



TAY & HELEN WONG  
LAW PRACTICE • AMALAN GUAMAN

---

## LAW UPDATE

### SPECIAL ISSUE 2 OF 2008 (SEPTEMBER)

We bring you this Special Issue 2 of 2008 (September) to draw your attention to four recent High Court decisions on Islamic financing, which have serious impact on existing financing transactions that apply the Islamic concepts of Al-Bai' Bithaman Ajil, Al-Istisnaa, Bai Al-Inah and Murabahah.

#### **IMPORTANT**

*Readers are strongly advised not to rely or act solely on the basis of the material contained herein which is meant for general information only and which is not intended as legal advice. Individual circumstances do vary, so specific advice must be sought before undertaking any transaction, taking any action or making any decision. Any liability that may arise from any reliance on or use of any part of the contents in this publication is expressly denied.*

## FAR REACHING IMPLICATIONS ON ISLAMIC BANKING

### Al-Bai' Bithaman Ajil

Bankers and financiers (particularly Islamic banking industry) will have to be prepared for dire consequences following the recent High Court decision on the legality of Al-Bai' Bithaman Ajil (BBA) financing transaction as practised in Malaysia. For the benefit of our readers, BBA Financing is a commonly used Islamic house-financing facility which is based on the Syari'ah concept of Al-Bai' Bithaman Ajil. It is a contract of deferred payment sale ie. the sale of goods on deferred payment basis at an agreed selling price, which includes a profit margin agreed by both parties. The customer will identify the asset to be purchased and approach the bank which will purchase the asset concerned and then sells it to the customer at an agreed price which consists of actual cost of the asset to the bank and the bank's profit margin. The customer is to settle the selling price by instalment payment throughout the financing period<sup>i</sup>.

In *Arab-Malaysia Finance Berhad v Taman Ihsan Jaya Sdn Bhd & 2 Ors and a Third Party*<sup>ii</sup> (heard together with 11 other cases), the learned High Court Judge Datuk Justice Abdul Wahab bin Patail held that BBA financing transactions as practised in Malaysia may not be valid. He observed that it was common to different mazhabs of Islam that *riba* was prohibited. Whilst *riba* in the Qur'an was the same as "usury" in Judaism and Christianity, there was a lack of study on the terms of loan with *riba*. The prevalent view was that *riba* was the interest upon the loan. Thus, a profit upon a sale was allowed but interest upon a loan was prohibited in Islam. It was therefore essential to maintain the distinction between a sale and a loan. Such distinction must not only in form but also in substance. The court must look at the actual facts of each case in order to determine the substance of the transaction between the plaintiffs and the defendants before it draws any conclusion on the nature of BBA transactions.

In the BBA cases before the court, the defendants had already purchased the property from a third party, and had paid for part of the price. Approaching the respective plaintiff (bank) for a facility to complete their purchase, the respective defendant was required to sell the property he had bought to the respective plaintiff for that balance sum under a bank's property purchase agreement (PPA). The respective plaintiff then sold the property to the respective defendant under a bank's property sale agreement (PSA), wherein the respective defendant agreed to pay an agreed number of monthly instalments of specific sums. As security, the defendant was required to execute a charge or an assignment of the property to the plaintiff. The total of the agreed instalments added up to the bank's "selling price". No more was the vendor of the property involved, except to receive the balance of his selling price to the respective defendants. The effort to purchase directly from the original vendor and then to sell to the bank's customer had been abandoned. The learned Judge ruled that in such case, where the bank purchased directly from its customer and sold back to the customer with deferred payment at a higher price in total, the sale was not a *bona fide* sale, but a financing transaction, and the profit portion of such BBA facility rendered the facility contrary to the Islamic Banking Act 1983.

On the other hand, where the bank was the owner or had become the owner by a direct purchase from the vendor or under a novation agreement from its customer, the sale to the customer was a *bona fide* sale<sup>iii</sup>.

In cases where the sale is a *bona fide* sale (and thus BBA transaction is to be upheld), the bank's "selling price" must also be given an equitable interpretation. In this respect, the

#### **IMPORTANT**

*Readers are strongly advised not to rely or act solely on the basis of the material contained herein which is meant for general information only and which is not intended as legal advice. Individual circumstances do vary, so specific advice must be sought before undertaking any transaction, taking any action or making any decision. Any liability that may arise from any reliance on or use of any part of the contents in this publication is expressly denied.*

learned Judge pointed out that under the facility granted under the Islamic concept of BBA, a defaulting defendant would invariably be liable to an amount far larger than that he would have been liable to in a conventional loan with interest. This was due to the bank's claim for the total of all instalment payments not yet due to be brought forward as due and payable upon the termination and declaration by the bank of a default. In the learned Judge's view:-

"the Qur'an could hardly have intended that its followers, faithfully and trustingly seeking an Islamic compliant facility, should be delivered to those who offer what appear to be perfectly Islamic compliant facilities, but upon a default, had an interpretation applied that imposes a far more onerous liability than the conventional loan with interest. It is difficult to conceive that the Religion of Islam intended to discourage its followers from the conventional loan with interest, condemn lenders for such loans, and deliver its followers into the hands of banks and financiers who under the sale agreements with deferred payments, exact upon default, payments far exceeding the liability upon default of a conventional loan with interest. One cannot say that the Religion of Islam is so much more concerned with form than substance as would sustain the bank's interpretation of "selling price".

The learned Judge then adopted the equitable interpretation of the bank's "selling price" as propounded by him in the earlier controversial case of *Affin Bank v Zulkifli Abdullah*<sup>iv</sup>. It was a formula that determined the bank's selling price from the original facility amount to which was applied the bank's profit margin rate as derived from the terms of the agreement between the parties, but applied as at the time the facility was paid off (emphasis ours), meaning that the parties had agreed to a selling price upon a formula which produced the sum to be paid at the time the facility was paid off and the total sum in the agreement only represented the selling price if the full term was utilized. Such interpretation took away the harsh result inherent under the banks' interpretation. (For a better understanding of how the formula works, please refer to our featured write-up in Law Update Issue 2/2005 [on *Affin Bank v Zulkifli Abdullah*] and also Law Update Issue 4/2006 [on *Bank Muamalat Malaysia Bhd v Suhaimi Md Hashim*]).

Consequent upon his decision, in cases where the BBA transactions were held to be illegal and void, the banks were held to be entitled under section 66 of the Contracts Act 1950<sup>v</sup> to the return of the original facility amount they had extended. It means that BBA financing customers would only need to pay the original facility amount without the profit portion.

In summary, there are two major points flowing from the decision. Firstly, while the concept of Al-Bai' Bithaman Ajil is in principle Islamic in nature since no *riba* (interest) is involved, the current application or implementation or contractual structure of BBA financing transaction in some (or rather most) cases is defective as stripped of its label and form, deferred payment of sale price is effectively a credit or loan extended and profit arising in such transaction is *riba*, the very element prohibited in Islam. Secondly, then bank's interpretation of the "selling price" which resulted in the startling liability upon the customer must be dropped in favour of an equitable interpretation.

Having said that, the above decision is pending appeal at the Court of Appeal. There are also other decisions by other High Court Judges prior to *Arab-Malaysia Finance Berhad v Taman Ihsan Jaya Sdn Bhd & 2 Ors and a Third Party* and subsequent to *Affin Bank v Zulkifli Abdullah* that did not subscribe to the view of the learned High Court Judge Datuk Justice Abdul Wahab bin Patail. Thus, until and unless the Court of Appeal comes out with a decision, the state of law in this area can only be regarded as anything but certain.

#### **IMPORTANT**

*Readers are strongly advised not to rely or act solely on the basis of the material contained herein which is meant for general information only and which is not intended as legal advice. Individual circumstances do vary, so specific advice must be sought before undertaking any transaction, taking any action or making any decision. Any liability that may arise from any reliance on or use of any part of the contents in this publication is expressly denied.*

The same learned Judge also handed down four other judgments pertaining to other types of Islamic banking transactions.

### **Al-Istisnaa**

In *Tahan Steel Corporation Sdn Bhd v Bank Islam Malaysia Berhad*<sup>vi</sup>, the transaction in question is based on Al-Istisnaa concept. Istisna' is a sale transaction where a commodity is transacted before it comes into existence. It is an order to manufacture a specific commodity for the purchaser. The manufacturer uses his own material to manufacture the required goods.

In this case, the plaintiff is a customer while the defendant is the financier. The defendant purchased a project (which comprised a piece of land and a factory to be built on it) from the plaintiff at RM97 million and an asset purchase agreement was entered into. On the same day, the plaintiff resold the project back to the defendant at a price of RM185.36 million and an asset sale agreement was likewise entered into. The selling price was to be settled by the plaintiff by 40 quarterly instalments.

Not surprisingly, given his view in *Arab-Malaysia Finance Berhad v Taman Ihsan Jaya Sdn Bhd & 2 Ors and a Third Party*, the Judge ruled that the Al-Istisnaa' transaction as formulated contained an element contrary to Islam and was thus illegal and void *ab initio*. In his judgment, he made clear that the concept of Istisnaa' is not the issue but the implementation.

"The issue is that when a party sells a thing to another and then at the same time purchases it back from the party to whom it was sold, it is impossible to hold that the transaction was in fact a *bona fide* trade and intended as such. The Plaintiff is not the manufacturer but is itself the purchaser from a contractor to build the mill, and in addition needed the funds to redeem the land. This is self evident from the Al-Istisnaa' Purchase Agreement as well as the Al-Istisnaa' Sale Agreement between the parties. ... The essence of financing a customer's purchase, be it an Istisnaa' or Al-Bai' Bithaman Ajil financing is that the customer does not yet own the thing, and seeks financing to enable him to do so. The Al-Istisnaa' is similar in concept to the Al-Bai' Bithaman Ajil where payment of the sale price by an agreed number of deferred instalments, except that the Al-Istisnaa' applies in respect of things that are yet to be made or manufactured. The Al-Istisnaa' Purchase Agreement between the Defendant and the Plaintiff shows clearly in this case that the Defendant did not purchase from another but from the Plaintiff. It was evidently to release and make available to the Plaintiff money to be used by the Plaintiff, being the classic financing transaction. In itself, as financing, it is permissible, but the payments under the Al-Istisnaa' Sale Agreement show an increase of RM88,360,000.00, which in the case of financing, is the prohibited and condemned *riba* in the Religion of Islam. Nothing has been shown that an Istisnaa' transaction in the form and the manner conducted in this case has been approved by any recognized authority."

### **Al-Inah**

In *Bank Kerjasama Rakyat Malaysia Berhad v Fadason Holdings Sdn Bhd & 3 Ors*<sup>vii</sup>, the transaction in question is based on Bai Al-Inah concept. The Bai Al-Inah concept is a combination of two separate agreements, the first being the Al-Bai, meaning a sale by the financier to the client, and the second being the buy-back by the financier from the client. The purchase price paid by the financier under the second agreement and the deferred payments under the first agreement provides the client with immediate funds that he desired, and the facility to pay back over a period of time.

### **IMPORTANT**

*Readers are strongly advised not to rely or act solely on the basis of the material contained herein which is meant for general information only and which is not intended as legal advice. Individual circumstances do vary, so specific advice must be sought before undertaking any transaction, taking any action or making any decision. Any liability that may arise from any reliance on or use of any part of the contents in this publication is expressly denied.*

In this case, the facilities under the Islamic Bai Al-Inah concept (Facilities) were provided by the Facilitator (the plaintiff) selling five blocks of shares quoted in the Kuala Lumpur Stock Exchange to the Clients (the 1<sup>st</sup> defendant) for RM12.31 million (the Sale Price) to be paid by the Clients to the Facilitator by way of Deferred Payments of 18 monthly instalments. On the same day, the Facilitator purchased from the Clients the quoted shares at the purchase price of RM10 million (the Purchase Price), thus providing a profit to the Facilitator amounting to RM2.31 million, while the Clients obtained funds amounting to RM10 million.

Under the Bai Al-Inah structure in this case, “profit from trading” was made by the Facilitator by the sale of the 5 blocks of shares to the 1<sup>st</sup> Defendant under the Asset Purchase Agreement (APA), and the 1<sup>st</sup> Defendant obtained immediate cash it desired as payment from the sale of the 5 blocks of shares to the Facilitator under the Asset Sale Agreement (ASA). The 2<sup>nd</sup> to 4<sup>th</sup> defendants were guarantors.

Both the APA and ASA when read individually, and without knowledge of the other, could not be said, of each, to contain any element not approved by the Religion of Islam. They individually complied with Islamic requirements as to the formation of binding contract in the Islamic laws of financial transactions (*Fiqh al-Muamalat*). But, the APA and the ASA did not separately constitute to be a Bai Al-Inah transaction, which in essence was a combination of two transactions, being a sale with deferred payments and a buy-back. When the APA and the ASA were read together, it was apparent that the 1<sup>st</sup> defendant who wanted the Facilities obtained it from the Facilitator from the Purchase Price when the 5 blocks of shares were sold to the Facilitator under the ASA. The 1<sup>st</sup> defendant when proceeded to the Facilitator to obtain the facilities did not have the 5 block of shares at that time. It obtained the 5 blocks of shares by buying the same when it had no money, from the Facilitator, for RM12.31 million. It bought with money it did not have. Immediately upon buying the 5 blocks of shares, the 1<sup>st</sup> defendant sold it to the Facilitator to obtain the facilities of RM10 million at the same time. The 5 blocks of shares need not even change hands. Delivery of the 5 blocks of shares did not arise. Shorn of the cloak of the APA and the ASA, it was no different from a personal loan secured with personal guarantees and other security arrangements. A person could not buy with money he did not have. He could do so only if payment was deferred. There was no real reason why he could not sell, if he had title and possession even before paying the full selling price. But, if the buyer was the very same person who sold to him, and did so at the very same time, there was, even to the inexperienced and naïve human much more than meets the eye, let alone *Allah*, who would know the RM10 million facility was a loan, and the RM2.31 million was the increase when the loan was repaid at RM12.31 million. Such increase or profit might not have been expressed as a percentage but as a sum, but it was no less *riba* in a usurious loan. Therefore, the Bai Al-Inah transaction as implemented contained the element of *riba*.

The plaintiff was entitled against the defendants to the sum made available under the facility it provided but not to the part that was *riba*.

### **Al-Murabahah**

The Al-Murabahah Short Term Financing was the featured Islamic financing product in the case of *Affin Bank Berhad v Abdul Aziz bin Hidzir*<sup>viii</sup>. The defendant was an employee of MRCB which was quoted on the Malaysian Bourse. Eligible employees determined by MRCB were offered to purchase shares of MRCB at a pre-determined price under a scheme known as Employee Share Option Scheme (ESOS). The plaintiff agreed to finance the purchase by offering 100% margin of finance so that the employees need not come up with cash themselves. The plaintiff's margin was fixed at 10.35% per annum and payments may be deferred up to 180 days from the date of disbursement. The employee was required to deposit

### **IMPORTANT**

*Readers are strongly advised not to rely or act solely on the basis of the material contained herein which is meant for general information only and which is not intended as legal advice. Individual circumstances do vary, so specific advice must be sought before undertaking any transaction, taking any action or making any decision. Any liability that may arise from any reliance on or use of any part of the contents in this publication is expressly denied.*

additional shares or case, failing which the plaintiff have a right to dispose off the shares in the event the price of the shares financed by the plaintiff fell below the offer price + RM0.50 or any price determined by the plaintiff. The shares financed were to be pledged to and deposited with the plaintiff under a memorandum of deposit of stocks and shares.

The Al-Murabahah concept is a cost-plus sale. The bank when approached by customer to provide financing for working capital to purchase stock and inventories first purchases or appoints the customers as its agent to purchase the required goods on its behalf and settles the purchase price from its own funds. The bank subsequently sells the goods to the customer at an agreed price comprising its purchase price and a profit margin, and allows the customer to settle this sale price on a deferred term within a stipulated period.

The learned High Court Judge upheld the Al-Murabahah transaction in this case. It did not contain any element that was contrary to Islam. The commodity was purchased from a third party and not from the customer himself or through a 'buy back' agreement which was not allowed in Shariah. The defendant's contention on uncertainty of the share price and hence, giving rise to *gharar*, was rejected. The imposition of margin trigger and trigger price was held as not an element of 'shurut' which 'invoked the element of unjust to the defendant and put him at the mercy of the plaintiff in the event that the plaintiff misused its discretion'.

### **Al-Wujuh**

In *Arab-Malaysian Merchant Bank Berhad v Silver Concept Sdn Bhd*<sup>i</sup>, an Al-Wujuh facility was given by the plaintiff as agent and a consortium of banks and financial institutions comprising the plaintiff itself and another financial institution (collectively vendors) to the defendant to pay the development costs of a piece of land. The facility comprised Al-Bai Bithaman Ajil facility with a sale price of RM96.225 million and purchase price of RM60 million and revolving drawing rights on the account managed by the plaintiff as agent of the vendors relating to the revolving Al-Wujuh facility.

The learned Judge did not make any finding in this case as further examination and submissions as to the nature of the transaction described as an Al-Wujuh facility is required.

---

<sup>i</sup> Extract from Bank Negara website.

<sup>ii</sup> KLHC D4-22A-067-2003

<sup>iii</sup> This brings to mind the previous practice of banks in Malaysia which entered into a novation agreement with the purchaser(customer) and the developer.

<sup>iv</sup> [2006] 3 MLJ 67, featured in our Law Update Issue 2/2005 under the heading 'Recovery of Islamic Loan' and Law Update Issue 1/2006 under the Epilogue section.

<sup>v</sup> Under the said section, "when an agreement is discovered to be void, or when a contract becomes void, any person who has received any advantage under the agreement or contract is bound to restore it, or to make the compensation for it, to the person from whom he received it."

<sup>vi</sup> KLHC D4-22A-48-2003

<sup>vii</sup> KLHC D4-22A-380-2005

<sup>viii</sup> KLHC D4-22A-257-2004

<sup>ix</sup> KLHC D4-22A-145-2003

### **IMPORTANT**

*Readers are strongly advised not to rely or act solely on the basis of the material contained herein which is meant for general information only and which is not intended as legal advice. Individual circumstances do vary, so specific advice must be sought before undertaking any transaction, taking any action or making any decision. Any liability that may arise from any reliance on or use of any part of the contents in this publication is expressly denied.*

## CONTACT US

For further information, explanation or analysis of the subject matter covered in this issue or to provide feedback, please contact us at:

TAY & HELEN WONG  
LAW PRACTICE  
Suite 703 Block F Phileo Damansara I  
No. 9 Jalan 16/11  
46350 Petaling Jaya  
Selangor Darul Ehsan  
Malaysia  
Tel (603) 79601863 Fax (603) 79601873  
email: lawpractice@thw.com.my

If you wish to unsubscribe, please email us at [lawpractice@thw.com.my](mailto:lawpractice@thw.com.my)

To know more about us, please visit our website at [www.thw.com.my](http://www.thw.com.my)

### **IMPORTANT**

*Readers are strongly advised not to rely or act solely on the basis of the material contained herein which is meant for general information only and which is not intended as legal advice. Individual circumstances do vary, so specific advice must be sought before undertaking any transaction, taking any action or making any decision. Any liability that may arise from any reliance on or use of any part of the contents in this publication is expressly denied.*