

DISPUTE RESOLUTION IN ISLAMIC FINANCE: A CASE ANALYSIS OF MALAYSIA

Umar A. Oseni ¹

Dr. Abu Umar Faruq Ahmad ²

The paper's purpose is to contribute to the existing body of work in the area of Islamic finance through the discovery of the feasibility of effective dispute resolution mechanisms for the resolution of disputes for Islamic banks and institutions offering Islamic financial services. This is investigated to determine whether the Sharī'ah framework for the enforcement of financial contracts and dispute resolution is a legal risk or appropriate alternative mechanism to the world as a whole, individual countries, the business environment, organisations and individuals. The research methodology employed in this study is an amalgamation of direct observation from legal and regulatory perspectives and case analysis of some landmark cases of the English and Malaysian courts. However, the Islamic legal framework remains the only hypothetical basis of the study. Through examining the above, the paper proposes to complement the civil court scheme with a hybrid feature of expert determination whereby the court would refer all issues pertaining to Islamic law to a recognised body of Sharī'ah experts for an opinion which would bind the court. Such body should be an independent arbitral tribunal, which may or may not be court-annexed, composed of Islamic finance experts whose decision is final. This will complement the work of the Financial Mediation Bureau, which has been handling small claims in banker-customer relationship. The paper concentrates on exploratory study of the viability of dispute resolution mechanisms for the resolution of Islamic finance disputes. The investigation has been supplemented by case analysis of some English and Malaysian courts.

Keywords: Dispute resolution, Islamic finance, Sharī'ah Advisory Council, Malaysian court, ADR

INTRODUCTION

The overwhelming growth and continuous expansion of the Islamic finance industry in the world during the last decade has been unparalleled. The faith-based finance, which spurns activities outlawed by Islam, is a viable ethical alternative to conventional financing. In addition to being legal under civil laws and tax and cost efficient, Islamic finance is also Sharī'ah-compliant. The dispute resolution framework in Islamic finance as practiced in most countries has proven to be inadequate, particularly in its application and interpretation of the Sharī'ah. Islamic law in Malaysia, which has a predominantly Muslim population that constitutes the Islamic economic sphere, is one of the major sources of law in the country. Islamic law is only applicable to Muslims and deals with property matters, matrimonial, and

¹ Visiting Research Fellow, Islamic Legal Studies Program, Harvard Law School. Email: umaroseni@gmail.com

² Associate Professor at Hamdan Bin Mohammed e-University (HBMeU), Dubai, UAE. Email: aufahmad@gmail.com

religious offences. The law of commerce and business is still either determined by statute law or English law. Shari'ah Courts only have jurisdiction over matters falling under the State list in the Federal Constitution. Islamic law is not applicable in the conventional Malaysian Judiciary, as it is administered separately in the Shari'ah courts. Consequently, Shari'ah compatibility in enforcement of financial contracts and dispute resolution becomes a legal risk.

Given the above mentioned legal complexity which Islamic finance casts over the law of the land, the study recommends to complement the civil court scheme with a hybrid feature of expert determination through mediation and arbitration whereby the court would refer all issues pertaining to Islamic law to a recognised body of Shari'ah experts for a binding decision which is enforceable in the court. This will facilitate the smooth running and operation of the Islamic financial system in the country. The study therefore explores the feasibility of alternative dispute resolution mechanisms as a form of resolving Islamic finance disputes. This paper is divided into two broad areas. The first is the mechanisms used to serve the resolution of disputes between parties involved in the Islamic banking and finance industry, as the study focuses on legal and regulatory perspectives on the problem. The second is the current legal and institutional framework for the resolution of Islamic finance disputes in Malaysia. This is investigated to determine whether Shari'ah compatibility in enforcement of financial contracts and dispute resolution is a legal risk to the Islamic finance industry.

The first section gives an insight into the modern history of Alternative Dispute Resolution (ADR) and the events that culminate into the paradigm shift to these forms of informal justice. The second section thereafter gives a brief overview of effective dispute resolution in Islamic law and the relevance of the ADR processes in Islamic law in modern Islamic finance disputes. The third section dilates on the dispute resolution framework in the Islamic finance industry in Malaysia through an examination of the institutional frameworks for the resolution of Islamic finance disputes. The recent trends in the resolution of Islamic finance disputes are also examined. The fourth section gives the conclusion, recommendations and potential areas for further research.

AN INSIGHT INTO THE HISTORY OF ALTERNATIVE DISPUTE RESOLUTION

Definition of alternative dispute resolution

Right from the time immemorial, dispute resolution has been practiced by humans of different generations because disputes are inevitable in human relationships. ADR is a range of processes for amicable resolution of disputes outside the formal court procedure or litigation where a third party neutral intercedes to resolve the dispute. Though its definition seems to be simple, there is an ongoing controversy on the actual meaning of ADR, the acronym often used for Alternative Dispute Resolution (Brown and Marriott 1999). The alternative processes give the idea of alternative to court litigation. However, some have referred to ADR as amicable dispute resolution while others prefer to merely call it. Whatever be case, ADR is an alternative to formal court litigation. When disputes are channelled through the formal court system, the parties tend to be farther from each other after the judgment because the judgment of the court leads to a win-lose situation where one of the parties rejoices with pomp while the other party wallow in anguish. In order to avoid a winner-takes-all syndrome as generally occasioned in litigation, effective alternatives were created which satisfies the needs of many litigants. The dramatic turn of events now shows

the complementary nature of ADR in litigation. ADR facilitates the administration of justice system and ensure speedy justice without compromising the rights and liabilities of the parties. In essence, ADR leads to a win-win settlement where the parties resolve the ensuing dispute amicably and secure the ongoing relationship.

Recent history of alternative dispute resolution

The recent history of ADR can be traced to the bold attempt by Roscoe Pound to redress the popular disaffection in the administration of justice system in the United States of America at the annual meeting of the American Bar Association in August 29, 1906. In his seminal speech, he highlighted the causes of general disaffection in the system and proposed a way forward (Pound 1912-1913). Despite the fact that some of the recommendations he made were not taken serious at the initial stage, the decades that followed his proposed reforms saw significant changes in the administration of justice system in America. The remarkable development spurred further developments in other jurisdictions across the world. Though there was that latent conception and practice of amicable resolution of disputes in other jurisdictions, the remarkable speech ushered in a regime of formalised ADR system in the modern world. The formalised court system began to appreciate their unutilised role of case management. Case management generally requires the court to facilitate amicable resolution of the dispute with some level of contribution by the parties while upholding the rights and liabilities of the parties.

As time goes on people begin to discuss the importance of access to justice and the manner at which the over litigation of the society has continuously denied an underprivileged segment of the society from formal justice through exorbitant cost of litigation and the protracted time it takes to successfully litigate a case from filing stage to the judgment stage (Resnik 1986). These, as well as other concerns, based on Pound's seminal speech constitute the "spark that kindled the white flame of progress" in the drive towards reforms in the administration of justice system (Wigmore 1937). Despite the fact that there were pockets of reforms across the world among different civilisations where amicable means of resolving disputes have been in place for some centuries, there were no formal systems of ADR as proposed by Pound. In the developed world, little or no attention was given to Pound's recommendations for the improvement of the administration of justice system through meaningful reforms. However, the accumulated backlog of cases in the United States signalled a new direction towards reforms in the 1960s. The anti-litigation wave emerged in the 1970s and by 1976, which marked seventy years after Pound made the remarkable speech, the Pound Conference was held. The need to improve the judicial system was highlighted during the conference (Kovach 2007: 1004). Frank E. A. Sanders of the Harvard Law School proposed what is known as Multi-door Courthouse where parties to a dispute are at liberty to choose from a variety of processes that is most suited for amicable resolution of the dispute. This significant conference ushered in a new era of court-annexed ADR that is now widely practiced across the world (Resnik, *Many Doors? Closing Doors? Alternative Dispute Resolution and Adjudication* 1995).

Remarkable reforms were experienced in the succeeding decades. In 1998, the Alternative Dispute Resolution Act³ was introduced in the United States. This was specifically introduced to reduce the increasing backlog of cases in the Federal courts through mandatory court-annexed ADR programmes. These mandatory court-referrals must be made as a preliminary step to court litigation. The court keeps a list of neutrals from which the parties

³ Alternative Dispute Resolution Act, 1998 (HR 3528). President Bill Clinton signed it into law on October 30 1998.

may choose after the court has ascertained the most suitable ADR process for the dispute. Section 3(a) of the ADR Act 1998 defines ADR as follows: “For purposes of this chapter, an alternative dispute resolution process includes any process or procedure, other than adjudication by a presiding judge, in which a neutral third party participates to assist in the resolution of issues in controversy, through processes such as early neutral evaluation, mediation, minitrial, and arbitration”. There is no doubt in the fact that this mandatory ADR programme has tremendously reduced the backlog of cases in the Federal courts.

Earlier on, there had been series of efforts to introduce reforms into the civil justice system in the United Kingdom. “Since 1851, there have been some 60 Reports on aspects of civil procedure and organization of civil and criminal courts in England and Wales itself” (Rashid 2002). The difficulties attending the adjudication of disputes in the courts brought about the most recent report, popularly called *Lord Woolf’s Report on Access to Justice*. This Report, which was submitted in 1996, significantly introduced far-reaching reforms in the civil justice system through the recommendation of court-annexed ADR as part of the case management role of the judge (Woolf 1996).

These reforms were meant to tackle head-on the negative aspects of litigation. Lord Woolf’s Report identified a number of the negative aspects of litigation apart from excessive cost. These aspects relate to excessive delay. The following five main areas of delay in litigation are summarised thus:

- a. *Delay in progressing the case from issue to trial.* In London, High court cases on an average took 163 weeks, elsewhere 189 weeks.
- b. *Delay in reaching settlement.* Majority of the cases took four and six years to settle. Late settlements involve the parties in substantial costs.
- c. *Delay in obtaining a hearing date.*
- d. *Delay due to time taken by the hearing.* No one knows for sure how long a hearing might last. Frequent adjournments and long submissions by the lawyers are mainly responsible for this, and no remedy appears to be available.
- e. *Low priority is given to civil cases,* because in criminal cases there is a prisoner in detention awaiting trial, so civil cases come for hearing after the judge finished the criminal business. As the number of criminal cases is usually larger than the civil cases, they consume much of court’s time. In recent times courts give more time to family cases than cases relating to business or contractual disputes (Woolf 1996; Rashid 2002: 5).

The recommendations contained in Lord Woolf’s Report were introduced in the amended Civil Procedure rules (CPR) in May 2000.⁴ Court referrals found their way, for the first time, into the CPR. As Mistelis rightly put it, “[t]he driving force behind the reforms was a combination of the lawyers involved in commercial litigation, a handful of academics, and the courts” (Mistelis 2003: 1). Rule 1.4 provides *inter alia*:

- (1) The court must further the overriding objective by actively managing cases.
- (2) Active case management includes —

⁴ Civil Procedure (Amendment) Rules 2000 (SI 221 of 2000). It should be observed that the Civil Procedure Rules are the rules of civil procedure used by the Court of Appeal, High Court of Justice, and County Courts in civil cases in the whole of England and Wales. The new rules came into force on 26 April 1999. The Rules were actually made in 1998. So, reference to the rules may sometimes read “Civil Procedure Rules 1998 (L17 No. 3132 of 1998). Some amendments were incorporated into it in 2000.

(e) encouraging the parties to use an alternative dispute resolution procedure if the court considers that appropriate and facilitating the use of such procedure;

...

(f) helping the parties to settle the whole or part of the case.⁵

This provision obliges the judge, as part of the case management role, to encourage the parties in a dispute to consider the use of an ADR process, and the court should facilitate the use of such procedure (Nesic 2001). Rule 26.4 CPR also enables the judge, either of its own initiative or with the agreement of both parties, to stay proceedings where they consider the dispute to be better suited to solution by alternative dispute resolution or other means. It is therefore the duty of the claimant to inform the court when settlement is reached.⁶ With this, ADR has been inducted into the courts in England as a procedural rule allowing the court to order parties to mediation (Trent 1999).

Islamic finance disputes cannot afford to suffer such protracted delays in the administration of justice system. The disputes emanating from the Islamic finance industry are *sui generis* that requires speedy and efficient framework for amicable resolution considering the need to secure ongoing business relationship and the recent fluctuations experienced in the financial markets across the world (Oseni and Hassan 2011).

Alternative dispute resolution in Malaysia

Amicable dispute resolution in Malaysia is as old as the culture of the people of Malaysia. There are recorded historical facts that reveal elements of dispute resolution in the cultures of the predominant tribes in Malaysia –Malays (Muhammad 2008), Chinese (Shijan MO 1999), and Hindus (Lahoti 1999). The customary values of these major races in Malaysia primarily provide for amicable settlement of disputes (Oseni 2010b). So, the formalised ADR introduced in the twilight of the 19th century was not new to Malaysia as a country. However, the models adopted by the court were based on best practices in Australia, United Kingdom and the United States. The court-annexed mediation programme is new to Malaysia as differentiated from the customary mediation practices common in the cultural heritages of the predominant cultures in the country. In 2000, the pilot project of court-annexed mediation was introduced in Penang. This project was a success but there was a need to amend the Rules of the High Court 1980 to allow for court referrals (Yiam 2009). For 10 years, there has been series of calls for reforms in the civil justice system to scale up the adjudication process in line with the advances experienced in other common law jurisdictions such as England, Canada, Australia and New Zealand.

As a welcome development in the civil justice system in Malaysia, the Chief Justice of Malaysia issued Practice Direction No. 5 of 2010 on 16 August 2010. This is the Practice Direction on Mediation (Mohamed 2010). So, for the first time, the civil courts are given a suitable framework to explore every amicable process of dispute resolution before proceeding for court adjudication. For the Shari'ah Courts, each state has its enactment on court referrals to *tahkim* (arbitration) popularly known as *hakam*, which was introduced in 1984. The Islamic Family Law (Federal Territories) Act 1984 ("IFLA 1984")⁷ introduced the

⁵ Rule 1.4(1) and (2) (e) - (f) CPR.

⁶ See Rule 26.4 (1)-(4) CPR.

⁷ There are corresponding Islamic Family Law Enactments across the States in Malaysia and they were modelled after the IFLA 1984 (Act 303). These enactments include Islamic Family Law Enactment 1990

framework for *Īakam* and the conciliatory committee. This court referral programme is purposefully meant for Islamic family disputes. Similarly, *sulh* (mediation) was introduced in the 1990s in the Malaysian Shari'ah Courts but the practice was consolidated in the next decade of 2000 where series of enabling enactments were made. Both the *sulh* and *hakam* programmes were meant for Islamic family disputes that fall within the jurisdiction of the Shari'ah Court (Abdul Hak 2006).

It should be borne in mind that despite the fact that Islamic law matters are state issues according to Federal Constitution,⁸ Islamic finance disputes are classified under the jurisdiction of the High Court (Mohamed Shariff 2005). Therefore, for this purpose, a Muamalat Bench was introduced at the Kuala Lumpur High Court in order to encourage a sort of expert determination of Islamic finance disputes albeit through adjudication. This Bench at the Commercial Division of the Court only hears and determines Islamic banking and finance cases.⁹ Despite the laudable efforts of this Bench as well as significant progress recorded over the years, certain problems have been highlighted. There is the problem of inadequate manpower to handle the increasing number of cases. This has led to a situation where other judges in the commercial division of the High Court who are not learned in Islamic finance hear and determine such cases. Judges who are ordinarily required to hear and determine conventional banking and finance cases now handle Islamic finance disputes. This has resulted in some untoward judgments that have attracted a lot of criticisms from Islamic finance practitioners. One aspect of the new Practice Direction on Mediation that would have been very useful to the amicable resolution of Islamic finance disputes is court-referrals. In order to encourage expert determination of Islamic finance disputes through amicable means, this Practice Direction on Mediation will play a significant role. But time will tell whether the judges in the Muamalat Bench practically consider the use of this Practice Direction.

(Johor) (No. 5 of 1990); Islamic Family Law Enactment 2002 (Kelantan) (No. 6 of 2002); Islamic Family Law (State of Malacca) Enactment 2002 (No. 12 of 2002); Islamic Family Law (Negeri Sembilan) Enactment 2003 (No. 11 of 2003); Islamic Family Law Enactment 1987 (Pahang) (No. 3 of 1987); Islamic Family Law (State of Penang) Enactment 2004 (No. 5 of 2004); Islamic Family Law (Perak) Enactment 2004 (No. 6 of 2004); Islamic Family Law Enactment 1992 (Perlis) (No. 4 of 1992); Islamic Family Law Enactment 1992 (Sabah) (No. 15 of 1992); Islamic Family Law Ordinance 2001 (Sarawak) (Cap 43); Islamic Family Law (State of Selangor) Enactment 2003 (No. 2 of 2003); Administration of Islamic Family Law Enactment 1985 (Terengganu) (No. 12 of 1985).

⁸ Article 74, Federal Constitution and section 1, Second List, Ninth Schedule to the Federal Constitution. Section 1 of the Second List in the Ninth Schedule provides in relation to the exclusive powers of State Legislature: "Except with respect to the Federal Territories of Kuala Lumpur and Labuan, Islamic law and personal and family law of persons professing the religion of Islam, including the Islamic law relating to succession, testate and intestate, betrothal, marriage, divorce, dower, maintenance, adoption, legitimacy guardianship, gifts, partitions and non-charitable trusts; Wakafs and the definition and regulation of charitable and religious endowments, institutions, trusts, charities and charitable institutions operating wholly within the State; Malay customs. Zakat, Fitrah and Baitulmal or similar Islamic religious revenue, mosques or any Islamic public places of worship, creation and punishment of offences by persons professing the religion of Islam against precepts of that religion, except in regard to matters included in the Federal List; the constitution, organisation and procedure of Syariah courts, which shall have jurisdiction only over person professing the religion of Islam and in respect only of any of the matters included in this paragraph, but shall not have jurisdiction in respect of offences except in so far as conferred by federal law, the control of propagating doctrines and beliefs among persons professing the religion of Islam; the determination of matters of Islamic law and doctrine Malay custom." Also see the Malaysian Supreme Court decision in *Mamat bin Daud v. Government of Malaysia* [1988] 1 MLJ 119 (SC) where the apex court held in its majority decision that only the State Legislature will have the exclusive powers to enact laws on Islamic matters.

⁹ See paragraph 2 of the Practice Direction No. 1/2003.

DISPUTE RESOLUTION IN ISLAMIC LAW

Muslim scholars have continuously argued that ADR has its source in the prime sources of Islamic law since it is a practice encouraged in Islam. Therefore, dispute resolution in Islamic law is a wide area of study that, though similar to the conventional practice of ADR, has its unique principles and concepts. The varieties of dispute resolution processes have been practiced at different momentum since the advent of Islam about 14 centuries ago. These processes are worth exploring and formalizing to suit the modern needs of Muslims across the world in their various endeavours.

Definition of dispute resolution in Islamic Law

There is no use of the term ‘Alternative Dispute Resolution’ in the Islamic sources but there are numerous references to amicable resolution of disputes. This has led modern Muslim thinkers to equate ADR to the Islamic ideals of dispute resolution encouraged in the Qur’an and Sunnah. For the purpose of this paper, the term ‘dispute resolution’ is used for the Islamic law paradigm. The definition of dispute resolution in Islamic law is in no way different from the earlier definition of ADR given above. However, one thing that is added is the underlying principle of all Islamic transactions, whether contractual or otherwise. This is the concept of *halal* (permissible terms) and *haram* (prohibited terms) in concluding a contract. As the dispute resolution clause is considered a binding contract between the parties, such must not involve the permissibility of what is prohibited under the law or the prohibition of what is expressly permissible under the law. All types of compromises or amicable settlement of disputes among disputing parties is permissible except settlements which make forbidden anything that is originally permissible in the eyes of the law and permit a thing that has been declared prohibited under the law (Zaidan 2007/1427).¹⁰

From the foregoing, dispute resolution in Islamic law can be defined as a range of processes for amicable resolution of disputes either as court-annexed processes or outside-court-settlement by a third party neutral based on the Islamic worldview without compromising the fundamentals of Islamic law. This is where another problem being faced in Islamic finance industry lies. In a bid to adopt ADR, conventional arbitration tribunals that specialise on banking and finance are now handling Islamic finance disputes. This is a counter-productive approach towards solving the challenges posed by litigation of Islamic finance disputes. A step towards the introduction of a new framework for the resolution of Islamic finance disputes has led to the emergence of another problem (Oseni 2010a). As will be seen below, Islamic law has its unique standards and requirements for arbitration. If a proper Islamic framework is not introduced for the arbitration of Islamic finance disputes, the repercussion of arbitrating such disputes under conventional arbitration rules may be devastating in the long run.

¹⁰ This is a popular hadith which was reechoed in the principles enumerated in Caliph Umar’s letter to Abu Musa Al-Ash’ari on the latter’s appointment as a judge. An aspect of this letter which deals with mediation as part of the case management apparatus of the court is the text of the hadith narrated by Amr bin Auf who narrated that the Prophet Muhammad (S.A.W.) said: “Conciliation is permissible among Muslims except the one which makes permissible what has been forbidden or forbids what has been permitted.” This hadith was related by al-Tirmidhi, Abu Dawud, Ahmad and Ibn Majah.

Processes of dispute resolution in Islamic law

The dispute resolution processes in Islamic law are meant for different types of disputes and some are relevant at various stages of a dispute. The Islamic concept of dispute resolution is a continuum of not less than nine processes of dispute resolution. The common processes of dispute resolution in Islamic law are (Rashid 2004):

- i. *Nasihah* (Counselling);
- ii. *Sulh* (Negotiation, mediation, conciliation, compromise of action);
- iii. *Tahkim* (Arbitration);
- iv. Med-Arb (A process that begins with mediation and ends in arbitration);
- v. *Muhtasib* (Ombudsman);
- vi. *Wali al-Mazalim* (Chancellor or Ombudsman Judge);
- vii. *Fatwa of Mufti* (Expert Determination);
- viii. Med-Ex (A combination of mediation and expert determination); and
- ix. *Qada* (adjudication).

The treasure-trove contained in these processes has not been fully explored in the modern practice of ADR (Oseni 2011; Yaacob 2009; Oseni 2009; Othman 2007; Zahraa and Abdul Hak 2006; Othman 2005; Rashid, 2004; Masud, Messick and Powers 1996; Al-Mawardi 1983; Khalil 1976). In fact, the Muslim countries tend to adopt the conventional practices rather than looking inwards to formalise some of these processes that have been practiced for centuries. Though most of these dispute resolution processes are relevant to most contractual disputes, not all are relevant to Islamic finance disputes. We shall shed some light on the most relevant processes in the next sub-section. The mostly used processes in Malaysia are *sulh* and *tahkim* for the resolution of family disputes in the Shari'ah Court. Meanwhile, expert determination is used in most cases inadvertently for the purpose of dispute avoidance. The Shari'ah Advisory Council of the Central Bank of Malaysia plays this important role, which has helped in the avoidance of foreseeable disputes in the Islamic finance industry in Malaysia.

Relevance of alternative dispute resolution in Islamic finance disputes

The repeated instances of Islamic finance litigation in the civil courts call for the need to have an Islamic framework for the resolution of Islamic finance disputes. There is no doubt in the fact that Islamic finance disputes can be best resolved through Islamic processes of dispute resolution and not otherwise. As earlier observed, Islamic finance disputes require speedy and efficient processes owing to the nature of business disputes and the need to secure ongoing business relationship and avoid unnecessary public attention, which may affect the credibility of the financial outfit. We must decide which way to follow: whether to adopt the conventional ADR processes or look inwards to evolve relevant processes for Islamic finance disputes.

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), a body that issues global standards on different aspects of Islamic finance, has issued the standard on arbitration. This is yet to be fully utilised by the Islamic banks and financial institutions including those in Malaysia. The AAOIFI standard on Arbitration is a welcome development, which mirrors the unique features of Islamic arbitration (Oseni, 2010a). Unfortunately, the Islamic banks and financial institutions in Malaysia and elsewhere only adopt other standards, which they feel affect their daily transactions while neglecting the

aspect of arbitration. In cases of default, it is common for Islamic banks to head for the court rather than giving effect to the AAOIFI standard on arbitration. It is appalling to observe that many Islamic finance practitioners have continued to neglect dispute resolution in Islamic finance in their policies and practices. Rather, they have focused on other areas that directly affect the profit and risk involved in financial transactions. It must be mentioned here that if care is not taken, the courts will eventually restructure all Islamic finance transactions in line with their limited understanding of the dynamics of most transactions (Oseni 2011).

As one of the countries with the most successful experiments of Islamic finance in the modern world, Malaysia is also leading in the increasing number of Islamic finance disputes. The number of cases has continued to rise by every passing day. The only Judge in the Mu`amalat Bench of the Commercial Division of the High Court in Kuala Lumpur is Dato' Rohana Yusuf who has considerable experience and expertise in Islamic finance. But a judge may not be enough for the current backlog of cases in the court. If the status quo is to be maintained, the Mu`amalat Bench has no choice other than embracing ADR or implementing the instructions in the Practice Direction on Mediation. This will enable the learned judge to be able to make requisite court referrals to expert arbitral panels or tribunals. Another option is to refer the parties to the Financial Mediation Bureau for mediation. Once a settlement is reached, the court may adopt such terms of settlement as consent judgment. The complexities involved in Islamic finance transactions require expert determination and there is a framework for court referrals to such in the current arrangement.

The Practice Direction on Mediation, if properly utilised, would be a veritable tool for the quick dispensation of justice through expert determination. According to the Practice Direction, all judges are required to "give such directions that the parties facilitate the settlement of a matter before the court by way of mediation". This is to encourage the parties to amicably arrive at an early settlement without necessarily going through the rigors of a complete trial in the court. The advantages of settling the dispute in line with the Practice Direction include: Parties are able to explore all options available; Underlying issues and common grounds may be identified; Good relationships are restored and maintained; Terms agreed upon would be acceptable to both parties; Settlement is expeditious; No delays in court hearings; and Terms of settlement are final. This court-annexed mediation is in line with *sulh* but one thing that must be emphasized is the need to make court referrals to experts in Islamic finance, and not just mediators on the court's list of neutrals.

There are two modes of referrals to mediation in the Practice Direction. The parties are given the option to choose based on the principle of party autonomy. Option A provides for judge-led mediation while Option B provides for the appointment of a mediator agreeable to the parties. The explanation given for these two options as contained in the Practice Direction is reproduced below.

Option A: Judge-led Mediation

1. Unless agreed to by the parties, the Judge hearing the case should not be the mediating Judge. He should pass the case to another judge. If the mediation fails then it will revert to the original judge to hear and complete the case.
2. The procedure shall be in the manner acceptable to both parties.
3. Unless agreed to by the parties the Judge will not see the parties without their lawyers' presence except in cases where the parties are not represented.
4. If the mediation is successful, the Judge mediating shall record a consent judgment on

the terms as agreed to by the parties.

Option B: Court-referred Mediation

1. Mediator

- 1.1 A mediator may be chosen by the parties from the list of certified mediators furnished by the Malaysian Mediation Centre (“MMC”) set up under the auspices of the Bar Council, or any other mediator chosen by the parties.
- 1.2 Such a mediator shall facilitate negotiation between the parties in the dispute and steer the direction of the mediation session with the aim of finding a mutually acceptable solution to the dispute.
- 1.3 If the parties so desire, they may appoint more than one (1) mediator to resolve their dispute.
- 1.4 Any mediator so chosen by the parties may agree to be bound by the MMC Code of Conduct and the MMC Mediation Rules, or not at all.

2. Procedure

- 2.1 If the parties agree that they be bound by the MMC Mediation Rules, upon direction of the Court, the Plaintiff’s solicitor shall, within (7) calendar days notify in writing to the MMC. Upon receiving such notification, MMC shall then proceed with the mediation process as provided under the MMC’s Mediation Rules.

3. Settlement Agreement

- 3.1 Any agreement consequent upon a successful mediation may be reduced into writing in a Settlement Agreement signed by the parties but in any case the parties shall record the terms of the settlement as a consent judgment.

This is a commendable effort on the part of the Malaysian judiciary but there is still further room for improvement. Expert mediators in Islamic finance should be identified and appropriately utilised in the Muamalat Bench of the High Court of Malaya. The MMC may assist the court in identifying leading experts in the field of Islamic finance who will exclusively sit to mediate disputes involving Islamic financial transactions.

DISPUTE RESOLUTION IN THE ISLAMIC FINANCE INDUSTRY IN MALAYSIA

The dispute resolution framework for the resolution of Islamic finance disputes in Malaysia has assumed an advance stage in the modern world. The prime stage of this aspect of the Islamic finance industry in Malaysia and the recurrent regulatory and legal reforms being introduced to improve the delivery of Islamic financial services is enviable considering the diverse rate of development of the industry across different jurisdictions in the world. The current institutional framework for the resolution of Islamic finance disputes is encouraging but to what extent the Islamic finance practitioners and financial institutions have utilised the frameworks necessities further analysis. The dynamics of the growing case law on Islamic finance have been studied and are worth further exposition to streamline the process of dispute resolution in the industry (Yaacob 2011).

Institutional framework for dispute resolution in Islamic finance industry in Malaysia

There are several institutions in Malaysia that undertake the services of resolving Islamic finance disputes through mediation, arbitration or through any other process. Though these bodies are setup under different auspices, they tend to achieve a common goal. A quick

overview of the institutional framework for ADR for Islamic finance cases include the following bodies:

- i. Kuala Lumpur Regional Centre for Arbitration
- ii. Financial Mediation Bureau
- iii. Sharī'ah Advisory Council of the Central Bank of Malaysia
- iv. Malaysian Mediation Centre

i. Kuala Lumpur Regional Centre for Arbitration

The Kuala Lumpur Regional Centre for Arbitration (KLRCA) is a dispute resolution body established under the auspices of the Asian-African Legal Consultative Organisation (AALCO) in 1978 (Lau 2009). It provides institutional support as well as a convenient venue for domestic and international arbitrations. It introduced the Rules for Arbitration of Kuala Lumpur Regional Centre for Arbitration (Islamic Banking and Financial Services) in 2007 to encourage the use of arbitration for disputes emanating from Islamic financial services. According to Rule 1, para 3, “These Rules shall be applicable for the purposes of arbitrating any commercial contract, business arrangement or transaction which is based on Shariah principles.” Though the Rules have been criticized as being a complete replica of the UNCITRAL Arbitration Rules of 1976 with some modifications to suit the specific needs of parties in Islamic financial transactions (Oseni 2009), it represents a significant innovation in the drive towards introducing better ways of resolving disputes in the industry. At present, there are 23 panelists for Islamic banking arbitration, one of who is from Singapore.¹¹ During an informal discussion with one of the arbitrators, she revealed that not more than two cases have been arbitrated under the KLRCA Rules since 2007. This is discouraging, as many of the Islamic banks and financial institutions prefer to head to the court to get their money in cases of default rather than arbitration. As earlier observed, many of the Islamic banks and financial institutions prefer to adopt other standards of AAOIFI on that regulate their transactions rather than implementing the AAOIFI Standard on Arbitration. This situation is appalling and calls for concern from all the stakeholders in the industry.

ii. Financial Mediation Bureau

The Financial Mediation Bureau (FMB) is an amalgam of the erstwhile Banking Mediation Bureau and Insurance Mediation Bureau. The two earlier bodies were independent initiatives by Islamic banks and financial institutions closely supported by the Central Bank of Malaysia. While the Banking Mediation Bureau handled Islamic banking issues between customers and banks who are its members, the Insurance Mediation Bureau provides a simple process for the resolution of insurance disputes. The whole process is simple, efficient and without costs on the part of the customers or the financial institution. The two bodies were merged in January 2005 and the FMB was established (Segara 2009). The FMB provides dispute resolution services to customers and their financial services provider. As an alternative to the court system, FMB provides free, fast, and efficient to customers and their financial services providers who are members. The body is under the close supervision of the Central Bank of Malaysia. A number of banks and financial institutions in Malaysia are members of FMB, including about 16 Islamic banks and financial institutions. Unlike the KLRCA, the FMB is very active in its service delivery in the Islamic finance industry because it is cost-effective and fast. From the case review released by FMB, most of the cases are petty disputes involving banker-customer relationship such as loss of deposits over the

¹¹ For a complete list of the panelists, their affiliations, expertise and addresses, see Islamic Banking Arbitrators, Kuala Lumpur Regional Centre for Arbitration at [http://www.klrca.org.my/KLRCA's_Panellists-@-Islamic_Banking_Arbitrators.aspx]

counter and unauthorized ATM withdrawal. This is due to the limited jurisdiction. The FMB can only handle disputes, claims or complaints involving financial loss of which the amount claimed does not exceed RM100,000 for banking and financial related matters. The exceptions to this are fraud cases involving payment instruments, credit cards, charge cards, ATM cards and cheques whose maximum limit is set at RM 25, 000. On the other hand, the maximum claim in disputes, claims or complaints involving insurance or *takaful* must not exceed RM200,000 in motor and fire insurance/*takaful* and RM100,000 for others. Since it is the parties who head to FMB for the amicable resolution of a case with their financial service provider, the FMB handles a lot of cases unlike instances where the bank seeks to recover its money from defaulting customers through litigation.

iii. Shari'ah Advisory Council of Central Bank of Malaysia

People, including many Islamic finance practitioners, tend to believe the Shari'ah Advisory Council (SAC) of Central Bank of Malaysia is only an advisory body saddled with the responsibility of performing its statutory functions. There is more to its functions, which is not expressly mentioned in section 51 of the Central Bank of Malaysia Act 2009 (CBM Act).¹² As the principal advisory body on Islamic financial services at the apex bank, SAC occupies a key position in respect of dispute resolution and dispute avoidance in Islamic law. Before unravelling the key role being played by SAC and the far-reaching effect in dispute avoidance in the Islamic finance industry, it may be necessary to enumerate the provisions of section 51 of the CBM Act on the functions of SAC.

The Shariah Advisory Council shall have the following functions:

- (a) to ascertain the Islamic law on any financial matter and issue a ruling upon reference made to it in accordance with this Part;
- (b) to advise the Bank on any Shariah issue relating to Islamic financial business, the activities or transactions of the Bank;
- (c) to provide advice to any Islamic financial institution or any other person as may be provided under any written law; and
- (d) such other functions as may be determined by the Bank.

These functions serve two important purposes in ADR; dispute resolution and dispute avoidance. But the kernel of the functions is more of dispute avoidance. In simple terms, when there is a reference of a Shari'ah issue from the court or arbitral tribunal, SAC ascertains the Islamic law on such a matter and issue a ruling which is considered in the final judgment or award of the court or arbitral tribunal respectively. Section 57 of the CBM Act provides that any ruling made by SAC pursuant to a reference made by either a court or arbitral tribunal shall be binding on such body. This helps in resolving the dispute expediently, effectively and promptly. The ruling of SAC at such instances of referrals serves as a catalyst that facilitates the quick disposal of the dispute. However, section 56 (1) of the Act provides for instances where the published rulings of SAC may serve as dispute avoidance mechanism. Any published ruling of SAC must be taken into consideration by the court or arbitral tribunal in any proceedings relating to Islamic financial business where any question arises concerning a Shari'ah matter. The published rulings are also reviewed and considered by the Shari'ah Advisory Committees of Islamic banks and financial institutions in Malaysia where reasonable steps are taken to streamline all contracts and financial dealings to avoid unforeseeable disputes with customers. The ultimate reference of the Shari'ah Advisory Committees is the ruling of SAC on any transaction in question. The

¹² Act 701 of 2009.

publication of the rulings and guidelines of SAC allows potential investors, customers and the financial institutions to understand their rights and liabilities with regard to certain contracts in question. Therefore, SAC is more than a mere financial advisory body but may also be considered as a dispute resolution and dispute avoidance body.

iv. Malaysian Mediation Council

The Bar Council of Malaysia established the Malaysian Mediation Council (MMC) as a foremost body for both institutional and ad hoc mediation on 5th of November 1999. This was the end result of the recommendations of the Alternative Dispute Resolution Committee set up by the Bar Council in 1995 to look into the possibility of establishing a world class Mediation Centre in Malaysia. The services of the MMC include mediation services, assistance and advice on how to get the other side to agree to mediation if one party has shown interest, and provision of mediation training for those interested in becoming mediators. It also accredits trained mediators and maintains a panel of mediators. Over the years, there have been concerted efforts to form a formidable synergy with the judiciary by encouraging the parties to a dispute to explore ADR processes as part of the pre-trial procedures (Bukhari n.d.). These efforts by the Bar Council were consolidated with the issuance of the Practice Direction on Mediation in August 2010. As cited above, the Practice Direction expressly provides for the use of MMC Code of Conduct and Mediation Rules. Except otherwise provided by the parties, all court referrals are made to a mediator appointed from the list of neutrals furnished by the MMC. The Muamalat Bench of the Commercial Division of the High Court of Malaya will also have course to refer Islamic finance disputes to qualified mediators. Such mediators who have requisite expertise in the practice of Islamic finance with many years of experience should be exclusively considered for this purpose.

Current trends in Islamic finance litigation in Malaysia

The litigation of Islamic banking and finance disputes in Malaysia dates back to 1985. Once the Islamic Banking Act of 1986 came into force with the proliferation of Islamic finance products in the country, the High Court began to hear related cases.¹³ Though it is beyond the scope of this paper to review all the cases, it is important to briefly review some cases and suggest better framework for the resolution of such litigated cases using appropriate ADR processes.¹⁴ The advantages of using ADR processes over litigation are obvious considering the legal complexities and procedural bottlenecks involved in Islamic finance litigation that may pose a threat to the future of the Islamic finance industry.¹⁵ In fact, the Court of Appeal held in *Bank Kerjasama Rakyat Malaysia Bhd v. Emcee Corporation*,¹⁶ that the law applicable to Islamic banking disputes is the same as that applicable to the conventional banking. Therefore, despite the fact that the case involved an Islamic facility, the court held that the procedure and principles applicable to conventional banking are also applicable in the case. This position is similar to the rulings of the English Courts in *Beximco Pharmaceuticals Ltd v Shamil Bank of Bahrain E.C.*¹⁷ where the court refused to apply the principles of Shariah as the governing law of the contract in a *murabahah* case.

¹³ The first reported case is *Tinta Press v. Bank Islam Malaysia Berhad* [1986] 1 MLJ 474.

¹⁴ Example of cases heard and decided by the civil courts in Malaysia include: *Tinta Press v. Bank Islam Malaysia Bhd* [1986] 1 MLJ 474; *Bank Islam Malaysia Bhd v Adnan bin Omar* [1994] 3 CLJ 735; and *Dato Hj Nik Mahmud bin Daud v Bank Islam Malaysia Bhd* [1996] 4 MLJ 295 (High Court); [1998] 3 MLJ 396 (Supreme Court).

¹⁵ Hakimah Yaacob, "Alternative Dispute Resolution in Islamic Finance...", 135.

¹⁶ [2003]1CLJ 625.

¹⁷ [2004] EWCA Civ 19. Also see the decision of the English Court in the earlier case of *Islamic Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems N.V. and others* [2002] All ER (D) 171.

The trends in Islamic finance litigation since 1986 have been classified into three phases: Phase One (1994-2002); Phase Two: (2003-2007); Phase Three: (2008 onwards) (Markom, et al. 2011), but we have modified the classification to reflect current trends. Phase One should be the period between 1986 and 2002, Phase Two (2003-2007), Phase Three (2003-2009), and Phase Four (2010 onwards). The reason for this additional phase is the affirmation of the value of the rulings of SAC in the new CBM Act 2009, which emphasises the binding nature of the rulings. Before this period, some judges were still sceptical about the weight to be attached to the rulings of SAC when cases are referred to it for its opinion. In *Affin Bank Berhad v. Zulkifli Abdullah*¹⁸ Abdul Wahab Patail J. was reluctant in making referral to SAC. Similarly, Rohana Yusuf J. in *Tan Sri Abdul Khalid bin Ibrahim v Bank Islam Malaysia Bhd and another suit*¹⁹ expressly stated her views regarding the relevant provision of the law which requires the court to make referrals to SAC. Though she accepted the opinion of SAC, she however re-echoed the position of the law where she observed: “Having examined the SAC, its role and functions in the area of Islamic banking, I do not see the need for me to refer this issue elsewhere though I am mindful that under s 16B (7) I am not bound by its decision.”²⁰ The CBM Act 2009 expressly provides that the Sharī'ah ruling of SAC is binding on the court or arbitrator. Therefore, this ushers in a new Phase, which has been further complemented by the Practice Direction of 2010. This argument justifies the reason why the Fourth Phase should be introduced in the history of Islamic finance litigation in Malaysia.

Judicial precedents and legal risks in the Islamic finance industry

The negative effect of judicial precedents applicable in common law jurisdictions such as Malaysia is now being felt in the Islamic finance industry. The principle of *stare decisis* provides that the judgments of superior courts are binding on the lower courts. The lower courts must take into consideration previous decisions of superior courts of records in arriving at a decision. This has negative effects in the Islamic finance industry because even if the single judge of the Mu`amalat Bench at the High Court is learned in Islamic finance, what is the probability that the judges who will be sitting to hear the appeal at the Court of Appeal and ultimately at the Federal Court are similarly learned in Islamic finance. With due respect to the expertise of the judges of superior courts of record, there are very complex issues and terminologies involved in Islamic financial transactions which may not be known to the learned judges. If they judges at the appellate court are allowed to hear and determine an appeal from the Mu`amalat Bench without necessary guidance from experts, the decisions handed down by such appellate courts will be binding in subsequent cases in the lower courts. This constitutes a legal risk for Islamic financial transactions since the courts may restructure the generally known Islamic finance products by their judgements. There is a mandatory requirement for Sharī'ah compatibility in the enforcement of financial contracts in Islamic finance. If judicial precedents supersede the mandatory Sharī'ah requirements in financial contracts, the Islamic finance industry will be facing legal risks because there are situations where the superior court will overrule the decision of a lower court as in the case of *Bank Islam Malaysia Bhd v Lim Kok Hoe & Anor and other appeals*²¹. In this case, the Court of Appeal overruled the decision of the High Court, which likened *Bai Bithaman Ajil* (BBA) contract to conventional loan agreement. Without going into the validity of BBA contract, it suffices to observe that if the superior court's decision is not in line with Islamic commercial

¹⁸ [2006] 1 CLJ 438 HC.

¹⁹ [2009] 6 MLJ 416.

²⁰ Ibid, pp. 426-427.

²¹ [2009] 6 MLJ 839; [2009] 6 CLJ 22.

law, then a binding precedent would have been created in the Islamic finance industry which would make such a decision binding on all subsequent similar cases until it is overruled by either another superior court or by itself.

CONCLUSION

The dynamics of dispute resolution in the Islamic finance industry seems to be complex particularly in the aspect of Islamic finance litigation. In order to mitigate legal and regulatory risks in the dispute resolution aspect of Islamic finance in Malaysia, the existing ADR institutions and bodies should be strengthened to reflect the modern drift towards amicable resolution of disputes, which incidentally is the underlying spirit of Islamic contracts. Rather than duplicating efforts in the establishment of more ADR bodies that would help in handling Islamic finance disputes, the existing bodies should be consolidated and a formidable court-annexed programme be put in place where experts will have the opportunity to mediate Islamic finance disputes while ensuring enforceability of such settlement. This is why Med-Ex, a combination of mediation and expert determination may be the best bet for the existing court-annexed mediation in the High Court of Malaysia introduced through the Practice Direction on Mediation. The members of the Shari'ah Advisory Council of the Central Bank of Malaysia may be enlisted as neutrals for the purpose of court-annexed mediation at the Mu'amat Bench. These recommendations will drastically reduce the existing tension in the Islamic finance industry, which is occasioned by the increasing number of cases in the court. Other potentially relevant areas of research include the practitioners' perspectives on Islamic finance litigation and efforts towards the reutilization of in-built mechanisms of dispute avoidance in Islamic finance contracts (Oseni 2011). The future of ADR in Islamic finance is dispute avoidance, which should be vigorously pursued by all (Rashid 2002).

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