approaches of the Malaysian courts.

Interventionist approach

The case of *Arab-Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd & Ors (Koperasi Seri Kota Bukit Cheraka Bhd, third party)*[51] may be regarded as the first case whereby the civil court entertain Shariah issue and declare the *Bai' Bithaman Ajil* transaction practised by Malaysian Islamic banks as illegal. The learned High Court judge was of the view that when a bank purchased an asset directly from its customer and sold back to the customer with deferred payment at a higher price in total, the sale is not a bona fide sale, but a financing transaction, and the profit portion of such *Al-Bai' Bithaman Ajil* facility rendered the facility contrary to the Islamic Banking Act 1983 or the Banking and Financial Institutions Act 1989 as the case may be. However, this decision was subsequently reversed by Court of Appeal.[52]

In addition, the court in another case namely *Maybank Islamic Berhad v M-10 Builders Sdn Bhd*, [53] has also taken *interventionist* approach when the court invalidated the *murabahah* financing transaction due to absence of element of mutual consent which is a basis of Islamic law of transaction. The *M-10 Builders*'s case above clearly rebuts the presumption that Malaysian court has never declared the whole Islamic finance agreement as void or illegal. The said case proves that there are judges who are prepared to adopt the *interventionist* approach in dealing wih Shariah non-compliance issue. In *M-10 Builders*'s case, the learned High Court judge in dealing with Shariah non-compliance issue held:

> [85] The defendants on the other hand submitted that the plaintiff was prohibited from relying on a contract that is prohibited by Shariah. As the *murabahah* contract was, illegal as shown above I am of the view that despite the CJ having been executed it did not mean that this court had no jurisdiction to decide on the issue of illegality. Learned counsel submitted

that pursuant to s 24 of the Contracts Act 1950, the *murabahah* contract was null and void and unenforceable against the defendants due to illegality.

[86] I am of the view that once the issue of illegality had been established this court is vested with the jurisdiction to deal with the matter despite the fact that the same was not pleaded in the pleadings. The principle that the court ought not to enforce an illegal contract if the illegality is duly brought to the notice of the court would be applicable.

[106] ... By their conduct, both parties were privy to the illegality and had camouflaged the MOD facility as *murabahah* and both had benefited from this illegality. Obviously, *this transaction had clearly violated the basic tenets of the financing premised on the Islamic concept*. Further as I had shown above the contract involving the MOD facility, which the parties termed as *murabahah* was contrary to the basic tenets of financing based on *murabahah* as there were no fresh ASA and APA having been executed. In view of this and as both parties were privy to the illegality as illustrated above both parties had not come to this court with clean hands. The court therefore would not assist the parties who had come to court to seek relief, if they had not come with clean hands.

The *M-10 Builders*'s case was however reversed by the Court of Appeal on 17 May 2016 in *Maybank Islamic Berhad v M-IO Builders Sdn Bhd.* [54]

In a more recent case namely *FLH ICT Services Sdn Bhd & Anor v Malaysian Debt Venture Bhd*,[55] the interventionist approach has been adopted by the Court of Appeal in relation to the issue of Shariah non- compliance involving the *Bai' al-Inah* financing. The Court of Appeal in the said case held:

[25] In our view the essence of *bai al-inah* transaction or contract in the matter before us as entered into by the parties herein must necessarily be grounded upon the basic premise that it must involve the sale and buy back transactions of an asset of a seller. The existence of the asset in the transactions is an imperative without which such contract is not a *bai al inah* contract, but something else outside the Syariah system.

...

[33] On the factual matrix of the case enumerated above, it is apparent that at the time the security documents (MFA, ASA and APA) were executed on 31 July 2009, the underlying asset in the *Bai Al-Inah* contract does not appear to exist. At the risk of being repetitive, in the MFA and both the ASA and APA, the description of the asset were merely referred to 'as set out in letter(s) of offer (if any)'. As said earlier, the first and second LO did not mention any asset whatsoever. Hence it begs

the question what actually was being transacted on 31 July 2009 between the seller and the purchaser in the MFA, ASA and APA. There are uncertainties in the underlying feature of the said *bai al-inah* contract/financing ie, the existence of the asset in the transactions. Following through, hence the *akad* to sell and the *akad* to purchase the asset are not certain and distinct in the absence of the same, a fundamental requirement under the bai al-inah contract.

[34] We are also of the view that the Mudharabah General Investment Certificate No 41098 attached to the inter-office memo (at pp 2720 to 2721 *RR* – *Jld* 3 Bahagian C5) could not have been the asset transacted on account that, firstly, the same was not mentioned in the LOs, the MFA, the ASA and APA. Neither was there any indication that the said certificate is intended to be the asset in the said transactions. Secondly, it was attached to an inter-office memo which is obviously for internal circulation only. Being an inter-office memo, it is doubtful whether the appellants had access to the same. It was the appellants' case that they knew nothing about the existence of the said certificate. Thirdly, the certificate was issued on 26 May 2009 and dated 13 July 2009. Obviously it predated the execution of the MFA, ASA and APA. As such if the certificate was intended to be the asset in the said transactions, then the parties should encounter no difficulty in naming the same as the asset in the MFA, ASA and APA. Obviously this was not done. It is also obvious that at the time of the first LO (dated 16 February 2009), this asset has yet to come into being. Otherwise it would have been stated in the first LO. Finally, the said certificate was endorsed with the endorsement 'Tidak Boleh Dipindahmilik (Not Transferable)'. In such event, the ownership of the asset cannot be transferred to the purchaser. The said endorsement plainly violated the condition of complete transferability of ownership of the said asset and valid possession (*qabd*) of the said asset in accordance with Syariah and current business practice (*urf tijari*) as resolved by the resolution of the SAC adverted to in para 22 above.

[35] In our view what had transpired obviously had violated the entrenched principles of *bai al-inah* contract as stated in paras 21 and 22 enumerated earlier which the learned judge herself had alluded to. *It is neither Syariah compliant. As such it is not a bai al-inah financing contract but something else unknown in the Syariah financing system. Hence the respondent's remedy is also elsewhere and not under the bai al-inah financing system. The respondent cannot take advantage of the system when the contract they entered into is unknown in the system*.

Non-interventionist approach

In most of cases dealing with issue of illegality and Shariah non-compliance involving Islamic financial transaction, it is observed that Malaysian courts adopt the *non-interventionist* approach.

In the case of *Bank Kerjasama Rakyat Malaysia Bhd v Flavour Right Sdn Bhd & Ors*,[56] the defendants argued that the plaintiff bank's entire claim was tainted with illegality and unenforceable under s 24 of the Contracts Act 1950 because the plaintiff has imposed

and levied interest/*riba* which was repugnant to Shariah principles. However, the court rejected the defendant's contention and held that late payment charge imposed by bank does not amount to *riba* as it is called *Ta'widh* which has been sanctioned by the Shariah Advisory Council of Bank Negara Malaysia's Guideline (BNM/RH/GL 01202) Item 8.

In another case of *Arab-Malaysian Merchant Bank Berhad v Silver Concept Sdn Bhd*,[57] s 24 of the Contracts Act 1950 has been invoked whereby the defendant alleged that the *Al-Wujuh* facility was a loan agreement with fixed interest rate payable by the defendant and not a sale agreement. As such, it was argued that the financing agreements were against illegal and public policy as they had deceived the public. Again, the court rejected the defendant's argument on illegality and held as follows:

> [54] Parties have agreed before executing the agreements, and without any undue pressure or persuasion, to the preconditions of the Islamic based contract. As mentioned above, as *parties have agreed to be bound by the al-aqd and hence have a conclusive contract (Uqud), they are thus bound by the obligation*. Both parties are equally bound and must comply with the conditions of the Uqud as *ordained by Allah at Ch. 5:1 of the al-Quran*. On that premise the defendant here must comply, and be bound by his willingness to contract into the impugned agreements. He cannot contract out now unless there are cogent reasons to justify that act. Here I found none.

The aforesaid judgments indicate that the court treated the defence of illegality as an afterthought and the customer is bound by the contract that he has signed.

The case of *Tan Sri Abdul Khalid bin Ibrahim v Bank Islam Malaysia Bhd and another suit*[58] also reveals how s 24 of the Contracts Act 1950 was used by defendant to argue that the *Bai' Bithaman Ajil* ('BBA') facility was illegal, contrary to law or public policy and cannot be enforced. The High Court judge however rejected the defendant's argument and held that the similar issue of invalidity of BBA has been earlier brought to High Court in the case of *Arab-Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd & Ors (Koperasi Seri Kota Bukit Cheraka Bhd, third party)*.[59] However, the said *Taman Ihsan*'s

case has been overruled and the validity of BBA has been recognised by the Court of Appeal.

In the case of *Bank Islam Malaysia Bhd lwn Rhea Zadani Corp Sdn Bhd dan lain-lain*,[60] the defendant has raised an issue that the *Istisna'* facility is invalid from Shariah perspective. However, the court rejected the defendant's contention and held that such issue was merely a lawyer's construct defence. In the case of *Bank Pertanian Malaysia Berhad v United Trade Arena (M) Sdn Bhd & Ors*,[61] the court also rejected the argument on Shariah non-compliance and held that imposition of *Ta'widh* does not amount to '*riba*' since *ta'widh* has been sanctioned by Shariah and provided in the Rules of Court 2012.

ROLE OF THE SHARIAH ADVISORY COUNCIL IN ASSISTING COURT IN SHARIAH NON-COMPLIANCE ISSUES

Pursuant to s 51(1) of the Central Bank of Malaysia Act 2009 ('the CBMA'), the Bank Negara Malaysia is authorised to establish a Shariah Advisory Council on Islamic Finance ('SAC') which shall be the authority for the ascertainment of Islamic law for the purposes of Islamic financial business. The functions of the SAC have been statutorily provided, inter alia, as follows:

(a) to ascertain the Islamic law on any financial matter and issue a ruling upon reference made to it in accordance with the CBMA;

(b) to advise Bank Negara Malaysia on any Shariah issue relating to Islamic financial business, the activities or transactions of Bank Negara Malaysia; and

(c) to provide advice to any Islamic financial institution or any other person as may be provided under any written law.[62]

From the above provision, it appears that the role of SAC is more towards ascertainment of Islamic law. As such, the courts still retain the right to make final adjudication whether

a particular transaction is Shariah compliant or not. Upon examination of several cases dealing with Shariah non-compliance issues, it is observed that the courts in those cases have not resorted to the SAC in adjudicating Shariah non-compliance issues. For instance, in the case of *Bank Kerjasama Rakyat (M) Bhd v PSC Naval Dockyard Sdn Bhd*,[63] the court in entertaining the issue of *gharar* has not made reference to the SAC. In the case of *Bank Kerjasama Rakyat Malaysia Bhd v Brampton Holdings Sdn Bhd*,[64] the court despite acknowledging the role of SAC in assisting court to determine Shariah non-compliance, has not referred the issue to SAC and instead has shifted the burden to defendant to obtain advice from SAC. The learned judge held:

> ... a court could not simply decide that an Islamic financing facility was not Shariah compliant. The court should be guided by the advice and ruling of the Shariah Advisory Council on Islamic Finance ('SAC'). Accordingly, the defendant could not merely allege that the Islamic Financing Facility was illegal and unenforceable. The defendant should have obtained advice or ruling from the SAC *as to whether the Islamic Financing Facility herein had complied with Shariah or otherwise*.

With due respect, the author is of the view that the above approach may not be in compliance with s 56 of the CBMA. Under s 56 of the CBMA, the court is duty bound to do the following when dealing with Shariah issue:

(a) firstly, to take into consideration of any published rulings of the Shariah Advisory Council; or

(b) secondly, to refer such question to the Shariah Advisory Council for its ruling.

It may not be statutorily correct for court to shift the duty to consumer or defendant to procure advice from SAC. In order to allow consumer to make reference to SAC for Shariah ruling, the author agrees with the recommendation by Dr Sherin Kunhibava (2015)[65] that ss 55 and 56 of the CBMA should be amended to extend the role of SAC to not only Bank Negara Malaysia, Islamic financial institutions courts and arbitrators but also to financial consumers, guarantors, lawyers and parties to an Islamic financial dispute.

Further, in the case of *MK Associates Sdn Bhd v Bank Islam Malaysia Bhd*,[66] it is also observed that the court has not referred to SAC to assist in determining the issue of applicability of *Ta'widh*. Instead, the court has made decision by referring to expert reports adduced by both litigants. From the grounds of decision, the learned judge preferred the views offered by the plaintiff's Shariah expert and held that the Islamic bank cannot claim *Ta'widh* due to the fact that ruling by SAC on *ta'widh* was only introduced in year 1998. The grounds of the decision are silent on why the parties had not made reference to SAC despite the fact that the SAC is supposed to be the statute-appointed expert.

CONCLUSION

Based on the aforesaid discussion, it is the author's observation that the Malaysian courts normally prefer to adopt the non-interventionist approach in dealing with Shariah non-compliance issues. However, there are some circumstances which justify the court to intervene in the practice of Islamic banking and finance which clearly does not comply with Shariah. But, it appears that there is no specific procedure or mechanism developed by the courts in dealing with Shariah non-compliance issue. The courts cannot decide on its own on Shariah non-compliance issues and must make reference to the SAC. Even though Shariah non-compliance may be rectifiable in certain circumstances, the court cannot simply intervene and re-write the contract between the parties. The author humbly proposes that a provision to be inserted in the Rules of Court 2012 or alternatively a practice direction is issued by the Chief Justice as a guide to all lawyers, judges, and judicial officers on the procedural mechanism in dealing with Shariah non-compliance issues in litigation proceedings.

[1] Section 28(1) of the IFSA 2013.

[2] Section 28(5) of the IFSA 2013.

[3] Dr Sherin Kunhibava, *Ensuring Shariah Compliance at the Courts and the Role of the Shariah Advisory Council in Malaysia* [2015] 3 MLJ xxi.

[4] *Ibid*.

[5] *Ibid*.

[6] [1992] 2 MLJ 281 at p 288.

[7] [1998] 4 MLJ 585; [1998] 4 CLJ 674.

[8] [1989] 1 MLJ 457; [1989] 1 CLJ Rep 1.

[9] [2002] 4 MLJ 411; [2002] 8 CLJ 982.

[10] [1892] 2 QB 724 at p 728.

[11] [2014] 1 MLJcon 236; [2011] 1 CLJ 210 (per Lee Swee Seng JC).

[12] *Ibid*.

[13] *Ngan Siong Hing v RHB Bank Bhd* [2014] 2 MLJ 449 (CA); *Gray v Thames Trains Ltd* [2009] 3 WLR 167; *Stone & Rolls Ltd (in liq) v Moore Stephens (a firm)* [2009] 4 All ER 431; [2009] UKHL 39.

[14] *Dato' Shazryl Eskay bin Abdullah v Merong Mahawangsa Sdn Bhd & Anor* [2014] 2 MLJcon 43.

[15] *Baghwant Genuji Girme v Gangabisan Ramgopal* AIR 1940 Bom 369.

[16] [1951] 2 KB 252.

[17] [1984] 1 MLJ 256; [1984] CLJ Rep 181.

[18] [1986] 1 MLJ 390 at p 394; [1985] CLJ Rep 64.

[19] [2013] 1 LNS 314.

[20] (1978) 139 CLR 410.

[21] [1990] 1 MLJ 356.

[22] [2015] 2 MLJ 801.

[23] [1989] 1 MLJ 457; [2011] 1 CLJ 210.

[24] [1998] 1 MLJ 393; [1998] 2 CLJ 75.

[25] [1996] 3 MLJ 327 at p 335; [1997] 1 CLJ 625 at pp 633–634.

[26] AIR 1965 SC 1288.

[27] [1987] 1 MLJ 302; [1987] 1 CLJ 123; [1987] CLJ Rep 102.

[28] [2011] 4 MLJ 173; [2011] 3 CLJ 16.

[29] [2008] 6 CLJ 31.

[30] Dr Sherin Kunhibava, *Ensuring Shariah Compliance at the Courts and the Role of the Shariah Advisory Council in Malaysia* [2015] 3 MLJ xxi.

[31] Asyraf Wajdi *et al, A Framework for Islamic Financial Institutions to Deal With Shariah Non-Compliant Transactions*, ISRA Research Paper No 42/2012, Kuala Lumpur.

[32] *Ibid*.

[33] *Ibid*.

[34] *Ibid*.

[35] Al-Zaylai (1313 AH), *Tabyin al-Haqaiq, Sharh Kanz al-Dawaiq wa Hashiyat al-Shalabi, Cairo: Al-Matba 'ah al Kubra al-Amiriyyah* as quoted in Asyraf Wajdi *et al, A Framework for Islamic Financial Institutions to Deal With Shariah Non-Compliant Transactions*, ISRA Research Paper No 42/2012, Kuala Lumpur.

[36] Asyraf Wajdi *et al, A Framework for Islamic Financial Institutions to Deal With Shariah Non-Compliant Transactions*, ISRA Research Paper No 42/2012, Kuala Lumpur.

[37] *Ibid*.

[38] [2009] 6 MLJ 839; [2009] 6 CLJ 22.

[39] [2013] 1 LNS 1253.

[40] [1984] 1 MLJ 256; [1984] CLJ (Rep) 181.

[41] [2012] 5 CLJ 821.

[42] [1961] Ch 555.

[43] (1911) 104 LT 85 at p 88.

[44] [2009] 6 MLJ 839; [2009] 6 CLJ 22.

[45] [2008] 5 MLJ 631; [2009] 1 CLJ 419.

[46] *Bank Islam Malaysia Bhd v Lim Kok Hoe & Anor and other appeals* [2009] 6 MLJ 839; [2009] 6 CLJ 22.

[47] Tun Ariffin bin Zakaria, *A Judicial Perspective on Islamic Finance Litigation in Malaysia*, IIUM Law Journal, (2013) 21 IIUMLJ 143 at p 156.

[48] *Ibid*.

[49] [2004] 4 All ER 1072; [2004] EWCA Civ 19.

[50] Tun Ariffin bin Zakaria, *A Judicial Perspective on Islamic Finance Litigation in Malaysia*, IIUM Law Journal, (2013) 21 IIUMLJ 143 at p 156.

[51] [2008] 5 MLJ 631; [2009] 1 CLJ 419.

[52] *Bank Islam Malaysia Bhd v Lim Kok Hoe & Anor and other appeals* [2009] 6 MLJ 839; [2009] 6 CLJ 22.

[53] [2015] MLJU 2035; [2015] 4 CLJ 526.

[54] [2016] MLJU 1353; [2016] MLJU 1415.

[55] [2016] 1 MLJ 248; [2016] 1 CLJ 243

[56] [2012] MLJU 1003; [2013] 1 CLJ 810.

[57] [2005] 5 MLJ 210; [2006] 8 CLJ 9.

[58] [2009] 6 MLJ 416; [2010] 4 CLJ 388.

[59] [2008] 5 MLJ 631; [2009] 1 CLJ 419.

[60] [2012] 10 MLJ 484; [2012] 1 LNS 367.

[61] [2015] MLJU 401; [2015] 1 LNS 610.

[62] Section 52 of the CBMA.

[63] [2007] MLJU 722; [2008] 1 CLJ 784.

[64] [2015] MLJU 2036; [2015] 4 CLJ 635.

[65] Dr Sherin Kunhibava, *Ensuring Shariah Compliance at the Courts and the Role of the Shariah Advisory Council in Malaysia* [2015] 3 MLJ xxi.

[66] [2015] 6 CLJ 97.
