Islamic Trade Law and the Smart Contract Revolution

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Abstract

The history of Islam is inextricably connected to a celebrated history of trade and commerce which distinguishes it amongst monotheistic faiths. The modern incarnation of Islamic trade finance, however, bears only rudimentary similarity to the trade practices of old. Modern Islamic trade finance is devised to replicate conventional trade practices so that the barter-like immediacy of the Islamic contract of sale has been replaced with promissory attributes (*wa'd*). Yet Islamic law (sharia) has shown itself to be fully capable of adapting to modern trade practices so long as its major principles remain intact. The introduction of blockchain and smart contracts for Islamic trade finance does not change this basic calculus and yet these technologies promise to revolutionise Islamic trade practices in a way that compels the industry to operate in closer keeping with its commercial principles. Paradoxically, these technologies require substantive changes in the way in which Islamic trade finance is practiced, helping the industry to overcome its attachment to legal artifice (*hiyal*). Using comparative law methodology, this contribution briefly examines a short history of trade and commerce in the Islamic tradition, followed by the development of modern Islamic finance. It addresses the principles of Islamic commercial law as the basis for understanding the *murabaha* contract for trade finance, followed by an analysis of the legal and sharia-related issues that English courts have dealt with in the practice of Islamic trade finance. Finally, the chapter considers the transformative capacity of blockchain and smart contracts for Islamic trade finance, highlighting prominent legal and sharia-related issues that compel the industry to transform its trade practices markedly.

I. Introduction

15.01 Islamic finance was conceptualised as a post-colonial assertion of cultural and religious diversity in the increasingly integrated and harmonised market practices of the global economy. Interest-free (*riba*) banking would help pious Muslims through everyday acts to develop an Islamic communitarian ethos in which everybody gained and in which transparency, honesty, and fairness prevailed. The amalgamation of individual Islamic acts would contribute to restoring Islamic civilisation to its rightful place amongst the community of nations.

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15.02 Despite the industry's postcolonial origins, many of the contracts which the industry uses as a conceptual basis derive from Islamic jurisprudence or the body of Islamic law known as sharia. The sharia comprises the holy sources of Islam including the Qur'an which Muslims believe originated from the Prophet Muhammad's revelation of the word of God in the early 7th century CE. However, Islamic jurisprudence (*fiqh*) was developed over the course of nearly two centuries and eventually was applied as a governing legal system throughout the Near and Middle East from around the 9th century CE.[1] This status persisted until the Ottomans undertook a series of reforms known as the *tanzimat*, which preceded the dissolution of the Ottoman Empire as well as the abandonment of the sharia throughout the empire's former territories. Whereas Islamic family law continues to play a role in many Muslim majority jurisdictions, the commercial rules of the sharia, with the possible exception of Saudi Arabia, were almost entirely discarded in favour of secular commercial law.[2] The reasons for this diminished role are complex and numerous but must include the impact of the West and its modernising project, which began with 'legal colonialism'.[3]

15.03 The first modern Islamic finance project began in the Nile Delta region of Egypt, where, in 1963, it was implemented to include underbanked and often poor farmers in an equitable and religiously compatible way.[4] Since these modest beginnings, it has become one of the fastest growing financial sectors, comprising over US$2 trillion in assets, and is now facilitated in over 60 countries worldwide. The IMF considers the Islamic finance industry systemically important in more than 14 jurisdictions.[5] The industry's success, however, has come at the cost of Islamic finance's traditional emphasis on financial inclusion, equitable outcomes, and the avoidance of interest and excessive risk. The invisible hand of the global economy has co-opted Islamic finance

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1 Technically, the sharia consists of the holy sources: the Quran, the Sunna, ijma' (consensus) and qiyas (analogical reasoning). Whereas *fiqh* is the 'understanding' of these sources, the jurisprudence which derives therefrom. Scholars increasingly refer to sharia as an umbrella term for both of these meanings. This is the meaning of the term, which I will employ throughout this chapter.

2 One of the most influential scholars of Islamic law in our time even concludes that 'traditional sharia can surely be said to have gone without return'. See Wael Hallaq, 'Can the Sharia Be Restored?', in Yvonne Y Haddad and Barbara F Stowasser (eds), *Islamic Law and the Challenge of Modernity* (Altamira Press 2004) 42. See also Wael Hallaq, 'Hegemonic Modernity: the Middle East and North Africa During the Nineteenth and Early Twentieth Centuries' in *Shari'a: Theory, Practice, Transformations* (Cambridge University Press 2009) 396.

3 Muslims refer to legal colonialism as *isti'mar qanuni*. Aharon Layish, 'Islamic Law in the Modern World: Nationalization, Islamization, Reinstatement' (2014) 21 Islamic Law. & Society 276, 277-78.

4 For a fascinating account by the progenitor of this project, see the German-trained economist, Ahmed El Naggar's, *Zinslose Sparkassen: Ein Entwicklungsprojekt im Nil-Delta* (2nd edn, Al-Kitab Verlag 1982).

5 Ghiath Shabsigh et al, 'Ensuring Financial Stability in Countries with Islamic Banking' (IMF Country Report No 17/145, International Monetary Fund 2017).

in its stream of increasingly harmonised financial practices.[6] The legal and economic substance of Islamic financial products which emerges in global financial markets reflects the neoliberal economic paradigm in which the global economy operates.[7]

15.04 Paradoxically, the technological revolution may allow Islamic finance to rediscover aspects of its trade finance roots, helping it to develop trade practices that are cheaper, financially inclusive, transparent, less risky, more efficient and which transfer a greater share of the risk to sellers. FinTech may help the industry to realise Islamic commercial principles to a greater extent. Technologies such as blockchain or distributed ledger technology (DLT) - a decentralised database infrastructure for storing data and managing software applications – may increase the transparency of supply chains, accelerate the digitalisation of trade processes and automate trade finance contracts. Other technologies such as the internet of things – everyday devices which communicate with other devices by means of sensors and other processes – enable the tracking of products along the supply chain and help to prevent equipment breakdowns. Artificial intelligence enables machines and computers to perform cognitive functions normally associated with humans. Robots direct warehouse storage, machines package products and corporations mine big data to determine consumer preferences and behaviour for customised selling. These and other technologies are bringing the world closer together in a 'New Digital Revolution' which promises to enact technology-driven structural change in the trade-based global economy.[8]

15.05 The general principles of Islamic trade finance have been discussed broadly in the voluminous literature. Most accounts deal with the different modes of facilitating finance including the *murabaha* (cost mark-up sale), *mudaraba*, *musharaka* (both profit- and loss-sharing partnerships), *wakala* (agency) and *kafala* (guarantee) contracts. Surprisingly, there is just one other account of the effects of blockchain and smart contracts on trade finance. However, this pioneering work does not grapple with the transformation of Islamic trade law, nor does it delve into the legal and sharia-related issues that these technologies bring forth.[9] There are several works that deal broadly

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6 For an analysis of the legal and market mechanisms which drive the standardisation of Islamic financial law, see Jonathan Ercanbrack, '*The Standardization of Islamic Financial Law: Lawmaking in Modern Financial Markets' (2019) 67(4) American Journal of Comparative Law 825* (hereafter, Ercanbrack, 'Standardization of Islamic Financial Law').

7 Jonathan Ercanbrack, *The Transformation of Islamic Law in Global Financial Markets* (Cambridge University Press 2015) (hereafter Ercanbrack, *Transformation of Islamic Law in Global Financial Markets*).

8 World Trade Organization, 'World Trade Report 2018' (WTO 2018) (hereafter 'WTO Report 2018').

9 Leisan Safina and Umar A. Oseni, 'The Potentials of Smart Contract in Islamic Trade Finance' in Umar A. Oseni and S. Nazim Ali (eds) *Fintech in Islamic Finance: Theory and Practice* (Routledge 2012) 226 (hereafter, Safina and Oseni, 'Potentials of Smart Contract') is the only other account that

with the innovative capacity that fintech can provide to Islamic finance in more or less a general sense. This chapter explores the commercial origins and contemporary practice of Islamic trade finance, highlighting its conceptual and practical transformation, and its blockchain- and smart contract-based future. The chapter examines the principles of Islamic trade finance, charting their transformation from the classical past to the present digital era. The chapter argues that the industry's ethical and social mission may be realised to a greater extent by looking to future-oriented technologies such as blockchain for trade finance.

15.06 Using comparative law methodology, which calls for the examination of multiple systems of law and is geared toward the development of new and divergent legal trends, this chapter is organised in the following way: First, a short history of trade and commerce in the Islamic tradition is examined; second, the chapter investigates the development of modern Islamic finance; third, the principles of Islamic commercial law are introduced, followed by fourth, a discussion of the *murabaha* for trade finance; fifth, the way in which English courts have dealt with Islamic financial transactions are considered; and, finally, blockchain and smart contracts for Islamic trade finance are introduced, highlighting its mechanisms, legal and sharia related considerations, and their potential to help Islamic trade finance realise its ethical aspirations and efficiency concerns. The conclusion follows.

II. Trade in the Muslim World – Then and Now

15.07 Trade – and its financing – has always been central to the economy of the Muslim world. As land was mostly unfit for agricultural production in southern Arabia, Arabs tended to

deals with blockchain, smart contracts and Islamic trade finance. The article, while pioneering, does not grapple with the wholesale transformation of Islamic trade law, nor does it go into detail regarding legal and sharia-related issues. Hazik Mohamed and Hassnian Ali, *Blockchain, Fintech, and Islamic Finance* (Walter de Gruyter 2019) (hereafter Mohamed and Ali, *Blockchain, Fintech and Islamic Finance*) focus on the wide array of fintech technologies including artificial intelligence, big data, blockchain, machine learning, internet of things devices and more, highlighting the innovative capacity of these technologies for the Islamic finance industry. The book is the first to introduce the topics in any depth and is an important source of further research. See also Islamic Financial Stability Board, 'IFSB Stability Report 2017' (IFSB 2017) (hereafter 'IFSB Report 2017'), which provides a brief analysis of blockchain for cryptocurrency and the interaction of blockchain-based smart contracts with sharia. Furthermore, a number of articles have addressed the compatibility of cryptocurrencies and sharia such as Mohammed Motlaq Assaf, 'Cryptocurrency According to the Objectives of Islamic Law: Bitcoin as a Case Study' 36 Journal of College of Sharia & Islamic Studies 21, which argues that cryptocurrencies cannot be considered currencies from a sharia perspective; and Mohd Ma'Sum Billah, 'Islamic Cryptocurency? A Model Structure' 35 Journal of Islamic Banking & Finance 20, which introduces the 'model' sharia-compatible cryptocurrency in relation to conventional cryptocurrencies such as Bitcoin. Imtiaz Mohammad Sifat and Azhar Mohamad, 'Revisiting Fiat Regime's Attainability of Shari'ah Objectives and Possible Futuristic Alternatives' (2018) 38 Journal of Muslim Minority Affairs 1 is an interesting paper, which briefly sketches the merits of cryptocurrencies for purposes of realising Islam's higher objectives (*maqasid al-sharia*).

become traders, manufacturers, navigators, transporters and middlemen. The dominant historical account indicates that prior to the advent of Islam, the trade activities of the Arabs had acquired significance as the agropastoral economy had merged with the commercial economy of the market towns.[10] Therefore, Islam likely originated in a dynamic trading culture, which at the time was ruled by a wealthy tribe known as the Quraysh. The Quran itself has been described as the embodiment of the relations between man and God of a "strictly commercial nature". Allah is the merchant and the universe his reckoning, where all is counted, and everything measured. His institution is the Quran and He establishes a pattern of honest dealing. Life is a business in which man gains or loses.[11] Indeed, the sharia is highly attuned to the benefits of trade. The Quran states, "let there be among you traffic and trade by mutual good will"[12] and a number of prophetic traditions attest to the merchant's exalted role in the afterlife, such as Muhammad's proclamation that: "*the merchant who is sincere and trustworthy will (at Judgment Day) be among the prophets, the just and the martyrs*".[13] Indeed, the Prophet Muhammad is to have been the agent of a *qirad* investment with his future wife Khadija and is considered to have been a successful trader in his own right.[14] Furthermore, it is estimated that over 75 per cent of jurists that lived during the 9th and 10th centuries engaged in commerce or handicrafts or had family who did.[15] In fact, the founder of the Hanafi school of Sunni Islam, Abu Hanifah, was a partner in a venture involving the export of silk from Kufa to Baghdad.[16]

15.08 The commercial impulse of Islam, which may distinguish the religion amongst the monotheistic faiths, was evidenced in the practice of medieval trade. Buying and selling on credit was an accepted commercial practice, allowing international and long-term trade to flourish and solving the problem of transporting large sums of money across perilous lands. Credit, in combination with other contracts, was also an effective means

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[10] Ziaul Haq, 'Inter-Regional and International Trade in Pre-Islamic Arabia' (1968) 7 Islamic Studies 207, 209-10. For a contrary view which holds that most Arab trade in pre-Islamic Mecca served the domestic needs of southern Arabia, rather than the surrounding empires, see Patricia Crone, *Meccan Trade and the Rise of Islam* (Basil Blackwell 1987).

[11] Charles Torrey, *The Commercial-Theological Terms in the Koran* (EJ Brill, 1892) 48.

[12] Quran, translated by M A S Abdel Haleem (OUP 2008) 4:29 (hereafter 'Quran').

[13] Sunan al-Darimi, XVIII, 8. Cf Maxime Rodinson, *Islam and Capitalism* (Allen Lane 1974) 16.

[14] Abraham L Udovitch, *Partnership and Profit in Medieval Islam,* (Princeton University Press 1970) 175 (hereafter Udovitch, *Partnership and Profit in Medieval Islam*).

[15] Hayyim Cohen, 'The Economic Background and the Secular Occupations of Muslim Jurisprudence and Traditionalists in the Classical Period of Islam' (1970) 13 Journal of the Economic & Social History of the Orient, 16, 39-40 (hereafter Cohen, 'Economic Background and Secular Occupations of Muslim Jurisprudence')

[16] hereafter Cohen, 'Economic Background and Secular Occupations of Muslim Jurisprudence' (n 15) 26.

of sharing commercial risk.[17] According to a study of the Cairo Geniza records, which document classical Middle Eastern civilisation between the 10th and 16th centuries, trade was carried out via mostly informal partnerships in the area between Morocco and Mesopotamia.[18] Partnerships were used for practically every economic activity as they substituted for contracts of employment and loans on interest.[19] Indeed, it is believed that Arabs developed complex credit facilities up to four centuries before the Europeans,[20] and that one of the earliest forms of business association practiced in Europe – the *commenda* – was received by Southern Europe from Arabia following Islamic conquests and was based on the pre-Islamic *qirad*.[21]

15.09 In the modern world, trade within the Muslim world has only grown in importance, with over 20 per cent of all trade between Organisation of Islamic Cooperation (OIC) countries in 2015 being with other OIC states.[22] In 2005, such trade only constituted 15 per cent of the total,[23] which demonstrates that intra-OIC trade is of ever-increasing importance to the Muslim world. Yet, contrary to its historical prominence, the Middle East and North Africa (MENA) region has generally been seen as one which under-trades with other countries, relative to its GDP and a number of other factors.[24] In 2017, the MENA region contributed only 5 per cent of global exports and 4.3 per cent of total imports. Non-tariff barriers in the region are seen as particularly high including burdensome technical regulations, import authorisation procedures, cumbersome customs clearance and border controls. Moreover, there is little transparency, harmonisation or standardised procedures for cross-border trade facilitation in the region, amongst other structural shortcomings. Heavy investment in trade-related

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17 Abraham L Udovitch, 'Reflections on the Institutions of Credits and Banking in the Medieval Islamic Near East' (1975) 41 Studia Islamica 5, 2.

18 Ercanbrack, *Transformation of Islamic Law in Global Financial Markets* (n 7) 79.

19 SD Goitein, *A Mediterranean Society: the Jewish communities of the Arab world as portrayed in the documents of the Cairo Geniza* (vol. 1, Economic Foundations, University of California Press 1967).

20 Udovitch, *Partnership and Profit in Medieval Islam* (n 14) 77.

21 The *qirad* is a profit- and loss-sharing partnership, similar to the *mudharaba*, and is used to finance trade. See Udovitch, *Partnership and Profit in Medieval Islam* (n 14) 172; Abraham L Udovitch, 'At the Origins of the Western Commenda: Islam, Israel, Byzantium?' (1962) 37 Speculum 198, 207.

22 Emmy Abdul Alim, 'What is the Value of Trade Among the Mostly Muslim-Majority 57 OIC Countries?' (*Salaam Gateway*, 25 October 2017) <https://www.salaamgateway.com/en/story/what_is_the_value_of_trade_among_the_%20mostly_muslimmajority_57_oic_countries-SALAAM25102017072648/> accessed 4 June 2019.

23 Organisation of Islamic Cooperation, 'OIC-2025: Programme of Action' (OIC) <https://www.oic-oci.org/docdown/?docID=16&refID=5> accessed 4 June 2019.

24 Alberto Behar and Caroline Freund, 'The Trade Performance of the Middle East and North Africa' (*Forum for Research in International Trade*, July 2011) < https://freit.org/WorkingPapers/Papers/TradePatterns/FREIT321.pdf> accessed 4 July 2019.

infrastructure and logistics, trade facilitation and digitalisation of the economy are seen as imperative if the region hopes to meet its contemporary challenges.[25]

15.10 Islamic trade finance is seen as having great potential in this context, but it is important not to overstate the current importance of sharia-compliant trade finance to intra-OIC trade. While the International Islamic Trade Finance Corporation was set up by the Islamic Development Bank to facilitate sharia-compliant trade finance and has successfully used sharia-compliant trade financing in projects from Kazakhstan[26] to Burkina Faso,[27] sharia-compliant trade finance accounts for only 1.14 per cent of intra-OIC trade according to a 2018 article.[28] Therefore, while the Islamic finance industry – including Islamic trade finance – is growing, it remains a niche market in all economies apart from those which have fully Islamised their banking systems or in which Islamic banking and finance have become systemically important.[29] Nonetheless, the industry provides a useful case study for examining modern Islamic trade finance mechanisms, their classical roots, and the implications of technological development.

III. The Development of the Modern Islamic Finance Industry

15.11 To understand Islamic trade finance, it is necessary to briefly examine the history of Islamic finance as a concept. In the classical period, as mentioned above, trade and its finance were conducted through informal partnerships, but the concept of modern finance was introduced to the Muslim world alongside colonialism.[30] From the middle of the 19th century colonialism caused almost all Muslim countries to adopt Western laws and legal systems, and this was particularly apparent in the commercial sphere.[31]

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25 Nasser Saidi and Aathira Prasad, 'Trade and Investment Policies in the MENA Region' (Background Note, MENA-OECD Working Group on Investment and Trade 28 November 2018), 5-7.

26 International Islamic Trade Finance Corporation, 'ITFC's Investment of Wheat in Kazakhstan' (*International Islamic Trade Finance Corporation*) <http://www.itfc-idb.org/en/content/itfcs-investment-wheat-kazakhstan> accessed 4 June 2019

27 International Islamic Trade Finance Corporation, 'ITFC Supports Burkina Faso's Cotton Sector With €85 Million Syndicated Murabaha Financing' (*International Islamic Trade Finance Corporation*) <http://www.itfc-idb.org/en/content/itfc-supports-burkina-fasos-cotton-sector-eu85-million-syndicated-murabaha-financing-1> accessed 4 June 2019.

28 Arno Maierbrugger, 'Islamic Trade Finance Has Much More Potential' (*Gulf Times*, 20 March 2018) <https://www.gulf-times.com/story/585900/Islamic-trade-finance-has-much-more-potential> accessed 4 June 2019.

29 Iran, Sudan, Brunei, Saudi Arabia, Kuwait, Qatar, Malaysia, the United Arab Emirates, Bangladesh, Djibouti, Jordan and Bahrain comprise Islamic banking and financial assets of 15 per cent or more of total banking and financial assets in their respective economies. See Islamic Financial Services Board, 'Islamic Financial Services Stability Report 2018' (IFSB 2018) 9.

30 Ibrahim Warde, *Islamic Finance in the Global Economy*, (Edinburgh University Press 2000) 49 (hereafter Warrde, *Islamic Finance in the Global Economy*).

31 Habib Ahmed, 'Islamic Law, Adaptability, and Financial Development' (2006) 13 Islamic Economic Studies 79, 85. From the mid-19th century the sharia was largely abandoned in favour of European law codes, mainly from France. Upon independence many states in the MENA region adopted the

Furthermore, the concept of the nation state, previously alien to Muslims, was introduced and took control from the jurists who had always served as a counterbalance to rulers.[32] The sharia's inherent pluralism and its base in unchanging texts meant that codification of its principles further distorted it and gradually removed it from the lives of Muslims.[33] By the end of the 19th century, these developments had combined to ensure that the financial systems of most Muslim countries were Westernised and secularised,[34] as can be seen in the fact that interest was permitted in the Egyptian Civil Code.[35]

15.12 Such developments caused inevitable discontent amongst some Muslims, with the influential Iraqi Shia mufti, Muhammad Baqir Al-Sadr, denouncing the "long, bitter history of exploitation and struggle" that the Muslim world had faced under colonialism.[36] Similarly, the activist and founder of the Muslim Brotherhood, Hassan Al-Banna, claimed that Western social principles had failed as they had not helped man reach "rest and tranquillity".[37] Thinkers such as Al-Banna and Al-Sadr advocated a return to Islam,[38] seeing it as a third way that would aid the development of the Muslim world more than either capitalism or communism.[39] This would be done through 'Islamic economics': the creation of the idealised *Homo Islamicus*, whose pious actions would build an alternative system to the capitalist one built on the greed of *Homo Economicus*.[40] And what better to represent the inherent greed of capitalist economics than the charging of interest? Interest is prohibited in classical Islamic law, and yet in the modern era jurists had allowed interest to be paid.[41] Islamic economists saw the charging of interest as an

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Egyptian or Kuwaiti law codes but these were derived from European civil law influences, primarily the French Civil Code. In particular, the Egyptian Civil Code of 1948 influenced the civil codes of many Arab countries. See David Suratgar, 'The Development of the Legal Systems of the Middle East; Islamic Law and the Importance of Civil Law to the Process of Modernisation', in Brian Russell (ed), *An Introduction to Business Law in the Middle East* (Drake Publishers 1975) 9.

32 Wael B Hallaq, '"Muslim Rage" and Islamic Law' (2003) 54 Hastings Law Journal 1705, 1710-1711 (hereafter Hallaq, '"Muslim Rage" and Islamic Law') .

33 Hallaq, '"Muslim Rage" and Islamic Law' (n 32) 1713; Haider Ala Hamoudi, 'The Muezzin's Call and the Dow Jones Bell: On the Necessity of Realism in the Study of Islamic Law' (2008) 56 America Journal of Comparative Law 423, 434-435 (Haider A Hamoudi, 'Muezzin's Call and the Dow Jones Bell').

34 Warde, *Islamic Finance in the Global Economy* (n 30) 36.

35 Warde, *Islamic Finance in the Global Economy* (n 30) 49.

36 Muhammad Al-Sadr, 'The Psychological Role of Islam in Economic Development' in John J Donohue and John L Esposito (eds), *Islam in Transition: Muslim Perspectives* (OUP 2007) 252 (hereafter Al-Sadr, 'Psychological Role of Islam in Economic Development').

37 Hassan Al-Banna, 'The New Renaissance' in John J Donohue and John L Esposito (eds), *Islam in Transition: Muslim Perspectives* (Oxford University Press 2007) 60 (hereafter Al-Banna, 'The New Renaissance').

38 Al-Banna, 'The New Renaissance' (n 37) 62; Al-Sadr (n 36) 254, 258.

39 Charles Tripp, *Islam and the Moral Economy: The Challenge of Capitalism* (Cambridge University Press 2006) 111 (hereafter Tripp, 'Islam and the Moral Economy').

40 Tripp, 'Islam and the Moral Economy' (n 39) 122.

41 Tripp, 'Islam and the Moral Economy' (n 39) 127.

injustice as it kept money in the hands of the moneyed classes and disincentivised the assumption of risk in equity-based investments as interest on a loan is payable regardless of the success of the venture in question.[42] Moreover, some opponents of interest denounced as a "fraud" the ability to make money out of nothing by demanding interest be paid alongside the principal.[43]

15.13 In resisting interest in the modern world, Islamic finance now had a purpose, a "desire to articulate a form of political, economic and social order that resists the dominant global paradigms and creates a separate, self-defined Islamic identity resting on unique ethical and moral bases".[44] Yet ,without the quadrupling of oil prices between 1973 and 1974, and the attendant talk of a new international economic order that this generated, perhaps Islamic finance would not have come into existence.[45]

15.14 In the 1970s, the first commercial Islamic banks were formed, with the purpose of creating a more socially valuable banking system. In practice, this meant a two-tier partnership, where individuals invested in the bank, and the bank invested in ventures, and profits and losses were shared in proportion to the amount invested.[46] Unfortunately, this proved unpopular with clients who had become used to the minimal risk of loss present in conventional deposits, and the cost of monitoring all the bank's investments proved too high to be practicable.[47] Thus, the idealism of the early Islamic finance industry began to fade, and instead the industry had to adapt to survive.[48] Meanwhile, the dreams of a new economic order began to fade as oil prices fell sharply in 1986.[49] This, combined with the end of the Cold War, the rise of neoliberalism, and the growing importance of technology, meant that a new type of Islamic finance was born out of necessity.[50] Islamic financial institutions have gradually moved away from profit and loss sharing structures towards structures more akin to conventional products.[51] One of those products, the *murabaha* agreement, is of particular importance to Islamic trade finance and will be examined shortly. First, the principles of classical

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42 Haider A Hamoudi, 'Muezzin's Call and the Dow Jones Bell' (n 33) 453-454.
43 Tarek El Diwany 'Travelling the Wrong Road Patiently' *Middle East Banker* (September 2003).
44 Haider Ala Hamoudi, 'Muezzin's Call and the Dow Jones Bell' (n 33) 425.
45 Warde, *Islamic Finance in the Global Economy* (n 30) 93.
46 Haider A Hamoudi, 'Muhammad's Social Justice or Muslim Cant?: Langdellianism and the Failures of Islamic Finance' (2007) (40) Cornell International Law Journal 89, 116-117 (Haider A Hamoudi, 'Langdellianism and the Failures of Islamic Finance').
47 Haider A Hamoudi, 'Langdellianism and he Failures of Islamic Finance' (n 46).
48 Tripp, 'Islam and the Moral Economy' (n 39) 142.
49 Warde, *Islamic Finance in the Global Economy* (n 30) 78.
50 Warde, *Islamic Finance in the Global Economy* (n 30) 78-80.
51 Haider A Hamoudi, 'Langdellianism and he Failures of Islamic Finance (n 46) 118-119.

Islamic commercial law – which modern Islamic finance still relies on for legitimacy – will be introduced.

IV. Principles of Islamic Commercial Law

A. Ownership and its Limits

15.15 Ownership (*al-milkiyyah*) is an Islamic legal relationship between a human being and property, which specifically attaches the said property to him/her. An owner is entitled to deal in his property unless there is a legal restriction which prevents him/her from doing so. Yet to speak of 'ownership' in the western context with regards to Islamic law is somewhat misleading. In fact, all property is owned by God, evidenced by the verse: "To Allah does belong the dominion of the heaven and the earth, and all that is therein."[52] To be the owner of a piece of property is thus to be a trustee and vice-regent of the said property – "and spend out of that whereof He has made you heirs."[53] In Islam property is not to be considered an end in itself but simply a means of satisfying human needs and wants. Indeed, humans are warned of the dangers of excessive consumption in an earlier verse: "Eat not up your property among yourselves in vanities, but let there be among you traffic and trade in good will."[54] All property rights in Islam should be viewed in the light of this verse, and constrained to avoid causing harm to others.

B. The Nature of Property

15.16 Property (*mal*) was not defined in either the Quran, or the Sunna, and as such its definition has been left to juristic interpretation.[55] While there are some differences between the schools regarding what constitutes *mal*, some general principles can be abstracted, which may affect the types of trade that can be financed Islamically:

1. To qualify as mal, something must be naturally desired by man. In modern terms, this can be defined as having commercial value.
2. It must also be capable of being owned and possessed. So, for example, fish in the sea or birds in the sky are not mal as it is impossible to possess them.
3. It must be capable of being stored.

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[52] Quran (n 13), 5:120.
[53] Ibid, 57:7.
[54] Ibid, 4:29.
[55] Muhammad W Islam, 'Al-Mal: The Concept of Property in Islamic Legal Thought' (1999) 14 Arab Law Quarterly 361, 362 (hereafter W Islam, 'The Concept of Property in Islamic Legal Thought').

4. It must be beneficial in the eyes of the sharia. Hence, poisonous substances and carrion are not considered mal. Additionally, there appears to be a *de minimis* threshold here, as small amounts of any good which are incapable of benefitting wider society, such as single ears of corn, are not considered mal.
5. Finally, the ownership of the thing must be assignable and transferable.[56]

15.17 As a result of this taxonomy, Islamic law makes a distinction between material things (*'ayn*) and immaterial things (*dayn*). *Dayn* is often considered to be a debt, but can be described as something which is not present, yet to be paid or completed, but is already owned by the creditor under a contract.[57] *Dayn* cannot be described to be in the creditor's possession; instead, *dayn* is embedded within their human capacity.[58] As such, Foster equates *dayn* with the common law concept of a 'chose in action'.[59]

15.18 One area in which this debate has surfaced in modern Islamic finance is in relation to intellectual property rights. If these rights are seen as dependent on corporeal matter, then they would be considered *'ayn*. If not, then due to the prohibition of *riba* described below, they could only be exchanged at par value.[60] Furthermore, the distinction proves vastly important to the debt-oriented modern finance industry as the sale of a debt for another debt at a discount (*bay' al-dayn bi al-dayn*) is not valid.[61] Therefore, debt may only be traded or assigned at par value. An oft-cited Hadith supported this prohibition: "The Messenger of God forbade sale of the delayed obligation (*al-kali'*) for a delayed obligation".[62]

C. Riba

15.19 The prohibition of *riba* is perhaps the most widely known principle of Islamic commercial law. *Riba* literally means 'increase' and has been defined as an unjust enrichment in which one party to an agreement receives a monetary advantage without giving a

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56 W Islam, 'The Concept of Property in Islamic Legal Thought' (n 55) 365.
57 Ercanbrack, *Transformation of Islamic Law in Global Financial Markets* (n 7) 64.
58 Ibid.
59 Nicholas H D Foster, 'Transfers of Rights and Obligations in the U.A.E: A Comparative Analysis in the Light of English Law, French Law and the Shari'a' in Eugene Cotran (ed) *Yearbook of Islamic and Middle Eastern Law,* vol VII (Brill, 2000-2001), 41 (hereafter Foster, 'Transfer of Rights and Obligations in the UAE').
60 Ercanbrack, *Transformation of Islamic Law in Global Financial Markets* (n 7) 65.
61 Wahbah Al-Zuhayli, *Financial Transactions in Islamic Jurisprudence* (translated by Mahmoud A. El-Gamal, vol I, Dar al-Fikr 2003) 81 (hereafter Al-Zuhayli, *Financial Transactions in Islamic Jurisprudence*).
62 Foster, 'Transfer of Rights and Obligations in the UAE' (n 59) 43.

countervalue in return.[63] The Quran exhorts generosity and the avoidance of exploitation of those worse off.[64] In theory, the prohibition of *riba* serves to replace zero-sum transactions with more just and equitable ones, as by removing the possibility of charging money for a loan transaction, only charitable loans – either gifts or loans requiring no interest – are available to lenders and these cannot be the source of commercial profitmaking.[65]

15.20 *Riba's* prohibition can be traced to several verses of the Quran, including "You who believe, do not consume usurious interest, doubled and redoubled […] beware of the Fire prepared for those who ignore [this],"[66] and "God has allowed trade and forbidden usury."[67] Through *qiyas* the principle of *riba* gradually expanded. In Islamic commercial law, *riba* encompasses two related phenomena. First, *riba al-fadl*, which can be described as the inequality of countervalues in a given exchange of items of the same type – for example, trading an amount of gold for a larger amount of gold or silver,[68] or trading one *dayn* for another *dayn* at a discount.[69] More relevant to modern financial practices is the prohibition of *riba al-nasi'a*, which can be defined as the deferred completion of such an exchange, regardless of whether the deferment is accompanied by an increase to one of the countervalues.[70] This prohibits charging a time value for money.[71]

15.21 All four major schools differ in their rules regarding when a transaction will be considered *ribawi* in nature, but it should be noted that over time there has been a trend towards a more rigid and conservative definition of *riba*.[72] This remains true to this day, although the translation of *riba* in modern editions of the Quran has been changed to 'usury', which may reflect a narrower focus on the prohibition of interest in modern Islamic finance when compared to its more expansive prior definitions.[73]

D. Gharar

63 Joseph Schacht, *An Introduction to Islamic Law* (Clarendon Press 1964) 145.
64 See for example, Quran (n 12) 30:39 which compares *ribawi* loans unfavourably with charitable giving.
65 Ercanbrack, *Transformation of Islamic Law in Global Financial Markets* (n 7) 71.
66 Quran (n 12) 3:130.
67 Ibid, 2:275.
68 Saleh, *Unlawful Gain and Legitimate Profit in Islamic Law* (n **Error! Bookmark not defined.**) 17.
69 Al-Zuhayli, *Financial Transactions in Islamic Jurisprudence* (n 61) 81.
70 Saleh, *Unlawful Gain and Legitimate Profit in Islamic Law* (n **Error! Bookmark not defined.**) 17.
71 Ercanbrack, *Transformation of Islamic Law in Global Financial Markets* (n 7) 76.
72 Fazlur Rahman, 'Riba and Interest' (1964) 3 Islam Studies 1, 13.
73 Haider A Hamoudi, 'Muezzin's Call and the Dow Jones Bell' (n 33) 460.

15.22 *Gharar* is another important prohibition of Islamic commercial law. It was developed by analogy from the Quranic prohibition of gambling and can be defined as the prohibition of risk, uncertainty, and speculation.[74] Its effect is to prohibit so-called zero-sum contracts where one party stands to gain at the expense of another's loss.[75] As Hassan notes, the rationale for the prohibition is a belief that a just profit should be the result of one's labour, time, and expenditure, and not simply 'winning' a speculative transaction.[76] As with the prohibition of *riba*, this appears to be Islamic law's attempt to create mutually beneficial contracts, and to prevent the exploitation of the weak by the strong.[77] It is important to note that Islamic law has no problem with a contract having an unequal result, if that result was not inherent to the contract itself in the form of *gharar*. What is important is that profit derives from the assumption of liability (*al-kharaj bi al-kharaj*). Without taking on commercial risk, the basis for profit-making in Islamic law does not exist.

15.23 With respect to the sales contracts that form the backbone of Islamic trade finance, *gharar* in a transaction can take many forms. Ibn Rushd, a Maliki scholar, wrote that *gharar* in sales transactions causes the buyer to suffer damage for want of knowledge which affects either of the countervalues to the contract. As such, he specified five conditions that had to be met for *gharar* to be averted. These are:

1. The price and the subject matter of the contract must be in existence. This is related to the rules on the nature of property discussed above.
2. The characteristics of the above countervalues must be known.
3. The amount of the countervalues must be determined.
4. The parties must have full control over both countervalues, to ensure that the transaction can take place.
5. If any part of the contract is to be performed on a future date, that date must be defined.[78]

15.24 Throughout the history of Islamic law, commercial necessity has dictated that the rigidities of *gharar* be avoided in certain instances. For example, the bartering of

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[74] Ercanbrack, *Transformation of Islamic Law in Global Financial Markets* (n 7) 62.

[75] Nayla Comair-Obeid, *The Law of Business Contracts in the Arab Middle East* (Kluwer Law International 1996) 55 (hereafter Comair-Obeid, *The Law of Business Contracts in the Arab Middle East*).

[76] Hussein Hassan, 'Contracts in Islamic Law: The Principles of Commutative Justice and Liberality' (2002) 13 Journal of Islamic Studies 257, 280.

[77] Sami Al-Suwailem, 'Towards an Objective Measure of Gharar in Exchange' (2000) 7 Islamic Economic Studies 61.

[78] Ibn Rushd, *The Distinguished Jurist's Primer, a Translation of Al-Bidayat Al-Mujtahid* (translated by Imran A. K. Nyazee, vol. II, Garnet Publishing Limited 1996) 148, 172.

livestock for meat was tolerated even though the unknown differences of the countervalues in the transaction violated both *gharar* and *riba*.[79] There has always been some element of *gharar* inherent to all trading, with respect to at least one portion of the transaction. For this reason, modern jurists such as Sanhuri saw *gharar* as more of a sliding scale than something to be completely eradicated from all commercial dealings.[80] Excessive *gharar* is to be completely prohibited, while more trivial instances of *gharar* are to be tolerated, although what constitutes excessive *gharar* is for each jurist to decide.

E. Freedom of Contract and the System of Islamic Nominate Contracts

15.25 In Islam, all obligations to which human beings are subjected arise out of the covenantal encounter between man and God.[81] This can be seen in several passages of the Quran, for example, "verily those who swear allegiance to thee, swear allegiance really to God",[82] and "Fulfil the covenant of God when ye have entered into it and break not your oaths after ye have confirmed them".[83] The importance of fulfilling one's obligations is made more explicit in the command: "Ye who believe! Fulfil all obligations!"[84] These passages are the source of the principle of the sanctity of contract in Islamic law.

15.26 Traditionally, Islamic law recognised no specific freedom of contract. Instead, by reference to the Quran and the Sunna (the sayings and doings of the Prophet Muhammad exemplified in written traditions known as *hadith*), and the application of *qiyas* (analogical reasoning) by jurists, a system of nominate contracts was developed.[85] Nominate contracts are a set of contracts in which jurists developed specific names and concise rules. The Islamic jurist's casuistic approach elicited subtle rules pertaining to specific contracts rather than formulating broad theories such as a general theory of obligations. The majority of scholars focused on the contract of sale as a kind of model for contracts. A sale contract can be defined as an immediate and concurrent exchange for a fixed price in cash or kind. The delivery of the goods cannot be delayed so that the contract resembles a barter transaction. The sale contract requires an exchange of offer (*ijab*) and acceptance (*qabul*) but these are not promissory. Offer and acceptance are understood as performatives, as 'constitutive, dispositive utterances', which to indicate finality, are to be phrased in the past tense. Therefore, the parties create immediate

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79 Ercanbrack, *Transformation of Islamic Law in Global Financial Markets* (n 7) 67-68.
80 Saleh, *Unlawful Gain and Legitimate Profit in Islamic Law* (n **Error! Bookmark not defined.**) 68.
81 Bernard Weiss, *The Spirit of Islamic Law* (University of Georgia Press 1998), 26-31.
82 Quran (n 12) 48:10.
83 Ibid, 16:91.
84 Ibid, 5:1.
85 Susan E. Rayner, *The Theory of Contracts in Islamic Law* (Arab and Islamic Laws Series, Graham & Trotman 1991) 100.

entitlements in each other, so that the goods pass to the buyer as soon as the contract has been concluded.[86] It would seem that the objective of the immediate exchange in the contract of sale is to avoid *riba* and *gharar* as discussed above.[87] Characteristically, the focus is on the subject matter of the contract as opposed to any obligation to which the contract gives rise. However, in practice the system was much more varied. Due to the requirements of business, the exceptions and qualifications far outnumber the rule. Such exceptions came to be known as innominate contracts. An example is the *bay' al-salam* or forward sale in which the subject matter does not yet exist, but the seller undertakes to make it available at a later date to the purchaser. The non-existent subject matter is a promise given in exchange for immediate payment. This kind of sale would normally be unlawful as the seller sales what is not in existence.[88]

15.27 Similarly, the extent to which parties to a contract may append conditions (*shurut*) to an agreement has been the subject of much debate, with some schools adopting a more conservative approach than others.[89] For the purposes of modern Islamic finance, the liberal view articulated by the Hanbali scholar Ibn Taymiyyah, that "the parties decide as they wish the content of their juridical acts and determine the effects on the condition that these effects are not contrary to public order and morals",[90] has been adopted. While this gives the appearance of greater party contractual freedom, there are still some important limitations. The most important such limitation in Islamic trade finance is the inability to combine two contracts together, or to make fulfilment of one contract necessary in the fulfilment of another.[91]

15.28 Due to what has been described as the inherently common law nature of Islamic finance, the industry looks to the old nominate contracts to legitimise modern financial practices.[92] Now that the sources and general principles of Islamic trade financing law have been enumerated, the way in which a traditional nominate contractual form has been adapted for modern trade financing purposes will be described.

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86 Aron Zysow, 'The Problem of Offer and Acceptance: A Study of Implied-in-Fact Contracts in Islamic Law and the Common Law' (1985-86) 34 Cleveland State Law Review 69, 76 (hereafter Zysow, 'Problem of Offer and Acceptance').

87 Noor Mohammed, 'Principles of Islamic Contract Law' (1988) 6 Journal of Law and Religion 115, 123 (hereafter Mohammed, 'Islamic Contract Law').

88 See Nabil Saleh, 'Definition and Formation of Contract under Islamic and Arab Laws', (1990) 5 Arab Law Quarterly 101; Comair-Obeid, *The Law of Business Contracts in the Arab Middle East* (n76).

89 See Ercanbrack, *Transformation of Islamic Law in Global Financial Markets* (n 7) 59-62 for an overview.

90 Comair-Obeid, *The Law of Business Contracts in the Arab Middle East* (n 75) 38.

91 Noel J Coulson, *Commercial Law in the Gulf States* (Graham & Trotman, 1984) 54. This restriction has been overcome in Islamic trade finance through 'Promises to Purchase' and other such undertakings.

92 Mahmoud A El-Gamal, *Islamic Finance: Law, Economics and Practice* (Cambridge University Press 2006) 64.

V. Islamic Trade Finance in Practice: The *Murabaha* Contract

15.29 While many, if not all, of the nominate contractual forms available to Islamic finance practitioners can be used as trade financing mechanisms, for reasons of space they cannot all be discussed here. Instead, the most used contractual form in the Islamic finance industry – the *murabaha*, which according to most estimates accounts for over 80 per cent of the Islamic banking business[93] – will be examined.

15.30 The *murabaha* has been defined as "a fiduciary credit sale with a fixed and disclosed profit margin over the cost of the subject matter of the sale".[94] It has a pre-Islamic origin and its original purpose appears to have been to assist less knowledgeable purchasers in determining a fair price for unfamiliar goods.[95] Thus, it was more a form of trade rather than a method of trade finance.[96] However, the inherent flexibility of the *murabaha* structure means that it can be used to approximate many conventional financial transactions, which makes it the perfect mode of finance for the acquisition of assets, goods or commodities.[97] As well as serving a trade finance purpose, the *murabaha* can also be used for other purposes including liquidity and risk management and the raising of capital,[98] which explains why it lies at the core of much of the current Islamic finance industry's business. The basic features of the *murabaha* as a means of trade finance will now be discussed.[99]

A. Structure, Profit, and Fees

15.40 Like many nominate contractual forms, the *murabaha* is based on the contract of sale, and therefore must first meet the requirements of a sale contract under Islamic law. Those requirements can be summarised as being: a buyer and seller; an object – both the price of the contract and the consideration provided for this price; and an expression of offer and acceptance.[100] Several *shurut* are also read into sale contracts, meaning

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93 Warde, *Islamic Finance in the Global Economy* (n 30) 133.

94 Craig R Nethercott, '*Murabaha* and *Tawarruq*' in Craig R. Nethercott and David M Eisenberg (eds) *Islamic Finance: Law and Practice* (OUP 2012) 193 (hereafter Nethercott, '*Murabaha* and *Tawarruq*').

95 Ibid., 192-193.

96 Ibid., 193.

97 Ibid.

98 Ibid., 200-205 contains some case studies of the different uses of the *murabaha*.

99 Subsections I-VI below are based on the detailed description of the *murabaha* found in Nethercott, '*Murabaha* and *Tawarruq*' (n 95) at 193-197. Where other sources are used in addition, they will be referenced.

100 Umar F Moghul and Arshad A Ahmed, 'Contractual Forms in Islamic Finance Law and *Islamic Inv. Co. of the Gulf (Bahamas) Ltd. v. Symphony Gems N.V. & Ors*.: A First Impression of Islamic Finance' (2003) 27 Fordham International Law Journal 150, 167 (hereafter Moghul and Ahmed, 'Contractual Forms in Islamic Finance Law').

that the contract will not be valid if one of the parties is a child, or is not sane, or if the offer and acceptance are not given during the same contract session.[101]

15.41 In its most basic form in relation to trade finance, the *murabaha* involves a financial institution and a customer. The customer wishes to purchase an asset from a third party and engages the financial institution to do this. The financial institution (seller) then acquires title to the asset from the third party before entering into a sales contract with the customer (purchaser) where the seller discloses the initial purchase price of the asset and both parties agree upon a profit margin which the purchaser agrees to pay to the seller in addition to the initial purchase price and in consideration for the asset. Deferred payment terms are agreed and then title to the asset is transferred from the seller to the purchaser.

15.42 The disclosure of the price of the asset and the agreement of a profit margin are fundamental to the *murabaha* structure, which is categorised as a type of trust sale (*bay' al-amanah*). Without this step, the contract is a normal type of sale contract (*musawamah*). In addition to disclosing the initial price of the asset, the seller must also disclose whether they obtained the asset in question on deferred payment terms.[102] Once the price has been agreed it cannot be modified under any circumstances due to the prohibition on *riba* discussed above. Similarly, there can be no uncertainty as to the price, for that would amount to *gharar*.

15.43 There is debate between the schools as to how the cost price of the asset may be calculated. For example, and importantly in the trade finance context, can expenses such as insurance, transportation and packing be included within the cost price? The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), a respected standard setting body for the industry, follows the Hanbali view that any expenses such as those mentioned above can be added to the cost price, if they are disclosed by the seller and both parties to the transaction agree to it.[103] However, if such an expense is "customarily considered as normal" to the transaction at hand, then it can be included in the cost price without disclosure to the purchaser.[104] The cost price must not include a conventional upfront fee or facility fee in consideration for the

[101] Ibid., 167-168.
[102] It is not permissible to carry out a *murabaha* on deferred payment terms where the asset involved is gold, silver or currencies. See Accounting and Auditing Organization for Islamic Financial Institutions, 'Shari'ah Standard No (8) (Murabahah)' (AAOIFI, 2015) 2/2/6 (hereafter AAOIFI, 'Shariah Standard').
[103] AAOIFI, 'Shariah Standard' (n 103) 4/4/3.
[104] Ibid.

transaction,[105] which is an important difference between the *murabaha* and conventional trade finance methods such as the letter of credit.

B. Payment Schedule

15.44 The pre-agreed price may be paid at any time on a deferred basis, either in instalments or as a lump sum. There is no restriction as to the timing of the payments – parties are free to contract according to their commercial requirements – except that the payment timings be agreed as part of the sale transaction.[106]

C. Title to the Asset

15.45 The seller must obtain the title to the asset before it can be transferred to the purchaser. The ownership of the title to the asset must be real – although it can be actual or constructive depending on the nature of the asset[107] – and the seller need not take physical possession of the goods prior to selling them.

D. Agency

15.46 It is permissible for the financial institution to authorise an agent, other than the purchase orderer (customer), to carry out the purchase. Only in "dire need" should the customer be appointed to act as an agent. The agent must not sell the asset to himself. Rather the institution must first acquire title to the asset and then sell it to the agent turned customer, by allowing 'an interval of time between the performance of the agency contract and the execution of the contract of *murabahah*'.[108]

E. Possible Syndication

15.47 Like a letter of credit, a *murabaha* may be bilateral (involving only the purchaser and the selling financial institution) or may be syndicated. In a syndicated *murabaha* the seller would act as a *mudarib* (partner) alongside other financial institutions.

F. Actual Sale

15.48 It is a requirement of the *murabaha* transaction that the sale between the seller and purchaser be a valid one. Hence, it is not permissible for a purchaser to use a *murabaha* transaction to raise funds over an asset which they already own.[109] If there has been

[105] AAOIFI, 'Shariah Standard' (n 103) 2/4/1-2/4/2.
[106] AAOIFI, 'Shariah Standard' (n 103) 4/8.
[107] AAOIFI, 'Shariah Standard' (n 103) 3/2.
[108] AAOIFI, 'Shariah Standard' (n 103) 3/1/3-3/1/5.
[109] AAOIFI, 'Shariah Standard' (n 103) 2/2/1.

any dealing between the third-party supplier of the asset and the purchaser, that must be excluded from the *murabaha*,[110] and it is not permissible for an existing contract between the third-party supplier and the purchaser to be assigned to the financial institution so that it can be used in a *murabaha* transaction.[111] It is also not permissible to enter into a *murabaha* transaction if the customer wholly owns or owns a majority share of the supplier of the item. [112] This restriction is meant to prevent the so-called *bay' al-'inah* (a legal stratagem in which a person sells an asset to another for a deferred payment. Thereafter, the seller buys back the asset for a cash payment before having made full payment of the deferred price). AAOIFI forbids the contract as it views the stratagem as a means of avoiding the *riba* prohibition. However, the Sharia Advisory Council of the Malaysian Securities Commission and the National Sharia Advisory Council of Bank Negara Malaysia – the central bank – have made the *bay' al-'inah* a lawful Islamic standard.[113] Finally, the sale of the asset may not be concluded prior to the seller gaining title to it.[114]

G. Subject Matter and Liability for Defects

15.49 Regarding the subject matter of the *murabaha*, the rules on the nature of property discussed above apply. For example, it would be impermissible to conduct a *murabaha* agreement in relation to pork products for they are considered *haram*. Cash is also not permitted to be the subject of a *murabaha* as that would amount to *riba*, meaning that the refinancing of an initial *murabaha*,[115] or creating a *murabaha* over gold, silver, or other *ribawi* goods, is not permitted.[116] The seller may sell the goods without liability for defects provided that if the seller does not do so, liability remains for latent defects after the execution of the contract. This would entitle the buyer to sue the seller for any defects.[117] In practice, Islamic financial institutions acting as sellers will allocate the risk of defects to the purchaser which would then preclude any such action. Furthermore, the buyer is not able bring an action against the supplier as they are a third party to the supply of the goods. This latter aspect distinguishes the Letter of Credit from the *murabaha* for trade finance. However, in general, the *murabaha* approximates the balance of risks in the transaction that are found in a conventional letter of credit

[110] AAOIFI, 'Shariah Standard' (n 103) 2/2/2.
[111] Ibid.
[112] AAOIFI, 'Shariah Standard' (n 103) 2/2/3.
[113] Ercanbrack 'Standardization of Islamic Financial Law' (n 7) 16. Notably, the stratagem is regularly used throughout the industry in an important financing contract known as the *tawarruq.*
[114] AAOIFI, 'Shariah Standard' (n 103) 3/1/1.
[115] AAOIFI, 'Shariah Standard' (n 103) 2/2/7.
[116] AAOIFI, 'Shariah Standard' (n 103) 2/2/6.
[117] AAOIFI, 'Shariah Standard' (n 103) 4/9-4/10.

arrangement.[118] The following section sets out the steps of the *murabaha* agreement, highlighting the contractual structure and the risks that this poses to the financier and the buyer.

H. Phases of the *Murabaha* Agreement

15.50 There are five phases to a typical *murabaha* agreement. First, there is the documentation phase where the seller and purchaser first enter into an agreement. This agreement will detail the seller's financial commitment under the *murabaha* and will include representations and warranties by the purchaser as to its credit and credit-related events, trading activity (as seen in a conventional financing facility), positive and negative undertakings as to its activities during the term of the *murabaha*, and events of default which would permit the termination and acceleration of the purchase price.[119] Within this agreement, the mechanics of the other stages of the *murabaha* will be set out and perhaps specimen forms will be attached which represent the said phases.[120]

15.51 The conditions precedent to the seller's obligations under the *murabaha* will also be set out in this phase.[121] They will be very similar to those found in an equivalent conventional finance transaction – for example they are likely to include legal opinions on the legality and enforceability of the *murabaha*, and copies of corporate authorisations and authority.[122] An important condition precedent unique to Islamic finance in general is the requirement that a *fatwa* be delivered stating that the proposed *murabaha* is Sharia-compliant.[123] Finally, this documentation phase will include information on the place and time of payment, clauses relating to the resolution of disputes and the governing jurisdiction of the agreement, and other clauses that operate in the same way as their conventional finance equivalents.[124]

15.52 The second phase of the *murabaha* agreement is the request phase, when, after all conditions precedent are met, the purchaser notifies the seller of the asset that it wishes to purchase.[125] The seller then arranges to purchase the said asset and notifies the

[118] Kilian Bälz, 'A Murabaha Transaction in an English Court: The London High Court of 13th February 2002 in *Islamic Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems NV & Ors*' (2004) 11 Islamic Law and Society 117, 122 (hereafter Bälz, 'A Murabaha Transaction in an English Court').
[119] Nethercott, '*Murabaha* and *Tawarruq*' (n 95) 198.
[120] Ibid.
[121] Ibid.
[122] Ibid.
[123] Ibid.
[124] Ibid.
[125] Ibid.

purchaser of the cost price and the proposed profit. This is done in the form of an offer to sell which is conveyed to the purchaser.[126]

15.53 Following receipt of this offer, the purchaser in turn delivers a 'promise to purchase' the asset at a certain price.[127] Traditionally a promise was not considered legally enforceable in Islamic law as the proto-typical sale contract is characterised as an immediate exchange of countervalues and therefore is not promissory. Known as *wa'd* in Arabic, the promise in Islamic law is unilateral and future-oriented and while the fulfilment of promises is commendable, only Allah determines whether it will happen. Therefore, the majority of classical jurists have deemed the *wa'd* as non-binding.[128] However, as many modern Islamic financial structures depend on the *wa'd* to accommodate modern finance structures, albeit according to the form of classical Islamic rules, minority opinions that view the *wa'd* as legally binding have been appropriated. This is the case with the *murabaha* as a non-binding promise from the purchaser would be unacceptable to the selling financial institution which has to buy assets at the request of the purchaser. As a result, some jurists allow that the purchaser is liable to the seller for any losses caused by a failure to complete the *murabaha*, although this remains subject to debate among scholars and practitioners.[129] If documented as a purchase undertaking, however, the promise is enforceable in modern municipal legal systems.

15.54 In the fourth phase of the *murabaha*, the seller purchases the asset detailed in the offer to sell and the promise to purchase and takes title to it. Then the asset is resold to the purchaser.[130] Importantly, and as discussed above, the seller need not have actual possession of the goods. Constructive possession is satisfactory. The important element of possession is the assumption of risk that the asset may be lost or damaged between the purchase and resale. Of course, this is mitigated by having the period in

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[126] Ibid.
[127] Ibid.
[128] Marjan Muhammad, Hakimah Yaacob and Shabana Hasan, 'The Bindingness and Enforceability of a Unilateral Promise (Wa'd): An Analysis from Islamic Law and Legal Perspectives' (2011) 30 International Shari'ah Research Academy for Islamic Finance 4-7 (hereafter Muhammad et al., 'Bindingness and Enforceability of a Unilateral Promise'). The Ottoman *Majalla* of the mid-nineteenth century, which included the Hanafi School of Islamic contract law, defined contract as 'the obligation and engagement of two parties with reference to a particular matter', indicating that it had opted for validating the exchange of promises for future performance whereas the premodern jurists had refused to countenance this understanding of the law. See Mohammed, 'Islamic Contract Law' (n 88) 127-128.
[129] Nethercott, '*Murabaha* and *Tawarruq*' (n 95) 198-199.
[130] Nethercott, '*Murabaha* and *Tawarruq*' (n 95) 199.

which the seller possesses the asset in question be very small in duration.[131] After the above phases are all complete, the sale transaction is regulated in its operation phase by the terms of the *murabaha* agreement.[132]

I. Ensuring Performance

15.55 Prior to the completion of the transaction, the seller may take money in the form of a security deposit known as *hamish jiddiyyah* which may be drawn upon if the customer breaches his/her binding promise to purchase the asset.[133] In the case of breach, the institution is limited to deducting only the amount of actual damage incurred as a result of the breach. A charge for the lost profit is not permissible.[134] However, this security cannot cover loss or damage to the goods which is suffered whilst the goods are in the possession of the seller.[135] The seller alone bears these risks which, according to sharia, cannot be offloaded to the buyer prior to the transfer of title. Moreover, according to sharia, the seller's liability extends to any defects of the goods as the seller must bear the responsibility of ownership. In practice, however, financial institutions regularly exclude liability for the risks of defects in *Murabaha* contracts despite the clear contravention of ownership responsibilities per the sharia. Notably, it is permissible for the financial institution to obtain a personal guarantee from the purchaser of the good performance of the supplier when the purchaser has suggested a particular source of supply for the item that is the subject matter of the contract.[136] Ostensibly, 'good performance' would exclude the risks of defective goods, thus providing a means of limiting risk in these circumstances. Regarding the security (*hamish jiddiyyah*), it cannot be used to cover loss or damage to the goods which is suffered while the goods are in the possession of the seller.[137] During the operations phase, the seller can receive a third party guarantee of the purchaser's obligations which can be called upon if there is a default event or if the purchase price needs to be accelerated.[138] It is also common practice to take security over the purchaser's other collateral to secure the buyer's obligation under the *murabaha* agreement.[139]

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[131] Haider A Hamoudi, "Jurisprudential Schizophrenia: On Form and Function in Islamic Finance' (2007) 7 Chicago Journal of International Law 605, 612 (hereafter Hamoudi, 'On Form and Function in Islamic Finance').
[132] Nethercott, '*Murabaha* and *Tawarruq*' (n 95) 199.
[133] AAOIFI, 'Shariah Standard' (n 103) 2/5/3-2/5/4.
[134] Ibid.
[135] AAOIFI, 'Shariah Standard' (n 103) 2/5/2.
[136] AAOIFI, 'Shariah Standard' (n 103) 2/5/1.
[137] Nethercott, '*Murabaha* and *Tawarruq*' (n 95) 200. See also AAOIFI, 'Shariah Standard' (n 103) 2/5/2
[138] Ibid.
[139] Nethercott, '*Murabaha* and *Tawarruq*' (n 95) 200.

J. Default and Restructuring

15.56 As the purchase price is fixed in a *murabaha* agreement, there can be no penalty for late payment in the form of an increase to the amount due.[140] However, AAOIFI Standards allow for such a late penalty if it is put to a charitable purpose.[141] Non-penalty charges such as enforcement and recovery costs are recoverable from the purchaser.[142]

15.57 The acceleration of charges in the event of a default is possible in a *murabaha* agreement.[143] In the event of a default, any security may be realised and the subject matter of the *murabaha* may be repossessed, although both of those remedies are subject to availability within the enforcement jurisdiction specified in the initial *murabaha*.[144]

15.58 One of the limits of the nominate contractual system is the lack of freedom to amend contractual terms, which severely limits the ability of defaulting *murabaha* purchasers to restructure their initial agreement through variation of terms.[145] Such a restriction is not present in a conventional trade financing scenario.

VI. Islamic Trade Finance in English Courts

15.59 Now that the theory behind the *murabaha* agreement and its potential application in a trade finance transaction has been discussed, it is worth examining what happens when such an agreement breaks down and is subject to litigation. Do certain defences apply in the event of a default which are unavailable to defaulting parties in a conventional trade finance transaction? Is non-compliance with the features of a classical *murabaha* agreement grounds for the revocation of the agreement? To answer those questions, it will be necessary to analyse the relevant case law in this area.

A. The *Symphony Gems* Case

15.60 *Islamic Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems NV and others*[146] was the first instance of an English court ruling on a *murabaha* transaction

[140] Nethercott, '*Murabaha* and *Tawarruq*' (n 95) 207.
[141] AAOIFI, 'Shariah Standard' (n 103) 5/6 and Appendix D.
[142] Nethercott, '*Murabaha* and *Tawarruq*' (n 95) 207.
[143] Nethercott, '*Murabaha* and *Tawarruq*' (n 95) 208.
[144] Ibid.
[145] Ibid.
[146] [2002] ALL ER (D) 171 (Transcript) (QB) (hereafter *Symphony Gems*).

used for trade finance purposes,[147] and, although it is not an authoritative judgment, it is a useful case study on how English courts approach such transactions.[148]

15.61 According to the facts of the case, Islamic Investment Company of the Gulf (Bahamas) Ltd (IICG) and Symphony Gems had entered into an agreement on 27 January 2000, the structure of which was very similar to that described above. IICG was defined as the 'Seller' and Symphony Gems as the 'Purchaser', and the intent was to grant Symphony Gems "a revolving purchase and sale facility whereunder the Seller shall purchase supplies and immediately sell them on to the purchaser on deferred payment terms subject to conditions contained within the agreement."[149] The other defendants in the case signed as guarantors of Symphony Gems' obligations under the agreement.[150]

15.62 To make use of this revolving facility, the Purchaser was to request through an irrevocable offer that the Seller buy supplies from a specified supplier. After receiving this offer, the Seller was to confirm the offer by sending an acceptance to the Purchaser, before purchasing the supplies requested and reselling them to the Purchaser on deferred payment terms.[151]

15.63 Under this agreement, two offers were made by the Purchaser, which involved the purchase of a total of US$15 million worth of rough diamonds from a supplier based in Hong Kong and trading as Precious (HK) Ltd. The initial cost price of the diamonds was US$7.5 million per transaction, which – after the agreed profit margin was applied – meant that Symphony Gems owed IICG US$7,917,450 per transaction. This was to be paid in three instalments, due in July, September, and November of 2000.[152] For some reason, the diamonds were never delivered to Symphony Gems, so they were unable to pay any of the money owed. Following a lengthy correspondence between both parties, IICG brought the matter to court to recover the money owed, plus interest pursuant to a liquidated damages clause in the *murabaha* agreement, and damages, minus US$7.5million that had already been recovered from a bank guarantee that had been realised.[153]

[147] Bälz, 'A Murabaha Transaction in an English Court' (n 119) 118.
[148] Ercanbrack, *Transformation of Islamic Law in Global Financial Markets* (n 7) 224.
[149] *Symphony Gems* (n 147).
[150] Ibid.
[151] Ibid.
[152] Ibid.
[153] Ibid.

15.64 Various defences to IICG's claim were raised, the most important being the non-delivery of the goods, since that strikes at the heart of the difference between a *murabaha* and a letter of credit arrangement. Under a conventional arrangement, payment obligations are autonomous, meaning that the risk of non-delivery is borne by the purchaser alone.[154] The *murabaha* agreement attempted to imitate such a risk profile by stating that title to the supplies would pass immediately from the Seller to the Purchaser as soon as the Seller gained title.[155] Similarly, clause 4.4 provided that the instalments due were payable notwithstanding the Seller breaching any of its obligations – which, per Tomlinson J, must include a failure to deliver.[156] Ultimately, Tomlinson J noted that the defendants had failed to raise the defence of non-delivery at any point before the trial and had in fact taken up the issue of non-delivery with the supplier of the goods and not IICG.[157] This aided him in deciding that the defendants were responsible for arranging the delivery of the goods in question, and that the *murabaha* agreement was in fact "a financing agreement facilitating or apparently facilitating the purchase of supplies by the purchaser."[158]

15.65 A second defence raised by the defendants was the illegality of the *murabaha* agreement, both because its inclusion of a liquidated damages clause was in breach of the principle of *riba* and because the contract was to be performed in Saudi Arabia, where it would be illegal. Tomlinson J held that the contract did not require performance in Saudi Arabia and was able to avoid pronouncing on the legality of the *murabaha* agreement itself because clauses 25.1 and 26 of the agreement made reference to English law being the sole governing law of the agreement.[159] Thus, this case became a case requiring the interpretation of a contract under English law,[160] and as such expert evidence stating that the *murabaha* agreement was not a true *murabaha* agreement could be ignored.[161]

B. *Shamil Bank v Beximco*

15.66 Although it is not a trade finance case, it is worth briefly discussing the later case of *Beximco Pharmaceuticals Ltd & Others v Shamil Bank of Bahrain EC* due to its authority

[154] Bälz, 'A Murabaha Transaction in an English Court' (n 119) 124.
[155] *Symphony Gems* (n 147).
[156] Ibid.
[157] Ibid.
[158] Ibid.
[159] Ibid.
[160] Ercanbrack, *Transformation of Islamic Law in Global Financial Markets* (n 7) 225.
[161] Bälz, 'A Murabaha Transaction in an English Court' (n 119) 124.

in relation to the use of non-national legal systems as the governing law of a contract.[162] Here it was argued that a contractual clause stating that "Subject to the principles of the Glorious Sharia'a, this Agreement shall be governed by and construed in accordance with the laws of England"[163] should incorporate Sharia principles such as the prohibition of *riba* and the proper nature of a *murabaha* contract into agreements between the parties.[164] In response to this argument the Court of Appeal stated that mere reference to the Sharia was not enough to incorporate such specific provisions.[165] However, had the parties specifically incorporated such provisions into their agreements the defendants would have been likely to succeed.[166]

15.66 A further, and perhaps unintended, consequence of the *Beximco* decision was its definition of the *murabaha* as a sales contract.[167] Potter LJ states that both parties were content to "dress up" the transaction as a *murabaha* "sale […] whilst taking no interest in whether the proper formalities […] were actually complied with."[168] Thus, with respect to Islamic nominate contractual agreements, English courts will look to their substance and purpose through the lens of English contractual principles, absent any expressly incorporated Islamic legal principles to the contrary, rather than looking to the nominate contract system's rules.[169] This provides legal certainty to Islamic financial institutions contracting under English law that their bargains will be enforced even if they depart from the rules of the *murabaha* discussed above, but it also reduces the Sharia element of such contracts from a matter of law to being merely a private matter of compliance where parties are free to structure their transaction in accordance with sharia or not.[170] This has been criticised by those who see the *murabaha* transaction as having converged excessively with its conventional finance alternatives, differing only in form but not in effect.[171] Perhaps the case law cited above evidences their view that Islamic trade finance is based on mimicry, or perhaps it simply reflects the modern commercial

[162] [2004] EWCA Civ 19 (hereafter *Beximco Pharmaceuticals v Shamil Bank*).
[163] *Beximco Pharmaceuticals v Shamil Bank* (n 163) [1].
[164] *Beximco Pharmaceuticals v Shamil Bank* (n163) [49].
[165] *Beximco Pharmaceuticals v Shamil Bank* (n163) [52].
[166] *Beximco Pharmaceuticals v Shamil Bank* (n 163) [55].
[167] Jason C T Chuah, 'Islamic Principles Governing International Trade Financing Instruments: A Study of the Morabaha in English Law' (2006-2007) 27 Northwestern Journal of International Law and Business 137, 149.
[168] *Beximco Pharmaceuticals v Shamil Bank* (n163) [47].
[169] Ercanbrack, *Transformation of Islamic Law in Global Financial Markets* (n 7) 229.
[170] Ercanbrack, *Transformation of Islamic Law in Global Financial Markets* (n 7) 232; See also Kilian Bälz, 'Sharia Risk? How Islamic Finance Has Transformed Islamic Contract Law' (*Islamic Legal Studies Program, Harvard Law School, Occasional Publications*, September 2008) <https://pil.law.harvard.edu/wp-content/uploads/2019/12/Sharia_Risk_by_Kilian_Balz.pdf>
[171] See, for example Hamoudi, 'On Form and Function in Islamic Finance' (n 131) 613.

reality that trade finance is trade finance, regardless of the religion of the parties involved.

VII. The Future: Blockchain for Islamic Trade Finance

15.67 Blockchain technology is a new infrastructure for storing data and managing software applications. It is essentially a database comprising records of multiple transactions which are collected into a block. A block of entries is recorded in electronic form and contains a cryptographic hash of the preceding block, which allows the blockchain to be linked together. These are stored as a ledger and can be distributed globally without a central repository.[172] Essentially, anyone with an internet connection can retrieve information stored on a blockchain, allowing parties to engage directly with one another for a number of reasons including storing information, transferring value and coordinating social or economic activity. Furthermore, the transnational peer-to-peer networks upon which blockchain relies enable people to store non-repudiable data pseudonymously and in a transparent manner. When data is stored on a blockchain, its distributed network and consensus mechanisms and other characteristics, make it exceptionally hard to change or delete. No single party has the ability to modify or revise information once it has been recorded, lending it a great deal of transparency. However, the use of digital signatures and public-private key cryptography allows persons storing information on a blockchain to engage in transactions privately, without revealing their identity.[173]

15.68 Trade finance transactions can be given effect through blockchain-based smart contracts. Smart contracts are computer programmes that, once information has been given as an input, process that information according to rules set out in a contract and carry out actions as a result. Consisting of binary 'if…then' statements, terms are given as an input which, when fulfilled, are given effect. Smart contracts are automatically self-enforcing, meaning that they are able to carry out these actions without the intervention of a third party, reducing or possibly even eliminating the need for human oversight. Importantly, even though parties may have different incentives and are located in disparate countries, no single party can affect the execution of the smart contract's code. In this way, the parties can be assured that the contract will be performed irrespective of their trust in the other party. They must only trust the blockchain, which is capable of

[172] Margo Tank, David Whitaker and Patricia Fry, 'Smart Contracts, Blockchain, and Commercial Law' in *Smart Contracts: Is the Law Ready?* (Smart Contracts Alliance and Chamber of Digital Commerce, September 2018) 112-113 (hereafter Tank et al., 'Smart Contracts, Blockchain and Commercial Law').

[173] Primavera De Filippi and Aaron Wright, *Blockchain and the Law: Rule of Code* (Harvard University Press 2018) (hereafter De Filippi and Wright, *Blockchain and the Law*).

enforcing the parties' contractual terms.[174] Smart contracts can be used to deal with basic economic transactions at a lower cost, higher speeds and with greater reliability.[175] Blockchain used in combination with a smart contract will create a trade, logistics and supply chain infrastructure which incentivises Islamic trade finance to become significantly more efficient and transparent. These technologies will compel the industry to overcome its attachment to legal artifice in favour of adopting substantive trade practices that are more closely aligned with Islamic commercial principles.

15.69 Trade finance, in particular letter of credit transactions, involves multiple stakeholders and is highly labour and paper intensive. Trade transactions are not yet digitalised in spite of a spate of recent efforts. A single shipment of roses from Kenya to Rotterdam generates a pile of paper 25 cm high, while the cost is higher than the shipment of containers. On average more than 100 stakeholders are involved in this type of shipment.[176] These interactions are highly costly and have led a number of banks to explore blockchain as a means of automating the process, improving efficiency and enhancing security. Numerous proofs of concept have been developed successfully in the last few years and blockchain's commercial application is imminent. For example, in 2016, the Bank of America Merill Lynch, HSBC and the Infocomm Development Authority of Singapore developed a prototype using blockchain which mirrored a paper-intensive letter of credit transaction. Information between exporters, importers and their respective banks was shared on a permissioned blockchain, which was then executed through a series of smart contracts.[177] The prototype transaction illustrated that blockchain can streamline financial flows and enhance the security, transparency, speed and reliability of supply chain financing. Smart contracts will help to streamline trade finance transactions, particularly those related to conventional letter of credit transactions and its nearly identical Islamic alternatives. The technology will make the role of some involved parties, such as correspondent banks, redundant.[178] Notably,

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[174] Max Raskin, 'The Law and Legality of Smart Contracts' (2017) 1 Georgetown Technology Review 305, 319-320 (hereafter Raskin, 'Law and Legality of Smart Contracts').

[175] Michael Casey et al, 'The Impact of Blockchain Technology on Finance: A Catalyst for Change' (International Center for Monetary and Banking Studies, Centre for Economic Policy Research, 2018) (hereafter Casey et al., 'Impact of Blockchain Technology on Finance').

[176] Ian Allison, 'Shipping Giant Maersk Tests Blockchain-Powered Bill of Lading' (*International Business Times*, 14 October 2016) <https://www.ibtimes.co.uk/shipping-giant-maersk-tests-blockchain-powered-bills-lading-1585929?webSyncID=6ccc1e6b-089a-2b6d-810d-e60990b22563&sessionGUID=8871313c-992a-4279-3293-95100716e18d> accessed 14 August 2019

[177] The Bank of America Merill Lynch, HSBC and the Infocomm Development Authority of Singapore, News Release, 'BofAML, HSBC, IDA Singapore Build Pioneering Blockchain Trade Finance App' (10 August 2016) <https://www.about.hsbc.com.sg/-/media/singapore/en/press-releases/160810-blockchain-letter-of-credit.pdf> accessed 14 August 2019.

[178] Leisan Safina and Umar A. Oseni, 'The Potentials of Smart Contract in Islamic Trade Finance' (n 10) 226.

however, a *murabaha* transaction for trade finance purposes still necessitates the involvement of the bank as a seller as a loan with interest is not permissible under sharia. In sum, blockchain has the potential of levelling the playing field in relation to logistics and related party costs, which would be particularly helpful as companies from developing countries are faced with costs almost double that of their developed country peers.[179] These costs are the result of extensive paperwork and the fact that a wide array of stakeholders involved in border and customs procedures.

15.70 Islamic trade finance, not unlike its conventional counterpart, has traditionally catered to mid- to large-sized businesses. The complexity and cost of *murabaha*-based trade finance has limited its scope as the industry has not been able to extend its sources of revenue. *Murabaha*-based transactions include complex contractual drafting including numerous security documents, multiple legal opinions, seller-issued *fatwas* (Islamic legal opinion) and credit and payment services comprising a higher level of counterparty risk. These processes have made them unaffordable for smaller businesses, particularly those in developing countries where SME access to finance is particularly low.[180] The use of blockchain may open up the industry to these smaller players by creating a marketplace that is open to any importer or exporter. Blockchain reduces the degree of coordination effort amongst numerous stakeholders involved in a trade financing transaction by allowing all of the trade finance information to be brought into one trusted environment that can be accessed by the interested parties. Typically, stakeholders act in silo and in a sequential manner. Records, such as those of shippers, export brokers, import customs, banks and transportation providers, are kept separately. Any party can alter them, which makes the process vulnerable to fraud.[181] Where multiple authorisations are required for the export of a product, blockchain allows an exporter to submit the information just once. Agencies involved with the platform would then be able to validate the transaction or issue relevant documents.

15.71 A smart contract can easily be programmed to give effect to a *murabaha*-based trade finance agreement between the buyer (importer) and seller (Islamic bank). The *murabaha* sales agreement, including security documents, *fatwas* and legal opinions, can be recorded on a smart contract and shared between the importer (buyer) and the

[179] WTO Report 2018 (n 8) 45.

[180] According to the WTO, tariffs accounted for 9 per cent on average in 2013. A 2015 WTO study found that trade costs can amount to a 134 per cent ad valorem tariff on a product in high-income countries and a 219 per cent tariff in developing countries. These costs are largely the result of paperwork and the number of agencies involved in border procedures. See Emmanuelle Ganne, 'Can Blockchain Revolutionize International Trade?' (World Trade Organization 2018) 28-29 (Ganne, 'Can Blockchain Revolutionize International Trade').

[181] Ibid., 31.

exporter (seller) and the supplier. The smart contract also allows for recording the details of any agency agreement between the buyer and the seller in relation to the purchase of the asset or commodity. In real-time the Islamic bank or its buyer/agent will have the capability to review the agreement and to carry out the purchase of the goods on behalf of the importer/buyer. Once the goods are purchased, the seller can initiate a second smart contract detailing the sale of the goods to the buyer. As Islamic commercial law requires a separate meeting of the minds for each contract of sale, an entirely self-executing smart contract would contravene its rules, which are meant to provide clarity to contracting parties and thereby avoid *gharar*. Therefore, smart contracts incorporating *murabaha* transactions would require the same binding promise (*wa'd*) which, while putatively allowing the transactions to be carried out individually, binds the buyer to a legally enforceable purchase undertaking. The parties' agreement would still be required prior to each sales transaction, which, while slowing the execution of the smart contract, does not wholly denude the technology of its numerous advantages.[182] Blockchain's facilitation of easy access to data and end-to-end transparency of the entire value chain would create a level playing field for all parties involved in a trade transaction. The exchange of trade data including the trader's credit history increases the speed, efficiency and security of financing.[183] Other events along the supply chain such as a customs agent's confirmation of approval or the approval of a bill of lading would not require action by the bank.

15.72 The code of a smart contract is remarkably similar to many terms and conditions normally found in a contract. There has been a good deal of debate amongst legal scholars as to whether a smart contract constitutes a legally valid contract.[184] The balance of arguments now weighs heavily in favour of smart contracts being fully capable of giving rise to a legally binding contract under English and American common law as well as Spanish civil law legal systems.[185] A judicial taskforce of the United

[182] Contrary to the position as expressed in IFSB Report 2017 (n 9)116, which envisions trade finance as merely the seller's offer and the buyer's acceptance, rather than the complex chain of stakeholder interactions that take place over the course of a trade finance transaction. This is not the sole issue at sharia that may conflict with blockchain technology. A comprehensive analysis of the compatibility of sharia and blockchain is beyond the scope of this chapter.

[183] Mohamed and Ali, *Blockchain, Fintech and Islamic Finance* (n 9) 145.

[184] A comprehensive legal analysis is beyond the remit of this chapter. For a brief analysis which argues that smart contracts should not be equated with a binding contract, see Richard Howlett, 'A Lawyer's Perspective: Can Smart Contracts Exist Outside the Legal Structure? (2016) Bitcoin Magazine < https://bitcoinmagazine.com/articles/a-lawyer-s-perspective-can-smart-contracts-exist-outside-the-legal-structure-1468263134> Accessed 21 August 2020 (hereafter, Howlett, 'A Lawyer's Perspective'). See also Raskin, 'Law and Legality of Smart Contracts' (n 175), who argues that traditional legal jurisprudence will not be displaced and can help craft simple rules to accommodate this technology.

[185] Miren B. Aparicio Bijuesca, 'The Challenges Associated with Smart Contracts: Formation, Modification, and Enforcement' in Smart Contracts: Is the Law Ready? (Smart Contracts Alliance

Kingdom has concluded the same in a much anticipated public statement.[186] The sharia is capable of viewing smart contracts similarly as Islamic jurists are primarily concerned with the avoidance of prohibited elements in transactions, i.e. *riba* and *gharar* as well as what is recognised as legitimate property, e.g. excluding alcohol, pork, pornography, and armaments. The rules of contract formation, vitiating factors and remedies have largely been outsourced to municipal systems of law such as English and New York law which are the vehicular legal systems in which cross-border Islamic finance contracts are given effect. Jurists have been prepared to treat Islamic contractual rules far more flexibly than these seemingly fixed prohibitions as reflected in numerous contractual practices including the binding promise (*wa'd*) discussed above. Subsidiary rules can change with time and place and societal developments such as technological advancement.[187] Moreover, legal strategems known as *hiyal* are widely viewed as necessary tools which allow Islamic law to adapt to modern financial markets.[188] *Ḥiyal* are the means by which legal theory can be put into practice, narrowing the gap between ideals and reality.[189] Classical Hanafi jurists, in particular, viewed *hiyal* as the means by which one could make lawful that which otherwise is unlawful; to create what the Hanafis called '*makharij* ' (sg. *makhraj*) or 'exits'.[190]

15.73 Some have argued that an agreement to execute the code could be legally valid so long as the terms of the code was expressed in human language.[191] Indeed, more abstract legal concepts such as 'force majeure' or 'good judgement' may require a broader

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and Chamber of Digital Commerce, September 2018) 21-22 (hereafter Aparicio Bijuesca, 'Challenges Associated with Smart Contracts').

[186] A UK Taskforce has publicly declared that a smart contract is capable of satisfying the basic requirements of an English law legal contract. See UK Jurisdiction Taskforce, 'Legal Statement on Cryptoassets and Smart Contracts' (UK Jurisdiction Taskforce, November 2019) [136] (hereafter Taskforce, 'Legal Statement').

[187] Mohamad Akram Laldin and Hafas Furqani, 'Fintech and Islamic Finance: Setting the Shari'ah Parameters' in Umar A. Oseni and S. Nazim Ali (eds.) Fintech in Islamic Finance: Theory and Practice (Routledge 2019) 115 (hereafter Laldin and Furqani, 'Fintech and Islamic Finance').

[188] Ibid.

[189] Joseph Schacht, '*Das Kitab Al-Hijal Fil-Fiqh (Buch der Rechtskniffe) Des Abu Hatim Mahmud Ibn Al-Hasan Al-Qazuini*' (Orient-Buchhandlung Heinz Lafaire 1924), 6 (hereafter Schacht, 'Das Kitab').

[190] Satoe Horii, 'Reconsideration of Legal Devices (Hiyal) in Islamic Jurisprudence: The Hanafis and Their "Exits" (Makharij)' (2002) 9 Islamic Law & Society 312, 312-313 (hereafter Horii, 'Reconsideration of Legal Devices'). Historically, *hiyal* were employed in nearly all facets of life. Their use dealt with matters that extended far beyond strictly legal transactions to everyday aspects of life. However, the chapters of the *fiqh* devoted to spiritual matters *('ibadat*) comprise a much smaller proportion of *ḥiyal,* indicating that ritual worship is more closely aligned with the ideals of the law. See Joseph Schacht, 'Die Arabische Hijal-Literatur: Ein Beitrag Zur Erforschung Der Islamischen Rechtspraxis' (1926) XV Der Islam 211, 213 (Hereafter Schacht, 'Die Arabische Hijal-Literatur').

[191] Volker Nienhaus, 'Blockchain Technologies and the Prospects of Smart Contracts' in Umar A. Oseni and S. Nazim Ali (eds) *Fintech in Islamic Finance: Theory and Practice* (Routledge 2019) 198 (hereafter Nienhaus, 'Blockchain Technologies and the Prospects of Smart Contracts').

contractual framework, particularly in relation to complex transactions and associated definitions of non-operational clauses such as choice of law, competent jurisdiction or any dispute resolution mechanisms.[192] Furthermore, a written agreement has the advantage of providing a roadmap of the parties' contractual intentions as these may need to be investigated should the code give effect to unwanted outcomes. This is particularly so given the irreversibility of smart contracts which makes it nearly impossible for the code to be changed or stopped once the process has been activated. The outcome is recorded on the blockchain and is immutable.[193] While the immutability of the code is designed to minimise or even abolish disputes, inevitably human language which feeds into code is prone to error or ambiguity and disputes will arise. Because smart contracts are either in the process of being executed or have already been executed, the aggrieved party will need to go to the court to remedy a contract. In all cases, the remedy must come after the execution of the contract and reference to an agreement in human language will be necessary.[194] The sharia is capable of accommodating these operational requirements so long as its major principles remain intact.

15.74 A number of legal, regulatory and interoperability issues must be addressed, particularly in less developed countries, for the technology to deliver its potential. While a more detailed analysis is beyond the scope of this contribution, one final observation regarding electronic communications legislation is warranted due to its significance. Legislation recognising the validity of e-signatures, e-documents and e-transactions including blockchain transactions is essential.[195] A robust regulatory framework for the digital market is crucial in supporting consumer trust. Yet many developing countries have lagged behind in promulgating e-commerce legislation and other aspects of their legal systems such as consumer protection laws and data protection laws, which may explain why many consumers in developing countries actively engage in social media while they abstain from online shopping.[196]

VIII. Conclusion

15.75 The pace at which the technological revolution is reshaping the global economy is like nothing the world has ever experienced. It may provide technological solutions to the

[192] Aparicio Bijuesca, 'Challenges Associated with Smart Contracts' (n 187) 24.
[193] Nienhaus, 'Blockchain Technologies and the Prospects of Smart Contracts' (n 193) 198.
[194] Raskin, 'Law and Legality of Smart Contracts' (n 179) 322.
[195] Ganne, 'Can Blockchain Revolutionize International Trade' (n 181) xiii.
[196] WTO Report 2018 (n 8) 45. An example of an Electronic Communications Statute that recognises, enables and enforces the use of smart contracts is the Uniform Electronic Transactions Act in the United States. Tank et al., 'Smart Contracts, Blockchain and Commercial Law' (n 173).

development of industries or even entire countries which hope to 'leapfrog' their historical underdevelopment to the most modern technological stage. Perhaps the most famous example is Africa's use of mobile phones for banking and remittances, which almost entirely bypassed fixed-line technology.[197]

15.76 The digitalisation of Islamic trade finance via blockchain and smart contracts will help Islamic finance to standardise its financial practices, as the technology itself requires increased standardisation and platform interoperability for it to function optimally. While religious and ethical considerations must be given to this market-driven development,[198] there is undoubtedly much to applaud about blockchain's potential for streamlining inefficient trade finance practices, creating a level playing field, increasing transparency and reducing opportunities for fraud. That technological innovation would help Islamic finance to realise its commercial principles is not what its theorisers had in mind when they set out to create an Islamic economy. Perhaps this paradox says something important about the monumental changes that Islamic financial law has undergone in the modern, globalised world. It would seem that innovation of the kind we are on the cusp of experiencing in Islamic trade finance may be conducive to generating more ethical and transparent trade finance processes.

15.77 Furthermore, the eventual success of blockchain for Islamic and conventional trade finance can help the states of the MENA region to seize the technological moment, radically transforming their state-led, oil-dependent economies so as to meet their citizens' increasing social and economic demands. Whether this becomes reality depends on the extent to which data can be standardised across blockchain platforms, so that disparate parties communicate with one another using a similar data format. Standardised data sets relating to import, export, transit, transport and finance are the prerequisites to the exchange of information.

15.78 Moreover, the complexity of international trade cannot be simplified unless the underlying trade finance and customs clearing processes as well as bills of lading are completely digitalised. While some previous attempts at creating electronic bills of lading systems failed, notably SEADOCS,[199] blockchain may offer a route to managing data in this particular area. Blockchain technology has been used to issue and transfer

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[197] David Pilling, 'Are Tech Companies Africa's New Colonialists?' (*Financial Times*, 5 July 2019) < https://www.ft.com/content/4625d9b8-9c16-11e9-b8ce-8b459ed04726> accessed 14 August 2019.

[198] See Ercanbrack, 'Standardization of Islamic Financial Law' (n 6) for an account of the market and legal mechanisms underlying standardisation and the ethical questions which arise therefrom. Further research concerning the compatibility of Islamic commercial law and smart contract technology is necessary, in particular.

[199] Ganne, 'Can Blockchain Revolutionize International Trade' (n 181) 44.

electronic bills of lading. The challenges of implementing blockchain and smart contracts for trade finance are significant but with concerted effort, surmountable and revolutionary.