

# Islamic finance disputes: Arbitration and litigation



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Industry specialists predicted that 2022 and 2023 would carry a sharp increase in Islamic finance court litigation, in comparison to a quiet 2021. Those projections were incorrect. However, the limited number of cases reported by the state courts does not necessarily indicate that the volume of Islamic finance disputes has declined. Rather, over the past few years, parties to Islamic finance instruments have gradually moved away from court litigation towards the use of alternative dispute resolution (ADR) processes, including arbitration. As such, disputes that were resolved through arbitration (for example) would not generally be reported to the public, unless the parties consent to the publication of the award. **AMJAD HUSSAIN** and **GUILLAUME HESS** write.

The primary driver for selecting arbitration over litigation is the concern that certain globally leading jurisdictions in Islamic finance disputes (including New York and London), are ill-equipped to ensure that the Islamic finance instruments will remain Shariah compliant throughout the dispute resolution process. The risk is that a court decision could render an instrument non-compliant with Shariah which, in turn, would entitle parties to challenge the validity of the instrument.

Further, English courts (for example) have refused to give full effect to governing law clauses that provide for the application of English law subject to the principles of Islamic Shariah because the latter is a non-national system of law. However, state courts will generally accept that Islamic Shariah is comprised of a set of rules that can be arbitrated. As such, arbitral awards based on Shariah principles are enforceable.

Finally, arbitration gives parties the flexibility to select i) a tribunal that is experienced in Islamic finance and ii) a specialist institution with a set of rules that is better tailored to the Islamic finance disputes, including the International Islamic Center for Reconciliation and Arbitration (IICRA), Asian International Arbitration Centre (AIAC), and Islamic Mediation and Arbitration Centre (IMAC).

Therefore, with arbitration offering the possibility of relying on for that can specifically cater for the resolution of disputes in Islamic finance, it is likely that fewer such disputes will be submitted to the state courts (even in Muslim jurisdictions). In 2023, other factors have contributed to the limited number of court cases.

## Review of 2023

Despite the continued increase in financial pressures across several industries, there has been little appetite from Islamic finance borrowers or lenders to engage in adversarial dispute resolution processes. Rather, the preference seems to have been to settle matters amicably in order to maintain liquidity and capital flows.

Further, the global Islamic finance services industry demonstrated that its investment products are relatively crisis-proof, with defaults on Sukuk reported to be as low as 0.21%. As a result, although financial stability risks continue to increase, largely due to COVID-19

resurgence in China, the Russia-Ukraine crisis, inflation, rising debt levels, and limited fiscal support, the demand for Islamic finance instruments grew, with assets estimated to reach US\$4.9 trillion by 2025 according to Standard Chartered Bank. For the year 2023, Moody's considers that the demand for Shariah compliant financing is set to outweigh conventional funding in the Middle East and Southeast Asia.

## Preview of 2024

Islamic finance disputes are likely to remain relatively scarce in 2024. However, there are a number of uncertainties on the direction in which the global economy is heading. The majority of chief economists predict that the global economy will continue to weaken in 2024. Growing geopolitical tensions coupled with tighter financial conditions may impact borrowers' abilities to satisfy their obligations under the Islamic finance instruments.

Further, as the demand for Islamic finance instruments will continue to grow, so does the risk of disputes. To take one example, COP 28 is expected to boost green financing. However, there is no universal definition of "green Sukuk". In general terms, green Sukuk can only be used to fund environmentally sustainable projects.

However, there is uncertainty on the level "greenness" of a Sukuk, including i) what constitutes a "green" project, ii) the level of proceeds that should be used to fund green projects and iii) the post-issuance compliance with the "greenness". In the absence of sector specific guidelines, green Sukuk currently carry a heightened risk of disputes.

Finally, two endemic issues are likely to continue to be central to Islamic finance disputes. The first is the lack of standardised legal framework and the diverse interpretations of Shariah, which can result in uncertainties in the interpretation of the law and, therefore, render the outcome of disputes relatively unpredictable. The second is the near-absence of homogeneity of Islamic finance contracts. The prime example of the need for a standardization of contracts is the infamous Dana Gas case.

## Conclusion

Islamic finance instruments proved to be crisis proof and default rates remain very low. However, parties to Islamic finance instruments should approach the recently introduced investment vehicles (including the green Sukuk) with some caution as these remain relatively untested and carry certain risks amplified by endemic issues introduced in this article. ☺