Lex Mercatoria Islamica:
Sharia as Choice of Law under Rome I Regulation

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Qui facit usuram vadit ad infernum;
qui non facit vergit ad inopiam

—Dante Alighieri, *Divina Commedia*

Resumen: El peso demográfico de la población musulmana en el mundo, unido al crecimiento económico de algunos países del Golfo Pérsico ha contribuido a que el derecho financiero islámico represente en la actualidad una práctica jurídica cada vez más implantada en países de África, Oriente Medio, Sudeste Asiático y –aunque en menor medida– Europa y Norteamérica. En este trabajo nos proponemos examinar las dificultades que se derivan de la cláusula de sumisión a la sharía de este contrato de financiación así como de la determinación de la ley aplicable en defecto de cláusula de sumisión válida, en particular, bajo el esquema de financiación denominado *murabaha*. Finalmente, nos proponemos demostrar que el auge de las finanzas islámicas, tal y como se entienden en la actualidad, ha terminado por generar –paradójicamente– un fenómeno de huida del derecho financiero islámico, de modo que éste sea percibido cada vez menos como 'ley aplicable' y más como 'riesgo' del contrato.

Palabras clave: sharía; murabaha; Shari'a risk; riba; AAOIFI; ley aplicable; Roma I.

Abstract: The worldwide growth of Muslim population and GCC's booming economies have turned Islamic finance into an ever more popular practice area in

jurisdictions of Africa, the Middle East, Southeast Asia and –to a lesser extent– Europe and North America. This communication describes the nature of Islamic law as applied to financing transactions, in particular, the complexities deriving from Sharia as choice of law and Sharia as a legal system capable of being chosen under closest connection principles under Rome I Regulation. Special attention will be paid to a financing scheme named *murabaha*. Finally, this communication shows how the global success of Islamic finance has made Islamic law –paradoxically– less attractive under choice of law considerations, so that it is no longer perceived as "law" but as "risk".

Keywords: Sharia; *murabahah*; *Sharia risk*; *riba*; AAOIFI; choice of law; Rome I Regulation.

Islamic finance can be defined as a body of principles consistent with the precepts of Islam[1]. According to the traditional view, Islamic finance is part of a given nation state's legal order and its creation is part of a broader "Islamization" process of secular law. Although this is the case of some countries, the traditional view of Islamic finance does not help when describing a second phenomenon emerged in modern financial practice and which we might call with some caution "Islamic corporate responsibility". Islamic finance understood in this sense describes a compendium of good Islamic

[1] Modern Islamic finance was officially born in Malaysia in the 1950s. However, the first major milestone was the creation of *Mit Ghamr*, an Islamic savings bank, in Egypt in 1963. In its beginnings, Islamic finance was very basic due to the economic underdevelopment of the region, the use of closed and archaic contractual models, the lack of experts in the field and the exclusive use of Arabic as the language of the contract. The establishment in 1973 of *Nasser Social Bank* in Egypt was the first Islamic commercial banking experience on a larger scale. Between 1970 and 1990 Islamic financial law goes through profound changes related to the economic development derived from oil exports in the Gulf monarchies, Pan-Islamism and a new sensitivity in the business world toward Islam. In this period the first major Islamic banks arise, a few Western banks create an Islamic window, in the Sunni context an effort is made to agree on certain basic financial cornerstones common to the four schools (*ijma*), AAOIFI, IFSB and the first Sharia boards are created, and contractual documents are translated into English. In 1998 the *Dow Jones Islamic Indexes Fatwa* is a boost for Islamic capital markets, since for the first time the notion of "tolerable impurity" of certain financial transactions is permitted, provided that they are subject to mechanisms of "cleansing", consisting in minor donations for charitable purposes. Until the 1990s, the main areas of practice focus on real estate and venture capital. Over time Islamic finance becomes increasingly complex both from the point of view of contracting and from the point of view of fundable activities. In the 1990s and early 2000, investment funds benefiting from tax efficient structures become the main sector of business within this practice, especially real estate investment funds. The issuance of treasury bills (*sukuk*) in 2002 by the Malaysian government represents another major milestone in the development of Islamic finance. Since 2004 some large international banks such as Citibank, HSBC, RBS, UBS, Goldman Sachs or Deutsche Bank have created or expanded their practices of Islamic finance, focusing mainly on investment funds, capital markets and securitization, while the "Sharia compliance" of some schemes is increasingly disputed by Islamic experts.

practices of voluntary adherence in banking, created and applied outside the nation states' legal systems.

The concept of "transnational legal practices" coined in the theory of comparative law is useful when addressing the nature of Islamic finance understood as "Islamic corporate responsibility", since it allows a departure from the traditional paradigm of state-centric law reform in the Muslim world. However, in the context of Islamic finance some postulates of transnational legal practice must be revised, for example, the idea that transnational legal practice inevitably tends towards uniformity and is not susceptible to certain regional pluralism. On the one hand, because Islamic finance transactions take place in many different jurisdictions, whose legal systems may be more or less sophisticated and inspired by common law or civil law, for instance. On the other hand, because the interpretation of the Sharia made by regulatory authorities and Sharia boards varies greatly by region. These differences have led to the development of Middle Eastern and Southeast Asian market practices, which in turn do not represent the notion of Islamic finance shared by all the market players operating in these regions.

The revival of Islamic finance as "Islamic corporate responsibility" faces two existential difficulties which it shares, to a large extent, with the wider process of restoration of Sharia law as a relevant part of Muslim life. First, this revival requires the development of what some authors have called an "internal logic" –different both from theological literalism and mere financial utilitarianism–, which would be acceptable to large sections of Islamic communities. Second, it requires the recognition of a legitimate regulatory body that confers validity to the rules of banking contracts. At present, financial market players tend to locate the "internal logic" of Islamic finance in the selection of certain standards derived from the four Sunni schools of thought that are deemed compatible with conventional banking practice, while so called "Sharia Boards" are seen as legitimate regulatory authorities. Critical voices have highlighted that this form of banking is not aligned with the interests of the underprivileged classes of the Muslim world, and does not serve the promotion of the Coranic mandate of justice (*'adl*).

Religious legal opinions (*fatwas*) are the main sources of application of the precepts of Sharia law to financial transactions. *Fatwas* do not usually include a ruling on the compatibility of a given transaction with the law of a certain nation state, but with

Islamic finance understood as a set of good contractual practices commonly accepted in the market. This approach is consistent with the idea of modern Islamic finance as "Islamic corporate responsibility", i.e. a body of principles to which the parties adhere voluntarily and independently of the choice of law applicable to the contract. The risk of a state court deciding to rule on religious matters and eventually making a different interpretation from the one expected in conventional banking practice is referred to in the market as "Sharia risk", which is even more pressing if the contract is subject to the laws of a state that has incorporated Sharia as a source of law of its national legal system. Not surprisingly, it is precisely in these jurisdictions where Islamic finance understood as "Islamic corporate responsibility" enjoys less popularity. In order to prevent the risk of "judicialization" of Sharia law it is increasingly common for contracting parties to stipulate a "waiver of Sharia defense" clause, that is, a waiver of the parties to bring any defense based on the non-compliance of the transaction with Sharia principles in court. Paradoxically, privatization of Islamic finance, both in its institutional and hermeneutical aspects, has caused a flight from Sharia law as can be seen in the phenomena "Sharia risk" and "waiver of Sharia defense" [2].

In the field of Islamic finance generally and in particular, under the scheme called *murabaha*, two choice of law clauses can be found, depending on whether the parties choose to submit the contract exclusively to the Sharia or, as is more usual, they prefer a mixed model of submission to the law of a reputable jurisdiction –usually the UK or the state of New York– and Sharia law[3]. In the first case the determination of the applicable law does not pose many problems. In the case of arbitration, the Rome I Regulation

[2] The wording of a waiver of Sharia defense clause can read as follows: "The transaction contemplated in this Agreement has been approved by [Sharia board], whose ruling with regard to Sharia matters shall be final and binding for the Parties. Neither Party shall be entitled to raise any objections or defenses based on the basis that the Agreement, the transaction envisaged therein or certain clauses contained therein, is not in compliance with the principles of Islamic Sharia (Waiver of Sharia Defense)".

[3] Currently, 80% of Sharia-compliant financial transactions are made in the form of *murabaha*. The *murabaha* is split into a brokerage contract and two sales contracts, which take place consecutively. A customer who wishes to acquire an asset, entrusts a financial institution with the acquisition of the asset, which then buys the asset according to the "first sales contract" for a price "x" from a given supplier and subject to the terms and conditions previously agreed between the supplier and the customer (acting as an agent or broker for the financial institution). Then under the "second sales contract" the financial institution sells the asset to the customer at a price of "x + y", which will be paid by the customer on the spot or in accordance with a payment calendar. The price difference we have termed "y" does not reflect the financial cost of delayed payment of the price by the financial institution, but the market value of the asset at a certain date to which the customer and the bank have agreed on. The customer is not required to buy the asset, although in practice the bank usually prevents this risk by obtaining a promissory note of the customer, an irrevocable offer to purchase and/or an advance payment by the customer.

appears to accept the submission of a contract to the principles of Sharia, provided that the venue is a court of arbitration whose statutes recognize the choice of non-state law as the law applicable to a contract. In the event that the venue is a state court, a combined reading of Article 3 (1) and recital (13) of the Rome I Regulation I suggests that the parties can incorporate a non-state law or an international treaty into their agreement only "by reference" (*materiellrechtlicher Verweis*).

The case of mixed clauses containing a reference both to the law of a given nation state and to Sharia law is difficult since Article 3 of the Rome I Regulation provides that the parties must choose "the" law of the contract, i.e. ruling out the submission of the contract to two different legal systems[4]. However, this position does not contradict the common market practice by which parties do not seek to subject the contract to two different systems, but to choose the law of a reputable jurisdiction as "applicable law" – whose courts will, in all likelihood, decline any pronouncement on religious matters– while introducing a programmatic declaration of Sharia conformity into the contract. Despite the prohibition of subjecting a contract to two different systems, Article 3 of Rome I Regulation I recognizes the case of *dépeçage*, according to which the parties may choose the law applicable to all "or only part of the contract" that is, the parties may submit different parts of the contract to different systems. However, parties tend to prefer a uniform choice of law clause for the whole contract, whether "single" or "mixed", as mentioned above.

Within the limits of the police laws referred to in Article 9 of Regulation Rome I, incorporation by reference of Sharia law into a contract would overrule any default rules applicable to the contract that are incompatible with the precepts Sharia law. Compared with the old wording of Article 7 of the Rome Convention, Article 9 of Regulation Rome I significantly reduces the cases of "overriding mandatory provisions" that allow a judge to declare a conflict of laws rule contained in the Regulation inapplicable. In the case of Sharia law, it seems that the essential principles of Islamic finance –prohibition of interest, speculation, uncertainty, and investment in *haram* activities, mandatory risk-

[4] The wording of the choice of law clause in the famous case *Shamil Bank of Bahrain EC v. Beximco Pharmaceuticals Ltd.* reads as follows: "Subject to the principles of the glorious Shari'a, this Agreement shall be governed by and construed in accordance with the laws of England".

sharing and investment in tangible assets–, should not be incompatible with “overriding mandatory provisions” of the Member states of the European Union.

In the absence of a valid choice of law clause, Article 4 (2) of Rome I Regulation provides that the contract shall be governed by the law of the country of habitual residence of the party required to effect the “characteristic performance” of the contract. In the case of *murabaha* it is not easy to determine the characteristic performance of the contract, since there are three distinct legal relations linked by the common economic function of a financing arrangement. Under Article 4 (2) of the Rome I Regulation there are two closely connected issues: (i) on the one hand, whether the *murabaha* scheme as a whole should be subject to one single applicable law or whether, on the contrary, each set of legal relations provided for in the contract should be subject to different applicable laws; and (ii) whether the characteristic performance of the contract should be defined in a formalistic manner as “the delivery of the asset” provided for in the two sales contracts or rather bearing in mind the financing function inspiring the *murabaha scheme* as a whole.

Regarding the first question, in the case of one single law applicable to the whole contract, the applicable law may be different depending on what is considered the characteristic performance of the contract, i.e. the financing arrangement or the delivery of the assets. In the first case, the applicable law would be that of the jurisdiction in which the financial institution has its registered office. In the second case, if the characteristic performance of the contract was the delivery of assets under the sales contracts, the applicable law would be the UN Convention on Contracts for the International Sale of Goods (Vienna Convention) or the law of the jurisdiction of the seller, as appropriate. Regarding the second question, the submission of different parts of the *murabaha* scheme to different applicable laws seems, in principle, more suitable to its nature, to the extent that it incorporates elements of both an asset purchase and a financing arrangement. The separation of the laws applicable to the *murabaha* scheme offers a set of distinct legal remedies for those dispute scenarios that are relevant from a conflict of laws point of view. On the one hand, in a dispute between the supplier and the financial institution – e.g. in the event that the bank refuses to pay the purchase price–, the *murabaha* could be termed a contract of credit, with the applicable law being the jurisdiction of the registered office of the financial institution, which would determine the obligation of the bank to pay the purchase price, provided the claim is justified. On the other hand, in a dispute between the supplier and the customer –e.g. a claim for defects in the goods delivered, the *murabaha* could be termed a sales contract subject to the Vienna Convention or the law of the jurisdiction in which the supplier has his habitual residence under Article 4 (1) a) of Regulation Rome I, basing its claim on the client Article 14 (2) of the Rome I Regulation.

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