MUSHĀRAKAH MUTANĀQIṢAH AND LEGAL ISSUES: CASE STUDY OF MALAYSIA

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Abstract

This paper explores home financing through mushārakah mutanāqiṣah in Malaysia and possible legal issues. This paper explains that there are a few methods in the practice of implementing mushārakah mutanāqiṣah legally. The first is where the customer is registered as the owner of the property and a charge is created in favour of the bank, and the second is where the bank is registered as the legal owner as the trustee for itself and the customer. As for the implementation of mushārakah mutanāqiṣah in the event of default, it depends whether there is a waʿd or not. This paper also elucidates the issues facing mushārakah mutanāqiṣah home financing for properties under construction and proposes an alternative model for solving the highlighted issues. Lastly this paper raises and analyses possible legal issues that may arise in enforcing a mushārakah mutanāqiṣah home financing contract where a legal charge is created and where a trust is created.

Keywords: *Mushārakah mutanāqiṣah, waʿd,* Legal Charge, Equitable Charge, Trust, s.344.

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I. INTRODUCTION

Mushārakah mutanāqiṣah ("MM") or the diminishing partnership or co-ownership financing technique was approved for house financing in 1991 during the workshop organised by the Islamic Research and Training Institute (IRTI), Jeddah, and the Sudanese Estates Bank, Sudan, held in Khartoum.[1] However, only in the last couple of years has this financing mode begun gaining more attention from both practitioners and academicians as a possible Islamic alternative for home financing.

While theoretically MM home financing may be an excellent alternative financing tool for home owners, the question arises as to whether this is true in practice. As it is a relatively new product for home financing, there are bound to be some uncertainties as to its operation and legal validity.

This paper aims at addressing these concerns by explaining the practice of offering MM home financing by Islamic banks in Malaysia. As we shall see in the pages that follow, there is more than one method used in the market for completed properties. This paper also discusses the method used for MM in properties under construction and a possible alternative model is proposed. This paper then explores the possible legal issues of the different methods used for MM home financing for completed properties.

II. OVERVIEW OF *MUSHĀRAKAH MUTANĀQIṢAH*

MM is a partnership or co-ownership culminating in legal ownership of the underlying asset by one of the partners, usually the customer (Bendjilali & Khan, 1995, p.49). According to Usmani, MM refers to a partnership between a financier and a client who jointly own a property or equipment, or commercial enterprise. The share of the financier is further divided into a number of units and the client is expected to purchase those units periodically. By doing so, the share

1 Proceedings of this Workshop have been published by IRTI. Please see: (Mahdi, 1995).

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of the client will increase and the share of the financier will decrease, until all the units are owned by the client (Usmani, 2002).

MM is also known as 'shared equity' and it is used mostly for home financing. MM is not found in classical *fiqh* literature as it is an innovative product or a hybrid product consisting of several classical contracts. In fact, the pure MM consists of three contracts, namely: *mushārakah, ijārah* and *waʿd* followed by *bayʿ*.

In brief, there are three stages of MM. First, it consists of *mushārakah* (co-ownership) between the customer and the bank. This is done through the contract of *'shirkat-al-milk'*. For example, the customer and the bank buy a house with initial capital investments of 10% and 90% by them respectively. It is worth noting here that – based on the current practice which is due to legal constraints imposed by domestic legislation – the MM agreement clearly states that MM is not a partnership. Thus for example, MM does not fall under the Partnership Act in Malaysia. Rather, MM is considered as a co-ownership or joint ownership of the underlying asset. Furthermore, the authors believe that the agreement should also include a separate clause stating that there is no implied agency. Currently, some agreements state this and others do not.

The second stage is implemented through the contract of *ijārah* between the customer and bank. Here, the customer rents the bank's undivided share or portion in the house and pays the rental payment. Finally, the customer will continue to buy the units representing the bank's share gradually until the house is fully owned by him. Slowly, the share of the customer in the house will increase while the share of the bank will decrease, through the periodical redemption of the units by the customer, until the house is fully owned by the customer. This purchase of the bank's share is carried out through the sale contract *(bayʿ)*. Furthermore, the customer will sign the *waʿd* agreement whereby he agrees to buy the outstanding share from the bank gradually.

The following discussion is focused on the implementation and operation of MM in Malaysia. While preparing this paper, the authors conducted several interviews with industry players in Malaysia.

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A. Mechanism of MM – An Overview

In general, the following are the steps involved in implementing the MM financing technique (see Figure 1 below):

i) *First Step*

   a. Customer identifies the property that he/she wants to purchase and signs a Sales and Purchase (S&P) agreement with the developer and pays a deposit.
   b. Customer approaches the bank for a financing facility.
   c. Once approved, customer and bank will enter into a MM arrangement where the purpose of the co-ownership is to acquire a property.
   d. The initial deposit/down payment made by the customer at this stage will be his/her contribution towards the MM venture while the bank's contribution will equal the financing amount.

ii) *Second Step*

   a. The bank subsequently leases the acquired property to the customer.
   b. The practice among the banks is to only lease their share in the property to the customer. In this case, all the rental payment goes to the bank.
   c. The bank's portion of the rental income is similar to a financing profit earned by a conventional bank.

iii) *Third Step*

   a. Throughout the tenure of the lease, at agreed time intervals, the customer will buy units representing the bank's share in the property from the bank. This is implemented by the customer paying an additional amount in addition to the rental payment to purchase the bank's share in the property (contract of *bay*ʿ takes place). The share of the bank will be reduced by every purchase of the units by the customer.
   b. At the end of tenure of the lease, the property will be wholly owned by the customer and the ownership title will

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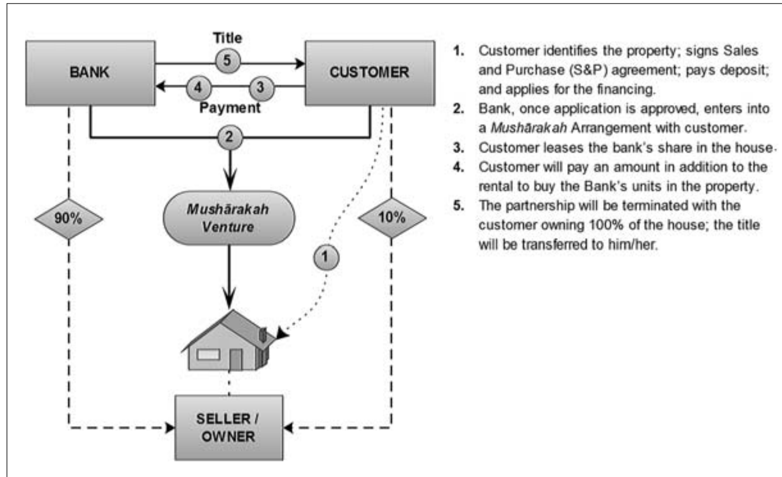
be transferred to the customer. With this the MM will be terminated.[2]

Figure 1: Mushārakah Mutanāqiṣah Structure



B. Practical Implementation of MM in Malaysia

In general, MM has been used in Malaysia for both completed properties and properties under construction. This section will explain the methods used in banks in Malaysia to enable the MM home financing to take place legally. We will start with a discussion of two models that are currently being used in Malaysia for completed

2 As can be seen from the above explanation, implementation of the MM mechanism creates a complex set of relationships, rights and obligations among the partners. As a result, financial institutions are exposed to credit risk which is enhanced by collateral, comparable to a conventional home loan. If the original *mushārakah* is implemented where the bank is exposed to the property price risk as well, then the capital risk weighting could be as high as 400%, thus increasing exponentially the financing cost for the customers. As a result, customers would not enjoy the same rate as a conventional home loan (which is currently around 5%, on a variable basis), and may end up paying a huge premium for Islamic home financing. For details see: *IFSB-2:* Capital Adequacy Standard for Institutions (other than Insurance Institutions) offering only Islamic Financial Services (IIFS), paragraphs 29 and 32 (2005).

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properties. Then, we will highlight the current practice of MM with regards to properties under construction and suggest a possible alternative model using the *istisnāʿ* contract.

1. Completed Properties

In general, there are two main differences in the practice of implementing MM home financing, which are:

- under whose name the property is registered (bank or customer); and,
- how the issue of default is treated?

A. Registration of the Property

The majority of banks in practice register the property under the customer's name. The following is an illustration of this method of MM home financing:

i) The Customer and Bank are co-beneficial owners of the property, but the Bank agrees to register the property in the name of the Customer. The Customer becomes the registered proprietor of the property as well as a trustee for the two co-beneficial owners (i.e. both the Bank and Customer). At this stage, the Customer is a registered proprietor, trustee and a beneficiary. The bank is another beneficiary.

ii) As security for the performance of its payment obligations to the Bank, the Customer then pledges his share of the beneficial ownership of the property to the Bank. However, given that the property is registered in the name of the Customer qua trustee for the Customer and Bank (as beneficiaries), both beneficiaries agree that the Customer qua trustee should register a charge over the whole property in favour of the Bank as security. In reality, the trustee should only charge the Customer's portion of the land to the Bank and not charge the Bank's portion of the land as well. However, given that the National Land Code ("NLC") only allows a charge on "the whole, but not a part only, of any alienated land" the trustee, with the consent of the Bank, charges the whole property in favour of the Bank.

iii) If the Customer defaults and fails to remedy the default, the Bank will sell the property through the charge provision under the NLC. If the sale leads to a surplus, the Customer will get

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the surplus. If there is a shortfall, the Customer will be liable to pay the shortfall amount to the Bank, based on a *waʿd* obligation assumed by the Customer. This position is also comparable to the charge foreclosure position under a conventional loan.

In the case of the second method, which is currently practiced by Kuwait Finance House (KFH), the property is registered in the bank's name. This method of MM home financing is as follows:

i) The Customer and Bank are co-beneficial owners of the property, but the Customer agrees to register the property in the name of the Bank. The Bank becomes the registered proprietor of the property as well as a trustee for the two co-beneficial owners (i.e. both the Bank and Customer). At this stage, the Bank is a registered proprietor, trustee and a beneficiary. The Customer is another beneficiary.
ii) To evidence the trust, a trust deed is executed and stamped, and the trust is registered under s.344 of the NLC.
iii) If the Customer defaults and fails to remedy the default, the underlying asset will be sold in the market and the proceeds will be shared between the co-partners according to the latest ownership share ratio (after all the outstanding costs and payments, such as outstanding rents and legal fees, are covered).[3]

However, there are two reasons why the method of having the bank own the property may not be viewed favourably in the market. The first reason is the customer's perception shaped by conventional mortgage practice where the customer is always the registered owner. The customer seeking Islamic financing also invariably wants the property to be registered in his/her name. The second reason is the possible liability linked to the ownership of the property by the bank in the event there is a tortuous claim. For example, if there is a defect in the property and someone is seriously injured in the property, the bank could potentially be held liable as the registered owner of the property.

3 However, in our personal communication with KFH following the initial write-up, we were told that they do not take any property price risk.

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B. Issue of Default

In general, in the event of default, the termination of MM – as highlighted by Bank Negara Malaysia (BNM) - can be done in two ways: (i) without a *waʿd* (purchase undertaking); and, (ii) with a *waʿd* (BNM, 2008, p. 96).

Where the customer has provided a *waʿd* to the bank at the outset of the MM home financing, in the event of default the customer is obliged to acquire the bank's remaining share. This creates a debt to be paid by the customer to the bank.

For example, say at the time of default if the bank exercises the *waʿd*, the amount of purchase price payable by the customer is RM100,000. And let us assume the amount of unpaid rental at the time of default is another RM10,000. The bank would be able to claim RM110,000 from the customer. And suppose the customer fails to honour the *waʿd* and the bank ends up selling the property under the charge for say RM80,000. In such a scenario, the bank would be able to claim the shortfall of RM30,000 from the customer as an unsecured debt.

However if no *waʿd* has been procured from the customer (or the *waʿd* is not excercised) then the underlying asset will be sold in the market and the proceeds will be shared between the partners according to the latest ownership share ratio (after all the outstanding costs and payments, such as outstanding rents and legal fees, are covered). The problem with this approach is that if the value of the property has depreciated, the bank does not have recourse to the purchase price payable by the customer under the *waʿd*.

Thus continuing with the example above, if there is no *waʿd,* the only **debt due** and payable by the customer to the bank is RM10,000 (unpaid rental)! And assuming that the sale proceeds are RM80,000 and the bank has a 90% share in the MM, the bank can retain RM71,000 as its capital distribution (90% x RM80,000), and from the customer's share of RM9,000 it can deduct the unpaid rental of RM10,000. The bank can claim the balance of unpaid rental amounting to RM1,000 as an unsecured debt from the customer. However, the bank has no further claim on the balance of RM20,000 from the customer, being the amount equal to the balance of the purchase price (RM100,000 – RM81,000). Under this scenario, the bank is worse off than in conventional mortgage or *bayʿ bi-thaman ājil* ("BBA") financing.

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However, if the sale proceeds are RM120,000 instead, and the bank has a 90% share in the MM, the bank can retain RM108,000 as its capital distribution and from the customer's share of RM12,000 it can deduct the unpaid rental of RM10,000. Under this scenario, the bank is better off than in conventional mortgage or BBA financing, given that it has ended up with RM118,000 compared to RM110,000.

Although the central bank allows a bank to choose option A or B (i.e. selling the property in the market for the prevailing price or executing *waʿd*) which is in line with the principles of the Sharīʿah, we recommend that the central bank should require banks to choose one of the two options at the beginning of the contract. The banks should not be given freedom to decide whether to take the *waʿd* option or the direct sale option (without *waʿd*) at the time of default. To illustrate this, let us take another example. Assume that the initial price of the house was RM100,000; the share-ratio between a bank and a customer is 70:30 respectively; and at the time of default the price of the house increased to RM150,000. It is obvious that in this case the bank will choose to sell the house for RM150,000 and get RM105,000 instead of RM70,000. The customer would receive the remaining balance of RM45,000, a sum which is lower that the amount (RM80,000) that the customer would otherwise obtain under the *waʿd* option. On the other hand, if the price has decreased to say RM80,000, the bank would choose to execute the *waʿd* and request RM70,000 from the customer. Hence, under this scenario, the bank has an option to choose what is in its best interests. This point is further illustrated in Table 1 below.

Table 1: Mushārakah Mutanāqiṣah in the Event of Default

Issue 1	*Without Waʿd 2*		*With Waʿd 3*	
Cost of the House	RM100,000		RM100,000	
Customer's Share (C)	RM10,000		RM10,000	
Bank's Share (B)	RM90,000		RM90,000	
Equity Ratio C:B	10:90		10:90	
Default after 3 yrs				
Customer's Share	RM30,000		RM30,000	
Bank's Share	*RM70,000*		*RM70,000*	
Equity Ration C:B	30:70		30:70	
Creates Indebtedness	No		Yes	
Sales proceeds	C-Share	B-Share	C-Share	B-Share
1. Price RM90,000	RM27,000	RM63,000	RM20,000*	RM70,000*
2. Price RM70,000	RM21,000	RM49,000	RM0**	RM70,000**
3. Price RM60,000	RM18,000	RM42,000	- RM10,000***	RM70,000***

Source: Authors' own

Note: For simplicity of discussion, we will ignore the outstanding rental and legal fees.

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- * The bank will claim all of the outstanding amount owed by the customer, while any surplus will be given to the customer.
- ** Banks use *waʿd* to create indebtedness, and the full amount is to be paid by the customer to a bank. Thus, if the proceeds are equal to the amount claimed, the customer will not receive anything, as his/her equity shares will be used to pay off the outstanding amount.
- *** On the other hand, if the proceeds are less than the amount claimed, the bank will go after the customer for the remaining balance.

From Table 1 above, we can see the difference in case of default when MM is implemented without *waʿd* and with *waʿd*. In short, when MM is implemented without *waʿd*, the property is sold at the market value. If there is a surplus, it will be shared between the parties based on the profit-sharing ratio. On the other hand, if there is a loss, it will be shared according to the capital share of each party in the property. In all the three sales proceeds scenarios in Table 1, the bank actually recovered less than RM70,000, the amount that would have been payable by the customer if a *waʿd* had been exercised.

However, in reality most banks use *waʿd* (purchase undertaking). It obliges the customer to buy all of the bank's outstanding share (in our case, RM70,000). However, as the customer will generally not be able to do so, the MM will be terminated and the underlying property will be sold at auction. The selling price of the house could be higher, lower, or equal to the amount claimed.

If the house is sold for, say, RM90,000, then RM70,000 will be paid to the bank for its share in the house. The additional RM20,000 (after deducting all unpaid rental) will be given to the customer. This is based on the principle of *'al-ghunmu bil-ghurm'*, meaning that, in general, no person is allowed to invest in a way that generates profit without exposing himself to the risk of loss. However, if the selling price is equal to the outstanding amount, the customer will receive nothing, as the proceeds will be entirely used to cover the amount claimed by the bank. Finally, if the proceeds are less than the amount claimed, the bank has the option of claiming the shortfall from the customer as an unsecured debt. What is certain is that in cases of default, when the MM is managed through *waʿd*, the bank

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is entitled to claim the full outstanding amount. Regardless of the selling price, the bank will be entitled to claim the full RM70,000 from the customer. The customer, however, would be entitled to any surplus from sale proceeds if the property price appreciates.[4]

2. Properties under Construction – A Proposal

When it comes to properties under construction, the current practice among the Islamic banks in Malaysia is very similar to the MM methods explained above. The only difference is that Islamic banks charge advance rental from the customer for the period during the construction. This advance rental is known as *ijārah mawṣūfah fī al-dhimmah* (forward lease).

However, issues arise if the property is abandoned. If the property is abandoned, the bank has to pay back the advance rentals to the customer and bear the risk according to the financing. This means that the customer and the bank are to share loss according to their capital share (e.g. 10% and 90%). On the other hand, if the customer is required to pay the full amount disbursed by the bank, then this mechanism is not in compliance with Sharīʿah. For example, consider that a developer is building a 20-floor condominium and that the customer has bought an apartment on the 19th floor. However, the developer abandoned the project just after finishing the 4th floor. How can the bank ask the customer to buy-back the bank's share in the property and pay back the full amount disbursed by the bank when the underlying property is non-existent at that point in time? In other words, what property or asset is the bank selling to the customer?

If the bank is merely selling its right in the MM to the customer without any underlying physical asset or property, such sale may not be in line with Sharīʿah requirements and will be tantamount to the customer guaranteeing the capital contribution of the bank in the MM venture. A review of the current MM legal documentation used by banks reveals that the banks have the right to legally sell their rights in the MM property to the customer for the full outstanding

4 Furthermore, it is worth noting that in the above cases the sale proceeds will first be used to cover all costs related to the legal action and property disposal before the bank's outstanding share is settled.

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amount under the MM facility, even though the property is yet to be constructed, due to say, the developer's default. Such legal documents may be challenged by the customer in a court of law on the ground that, given that the property is held under MM, both the customer and the bank have to share the risk of non-completion of the property in proportion to the capital contribution. Such legal risk, however, does not occur in MM for a completed property given that the bank can always compel the customer, who has furnished a *waʿd* upfront, to buy the bank's share in the completed property in the event of a default. Unfortunately, the current MM documentation for under-construction property seems to have taken an easy route by replicating the remedy clauses applicable to completed properties without creating bespoke documentation that would capture the right remedies for under-construction property in line with Sharīʿah requirements.

Keeping this in mind, we propose the following solution – a modified MM with *istisnāʿ* structure. The key difference between the original model, as depicted in Figure 1 above, is that the MM venture will enter into an *istisnāʿ* agreement with the customer - whereby the customer will agree to procure the **construction** of the property for the MM venture. The customer will enter into a Sale and Purchase Agreement with a developer to **contract** the *istisnāʿ* obligations to a developer of his choice. This way, the customer is legally responsible to the MM venture to procure the construction and delivery of the property and if the customer fails to deliver, in accordance with the *istisnāʿ* agreement, then the MM venture has a full right to claim the outstanding amount owed by the customer to the MM venture. If the customer fails to deliver the property as required under the *istisnāʿ* agreement due to, for example, the developer defaulting, the customer would be legally bound to return the actual amount disbursed to him under the *istisna'*. Given that the funding under the *istisnāʿ* came from the bank, the amount repayable by the customer will be for the account of the bank as the MM party. Using the *istisnāʿ* structure, the bank is able to mitigate the construction risk without invoking the *waʿd* against the customer (such undertaking is not possible under Sharīʿah as highlighted above).

If the property is not completed under the *istisna'*, the bank will be required to repay to the customer the advance rentals paid by the customer (as lessee) to the bank (as lessor) during the construction

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stage. The bank can mitigate this risk by seeking compensation from the customer (as the procurement party) under the *istisnāʿ* for failing to deliver the property as per the *istisnāʿ* terms. For the sole purpose of computing the compensation, the quantum of compensation can be equal to the amount of advance rental repayable to the customer. This arrangement is in line with market reality whereby it is the customer who has decided on the contractor after performing the required due diligence and, therefore, would bear the risk of non-completion of the property.

This arrangement may at first blush appear unjust to the customer who is bearing all the risks related to the property without exposing the bank to any risk other than credit risk of the customer. Should the bank also share the construction risk related to the property? In line with the principle of risk-sharing, the cornerstone of Islamic economics, the bank and the customer must both share the risk of the underlying property, including the construction risk. In practice, however, if the bank were to assume any risk related to the construction of the property, the bank would have to allocate a higher percentage of the capital to back the MM facility, which would make the MM facility extremely expensive in the market. Currently, the MM facility which does not expose the bank to the construction risk enjoys a 50% risk weight on capital requirements and consequently the MM facility is priced on par with comparable conventional mortgage. This makes the MM facility affordable to the customers. If the customers feel that the banks must also share the risk then they should be prepared to pay the premium corresponding to the risk assumed by the bank. Any construction risk exposure to the bank would increase the risk weight to 400% and this would increase the overall cost to the customer by a manifold amount (IFSB 2005). If the customers are prepared to pay a higher price for the bank's additional exposure, then the banks would be able to offer a risk-sharing MM facility. The stark reality is that the customers are not prepared to pay additional costs beyond what the market is pricing for the comparable conventional loan (which does not expose the conventional banks to any construction risk). It is only fair to compel the banks to take construction risk if the customers are prepared to pay the corresponding premium. Until the customers are prepared to pay such a premium the banks are not likely to share in construction risk.

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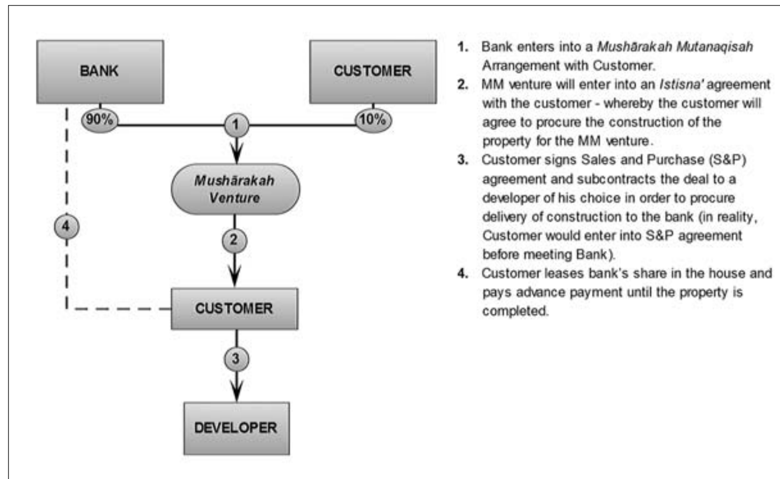
Interestingly, the above MM- *istisnāʿ* model is already widely used in the Middle East and the customer is given three roles: that of a contractor (subcontracts to a developer), co-owner and lessor. The proposed model is depicted in Figure 2 below.

Figure 2: Mushārakah Mutanāqiṣah Structure with Istina'



Having explained the theory and practice of MM home financing, this paper turns to explore the legal issues that may occur in MM home financing for completed properties.

III. LEGAL ISSUES

Under this section the legal issues in MM home financing where the customer is the legal owner and a charge is created over the property will first be discussed, then the legal issues where the bank is the legal owner and a trust is created will be explored.

A. Property where the Customer is the Legal Owner and a Charge is Created in Favour of the Islamic Bank

As explained earlier, under this method of MM home financing, since the land is registered in the name of the customer as trustee for the customer and bank (as beneficiaries), both beneficiaries agree that

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the customer as trustee should register a charge over the whole land in favour of the bank as security. In reality, the trustee should only charge the customer's portion of the land to the bank and not charge the bank's portion of the land as well, but given that the NLC only allows a charge on "the whole, but not a part only, of any alienated land" (s. 241(1)(a) NLC), the trustee, with the consent of the bank, charges the whole land in favour of the bank.

The question arises as to whether the NLC legal charge can be challenged.

1. Legal Charge

A charge is defined as a security interest in property; it transfers neither title nor possession. **A legal charge** is one which is registered under the National Land Code 1965 and has the following effect according to section 243 of the NLC:

> Every charge created under this Act shall take effect upon registration so as to render the land or lease in question liable as security in accordance with the provisions thereof, express or implied.

Registration confers upon the holder of the charge or chargee the power of foreclosure upon default of repayment of the debt. Registration of the charge confers upon the chargee a legal interest in the land. Thus a legal charge is an encumbrance on the land which prevents any further dealings whether by way of sale and transfer of that land or the grant of a second charge without the consent of the first chargee (Lee, 2005, p.289).

The NLC only allows a charge over the whole, but not a part only, of an alienated land. Since the bank owns a portion of the land beneficially, the issue may be raised that the bank cannot take a charge over its own beneficial ownership of the land. According to s.241 (1)(aa), land may be charged under the NLC with the repayment of any debt, or the payment of any sum other than a debt; or, (bb) the payment of any annuity or other periodic sum. Since the bank's portion of the land owned beneficially by the bank is not for the payment of any sum, debt, annuity or other periodic sum, it may be challenged that the legal charge is invalid. Naturally it would be counter argued by the bank that due to the requirements of the NLC itself, that the whole alienated land must be charged and not part only, the bank had no choice but to have a charge over the whole

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land. This argument may suffice to ensure that the legal charge is not challenged. Notwithstanding this, let us say for argument's sake that the legal charge is found to be invalid, what recourse will the bank have over the property?

2. Equitable Charge

If the legal charge is found to be invalid the bank will have recourse to an **equitable charge**. The NLC, based on the Torrens system, does not prevent the court from recognising equitable principles as long as the rights of third parties have not intervened.

Taylor J. in *Wilkins v. Kannamal* [1951] MLJ 99 stated:

> The Torrens law is a system of conveyancing; it does now abrogate the principles of equity; it alters the application of particular rules of equity but only so far as is necessary to achieve its special objects.

And as stated in *Mahadevan Mahalingam v. Manilal & Sons (M) Sdn. Bhd.* [1984] 1 CLJ (Rep) 231 at p.237 by Salleh Abas CJ (Malaya) at the Federal Court:

> There is, however no provision in the National Land Code prohibiting the creation of equitable charges and liens. The Code is silent as to the effect of securities which do not conform to the Code's charge or lien. Therefore equitable charge and liens are permissible under our land law. We, therefore, think that the words "or other charge on land" in s. 21(1) of the Limitation Act must be construed to include equitable charges and liens as well.

In *Re Lin Securities (Pte)* [1988] 2 MLJ 137, Chao Hick Tin JC (as he was then) stated that no particular form of words is necessary for the purpose of creating a charge. The judge quoted Scrutton LJ in *National Provincial & Union Bank of England v. Charnley* [1924] 1 KB 431, defining an equitable charge in the following manner at p.445:

> I am not going to attempt an exhaustive definition of an equitable charge, but I think that the substance of an equitable charge is this: if an agreement be made to grant some interest in existing or future property for the purpose

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> of securing the payment of a debt, that agreement to give the security confers an equitable security or charge, though all the formalities necessary to create the actual security have not been complied with.

Thus what is necessary for an equitable charge to exist is a valid contract that grants interest in existing property for the purpose of securing the payment of a debt.

In the case of *UMBC Bhd v. Goh Tuan Laye* [1976] 1 MLJ 169, the court cited with approval the decision of the Privy Council in *Abigail v. Lapin* [1934] AC 491, an appeal from the High Court of Australia to the Privy Council, which approved the judgment of Griffith CJ speaking for the High Court of Australia, in *Butler v. Fairclough* [1917] 23 CLR 78, 91. The latter case stated that equitable rights are valid in a system of registration of titles to land except when they are precluded from doing so by any statute. Further, in the contest between two equitable rights, the first in time, all other things being equal, is entitled to priority.

The Privy Council also stated that a person who has an equitable charge upon the land may protect it by lodging a caveat which operates as notice to the entire world that the registered proprietor's title is subject to the equitable interest alleged in the caveat.

At the same time it would seem that from the case of *Vallipuram Sivaguru v. PCRM Palaniappa Chetty* [1937] MLJ 59 the fact of not lodging a caveat will not forfeit a person from having priority of his equitable right so long as other factors do not affect priorities. In other words the failure to lodge a caveat will not cause the priority of equitable rights to be affected so long as there are no other factors affecting priorities[5].

5 Where the first claimant who is first in time 'may lose his priority by any act or omission which had or might have had the effect of inducing the claimant later in time to act to his prejudice for example where the equitable mortgagee of land allows the mortgagor to retain possession of the title deeds, a person dealing with the mortgagor on the faith of that possession is entitled to priority in the absence of special circumstances to account for it' - see *Butler v. Fairclough* [1917] 23 CLR 78, 91.

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According to *Loke Yew v. Port Swettenham Rubber* Co [1913] AC 491 and cited in *Bhagwan Singh & Co. Sdn. Bhd. v. Hock Hin Bros Sdn. Bhd.* [1986] 2 CLJ 224, it was stated that the Malaysian registration of titles based on the Torrens system does not prevent the court from doing equity where the rights of third parties have not intervened.

Thus in the event that a legal charge of a bank in a MM home financing is challenged in a court of law and found to be invalid, a valid equitable charge would exist as long as there is a valid contract evidencing the charge and there are no third party rights that have intervened.

An example of a third party right may be a *bona fide* purchaser for value who has no notice of the equitable charge. However in the case of a MM home financing, since the bank has already registered the charge under the NLC (even though it may be challenged at a later time), the third party would have had notice of the charge, so it is opined that it would be difficult for a third party to claim that it had no notice of the bank's charge in a MM home financing.

What if the customer becomes a bankrupt; can the official assignee challenge the Islamic Bank's equitable charge?

It would seem that as long as the bank has an equitable charge and there are no intervening third party rights the charge would be secured.

In the case of *Mercantile Bank Ltd. v. The Official Assignee of The Property of How Han Teh* [1969] 2 MLJ 196, How Han Teh deposited documents of title with Merchantile Bank for the purpose of securing a loan. How Han Teh failed to repay the loan and was eventually declared a bankrupt. The Merchantile Bank thereafter registered caveats against the titles deposited with it under s.330 NLC. Thereafter Merchantile Bank made an application to sell the lands by public auction. The application was opposed by the Official Assignee stating that Merchantile Bank was not the lien holder on the property at the time of the act of bankruptcy as there was no caveat entered under the National Land Code. Merchantile Bank submitted that at the time when the act of bankruptcy was committed the applicants had equitable rights to a lien in contract. It was held by Raja Azlan Shah J (as he then was) that:

> ...when the act of bankruptcy was committed the applicants had an equitable right to a lien and the trustee in bankruptcy who steps into the bankrupt's shoes, takes a title no better

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> than him. He takes subject to the same equities as affected the property in the bankrupt's hands.

In other words when the act of bankruptcy was committed, Merchantile Bank had an equitable right to a lien and the Official Assignee, who steps into the bankrupt's shoes, takes a title no better than the bankrupt. He takes subject to the same equities as affected the property in the bankrupt's hands. Merchantile Bank had a prior interest and was entitled to an order for sale. This would similarly apply in the case of an equitable charge where the customer becomes a bankrupt.

3. Form 16A

On another issue, of the charge form itself (Form 16A), it is suggested that changes be made to accommodate MM home financing. Currently the words in Form 16A state:
'For the purpose of securing-
*(a) the repayment to the chargee named below, with/without interest, of a loan of $.........., the receipt of which I hereby acknowledge'

It is suggested that the following phrase be added to reflect the true arrangement between the parties:
'For the purpose of securing-
*(a) the repayment to the chargee named below, of the agreed installments pursuant to a Musyarakah Mutanaqisah Facility of Bank.........., the receipt of which I hereby acknowledge.'

Thus to conclude this section, where the MM home financing is secured through a legal charge in favour of the bank, such legal charge is valid, and in the rare event that it is found to be invalid, an equitable charge would exist based on the existing case law. An equitable charge would be valid subject to the rights of a *bona fide* purchaser for value. In a MM home financing it would be hard to convince the court that a third party had no notice of the legal charge, though later found to be invalid. Equitable charges first in time have priorities, all other things being equal. An Official Assignee takes a title no better than the bankrupt. A caveat can be lodged to secure the

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equitable charge, but is not a necessity for an equitable charge to be valid or ensure priority. Lastly, on the charge form itself (Form 16A), it is suggested that changes be made to accommodate MM home financing.

Next, we move to legal issues in a MM home financing facility where the Islamic bank is registered as the legal owner and a trust is registered under s.344 of the NLC.

B. Property where the Islamic Bank is Registered as the Legal Owner and as Trustee for Itself and Customer

In this situation the Islamic bank is registered as the legal owner and holds the property on trust for itself and the customer. Thus the customer is the co-beneficial owner of the property with the Islamic bank. To evidence the trust, a trust deed is executed and stamped and the trust is registered under s.344 of the NLC:

> 344. Registration as trustee or trustees, and deposit or trust instrument....
>
> (2) The proprietor or co-proprietors of any alienated land, and any person or body in whom any share or interest in alienated land is for the time being vested, may apply to the Registrar to be registered in respect of that land, share or interest "as trustee", or, as the case may be, "as trustees", and the Registrar shall give effect to any such application by making the appropriate addition to, or amendment of, the existing memorial of registration.

The question arises as to whether there are any legal concerns with the registration of a trust to evidence the co-ownership of the property between the bank and the customer. Here cases on trust will be explored.

1. Express and Resulting Trust

In the case of *Tan Kheng Guan v. Pendaftar Hakmilik Johor; Teo Ah Bin (Intervener)* (2000) 8 CLJ 593, the plaintiff through an agreement purchased a property, and the intervener in the case advanced a certain sum of money as a loan to finance the said property on the request of the plaintiff. By consent, the plaintiff's shareholding was registered

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as 4/10 and the intervener was allocated 6/10. The plaintiff failed to repay the loan. The intervener claimed that since the loan had not been paid off, the plaintiff was actually holding the property on trust for the intervener. The facts of the case provided that nowhere did the intervener state that the plaintiff was holding 4/10 of the property on trust. The written agreement had used the words 'loan or advance'. The court held that where money is loaned and advanced and referred to as a loan or advance and where there is no mention that the property is to be held on trust, then there can be no resulting or implied trust. Judge Abdul Malik Ishak held, at p. 623:

> H.A.J. Ford and W.A. Lee in their book entitled *"Principles of the Law of Trusts",* 1983 edn at p. 67 said that: "Equity will only enforce a trust to the extent to which the intention to create a trust is clear." Here, there was no clarity of intention on the part of the intervener to create a trust emanating from the plaintiff to himself. When the intervener advanced the monies to the plaintiff, he was acting in the character of a lender and no resulting trust can possibly arise from that kind of transaction. At p. 964 of the book *"Principles of the Law of Trusts",* the learned authors said:
>
> Where X purchases property and directs the vendor to transfer the title to Y, a resulting trust is presumed if Y is a stranger. Y can take beneficially only if he can prove that X intended him to take beneficially. However, the raising of a presumption of resulting trust will only occur where X was putting up the money in the character of a purchaser. **There will be no resulting trust if X was financing a purchase by Y by lending Y the amount of the purchase price in the character of a lender.**

The above case, *Tan Kheng Guan*, can be distinguished from the practise of MM home financing. Where an Islamic bank is registered as the owner but holds on trust for the customer, the trust is expressly indicated by a trust deed, and further registered under s.344 NLC. There is no need to imply a trust. In fact, in the same case Judge Abdul Malik Ishak stated that if there was a trust the intervener should have complied with s.344 NLC, at p. 622:

> That trust was not even registered on the relevant document of title. Under the Torrens System the register is everything. It is the mirror for everyone to see.

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We can infer from *Tan Kheng Guan* that if there is an express trust created and registered under s.344 of the NLC it will be valid and enforceable.

2. Constructive and Resulting Trust

In another case, *Takako Sakao v Ng Pek Yuen* (2010) 1 CLJ 383, the appellant, a Japanese, and the first respondent were partners of a restaurant business. They decided to acquire a building and contribute towards the purchase price. The appellant claimed there was a mutual understanding that the building acquired would be purchased and registered in the joint names of herself and the respondent in equal shares. The appellant provided a certain sum for the property; however the respondent purchased the property and registered it solely in her name. Subsequently the first respondent sold the property to a second respondent which was a private limited company owned by her husband. The appellant lodged a caveat to protect her interest and commenced proceedings to enforce a trust that she claimed existed in her favour. The Federal Court tackled a number of issues relevant to this research. The relevant issues that were discussed in this case were:

- the effect of a constructive trust and its difference from a resulting trust,
- a *bona fide* purchaser for value,
- whether compliance with section 433B is necessary when there is a constructive trust. Section 433B of the NLC requires that non-citizens and foreign companies obtain the State Authority's approval to acquire property.

On the above issues Gopal Sri Ram FCJ held for the Federal Court that:

- Firstly, the appellant at all material times was entitled to a half share in the trust property as a beneficiary under a constructive trust. Where a trustee acquires property in breach of trust or by other unconscionable conduct, he or she holds it on a constructive trust for the beneficiary. A constructive trust is imposed by law irrespective of the intention of the parties. A resulting trust on the other hand requires that the

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initial dishonour intended it to be held in trust by the trustee for some other person.

- Secondly, equity will not assist a victim of a breach of trust to trace the trust property if it is inequitable to do so, for example when a *bona fide* purchaser for value acquires it. In this case the Federal Court decided that the second respondent was not a *bona fide* purchaser of fair value because the knowledge of the first respondent should be attributed to the second respondent.
- Thirdly, s.433B did not apply to the appellant, who was a foreigner, in this case. This is because s.433b(1)(c) states "created in favour of any person or body as 'trustee'" and this applies only to express trusts registered in accordance with s. 344 of the NLC. The Federal Court held that it does not include within its purview constructive trusts which arise by operation of the law.

The above case provides some lessons for home financing through MM:

- If for some reason when the customer enters into a MM home financing with an Islamic bank the trust is not registered under s.344, the courts would still recognise the existence of a trust; whether it is an express trust through the existence of the trust deed that the Islamic bank executes, or through a constructive trust if the trust deed is not created (for some reason, through negligence for example).
- Where a constructive trust is recognised by the courts it is subject to the rights of any *bona fide* purchaser for value.
- If the co-owner/purchaser is a foreigner, or more relevantly for MM home financing a company, it must comply with s.433B NLC to co-own the property if there is an express trust. However if there exists only a constructive trust then s.433B would not apply.

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3. Foreign Companies

This brings us to the requirements of s.433B.

Section 433B of the NLC states:

- **433B. Non-citizens and foreign companies may acquire, etc., land only with approval of State Authority.**

1. Notwithstanding anything contained in this Act or in any other written law-
   (a) a non-citizen or a foreign company may acquire land by way of a disposal under Division II;
   (b) a dealing under Division IV with respect to alienated land or an interest in alienated land may be effected in favour of a non-citizen or a foreign company;
   (c) alienated land, or any share or interest in such land, may be transferred or transmitted to, or vested in, or created in favour of any person or body as "trustee", or of two or more persons or bodies as "trustees", where the trustee or one of the trustees, or where the beneficiary or one of the beneficiaries, is a non-citizen or a foreign company;
   (d) the Registrar may in respect of any land register any person or body as "representative" or make a memorial in favour of any person or body as "representative" if such person or body is a non-citizen or a foreign company;
   (e) the Registrar may endorse any memorial of transmission on the register document of title to any land in favour of a non-citizen or foreign company, **but only after the prior approval of the State Authority has been obtained upon an application in writing to the State Authority by such non-citizen or foreign company**... (emphasis added).

Thus where an Islamic bank is registered as a trustee (s.433B(1)(c)) of the property in a MM home financing it has to firstly obtain the approval in writing of the State Authority. In Malaysia this means the Islamic bank has to go to each States' State Authority and get written approval to be able to offer MM home financing.

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4. Malay Reserve Land

Another issue is **Malay Reserve Land.**

Under article 89 of the Federal Constitution 'Malay reservation' is explained as follows:

> (6) ... "Malay reservation" means land reserved for alienation to Malays or to natives of the State in which it lies; and "Malay" includes any person who, under the law of the State in which he is resident, is treated as a Malay for the purposes of the reservation of land.

Malay reserve land is under the jurisdiction of the States. There is a one uniform legislation covering Perak, Pahang, Selangor and Negeri Sembilan known as the Malay Reservations Enactment FMS 142, and there is separate legislation covering the remaining states. Malacca is covered under the National Land Code (Penang And Malacca Titles) Act 1963 (Revised 1994). The basic objective of these laws is to restrict any form of dealings affecting these lands by non-Malays (Buang, 2002).

According to the Malay Reservations Enactment F.M.S CAP 142 which applies to Perak, Pahang, Selangor and Negeri Sembilan, section 2:

> "Malay", means a person belonging to any Malayan race who habitually speaks the Malay language or any Malayan language and professes the Moslem religion;
>
> "Malay holding" includes -
>
> [where]...a company registered under Companies Enactment ... and ... every member thereof is a Malay and the transfer of shares therein is restricted by the Articles of Association thereof to Malays be deemed to be a Malay, and any registered interest in land of which such a company is proprietor shall be deemed to be a Malay holding.

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According to s.8 of the Malay Reservations Enactment no Malay holding shall be transferred, charged[6], leased or otherwise disposed off to any person not being a Malay, and no memorandum of transfer, charge or lease in contravention of this section shall be capable of registration in any Land Office or Registry of Titles. Further, according to s.14 of the Malay Reservations Enactment every trust whether express, implied or constructive, which purports to be created in respect of any Malay holding by the proprietor thereof in favour of or for the benefit of any person who is not a Malay shall be null and void and shall be incapable of being enforced by any court.

Thus where a customer is a Malay and wants to finance the purchase of Malay reserve land through an Islamic bank, he would be unable to do so. The above provisions prevent an Islamic bank from being able to register itself as a trustee under s.344 of the NLC where the land involved is a Malay reserve land. Further under the Malay Reservations Enactment itself there are no provisions that allow a non-Malay person or company from overcoming this provision, for example by getting a written consent from the State Authority. However in the Federal Constitution there is a provision which allows a Malay reserve land to be converted to freehold property if certain procedures are adhered to, such as buying another plot of the same size in the state and having it "converted" to Malay reserve land – article 89(2) Federal Constitution.

This sort of restriction is not true for all States; in Malacca for example, according to the National Land Code (Penang And Malacca Titles) Act 1963 (Revised 1994), s.104 allows the State Authority to issue a certificate to any person who is not a Malay to be registered as the proprietor of any customary land.

Thus a MM home financing where the bank is registered as the legal owner and registered as a trustee would be not be available as a home financing service to a Malay who wants to finance the purchase of Malay reserve land because of the restrictions in dealings with those lands. This seems to defeat one of the purposes of setting up

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6 However according to section 17 and the second schedule of the Malay Reservations Enactment F.M.S CAP 142, Malay reserve lands can be charged to those banks listed in the second schedule. So this restriction of dealing with Malay reserve land does not apply to home financing that charges a property to the bank (so long as the bank is listed in the second schedule).

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Islamic banks, that is, to provide financial solutions for Muslims in Malaysia. There has to be some exception that has to be made so that Malays can buy Malay reserve land using MM home financing with the method used by KFH Bank.

In concluding this section, it can be seen that an express trust which is registered under s.344 of the NLC is secure and will be a notice to the world of the interest in the property of the customer and the Islamic bank. If the trust is duly registered under s.344 it would be indefeasible and the validity of the bank's interest or the customer's interest in the property could not be questioned. If the trust is not registered then there would still exist a trust in the form of an express trust if a trust deed was executed, or a resulting or constructive trust depending on the facts of the case, as to the intention of the parties and whether there was any unconscionable conduct.

IV. LEASE OF MORE THAN 3 YEARS

Finally, another issue of MM Home financing that would be applicable to all methods in practice is the issue of leases of more than three years. Section 221 of the NLC provides that a lease of more than three years must be registered under the NLC. Failure to register will not mean that the lease is invalid or unenforceable. Like an equitable charge, an unregistered lease will be recognised as an equitable lease and the bank's rights as an equitable lessor will be protected as long as there is no *bona fide* lessee (who obtained a lease from the customer without notice of the bank's prior interest) challenging the bank's rights as an equitable lessor. Given that the bank has registered a charge, any *bona fide* lessee will clearly have notice of the bank's rights as chargee and the lessee must obtain the consent of the bank. Failure to obtain the bank's consent will defeat the lessee's rights and the bank will prevail over any such lessee.

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V. CONCLUSION

This paper has explored home financing techniques in Malaysia and possible legal issues.

In MM home financing for completed properties there are a few methods in the practice of implementing MM legally. In the case of registering the property there seems to be two methods. The first is where the customer is registered as the owner of the property and a charge is created in favour of the bank, and the second is where the bank is registered as the legal owner as the trustee for itself and the customer. As for the implementation of MM in the event of default, it depends whether there is a *waʿd* or not.

Where the customer has provided a *waʿd* to the bank at the outset of the MM home financing, in the event of default the customer is obliged to acquire the bank's remaining share. This creates a debt to be paid by the customer to the bank.

However if no *waʿd* has been procured from the customer (or the *waʿd* is not exercised), then the underlying asset will be sold in the market and the proceeds will be shared between the partners according to the latest ownership share ratio (after all the outstanding costs and payments, such as outstanding rents and legal fees, are covered). The authors believe that the central bank should force the bank to choose either option (*waʿd* or without a *waʿd*) at the beginning of the contract to avoid cherry-picking by the bank.

This paper also discusses the problem of selling mere rights by the bank to the customer in MM home financing, for property under construction, where a property is incomplete. An alternative model using the *istisnāʿ* contract is recommended.

As for the legal issues where the MM home financing is secured through a legal charge by the bank, our research shows that the legal charge should be valid; in the rare event that it is found to be invalid, an equitable charge would exist. An equitable charge would be valid subject to the rights of a *bona fide* purchaser for value. In a MM home financing it would be hard to convince the court that a third party had no notice of the legal charge, though later found to be invalid. Equitable charges first in time have priorities, all other things being equal. An Official Assignee takes a title no better than the bankrupt. Lastly, on the charge form itself (Form 16A), it is suggested that changes be made to accommodate MM home financing.

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Where the MM home financing is secured through the registration of the trust under s.344 it would be notice to the world of the interest in the property of the customer and the bank. If the trust is duly registered under s.344 it would be indefeasible and the validity of the bank's interest or the customer's interest in the property could not be questioned. If the trust is not registered then there would still exist a trust in the form of an express trust if a trust deed was executed, or a resulting or constructive trust depending on the facts of the case as to the intention of the parties and whether there was any unconscionable conduct.

From a legal point of view, the authors believe that MM home financing as it is being practised in Malaysia, whether executed through a charge or a trust registered under s.344, is legally sound and would be upheld in a court of law based on the existing case-law authorities.

MM home financing is therefore a definite alternative home financing model for home buyers who want to finance their property.

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