Kencom Sacco Society Limited v National Bank of Kenya Limited (Civil Suit 169 of 2019) [2025] KEHC 1711 (KLR) (Commercial and Tax) (7 February 2025) (Judgment)

Neutral citation: [2025] KEHC 1711 (KLR)

REPUBLIC OF KENYA

IN THE HIGH COURT AT NAIROBI (MILIMANI COMMERCIAL COURTS)

COMMERCIAL AND TAX

CIVIL SUIT 169 OF 2019

FG MUGAMBI, J

FEBRUARY 7, 2025

BETWEEN

KENCOM SACCO SOCIETY LIMITED ..... PLAINTIFF

AND

NATIONAL BANK OF KENYA LIMITED ..... DEFENDANT

Interest charges on Islamic Banking loan facility deemed unlawful

A Sacco sued a Bank over Musharaka and Mudaraba facilities, alleging the Bank charged interest contrary to Islamic banking principles and delayed disbursements. The Musharaka facility funded a 113-unit housing project, with profits pre-determined at 15.45% and ownership gradually transferring to the Sacco. Documents, including the offer letter, financing agreement, and replacement charge, reflected binding terms granting the Sacco exclusive use and outlining payment obligations. Evidence showed the Bank charged interest in breach of Islamic law. Disputes over profit timing and account reconciliation arose, with the Bank bearing the burden of proof. The court declared the Bank's demand unlawful, ordered proper accounting, issued an injunction against the sale of the property, and awarded costs to the Sacco.

Reported by John Ribia

Banking Law *- Islamic Banking - musharaka facility - concept of no interest in Islamic Banking - where it was alleged that a musharaka facility contained interest and a demand and statutory power of sale was being sought by the bank - whether a bank that offered an Islamic Banking loan agreement (musharaka facility) could be deemed in breach of Islamic Law by charging interest on the musharaka facility - whether a bank could exercise statutory power of sale in an Islamic Banking loan agreement (musharaka facility) where the demand erroneously charged interest on the loan - whether, under a musharaka property development facility, the profit should have been pre-determined and collected before the project commenced, during the project's execution, or only after its completion.*

Law of Evidence *- loan agreements - musharaka facility - burden of proof to provide accurate financial records - in a loan agreement, which party bore the burden of proof to provide accurate records detailing proceeds, profits, and outstanding amounts - Evidence Act (cap 80) section 112.*

Brief facts

The Sacco filed suit on 17 July 2019, challenging the Bank's handling of facilities provided under Islamic banking principles of *musharaka* and *mudaraba*, secured by a replacement charge over the suit property. The *musharaka* facility, totaling Kshs. 1.95 billion for a two-year term, aimed to fund a 113 unit housing project. The Sacco alleged the Bank charged profit before disbursing principal and delayed fund release, asserting that having paid Kshs 2.4 billion, no further payments were due. Under the *mudaraba* facility of Kshs. 100 million, the Sacco claimed the Bank collected Kshs. 30,916,000 in interest contrary to Islamic principles. Settlement efforts failed, prompting the suit seeking declarations, injunctions, account-taking, and refund of overpayments.

The Bank acknowledged financing the project, maintaining that the Sacco was bound by executed offer letters and statutory provisions under the replacement charge. Bank witnesses confirmed compliance of the facilities with Islamic principles and noted breaches by the Sacco, including diversion of escrow funds, with unsold units preventing discharge of the main title. The dispute centered on profit calculation, timing, and proper accounting under Islamic finance principles.

Issues

i. Whether a bank that offered an Islamic Banking loan agreement (*musharaka* facility) could be deemed in breach of Islamic Law by charging interest on the *musharaka* facility.

ii. Whether a bank could exercise statutory power of sale in an Islamic Banking loan agreement (*musharaka* facility) where the demand erroneously charged interest on the loan.

iii. Whether, under a *musharaka* property development facility, the profit should have been pre-determined and collected before the project commenced, during the project's execution, or only after its completion.

iv. In a loan agreement, which party bore the burden of proof to provide accurate records detailing proceeds, profits, and outstanding amounts.

Held

1. The existence and terms of a binding contract depended on what the parties had agreed, assessed objectively through their words and conduct, rather than their subjective intentions. The parties' communications and actions were considered to determine whether they intended to create legal relations and had agreed upon all essential terms. Courts did not rewrite contracts but construed them and any terms implied by law, unless coercion, fraud, or undue influence were proved.
2. Given that expert witnesses differed on their interpretation of Islamic principles between the AAOIFI Standards and the International Islamic Fiqu Academy or Permanent Committee for Scholarly Research and Ifta; the court would rely on the intentions of the parties entering the agreement.
3. The specific terms of the *musharaka* facility were contained in the offer letter dated 30 December 2014, the executed Financing Agreement, and the replacement charge dated 15 July 2015. The replacement charge explicitly referred to the offer letter and confirmed that no representations or promises contrary to the terms were outstanding at the time of execution. The Financing Agreement further provided that no amendment or modification would be effective unless in writing and signed by both parties.
4. The documents collectively reflected the parties' intentions and agreement, forming the binding terms of the *musharaka* facility. Consistent language across the documents underscored mutual commitment to the terms, including the purchase of undivided beneficial ownership interests in the property, granting the customer exclusive enjoyment and exploitation rights. The instruments established the contractual framework that governed the relationship between the bank and the customer.
5. In alignment with the core characteristics of Islamic banking, the parties recognized and agreed that no interest would be payable on the facility. There was no indication that the Bank would charge or collect

interest on the facility. Thus, while the Sacco was liable to make monthly payments to the Bank as outlined in the letter of offer and in accordance with the *musharaka* terms, no interest was chargeable.

6. The arrears demanded by the Bank consisted solely of arrears on the principal amount and profit. The Bank vehemently denied having charged any interest on the facility. However, from an examination of the loan statements for the period between 4 October 2013 and 26 April 2015, the Bank had in fact been charging interest on the facility. That was in breach of the agreement between the parties and the core fundamentals of Islamic banking.
7. While the Sacco acknowledged it's indebtedness to the Bank, it would be unjust to allow the Bank to benefit from its own breach and proceed to exercise its statutory power of sale based on an erroneous demand.
8. The parties had agreed, in the offer letter of December 30, 2014, that the Bank would contribute 84.2% and the Sacco 15.8% of the total investment for the purchase and construction of 113 units on the property, reflecting the Islamic concept of co-ownership under the *musharaka* arrangement. The Sacco was granted exclusive use and occupation of the property, including the Bank's share, with ownership gradually transferring to the Sacco through a pre-determined buyout mechanism. The buyout price carried a profit rate of 15.45%, ensuring the Bank's interest in the property diminished over time.
9. The Sacco executed an undated undertaking to purchase the units periodically at the agreed buyout price and on the specified dates, and to complete the purchase of any remaining units upon termination. That confirmed the intention for a gradual buyout and rejected the Sacco's claim that profit determination would only occur after project completion. The arrangement obligated the Sacco to pay on time, with default provisions incorporated.
10. The pre-determined profit rate of 15.45% was consistently reflected in the replacement charge, and the Sacco serviced the facility throughout the repayment period. Evidence, including letters from the Bank, demonstrated that the profit was payable during construction, in addition to the principal, subject to the moratorium on the principal.
11. Disputes over the profit ratio only arose when the Bank threatened to exercise its statutory power of sale. The Sacco contended it had paid Kshs 2.4 billion against the original principal of Kshs 1.8 billion and argued that any excess constituted profit. The Bank challenged the accuracy of the Sacco's accounts, asserting the need for proper reconciliation.
12. The Bank, holding the account statements for both the *musharaka* and escrow accounts, bore the responsibility to provide accurate records detailing proceeds, profits, and outstanding amounts. Proper accounting was necessary to determine the amount legitimately owed. Section 112 of the Evidence Act reinforced that the burden of proving facts within a party's knowledge rested on that party, supporting the need for detailed financial verification in the instant case.

Claim allowed.

Orders

i. *The defendant's demand notice and subsequent notices were illegal and unlawful.*
ii. *A proper accounting under the musharaka financing agreement was to be carried out in accordance with the findings of the instant judgment within 30 days;*
iii. *Any monies found to be due to the plaintiff or monies due to the defendant was to be paid within 45 days of the accounts being completed.*
iv. *An injunction was issued against the sale/auction of the suit property pending (b) and (c) above.*
v. *In the event that any amount found to be due to the defendant, was not paid in compliance with these orders, for the avoidance of doubt, and subject to compliance with the law, the defendant would be at liberty to exercise its statutory power of sale then.*
vi. *The plaintiffs were awarded the costs of the suit.*

Citations

Cases

1. National Bank of Kenya Ltd v Pipeplastic Samkolit (K) Ltd & another (Civil Appeal 95 of 1999; [2001] KECA 362 (KLR); [2001] KLR 112) — Mentioned
2. RTS Flexible Systems Ltd v Molkerei Alois Müller GmbH ([2010] 1 WLR 753 at [45], [2010] UKSC 14) — Explained

Statutes

1. Evidence Act (cap 80) — section 112 — Cited
2. Land Act (cap 280) — In general — Cited

Advocates

None mentioned

JUDGMENT

Background and Introduction

1. The plaintiff (hereinafter 'the Sacco') filed this suit on July 17, 2019, concerning a dispute over facilities that the defendant (hereinafter 'the Bank') had extended to the Sacco. These facilities were advanced under the Islamic banking principles of Musharaka and Mudaraba. The consolidated facilities were secured by way of a replacement charge over property LR 12825/195 (the subject property). The purpose of the facilities was to facilitate the Sacco's development of a housing project.

2. The Sacco pleads that under the Musharaka financing arrangement, it borrowed Kshs 1.95 billion for a period of 2 years. It contends that the Bank began charging interest before first collecting and settling the principal amount and caused delays in the disbursement of funds. Having paid an amount of Kshs 2.4 billion, the Sacco asserts that no further monies are due to the Bank.

3. Under the Mudaraba financing arrangement, the Sacco acknowledges having borrowed a total of Kshs 100 million. It contends that the Bank had collected an amount of Kshs 30,916,000/= as interest contrary to the Islamic banking principles.

4. In an effort to settle the dispute, the Sacco acknowledges offering to pay Kshs 750 million against the Bank's demand of Kshs 982,785,763.47. The Bank declined this offer, culminating to the suit now before the court. The Sacco seeks a declaration that the Bank's continued demand is unlawful, an injunction against the sale of the suit property, taking of accounts and a refund of overpaid amounts, together with costs.

5. During the trial, the Sacco called three witnesses. PW1 was Joseph Mutuku Wambua, a banker with KCB Group. His testimony followed his written statement dated July 17, 2019 and the contents of the plaint. He testified that even after developing and selling the housing units, the Bank failed to discharge the charge over the original title which delayed the transfer of housing units to the buyers.

6. During cross-examination, PW1 confirmed the requirement for the Sacco to open an escrow account for all proceeds from the sales. However, he acknowledged that not all proceeds had been deposited into the escrow account, attributing the failure to buyers who did not deposit the monies directly, rather than to the Sacco.

7. The witness also confirmed that the Bank had the right to issue notices in case of default under Clause 7 and Clause 8 of the replacement charge. He acknowledged that the Sacco had received these notices, but the amounts stated were disputed. He further testified that the parties had not agreed on a profit-sharing ratio, which was to be determined at the end of the project.

8. PW2, Abdishakur Mohamed, an Islamic banking consultant, testified based on his report dated April 6, 2023. He was questioned about the terms of the financial arrangement agreements. He confirmed that under Islamic law, the offer letters relating to the two facilities were binding on both parties, provided they were signed with full knowledge of their terms. It was his view that the letter of offer for the Musharaka facility complied with Islamic principles, as it specified the profit-sharing percentage. He raised concerns about the Mudaraba letter of issue, particularly Clause 1.7 which provided for events of default.

9. It was his further testimony that the security in this case was charged under Kenyan law, not Islamic law. He also affirmed that the default clause in the charge was appropriate, as it could be invoked when the client was at fault.

10. PW3, Camelyne Sheila Khamati, an accountant with the Sacco testified in alignment with her witness statement dated April 11, 2023. During cross-examination, she admitted that some purchasers of the housing units had paid monies directly into the Sacco's account instead of the escrow account. While she confirmed that these monies were later transferred to the Bank's account, she was unable to confirm whether all the funds had been transferred.

11. She further confirmed that the parties had held reconciliation meetings to determine the amounts due. According to the witness, the Sacco offered to pay Kshs 750 million, even though the actual amount outstanding, in her view, was Kshs 400 million.

The Bank's case:

12. The Bank's case is set out in the statement of defense dated August 27, 2019. The Bank acknowledges extending financing facilities to the Sacco for the construction of 113 housing units. It confirms that the total Musharaka facility advanced to the Sacco amounted to Kshs 1,950,000,000. This amount was to be repaid to the Bank at a rate of 15.45%, as specified in Clause 3.1.1 of the replacement charge. The Bank disputes the Sacco's failure to regularize the account and deposit the proceeds from sales into the escrow account, as stipulated in the letter of offer.

13. It is the Bank's case that the Sacco was bound by the terms of the offer letters which it had executed and benefited from. Further, the Bank contends that Islamic banking principles do not absolve the Sacco from repaying the loan. The Bank pointed out that the Sacco had acknowledged the debt through a settlement offer of Kshs 750,000,000.

14. The Bank pleads that it is within its right to exercise its statutory power of sale and issue a statutory notice of sale under Clause 8 of the replacement charge and the *Land Act*.

15. During trial, the Bank called two witnesses. DW1 was DR Manswab Mahsen Abdulrahman, an Islamic law expert. His testimony was as contained in his witness statement dated July 29, 2023. He confirmed amongst others that the Musharaka and Mudaraba agreements complied with Islamic principles, and that they included valid terms for both capital contribution and profit-sharing.

16. Dr. Abdulrahman disagreed with PW2 about the maintenance transfer, arguing that the transfer did not invalidate the agreement since the terms of maintenance were agreed upon by the parties. He also stated that capital could be guaranteed by the contracting parties.

17. DW2 was Nancy Naswa, a Credit Manager with the Bank. She relied on her witness statement and in her testimony explained that the Sacco had breached the contract by diverting payments from the escrow account. She confirmed that the Mudaraba agreement had been fully implemented, and the

bank had received the agreed-upon profit. She highlighted the remaining unsold properties as the reason the main title could not be discharged.

Analysis and determination

18. In support of their arguments, the parties filed written submissions, which I have carefully considered alongside the pleadings, evidence and cases cited. It is evident that the dispute before the court pertains to the amounts demanded by the Bank under the musharaka agreement, as the mudaraba agreement had been fully complied with and settled. My focus will therefore be on the musharaka agreement.

19. I have accordingly distilled the following issues for determination, arising from the pleadings:

    i. Whether the Bank was in breach of Islamic law by charging interest on the musharaka facility;

    ii. Whether interest or profit ought to have been pre-determined and collected after the project was completed and not before;

    iii. Whether the demand by the Bank was lawful.

20. I begin my analysis of the issues from a passage by Lord Clarke, in *RTS Flexible Systems Ltd v Molkerei Alois Müller GmbH*, [2010] 1 WLR 753 at [45], [2010] UKSC 14 as follows:

> "Whether there was a binding contract between the parties and if so, upon what terms depends upon what they have agreed. It depends not upon their subjective state of mind, but upon a consideration of what was communicated between them by words or conduct, and whether that leads objectively to a conclusion that they intended to create legal relations and had agreed upon all the terms which they regarded or the law requires as essential for the formation of legally binding relations."

21. This dictum resonates with the well-recognized maxim of law by our courts that it is not the business of courts to rewrite contracts between parties. They are bound by the terms of their contracts, unless coercion, fraud or undue influence are pleaded and proved. (See *National Bank of Kenya Ltd v Pipeplastic Samkolit (K) Ltd*, [2002] 2 EA 503). The primary task of the court is to construe the contract and any terms implied in it.

22. Notably, PW2 and DW1, the experts invited by either party, clashed on their interpretation of some of the clauses contained in the agreements between the parties. They also differed on their interpretation of Islamic principles between the AAOIFI Standards and the International Islamic Fiqu Academy or Permanent Committee for Scholarly Research and Ifta.

23. Given this, I must turn to what the parties intended to be bound by and what, through their actions and conduct over the years, they represented to each other as having agreed upon. This, in my view, is the principle upon which the sanctity of any agreement is premised.

24. While there was more than one (1) offer letter for the musharaka facility, the specific terms of the facility are to be found in the offer letter dated December 30, 2014 (at pages 74 to 77 of the Sacco's documents), the undated but executed Financing Agreement (at pages 78 to 97) and the replacement charge dated July 15, 2015. The replacement charge confirms in recital (G) that it was based on the terms and conditions in the offer letter of December 30, 2014. For the avoidance of doubt, the offer letter is executed by the Bank and the Sacco and is accompanied by the Sacco's acceptance of the terms.

25. Each of these documents confirms that the parties contracted in tandem with the conditions that they set out. Clause 35 of the replacement charge states:

> " This charge together with the documents referred to herein contain the whole agreement between the Bank and the Chargor and the Chargor acknowledges that no representations or promises contrary to its terms have been made to the Chargor and are outstanding at the date of execution of the Charge."

26. Clause 13.16 of the accompanying financing agreement further states:

> " This agreement represents the entire agreement and understanding between the parties in relation to the subject matter and no amendment or modification to this agreement will be effective or binding unless it is in writing, signed by both parties and refers to this agreement."

27. It is evident that the parties' intentions and agreements are clearly articulated through the various documented terms and conditions. The offer letter, financing agreement, and replacement charge collectively represent the binding terms agreed upon by both parties. The consistent language used across these documents underscores their mutual commitment to the terms of the musharaka financing agreement defined at Clause 1(q) of the financing agreement as:

> " The agreement between the customer and the bank to which the bank and the customer will purchase from the seller of the property an undivided beneficial ownership interest in the property for the purpose of creating a beneficial ownership as proprietors in common in specified shares in the property as provided for in this agreement with the customer having the right to exclusively enjoy and exploit the property."

(i) Whether the Bank was in breach of Islamic law by charging interest on the musharaka facility:

28. In alignment with the core characteristics of Islamic banking, the parties recognized and agreed that no interest would be payable on the facility. Clause 19 of the Financing Agreement provides:

Payment of Interest:

> " The parties hereby recognize and agree that the payment of interest is repugnant to the principles of Sharia and accordingly to the extent that any legal system would (but for the provisions of this clause) impose (whether by conduct or by statute), any obligation to pay interest, the parties hereby irrevocably and unconditionally expressly waive and reject any entitlement to recover any interest from each other."

29. A review of the replacement charge and the admission in the Bank's submissions confirm that there was no indication that the Bank would charge or collect interest on the facility. Thus, while the Sacco was liable to make monthly payments to the Bank as outlined in the letter of offer and in accordance with the musharaka terms, no interest was chargeable.

30. The issue is whether the Bank adhered to this condition of the agreement. I have reviewed the tabulation on page 305 of the Bank's documents, which provides a breakdown of the Bank's demand. According to that schedule, the arrears demanded consist solely of arrears on the principal amount and profit. The Bank vehemently denies having charged any interest on the facility.

31. However, from an examination of the loan statements (at pages 59-61 and 77 of the Bank's bundle) covering the period between October 4, 2013 and April 26, 2015, it is evident that the Bank had in fact been charging interest on the facility. This was in breach of the agreement between the parties and the core fundamentals of Islamic banking. While the Sacco acknowledges it's indebtness to the Bank, it would be unjust to allow the Bank to benefit from its own breach and proceed to exercise its statutory power of sale based on an erroneous demand.

32. I do therefore find that the demand by the Bank based on interest rates as proved is unlawful.

(ii) Whether interest or profit ought to have been pre-determined and collected after the project was completed and not before:

33. Having already dealt with the question of interest, I now turn to address the question of profits under the financing agreement. From the offer letter of December 30, 2014, parties agreed to a financial contribution towards the investment. The Bank would contribute 84.2% and the Sacco 15.8% of the total investment required for purchasing and constructing 113 units on the subject property. This is in tandem with the Islamic concept of co ownership.

34. Clause 2.6 of the financing agreement grants the Sacco the exclusive right to occupy and use the property, including the Bank's share. However, in line with the musharaka concept, which involves a gradual transfer of ownership from the financial institution to the customer, the Bank was not meant to retain ownership of the units. These units were to be eventually bought out by the Sacco at an agreed buyout price. This arrangement would ensure that the Bank's interest in the property diminishes over time. From the offer letter and the replacement charge, the buyout price was set at a profit rate of 15.45% on the units sold.

35. In line with this, the Sacco executed an (undated) undertaking (at pages 98 and 99) in which it undertook to periodically purchase the units from the bank, at the agreed buyout price and on the agreed buy out dates. The Sacco further agreed that failure to pay the amount due on time would constitute a default on its part. Additionally, the Sacco undertook to purchase any remaining units on termination, upon issuance of a notice of such termination. This confirms the parties' intention for a gradual buyout and refutes the Sacco's submission that they had agreed to wait until the project was completed to determine the profit ratio.

36. This pre-determined profit rate of 15.45% in the offer letter also explains the rate of 15.45% in Clause 3.1.1 of the replacement charge (at page 188 of the Bank's documents), vis-à-vis the same Clause 3.1.1 (at page 270 of the Sacco's documents), which is blank. In any case, the Sacco had serviced the facility throughout, as evidenced by the letters on pages 233 to 243 of the Bank's documents and even offered to settle the debt at a figure of Kshs 750 million in full and final settlement. This confirms that indeed the profit was payable during the construction period, in addition to the principal amount, subject to the moratorium on the principal amount.

37. I further note that during the period when the Sacco was repaying the facility, the issue of the profit ratio was never raised until the Bank threatened to exercise its statutory power of sale. Having agreed to the terms in the offer letter and benefitted from the facility, it is in bad faith for the Sacco to attempt to disown the terms now.

38. That said, the Sacco contends that it has paid a total of Kshs 2.4 billion against the original principle amount of Kshs 1.8 billion even before project completion. The Sacco further argues that any amount over and above the principle amount ought to be treated as profit and therefore nothing is due to the

Bank. The Bank on the other hand takes issue with the accounts submitted by the Sacco in support of these figures.

39. It is unreasonable for the Bank to claim that it is not responsible for disproving the Sacco's assertion. The Bank holds the statements of accounts for the musharaka and the escrow accounts, making it their duty to provide accurate and up-to-date statements. These statements should detail the proceeds of sales paid so far, the profits from these sales, and the outstanding amounts in terms of both profits and the principal amount due to the Bank. This responsibility aligns with section 112 of the *Evidence Act*, which states:

> " In civil proceedings, when any fact is especially within the knowledge of any party to those proceedings, the burden of proving or disproving that fact is upon him."

40. The implication of this is that I agree with the Sacco on the necessity for proper accounting to accurately determine the amount legitimately owed to the Bank.

Disposition

41. Accordingly, the plaint dated July 17, 2019 succeeds and I do find and order that:

    i. The defendant's demand notice and subsequent notices are illegal and unlawful;

    ii. A proper accounting under the musharaka financing agreement be carried out in accordance with the findings of this judgment within 30 days;

    iii. Any monies found to be due to the plaintiff or monies due to the defendant be paid within 45 days of the accounts being completed;

    iv. An injunction is hereby issued against the sale/auction of the suit property pending (ii) and (iii) above;

    v. In the event that any amount found to be due to the defendant, is not paid in compliance with these orders, for the avoidance of doubt, and subject to compliance with the law, the defendant will be at liberty to exercise its statutory power of sale then.

    vi. The plaintiffs shall have the costs of the suit.

DATED, SIGNED AND DELIVERED IN NAIROBI THIS 7TH DAY OF FEBRUARY 2025.

F. MUGAMBI

JUDGE