

CRITICAL ANALYSIS ON THE ESSENCE OF MUḌĀRABAH AND MUSHĀRAKAH AND ITS RELATION TO ḌAMĀN

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Abstract

The study aims to explore the permissibility of guarantee for muḌārabah and mushāraakah based contracts and to discuss in detail the essence of muḌārabah and mushāraakah, which both contracts contain the concepts of trust and profit sharing. The study conducted the qualitative research approaches which consist of documents analysis, interviews and observations in few phases. The study found that there are few matters that can be listed as genuine essence of muḌārabah and mushāraakah. It also found that the majority of scholars were of the view of prohibiting capital guarantee by partners. It also proved that few statements such as Ibn Taymiyah's statement were quoted out of context and definitely not appropriate to attribute the stance of those who allowed capital guarantee to him by using his statements, as those statements showed something else. However, a third party may undertake to bear the loss of capital due to misconduct or negligence on the part of the manager for both contracts. The rabb al-māl (capital provider) may also take collateral from the muḌārib, provided that the collateral can only be liquidated in the event of negligence or misconduct or violation of contractual terms by the muḌārib.

Keywords: *Muqtada al-'aqd, muḌārabah, mushāraakah, Ḍamān*

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Introduction

In the wake of the vast development of Islamic finance over the last few decades, much has been said about the limited track record of Islamic financial institutions (IFIs) applying risk sharing principles, especially *muḌārabah* and *mushāraakah*. The issues of high risk in general and multi-faceted business risks in particular that are associated with *muḌārabah* and *mushāraakah* remain obstacles to their implementation. To minimize those risks scholars have suggested a few steps such as proper guidelines on *taqṣīr*

(negligence) and *ta'addī* (transgression). Discussion of the concepts of *taqṣīr*, *ta'addī*, guarantee and the management of moral hazard in *muḌārabah* and *mushāraakah* products is paramount in realizing their implementation.

Problem Statement

One major problem with the profit and loss sharing (PLS) contracts that has been frequently mentioned in the literature is the agency problem, which is said to be inherent to these types of contracts. For example, in the words of the State

Bank of Pakistan 2008, “The agency problem is one of the major factors for the reluctance on the part of banks to undertake equity based modes of financing, as it gives entrepreneurs the incentive to under ‘state profits.” [Kazarian E.G, 1993; Rickwood and Murinde in Iqbal M. & Llewellyn D. T. (eds.), 2002; Dār H. A. & Presley J. R., 2000; Iqbal M. & Molyneux P., 2005].

Ashraf and Lokmanul Hakim [2011], after noting the moral hazard of customers reporting losses in their financial statements in order to avoid paying the *rabb al-māl*, suggested that IFIs in *muḍārabah* and *mushārahah* arrangements may require customers to prove their integrity in order to protect the IFIs’ position. Part of the due diligence process when applying for *muḍārabah* financing involves feasibility studies. Financing will not be approved unless the proposed project is determined to have a good probability of being profitable. The occurrence of loss raises the very real possibility that the customer was negligent. Hence, such customers have a responsibility to prove that they are not guilty.

However, this view seems to contradict the stance of Sharī’ah from a few aspects. First, the Islamic legal maxim states: *al-aṣl barā’at al-dhimmah* (freedom from liability is the pre-existing and therefore prevailing state). Second, *muḍārabah* is a trust-based contract; the entrepreneur holds the capital provider’s fund under the principle of trust. Requiring the entrepreneur to prove his innocence means that he is presumed guilty unless he provides evidence to the contrary, which may contradict the essence of the *muḍārabah* contract.

All of this highlights the need to analyse the issues in detail in to uphold the appropriate view related to the essence of both contracts and the limitation that a guarantee can be implemented in partnership contracts. There is a need for a concrete view of the essence of *muḍārabah* and *mushārahah* in order to avoid any possibility of transforming them into a contract of *ḍamān* (guarantee).

Objectives

The objectives of this study are to explore the permissibility of guarantee for *muḍārabah* and *mushārahah* based contracts and to discuss in detail the essence of *muḍārabah* and *mushārahah*, which both contain the concepts of trust and profit sharing.

Literature Review

This section discussed about the previous study done by other researches related to the contract of *muḍārabah* and *mushārahah*. Besides, this reviews also touched about the problem of capital and *Muqtaḍā al-’Aqd* in the both contracts. Thus, based on literature analysis, there are some of issues arises related to the contracts that has been listed at the end of the section.

Hassan and Mehmat [2008] said that *muḍārabah* contains many risks, particularly business risks. They insisted that managing a business has its own risks and that Islamic banks need to face these risks. Among other risks inherent to *muḍārabah* are the business partner’s freedom to terminate the partnership at any time, which will definitely cause the business to be liquidated because no one can be forced to continue a partnership against his/her will. Given this reality, many Islamic banks avoid unnecessary exposure to *muḍārabah* risk.

However, a few studies revealed that some anxieties, such as the withdrawal of investors, have been overcome through the existing structure of the *muḍārabah* contract, based on the decisions of the Accounting and Auditing Organisation for Islamic Finance Institutions (AAOIFI) as stated in Sharī’ah Standard 2010, Standard 13, Section 4, which affirms that the *muḍārabah* contract is not binding (*ghayr lāzim*) and that each contracting party is free to withdraw except in two situations:

1. The *muḍārib* has started the work; as soon as that happens the *muḍārabah*

becomes binding until the occurrence of liquidation (*tandīd*), either actual (*haqīqī*) or constructive (*ḥukmī*).

2. If the two sides have agreed to stipulate a term for the *muḍārabah*, it cannot be dissolved before the due date except with the consent of both parties.

If an Islamic bank enters into a partnership in which the managing partner cannot be held responsible for any operational losses, it means the Islamic bank cannot collateralize the risk. Therefore the *muḍārabah* structure of equity finance becomes riskier for the Islamic banks. In fact, it is listed as the fifth risky type of financing in terms of credit risk [Khan and Ahmed, 2001]. Moreover, Islamic banks as financial intermediaries have to undertake the process of project evaluation, which is very long and costly. The expertise that is needed for the decision process is complicated. Several authors have come up with a number of solutions in order to make PLS contracts more appealing to IFIs. Bacha [1997] proposed that the *muḍārib* must 'reimburse' the *rabb al-māl* in the event of certain outcomes. Karim [2000] recommended that the *muḍārib* contribute some capital or collateral in the project. Adnan & Muḥammad [in Obaidullah, 2008] argued that while cases of *muḍārib* negligence leading to losses are taken care of in *muḍārabah*, proper systems should evolve to establish such negligence and ascribe the losses to the *muḍārib*. Khan [2003] suggested that banks guarantee investment deposits by *tabarru'* to minimize the agency problem.

A few papers were presented on this topic at the Fifth Regional Sharī'ah Scholars Dialogue in Phuket, Thailand in 2011. Ashraf and Lokmanul Hakim [2011] emphasized that the view of the majority of scholars prohibiting a guarantee in *muḍārabah* is the strongest opinion. However, they said that stipulating a guarantee in *muḍārabah* using the same basis as in the imposition of liability on artisans and on those offering their labor to the general public (*taḍmīn al-ṣunnā'* and *al-ajr al-mushtarak*) seems acceptable in order to protect public

interest (*maṣlahah 'ammah*) against the loss of wealth, especially in a time when dishonesty has become typical behavior.

Reflecting on the view above, this study observes that the guarantee element in both issues, i.e., *taḍmīn al-ṣunnā'* and *al-ajr al-mushtarak*, does not change the nature of either contract. Each is inclined to be categorized as *ḍamān al-yad* (liability due to possession) or *ḍamān al-mutlafāt* (indemnity for damage). Therefore, the guarantee should be allowed in both cases as no element of *qarḍ* and *ribā* appears in them. However, the case is different in a *muḍārabah* contract, as the arrangement in *muḍārabah* is providing money against a portion of the profit. Therefore, any guarantee element shall transform the contract into a *qarḍ* contract. Hence, the guarantee element has changed the essential nature of *muḍārabah* (*muqtaḍā al-'aqd*). Therefore, any measures to protect the investors (*rabb al-māl*) should observe these matters. Steps in that direction are still possible as long as the efforts do not exceed the boundaries of *muḍārabah*'s essential nature.

Ashraf and Hakim [2011: 16-17] then suggested that *muḍārabah* contracts with small and medium industries should be treated on the basis that they are liable for the capital in the event of loss unless they are able to prove that they were free from any negligence or irregularities in the management of the capital. The authors then gave the justifications for this view and suggested maintaining the original rules of *muḍārabah* for strong companies.

This research is of the view that the nature (*muqtaḍā*) of *muḍārabah* has been changed to *ḍamān* when the losses are placed directly on the entrepreneur. Whenever the nature of *muḍārabah* has been shifted to a guarantee-based contract, the *rabb al-māl* is permitted to take collateral against any loss. In addition, the nature of *muḍārabah* becomes similar to *qarḍ*. Furthermore, the entrepreneurs then have to fight to prove their innocence. Another issue that may arise is to whom they have to prove it. This needs

to be proven in court, which consumes a lot of time and money. Assigning the *rabb al-māl* the right to determine wrongdoing is hardly likely to result in an objective and impartial judgment. Notwithstanding these complications, this research is interested in the idea of developing an instrument to enable the *rabb al-māl* to get compensation if entrepreneur negligence and misconduct do occur.

Adiwarman [2011] also emphasizes the element of security or collateral in *muḍārabah* financing as practiced by Islamic banks in Indonesia. In their implementations, the *muḍārabah* contract is maintained as a trust contract, but the financier (bank) is allowed to impose collateral against any customer negligence or misconduct. This practice is supported by AAOIFI in Shari'ah Standard No. 13, Section 6, which allows the placement of such securities by stating:

“The capital provider is permitted to obtain guarantees from the muḍārib that are adequate and enforceable on condition that the capital provider will not enforce these guarantees except in cases of misconduct, negligence or breach of contract on the part of the muḍārib.”

However, Adiwarman [2011] did not mention when the collateral will be used to claim compensation for clients and customers. Does the practice of the banks genuinely compensate the capital provider regarding the negligence or misconduct of the entrepreneur, or are there cases where they liquidate the collateral against losses not resulting from negligence and misconduct? Furthermore, who will determine that the entrepreneurs have committed negligence and misconduct in their actions? Can the bank alone decide on the matter? If the bank is the only party that can determine whether entrepreneurs have committed negligence or misconduct, is it fair to customers to have their fates determined by the financiers? Who then will examine the

moral hazard of the financier (*rabb al-māl*) determining customers' negligence?

The Problem of Capital and Muḍāḍā al-'Aqd.

Aznan and Zaharuddin [2011], like Ashraf and Hakim [2011], have chosen the majority view of scholars that does not allow the element of guarantee in trust-based contracts such as *muḍārabah* and *mushārahah*, except if there is an element of *ta'addī* and *taqṣīr*. However, the authors raised several other issues that could be classified as controversial.

Aznan and Zaharuddin [2011] cited the views of some contemporary scholars about the types of *ta'addī*; for example, Hussein Hamid and Abdul Hamid al-Ba'li proposed that if that *muḍārib* has done feasibility studies and the investment results differ from the projections contained therein, the *muḍārib* should be considered to have committed negligence and misconduct in his operations. In addition, the case can be analogized with the case of *al-taghrīr bi al-fi'l* (deceiving by deeds). Here, as in Ashraf and Hakim's view, it is the responsibility of the *muḍārib* to prove that the failure to achieve profitability as in the feasibility studies is not due to his negligence.

The view of Hussein Hamid and al-Ba'li places too much weight on the feasibility study as a criterion for honesty, equating honesty with profit and dishonesty with loss. Interviews with the entrepreneurs showed that the feasibility study is not a primary factor of success or a very reliable predictor of it. On the other hand, the view of Ashraf and Lokmanul Hakim [2011] may be more suitable to protect the capital owner.

Aznan and Zaharuddin [2011] also appeared to agree with Hussein Hamid in allowing liability for *ta'addī* to cover submission of all the *muḍārabah* assets to the *rabb al-māl* even if the *muḍārabah* assets exceed the capital costs. This view is intended to prevent the *muḍārib* from committing *ta'addī* in situations in which the value of the assets rise during the course of the

muḍārabah venture, which may motivate him to liquidate the *muḍārabah* assets, return the capital back to the *rabb al-māl*, and pocket the difference.

However, this view does not recognize the increased value of company properties as a profit that reflects the *muḍārib*'s good management through smart purchasing strategies. Therefore, it is more preferable if both parties should share accordingly any amount above the capital amount. Furthermore, this view may not be feasible in *mushārah* in which the IFI provides part of the working capital that is used to bear the operating costs. In this kind of *mushārah*, the determination of profit is settled after calculating the overall profit of the company's operations. In the event of *ta'addī*, the *mushārik* seems to be a guarantor and liable to repay the investment by surrendering all of the company's assets. It seems unfair to the *mushārik* when *mushārah* puts profit-sharing as a major requirement.

Aznan and Zaharuddin [2011] stressed that some past scholars such as al-Shawkānī and Ibn Taymiyyah and recent scholars such as Nazih Ḥammād allow the stipulation of *ḍamān* upon the *muḍārib* or *mushārik*. This study humbly offers a contrasting view from that of Aznan and Zaharuddin [2011] in their interpretation of Ibn Taymiyyah's view, which they understand to support the permissibility of holding the *muḍārib* or the *mushārik* liable. The differing interpretations of Ibn Taymiyyah's statements will be discussed in detail in section 3.4.1 on the essential nature of *muḍārabah*.

Although Ḥammād [2011] also upheld the non-guarantee element in *muḍārabah*, he inclined towards shifting the burden of proof in disputes over profit shortfalls to the entrepreneur (*muḍārib*), i.e., he would have to prove that he had not been negligent and had not engaged in misconduct [Aznan & Zaharuddin, 2011].

A few writers before Ḥammād explored *muḍārabah* and *mushārah* contracts. For

instance, Uthmani [2005: 38-40] discussed in detail current Islamic finance practices, including *muḍārabah* and *mushārah*. He called attention to the element of capital guarantee in *mushārah mutanāqishah* as presenting a possible issue of Sharī'ah non-compliance in the arrangement. 'Abd al-Muṭalib [2005] and Al-Khuwaytir, [1999] also explored *muḍārabah* and *mushārah* contracts and related them to the practices of Islamic financial institutions. However, they did touch upon a few relevant issues related to this study, such as the nature of the *muḍārabah* contract, the capital contribution, negligence and misconduct, among others. On the other hand, al-Dabb [1998] explored *muḍārabah* within the scope of Islamic economics. He compared the view of the Sharī'ah on *muḍārabah* with the existing law of his country, Jordan.

A number of studies have explored the issues of *ḍamān*, *taqṣīr* and *ta'addī* in some detail. Ahmad [2009] touched upon the issues of *tafrīt*, *ifrāt* and *ta'addī* and the consequence of those acts, including *ḍamān* such as Al-'Anzī [2009] wrote clearly and systematically about compensation conditions in contracts. He discussed *taqṣīr* and *ta'addī* as well as the ways to compensate for those acts. Similarly Al-Khafīf [1981] wrote a valuable book on *ḍamān* in Islamic jurisprudence. He differentiated between contracts whose nature is guarantee and situations where a partner is liable (*ḍāmin*) because of his acts without transforming the contract into a guarantee-based contract.

To conclude the literature review, based on the discussion above, there are certain issues that do not require further debate, such as jurists' views on *muḍārabah* and *mushārah*; and debate on the evidence for the legality of *muḍārabah* and *mushārah*.

However, a brief discussion of these topics is still relevant for maintaining an orderly presentation of the concept under discussion. After analyzing the works cited, it is very clear that a few topics require further discussion; for example:

1. issues related to *muqtaḍā al-'aqd* in *muḍārabah* and *mushāarakah*;
2. types of actions that can be considered from an Islamic point of view as *taqṣīr* or *ta'addī*;
3. elements of security and guarantee in *muḍārabah* and *mushāarakah* that are permissible as long as they do not change the essence of *muḍārabah* and *mushāarakah*;
4. the contention that placing the burden of proof on the *muḍārib* or *mushārik* does not transform the *muḍārabah* or *mushāarakah* into a guarantee-based contract.

Methodology

This research applies qualitative research approaches using content analysis, which is via *fiqh muqāran* (comparative analysis of jurists' arguments) and other related sources. In the first phase, the study collected data from libraries in the form of appropriate books, journals and other publications and from recognized internet websites that discuss some of the issues related to the research objectives: inter alia, Islamic principles and concepts related to Islamic law, and standards and guidelines on finance and the banking industry. The researchers also engaged in various industry talks in order to further understand the subjects of the study.

In the second phase, the *fiqh muqāran* and the related sources that been chosen. Thus, effort was then made to determine which of their views is the most preferable. All the data generated was critically analyzed to answer the objectives progressively.

The Essential Nature Of Partnership Contracts

The subject of *muqtaḍā al-'aqd* (the essential nature of the contract) remains relevant as scholars disputed in determining the permanent elements of a contract. One scholar may say

that the non-guarantee basis is an untouchable element in the partnership contract while others may reject such a sweeping generalisation. Therefore, a reasonably thorough discussion is needed in order to explore the essence of *muḍārabah* and *mushāarakah* and discover the elements of *muqtaḍā al-'aqd* for both contracts.

This section focuses the discussion on definitions of *muḍārabah* and *mushāarakah*, comparing and contrasting them, identifying the roles of the entrepreneur in *muḍārabah* and the partner (*sharīk* or *mushārik*) in *mushāarakah*, the types of *muḍārabah* and *mushāarakah*, the features of *muḍārabah* and *mushāarakah* which relate to the essence of the contracts, the contracting parties, the capital, the loss-sharing element, management of the fund and enhancement of the contracts.

Definitions of Muḍārabah and Mushāarakah

Muḍārabah is derived from the Arabic word “*ḍarb*” which, when used in the phrase “*ḍarb fī al-ar*”, means to travel on the earth for trade or business [Ibn Manẓūr, n.d.: 545]. The Qur’ān mentions the root word with this meaning in Sūrah al-Muzammil, verse 20 which means: “... and others traveling throughout the land seeking of the bounty of Allah...” As a technical term, Ḥanafī and Ḥanbalī scholars have defined the *muḍārabah* contract as a contract for partnership in profit using the capital of one party and the efforts of the other [al-Marghīnānī, n.d.: 4/200; Ibn Qudāmah, n.d.: 5/134; Al-Baghdādī, 1999: 303]. Mālikī and Shāfi’ī scholars defined *muḍārabah* as an authorization to conduct trade using cash turned over to the entrepreneur against a portion of the profit when it becomes known [Khalīl, n.d.: 6/203, Al-Bujayrīmī, 1996: 3/537].

The Mālikīs and Shāfi’īs preferred to use the term *tawktīl* (authorization or appointment of an agent) in their definition whereas the Ḥanafīs and Ḥanbalīs inclined towards using the term *ishtirāk* (partnership). It is understood that the

Mālikīs and Shāfi'īs looked at this contract as a variant or manifestation of the *wakālah* (agency) contract and saw the elements of the agency contract to be more relevant than the partnership elements. On the other hand, the Ḥanafī and Ḥanbalī Schools have used the term *ishtirāk* (participation), which suits their practice of discussing this contract under the rubric of the *mushārahah* contract, and they classified it as *sharikat al-'inān* [Ibn Qudāmāh, n.d.: 5/136, al-Kāsānī, 2000: 5/112]. Ibn Qudāmāh [n.d.: 5/136] says that [Muḍārabah] follows the rule of *shirkat al-'inān* in that anything permissible for the partner to do is permissible for the entrepreneur to do, and anything prohibited for the partner is prohibited for the entrepreneur.

However, although they did not refer to agency in the definition, the Ḥanafī School agreed that the meaning of *wakālah* still remains as the essence of contract in *muḍārabah*, al Kasani [2000: 5/112] states that [the condition of validity] related to the contracting parties- i.e., the capital owner and the entrepreneur - is the legal capacity to appoint an agent or to act as an agent because the entrepreneur acts according to the instructions of the capital owner, which is the meaning of agency. One contemporary writer, Ismail [2010], summarized the components of *muḍārabah* and classified this kind of contract as a partnership in profit, joint venture in which one party provides capital and the other party provides managerial skill and labour. Hence, according to al-Zayla'ī [1313H: 5/52] in *Tabyīn al-Ḥaqā'iq*, *muḍārabah* is profit sharing in which both parties share the profit, though the capital is taken from the capital owner alone and the work is done by the entrepreneur alone. The provider of the capital is called *rabb al-māl* or *ṣāhib al-māl*, while the provider of skill and labour is called the *muḍārib*. [Ismail, A. G., 2010].

Any profit from the business will be shared according to a pre-agreed profit-sharing ratio. If there is a loss, the capital provider will absorb the loss while the entrepreneur will lose all the effort and time put into the business. But if it

was proven that the entrepreneur was negligent in conducting the business, he will have to bear the loss. Another terminological difference is that the Ḥanafī and the Ḥanbalī Schools call this partnership *muḍārabah* while the Shāfi'ī and the Mālikī Schools call it *muqāraḍah*, which is derived from the Arabic word *qar'* meaning 'loan'. The technical meaning of *qarḍ* is surrender of right over capital by the owner to the user, as a charitable act and not to obtain profit but with the stipulation that the original amount be returned to its owner. A linguistic variant of *muqāraḍah* is *qirāḍ* [al-Bayjurī, 1999:2/37,38].

According to Abu Saud [1976], both words, *muḍārabah* and *qirāḍ*, are used to signify the same idea, which is to give somebody out of your capital a part to trade in, provided that the profit is shared between both of you or that an apportioned share of profit is allocated to him accordingly. The active partner is called a *ḍārib* [*sic*] because he is the one who travels and trades. It is also possible for both the capital provider and the active partner to be called *muḍārib* or *muqāriḍ* as both share the profits with each other. On the other hand, Al-Bayjurī [1999: 1/734], Shāfi'ī scholar, defines *mushārahah* or *shirkah* as an establishment of a right by way of joint ownership between two or more parties. The Ḥanbalī scholar, Ibn Qudāmāh [n.d.: 5/109] says that it is sharing in entitlement or in disposal." Both of these definitions avoid restricting them to contractual acts as the partnership in *mushārahah* is not necessarily derived from a contract; it may result from other causes such as inheritance, a gift, charity, etc.

Ḥanafī scholars such as al-Marghīnānī and al-Kāsānī preferred not to define *shirkah* as they directly divided *shirkah* into two types: *shirkat al-milk* and *shirkat al-'aqd* [al-Marghīnānī, n.d.: 3/5; al-Kāsānī, 2000: 5/73]. A similar approach can be seen in Mālikī books such as *Bidāyat al-Mujtahid* [Ibn Rusḥd/, 1995: 2/203]. There is a consensus of opinion among the jurists of all schools (including Ḥanafīs, Mālikīs, Shāfi'īs and Ḥanbalīs) that *mushārahah* is a valid and

legitimate contract in Islam; however, they dispute regarding the types of permissible *musharakah* contracts. This will be discussed in a coming subtopic [Usmani, 2005: 82; Usmani, 2003: 249-255].

Types of Muḍārabah and Musharakah Contracts

The *muḍārabah* contract can be categorized into two types: restricted (*muḍārabah muqayyadah*) and unrestricted (*muḍārabah muṭlaqah*) [al-Marghīnānī, n.d.: 4/201]. According to Ismail [2010], restricted *muḍārabah* is defined as a contract in which the *rabb al-māl* restricts the actions of the *muḍārib* to a specified period and/or location or to a particular type of business that the *rabb al-māl* considers appropriate, but not in a manner that would unduly constrain the *muḍārib* in his operations. Unrestricted *muḍārabah* may be defined as a type in which the *rabb al-māl* permits the *muḍārib* to manage the *muḍārabah* fund without any restriction. If the finance provider stipulates restrictions in the contract and the *muḍārib* agrees to them, then he is bound by the terms he has agreed to Ayub [2007]. In unrestricted *muḍārabah*, the *rabb al-māl* has left it up to the *muḍārib* to undertake any business he wishes; hence, the *muḍārib* is authorized to invest the funds as he deems fit. However, the contracting parties may mutually agree to change the type of *muḍārabah* that they entered into to another type of *muḍārabah* at any point of time.

Jurists have used a different set of considerations in their categorisation of the *musharakah* contract. According to the Ḥanafīs and the Ḥanbalīs, the two main types are *shirkat al-'uqd* (pl. *al-'uqūd*) and *shirkat al-milk* (pl. *al-amlāk*) [al-Kāsānī, 2000: 4/73; Ibn Qudāmah, n.d.: 5/109; Asmadi, 2011]. This categorization is of paramount importance because the consequences and rulings of the two categories differ from one another. *Shirkat al-milk* is joint ownership on a non-contractual basis while *shirkat al'uqūd* is contractual partnership. They further divide

shirkat al-milk into two types [al-Kāsānī, 2000: 4/74-75]:

1. *Shirkat al-milk al-ikhtiyārī* (discretionary joint ownership). It is co-ownership of an asset resulting from the decision of two or more parties to jointly purchase it. It could also result from a gift to the partners during the lifetime of the donor or by a bequest, which transfers its ownership after the donor's death, or from a charitable donation. If they accept the gift or the bequest or the donation, they become partners in the asset without any contractual partnership.
2. Non-discretionary *shirkat al-milk* is joint ownership that occurs without the partners' willingness playing any role. It is a result of automatic inheritance (*mīrāth*), whereby the entitlement is prescribed by the Sharī'ah.

The Mālikīs categorized *shirkah* into three categories, those are *shirkat al-irṭh* (partnership because of inheritance), *shirkat al-ghanīmah* (partnership amongst the soldiers of an army regarding property captured from the enemy) and *Shirkat al-mubtā'īn* (partnership among purchasers). *Shirkah al-mubtā'īn* as elaborated by the Mālikīs is similar to *shirkat al-milk* as discussed by the Ḥanafīs and the Ḥanbalīs, although the Mālikīs separated the partnership due to inheritance from the partnership due to purchase [al-Kāsānī, 2000: 4/73; Ibn Rushd, 1995: 2/203,206; Ibn Qudāmah, n.d.: 5/109; al-Jazīrī, 2001: 654-661]. In contrast, the tendency of most Shāfi'ī scholars in their treatment of partnership is to limit their discussion to the permissibility of *shirkat al-'inān* without any reference to *shirkat al-milk* [al-Kāsānī, 2000: 4/73; Ibn Rushd, 1995: 2/203,206; Ibn Qudāmah, n.d.: 5/109, Al-Jazīrī, 2001: 654-661; Asmadi, 2011].

Shirkat al'uqūd (contractual partnership), *Shirkat al-'uqūd* can be considered a proper partnership because the concerned parties have willingly

entered into a contractual agreement for joint investment and the sharing of profits and risks. The Ḥanafī and Ḥanbalī scholars subdivided this kind of *shirkah* into four different types [al-Kāsānī, 2000: 4/73; Ibn Rushd al-Hafīd, n.d.: 2/203,206; Ibn Qudāmah, n.d.: 5/109]. In case of *Al-nān*, it is a contract where two or more parties agree to share their capital and efforts in a business. The shares in the profit and loss from the business must be determined at the beginning of the contract. *Al-nān* implies that the partners need not all be adults, nor must they have an equal share in the capital. Likewise, they are not necessarily equally responsible for the management of the business. Accordingly, their share in the profits may be unequal, but this must be clearly specified in the partnership contract. On the other hand, their share in the losses would be proportional to each partner's capital contribution.

Discussion of shirkat al-milk and the common requirements of musharakah

In examining *shirkat al-milk*, the Ḥanafīs discussed a number of issues such as the use of the asset by one party in the absence of the other owners; the sale of one partner's ownership share to other partners or to a third party; and the status of the asset and the permissibility of selling it if it is on another party's land; e.g., a building on leased land (al-Jazīrī, 2001: 654-655).

The Mālikīs enumerated a number of issues, *inter alia*, ways to resolve the problem when the sleeping partner of jointly owned property declines the active partner's request to use the asset; how the active partner deals with certain circumstances; the right of each partner to protect his or her asset; and how they can ensure that their asset is protected physically or constructively during its use [al-Jazīrī, 2001: 657-658]. The Ḥanafīs deliberated two main conditions for common *shirkah* (including *shirkat al-milk*) [al-Jazīrī, 2001: 662], those are the subject matter of *shirkah* must be amenable to disposal under an agency (*wakālah*) contract;

and the profit must be pre-determined by ratio or percentage. *Shirkah* is void if there was no pre-determined ratio or if the profit of one of the partners is pre-determined as a fixed amount such as one thousand dollars.

Actually, the second condition was meant for contractual partnership (*shirkat al-'aqd*) rather than *shirkat al-milk*. Profit in *shirkat al-milk* should be equal to the partners' portions in the partnership. No further discussion on *shirkat al-milk* was found in the Mālikī and Ḥanbalī literature. By understanding these requirements, this study will be able to analyse the practices of *musharakah* in the existing Islamic finance industry.

The Essence of the Muḍārabah and Musharakah Contracts

There are a number of features in the *muḍārabah* contract that comprise the *muqtaḍā al-'aqd* (the nature and implications of the contract). *Muqtaḍā* is derived from *iqtaḍā/yaqtaḍī*. It literally means 'contents' or 'reasons', as quoted by Jarjīs [1996: 124]: "*He wanted it; or the cause required it.*" *Muqtaḍā* (nature and implications) is defined as theories and general rules which are the foundations of the contract [See: Maany website, 2013].

The Essential Nature of Muḍārabah

There are a number of features which comprise the *muqtaḍā al-'aqd* of the *muḍārabah* contract. Al-Kāsānī [2000: 5/82] mentioned the relation between the profit (*ribḥ*) and the elements that justify entitlement to it. He stresses that the *rabb al-māl* is entitled to profit because of the risk facing his capital, and profit is the way to grow the capital. Likewise, the *muḍārib* (entrepreneur) in *muḍārabah* or the partner in *musharakah* is the one who works for the business; thus the profit is compensation of his work. On the other hand, whenever the *muḍārib* becomes liable for the *muḍārabah*, then the whole profit must become his right. Hence, the element of facing

risk is crucial to the *rabb al-māl's* entitlement to profit in *muḍārabah* and *mushārahah*. Therefore, the risk that accompanies investment is a paramount element and an essential aspect of both contracts. Ibn Taymiyyah [2001, 29/75] makes a fine distinction regarding *muqtaḍā al-'aqd* as follows:

If someone says, "This stipulated condition conflicts with the muqtaḍā al-'aqd," one may say to him, "Does it conflict with the nature of the unrestricted contract or [does it] absolutely [conflict] with the nature of the contract? If he meant the first, then all conditions do that. If he meant the second, his claim is not conceded. The prohibition in stipulation is when it contradicts the purpose of the contract.

He further explained [2001, 29/85]:

The contract has two states: unrestricted and restricted. A distinction has been made [in the Sharī'ah] between the unrestricted contract and the unrestricted meaning (al-ma'nā al-muḥlaq, i.e., purpose) of contracts. If someone says, "This stipulation contradicts the nature of the contract (muqtaḍā al-'aqd)," he may mean that it contradicts the unrestricted contract, but the same goes for every added condition, and there is no harm in that. If the intended meaning is that the stipulation contradicts the nature of [both] the unrestricted and restricted contract, evidence needs to be presented for that. This [statement] is only true if the stipulation contradicts the purpose of the contract.

From the above statements, it can be understood that Ibn Taymiyyah rejected the categorization of all conditions as conflicting with the essence of *muḍārabah*. He excludes conditions that do not contradict the purpose of the contract, which is considered as the genuine essence of the contract. He clearly affirms two points; first, if the terms contradict the purpose of the contract, the terms are considered invalid and can nullify the contract. Second, if the terms contradict the Qur'ān and Sunnah, then such terms are considered null and void. Almost all scholars agreed that the element of bearing investment risk is paramount in the *muḍārabah* contract and can be considered as the main characteristic that distinguishes it from a loan contract and a *ribā*-based contract.

The Contradicting Views on a Capital Guarantee

As discussed in the literature review, a few scholars argued that a capital guarantee is permissible in *muḍārabah*. They supported their view by mentioning certain statements of Ibn Taymiyyah [2001: 30/62].

"As for stipulating the return of the capital or its value, it is comparable to asking for the return of the tree and the land. As for stipulating the return of an equivalence of the seed, the discussion is involved and I have mentioned it elsewhere."

"If the owner of the seeds stipulates getting [back the volume of] the seeds [he contributed] and that they divide the rest, it is permissible, as in muḍārabah."

They understood Ibn Taymiyyah's view as being the same as their own in the course of arguing that it is permissible to impose *ḍamān* on the *muḍārib* or the *mushārik* (i.e., to make them liable for any loss). We do not understand

Ibn Taymiyyah's statements to support capital guarantee; rather, he is dealing with the methods of distributing profit after it has been realized. Furthermore, as discussed before, it should be understood that the statement above was part of his explanation of *musāqāh* and is not about *muḍārabah* per se, although the elements of risk sharing and partnership are also present in *musāqāh*. Moreover, this statement was part of his reasoning for rejecting the stipulation of a capital owner reserving for himself the fruits of certain trees or the profit from selling certain goods. On the other hand, it is permissible for the partner in *musāqāh*, in the event of positive income, to stipulate that he should get the value of his capital in its original form.

Obviously, the second quoted statement indicates that in certain ways the rules of *musāqāh* are similar to *muḍārabah*. Likewise, it is allowed to stipulate the regaining of the seeds owner's original volume as it is included in the retrieval of the original capital, which is permissible in *muḍārabah* and *musāqāh* if the outcomes of the activities were positive. On the other hand, it is prohibited to earmark the outcomes of certain activities in the *muḍārabah* or *musāqāh* pool of activities for one party and of other activities to the other party. This matter has been discussed by AAOIFI in its Sharī'ah Standards [AAOIFI, 2010: No. 13, Section 8].

Ibn Taymiyyah prohibited capital guarantees in *muḍārabah* can be seen in many of his statements; for example [Ibn Taymiyyah, 2001: 30/61]:

“It is because partnership [including musāqāt, muzāra'āt and muḍārabah] requires justice for both parties; therefore they share the yields and the risks after both of them have obtained their capital.”

The capital guarantee is a kind of unfairness in investment. To uphold justice one should be

ready to bear the investment risk in order to be entitled to a profit. Ibn Taymiyyah was very strict in prohibiting gifts in *muḍārabah* [Ibn Taymiyyah, 2001: 30/62]:

“Some people have disputed with us on this [point]. They are of the view that the donor is making a voluntary contribution, which is not so. Rather, it is a gift motivated by the loan transaction between them” [though the original contract in this arrangement is muḍārabah]

Therefore, the study found that Ibn Taymiyyah's view is in line with that of the majority of scholars in prohibiting a capital guarantee. It is not appropriate to interpret his statements out of context and definitely not appropriate to attribute the stance of those who allowed capital guarantee to him by using his statements, for those statements show something else.

The Essential Nature of Mushārahah

The discussion of the essence of the *mushārahah* contract is directly related to the categorization of *mushārahah* into *shirkat al-milk* and *shirkat al-'aqd*. Therefore, Muṣṭafā al-Zarqā and Taqī Uthmani elaborated these categories and their relation to the issue of the guarantee element in *mushārahah* [Asmadi, 2011]. Muṣṭafā al-Zarqā [2004: 1/354] was among the scholars who pioneered the discussion of *shirkat al-milk*. He elaborated this issue under the rubric of “undivided ownership” (*al-milkiyyah al-shā'i'ah*). There are two main factors that exclude any form of partnership from *shirkat al-'aqd*; firstly, the partnership is solely in ownership of a tangible asset; secondly, there is no agreement to jointly invest it [Taqī Uthmani 2005: 82]. Moreover, the partnership can be considered as *shirkat al-milk* if no promise has been made that either party will invest the asset by way of leasing or another method of generating income from it [Al-Zarqā, 2004: 1/616]. In the event that both parties agree to invest the asset, or for

one of them to lease it to the other, or to a third party, the joint ownership partnership has been transformed into a contractual partnership.

Al-Zarqā clearly states that the arrangement must be free from prearrangement to lease or invest the subject matter in order to consider it a non-contractual partnership. Therefore, when there was a prearrangement to lease, the partnership has been transformed into a contractual partnership in which any promise to guarantee the capital or profit is *ḥarām* as it contradicts the essential nature of *shirkat al-'aqd*.

One may argue against the approach of this study to refer mainly to al-Zarqā, Taqī Uthmani and a few schools of thought in this discussion. However, those who are familiar with the issue of *mushārah* in Islamic law discourse are able to understand this approach as the division of *mushārah* into co-ownership and contractual ownership was initiated by the scholars from the Ḥanafī and Ḥanbalī *madhhabs*. Other *madhhabs* focused specifically on the usage of a jointly owned undivided asset, as discussed earlier. Recent scholars who actively discussed these issues are al-Zarqā in his book *al-Madkhal al-Fiqhī al-'Āmm* and Taqī Uthmani. According to them, shifting the essence of contractual *mushārah* by classifying it as a type of co-ownership in order to permit a capital guarantee is not appropriate as this kind of *mushārah* does not have the features of *shirkat al-milk*.

The Management of the Muḍārahah and Mushārah Venture

Regarding the contracting parties in *muḍārahah*, they consist of the *rabb al-māl* and the *muḍārib*. The *rabb al-māl* and *muḍārib* must have legal capacity to execute contracts, including the agency (*wakālah*) contract as either a principal or an agent. The legal capacity of a natural person is defined as the capacity to have rights and responsibilities and the capacity to have one's actions take legal effect. The primary requirement for the legal capacity of a natural person is to be of sound mind (al-Jazīrī, 2001; Ibn

Hazm, n.d.: 638). Meanwhile, the legal capacity of a legal entity is defined as the eligibility to acquire rights and assume responsibilities. As discussed before, the element of *wakālah* is explicitly mentioned by al-Kāsānī [2000: 6/81]:

“The [condition] that relates to both contracting parties-i.e., the capital owner and entrepreneur-is that they should have the legal capacity to appoint an agent or to act as one.”

Furthermore, the contracting parties in *muḍārahah* may involve more than one *muḍārib* or *rabb al-māl*. This contract is not limited to only two parties. But if *muḍārahah* involves more than one *rabb al-māl*, an agreement among the capital providers may be established whereby an existing capital provider agrees to relinquish his right over a certain portion of the profit if he withdraws from the *muḍārahah* prior to its maturity date and also a new capital provider agrees to assume liability in respect of the *muḍārahah* that is already in operation prior to his participation. An example of multiple *muḍāribs* is that a *rabb al-māl* offers his money to Party A and Party B, such that each one of them can act for him as *muḍārib*, and the capital of the *muḍārahah* shall be utilized by both of them jointly, and the share of the *muḍārib* shall be distributed between them according to the agreed proportion. Consequently, both *mudaribs* shall run the business as if they were partners.

Other than that, *muḍārahah* can be individual or joint. Islamic banks practice *muḍārahah* in both forms. In case of individual *muḍārahah*, an Islamic bank provides finance to a commercial venture run by a person or a company on the basis of profit sharing. The joint *muḍārahah* may be between the investors and the bank on a continuing basis. Many Islamic investment funds operate on the basis of joint *muḍārahah*. The *muḍārib* is an entrepreneur who provides management skills. His status in the business is that he is a fiduciary (*amīn*). Hence, the *muḍārahah* capital is an *amānah* (trust) in the

hand of the *muḍārib*. Therefore, if any loss incurs to the business without negligence by the *muḍārib*, the *muḍārib* shall not be liable for that loss [al-Marghīnānī, n.d.: 4/200].

As discussed before, the Ḥanafīs in elaborating *shirkat al-milk*, have highlighted a few issues related to the use of the asset by one party in the absence of the other owners; the sale of one partner's ownership to the other partners or to a third party; and the status of the asset and the permissibility of selling it if it is on a third party's land, e.g., a building on leased land (al-Jazīrī, 2001: 654-658). In addition the Mālikīs have discussed the ways to resolve the problem when a sleeping partner of jointly owned property declines a request by the active partner to use the asset, and the right of each partner to act to protect his/her asset. Specifically, their discussions focused on the limitations to the independence of each partner, which indicates that in *shirkat al-milk* each partner acts independently within certain limits [al-Jazīrī, 2001: 654-658]. In contrast, both contracting parties in *shirkat al-'aqd* are responsible to conduct the business. Therefore, each of them should have the capacity to be an agent for the other [al-Kāsānī 2000: 5/77].

A similar stance can be seen in the Shāfi'ī and Ḥanbalī Schools [al-Bayjurī, 1999: 1/736-737]. Ibn Qudāmah [n.d.: 5/129] of the Ḥanbalī School says that the *'inān* partnership is based upon [the principles of] agency and trusteeship. However, in discussing the legal capacity of partners for *shirkat al-mufāwāḍah*, the Ḥanafīs add another condition: legal capacity to provide a guarantee. That is because each party is liable for the other party's acts (al-Kāsānī, n.d.: 5/80). Therefore, scholars agreed that the role of the partners in *mushārahakah* is to jointly conduct and manage the business or asset. Both parties have the status of a trustee as either one can act on behalf of the business

The Capital

Capital is the principal element of *muḍārahakah*, forming the substance of the contract. What

makes *muḍārahakah* different from *mushārahakah* is that the *muḍārahakah* capital is to be contributed solely by the capital provider. Scholars are of consensus that capital in a monetary form is valid; however, they disputed the acceptability of a non-monetary asset as capital. The argument against it is that a dispute may arise in determining the value of the asset. Al-Shīrāzī [n.d.: 2/227] stated that the majority of jurists hold the view that the capital must be in monetary form. The same view can be found in the literature of the Mālikīs, Ḥanafīs and Ḥanbalīs. They held that the prohibition is due to the element of uncertainty (*gharar*). A few scholars, such as Ibn Abī Laylā¹ and Aḥmad, in the view less favored by his followers, permit *muḍārahakah* capital to be in the form of assets [Ibn Rushd, 1995: 2/191; Ibn Qudāmah, n.d.: 5/124; al-Kāsānī, 2000: 5/112; al-Shīrāzī, n.d.: 2/227].

In contrast, the capital in a *mushārahakah* venture must come from both contracting parties, either by way of a contractual partnership agreement or co-ownership by way of inheritance, joint purchase of an asset, etc. It is also permissible to structure this kind of ownership so that one party gradually purchases the other party's ownership so as to become the sole owner of the venture. The determination of the price should observe the rule that a capital guarantee is not allowed.

With regards to the type of capital in *mushārahakah*, according to the Mālikī School and some Ḥanbalī scholars, assets shall be valued according to the market price. Therefore, monetary assets of different currencies shall be valued according to an agreed currency at the time of signing the *mushārahakah* contract, and physical assets shall be valued according to a recognised valuation method and with the agreement of all parties [Ibn Rushd, 1995: 2/204; Ibn Qudāmah, n.d.: 5/125]. On the other hand, Imām Abū Ḥanīfah

¹ Muḥammad ibn 'Abd al-Raḥmān ibn Abī Laylā was recognized as a major scholar during his lifetime and was appointed as the Mufti of Kufah. He died in 148 AH (see: www.islamweb.net/newlibrary/showalam.php?ids=12526 accessed on 4 Desember 2013).

and the majority of Ḥanbalīs are of the view that the capital must be in cash so as to avoid two things; first, the inability to mix the ownership of the items as each tangible asset would belong to one of them; hence, partnership would not occur; second, the inability to divide undividable items when the share capital is redistributed to each partner during the winding up process [al-Kāsānī, 2000: 5/112; Ibn Qudāmah, n.d.: 5/124].

Meanwhile, the Shāfi'īs are of the view that it is permissible to use fungible items (*dhawāt al-amthāl*); i.e., items of similar quality such as grades of wheat, rice, etc. that are treated as interchangeable in the market; however, it is not permissible to use non-fungible items (*dhawāt al-qīmah*); i.e. items too dissimilar to be treated as interchangeable in the market, such as animals. Compensation for destruction of items of the latter category is not by replacement but by paying the price [al-Shīrāzī, n.d.: 2/156; al-Bayjurī, 1999: 2/38; al-Jazīrī, n.d.]. According to Usmani [2005], this categorization enabled Imām al-Shāfi'ī to answer the redistribution issue at the time of winding up the venture; however, it still could not answer the issue of mixing the ownership of the items with other partners after the partnership execution. Therefore, the most appropriate view to deal with this issue is to allow the usage of non-cash as capital in *muḍārabah* and *mushāarakah* subject to the ability to have it valued at market price and to grant the ownership of the assets to the venture.

The capital provider and manager may agree to a gradual withdrawal of the *muḍārabah* capital by the capital provider. Failure to provide capital by the capital provider as per the agreed schedule shall constitute a breach of promise according to the specified terms and conditions of the contract. The manager has an option to terminate the agreement, or both parties may agree to revise the agreement based on actual capital contribution. If the agreement is terminated, the manager has to return the outstanding capital. If the *muḍārabah* expenditure exceeds the actual capital contribution, the liability shall be borne

by the capital provider up to the limit of the total amount committed under the contract [Usmani, 2005].

Profit Sharing in Muḍārabah and Mushāarakah, and Loss Treatment in Mushāarakah

All juristic schools agreed that the objective of both *muḍārabah* and *mushāarakah* is to gain and share the profit (*rib'*) [al-Kāsānī, 2000: 5/82-87; Ibn Qudāmah, n.d.: 5/140]. The distribution of profit must be pre-determined by the contracting parties. Furthermore, the amount of profit ascribed to either of the parties must be independent of the capital amount; it should be dependent solely on the pre-agreed ratio and the actual profit realized by the commercial enterprise. Al-Kāsānī [2000: 5/82-83] reports a representative wording for a *muḍārabah* contract:

“Take this capital as muḍārabah whereby anything given by Allah from the business in the form of profit shall be shared between us thus;’ either one half, or a quarter, or a third, or any other pre-determined ratio.”

Al-Kāsānī [2000: 5/119] further states that if both of them stipulated that one of them shall have half, or one-third, plus 100 dirhams; or they said: ‘except 100 dirhams,’ [both cases are] impermissible. As such, the only determination of profit distribution that is permissible is based on the actual profit earned by the enterprise. The Shar‘ah does not restrict or specify proportions to be distributed between the parties, leaving it to the best judgment of the two independent parties. This ruling follows from the view that equality is the default rule of division in *muḍārabah*. The profit-sharing ratio shall be determined at the time of the conclusion of contract and may be revised from time to time during the contract subject to mutual agreement [al-Kāsānī, 2000: 5/82, 83,84, 87; al-Shīrāzī, n.d.: 2/227; Ibn Qudāmah, n.d.: 5/140,141].

With regards to *musharakah*, scholars disputed on the treatment of profit. The Mālikīs and Shāfi'īs are of the view that the profit should follow the ratio of capital [Ibn Rushd, 1995: 2/204,205; al-Shīrāzī, n.d.: 2/158]. However, the Ḥanafīs and Ḥanbalīs are of the view that the ratio need not be in accordance to the capital, taking into consideration variations of labour contributed by each partner; the partner who played the primary role in the business is allowed to obtain a larger portion of the profit provided that it has been pre-agreed during the contract execution [al-Kāsānī, 2000: 5/82, 83, 84, 87; Ibn Qudāmah, n.d.: 5/140]. In reality, their disputes arose due to the angle from which they viewed *musharakah*. The first group of scholars looked at *musharakah* as a kind of usufruct of an asset belonging to both partners whereby both of them are entitled to the profit in accord with their proportion of the ownership. The second group analysed *musharakah* as a kind of *muḍārabah* whereby the labour contributes to the gain of profit [Ibn Rushd, 1995: 2/204-205].

However, it should be observed that the profit assigned to a party cannot be a percentage of the capital amount contributed as that would be considered a fixed return tantamount to interest. Likewise, the profit assigned to either party cannot be a lump sum amount as this would also constitute interest [al-Kāsānī, 2000: 5/83].

Loss

Typically in *muḍārabah*, the *rabb al-māl* shall bear the loss from the investment while the *muḍārib* just loses his efforts [al-Kāsānī, 2000; Ibn Qudāmah, n.d.]. On the other hand, all scholars are of the view that all partners in *musharakah* should bear the loss in proportion to their capital contribution [al-Kāsānī, 2000; Ibn Qudāmah, n.d.]. A third party may undertake to bear the loss of capital due to misconduct or negligence on the part of the manager for both contracts. The *rabb al-māl* (capital provider) may take collateral from the *muḍārib*, provided that the collateral can only be liquidated in the

event of negligence or misconduct or violation of contractual terms by the *muḍārib*. AAOIFI has approved this ruling, as mentioned previously. However, the issue of who should determine whether negligence and misconduct has occurred may cause a dispute between the parties.

Conclusion

The discussion of *muḍārabah* and *musharakah* was meant to analyse the most accurate view on the essence of both contracts and its relation to *daman*. Therefore, the study found that the majority of scholars (including Ibn Taymiyyah) were of the view that prohibited a capital guarantee as sharing risk in an integral element in partnership contracts. It is not appropriate to interpret Ibn Taymiyyah's statements out of context and definitely not appropriate to attribute the stance of those who allowed capital guarantee to him by using his statements, for those statements show something else.

However, a third party may undertake to bear the loss of capital due to misconduct or negligence on the part of the manager for both contracts. The *rabb al-māl* (capital provider) may also take collateral from the *muḍārib*, provided that the collateral can only be liquidated in the event of negligence or misconduct or violation of contractual terms by the *muḍārib*.

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