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## Arbitrating Disputes In The Retakaful World

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The remarkable economic growth that the Muslim world has experienced in recent years, together with a substantial increase in the availability of Shari'a compliant financing, has created a burgeoning demand for insurance products that are compatible with Islamic principles (commonly referred to as "takaful"). The market for takaful has grown at a precipitous rate and is expected to continue trending upwards. One estimate of the global takaful market anticipates an \$11 billion industry by 2015.<sup>1</sup>

Many of these companies are pure takaful companies established in countries with significant Muslim populations. Reinsurance companies have been established in these countries as well. In recent years, non-Islamic reinsurers have sought to enter the takaful market by providing reinsurance capacity through Shari'a compliant entities (referred to as "retakaful"). Tokio Marine, Mitsui Sumitomo, Munich Re and Swiss Re are just a few of the conventional reinsurers who have established Shari'a compliant subsidiaries or divisions.

With the entrance of conventional reinsurers into an industry long dominated by Islamic-focused companies, the specter of how to resolve disputes arising under retakaful agreements has become an important topic of conversation. While conventional reinsurers rely on well-established arbitration practices that have become widely prevalent across jurisdictions, these practices are now faced with a new challenge: recognizing and addressing the need of Shari'a compliant

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1. Cecilia Valente and Jason Benham, "Global Takaful Market on Growth Track," *Reuters*, Apr. 17, 2009, available at <http://www.insurancejournal.com/news/international/2009/04/17/99723.htm>.

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companies to abide by the requirements of Islamic law, while protecting both parties' desire to institute an effective dispute resolution mechanism. Some aspects of conventional reinsurance arbitration may need to be reinvented in the context of retakaful disputes.

### **Retakaful Products: Complying With Shari'a Law**

Generally speaking, conventional insurance/reinsurance violates Shari'a in three fundamental ways: it involves speculation, uncertainty, and usury. First, the policyholder of a conventional insurance or reinsurance policy pays a premium in exchange for insurance protection against the occurrence of certain events. Should a covered event occur, the policyholder may receive a payment that is much larger than the sum of his or her premiums; should the policy expire without the occurrence of such an event, he or she receives nothing. Islamic law regards this aspect of the insurance/reinsurance business as akin to speculation, or gambling, both of which are forbidden.<sup>2</sup> Second, because the insured/reinsured pays premiums to insure against losses that may never occur, conventional insurance/reinsurance violates the Shari'a prohibition against uncertainty. The prohibition against uncertainty is rooted in the principles of Islamic contract law, which does not recognize contracts that involve unknown values, as these may allow one party to gain an unfair advantage at the other's expense.<sup>3</sup> Third, insurance/reinsurance companies increase their profits by investing premium revenue in interest-bearing assets, which violates Islam's prohibition against usury.<sup>4</sup>

Takaful/retakaful providers avoid these three features of conventional insurance/reinsurance with a business model similar to that of cooperative insurance, and by observing the tenets of Shari'a law when making investments. Takaful, which translates roughly as "mutual guarantee," works by pooling together the insureds' premium subscriptions and paying covered losses from this fund. Unlike conventional insureds, takaful/retakaful policyholders retain an interest in this fund, and participate in any profits or losses that the fund experiences. Islamic scholars view the takaful/retakaful policyholders as guaranteeing one another against certain defined losses, rather than 'gambling' on the occurrence or non-occurrence of future events. Likewise, because the policyholders retain an ownership interest in the fund, neither the insurer nor the insured benefits at the other's expense. Whereas conventional insurance/reinsurance facilitates the transfer of risk, takaful operates by sharing risk.

In order to ensure that its operations are Shari'a compliant, every takaful provider must have a Shari'a Supervisory Board.<sup>5</sup> At present, there are no industry-wide rules governing the authority of the Supervisory Boards, and no generally applicable interpretations of Shari'a are available to guide individual boards.<sup>6</sup> Rather, Shari'a compliance standards and the authority of Shari'a Supervisory Boards vary from jurisdiction to jurisdiction.

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2. See Mohd Ma'sum Billah, *Applied Takaful and Modern Insurance*, 89, 143 (3d ed. 2007).

3. Michelle Penzer, et. al., "Shari'a Compliant Financings: New Opportunities for the U.S. Market," 126 *Banking L.J.* 59, 60 (2009); Mohammad Hashim Kamali, *Uncertainty and Risk-Taking in Islamic Law* (July 2006), <http://pithkawe.multiply.com/journal/item1> (last visited June 23, 2009).

4. Additionally, a Shari'a-compliant investment portfolio may not include investments in any industries or activities that are forbidden by Islam, such as those that involve alcohol, pork, gaming or pornographic materials. Penzer, *supra* note 3, at 60.

5. Billah, *supra* note 2, at 57.

6. While there are no industry-wide rules, some nations have set Shari'a standards for takaful and retakaful companies operating within their borders. For example, in Bahrain, "all takaful and retakaful companies are already required to adhere to accounting, auditing and Shari'a standards of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)." *BMA to issue new rules for takaful, retakaful*, *Islamic Fin. Rev.* (Bahrain Monetary Agency, Bahr.), at 1, available at [http://www.bma.gov.bh/cmsrule/media/pdf/islamichub/if\\_review\\_issue5.pdf](http://www.bma.gov.bh/cmsrule/media/pdf/islamichub/if_review_issue5.pdf).

These boards, generally consisting of at least three members with deep knowledge of both Shari'a law and commercial and financial transactions, have significant authority over the way the company conducts itself. The boards approve the structure of the company and the products which it sells, and ensures on a broad level that the company is conducting itself in conformity with Shari'a principles. While the board's rulings are religious in nature, they have direct commercial implications on how the company conducts itself.

### **Arbitrating Retakaful Disputes**

There are some significant aspects of conventional reinsurance arbitration that may need to be reshaped given the unique nature of retakaful arrangements.

**Arbitrator Qualifications:** Typical arbitration clauses in reinsurance agreements specify that party-appointed arbitrators and the umpire must be current or former executives of insurance or reinsurance companies. The submission of disputes to arbitrators experienced in the reinsurance industry greatly facilitates the resolution of disputes involving concepts, principles and customary practices that are unfamiliar to those outside the industry. The advent of retakaful relationships raises the question as to whether these same efficiencies are present when one central element of the reinsurance contract is the applicability of Shari'a principles. Whether an arbitrator experienced in the reinsurance industry brings the same strengths to resolving a dispute arising from a retakaful agreement depends on the nature of the dispute – a dispute over proper notice may not engage Shari'a law, but one regarding the accounting of premiums might.

Because it is impractical to have separate sets of arbitrator qualification standards based on the nature of the dispute, companies will be faced with two options: (1) maintaining the standard language regarding experience in the insurance or reinsurance industry and relying on the parties and their counsel to explain the impact of Shari'a law on the dispute, or (2) requiring that the arbitrators be current or former officers of takaful or retakaful companies. The former option places the burden on the parties and their attorneys to explain the applicability of Shari'a law to the arbitration panel, just as they would if they were explaining the applicability of a particular jurisdiction's law. The latter option eases that burden by ensuring that the arbitration panel brings to the dispute their collective experience in a legal and financial system that most reinsurance practitioners have never encountered.

There are practical considerations to account for as well. Requiring experience in the takaful or retakaful industry greatly limits the pool of available arbitrators given the small number of reinsurance companies that operate retakaful subsidiaries and the concentration of those companies in markets where most reinsurance companies do not regularly operate.

**Custom and Practice:** Another provision found in a typical arbitration clause directs arbitrators to resolve the dispute as an "honorable engagement" by applying the "custom and practice" of the insurance and reinsurance industry with a view to effecting the general purpose of the reinsurance agreement. Because many aspects of conventional insurance and reinsurance are not compatible with Shari'a law, arbitration panels may be faced with determining whether and how traditional reinsurance custom and practice conflicts with Shari'a principles. Again, whether such a conflict exists

depends in part on the nature of the dispute. Because the development of a global retakaful market is still relatively young, it is unlikely that companies will be able to rely on the custom and practice of the retakaful industry to resolve all disputes.

Companies may also want to ensure that where there is in fact no conflict – or where Shari'a principles are not at issue – the arbitration panel is permitted to revert to the norms of the conventional reinsurance industry. Language in the arbitration clause that permits application of the custom and practice of the reinsurance industry to the extent it does not conflict with Shari'a law will help ensure that traditional reinsurance practices continue to be the guiding principle for the arbitration panel to the greatest extent possible.

**Site of the Arbitration:** Selecting a site for the arbitration is a challenge for all companies involved in international litigation. Where the arbitration is held determines in part which jurisdiction's courts will have authority to enforce the panel's awards.

The retakaful industry has thus far been concentrated in Southeast Asia, with Malaysia leading the way in terms of the sheer number of takaful and retakaful companies. Indeed, the Malaysian government was the first to sanction the takaful/retakaful industry, passing the Takaful Act of 1984. Takaful operators are regulated by the Malaysian central bank, the Bank Negara Malaysia ("BNM"). Guidelines issued by Malaysian authorities explicitly state that the BNM aspires to produce consistent interpretations of Islam, at least where Islamic finance and insurance are concerned.<sup>7</sup> The BNM established the Shari'a Advisory Council ("SAC") in May 1996 to act as the nation's sole authority on all Shari'a issues related to Islamic finance and insurance.<sup>8</sup> The SAC develops and disseminates interpretations of Islamic law, advises courts and arbitrators when disputes concern religious doctrine,<sup>9</sup> issues licenses to takaful operators, and assists financial institutions in developing Shari'a compliant financial products. The members of the SAC are appointed by the Minister of Finance on the recommendation of the Board of Directors of the BNM.<sup>10</sup>

Although Malaysian law relies upon religious authorities to regulate takaful and other Islamic financial products from the outset, the SAC does not normally participate in the interpretation or enforcement of Shari'a compliant financial products once those products enter the market. Under Malaysian law, the civil courts in which takaful disputes are tried are secular, federally administered courts; neither the SAC nor the country's Shari'a courts have jurisdiction over disputes related to Islamic finance. As a result, the SAC shares responsibility for regulating the takaful and Islamic financial markets with Malaysia's civil courts.<sup>11</sup>

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7. See Guidelines on the Governance of Shari'a Committee, BNM/RH/GL/005-6, § 1 available at [http://www.bnm.gov.my/guidelines/03\\_dfi/03\\_prudential/03\\_gl\\_governance\\_of\\_shariah\\_committee.pdf](http://www.bnm.gov.my/guidelines/03_dfi/03_prudential/03_gl_governance_of_shariah_committee.pdf).

8. Securities Commission of Malaysia, *Islamic Capital Market Frequently Asked Questions*, <http://www.sc.com.my/main.asp?pageid=256&menuid=285&newsid=&linkid=&type=> (last visited June 24, 2009).

9. See Guidelines on the Governance of Shari'a Committee, *supra* note 7, at § 2. Under existing law, the High Courts of Malaysia may refer such disputes to the SAC, but cannot be compelled to do so. There is, however, a movement to make such referrals mandatory in cases involving Islamic financial products. Halim Wahab & Habhajan Singh, "SAC: BNM to review SAC's role," *Islamic Fin. Asia*, Oct. 29, 2008, <http://islamicfinanceasia.blogspot.com/2008/10/sac-bnm-to-review-sacs-role.html>.

10. See Bank Negara Malaysia, *Resolution of the Shariah Advisory Council of Bank Negara Malaysia on the Distribution of Surplus in Takaful Scheme and the Application of Wakalah Contract in Deposit Instrument*, 09/07/07 (September 25, 2007), available at <http://www.bnm.gov.my/index.php?ch=8&pg=14&ac=1511&print=1>.

11. See Takaful Act of 1984 §§ 53-63.

This article is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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New entrants to the Malaysian market may not have experience appearing before Malaysian courts. Those courts may also be reluctant to enforce any arbitration award that strays from Shari'a principles that are prevalent in that particular jurisdiction.

**Arbitrators' Decisions vs. Supervisory Boards' Rulings:** Given the connection between directives issued by a retakaful's supervisory board and the commercial decisions made by that company, an arbitration panel's ruling in a retakaful dispute may infringe on a Shari'a supervisory boards' jurisdiction. A company that has been directed to act a certain way by its supervisory board cannot simply discard that board's guidance simply because an arbitrator – especially one inexperienced in Islamic law – rules that the board's guidance is in conflict with a retakaful agreement or with the rulings of another supervisory board. The arbitration panel may also find itself facing two different directives from Shari'a boards – one issued by a ceding takaful operator's board and the other from the assuming retakaful company's board.

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As the retakaful industry continues to grow, the best practices for arbitrating disputes will surely come into focus. In the meantime, companies and practitioners must recognize that they will be at the forefront of developing a model for arbitrating that will continue to evolve. Recognizing the specific issues raised by the interplay of Shari'a principles with the long standing customs and practices of the conventional reinsurance industry is an important component of ensuring that the parties to the agreement will be able to enforce the bargain they strike.