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Insolvency in Relation to Islamic Finance: Malaysian Law and *Shariah* Perspective

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Insolvency in relation to Islamic Finance: Malaysian Law and *Shariah* Perspective

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Acknowledgement

INSOL International is pleased to present the 20th Technical Paper under its Technical Papers Series titled “Insolvency in Relation to Islamic Finance: Malaysian Law and *Shariah* Perspective” written by Dr Nik Norzrul Thani, Chairman and Senior Partner, Zaid Ibrahim & Co., Kuala Lumpur, Malaysia and Mohd Hariz Daud, Senior Associate at Zaid Ibrahim & Co.

The recent global financial crisis has adversely affected the major lenders across the world, including institutions that manage Islamic funds. This paper is therefore timely because it provides an overview of the key Islamic finance concepts in general and the impact of insolvency where funding has been provided according to the Islamic finance principles. The paper also considers the position in Malaysia as an example of a jurisdiction that provides Islamic finance.

The authors have suggested that further research and pronouncement by the *Shariah* scholars with regard to the issue of insolvency in relation to Islamic finance is made in order to further improve the sophisticated state of Islamic finance that currently exist. This is important to ensure that the Islamic finance industry community are well prepared and equipped with the available information and possible solutions to face any new issues on insolvency that may arise in relation to Islamic finance in the future.

INSOL International would like to thank Dr Nik Norzrul Thani and Mohd Hariz Daud for writing this very informative paper.

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Insolvency in Relation to Islamic Finance: Malaysian Law and *Shariah* Perspective

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1. Introduction

Islamic finance is a form of financing which is founded on *Shariah* principles. The mode of financing under Islamic finance is undertaken by using various underlying *Shariah* principles / concepts and Islamic financial instruments to facilitate the provision of financing by the financiers to the customers. In Malaysia, the Islamic finance industry has developed tremendously since the establishment of the first Islamic bank in Malaysia in 1983 involving all segments of the Islamic financial system; from the Islamic banking and *takaful* industry to the Islamic capital and money markets.

The recent global financial crisis affected a number of renowned players involved in the management of Islamic funds such as The Investment Dar and Global Investment House, both based in Kuwait, who suffered major losses during the crisis and have become insolvent¹ and also the near default of Dubai World has raised concerns among the Islamic finance community on the need for a greater understanding in respect of the Islamic finance industry's legal risks particularly in the area of insolvency. In Malaysia, the insolvency law is governed by the Bankruptcy Act 1967 (Revised 1988) for personal insolvency whilst the Companies Act 1965 (Revised 1973) provides statutory provisions in relation to corporate insolvencies. This article aims to highlight briefly the issue of insolvency in relation to Islamic finance from the Malaysian law as well as *Shariah* perspective.

2. Overview on Several Prominent Types of Islamic Finance Concepts

There are various types of Islamic finance concepts such as equity financing, leasing financing as well as investment financing. The Islamic finance concepts as applied in financing transactions are not totally peculiar for Islamic finance only, but in actual fact such concepts have some similarities with conventional loan transactions. For instance, the Islamic finance concept of *Ijarah* is similar with the operational and financial leasing arrangement, the *Musharakah* concept is similar to the equity partnership arrangement and the *Wakalah* concept is akin to agency arrangement. This part of the article will provide a brief overview on several prominent types of Islamic finance concepts which are widely applied.

2.1 *Murabahah* (Cost Plus Profit Sale)

Murahabah refers to the sale of goods at a price covering the purchase price plus a profit margin agreed upon by both parties. It is an agreement that refers to the sale and purchase transaction for the financing of an asset or project whereby the costs and profit margin are made known and agreed by all parties involved.² The settlement for the purchase can be done in cash or in instalments and will be specified in the agreement.

2.2 *Musharakah* (Equity Partnership)

Musharakah means a joint - venture or partnership agreement between two (2) or more parties to engage in a specific business activity with an aim of making profit. All parties contribute to the capital of the operation in varying degrees and agree to divide the net profit in proportion to the amounts invested by each.³ Any losses incurred will be shared based on the ratio of funds invested by each partner.

* The views expressed in this article are the views of the authors and not of INSOL International, London.

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¹ Madzlan Mohamad Hussain, *Demystifying Islamic Finance: Correcting Misconceptions, Advancing Value Propositions*, Zaid Ibrahim & Co, 2010, p. 19

² Dato' Dr. Nik Norzrul Thani, Mohamed Ridza Mohamed Abdullah and Megat Hizaini Hassan, *Law and Practice of Islamic Banking and Finance*, Sweet & Maxwell Asia, 2003, p. 75

³ Supra Note 2, p. 70

2.3 *Mudharabah* (Investment Arrangement)

Mudharabah is a form of joint - venture between a party who contributes capital (*rabb al-mal*) while the other party who contributes efforts in the form of managerial skills (*mudharib*). Profit from the outcome of the venture is shared between the capital provider and the manager according to mutually agreed profit sharing ratio whilst losses are borne solely by the capital provider, provided that such loss is not due to the manager's negligence or violation of specified conditions.⁴

2.4 *Ijarah* (Lease)

Ijarah means a lease contract as well as a hire contract. It is a *Manfaah* (usufruct) type of agreement whereby the lessor (owner) leases out an asset or equipment to its client at an agreed rental fee and pre-determined lease period upon the 'aqad (contract). The ownership of the leased equipment remains in the hand of the lessor.⁵ The lease, rental and other terms and conditions is agreed upon by both parties.

2.5 *Istisna'* (Commissioned Manufacture)

Istisna' is a purchase contract of an asset whereby the buyer will require a seller or a contractor to deliver or construct the asset that will be completed in the future according to the specifications given in the sale and purchase contract. Both parties of the contract will decide on the sale and purchase prices as they wish and the settlement can be delayed or arranged based on the schedule of the work completed.⁶

2.6 *Wakalah* (Agency)

Wakalah is a contract whereby a person (principal) asks another party to act on his behalf (as his agent) for a specific task. The person who takes on the task is an agent who will be paid a fee for his services. For instance, a customer asks a bank to pay someone under certain terms. The bank is therefore the agent for carrying out the financial transaction and the bank will be paid a fee for its services.⁷

2.7 *Qard Hasan* (Benevolent Loan)

Qard Hasan means a benevolent loan which is given for a fixed period on a goodwill basis. In practice, *Qard Hasan* is a contract of loan between two (2) parties to fulfil a short - term financial need of the borrower. The amount of repayment must be equivalent to the amount borrowed. It is however legitimate for the borrower to pay more than the amount borrowed as long as it is not stated or agreed at the point of contract. This kind of arrangement is the only loan permitted by *Shariah*.⁸

2.8 *Sukuk* (Islamic Bond)

Sukuk (plural of *sakk*) are frequently referred to as "Islamic bonds". A more accurate translation of the concept would be "Islamic investment certificates" or even "participation certificates". In contrast to a bond, each of the *sukuk* - holders in a *sukuk* structure holds an undivided beneficial ownership in the underlying assets (the *sukuk* assets). Consequently, *sukuk* - holders are entitled to share in the revenues generated by the *sukuk* assets and may be entitled to share in the proceeds of the realization of the *sukuk* assets.⁹

3. Legal and Regulatory Framework for Islamic Finance in Malaysia

The legal and regulatory framework in Malaysia has been structured to facilitate the development of an efficient Islamic financial system. Various efforts have been made by the Malaysian government to facilitate the application of Islamic finance in Malaysia within its legal

⁴ Malaysia International Islamic Financial Centre ("MIFC"),

⁵ http://www.mifc.com/index.php?ch=menu_know_principals_mudharabah&pg=menu_know_principals_mud_concept&ac=424

⁶ Supra Note 2, p. 61

⁷ Islamic Securities Guidelines, Securities Commission Malaysia, http://www.sc.com.my/ENG/HTML/icm/Guidelines-IslamicSecurities_apdx1.pdf

⁸ Bank Negara Malaysia, http://www.bankinginfo.com.my/system/media/downloadables/islamic_banking.pdf

⁹ Supra Note 2, p. 87

⁹ Shabnam Mokhtar, Saad Rahman, Hissam Kamal and Abdulkader Thomas, *Sukuk and the Capital Markets, Sukuk: Islamic Capital Market Series*, Securities Commission of Malaysia, Sweet & Maxwell Asia and Thomson Reuters, 2009, p. 21

framework. This is evidenced by the amendments made to several statutes such as the Central Bank of Malaysia Act 2009, the Banking and Financial Institutions Act 1989, the Securities Commission Act 1993 and the Capital Markets and Services Act 2007 and also the enactment of new statutes such as the Islamic Banking Act 1983 and the *Takaful* Act 1984. This section of the article will enumerate the salient provisions of the Malaysian statutes that relate to Islamic finance.

3.1 Central Bank of Malaysia Act 2009 (“CBMA”)

The CBMA was enacted in 2009 to repeal the Central Bank of Malaysia Act 1958 and became effective on 25 November 2009. The provisions in the CBMA which relate to Islamic finance are primarily set out in Part VII of the CBMA comprising Section 51 to Section 60. Section 51 of the CBMA provides that BNM may establish a *Shariah* Advisory Council (“SAC”) on Islamic finance which shall be the authority for the ascertainment of Islamic law for the purposes of Islamic financial business.¹⁰ The functions of the SAC of BNM, among others, are to ascertain the Islamic law on any financial matter and issue a ruling upon reference made to the SAC of BNM in accordance with Part VII of the CBMA, to advise BNM on any *Shariah* issue relating to Islamic financial business, the activities or transactions of BNM and to provide advice to any Islamic financial institution or any other person as may be provided under any written law.¹¹ Where the Islamic financial institutions, the court or the arbitrator has referred to the SAC of BNM for a ruling on any *Shariah* matter, the ruling by the SAC of BNM shall be binding upon them.¹²

3.2 Securities Commission Act 1993 (“SCA”)

The SCA was enacted in 1993 and became effective on 1 March 1993. The provisions in the SCA which indirectly relate to Islamic finance are as set out in Section 18 relating to the establishment of a committee by the Securities Commission of Malaysia (“SC”).¹³ By virtue of the provisions of Section 18, the SAC of SC was established as a committee by the SC in 1996. The SAC of SC was given the mandate to ensure that the running of the Islamic capital market (“ICM”) complies with *Shariah* principles. Its scope of jurisdiction is to advise the SC on all matters related to the comprehensive development of the ICM, and functions as a reference centre for ICM - related issues. The members of the SAC of SC consist of Islamic scholars and Islamic finance experts.¹⁴ The SC is the first regulatory body relating to capital market to have its own SAC.¹⁵

3.3 Islamic Banking Act 1983 (“IBA”)

The IBA was enacted in 1983 and became effective on 7 April 1983. Full-fledge Islamic banks which are established and licensed as Islamic banks are governed by the IBA. Among the provisions in the IBA which should be noted are as set out in Section 3 relating to the licensing of Islamic banks. To obtain a licence as an Islamic bank, the Islamic bank must ensure that the aim and operations of its banking business will not involve any elements that are in contravention with the religion of Islam. The articles of association of the Islamic bank must provide a provision for the establishment of a *Shariah* advisory body whose function is to advise on the operations of the Islamic bank’s banking business and to ensure that such operations do not involve any elements which contravene the religion of Islam.¹⁶ Section 13A of the IBA provides that an Islamic bank may seek the advice of the SAC of BNM on *Shariah* matters relating to its banking business and the Islamic bank shall comply with the advice of the SAC of BNM.¹⁷

3.4 Takaful Act 1984 (“TA”)

The TA was enacted in 1984 and became effective on 1 January 1985. Among the provisions in the TA which should be noted are set out in Section 8 which provides for the registration of *takaful* operators by the Director General of *Takaful*. To be registered as *takaful* operators, the *takaful* operators must ensure that the aim and operations of its *takaful* business will not involve

¹⁰ Section 51(1) of the CBMA

¹¹ Section 52(1) of the CBMA

¹² Section 57 of the CBMA

¹³ Section 18 of the SCA

¹⁴ Securities Commission of Malaysia, Resources, FAQs, <http://www.sc.com.my/main.asp?pageid=445&menuid=349&newsid=&linkid=&type=>

¹⁵ Dato’ Dr. Nik Norzrul Thani Nik Hassan Thani and Madzlan Hussain, Breaking New Ground, New Voice of Asia, Third Quarter 2003, p. 5

¹⁶ Section 3(5) of the IBA

¹⁷ Section 13A(1) of the IBA

any element which is not approved by *Shariah*. The articles of association of the *takaful* operators must provide a provision for the establishment of a *Shariah* advisory body whose function is to advise on the operations of the *takaful* operators' *takaful* business and to ensure that such operations do not involve any element which is not approved by *Shariah*.¹⁸ Section 53A(1) of the TA provides that a *takaful* operator, a *takaful* agent, a *takaful* broker or an adjuster may seek the advice of the SAC of BNM on *Shariah* matters relating to its *takaful* business and such parties shall comply with the advice of the SAC of BNM.¹⁹

3.5 Capital Markets and Services Act 2007 (“CMSA”)

The CMSA was enacted in 2007 and became effective on 28 September 2007 (except for Division 2 of Part VI which became effective on 1 April 2010). The salient provisions in the CMSA which relate to Islamic finance are primarily set out in Part VI, Division 6 comprising Sections 316 to 316H. Section 316A provides that the SC may establish an SAC for ICM which shall be the authority for the ascertainment of the application of *Shariah* principles for the purposes of ICM business or transaction.²⁰ The functions of the SAC of SC, among others, are to ascertain the *Shariah* principles on any matter pertaining to ICM business or transaction and issue a ruling upon reference made to the SAC of SC in accordance with Part VI, Division 6 of the CMSA, to advise the SC on any *Shariah* issue relating to ICM business or transaction, and to provide advice to any person on any *Shariah* issue relating to ICM business or transaction.²¹ Any ruling made by the SAC of SC shall be binding on the licensed person, stock exchange, futures exchange, clearing house, central depository, listed corporation or any other person referred to in Section 316E of the CMSA and the court or arbitrator referred to in Section 316F of the CMSA.²²

3.6 Banking and Financial Institutions Act 1989 (“BAFIA”)

The BAFIA was enacted in 1989 and became effective on 1 October 1989. The provisions in the BAFIA which relate to Islamic finance are as set out in Section 124. Section 124(1) provides that any conventional licensed institution shall not be prohibited or restricted from carrying on Islamic banking or financial business, in addition to its existing licensed business, provided that the applicable conventional licensed institution shall consult BNM before it carries on Islamic banking or financial business.²³ This is commonly referred to as an Islamic banking window under the Islamic banking scheme where license is also given to any conventional licensed institution to carry on Islamic banking business or Islamic financial business. These conventional licensed institutions however, are not considered as Islamic banks.²⁴ Hence, it should be noted that conventional banks which carry on Islamic banking or financial business via Islamic banking window under the Islamic banking scheme are governed by BAFIA whereas full-fledged licensed Islamic banks are governed by IBA.

4. Insolvency Law in Malaysia

Insolvency law in Malaysia is divided into two categories namely (i) personal insolvency under the Bankruptcy Act 1967 (Revised 1988); and (ii) corporate insolvency under the Companies Act 1965 (Revised 1973).

4.1 Personal Insolvency under the Bankruptcy Act 1967 (Revised 1988)

The legislation relating to personal insolvency in Malaysia is primarily contained in the Bankruptcy Act 1967 (Revised 1988) (the “Bankruptcy Act”). The Bankruptcy Act was enacted in 1967 and came into effect on 30 September 1967. The Bankruptcy Rules 1969 governs the legal procedure in bankruptcy matters in general.²⁵

¹⁸ Section 8(5) of the TA

¹⁹ Section 53A(1) of the TA

²⁰ Section 316A(1) of the CMSA

²¹ Section 316B of the CMSA

²² Section 316G of the CMSA

²³ Section 124(1) of the BAFIA

²⁴ Section 124(5) of the BAFIA

²⁵ Khoo Kay Ping, *Khoo's Law and Practice of Bankruptcy in Malaysia*, Second Edition, Malayan Law Journal, 2003, p. 3



4.2 Procedures for Bankruptcy Proceedings under the Bankruptcy Act

In Malaysia, before an individual is declared as bankrupt under the Bankruptcy Act, there are several procedures which should be undertaken in accordance with the provisions of the Bankruptcy Act as follows.

4.2.1 Obtain Judgment in Respect of Debt Owed

Before a bankruptcy proceeding can take place, the creditor(s) have to obtain a judgment or an order from court whereby the debt owed by the debtor(s) to the creditor(s) must be RM30,000.00 or more. The requirements as set out in Section 5(1) of the Bankruptcy Act also need to be complied with prior to the commencement of the bankruptcy proceedings, among others, (i) the debt is a liquidated sum payable either immediately or at some certain future time; (ii) the act of bankruptcy has occurred within six (6) months before the presentation of the petition; and (iii) the debtor is domiciled in Malaysia or within one (1) year before the date of the presentation of the petition has resided or had a place of business in Malaysia, or has carried on business in Malaysia personally or has been a member of a firm or partnership which has carried on business in Malaysia.²⁶

4.2.2 Application for the Issuance of Bankruptcy Notice

Upon obtaining a final judgment from court for debts owed by debtor(s) to the creditor(s), the judgment creditor(s) may make an application for the issuance of bankruptcy notice in order to demand the debtor(s) to make payment pursuant to the judgment debt. A bankruptcy notice is a notice issued by court requiring the debtor(s) to pay specified sum of money or to secure or compound for it to the satisfaction of the creditor(s) or the court within a prescribed period. After its issue, the bankruptcy notice must be served on the debtor(s). Upon the debtor's failure to comply with the bankruptcy notice, an act of bankruptcy is committed and a creditor's petition may be presented against the debtor(s).²⁷

4.2.3 Commission of Act of Bankruptcy

An act of bankruptcy is an occurrence of an event in connection with the conduct of the debtor or his financial status that entitles an adjudication order to be made against him. The commission of an act of bankruptcy is the basis of a creditor's petition. Though most proceedings begin with a bankruptcy notice served on the debtor, the Bankruptcy Act in fact sets forth ten (10) acts of bankruptcy as set out in Section 3(1) of the Bankruptcy Act. Among the acts of bankruptcy as set out in Section 3(1) of the Bankruptcy Act are: (i) conveyance of property to trustee for the benefit of the general creditors;²⁸ (ii) filing of declaration of inability to pay debts or debtor's petition;²⁹ (iii) giving notice of suspension of payments of debts;³⁰ and (iv) non-compliance with bankruptcy notice.³¹

4.2.4 Bankruptcy Petition

A bankruptcy petition may be presented either by a debtor against himself or by his creditor. By the petition, the court is requested to make a receiving order against the debtor. As the court grants the order against the debtor, the court will also make an adjudication order against him unless he can satisfy the court that he is in a position to offer composition or enter into a scheme of arrangement with his creditors. By the receiving order, the debtor's assets are taken and administered by the Director General of Insolvency for the protection of the estate.³²

4.2.5 Receiving Order

At the hearing of the bankruptcy petition, the court may make a receiving order and an adjudication order against the debtor if it is satisfied that an act of bankruptcy has been committed and some other requirements have been satisfied. A receiving order alone will be

²⁶ Section 5(1)(a) to (d) of the Bankruptcy Act

²⁷ Supra Note 25, pp. 28-29

²⁸ Section 3(1)(a) of the Bankruptcy Act

²⁹ Section 3(1)(f) of the Bankruptcy Act

³⁰ Section 3(1)(g) of the Bankruptcy Act

³¹ Section 3(1)(i) of the Bankruptcy Act

³² Supra Note 25, pp. 97-98

granted if the debtor can satisfy the court that he is in a position to offer a composition or make a scheme of arrangement satisfactory to his creditors.³³

4.2.6 Adjudication Order³⁴

At the hearing of a creditor's or a debtor's petition, if the court decides to grant a receiving order against the debtor, it shall also adjudge the debtor bankrupt unless the debtor can satisfy the court that he is in a position to offer a composition or scheme satisfactory to his creditors. By the adjudication order, the debtor becomes a bankrupt, and his property is vested in the Director General of Insolvency and become divisible among his creditors.³⁵ The vesting of the property in the Director General of Insolvency takes place immediately on the making of the adjudication order and is not dependant on the publication and advertisement of the receiving order.³⁶

4.3 Corporate Insolvency under the Companies Act 1965 (Revised 1973)

The legislation relating to corporate insolvency in Malaysia is primarily contained in the Companies Act 1965 (Revised 1973) (the "Companies Act"). The Companies Act was enacted in 1965 and came into effect on 15 April 1966. The Companies (Winding - up) Rules 1972 govern the legal procedure in winding - up matters in general.

4.3.1 Types of Winding - up under the Companies Act³⁷

There are four types of winding - up under the Companies Act. In the two (2) types of voluntary winding up namely (i) members' voluntary winding - up; and (ii) creditors' voluntary winding - up, the process is triggered by a special resolution of the company's members in general meeting. In the two (2) types of compulsory winding - up namely (i) in insolvency; and (ii) on another ground, the process is triggered by a court order.

4.4 Procedures for Winding - up Proceedings under the Companies Act

In Malaysia, before a corporation or company is liquidated or being wound - up under the Companies Act, there are several procedures which should be undertaken in accordance with the provisions of the Companies Act.

4.4.1 Members' Voluntary Winding - up³⁸

Members' voluntary winding - up is the liquidation of a solvent company under Division 3 of Part X where a declaration has been made and lodged in pursuance of Section 257 of the Companies Act.³⁹ The steps involved are as follows:

- (i) A company's directors (or a majority of them if more than two (2)) declare in writing and lodge with the Registrar of Companies ("ROC") a written declaration of solvency that they believe the company will be able to pay its debts in full within a period not exceeding twelve (12) months after the commencement of winding-up.⁴⁰ The declaration must be made before the notices of the meeting at which the resolution for winding - up of the company is to be proposed are sent out.
- (ii) The company's members in general meeting pass a special resolution for the company to be wound up voluntarily.⁴¹
- (iii) The members in general meeting appoint a liquidator.⁴²

³³ Section 24(1) of the Bankruptcy Act

³⁴ Supra Note 25, pp. 196, 203

³⁵ Section 24(4) of the Bankruptcy Act

³⁶ *Kwan Chew Shen v Citibank N.A.* [1987] 1 CLJ 314 at p 316 paragraph 8 (HC, Kuala Lumpur (VC George J)).

³⁷ Aiman Nariman Mohd Sulaiman, Aishah Bidin, Pamela Hanrahan, Ian Ramsay, Geof Stapledon, Commercial Applications of Company Law in Malaysia, 2nd Edition, CCH Asia Pte Limited, p. 523

³⁸ Ibid, pp. 524-525

³⁹ Section 4(1) of the Companies Act

⁴⁰ Section 257(1) of the Companies Act

⁴¹ Section 254(1)(b) of the Companies Act

⁴² Section 258(1) of the Companies Act



- (iv) From the time of the liquidator's appointment, the directors lose their powers, except to the extent that the liquidator approves or the company in general meeting with the consent of the liquidator approves otherwise.⁴³
- (v) The liquidator will carry out his or her functions which include "realising" the company's assets and distributing the proceeds among the company's creditors.
- (vi) If at any time the liquidator forms the opinion that the company will not be able to pay its debts in full within the twelve (12) month period, the liquidator must call a meeting of the company's creditors, after which the winding-up proceeds as if it were a creditors' voluntary winding - up.⁴⁴
- (vii) When the winding - up is completed, the company is normally deregistered.

4.4.2 Creditors' Voluntary Winding - up⁴⁵

A creditors' voluntary winding - up is similar to a members' voluntary winding - up, except that the company is insolvent. It is a winding - up under Division 3 of Part X other than a members' voluntary winding - up.⁴⁶ The steps involved are as follows:

- (i) A company's members in general meeting pass a special resolution that the company be wound up voluntarily, where the directors have not made a solvency declaration.⁴⁷
- (ii) A meeting of the company's creditors is held within one (1) day. The directors provide a report on the company's affairs and a list of the company's creditors.⁴⁸
- (iii) The creditors may nominate a liquidator. If the creditors do not do so, the person nominated by the members at the general meeting becomes the liquidator.⁴⁹
- (iv) From the commencement of step (i) above, among the effect are: (a) the company shall stop carrying on its business, except to the extent the liquidator believes is necessary for the beneficial disposal or winding - up of the business;⁵⁰ and (b) any transfers of the company's shares are void unless the liquidator approves.⁵¹
- (v) From the time of the liquidator's appointment, the liquidator will carry out the functions accordingly and all powers of the directors shall cease, except so far as the committee of inspection, or if there is no such committee the creditors approve the continuation thereof.⁵²
- (vi) When the winding - up is completed, the company is normally deregistered.

4.4.3 Compulsory Winding - up in Insolvency⁵³

A compulsory winding - up in insolvency is a winding - up of an insolvent company that begins with a court order on the application of one (1) or more parties listed in Section 217 of the Companies Act. Further, the petitioner must establish one (1) of the grounds for winding - up stipulated in Section 218(1) of the Companies Act. The steps involved are as follows:

- (i) A company is "insolvent" i.e unable to pay its debts. The most common way to raise the presumption of insolvency is non - payment by the debtor company, having been served with a "statutory demand" for payment of debt (or debts) worth at least RM500, due and payable within three (3) weeks.⁵⁴

⁴³ Section 258(2) of the Companies Act

⁴⁴ Section 259(1) of the Companies Act

⁴⁵ Supra Note 37, pp. 525-526

⁴⁶ Section 4(1) of the Companies Act

⁴⁷ Section 260 of the Companies Act

⁴⁸ Section 260(4) of the Companies Act

⁴⁹ Section 261 of the Companies Act

⁵⁰ Section 256(1) of the Companies Act

⁵¹ Section 256(2) of the Companies Act

⁵² Section 261(4) of the Companies Act. See *Cheng Heng Ping & Ors v Perwira Affin Bank Bhd* [1999] 1 CLJ 611

⁵³ Supra Note 37, pp. 526-528

⁵⁴ Section 218(2)(a) of the Companies Act

- (ii) An application is made to the court for the company to be wound up in insolvency. The application may be made by, among others: (a) the company; or (b) a creditor including a contingent or prospective creditor of the company; or (c) a liquidator of the company.⁵⁵
- (iii) At any time after the filing of the winding - up application and before the making of a winding - up order, the court may appoint a "provisional liquidator" if that is necessary to protect the company's assets.⁵⁶
- (iv) Where before the presentation of the petition, a resolution has been passed by the company for voluntary winding - up, the winding - up of the company shall be deemed to have commenced at the time of the passing of the resolution and unless the court, on proof of fraud or mistake, thinks otherwise all proceedings taken in the voluntary winding - up shall be deemed to have been validly taken.⁵⁷
- (v) If the court makes a winding - up order, among the effect are: (a) all the company's properties come under the control of the liquidator;⁵⁸ (b) the powers of the directors and other company officers are suspended and they cannot act without approval from the liquidator or the court; and (c) legal proceedings cannot be started or continued against the company unless the court approves.⁵⁹
- (vi) When the winding - up is completed, the company is normally deregistered.

4.4.4 Compulsory Winding - up on Grounds Other than Insolvency

The court has the power to wind up a company on grounds other than insolvency. The steps involved are as follows:

- (i) An application is made to the court for the company to be wound up on one (1) of the grounds set out in Section 218 of the Companies Act. These grounds include (among others): (a) the company has by special resolution resolved that it be wound up by the court; or (b) the company has not commenced business within one (1) year from its incorporation or has suspended its business for a whole year; or (c) the company is being used for unlawful purposes or any purpose prejudicial to or incompatible with peace, welfare, security, public order, good order or morality in Malaysia.⁶⁰
- (ii) The application may be made by the same parties as set out in paragraph 4.4.3(ii) above including by the ROC particularly on the ground specified in Section 218(1)(m) or (n), in limited circumstances.
- (iii) At any time after the filing of the winding - up application and before the making of a winding - up order, the court may appoint a "provisional liquidator" if that is necessary to protect the company's assets.⁶¹
- (iv) If the court makes a winding - up order, among the effect of such action is similar with the one as set out in paragraph 4.4.3(v) above.
- (v) When the winding - up is completed, the company is normally deregistered.

5. *Shariah* Perspective on Insolvency

5.1 Definition of Bankruptcy / Insolvency

The Arabic word *iflas* means bankruptcy and insolvency.⁶² It covers both the modern sense of (i) balance sheet insolvency, when an entity's assets are less than its liabilities; and (ii) income statement or cash flow insolvency, when an entity has insufficient liquid or monetizable assets to

⁵⁵ Section 217 of the Companies Act

⁵⁶ Section 231 of the Companies Act

⁵⁷ Section 219(1) of the Companies Act

⁵⁸ Section 233(1) of the Companies Act

⁵⁹ Section 226(3) of the Companies Act

⁶⁰ Section 218 of the Companies Act

⁶¹ Section 231 of the Companies Act

⁶² Elias A. Elias and Ed. E. Elias, *Elias Modern Dictionary Arabic-English*, Ninth Edition, 1962, Elias' Modern Press, Cairo, Egypt, p. 523



pay its debts as they come due.⁶³ Legally, the term refers to a court - order that forbids the declared bankrupt individual from dealing in his property, and thus enabling his creditors to protect their rights thereof.⁶⁴

The Arabic word *mufliis* means a bankrupt entity, whether male or female or business enterprise.⁶⁵ Legally, the term is often applied if the volume of a person's matured debts exceeds the value of his property. In this regard, a person may be legally bankrupt despite having some properties, since whatever he owns is claimed by one (1) or more of his creditors.⁶⁶ Once a person is a *mufliis*, there are only two (2) ways that status ends: (i) full repayment of all unforgiven debts; or (ii) death.⁶⁷

5.2 References in Relation to Bankruptcy / Insolvency under *Shariah*

The primary reference for the Islamic law of bankruptcy is stated in the *Qur'an*, the primary source of *Shariah*, in *Surah Al-Baqarah* (Chapter 2) at verse 280 states as follows:⁶⁸

*"And if the debtor is in a hard time (has no money), then grant him time till it is easy for him to repay, but if you remit it by way of charity, that is better for you if you did but know."*⁶⁹

It is clear from this verse that at the heart of the Islamic law of bankruptcy are the principles underlying all of the *Shariah* i.e social responsibility and charity. This forceful divine, but not compulsory, recommendation to be kind to one's debtor, is balanced by the *Qur'anic* verse that compels a Muslim to repay one's debts, making it a sin and not just a legal obligation not to pay off all of the debts that you have the capacity to repay:⁷⁰

*"O you who believe! Fulfil (your) obligations."*⁷¹

This is a divine instruction to fulfil one's contracts. To make this point, the jurists frequently cite a tradition from the Prophet Muhammad (Peace be upon him ("PBUH")) which stated that a debtor delaying paying a debt or an obligation without a valid excuse, even to a wealthy person, is unjust. It is believed that the Prophet Muhammad (PBUH) had told his believers that the soul of the Muslim will be suspended with his debts and freed only when his debts are satisfied.⁷²

5.3 Personal Insolvency versus Corporate Insolvency

There is no distinction in classical Islamic bankruptcy law between personal and corporate insolvencies. This is consistent with related elements of a continuing duty to pay one's debts and the lack of development of limited liability, entity - shielded, business vehicles, such as the corporation. As a result, the liabilities of the business enterprise would also be the obligations of the individual owner or the partners in the partnership.⁷³

5.4 Effect of Bankruptcy / Insolvency

Once a debtor is declared bankrupt or insolvent, he may be interdicted or prohibited to deal with financial matters. The majority of Hanafi⁷⁴ jurists ruled in accordance with the opinions of Abu Yusuf, Muhammad, and the majority of jurists, that a bankrupt debtor may be interdicted in financial matters, to protect the rights of his creditors. They based this ruling on the

⁶³ Abed Awad and Robert E. Michael, Iflas and Chapter 11: Classical Islamic Law and Modern Bankruptcy, 44 International Law, 975 (2010), p. 980

⁶⁴ Dr Wahbah Al-Zuhayli, *Al-Fiqh Al-Islami wa-Adillatuh* (Islamic Jurisprudence and Its Proof), Translated by Mahmoud A. El-Gamal, Revised by Muhammad S. Eissa, Financial Transactions in Islamic Jurisprudence, Volume 2, Dar al-Fikr al-Mouaser, Beirut, Lebanon, Dar al-Fikr, Damascus, Syria, p. 383

⁶⁵ Supra Note 63, p. 980

⁶⁶ Supra Note 64, p. 383

⁶⁷ Supra Note 63, p. 980

⁶⁸ Supra Note 63, p. 980

⁶⁹ *Qur'an, Surah Al-Baqarah* (Chapter 2) Verse 280. All translations of the *Qur'an* are from translation of the meanings of The Noble *Qur'an* in the English language by Dr Muhammad Taqi-ud-Din Al-Hilali and Dr Muhammad Muhsin Khan, King Fahd Complex for the printing of the Holy *Qur'an*, Madinah, Kingdom of Saudi Arabia

⁷⁰ Supra Note 63, p. 980

⁷¹ *Qur'an, Surah Al-Ma'idah* (Chapter 5) Verse 1

⁷² Supra Note 63, p. 980

⁷³ Supra Note 63, p. 985

⁷⁴ There are basically four (4) main *mazhab* (school of *fiqh*/thought) which are recognized by Muslim scholars namely *mazhab* Hanafi, Maliki, Shafi'i and Hanbali. These four (4) *mazhab* are named after its founder and each of the *mazhab* give different weight in legal opinions to prescriptions in the *Qur'an*, the *Sunnah* (the actions and sayings of the Prophet Muhammad (PBUH)), the *Ijma'* (consensus of Muslim scholars) and the *Qiyas* (the deductive analogy and reason for opinion).



Hadith narrated by Al - Daraqutni and Al - Khallal, and rendered valid by Al - Hakim, that the Prophet Muhammad (PBUH) interdicted Mu'adh (a companion of the Prophet Muhammad (PBUH)) and sold his property to repay his debt, thus repaying five - sevenths of the total debts he owed. The Prophet Muhammad (PBUH) then told the creditors that that is all they can get in lieu of Mu'adh's debts.⁷⁵

Before a bankrupt debtor is interdicted, some jurists are of the view that there is a need for a court order prior to the interdiction of the bankrupt debtor. The non - Malikis jurists ruled that a debtor may only be interdicted by a court order. Thus, prior to a court declaration of bankruptcy, all of his dealings would be executed. Then, if he is interdicted by the judge, he is prevented from engaging in any compensated or uncompensated financial dealings, or any acknowledgements of debt that may affect his creditors adversely. Thus, the judge may confiscate and sell his property, and distribute the proceeds to the creditors. The accepted opinion among the Hanafis jurists, which was first expressed by Abu Yusuf and Muhammad, is that two (2) conditions must be satisfied to interdict a debtor: (i) his debt must equal or exceed the value of his properties; and (ii) his creditors must request his interdiction. The Shafi'is and Hanbalis jurists also agreed with the necessity of those conditions for interdiction of bankrupt debtors.⁷⁶

5.5 Consequences of Interdiction Pursuant to Bankruptcy / Insolvency⁷⁷

There are a number of consequences of the legal interdiction of bankrupt debtors and among such consequences are as follows:

(i) **Creditors' rights**

When a bankrupt debtor is interdicted, the rights of the creditors are attached to his property, and he is forbidden from dealing in that property. In this regard, it is highly recommended that the declaration of legal bankruptcy and interdiction is witnessed by a judge, so that everyone will know of his state of bankruptcy, and would only deal with him with full knowledge of his financial situation.

(ii) **Maturity of deferred debts**

The Hanafis and most of the Malikis ruled that once interdiction is established for a bankrupt debtor, all of his deferred debts are matured at the date of interdiction, in analogy to the maturity of debts upon the debtor's death. The instigating factor for ruling by analogy in the cases of bankruptcy and death of the debtor is the fact that his juristic personality ceases to be eligible for debts in both cases. The majority of the Shafi'is and the majority of Hanbalis ruled that deferred debts are not matured upon the declaration of the debtor's bankruptcy. They based this ruling on the view that deferment is a legal right of the debtor, which is not dropped by bankruptcy, like his other debts. In this regard, they distinguished between the bankruptcy of a debtor, and in the case of his death by virtue of the fact that death obliterates the juristic personality of the deceased.

(iii) **Precautionary incarceration and monitoring**

It is a well known Islamic ruling that a debtor who is capable to repay his matured debts must do so, while a debtor who is incapable to repay must be given a grace period until he can. Thus, if the debtor has property with which he can repay matured debts, but he refuses to repay them, then the ruler may incarcerate him to force him to repay. This latter ruling is based on the *Hadith*:

"A lingering debtor who refuses to pay despite his ability is a transgressor, and thus it is permissible to complain about his transgression and to punish him [by incarceration]."

However, the jurists of different schools stipulated various conditions for the permissibility of incarcerating a debtor who lingers despite his ability to repay his matured debts.

⁷⁵ Supra Note 64, p. 384

⁷⁶ Supra Note 64, pp. 385-386

⁷⁷ Supra Note 64, pp. 388-390



(iv) **Selling the debtor's property**

Jurists agree that an interdicted bankrupt debtor's property may be sold, and its price may be distributed among his creditors in proportion to their debts. In this regard, it is preferable that the debtor's property is sold immediately following his interdiction, to minimize the period of interdiction and to clear his liabilities and repay his creditors as soon as possible. Moreover, the Prophet Muhammad (PBUH) interdicted Mu'adh (a companion of the Prophet Muhammad (PBUH)) thus immediately selling his property and distributing the price among his creditors. Thus, if the debtor's property was of the same genus as the debts, the judge may repay the debts directly without his permission, otherwise he may sell it and repay the debts from its price.⁷⁸

6. **Insolvency vis - à - vis Islamic Finance**

6.1 **Insolvency in Relation to Islamic Finance**

Contextually and philosophically, there is a direct link between the Islamic law of bankruptcy and the Islamic law of finance. Both are tied to social responsibility and economic equity. In fact, the *Qur'anic* verse that outlaws all forms of *riba* (usury) follows immediately the verses that require Muslims to be charitable. The two (2) concepts are then blended together. This is stated in *Surah Al-Baqarah* verses 275 and 276 as follows:

275 - *"Those who eat Riba' (usury) will not stand (on the Day of Resurrection) except like the standing of a person beaten by Shaitan (Satan) leading him to insanity. That is because they say: "Trading is only like Riba' (usury)," whereas Allah has permitted trading and forbidden Riba' (usury). So whosoever receives an admonition from his Lord and stops eating Riba' (usury) shall not be punished for the past; his case is for Allah (to judge); but whoever returns [to Riba' (usury)], such are the dwellers of the Fire - they will abide therein."*⁷⁹

276 - *"Allah will destroy Riba' (usury) and will give increase for Sadaqat (deeds of charity, alms, etc.) And Allah likes not the disbelievers, sinners."*⁸⁰

The aforementioned verses reflect that both lending and repaying are interwoven with powerful divine compulsions to be charitable and compassionate. The consistent requirement for fair treatment and avoidance of punishment for inability to pay one's debts due to economic hardship is one of the important elements under Islamic law. Another element that should be noted is that there is no equivalent to "discharge of debts" under Islamic law. This rule, which seem to be inconsistent with a charitable imperative, is the natural extension of the fact that Muslims are directed to fulfill their obligations. This is in line with verse 1 of *Surah Al - Ma'idah* as stated in paragraph 5.2 above. A debt owed to someone must be paid if possible. Muslims must fulfill their obligations to Allah and to man. These key tenets of no discharge and social responsibility are prescriptive elements of Islamic law that differentiate it from Western law.⁸¹

6.2 **Grace Period for Payment of Debts Prior to Insolvency Proceedings**

Based on the information as stated in paragraph 5 above relating to the *Shariah* perspective on insolvency particularly based on the reference as stated in the *Qur'anic* verse 280 of *Surah Al-Baqarah* which provides that if the debtor is in "hard time" (i.e has no money) the creditor should grant him time until it is easy for the debtor to repay his debts, it could be noted that one (1) of the key points as set out in such verse is that if the debtors are in financial difficulties (i.e. has no money etc.), the creditors should grant the debtors "time" until it is easy for the debtors to repay their debts to the creditors. This verse seems to reflect that before the creditors proceed to undertake bankruptcy or winding - up proceedings against their debtors, "adequate time" should be granted to the debtors' concerned in order for him to repay his debts to the creditors. The issue which would be the concern of the creditors relating to "adequate" or "sufficient time" is

⁷⁸ Supra Note 64, p. 394

⁷⁹ *Qur'an, Surah Al-Baqarah* (Chapter 2) verse 275

⁸⁰ *Qur'an, Surah Al-Baqarah* (Chapter 2) verse 276

⁸¹ Supra Note 63, pp. 980-981



that how long would it be considered adequate or sufficient time since it is subjective in nature. Without a clear determination on the period of time or grace period provided for the payment of debts by the debtors, there is a possibility for abuse particularly by the debtors which would be detrimental to the interest of the creditors.

6.3 Priority of Claims in Case of Insolvency: *Shariah* Perspective versus Malaysian Law

Under the Islamic law of bankruptcy, the creditors are primarily classified in order of priority⁸² for the purpose of claims in respect of the properties or assets of the bankrupt debtors. A comparison between the treatment on priority of claims under the Islamic law of bankruptcy and the Malaysian law under the Bankruptcy Act and the Companies Act respectively are summarized in the Schedule. The order of priority for claims under the Islamic law of bankruptcy and the Malaysian law under the Bankruptcy Act and the Companies Act as set out in the Schedule is applicable for bankruptcy and winding - up cases in general including in case of insolvency in relation to Islamic finance. Such order of priority is not peculiar or specifically meant in the case of insolvency in relation to Islamic finance only.

6.4 Depositors' Priority in the Event of Dissolution of Islamic Financial Institutions

In Malaysia, Islamic banking deposits use various *Shariah* concepts such as the *Shariah* concept of *Wadi'ah* (safekeeping) and *Mudharabah* (investment arrangement) with different implications therein. In general, Islamic banking deposits can be classified into three (3) main categories namely (i) *Wadi'ah* deposit; (ii) *Mudharabah* deposit; and (iii) deposit based on other *Shariah* concepts such as *Bai' Bithaman Ajil* (deferred payment sale) and *Bai' Inah* (sale and buy back). In the case of dissolution of an Islamic financial institution ("IFI") including in the event of insolvency / liquidation / winding - up, the key issue relates to the priorities of the depositors to recover their deposits which are based on certain *Shariah* concepts, compared to other depositors.⁸³

6.4.1 Ruling by the SAC of BNM on Priority of Claim by Depositors

The SAC of BNM decided during its 26th meeting on 26 June 2002 and its 30th meeting on 28 October 2002 that the priority of depositors in the IFIs to recover their deposits in case of a dissolution of an IFI, including in the event of insolvency / liquidation / winding - up, will be based on the '*aqad* (contract) or concept which was agreed upon with the respective IFI. In this regard, the deposit accounts of the depositors should be evaluated based on face value of the deposits' concerned at the date of the dissolution of the IFIs. It was resolved by the SAC of BNM that priority should be given to *Wadi'ah* deposit and other type of deposits which are received on loans by the IFIs compared to *Mudharabah* deposits.⁸⁴

6.4.2 Rationale of the Ruling by the SAC of BNM

The rationale for the ruling by the SAC of BNM relating to priority of claim by depositors is that from the perspective of *fiqh*⁸⁵, since *Wadi'ah* in the IFIs is largely considered as *qard* (loan) by depositors to the IFIs, the IFIs are obliged to ensure and restore all money which were deposited in the *Wadi'ah* deposits accounts' concerned.⁸⁶ Meanwhile for deposits which are based on the contract of *Mudharabah*, from the perspective of *fiqh*, the IFIs are not obliged to ensure or restore all the *Mudharabah* money or its profits, unless the monetary loss was caused by negligence and errors of the IFIs as *mudharib* (the manager).⁸⁷ This is because under the concept of *Mudharabah*, both the capital provider (*rabb al - mal*) and the manager (*mudharib*) agree to share profit and loss together in their business venture in accordance with the proportionate ratio as agreed between them. As such, if the business venture suffers any loss which is not due to the negligence and errors of the IFIs as *mudharib*, then the IFIs are not obliged to make good or return all the *Mudharabah* deposits which were deposited with the IFIs to the affected depositors.

⁸² Supra Note 63, p. 991

⁸³ Bank Negara Malaysia, *Shariah Resolutions in Islamic Finance*, Second Edition, 2010, p. 187.

⁸⁴ Supra Note 83, p. 187

⁸⁵ *Fiqh* is an arabic word for Islamic jurisprudence.

⁸⁶ Organisation of Islamic Conference ("OIC") *Fiqh Academy, Majallah Majma' al-Fiqh al-Islami*, 9th Conference, Resolution No. 86 (9/3)

⁸⁷ Supra Note 83, p. 180



6.4.3 Depositors' Priority under IBA

The ruling by the SAC of BNM relating to priority of claim by depositors is in line with the provisions as set out in Section 45(1) of IBA which provides that where an Islamic bank is wound-up under paragraph 37(2)(f) of IBA, the proceeds of the liquidation of the Islamic bank shall, subject to section 10 of the Government Proceedings Act 1956 and subsection 45(2) of IBA, be paid to the depositors in priority over all other unsecured liabilities in the following manner: (i) Islamic deposits based on custody; and (ii) other Islamic deposits.⁸⁸

Based on the provisions of Section 45(1) of IBA, it is clear that for depositors in IFIs which are governed under IBA, depositors who deposited their money into Islamic deposits based on custody (i.e. *Wadi'ah* deposits) will have priority of claim over other types of Islamic deposits such as *Mudharabah* deposits etc.

6.4.4 Depositors' Priority under BAFIA

For depositors in financial institutions which operates under the Islamic banking scheme within BAFIA (as opposed to IBA), the priority treatment to the depositors in such financial institutions will be based on the provisions as set out in Section 81(1) of BAFIA which provides that subject to section 10 of the Government Proceedings Act 1956 and subsection 74(5) of BAFIA, where a licensed institution becomes unable to meet all or any of its obligations, suspends payment to any extent or is wound-up under paragraph 73(2)(c) of BAFIA, the properties of the institution in Malaysia shall be available to meet all liabilities of that institution in respect of all deposits in Malaysia in priority over all other unsecured liabilities of that institution in Malaysia.⁸⁹

Based on the provisions of Section 81(1) of BAFIA, for depositors in financial institutions which operates under the Islamic banking scheme within the purview of BAFIA, all depositors who deposited their money into such financial institutions, either in conventional deposit accounts or Islamic deposit accounts such as *Wadi'ah* deposits or *Mudharabah* deposits etc, will have priority of claim over all other unsecured liabilities of that institution in Malaysia. The priority of claim for depositors under BAFIA where all depositors rank equally among themselves is different from the priority treatment for depositors under IBA whereby it differentiates in respect of claim between *Wadi'ah* depositors and *Mudharabah* depositors and other depositors.

6.4.5 Section 45(1) of IBA vs Section 81(1) of BAFIA

Different provisions of Section 45(1) of IBA and Section 81(1) of BAFIA as set out above relating to the priority of Islamic depositors in the event of insolvency are due to the fact that full-fledged licensed Islamic banks are governed by IBA thus Section 45(1) of IBA is applicable for Islamic banks whereas for conventional banks which carry on Islamic banking or financial business via Islamic banking window under the Islamic banking scheme, they are governed by BAFIA thus Section 81(1) of BAFIA is applicable for such conventional banks.

7. Conclusion

The Malaysian law perspective regarding the issue of insolvency in relation to Islamic finance, particularly the applicable procedures under the Bankruptcy Act and the Companies Act for the bankruptcy proceedings and the winding-up proceedings respectively, is similar with other cases of insolvency. The peculiar aspect which could be noted regarding the issue of insolvency in relation to Islamic finance is with regard to the priority of claims by the depositors in the event of dissolution of IFIs in Malaysia. In such circumstances, priority of claim should be given to *Wadi'ah* deposit and other types of deposits which are received on loans by the IFIs compared to *Mudharabah* deposits pursuant Section 45(1) of IBA. However for depositors in financial institutions which operates under the Islamic banking scheme under BAFIA, all depositors who deposited their money into such financial institutions, either in conventional deposit accounts or Islamic deposit accounts such as *Wadi'ah* deposits or *Mudharabah* deposits etc, will have priority of claims over all other unsecured liabilities of that institution in Malaysia pursuant to Section 81(1) of BAFIA.

⁸⁸ Section 45(1) of the IBA

⁸⁹ Section 81(1) of the BAFIA



The *Shariah* perspective regarding the issue of insolvency as highlighted above generally reflects that the procedures and treatment are similar for general insolvency cases including for insolvency in relation to Islamic finance. One of the main points which should be noted is that from *Shariah* perspective, “adequate time” or “grace period” should be granted to the debtors to repay their debts to the creditors prior to undertaking the bankruptcy or winding - up proceedings. This is based on the reference as stated in verse 280 of *Surah Al - Baqarah*. Notwithstanding such reference, it is submitted that a proper formula or guideline should be determined by the *Shariah* scholars regarding the meaning of “adequate time” or “grace period” from *Shariah* perspective which should be provided to the debtors to repay their debts to the creditors prior to undertaking the bankruptcy or winding - up proceedings in order to avoid any potential issues or disputes relating to the interpretation or understanding of such term.

In summary, it could be stated that the Malaysian law, to some extent, has taken into account the applicable treatment which should be undertaken for insolvency in relation to Islamic finance by incorporating the provisions as set out in Section 45 of IBA and Section 81 of BAFIA respectively. The deliberation and ruling made by the SAC of BNM relating to the issue of depositors’ priority in the event of dissolution of IFIs is a commendable and far - sighted effort taken by the SAC of BNM in anticipation of such probable scenarios in the future. It is suggested that further research and pronouncement by the *Shariah* scholars with regard to the issue of insolvency in relation to Islamic finance be made in order to cater to the current advanced and sophisticated feature of Islamic finance. This is to ensure that the Islamic finance industry community are well prepared and equipped with the available information and possible solutions to face any applicable issues on insolvency in relation to Islamic finance in the future.



Schedule

Priority of Claims in case of Insolvency: *Shariah* Perspective versus Malaysian Law

A. Priority of Claims in case of Insolvency from *Shariah* Perspective⁹⁰

1. The Receiver

The first priority to be paid from the liquidation of the debtor's assets remaining after the recoveries are the fees, expenses and compensation of the receiver to manage the bankruptcy proceeding.

2. Reclamation Creditors

The creditors who are able to discover that his property is in possession of the debtor have priority as reclamation creditors. This is subject to the creditors' concerned satisfying certain conditions and provided that there has been no change as to the condition of the property in question.

3. Lessors

Landlords have similar preferential rights. The priority of the lessors depends on whether the lease period has commenced or ended. If the lease period has not commenced, the lessor has the right to annul the contract and take back his property. If the lease period has expired, the lessor becomes a creditor for unpaid rent. If the lease is still operative, the lessor cannot annul the contract as the usufruct remains the asset of the bankrupt, while the lessor becomes a creditor for the unpaid rent.

4. Secured Creditors

Creditors with a secured interest over collateral will have priority against the said collateral in the event of bankruptcy. In classical Islamic law, security interest can be created over real property or collateral by way of *Murabahah* (Cost plus profit sale) and *Rahn* (Pledge / Collateral).

5. Personal Exemptions

Classical Islamic law protect the debtor's reasonable living expenses which includes the basic necessities for the livelihood of the bankrupt and his family. There are also opinions which provide that the creditors and court must leave sufficient capital for the bankrupt to continue with his trade. The tools of trade of the bankrupt are also exempted from liquidation.

6. Other Priorities

Specific preferences and priorities for certain unsecured creditors are recognized by classical Islamic law. Employers who are bankrupt are still obliged to pay his employees wages. Fees for services engaged by the bankrupt must also be paid.

7. All Other Creditors

This class of creditors do not have priority and they all share equally proportionate to their debts.



⁹⁰ Supra Note 63, pp. 991-997

Priority of Claims in Case of Insolvency from Malaysian Law Perspective

B. Priority of Claims in Case of Bankruptcy⁹¹

1. Receiver Fees

Expenses incurred in the administration of the bankruptcy.

2. Secured Creditors

After the payment of the receiver fees, secured creditors will get priority of claims over other types of claims since their rights are secured by virtue of the security created in respect of the debts owed by the debtors towards them.

3. Debts of Priority

Priority to all other debts comprising:⁹²

- (a) Local rates and land tax.
- (b) Income tax and other assessed taxes.
- (c) Wages or salaries of employees (clerk, servant, labourer or workman).
- (d) Employee's provident fund.
- (e) Workmen's compensation.

The foregoing debts shall rank equally between themselves, and shall be paid in full unless the property of the bankrupt is insufficient to meet them, in which case they shall abate in equal proportions between themselves.⁹³

4. Preferential Claims

Claims of an apprentice, articled clerk or any expatriate employee of the bankrupt.⁹⁴

5. Non - Priority Debts

When there is surplus after the settling of priority and preferential debts, all other debts proved shall be ranked *pari passu* i.e equally and without preference.⁹⁵

6. Interest

Where a debt proved by any creditor includes interest or any pecuniary consideration in lieu of interest, such interest or consideration shall for the purposes of dividend be calculated at a rate not exceeding six percent (6%) per annum up to the date of the receiving order is granted by the court.⁹⁶

C. Priority of Claims in Case of Winding - up⁹⁷

1. Secured Creditors

Secured creditors do not need to prove their debts as they may realize the secured asset and prove for deficiency, if any.

⁹¹ Supra Note 25, p. 295

⁹² Section 43(1) of the Bankruptcy Act

⁹³ Section 43(2) of the Bankruptcy Act

⁹⁴ Section 44(1) of the Bankruptcy Act

⁹⁵ Section 43(4) of the Bankruptcy Act

⁹⁶ Section 43(6) of the Bankruptcy Act

⁹⁷ Supra Note 37, p. 536



2. Winding - up Expenses

Costs and expenses of winding - up, including the remuneration of the liquidator.⁹⁸

3. Preferential Debts

(a) All unpaid wages, salaries, vacation leave, unpaid superannuation contributions, provident funds payment and other employees entitlements.⁹⁹

(b) Federal taxes, service tax, capital gains tax and sales tax.¹⁰⁰

4. Unsecured Creditors

Creditors who do not have any security created in respect of the debts owed by the debtors towards them will get their claim after payment of the preferential debts is settled.

5. Members

Assuming that there is surplus after all creditors have been paid accordingly what they are owed.

⁹⁸ Section 292(1)(a) of the Companies Act

⁹⁹ Section 292(1)(b)-(e) of the Companies Act

¹⁰⁰ Section 292(1)(f) of the Companies Act