

REINSURANCE MARKET UPDATE

CULTURAL DIVIDE

Get The Facts On Dispute Resolution Before Entering Into A Takaful Venture

Sharia-compliant transactions offer unique opportunities, but pose risks as well

BY ALUYAH I. IMOISILI

WITH ALL THE DOMESTIC financial chaos in the United States today, it's no surprise that many financial institutions—especially insurers and reinsurers—are seeking fresh, non-conventional, foreign sources of capital and revenue.

Many have been looking to countries such as Saudi Arabia, Bahrain, Malaysia and others in the Middle East and Southeast Asia that ascribe to Islamic law and its system of financing and insurance. Several U.S. insurers and reinsurers, in fact, have already established successful operations in the region, offering a range of Takaful (Islamic insurance) and ReTakaful (Islamic reinsurance) products.

But before other carriers join their insurance and reinsurance counterparts in a race for (Re)Takaful business, consider the ramifications of entering into such schemes in the event that disputes arise between the parties. Here are some questions that should be seriously considered before jumping into a (Re)Takaful transaction:

- ▶ Where should the action take place—in the United States or in a Sharia court abroad?
- ▶ What law should govern the dispute—domestic law or Sharia law?
- ▶ Should the dispute be handled in litigation or arbitration?

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To answer these questions, a basic understanding of how Islamic finance and (Re)Takaful transactions work is in order.

Islamic finance is a method of conducting business transactions congruent with principles of the Muslim faith—in other words, compliant with Sharia law or Islamic law. It is based on the Quran and teachings of Islamic scholars.



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Aluyah Imoisili

Sharia-compliant business transactions have existed for centuries, but were uncommon in the global arena until relatively recently. There was a boom in Sharia-related business activity in the 1970s due to an influx of petrodollars and the increased price of oil in the Middle East, and more recently, post Sept. 11, 2001, with the falling dollar, rise of Southeast Asian economies and increased price of oil.

Business deals under Sharia must be in line with the Islamic precepts, recognizing the supremacy and divinity of a higher authority, avoiding usury, promoting equity and encouraging fairness.

Expressly forbidden are transactions that involve interest on money (*riba*); forbidden goods or services, such as alcohol, pork, or gambling (*haram*); and speculative future transactions or contracts that involve uncertainty (*gharar*).

This latter prohibition on *gharar* made conventional insurance impermissible in countries that employ Sharia law.

Takaful stands for “guaranteeing each other.” It is a form of mutual insurance, where the participants subscribe to a fund designed to help members when they experience a prescribed mishap.

In addition, all participants share in the profits and losses from the investment activities of the fund. Typically, an independent, third-party Sharia advisory council approves the arrangement and monitors the fund's compliance with Islamic law. Islamic insurers are required to exhaust (Re)Takaful options before looking to non-Sharia sources for reinsurance coverage.

Two common models for (Re)Takaful are:

- 1 *Al-Wakalah*, where the participant hires the (Re)Takaful operator as an agent for the fund. The fund operator obtains its fees for investing and administrative activities from the fund. Profits, or returns on investment plus underwriting surplus, are paid as dividends to participants.

② *Al-Mudarabah*, where the participant and the (Re)Takaful operator are mutual partners in the (Re)Takaful fund. The participant contributes premiums and the operator handles investing and administration of the fund. Profits are shared proportionately among the participants and the (Re)Takaful operator.

Essentially, risk *and* profit-sharing underlie (Re)Takaful operations.

As with all business transactions, the possibility of disputes arising is present in a (Re)Takaful relationship. The risks to a U.S. insurer or reinsurer, however, are unique and the parties should analyze these risks at the inception of the contract.

The forum that the parties select, whether in the United States or in the Sharia-following country where the insurable interests reside, may affect the predictability of the litigation outcome.

U.S. courts have not analyzed many Sharia issues, and even fewer have considered (Re)Takaful concepts. Thus, there is very little U.S. precedent for how to analyze (Re)Takaful issues.

On the other hand, Sharia courts abroad have more experience dealing with Sharia-related legal issues and offer more expertise on these issues. Sharia courts, however, do not publish their opinions, so the predictability problem still exists. There is also the

possibility that a Sharia court will apply Sharia law more strictly than a U.S. court.

Assuming that the parties select a U.S. forum, the law that the parties choose to govern the contract may have interesting consequences on the parties' rights. If the parties do not include a choice-of-law provision, Sharia law may apply to the extent that the insurable interest is abroad and the parties' intent was for the contract to comply with Sharia law.

If Sharia law applies, a U.S. court may exclude certain claims and defenses that violate Sharia principles. For instance, U.S. courts have disallowed claims for damages based on lost future profits, on the grounds that such damages are speculative and prohibited as *gharar* under Sharia law.

Similarly, it is unlikely a court will allow for a strict application of late-notice defense to deny coverage altogether, because denying coverage on this basis may run counter to the notions of equity and fairness. There is also the risk that a party will argue that the (Re)Takaful contract is void because it violates the tenets of Sharia law.

Alternatively, the parties may select U.S. local law to govern the contract. In that event, it is likely that a U.S. court would exclude Sharia-related arguments and claims,

and focus on the contract language.

The parties may avoid some of the uncertainties that abound in litigation and prospectively contract to arbitrate their disputes. Because arbitration proceedings typically do not follow strict applications of substantive law, it might be a valid option for dealing with (Re)Takaful disputes.

U.S. arbitrators, however, may not have experience or expertise dealing with (Re)Takaful issues. Furthermore, the victor in arbitration may face difficulties trying to enforce the arbitration award in a Sharia law-employing country, especially if the award deviates from what is permissible under Islamic law.

The alternative—Sharia arbitration—has its own risks. A Sharia arbitrator might be biased in favor of applying strict interpretations of Islamic law.

So, while U.S. insurers and reinsurers consider capitalizing on Takaful and ReTakaful opportunities in the Middle East and Asia, they need to consider the consequences of those schemes on dispute resolution.

Forum-selection, choice of law and arbitration provisions are key to determining the parties' rights when a dispute arises. Hence, the parties should pay close attention to these provisions and determine what best suits their interests. ■

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