Incorporating Fatwa Validation Clause in Sukuk Legal Documentations: A Tool for Shariah Risk?

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ABSTRACT  
Sukuk is the most disputable structures with complicated issues of Shariah being litigated in courts. Over reliance on the brief Shariah pronouncement may cause uncertainty of legal standing. This paper is an attempt to justify factors on the importance of incorporating Fatwa Validation Clause into the legal documentations. The objective is to look into the materiality of fatwa validation clause in sukuk documents. This paper employs library research. The findings led to several observations where cases decided in England High Court indicates alarming signals on the fate of shariah documentations. In addition, Several jurisdictions refused to recognise shariah contracts due to absence of enabling legal environment. Furthermore, the borderless transactions in finance has led to incorporate the lex mercatoria of trade into their legal documentations. The litigants have been trying to merge out their autonomy over the contract by stipulating terms and clauses that works in their favor. However, to some extent, the struggles shrinked by the legal framework derecognised their intended values. The paper concludes with several recommendations for future consideration.

Introduction  
Sukuk is one of the Islamic financial contracts which are popular in financial institutions nowadays and which actors are proposing as an alternative to conventional finance.\(^1\) The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) defines sukuk as being:  
“Certificates of equal value representing after closing subscription, receipt of the value of the certificates and putting it to use as planned, common title to shares and rights in tangible assets, usufructs and

services, or equity of a given project or equity of a special investment activity."²

It is otherwise known as "Islamic bond" and further defined to be "document, note, bond or certificate that represent ownership in an asset. It grants the investors a share of the asset along with profit and risks resulting from such or said ownership."³ The usage of sukuk can be traced back to the 1st Century AH during the Umayyad Caliphate under the rule of Khalifah al-Marwan ibn al-Hakam as recorded by Imam Malik in Al-Muwatta’, Book 31, Number 31.19.44.

Yahya narrated to me from Malik that he had heard that receipts (sukuk) were given to people in the time of Marwan ibn al-Hakam for the produce of the market at al-Jar. People bought and sold the receipts (sukuk) among themselves before they took delivery of the goods. Zayd bin Thabit and one of the Companions of RasululLah (SAW) went to Marwan and said, "Marwan! Do you make usury halal (permissible)!?” He said: “I seek refuge with Allah! What is that?” He said, “These receipts (sukuk) which people buy and sell before they take delivery of the goods.” Marwan therefore sent a guard to follow them and to take them from people’s hand and return to their owners.”

In 1775, the Ottoman Empire issued esham to fund its budget deficit after its defeat by the Russians. The government securitised the tobacco custom collection, in which the investors received annuity (variable return) for the rest of their life. The government may buy back the sahim or shares at their discretion.⁴

With the rapid growth of the Islamic capital market (ICM), various products have been discussed and resolved by the Shariah Advisory Board on approving sukuk through Fatwas. However, the Fatwa issued relied upon the Fatwa or Shariah Pronouncement is insufficient to reflect the comprehensive structures involved in sukuk. This has resulted in negative outcomes in respects to the recognising Fatwa based on shariah values unrecognised. Sukuk delineates funds raised must be used for Shariah compliant (halal) activities. Fund raised may be used to finance needed tangible assets. Specificity of assets is important income received by sukukholders (investors) must be derived from the cash flows generated by the underlying. Sukukholders have a right to the ownership of the underlying asset and its cash-flows. There also clear requirement on transparency specification of rights and obligations of all parties to the transaction, in particular the originator (customer) and sukukholders. In addition, there shall be no fixity in returns. All these elements will be incorporated into as structured as the basis of the intended contractual obligation. However, there is no requirement on the rationale behind allowing such products to be launched in detail.

Literally, fatwa means seriousness, which implies being serious and quiet. Al-fata, which is translated as ‘young man’ or ‘one in the prime of life’, connotes one who possesses these qualities. Fatwa also means an explanation or clarification, more particularly, an explanation of an unclear matter.⁵

Fatwa, technically defines as any resolution of Shariah Boards decision or better known as Shariah advisors⁶ on any products or securities issued. For the purpose of this paper, the fatwa is referred to as the shariah resolutions or decisions made by the shariah scholars or shariah advisors on approving certain products or securities such as sukuk. In many instances, the Fatwa on product approval was not inserted as part of the clauses and terms in the contract.

The purpose of this paper is to propose that fatwa should be incorporated into the Sukuk legal documents. This is essential in order to mitigate risk of non-compliance either from legal or shariah. Once it is embedded into the legal documents, fatwa is binding upon the parties. The court are bound to execute the contract as intended by the litigants as part of their party autonomy’s rights.

2 AAOIFI Shari’ah Standard No. (17/2): Investment Sukuk
5 Lahasna Ahcene, Introduction to Fatwa, Shari‘ah Supervision & Governance in Islamic Finance, Kuala Lumpur, CERT 2010, P20.
6 In Malaysia, the Shariah advisors are known as Shariah Committee as perGuideline of Shariah Governance Framework (SGF), BNM.
pronouncement mentions merely on validation of the product without any supporting references towards the validation.

This paper claims that it is not being made as a practice since the beginning of Islamic finance documentations as it is considered as not part of the Uraf Tijarf. Indeed this paper claims that the style and terms incorporated into the legal documents were inherited from the western tradition in writing a contract. The legal documentations normally divided into seven (7) parts. The recital part is the most important part since it explains the intention or objectives of both parties entering into the contract. The contract spells out the types of contract / aqal used in the title and the definition part in the legal documents. The other parts of the contracts spells out rights and obligations of the contracting parties and supported with generic boilerplate clauses and miscellaneous provisions.

In order to complete a sukuk issuance, subscriptions and arrangement, there are different types of legal documentations involved depends on the structures approved by the Shariah advisors. Begin with the Term Sheet, the Prospectus, Investor's Agreements, etc the fatwa resolutions on approval of such a product only spelt out in the term sheet. In the absence of fatwa resolutions in the main legal documents this will resulted in ignoring the shariah principles embodied as products approval rationale.

A term sheet is a non-binding agreement setting forth the basic terms and conditions under which an investment will be made. A term sheet serves as a template to develop more detailed legal documents. Once the parties involved reach an agreement on the details laid out in the term sheet, a binding agreement or contract that conforms to the term sheet details is then drawn up.

In the absence of any rulings authorised the validity of sukuk in a jurisdiction, may cause difficulties. It is imperative to mitigate risks by incorporating fatwas as guidance in case of disputes. The structures and the products will eventually be interpreted in the eyes of the English law. We shall discuss in detail the effects of absence of written fatwa on shariah rulings in the legal documentation by some examples from several cases in different jurisdictions.

3.0 Rationale for the Fatwa Incorporation

Shariah does not allow freedom of contract in toto. The principles of autonomy of will is limited to several restrictions being the basis of contracting. The reflection of Islamic economy is transpired in the contract to uphold the Islamic economy, the principles on the prohibition of riba, maysir and gharar were introduced. These principles are the basis of Islamic economy to ensure the circulation of economy are free from oppression and injustice. As the vicegerent of God, human is accountable to Him for all his actions on the Day of Judgment. Thus Islam prescribes a strong system of accountability at all levels. Islamic economic teaches human to observe certain limits in the exercise of his freedom. Within these bounds all his acts are worship of God. In an Islamic society taqwa (God-consciousness) is considered very highly. The more a person is God-conscious, the more highly he is esteemed in the society. Taqwa comprises a cluster of values like justice (’adl), benevolence (ihsan), benevolence spending in the cause of God (infaq), remembering God (zikr), etc. Taqwa is a multi-dimensional value. The values brings towards wasathiyyah (moderation). In Islam, money is not the objective of life, it is just means to achieve the objectives. In Islam, the objectives of Muslims are to pursue the maqasid al-shariah (the objective of shariah), to protect life, intellect, religion, property and Nasab.

Surah Al-Baqarah of verse 274 states

“Those who consume interest cannot stand [on the Day of Resurrection] except as one stands who is being beaten by Satan into insanity. That is because they say, “Trade is [just] like interest.” But Allah has permitted trade and has forbidden interest. So whoever has received an admonition from his Lord and desists may have what is past, and his affair rests with Allah. But whoever returns to [dealing in interest or usury] - those are the companions of the Fire; they will abide eternally therein”.

Yusof Ali has commented the verse explaining that usury is any increase sought through illegal means. These include usury, fraudulent trading and bribery. The prohibition is due to economic selfishness. Islam has prohibited interest on capital and thus has foreclosed the door of accumulating wealth without work or without assuming risk. Imposing any interest or riba on principal is an act of transgression and diverted from the value of Islamic economic. Imam Ibn Taymiyah explains the difference between ibadah and Muamalat as follows:

“The acts and deeds of individuals are of two types: Ibadat, whereby their religiousness is improved, and Adat or Muamalat (transactions), which they need
In their worldly matters. The principles governing shariah contracts would be permissibility and absence of prohibition. So nothing can be prohibited unless it is prescribed by Allah (SWT) and His Prophet (pbuh) in the overall framework.”

Ibn Taymiyyah indeed encourage the freedom of exercising ijtihadyyah as long as no transgression against the prohibition. There are splitting views in categorising the types of Shariah contracts. ‘Aqad or contract is an implied obligation arising out of a mutual agreement. The term ‘Aqad has an underlying idea of conjunction, as it joins the intention as well as the declaration of two parties. The Holy Qur’an has used the word in this sense: "O believers! Fulfil your contracts (‘Uqud).”

According to Al-mansoori, ‘Aqad is used in two senses: in the general sense, it is applied to every act which is undertaken in earnestness and with firm determination, regardless of whether it emerges from a unilateral intention such as Waqaf, remission of debt, divorce, undertaking an oath, or from a mutual agreement, such as a sale, lease, agency or mortgage. In this sense, ‘Aqad is applicable to an obligation irrespective of the fact that the source of this obligation is unilateral declaration or agreement of the two declarations. In the specific sense, it is a combination of an offer and acceptance, which gives rise to certain legal consequences. Disciplines while contracting is essential. There is no full freedom of autonomy without observing the principles and disciplines. In brief, the principles are read within the ambit of non-free autonomy due to dynamic features of shariah contracts. Shariah contracts featured and translated in tortu or composed. The composition of pillars, and every syuruth / conditions emanates of pillars reflects the sequence in contracting. Shariah contracts never imposed syuruth or conditions precede the pillars. The consequences of breach in each composition may lead to different consequences. The pillars of each contracts can never be the same from one contract to another. Based on the above, this paper claims that by incorporating detail fatwas into the documents, dynamism of shariah contracts are protected and may lead to better resolution in settling dispute.

In Boissevain v. Well, [1949] 1 KB 482, 491, Denning LJ (as he then was) stated, “I do not believe that parties are free to stipulate by what law the validity of their contract is to be determined. Their intention is only one of the factors to be taken into account.”

Likewise, in Re Herbert Wagg & Co. Ltd., [1956] Ch. 323, 341, the judge stated, “This Court will not necessarily regard th governing consideration where

11 see 2: 235; 5: 88.
12 Mansoori, 2005

a system of law is chosen which has no real or substantial connection with the contract looked as a whole.” The views concluded that the courts should have residual power to strike off, for good reason, choice of law clauses totally unconnected with the contract.”

By incorporating Fatwas into the documents, despite of negative perception and attitude of the judges, the contracting parties in matters of choice of laws, the party autonomy rules applies.

The beginning of fatwa reference in the legal documentation in the conventional High Court was in the Shamil Beximco’s case13 and the Aramco Petroleum’s. these two cases reflects the intention of both parties to be governed by the Shariah law. One of such case, Shamil Bank of Bahrain v Beximco Pharmaceuticals, illustrates this point very well. The case was significant because for the first time, the questions of the validity, interpretation and scope of the English law vis-à-vis Islamic principles were considered by a secular court.

However, as regulated by the existing framework during that time, the courts and the arbitrators were bound to follow the existing regulatory framework. In light of Shamil Beximco’s case, the lawyers’ contracts brings down the intention of both parties to contract in shariah. Infact, the court were bounded by the Rome Convention14 applicable for the European Union (EU). The arbitration was applied in a landmark case of Saudi Arabia v. Arabian American Oil Co (Aramco)15. In this the tribunal held that ‘as Saudi law contained ‘no particular rules which define mining concessions in general and petroleum concessions in particular’, Saudi law had to be ‘interpreted or supplemented by general principles of law, by the custom and practice in the oil business and by notions of pure jurisprudence’.

This case has resulted in the issuance of the Council of Ministers Resolution No. 58, dated 03/02/1383 AH (25 June 1963): see also Article 8 of the Implementing Regulations, in which the Council of Ministers Resolution barred government agencies from entering into arbitration without approval of the President of the Council of Ministers, and required that contracts with Saudi government agencies be subject to Saudi law. In furtherance of the above, another Royal Decree M/8, dated 22/3/1394 AH (28 September 1979), was issued, precludes investment disputes involving oil and acts of sovereignty from being adjudicated under the terms of the ICSID Convention. Saudi become a

14 The Rome Convention has been repealed in 2009 and replaced by the Rome Regulation 1.
member to the New York Convention on Enforcement of Arbitral Award in 1994. During the 1950’s, Saudi Arabian courts refused to enforce many non-Saudi Arabian arbitral awards, finding them degrading and disrespectful to Saudi Arabia’s Islamic legal system. This has resulted in the issuance of a Decree in 1963 banning the Saudi Arabian governmental agencies to use arbitration in resolving international commercial disputes. A contract containing Riba will not be enforced by a Saudi Arabian court. Any practice of gharrar such as insurance is prohibited. The sensitivity on ‘shariah’ is higher compared to other jurisdictions. Dana Gas mudharabah contract was decided to be unenforceable in UAE due to contradiction of the existing laws in the Saudi.

This paper also claims that incorporation of fatwas into the sukuk legal documents is imperative due to limited recognition of ‘shariah’ in legal system. Undeniably, the sukuk contracts executed using shariah principles. However, the governing law clause adopts English law and given exclusive jurisdiction to the England High Court. In *Islamic Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems N.V. and others*, the case was heard in the English High Court in 2002 before Tomlinson J, and it represents a landmark decision because it was the first case to be brought before the English High Court concerning a murabahah financing dispute. The murabahah financing agreement contained an English law choice of law and jurisdiction clause. Following an event of default, IICG commenced claim proceedings for 'summary judgment' i.e. a judgment on the basis that the defendants had no arguable defence. In order for a defendant to successfully defend an application for judgment' i.e. a judgment on the basis that the defendants had no arguable defence. In order for a defendant to successfully defend an application for summary judgment, the defendant need only convince the court that there is an arguable defence. If indeed there is any arguable defence, it is not necessary to establish that the argument would succeed if argued in detail.

**Beximco Pharmaceuticals Ltd v Shamil Bank of Bahrain E.C.** It was decided in 2004 by the English court. That Shamil Bank of Bahrain ("Shamil Bank") professes to conduct Islamic banking business in line with the Shariah. The case highlight an important effect on non recognition of shariah contract of Article 1.1 of the Rome Convention has clearly mention that the reference to the parties’ choice of law to govern a contract is a reference to the law of a country, not to a non-national system of law such as the Shariah. Indeed, it is perfectly open to the parties to a contract incorporating some provisions of a foreign law into an English contract, but only where the parties sufficiently identified specific provisions of a foreign law or an international code or set of rules; then such foreign law or international code or set of rules would prevail as the governing law, rather than Shariah law. Both sides accepted that there were areas of considerable controversy and difficulty to applying Shariah to matters of finance and banking. Consequently, it was “improbable in the extreme, that the parties were truly asking (the Courts) to get into matters of Islamic religion and orthodoxy”. The general consensus of Muslim scholars to the prohibition of interest (riba) and the essentials of a valid murabahah agreement did no more than indicate that if the governing law clause had sufficiently incorporated the principles of Shariah into the agreements, the Borrowers would have likely succeeded. The Court also noted that there was no suggestion that the Borrowers had been in any way concerned with the principles of the Shariah either at the time the agreements were made or at any time before the proceedings were started. In the Court’s opinion, the Shariah defence was “a lawyer’s construct”. Therefore, the Court inclined against the construction, which would defeat the commercial purpose of the documents. As proposed by Yaacob (2011), legal documents should be carefully drafted. She propose reference to be made and referred to from any Standards such as AAIOFL. By incorporating Fatwas into the documents, the party autonomy rule applies and consequently

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17 Council of Ministers Resolution No. 58, Restricting Right of Saudi Governmental Agency to Submit to Arbitration, dated 17/1/1388.

1818 This case is pending decision in the UK High Court 19 [2002] All ER (D) 171

20 [2004] EWCA Civ 19

21 For details refer to Yaacob.h (2011), Research Paper 18, International Shariah Research Academy (ISRA) Malaysia

murabahah. While interpreting the agreement, and reference was made in particular to the word of “Glorious Shariah” in the governing law clause, the judges took a stance it was merely intended to reflect the Islamic religious principles according to which Shamil Bank professed to be doing business. Shariah practitioners should not blame the English law, for ignoring shariah to be the governing law of the contract. But rather understand how the English courts in England adaptive to the Rome Convention through the Law Applicable to Contractual Obligations 1980 ("the Rome Convention"), which has the force of law in England by virtue of s.2 (1) of the Contracts (Applicable Law) Act 1990 (equivalent to Article 3.1 of the Rome Convention).
sending a clear signals to the judges on the wishes of both litigants.

In recent years, It's becoming a trend in drafting that incorporating waiver clause against Shariah immunity. This clause describe the parties agree to waive any claim against shariah non-compliance in future from being litigated in any court of law. This reflects the agreement of both parties not to bring any action in court of law in any matters related to Shariah non-compliance. This practice is misleading. As submitted above, any transgressor to the principles of Shariah is prohibited. The framework of shariah based contract is to ensure the supportive framework for the Islamic economics emphasising on the integrity of shariah. Waiver provision is just another hilah to allow the execution of shariah non-compliance contracts. The rationale of adopting fatwa validation clause is to ensure all shariah is complied with without any other non-shariah-legal sense interpretation.

The uncertain fate of Islamic finance does not stop there. Several cases have been reported to face the fate as Shamil and ICG Symphony’s cases as above. In truth, English law is not to be blamed. Islamic legal documentation must be consistent in upholding Shariah. One example in Malaysia, In Maybank Islamic Bhd v M-10 Builders Sdn Bhd & Anor (Rohana Yusuf [CA], she adopted the approach of stated in the case of Bank Rakyat v Emcee. She opined and was of the view that the “provisions of the Contracts Act 1950 still govern Islamic contracts”. It follows therefore the MOD facility agreements are not one that can be avoided under s 24 of the Contracts Act nor an illegal contract under s 25 and therefore remains an enforceable agreement and must be adhered to. Post judgment interest of 5% is allowed pursuant to O 42 r 12A from 3 September 2014 until full realisation of the payment. As a matter of fact, the Rules of Court prohibit any interest on post judgment for islamic finance contracts.24

This can be portrayed via good Islamic drafting. Obviously, most of the drafting adopted in the Islamic documentation are English documents based. Lacking in terms of principles. Most of the legal drafters will claim this is generic clauses that every documents must have it. As a matter of fact, not all generic clauses are amiable to Islamic contract. Due to the confined environment where English law is dominant, it is substantial for Shariah contracts to express their wants and needs clearly in the contract. If the contract is to follow a selected and particular fatwas from any selected scholars of choice or institutional scholars (Shariah Committee/ Shariah Board members), then the Fatwa validation clause should be inserted emphasising the adoption of those views after getting an approval by the Board of Directors of each institution. This paper further submits that it is worrisome to see islamc contract terms and clauses are equated to the conventional contract. By deleting the word interest with profit does not make a contract compiled with shariah. There are other terms such as conditions / syuruth under the dealing clauses or the so called generic clauses or even boilerplate clauses are not suitable for shariah contract. For example severability clause or

Invalidity of Any Provision clause may state "Any term, condition, stipulation, provision, covenant or undertaking contained herein which is illegal prohibited or unenforceable in any jurisdiction shall, as to such jurisdiction, be ineffective to the extent of such illegality, prohibition or unenforceability without invalidating the remaining provisions hereof and any such illegality, prohibition or unenforceability in any jurisdiction shall not invalidate or render illegal, void or unenforceable any such term, condition, stipulation or undertaking in any other jurisdiction." In Shariah, if a contract is declared to be void, then all contracts will be void because the terms and conditions shall follow the Rukn or pillars of the contract. Shariah does not accept severability clause as validating other clauses after other clauses declared void in shariah. The rationale could be seen in the sequence of the documents executed. Main contracts must be executed first then followed by supporting contract that cannot stand on its own without the main contract.

Conclusion and recommendations

This paper submits that by incorporating the Fatwa Validation Clause, Shariah principles will be protected. The clause send signals to the arbitrator or judges or mediator that the contract shall be governed by Shariah principle only and interpretation shall only be made within Shariah law. No other laws shall be used to interpret the contract except shariah law. The validity of the product in the contract shall be made valid according to interpretation as in Fatwa Validation clause. the details of the fatwa may be inserted in clauses or schedule as an attachment. By inserting these clauses the parties are confirmed to be protected under the shariah contract. In conclusion, due to the absence of comprehensive enabling regulatory framework in recognising sukuk based on Shariah, it is imperative for the parties to insert ‘Fatwas Validation Clause’ in each sukuk documentations. This paper submits that there shall be a memorandum from all Islamic banks to be submitted to the court of England to recognise the shariah based contracts adherence to

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the international law principles on respect the ‘party autonomy rule’ in relation to fatwa validation. In addition, the International Arbitration Centre or judiciary must adhere to respect the Fatwas should the dispute resolution mechanism opted to be resolved through arbitration.

Fatwa validation clause is important in sukuk documents to strengthen the aqd as well as to guard shariah compliance based contract. consequently, mitigating all types of risks associated within the sukuk market.

References


