

Shari'ah Standard No. (12)

**Sharikah (Musharakah)
and Modern Corporations
(Revised Standard)**



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IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

Preface

The objective of this standard is to explain the basis and general rulings for Sharikat al-'Aqd, (contractual partnership) which is known today as Musharakah, including the rulings for joint partnership, reputation (creditworthiness) partnership, vocation partnership, diminishing partnership and modern corporations. The explanation of these partnerships includes definitions, rulings applicable to each partnership and the Shari'ah limitations that must be taken into account by Islamic financial Institutions (Institution/Institutions).⁽¹⁾

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

Statement of the Standard

1. Scope of the Standard

This standard covers all forms of traditional Fiqh-nominate partnerships that operate on the basis of Sharikat al-'Aqd (contractual partnership), except the partnerships that are explicitly excluded by this standard as indicated below. The standard also applies to all modern forms of partnerships including diminishing Musharakah. The standard does not cover ownership partnership where the parties jointly own an asset. It does not include rules for Sharikat al-Mufawadah because the practical application of this form of partnership is rare and, if need be, reference should be made to Fiqh books. The standard does not cover Mudarabah, because this form of partnership has a separate standard. In the same vein, it does not cover sharecropping partnerships, such as irrigation and agricultural partnerships. The standard also does not cover, as far as modern partnerships are concerned, regulatory policies and procedures necessary for operations in the market.

2. Definition, Classifications and Types of Sharikat al-'Aqd

2/1 Definition of Sharikat al-'Aqd

Sharikat al-'Aqd (contractual partnership) means an agreement between two or more parties to combine their assets, labour or liabilities for the purpose of making profits.

2/2 Classifications of Sharikat al-'Aqd

Sharikat al-'Aqd is classified into two main categories:

First Category: Traditional Fiqh-Nominate Partnerships.

Second Category: Modern Corporations.

2/2/1 The traditional Fiqh-nominate partnerships are as follows:

a) Sharikat al-'Inan (contractual partnership)

- b) Sharikat al-Wujuh or Al-Dhimam, i.e. partnership of credit-worthiness or reputation (liability partnership)
- c) Sharikat al-A'mal (vocational partnerships and partnerships for undertaking difficult work or accepting jobs)

2/2/2 Modern corporations and their well-known forms are as follows:

- a) Stock company
- b) Joint-liability company
- c) Partnership in commendum
- d) Company limited by shares
- e) Allotment (Muhassah) partnership
- f) Diminishing partnership (this partnership has originated from Sharikat al-'Inan)

3. First Category: Traditional Fiqh-Nominate Partnerships

3/1 General rulings for Sharikah, especially Sharikat al-'Inan

Sharikat al-'Inan is a partnership between two or more parties whereby each partner contributes a specific amount of money in a manner that gives each one a right to deal in the assets of the partnership, on condition that the profit is distributed according to the partnership agreement and that the losses are borne in accordance with the contribution of each partner to the capital.

3/1/1 Conclusion of a Sharikah contract

3/1/1/1 A Sharikah contract can be concluded by agreement between the parties concerned on the basis of offer and acceptance. The contract of partnership should, if necessary, be documented and registered officially. The objectives of the partnership must be clearly spelt out in the document of partnership or in the articles of association of the company.

3/1/1/2 It is permissible for the Institution to enter into a partnership contract with non-Muslims or conventional banks to carry out operations acceptable by Shari'ah

unless it has become evident that the funds or items presented by these entities for the purpose of the partnership are from non-permissible sources. In operating a partnership with non-Muslims or conventional banks, arrangements must be made to obtain all necessary assurances and guarantees that rules and principles of the Shari'ah are observed during operations of the partnership. Among such guarantees is one to the effect that the operations of the company be either managed or supervised by an entity that observes the Shari'ah rules.

3/1/1/3 It is permissible for the Institutions to include conventional banks as partners in a syndicated financing which operates on the basis of Shari'ah, provided that the Institution secures the right to manage the partnership's operations and that such operations are subject to the Shari'ah supervision. [see Shari'ah Standard No. (24) on Syndicated Financing]

3/1/1/4 It is permissible for the partners to amend at any point of time the terms of a partnership contract. They may make changes to the ratio of profit-sharing, taking into account that any losses are shared according to the share of each partner in the partnership capital.

3/1/2 The capital of Sharikah

3/1/2/1 In principle, the capital of Sharikah should be contributed in the form of monetary assets on which one can rely in order to determine the amount of the capital and to recognise profit or loss. Nevertheless, it is permissible, with the agreement of all partners, to provide tangible assets (commodities) as the capital of Sharikah after the monetary values of these assets are determined and expressed in currency in order to know the share contributed by each partner.

3/1/2/2 If partners have contributed their partnership capital in different currencies, these currencies must be translated into the currency of the Sharikah at current exchange rates so as to determine the shares and liabilities of each partner.

3/1/2/3 The share of each partner in the capital should be determined, whether it is contributed in the form of one lump sum or by more than one payment over time; i.e., when there is a need for additional funds to increase the capital.

3/1/2/4 It is not permitted that debts (receivables) alone be used as a contribution to the Sharikah capital. However, debts may form part of the contribution to the capital where they become inseparable from other assets that can be presented as a contribution to the capital in Sharikah, such as when a manufacturing firm use its net assets as a contribution to the capital. [see Shari'ah Standard No. (21) on Financial Paper]

3/1/2/5 The funds of current accounts, although they are juristically classified as loans to the Institutions, can be presented as a contribution to the capital in a Sharikah either with the Institution itself or with a third party.

3/1/3 Managing a Sharikah venture

3/1/3/1 In principle, each partner is entitled to act in the interest of the partnership in the following transactions: spot or deferred sales; taking possession or custody of the partnership receivables; making payments or deposits and providing or receiving a mortgage on behalf of the partnership; asking for payment of debts, admission of liabilities, taking up legal actions, cancellation of contracts, rejecting defective goods, renting the assets of the partnership, processing transfers of rights and

debts; requesting credit facilities in the interest of partnership; and doing what is customary in the interest of trading. A partner is not entitled to act against the interest of the partnership or to perform actions that will damage the partnership, such as giving out grants or loans, unless all the partners have consented to such an action. However, the partner may give out short-term minor loans that will not, according to customary practice, affect the operation of partnership.

- 3/1/3/2 It is permissible for the partners to agree that the management of the partnership will be restricted to certain partners or to a single partner. In this case, the other partners are bound to abide by their consent not to act on behalf of the partnership.
- 3/1/3/3 It is permissible for the partners to appoint a manager other than one of the partners and pay him a fixed remuneration that will be included in the expenses of the Sharikah. It is also permissible that the partners set aside a portion of the investment profit plus a fixed remuneration as a form of incentive for the manager. However, if the management is carried out from the outset for a percentage share in the profit earned, this action classifies the manager as a Mudarib and he is only entitled to a share in the profit, if any, and deserves no further remuneration for management services.
- 3/1/3/4 It is not permitted, in a Sharikah contract, to specify a fixed remuneration for a partner who contributes in managing the Sharikah funds or provides some form of other services, such as accounting. However, it is permissible to give him a greater share of profit than he would receive solely on the basis of his share in the partnership capital.

3/1/3/5 It is permissible that one of the partners be appointed to provide services that are mentioned in item 3/1/3/4 provided that the appointment is based on an independent contract from the Sharikah contract so that he may be dismissed as a manager at any point of time without the need to amend or to terminate the Sharikah contract. In this case, the appointed partner may earn a specific remuneration.

3/1/4 Guarantees in a Sharikah contract

3/1/4/1 All partners in a Sharikah contract maintain the assets of the Sharikah on a trust basis. Therefore, no one is liable except in cases of misconduct, negligence or breach of contract. It is not permitted to stipulate that a partner in a Sharikah contract guarantees the capital of another partner.

3/1/4/2 It is permissible for a partner in a Sharikah contract to stipulate that another partner provides a personal guarantee or a mortgage to cover cases of misconduct, negligence or breach of contract.

3/1/4/3 A third party may provide a guarantee to make up a loss of capital of some or all partners. This guarantee is circumscribed with the conditions that (I) the legal capacity and financial liability of such a third party as a guarantor are independent from the Sharikah contract, (II) the guarantee should neither be provided for consideration nor linked in any manner to the Sharikah contract; (III) the third party guarantor should not own more than a half of the capital in the entity to be guaranteed, and (IV) the guaranteed entity should not own more than a half of the capital in the entity that undertakes to provide a guarantee. In case of a third party's undertaking to guarantee, the partner benefiting from such

an undertaking is not, however, entitled either to claim that the Sharikah contract becomes null and void or to refuse to meet his obligations under the contract if the guarantor fails to meet his voluntary promise to cover the loss of his capital, on the grounds that he (the beneficiary) entered into the Sharikah contract taking into account the state of such a third party's undertaking to guarantee the loss of his capital.

3/1/5 The outcome of Sharikah investments (profit and loss)

- 3/1/5/1** The Sharikah contract should incorporate a provision specifying the manner of sharing profits between the parties. The allocation of profits must be made in a manner that gives each partner an undivided percentage of profit, not a sum of money or a percentage of the capital. [see item 3/1/5/9]
- 3/1/5/2** It is not permitted to defer the determination of the profit percentages due to each partner until the realisation of profit. The profit percentage for each partner must be determined at the conclusion of Sharikah contract. The parties may bilaterally agree to amend the percentages of profit-sharing on the date of distribution. Also, a partner may relinquish, on the date of distribution, a part of the profit that is due to him in favour of another party.
- 3/1/5/3** In principle, the shares of profit may be in proportion to the percentage of each partner's contribution to the Sharikah capital. Nevertheless, the partners may agree to make profit-sharing not proportionate to their contributions to capital, provided the additional percentage of profit over the percentage of contribution to the capital is not in favour of a sleeping partner. If a partner did not stipulate a condition that he be

a sleeping partner, then he is entitled to stipulate an additional profit share over his percentage of contribution to the capital even if he did not work.

- 3/1/5/4 It is a requirement that the proportions of losses borne by partners be commensurate with the proportions of their contributions to the Sharikah capital. It is not permitted, therefore, to agree on holding one partner or a group of partners liable for the entire loss or liable for a percentage of loss that does not match their share of ownership in the partnership. It is, however, valid that one partner takes, without any prior condition, the responsibility of bearing the loss at the time of the loss.
- 3/1/5/5 It is permissible for the partners to agree on the adoption of any method of allocation of profit, either permanent or variable, for example, by agreeing that the percentages of profit shares in the first period are one set of percentages and in the second period are another set of percentages, depending on the disparity of the two periods or the magnitude of the realised profit. This is allowed provided that using such a method does not lead to the likelihood of a partner being precluded from participation in profit.
- 3/1/5/6 It is not permitted to start the allocation of profit between the partners unless the operating costs, expenses and taxes are deducted in calculating the profit and the capital of the Sharikah is maintained intact.
- 3/1/5/7 It is not permitted that the conditions or modes of profit allocation in a Sharikah contract include any clause or condition that may result in the probable violation of the principle of sharing profit. For example, if a pre-determined amount of profit or a specific percentage of capital is assigned to one of the partners, this assignment will be rendered void. If the assignment

is amended before profit comes forth, profit shall be divided in accordance with what partners agreed on as to amendment. Otherwise, profit shall be divided based on each partner's respective share in capital.

- 3/1/5/8 Taking into account the provisions of item 3/1/5/3, it is permissible to agree that if the profit realised is above a certain ceiling, the profit in excess of such a ceiling belongs to a particular partner. The parties may also agree that if the profit is not over the ceiling or is below the ceiling, the distribution will be in accordance with their agreement.
- 3/1/5/9 The profit may be finally distributed on the basis of the proceeds of selling all the existing assets, known as actual valuation, or on the basis of constructive valuation of assets which means valuation of the assets of the Sharikah at fair value. The receivables must be valued at the cash value that is expected to be realised, i.e. after deduction of an allowance for doubtful debts. In valuing receivables, it is not permitted to take account of the time value of money (interest) or the notion of discount on the basis of current value, i.e. a discount of the amount of the debt as consideration for earlier payment, and cash amounts shall be recognized as is.
- 3/1/5/10 It is not permitted that the final allocation of profit take place based on expected profit, i.e. it is necessary that the allocation of profit take place on the basis of actual profit earned through actual or constructive valuation of the sold assets.
- 3/1/5/11 It is permissible to allocate some funds to any of the partners on account, i.e. before actual or constructive valuation, on condition that the final actual settlement will take place at a later stage. In this case, the parties

should undertake to reimburse to the Sharikah any amount that they have received in excess of their share of profit after actual or constructive valuation.

3/1/5/12 If the subject matter of Sharikah is assets acquired for leasing that bring in income or the subject matter is services that bring in revenue, then the amount distributed to the partners annually is on account, and it is subject to settlement and reimbursement at the end of the Sharikah.

3/1/5/13 It is permissible, based on the articles of association or a decision of the partners, not to distribute the profits of the company. It is also permissible to set aside periodically a certain ratio of profit as a solvency reserve or as a reserve for meeting losses of capital (investment risk reserve) or as a profit equalisation reserve.

3/1/5/14 It is permissible to agree on setting aside a proportion of profit for non-partners as a charitable donation.

3/1/6 Maturity of Sharikah

3/1/6/1 Each partner is entitled to terminate the Sharikah (i.e. to withdraw from the partnership) after giving his partner/s due notice to this effect, in which case he shall be entitled to his share in the partnership, and this withdrawal would not necessitate the termination of the partnership of the remaining partners. It is permissible for the partners to enter into a binding promise for the continuity of the partnership for a period of time. In this case, it is permissible for the parties to agree to terminate the partnership before such a fixed period. In all these cases, the obligations and actions that took place before termination will remain unaffected and they will continue to exist.

3/1/6/2 It is permissible for a partner to issue a binding promise to buy, either within the period of operation or at the time of liquidation, all the assets of the Sharikah as per their market value or as per agreement at the date of buying. It is not permissible, however, to promise to buy the assets of the Sharikah on the basis of face value.

3/1/6/3 A Sharikah venture comes to an end at the expiry date or before the expiry date if the partners agree to terminate it prematurely, or, in the case of partnership in a particular business, by actual liquidation of the assets that constitute the subject matter of the partnership. The termination of a Sharikah can take place on the basis of constructive liquidation. In this case, the Sharikah will be regarded as if it has been ended and the parties have commenced a new partnership whereby the assets that were not sold through actual liquidation, but have been valued on the basis of constructive liquidation, will be considered as the capital of the new partnership. If the liquidation is based on the expiry date, then all the existing assets shall be sold according to current market values and the proceeds will be used as follows:

- a) Payment of liquidation expenses.
- b) Payment of financial liabilities from the net assets of the partnership.
- c) Distribution of the remaining assets among the partners in accordance with their percentage of contribution to the capital. If the assets fall short and the partners do not recover all of their contributed capital, the distribution shall take place on a pro rata basis to the shares of capital.

3/2 Partnership in creditworthiness or reputation (liability partnership)

3/2/1 A partnership in creditworthiness (partnership of liability) is a bilateral agreement between two or more parties to conclude a partnership to buy assets on credit on the basis of their reputation for the purpose of making profit, whereby they undertake to fulfil their obligations according to the percentages determined by the parties. In addition, the parties should determine for each partner the percentage of profit sharing and of liability sharing, which latter may, by agreement, differ, downwards or upwards, from the percentage of profit sharing.

3/2/2 The partnership in creditworthiness has no monetary capital. This is because the subject matter of the partnership is an obligation or a liability that is contingent on creditworthiness (outstanding reputation). This is the obligation of the partners to pay the amount of debts created through purchases on credit, which form the liability of the partners. Therefore, the parties should agree on the ratio of liability for which each partner is responsible when paying such debts.

3/2/3 The profit shall be distributed according to the agreement. However, the loss will be borne by each partner according to the ratio that each partner had undertaken to bear in proportion to overall assets that are purchased on credit. It is not permitted that the contract of partnership incorporates a provision that specifies a lump sum from the profit for a particular partner.

3/3 Service partnerships (professional or vocational partnerships and partnerships in skilled trades)

3/3/1 A service partnership is an agreement between two or more parties to provide services pertaining to a profession, vocation or skilled trade or to render some services or professional advice or to manufacture goods, and to share profit according to an agreed upon ratio.

- 3/3/2 The service partnership has no monetary capital. This is because the subject matter of the partnership is rendering services. There is no Shari'ah implication regarding any disproportion in the services the partners or their representatives may have rendered. The partners may also distribute different types of services among themselves and may assign some or all partners a set of services or a particular service in a way that will achieve the integration and purpose of the overall service to be rendered.
- 3/3/3 The profit shall be distributed among the partners according to the agreed ratio, but the contract should not specify that a lump sum be paid from the profit to a particular partner.
- 3/3/4 If the service partnership requires capital goods (e.g., equipment or tools), then it is permissible for each party to provide the necessary goods that his services require, in which case each partner owns the goods he has provided. The partners may contribute funds to acquire the goods on the basis of a partnership in ownership. It is also permissible for a party to a Sharikah contract to provide the capital goods required by the partnership in consideration for fees that will be charged against the Sharikah operation as expenses.

4. Second Category: Modern Corporations

4/1 Stock company

4/1/1 Definition of a stock company

- 4/1/1/1 A stock company is a company of which the capital is partitioned into equal units of tradable shares and each shareholder's (co-owner's) liability is limited to his share in the capital. It is a form of financing partnership. The rules of Sharikat al-'Inan apply to this company except on the issue of the limited liability of the shareholders and the fact that this type of company cannot be unilaterally terminated by one party or a minority of its shareholders. [see items 4/1/2/1 and 4/1/2/9]

4/1/1/2 The stock company has a juristic personality through its incorporation by law in such a way that it cannot avoid its obligations to people dealing with it. This separates the liability of the company from the liability of its shareholders (the co-owners) and also establishes for it a separate legal capacity as required for necessary legal arrangements, irrespective of the legal capacity of the shareholders. By definition, a stock company is entitled to initiate legal claims through its representative. It is subject to the jurisdiction of the place of its incorporation.

4/1/2 Shari'ah Rulings relating to a stock company

4/1/2/1 The contract forming a stock company is binding during the duration designated by the articles of association for the continuity of the company on the basis of the undertaking of the parties not to dissolve the company unless the majority of the partners have consented to do so. Therefore, no one is entitled to dissolve (to terminate) the company in respect to his shares. However, a shareholder is entitled to sell his shares or to relinquish title to them in favour of another person.

4/1/2/2 It is permissible for the issuer of shares to add a certain percentage to the actual value of the shares on the subscription date in order to recover issuing expenses, provided that such percentage is appropriately estimated to reflect the actual expenses incurred.

4/1/2/3 It is permissible to issue new shares in order to increase the capital provided the new shares are issued at the fair value of the old shares. This should be done in accordance with the opinion of experts in valuation of the company's assets. In other words, the new issues can be issued at a premium or at a discount to their nominal value, or issued at a market value.

- 4/1/2/4 It is permissible that a shareholder underwrite an issue of shares without any consideration. In such a case, there is an agreement between a person and the company on the date of incorporation of the company, or of a share issue, to the effect that such a person is undertaking to buy all or part of the shares issued. In other words, it means an undertaking to subscribe all the remaining shares that are not subscribed at its nominal value. However, it is permissible for a shareholder to ask for consideration for services provided other than the underwriting, such as conducting feasibility studies or marketing the shares.
- 4/1/2/5 It is permissible that a part of payment for subscription of shares be made in an instalment and that the other instalments be deferred. In this case, the paid instalment is a contribution to the Sharikah capital, and the deferral of some instalments constitutes an undertaking to increase his share of capital in the company subsequently. This is permissible provided the instalments cover all the shares and that the company's liability is confined to the value of the subscribed shares.
- 4/1/2/6 It is not permitted to purchase shares using interest-based loans, provided by either a broker or any other person, in consideration for mortgaging the shares as a security for payment.
- 4/1/2/7 It is not permitted for someone to sell shares that he does not own and the promise of a broker to lend the shares to him at the date of delivery does not constitute ownership or possession of the shares. This is not allowed especially if the broker stipulates that the seller must pay the price of the shares so that he can deposit it and earn interest in return for such a loan.

- 4/1/2/8 In the legitimate public interest, it is permissible for the relevant authorities to organise trading in shares in such a way that trading will not take place except through specific licensed stockbrokers.
- 4/1/2/9 It is permissible to restrict the liability of a company to its paid up capital if this is made public, in order to make the customers of the company aware of the financial position of the company without any uncertainty or lack of transparency.
- 4/1/2/10 It is permissible to sell shares in the company subject to rules and regulations of the company that do not conflict with Shari'ah, such as pre-emptive rights of the existing shareholders to purchase the shares.
- 4/1/2/11 It is permissible to mortgage the company's shares. However, this is subject to the rules and regulations of the company vis-à-vis the right of the shareholders to mortgage their ownership rights to undivided shares in the company.
- 4/1/2/12 It is permissible to issue shares "to the order of" (nominative shares).
- 4/1/2/13 It is permissible to issue "bearer shares". This is executed by handing over to the investor a certificate that represents a right to shares in the company and receiving their value in cash or acquiring a counter deed recognising a debt against the shareholder. In this case, the common ownership of shares represented by the certificate is vested in the holder of the certificate of shares at any time.
- 4/1/2/14 It is not permitted to issue preference shares, i.e. shares that have special financial characteristics that give them a priority at the date of liquidation of the company or at the date of distribution of profit. However, it is

permissible to grant certain shares, in addition to being entitled to rights attached to common shares, certain procedural and administrative privileges, such as a right of vote.

4/1/2/15 It is not permitted to issue *Tamattu'* (enjoyment) shares: shares that entitles the holder a participation in the net profit, but not to vote and which are gradually redeemed before the termination of the company through distribution of profits.

4/2 Joint-liability company

4/2/1 Definition of Joint-liability Company

4/2/1/1 A joint-liability company is a form of personal partnership. It is a necessary requirement that this partnership is publicly declared as a registered company assigned a unique title (trademark).

4/2/1/2 A joint-liability company has a juristic personality and independent financial liability unrelated to the liability of the partners. Nevertheless, all the partners are personally responsible for the obligations and liabilities of the company if the existing assets cannot meet the liabilities of the company.

4/2/1/3 In addition to maintaining documents of the joint-liability company, the partners are also obliged to maintain commercial documents relating to external trade activities.

4/2/2 Shari'ah Rulings relating to Joint-liability Companies

4/2/2/1 A creditor of a joint-liability company is entitled to demand fulfilment of all or part of his rights from any of the partners in any way the creditor deems fit. Therefore, the creditor is not obliged to claim such fulfilment from the company first.

4/2/2/2 The contract of a joint-liability partnership is not binding; hence, a partner is entitled to withdraw from the partnership on the following conditions:

- a) If the partners did not set a duration for the company. If they agreed on a duration, then such duration must be observed.
- b) The partner should notify the other partners of the intention to withdraw.
- c) If the unilateral withdrawal from the partnership would not cause damage to other partners.

4/2/2/3 It is not permissible for the partner to bring in a substitute for himself without the agreement of the other partners.

4/3 Partnership in commendum

4/3/1 Definition of partnership in commendum

4/3/1/1 Partnership in commendum is a form of financing partnership. This is because the personality of the operating partner is important for the sleeping partner and because there is a difference in terms of determination of the ownership of the partners, whereby the ownership is calculated based on disproportionate lots and not on the basis of proportionate shares that are equal in number.

4/3/1/2 This form of company consists of managing partners and sleeping partners. The managing partners in this partnership are jointly liable for the obligations of the company from their personal wealth on the basis of joint-liability. The liability of each sleeping partner is limited to the number of lots he owns and his liability does not extend to his personal assets. It is permissible to limit the liability of some investors

without any consideration for limiting their liability, in which case the company consists of joint-liability partners and partners with limited liability. [see item 4/1/2/9]

4/3/1/3 It is not permissible for the sleeping partners to interfere in the operations of the company. The law does not even allow that their names be mentioned on the date of the registration of the company. Only the funds collected from the sleeping partners are mentioned.

4/3/1/4 The management of the company may be delegated either to one of the joint liability partners or to a third party. The sleeping partners are not entitled to manage the company.

4/3/2 Shari'ah Rulings relating to the partnership in commendum

4/3/2/1 Profit must be distributed according to the ratio of lots or agreement. Losses are borne by managing and sleeping shareholders partners, according to the ratio of their shares in the capital.

4/3/2/2 It is not permissible to stipulate that a sleeping partner has a right to an amount of profit according to a particular percentage of the capital or a lump sum. [see item 3/1/5/8]

4/4 Company limited by shares

4/4/1 Definition of a company limited by shares

The company limited by shares is a form of personal partnership. The subscription in this company is in accordance with equal numbers of shares and it comprises of managing partners and sleeping partners.

4/4/2 Shari'ah Rulings relating to the company limited by shares

4/4/2/1 The managing partners in this company are liable for the obligations of the company from their personal

assets on the basis of joint liability. They are in the position of a person who works as a Mudarib and simultaneously participates in a partnership. The sleeping partners' liability is limited to the number of the shares each partner owns and does not extend to his own assets. In this case, the liability of sleeping partners is equivalent to that of the capital providers in a Mudarabah contract. It is permissible to limit the liability of some investors without any consideration for limiting their liability, in which case the company consists of joint liability partners and partners with limited liability. [see item 4/1/2/9]

- 4/4/2/2 It is not permissible for the sleeping partners to interfere in the operations of the company. The law does not even allow that their names are mentioned on the date of the registration of the company. Only the funds collected from the sleeping partners are mentioned.
- 4/4/2/3 The management of the company may be delegated either to one of the managing partners or to a third party. The sleeping partners are not entitled to manage the company.
- 4/4/2/4 Profit must be distributed according to the ratio of participation or agreement. Losses are borne by the managing shareholding partners and sleeping shareholding partners according to their shares in the capital. And any excess losses shall be borne by managing partners.
- 4/4/2/5 It is not permissible to stipulate that a sleeping partner has a right to an amount of profit according to a particular percentage of the capital or a lump sum.

4/5 Allotment/particular (Muhassah) partnership

4/5/1 Definition of allotment partnership

- 4/5/1/1 The definition of Sharikat al-'Inan is applicable to an allotment partnership [see item 3/1]. This type of partner-

ship belongs to the personal (private) form of company. The reason for this is that the partners take into account before concluding a partnership each one's financial strength and ability to meet financial obligations from his personal assets.

4/5/1/2 Sharikat al-Muhassah has no juristic personality because people other than the partners do not know about it. This partnership does not have any separate financial liability as an entity.

4/5/2 Shari'ah rulings relating to Muhassah Company

4/5/2/1 The rulings for and basis of a Muhassah company do not differ from those for an 'Inan partnership. [see item 3/1]

4/5/2/2 The liability of partners is personal and, as such, they are liable for the liabilities of the company from their personal assets. The rules for and classification of an allotment partnership do not differ from 'Inan partnership.

4/5/2/3 The contract of a Muhassah partnership is not binding. However, if the parties agree to make it binding for a particular period of time, then they shall be bound by such an agreement. [see 4/3/2/2]

4/5/2/4 A partner in Sharikat al-Muhassah is entitled to terminate his partnership on condition that (I) he notifies other partners of his intention to withdraw and (II) the unilateral withdrawal from partnership would not cause damage to other partners or clients of the company. The partnership can be liquidated by way of actual or constructive liquidation of the company's assets.

5. Diminishing Musharakah

5/1 Diminishing Musharakah is a form of partnership in which one of the partners promises to buy the equity share of the other partner

gradually until the title to the equity is completely transferred to him. It is necessary that this buying and selling should not be stipulated in the partnership contract. In other words, the buying partner is allowed to give only a promise to buy. This promise should be independent of the partnership contract. In addition, the buying and selling agreement must be independent of the partnership contract. It is not permitted that one contract be entered into as a condition for concluding the other.

- 5/2 The general rules for partnerships must be applied to a diminishing partnership, especially the rules for Sharikat al-'Inan. Therefore, it is not permitted that the contract of diminishing partnership include any clause that gives any of the parties a right to withdraw his share in the capital.
- 5/3 It is not permitted to stipulate that one partner should bear all the cost of insurance or maintenance on the ground that he will eventually own the subject matter of the partnership.
- 5/4 Each partner should contribute part of the capital. The contribution may be in the form of cash or tangible assets that can be translated into a monetary value, for example, a land for building or equipment required for the operation of partnership. The loss, if any, shall be borne periodically by the parties in accordance with the participation ratio of each partner as the equity stake of one partner decreases and the stake of the other partner increases.
- 5/5 The ratio of profit or income of the partnership that each partner (the Institution and customer) is entitled to should be clearly determined. However, it is permissible for the partners to agree on a ratio of profit sharing that is disproportionate to the ratio of equity ownership. It is also permissible for the partners either to maintain the ratio of profit already determined even if the ratio of equity shares has changed, or to agree on amending the ratio of profit sharing due to the change in the ratio of equity shares. In doing so, they must ensure that the principle of allocation of losses in accordance with the ratio of equity share of ownership is maintained.

- 5/6 It is not permitted to stipulate that one partner has a right to receive a lump sum out of the profits. [see item 3/1/5/8]
- 5/7 It is permissible for one of the partners to give a binding promise that entitles the other partner to acquire, on the basis of a sale contract, his equity share gradually, according to the market value or a price agreed at the time of acquisition. However, it is not permitted to stipulate that the equity share be acquired at their original or face value, as this would constitute a guarantee of the value of the equity shares of one partner (the Institution) by the other partner, which is prohibited by Shari'ah.
- 5/8 The partners may arrange for the acquisition of the equity share of the Institution in a manner that serves the interests of both parties. This includes, for example, a promise by the Institution's client to set aside a portion of the profit or the return he may earn from the partnership for the acquisition of a percentage of the equity of the Institution. The subject matter of the partnership may be divided into shares, in which case the Institution's partner can purchase a particular number of these shares at certain intervals until the partner becomes the owner of the entire shares and consequently becomes the sole owner of the subject matter of the partnership.
- 5/9 It is permissible for either of the partners to rent or to lease the share of the other partner for a specified amount and for whatever duration, in which case each partner will remain responsible for the periodical maintenance of his share on a timely basis.

6. Date of Issuance of the Standard

This Standard was issued on 4 Rabi' I, 1423 A.H., corresponding to 16 May 2002 A.D.

Adoption of the Standard

The Shari'ah Standard on Sharikah (Musharakah) and Modern Corporations was adopted by the Shari'ah Board in its meeting No. (8) held in Al-Madinah Al-Munawwarah on 28 Safar - 4 Rabi' I, 1423 A.H., corresponding to 11-16 May 2002 A.D.

Appendix (A)

Brief History of the Preparation of the Standard

In its meeting No. (5) held in Makkah Al-Mukarramah on 8-12 Ramadan 1421 A.H., Corresponding to 4-8 December 2000 A.D., the Shari'ah Board decided to give priority to the preparation of a Shari'ah Standard on Sharikah (Musharakah) and Modern Corporations.

On Saturday 15 Dhul-Hajjah 1421 A.H., corresponding to 10 March 2001 A.D., the Fatwa and Arbitration Committee recommended to the Shari'ah Board the commissioning of a Shari'ah consultant to prepare a juristic study and an exposure draft on the Shari'ah Rules for Sharikah (Musharakah) and Modern Corporations.

In its meeting held on 18 Muharram 1422 A.H., corresponding to 12 April 2001 A.D., the Fatwa and Arbitration Committee discussed the exposure draft of the Shari'ah Rules for Sharikah (Musharakah) and Modern Corporations and asked the consultant to make amendments in light of the comments made by the members. The Committee also held a meeting on 20 Jumada II 1422 A.H., corresponding to 8 September 2001 A.D. and made some amendments in light of the comments made by the members.

The revised exposure draft of the Standard was presented to the Shari'ah Board in its meeting No. (7) held in Makkah Al-Mukarramah on 9-13 Ramadan 1422 A.H., corresponding to 24-28 November 2001 A.D. The Shari'ah Board made further amendments to the exposure draft of the standard and decided that it should be distributed to specialists and interested parties in order to obtain their comments and discuss them in a public hearing.

A public hearing was held in Bahrain on 29-30 Dhul-Hajjah 1422 A.H., corresponding to 2-3 February 2002 A.D. The public hearing was attended by more than thirty participants representing central banks, institutions,

accounting firms, Shari'ah scholars, academics and others who are interested in this field. Some of the members of the Shari'ah Board responded to the written comments that were sent prior to the public hearing as well as to the oral comments that were expressed in the public hearing.

The Shari'ah Standards Committee in its meeting held on 21-22 Dhul-Hajjah 1422 A.H., corresponding to 6-7 March 2002 A.D., in the Kingdom of Bahrain discuss the comments made about the exposure draft. The Committee made the necessary amendments, which it deemed necessary in light of both the discussions that took place in the public hearing, and the written comments that were received.

The Shari'ah Board in its meeting No. (8) held on 28 Safar – 4 Rabi' I, 1423 A.H., corresponding to 11-16 May 2002 A.D., in Al-Madinah Al Munawwarah discussed the amendments made by the Shari'ah Standards Committee, and made the necessary amendments, which it deemed necessary. Some paragraphs of the standard were adopted by the unanimous vote of the members of the Shari'ah Board, while the other paragraphs were adopted by the majority vote of the members, as recorded in the minutes of the Shari'ah Board.

The Shari'ah Standards Review Committee reviewed the standard in its meeting held in Rabi' II 1433 A.H., corresponding to March 2012 A.D. in the State of Qatar, and proposed after deliberation a set of amendments (additions, deletions, and rephrasing) as deemed necessary, and then submitted the proposed amendments to the Shari'ah Board for approval as it deemed necessary.

In its meeting No. (41) held in Al-Madinah Al Munawwarah, Kingdom of Saudi Arabia on 27-29 Sha'ban 1436 A.H., corresponding to 14-16 June 2015 A.D., the Shari'ah Board discussed the proposed amendments submitted by the Shari'ah Standards Review Committee. After deliberation, the Shari'ah Board approved necessary amendments, and the standard was adopted in its current amended version.

Appendix (B)

The Shari'ah Basis for the Standard

Permissibility of Partnership

The Fuqaha have classified partnerships into four categories, namely Sharikat al-'Inan (contractual partnership), Sharikat al-Abdan (skilled trade partnership), Sharikat al-Mufawadah (agency-like partnership) and Sharikat al-Wujuh (creditworthiness or reputation partnership). The most important of all is Sharikat al-'Inan (contractual partnership). The permissibility of this form of partnership is established by the Qur'an, the Sunnah and practical consensus of the Fuqaha.

The permissibility of Sharikah is supported by the Saying of Allah, the Almighty: *{“...And, verily, many partners oppress one another, except those who believe and do righteous good deeds, and they are few...”}*.⁽²⁾

Among the Sunnah provisions that support the permissibility of partnership is the case of Al-Sa'ib Ibn Abu Al-Sa'ib Al-Makhzumi who was a partner of the Prophet (peace be upon him) in business at the beginning of Islam. On the day when the Prophet (peace be upon him) conquered Mecca, he met Al-Sa'ib, then he (peace be upon him) said: *“Welcome my brother and my partner. He jokes not (i.e. he is serious in business) and do not argue (unnecessarily).”*⁽³⁾

Moreover, partnership is one of the main transactions in all societies since the advent of Islam. This constitutes, therefore, a practical consensus for the permissibility and validity of partnerships.

The partnerships for which the jurists have clarified their rules are the origins of the modern corporations, such as joint-stock companies whose

(2) [Sad: 24]

(3) The Hadith had been related by Al-Hakim who deemed it authentic [2: 61]. Al-Dhahabi agreed with Al-Hakim.

financial standing and obligations are related to the volume of the shares of the company and on its juristic personality, not on the personality of the shareholders. Therefore, the general rules for various partnerships in Shari'ah will govern modern forms of corporations. However, the procedural systems relating to representation of partnership companies and bureaucratic, administrative and accounting procedures are required by Maslahah (consideration of the public good or common need), which is an acceptable source for validating human actions provided it is employed in line with the principles of Shari'ah.

The general basis of Sharikah is agency (Wakalah) because each partner is acting as a principal partner, on one hand, and acting in the interest of the partnership, on the other hand, as an agent for the remaining partners. Unlike other partnerships, *Sharikat al-Mufawadah* combines rules of agency and guarantee simultaneously.

Conclusion of Sharikah Contract

- It is permitted to conclude a partnership contract with non-Muslims or conventional banks for carrying out permissible operations in association with necessary guarantees that they will observe Shari'ah precepts and principles. The Shari'ah basis for this is the Hadith stating: *"The Messenger of Allah has prohibited concluding partnership with Jews and Christians unless the selling and buying is in the hands of the Muslim".*⁽⁴⁾ The cause of the prohibition is the fear of being involved in interest-based transactions or in concluding impermissible contracts and this fear is absent when there are guarantees to observe and apply Shari'ah rulings.⁽⁵⁾ Al Baraka Forum has issued a resolution in support of partnership between Islamic banks and conventional banks.⁽⁶⁾
- The basis for the permissibility of an agreement on amending the terms of partnership and the profit sharing ratio is that this action does not lead to a possibility of precluding a partner from getting a share of profit.⁽⁷⁾

(4) *"Musannaf Ibn Abu Shaybah"* [6: 9].

(5) See: Ibn Qudamah, *"Al-Mughni"* [7: 110-111].

(6) See: Resolution No. (9/1): *"Fatawa Nadwat Al Baraka"* No. 9, (P. 151).

(7) See: Resolution No. (11/8): *"Fatawa Nadwat Al Baraka"* No. 11, (P. 194).

Capital of Sharikah

- The basis for the permissibility that Sharikah capital may be contributed in the form of tangible assets other than cash, after valuation, is that the purpose of Sharikah is to give partners a right to use the contributed money freely and to share the profit. This objective is realisable even if the capital is contributed in the form of tangible assets just as it is in the case of a contribution in cash. Therefore, it is just as valid to present tangible assets for Sharikah investment as to present cash. At the liquidation, each one of the partners will be entitled to the equivalent value of the assets presented at the conclusion of the Sharikah.⁽⁸⁾ This is the view of the Maliki and the Hanbali scholars.⁽⁹⁾
- The basis for the requirement that a payment of contribution to Sharikah capital in a currency different from the designated currency of partnership must be valued according to the current exchange rate at the time of payment is that this action is a currency exchange between two currencies which is permitted provided it is carried out at the current exchange rate. This is evidenced by the Hadith in which Ibn Umar asked the Prophet (peace be upon him) concerning selling camels at (a place in Medina called Al-Baqi') in a currency and collecting payment in a different currency. The Prophet (peace be upon him) endorsed the transaction provided it had taken place according to the current exchange rate.⁽¹⁰⁾
- The basis for the requirement that the investments of parties in the capital should be properly determined is that failure to do so will lead to ambiguity in respect to the capital. It is not permissible that the capital of Sharikah be ambiguous since certainty as to the amount of the capital is a benchmark for sharing profit. The equitable distribution of profit is not possible if the amount of capital contributed by each party is ambiguous.⁽¹¹⁾
- The basis for rejecting payment of partnership capital in receivables alone is that debts owed to a partner by another partner cannot actually be used in partnership operations, as they are not assets in possession.

(8) *"Al-Mughni"* [7: 124]

(9) *"Hashiyat Al-Dusuqi"* [2: 517]; and *"Al-Mughni"* [5: 17].

(10) The source of the Hadith has been stated earlier.

(11) *"Al-Mughni"* [7: 125].

Again, this may potentially lead to Riba when the partner is the one in debt.⁽¹²⁾ However, if the receivables are combined with other assets and the ratio of debt to the total assets is negligible, then debt and the other assets can be presented as a contribution to partnership capital. The basis for this is the principle of *Taba'iyyah* (things dependent on another thing) as per the legal maxim: "A thing which in fact follows from another thing follows it also in law and judgment cannot be given separately for a thing that follows from another" and the legal maxim: "The law is flexible in things that follow from another".

- The basis for allowing current accounts as capital in partnership is that, in spite of their being considered as loan, they are presumed to be possessed by the accountholders because the funds are available on demand. This is because the Institutions are obliged by their regulations and directives of the supervisory bodies to pay the owner on demand or accept cheques against these accounts irrespective of the financial situation of the Institution.

Managing a Partnership

- The basis for the right of each partner to participate in the management of the partnership is that partnership is based on elements of agency and trust. The element of agency requires that each party be entitled to be involved in the operations in a manner that is in the interest of the partnership. The element of trust requires that each party act for the benefit of the partnership.⁽¹³⁾
- The basis for not allowing a fixed remuneration for a partner who assists in the management is that this may lead to guaranteeing the capital of this partner, or to his not being exposed to risk of loss, if any, in proportion to his contribution in the capital.
- The basis for the permissibility of appointing, by a separate independent contract, one partner to manage the partnership and the permissibility of paying him wages is that the partner becomes an employee of the company and he is not acting in the capacity of a partner.

(12) "*Hashiyat Al-Dusuqi*" [3: 517]; and "*Al-Mughni*" [5: 17].

(13) See: "*Al-Mughni*" [7: 128].

Guarantees in Partnership

- The basis of the requirement that a partner is not liable except in cases of misconduct or negligence, and of the impermissibility of a stipulation to the effect that a partner guarantees the capital of another partner, is that partnership operates on the basis of trust, and to hold a trustee liable for losses (except in the case of misconduct or negligence) is impermissible.⁽¹⁴⁾
- The basis for allowing a party to a partnership to require a guarantee or a mortgage from another party as security against cases of misconduct and the like is that this requirement does not conflict with the rules for partnership. Again, the general principle of contracts and partnerships is that parties are required to observe stipulated terms as far as possible.⁽¹⁵⁾
- The basis for the permissibility of a “promise to guarantee” by a third party whose financial liability is independent from the parties to a partnership is that this action is a mere charitable act and an undertaking that is independent of the partnership contract. In other words, a fulfilment of a promise by a third party is not a condition for the permissibility of the contract. In addition, the third party’s guarantee does not adversely affect the established Shari’ah principle against guaranteeing capital or profit. A resolution was issued by International Fiqh Academy in support of the permissibility of a third party’s promise to guarantee.⁽¹⁶⁾
- The basis for the requirement that the guaranteeing Institution should not be the owner of the guaranteed Institution or vice versa is that by ownership the transaction becomes in substance a guarantee by a partner of the capital of another partner.

Outcome of Partnership Investment (Profit and Loss)

- The basis for the impermissibility of an agreement to determine the profit share on the basis of a lump sum or a percentage of the capital is because this is inconsistent with the sharing of profit and because profit is not realised unless the capital is maintained intact.

(14) See: Ibn Qudamah, *“Al-Kafi”* [2: 230]; and *“Al-Mubdi”* [4: 256].

(15) See: Fatwa (1/5) of Al Baraka First Forum, 1403 A.H.: *“Qararat Wa Fatawa Nadwat Al Baraka”* (P. 18).

(16) International Fiqh Academy resolution No. 30 (5/4).

- The basis for the impermissibility of deferring the statement of the profit ratio of each party until profit is realised is because such a procedure involves uncertainty which may potentially lead to dispute. However, the parties are entitled to amend the profit ratio or to relinquish a right to profit on the date of distribution. This is because the profit belongs to them; hence, it is permissible for them to make amendments or relinquishments.
- The basis for the requirement that the profit share may be either proportionate or disproportionate to the contribution of each party in the capital is that an individual deserves a share in profit on the basis of the funds contributed, the work done or the risk borne. If an individual is involved in any of these three, then it is allowed for the parties to agree on a profit ratio accordingly. This is the opinion of the Hanafi and Hanbali schools.⁽¹⁷⁾
- The basis for the impermissibility of one party bearing losses or that each party bear a portion of losses that may not be proportionate to the share of each party in the capital is the saying of Ali Ibn Abu Talib (may Allah be pleased with him): "Profit distribution is according to agreement of the partners and loss must be borne in proportion to the contribution in the capital."⁽¹⁸⁾ Therefore, it is a void condition that one party should bear the loss of other parties and such a condition facilitates misappropriation of the property of others.
- The basis for the permissibility of the partners agreeing on any method for allocation of profit, whether fixed or variable during a particular period, is that this agreement is circumscribed with a condition that the method adopted should not contravene any Shari'ah principle, which means the method should not preclude a party from sharing in profit.
- The basis for not allowing final distribution of profit before deduction of expenses and expenditure is that there is no profit unless the capital is maintained intact.

(17) See: Al-Mirghinani, *"Al-Hidayah Sharh Al-Bidayah"* [3: 7-8], Al-Maktabah Al-Islamiyyah edition; Al-Kasani, *"Bada' i' Al-Sana' i'"* [6: 62-63]; and Ibn Muflih, *"Al-Mubdi"* [5: 4], Al-Maktab Al-Islami edition

(18) This Athar has been reported by Ibn Abu Shaybah in his *"Musannaf"* [4: 268], Riyadh: Maktabat Al-Rushd.

- The basis for the impermissibility of specifying a lump sum profit amount for one partner is that this action is inconsistent with sharing in profit.
- The basis for not allowing a partner to earn a share of profit and a fee simultaneously is that this fee is a lump sum that may preclude sharing in profit due to the possibility that the partnership business may not realise enough profit to cover it. The basis for allowing a partner to receive, based on a separate contract, a fee is that the contract that entitles a partner to a fee is not part of the partnership contract and because this fee is not inconsistent with sharing in profit, as the partner in this case is considered to be a third party.
- The basis for the permissibility of an agreement that if the profit realised is above a certain ceiling, the profit over such ceiling belongs to a particular partner, is because this constitutes a valid condition that is not inconsistent with profit sharing.⁽¹⁹⁾ Moreover, the capital provider is the one who will bear losses, if any.
- The basis for the permissibility of distributing profit based on constructive valuation is that the use of this method is permitted by Shari'ah⁽²⁰⁾ and was used in a number of cases, such as Zakah and theft. The basis for the permissibility of constructive valuation is also the saying of the Prophet (peace be upon him): *"If a co-owner of a slave frees his part, the slave will be set free against his property if he has property; otherwise, it will be valued by fair value and freed."*⁽²¹⁾
- The basis for the permissibility of distributing funds to partners on account, i.e. subject to settlement and refund of any additional profit acquired over the contribution to the capital on the date of actual liquidation, is because this action causes no damage to any of the partners since the distributed funds on account are subject to settlement at a later stage.

(19) *"Al-Bahr Al-Zakhkhar"* [5: 83], Dar Al-Kitab Al-Islami edition.

(20) See: Resolution No. (4) of the Islamic Fiqh Academy under the auspices of Muslim World League that was issued in the 16th session held in Mecca on 21-26/10/1422 A.H.; the International Islamic Fiqh Academy resolution No. 30 (5/4) and Fatwa No. (8/2) issued during the Al Baraka's 8th Forum on Islamic Economics in *"Fatawa Al Baraka"* (P. 134).

(21) This Hadith has been related by Muslim, See: *"Sahih Muslim"* [2: 1140].

- The basis for allowing distribution of partnership revenues, including the capital assets, prior to liquidation of the partnership is that the partners suffer no damage from this and also the distribution is subject to review and reimbursement when liquidation is actually effected.⁽²²⁾

Termination of Partnership

- The basis for the rule that termination of partnership will not affect obligations and actions that took place before it is protection of the remaining partners against any potential damage.
- The basis for the impermissibility of a promise by one of the partners to buy assets of the partnership at face value is that this constitutes a guarantee of the capital which is prohibited by Shari'ah. The basis for the permissibility of a promise to buy the assets of partnership at the market value is that this does not constitute a guarantee of capital.

Modern Corporations

- The permissibility of modern corporations is dependent on the principle of Shari'ah that human transactions are, in principle, permissible (*Mubah*) as long as there is no clear injunction against them, especially in view of the fact that the categorisation of any one or more of these corporations had parallels in Shari'ah-nominate contracts, such as 'Inan partnership, Mudarabah and the like.⁽²³⁾

Stock Companies

- The basis for the permissibility of underwriting issues of shares without taking consideration is that this is an undertaking that does not involve an impermissible act, such as taking a commission for a guarantee. The International Islamic Fiqh Academy has issued a resolution in this respect.⁽²⁴⁾
- The basis for the impermissibility of buying shares using an interest-based loan provided by a stockbroker or other party against a mortgage of the shares is that this is an interest-based transaction secured by

(22) See: International Islamic Fiqh Academy Resolution No. 30 (5/4), and resolution of Islamic Fiqh Academy under the auspices of Muslim World League during its 16th session.

(23) See: Abdul-Aziz Al-Khayyat, "Al-Sharikat" [2: 158-159].

(24) See: The International Islamic Fiqh Academy Resolution No. 63 (1/7).

shares.⁽²⁵⁾ In this case, both transactions are prohibited by an explicit source that indicates that Allah, the Almighty, has cursed a person who lives on interest-based transactions, a person who pays such interest, and a person who notarises or acts as a witness for such transactions.

- The basis for the impermissibility of selling shares that the seller does not own is that this constitutes selling of an item that one does not own or an involvement in a transaction without bearing a risk which is prohibited by Shari'ah.
- The basis for allowing a mortgage of shares is that mortgaging is permissible. Moreover, anything that can be sold may be presented as a mortgage as in the case of shares unless the bylaws of the company state otherwise in which case the conditions stated must be observed.
- The basis for the permissibility of "shares to the order of" (nominative shares) is that this is a form of transferring ownership of shares to another investor. The acceptance by the remaining shareholders of the bylaws of the company that give a right to transfer is an implied consent to the transfer of ownership.⁽²⁶⁾ The basis for the permissibility of "bearer shares" is that it is a sale of shares by a shareholder to another investor. The acceptance by the remaining shareholders of the bylaws of the company that give a right to sell is an implied consent to the sale. The fact that the identification and personality of the new shareholder (the purchaser) is not known to other shareholders will not affect the sale as they may be provided with this information if need be.⁽²⁷⁾
- The basis for the impermissibility of issuing preference (preferred) shares is that preference shares are inconsistent with profit sharing and involve depriving other partners of their fair share of profit.⁽²⁸⁾
- The basis for the impermissibility of issuing shares that entitle the holder a participation in the net profit and entitles the company to gradually redeem the participation through the distribution of profits before the termination of the company, is because the funds the certificate holders receive constitute profit in respect of their shares. The claim that the

(25) See: International Islamic Fiqh Academy Resolution No. 63 (1/7).

(26) See: International Islamic Fiqh Academy Resolution No. 63 (1/7).

(27) See: International Islamic Fiqh Academy Resolution No. 63 (1/7).

(28) See: International Islamic Fiqh Academy Resolution No. 63 (1/7).

participations are redeemed in consideration for the distributed profit is invalid. Therefore, the certificate holders remain owners of the shares and are entitled to proceeds when the company is liquidated.⁽²⁹⁾

Joint Liability Company

- The basis for the permissibility of the undertaking of partners in a joint liability company to be jointly responsible is that the joint liability in this way is subject to the rules for guarantees. The permission granted by each of them to the others to act on behalf of the company is subject to the rules of agency as in the case of Mufawadah partnership which combines elements of guarantee and agency. The partners have consented to be liable jointly because there is no gain at the expense of any of the partners and no one is to be cheated.⁽³⁰⁾
- The basis for the impermissibility of bringing in a substitute partner in a joint liability company when the other partners did consent to it is that the personality of the partner is significant for the partners because the liability of the company includes his personal assets and the substitute may not be in the same financial position as the partner.

Partnership in Commendum

- The basis for the impermissibility of sleeping partners of partnership in commendum or company limited by shares being entitled to interfere in the management of the company is that they have agreed not to do so and this agreement does not affect the rules of partnership.
- The reason why the financial liability of the sleeping partners in partnership in commendum is limited to their shares is that they are in the position of capital providers in a Mudarabah contract.

Allotment (Particular) Partnership

The basis for the permissibility of unilateral termination of participation in this kind of partnership by any of the partners is that, in principle, unilateral termination of participation is allowed provided such action inflicts no damage to any of the partners as per the saying of the Prophet (peace be upon him): *"No harm to be inflicted and no reciprocal harm."*⁽³¹⁾

(29) See: International Islamic Fiqh Academy Resolution No. 63 (1/7).

(30) See: Abdul-Aziz Al-Khayyat, *"Al-Sharikat"* [2: 235].

(31) The Hadith has been related by Ibn Majah in his *"Sunan"* [2: 784].

Diminishing Partnership

- The basis for saying that all the general rules for partnerships, especially the rules for 'Inan partnership, are applicable to diminishing partnerships is to safeguard this new form of partnership from becoming a mere interest-based financing transaction in which a client undertakes to pay another party for his finance in addition to a share in the partnership income.
- The basis for the impermissibility of one partner being responsible for the expenses of insurance or maintenance is that this condition is in conflict with the nature of the partnership contract.⁽³²⁾

(32) See: Fatwa No. (219) of the Fatwas of Kuwait Finance House.

Appendix (C)

Definitions

Contract Partnership (Sharikat al-'Aqd)

Contract partnership is an agreement between two or more parties to combine their assets or to merge their services or obligations and liabilities with the aim of making profit.

Partnership of Ownership (Sharikat al-Milk)

Partnership of ownership (Sharikat al-Milk) is the combination of the assets of two or more persons in a manner that creates a state of sharing the realised profit or income or benefiting from an increase in the value of the partnership assets. This combination of assets for making profit necessitates bearing losses, if any. The ownership partnership is created by events beyond the partners' control such as the inheritance rights of heirs in the legacy of a deceased person. This partnership is also created by the wish of the partners such as when two or more parties acquire common shares in a particular asset.

Mufawadah Partnership

Mufawadah partnership is any partnership in which the parties are equal in all respects, such as funds contributed by them, their right to act and their liability, from the commencement of the partnership to the date of its termination.

Sharecropping Partnership (Muzara'ah)

Sharecropping is partnership in crops in which one party presents land to another for cultivation and maintenance in consideration for a common defined share in the crop.

Irrigating Partnership (Musaqat)

Irrigating partnership is a partnership that depends on one party presenting designated plants/trees that produce edible fruits to another in order to work on their irrigation in consideration for a common defined share in the fruits.

Agricultural Partnership (Mugharasah)

Agricultural partnership is a partnership in which one party presents a treeless piece of land to another to plant trees on it on the condition that they share the trees and fruits in accordance with a defined percentage.

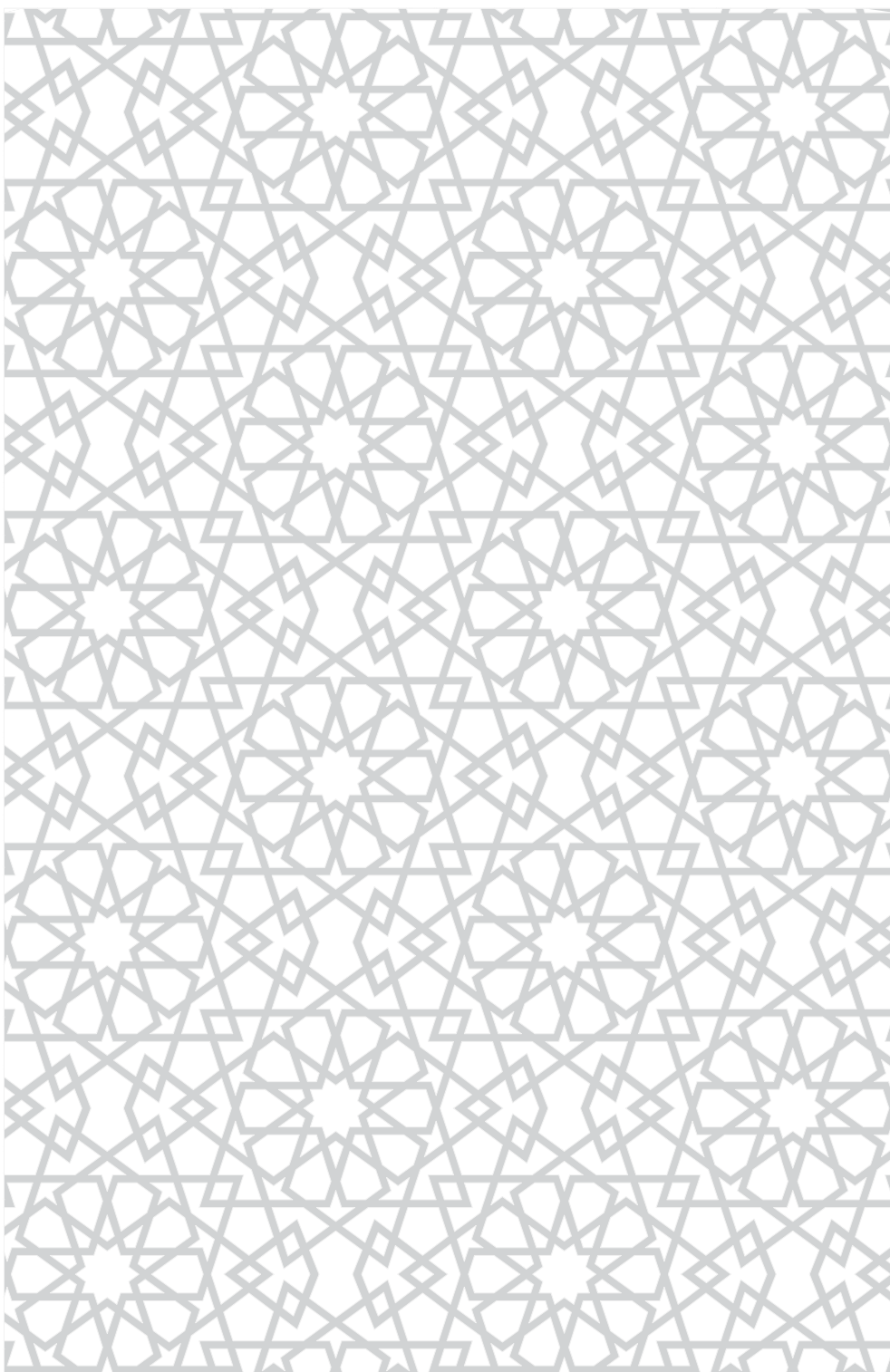
Distribution of Proceeds and Profits

Distribution of proceeds and profits is a process of termination an undivided ownership in the company by the final distribution of the assets whereby rights of each partner are defined and common shares are partitioned into identified sets for each partner. This is why distribution is defined as identification of undefined shares or proceeds of a particular person.



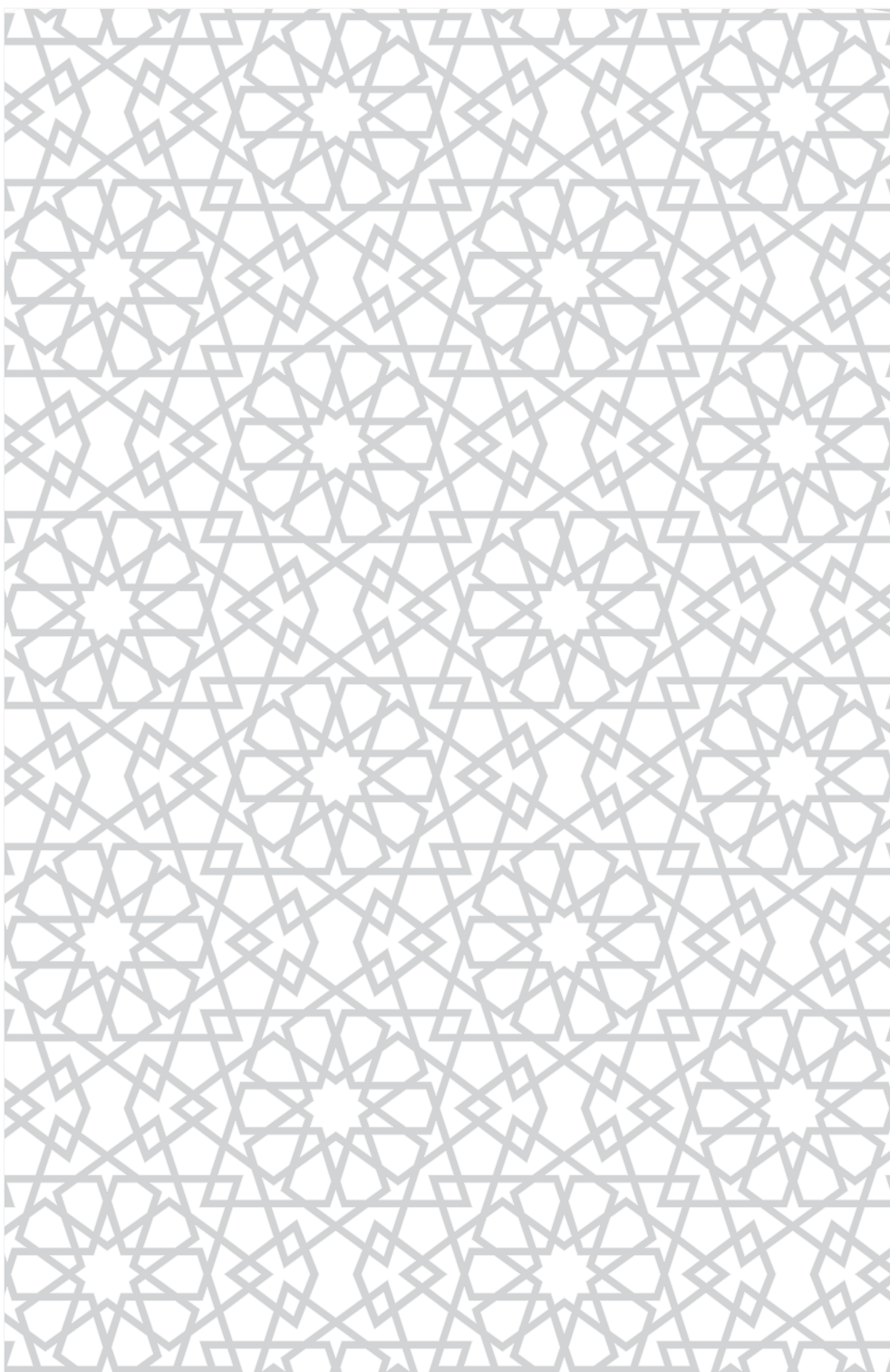
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IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

Preface

The aim of this standard is to explain the Shari'ah rulings for restricted and unrestricted Mudarabah, whether the Islamic financial Institution (Institution/Institutions)⁽¹⁾ is acting in the capacity of a Mudarib (entrepreneur) or in the capacity of an investor.

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

Statement of the Standard

1. Scope of the Standard

This standard covers Mudarabah contracts between the Institution and the other entities or individuals. It also covers joint investment accounts and special purpose investment accounts if these accounts are administered on the basis of Mudarabah.

The standard does not cover Sukuk of Mudarabah (Mudarabah Certificates) or other types of partnership contracts, as these are covered by separate standards.

2. Definition of Mudarabah

Mudarabah is a partnership in profit whereby one party provides capital (Rab al-Mal) and the other party provides labour (Mudarib).

3. Agreement of Mudarabah Financing

3/1 It is permissible, on the basis of a general framework or a memorandum of understanding, to conclude Mudarabah financing contracts for a particular sum of money and within a particular defined duration provided that the memorandum of understanding will be later implemented in line with specific or successive Mudarabah transactions.

3/2 The memorandum of understanding should define the general contractual framework, indicating the intention of the parties to use either unrestricted or restricted Mudarabah financing instrument, either through revolving transactions or separate transactions. Also, the memorandum of understanding should indicate the profit ratio, and type of guarantees that shall be presented by the Mudarib to cover situations of negligence, misconduct or breach of contract and other relevant issues in this regard.

- 3/3 If the Mudarabah contract is actually concluded on the basis of the memorandum of understanding, the contents of the memorandum become an integral part of any future contract, unless the parties had originally agreed to exempt themselves from some of the obligations mentioned therein.

4. Mudarabah Contract

- 4/1 The Mudarabah contract may be concluded using terms such as Mudarabah, Qirad or Mu'amalah.
- 4/2 Both parties should possess the legal capacity to appoint agents and accept agency. Therefore, a Mudarabah contract may not be concluded in the absence of two contracting parties with absolute legal capacity or of their agents who enjoy legal capacity similar to that of the contracting parties.
- 4/3 The general principle is that a Mudarabah contract is not binding, i.e. each of the contracting parties may terminate it unilaterally except in two cases:
- 4/3/1 When the Mudarib has already commenced the business, in which case the Mudarabah contract becomes binding up to the date of actual or constructive liquidation.
- 4/3/2 When the contracting parties agree to determine a duration for which the contract will remain in operation. In this case, the contract cannot be terminated prior to the end of the designated duration, except by mutual agreement of the contracting parties.
- 4/4 A Mudarabah contract is one of the trust-based contracts. Therefore, the Mudarib is investing Mudarabah capital on a trust basis in which case the Mudarib is not liable for losses except in case of breach of the requirements of trust, such as misconduct in respect to the Mudarabah fund, negligence and breach of the terms of Mudarabah contract. In committing any of these, the Mudarib becomes liable for the amount of the Mudarabah capital.

5. Types of Mudarabah

Mudarabah contracts are divided into unrestricted and restricted Mudarabah.

5/1 An unrestricted Mudarabah contract is a contract in which the capital provider permits the Mudarib to administer a Mudarabah fund without any restrictions. In this case, the Mudarib has a wide range of trade or business freedom on the basis of trust and the business expertise he has acquired. An example of unrestricted Mudarabah is when the capital provider says, "Do business according to your expertise". However, such unrestricted business freedom in an unrestricted Mudarabah must be exercised only in accordance with the interests of the parties and the objectives of the Mudarabah contract, which is making profit. Therefore, the actions of the Mudarib must be in accordance with the business customs relating to the Mudarabah operations: the subject matter of the contract.

5/2 A restricted Mudarabah contract is a contract in which the capital provider restricts the actions of the Mudarib to a particular location or to a particular type of investment as the capital provider considers appropriate, but not in a manner that would unduly constrain the Mudarib in his operations.

6. Guarantees in a Mudarabah Contract

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

7. Requirements Relating to the Capital

7/1 In principle, the capital of Mudarabah must be provided in the form of cash. However, it may be presented in the form of tangible assets, in which case the value of the assets is the contribution to the Mudarabah capital. The valuation of the assets may be conducted by experts or as agreed upon by the contracting parties.

- 7/2 The capital of Mudarabah should be clearly known to the contracting parties and defined in terms of quality and quantity in a manner that eliminates any possibility of uncertainty or ambiguity.
- 7/3 It is not permissible to use a debt owed by the Mudarib or another party to the capital provider as capital in a Mudarabah contract.
- 7/4 For a Mudarabah contract to be valid and for the Mudarib to be considered as having control over the capital, the capital must be, wholly or partially, put at the disposal of the Mudarib, or the Mudarib must have free access to the capital.

8. Rulings And Requirements Relating to Profit

- 8/1 It is a requirement that the mechanism for distributing profit must be clearly known in a manner that eliminates uncertainty and any possibility of dispute. The distribution of profit must be on the basis of an agreed percentage of the profit and not on the basis of a lump sum or a percentage of the capital.
- 8/2 In principle, it is not permissible to earn a share of profit in addition to a fee in a Mudarabah contract. However, it is permissible for the two parties to construct a separate agreement independent of the Mudarabah contract assigning one party to perform, for a fee, a business activity that is not by custom part of Mudarabah operations. The independence of this separate agreement means that if the contract of providing this activity is terminated, this will not affect the contract of Mudarabah.
- 8/3 The parties shall agree on the ratio of profit distribution when the contract is concluded. It is also permissible for the parties to change the ratio of distribution of profit at any time and to define the duration for which the agreement will remain valid.
- 8/4 If the parties did not stipulate the ratio of profit distribution, then they shall refer to customary practice, if any, to determine the shares of profit. If the customary practice is that the profit is distributed equally, then this will be applied as such. If there is no customary practice in this regard, the Mudarabah contract is regarded void

ab initio, and the party who acts as the Mudarib should receive a common market price for the kind and amount of services that he provided as Mudarib.

- 8/5 If one of the parties stipulates that he should receive a lump sum of money, the Mudarabah contract shall be void. This rule does not apply to a situation where the parties agree that if the profit is over a particular ceiling then one of the parties will take the additional profit and if the profit is below or equal to the amount of the ceiling the distribution of profit will be in accordance with their agreement.
- 8/6 It is not permissible for the capital provider to give the Mudarib two amounts of capitals on condition that the profit earned on one of the two amounts would be taken by the Mudarib while the capital provider would take the profit earned on the other amount. It is not also permissible for the capital provider to state that the profit of one financial period would be taken by the Mudarib and the capital provider would take the profit of the following financial period. Similarly, it is not permissible to assign the profit from a particular transaction to the Mudarib and the profit from another transaction to the capital provider.
- 8/7 No profit can be recognised or claimed unless the capital of the Mudarabah is maintained intact. Whenever a Mudarabah operation incurs losses, such losses stand to be compensated by the profits of future operations of the Mudarabah. The losses brought forward should be set against the future profits. All in all, the distribution of profit depends on the final result of the operations at the time of liquidation of the Mudarabah contract. If losses are greater than profits at the time of liquidation, the balance (net loss) must be deducted from the capital. In this case, as he is a trustee the Mudarib is not liable for the amount of this loss, unless there is negligence or misconduct on his part. If the total Mudarabah expenses are equal to the total Mudarabah revenues, the capital provider will receive his capital back without either profit or loss, and there will be no profit in which the Mudarib is entitled to a share. If profit is realised, it must be distributed between the parties as per the agreement.

- 8/8 The Mudarib is entitled to a share of profit as soon as it is clear that the operations of the Mudarabah have led to the realisation of a profit. However, this entitlement is not absolute, as it is subject to the retention of interim profits for the protection of the capital. It will be an absolute right only after distribution, i.e. when actual or constructive valuations take place. It is permissible to distribute the realised profit among the parties on account, in which case the distribution will be revised when actual or constructive valuation takes place. The final distribution of profit should be made based on the selling price of the Mudarabah assets, which is known as actual valuation. It is also permissible that the profit be distributed on the basis of constructive valuation, which is valuation of the assets on the basis of fair value. Receivables shall be measured at the cash equivalent, or net realisable value, i.e. after the deduction of a provision for doubtful debts. In measuring receivables, neither time value (interest rate) nor discount on current value for extension of period of payment shall be taken into consideration.
- 8/9 If the Mudarib has commingled his own funds with the Mudarabah funds, the Mudarib becomes a partner in respect of his funds and a Mudarib in respect of the funds of the capital provider. The profit earned on the two commingled funds will be divided proportionately to the amounts of the two funds, in which case the Mudarib takes the profit attributable to his own funds, while the remaining profit is to be distributed between the Mudarib and the capital provider according to the provisions of the Mudarabah contract.

9. Duties and Powers of the Mudarib

The Mudarib should employ his best efforts to accomplish the objectives of the Mudarabah contract. The Mudarib should assure the capital provider that his money is in good hands that will act to find the best ways of investing it in a permissible manner.

- 9/1 If a Mudarabah contract is concluded on an unrestricted basis, the Mudarib is permitted, in general, to do what entrepreneurs do in his field of activity, including the following:

- 9/1/1 Attending to all permissible investment or trading fields that are feasible, given the amount of the capital at his disposal, and in which he believes that his expertise, and technical and professional qualifications are likely to give him the ability to compete effectively.
- 9/1/2 Carrying out the work himself or appointing another person to carry out some work if necessary, such as buying a commodity or marketing it for him.
- 9/1/3 Choosing as far as possible appropriate places and markets that are seemingly free of risks.
- 9/1/4 Safeguarding the Mudarabah funds or depositing them in the custody of a trustworthy person whenever appropriate.
- 9/1/5 Selling and buying on a deferred payment basis.
- 9/1/6 The Mudarib may do, either by permission or appointment of the capital provider, the following:
 - a) The Mudarib may, at any time, combine a Mudarabah contract and a partnership (Sharikah) contract, irrespective of whether this takes place at the outset of the contract or after the commencement of Mudarabah operations, and of whether the partnership contribution is from the Mudarib himself or from a third party. The mixture of unrestricted investment deposits with the Institutions' funds is an example of this kind of combination.
 - b) The Mudarib may accept funds from a third party on a Mudarabah basis if this new contract will not affect his investment and management responsibility in respect of the first Mudarabah contract.
- 9/2 It is permissible for the capital provider, on the basis of his interests, to place restrictions on the actions of the Mudarib. Thus, Mudarabah operations may be restricted to a specified time and place, so that the Mudarib may only invest the Mudarabah funds during a particular time period or in a specified country or in a market of a particular

country. In addition, the Mudarabah operations may be restricted to investment in certain sectors such as services or trade sectors or a single commodity or a group of commodities. However, restricting the Mudarabah operations to certain commodities is circumscribed with a condition that such commodities must be commonly available so that, other things being equal, the restriction will not prevent the objectives of the Mudarabah contract from being achieved. For example, the commodities to which the Mudarabah is restricted must not be scarce, seasonal (and out of season) or in very limited supply with the consequence that the objectives of the Mudarabah contract cannot be achieved.

- 9/3 The capital provider is not permitted to stipulate that he has a right to work with the entrepreneur (Mudarib) and to be involved in selling and buying activities, or supplying and ordering. However, the Mudarib should refer to him in performing any action and should not act without consulting him. Also, the capital provider is not entitled to lay down conditions that will restrict movements or actions of the Mudarib, such as a stipulation that the Mudarib must enter into a partnership with others or a stipulation that the Mudarib must mix his personal funds with the Mudarabah funds.
- 9/4 The Mudarib must carry out all the work that any similar asset or fund manager would be liable, by custom, to do. In this case, the Mudarib is not entitled to a fee for this work as this is part of his responsibilities. If the Mudarib appoints another party on an Ijarah (hiring contract) basis to carry out such work, the wages for the worker must be paid from the personal funds of the Mudarib and not from the Mudarabah funds. The Mudarib may hire against the account of Mudarabah funds another party, at the prevailing rate, to execute work that is not by custom the responsibility of the Mudarib.
- 9/5 The Mudarib is not entitled to sell items for the Mudarabah operation at less than the common or market price, or to buy items for the Mudarabah operation at a price higher than common prices, unless if such action in either case is intended to achieve an objective that is obviously in the interest of the Mudarabah.

9/6 It is not permissible for the Mudarib to make a loan or a gift or a charitable donation out of the Mudarabah funds. Likewise, the Mudarib is not entitled to waive a right associated with the Mudarabah operation unless the capital provider has consented to his doing so.

9/7 If the Mudarib has a right to receive living expenses from the Mudarabah funds that has been approved by the capital provider, then he is entitled to the amount so approved for him. If there is no agreement on this, then the Mudarib should take living expenses in accordance with custom and reason. The Mudarib is also entitled to travelling expenses in accordance with custom and reason.

10. Liquidation of a Mudarabah Contract

10/1 A Mudarabah contract can be liquidated in the following manner:

10/1/1 Being a non-binding contract, it can be liquidated by unilateral termination of the contract by one of the parties.
[see item 4/3]

10/1/2 With the agreement of both parties.

10/1/3 On the date of maturity if the two parties had earlier agreed to set a time limit for it. [see item 3/4]

10/1/4 When the funds of Mudarabah contract have been exhausted or have suffered losses.

10/1/5 The death of the Mudarib or the liquidation of the institution that acts as Mudarib.

10/2 On the maturity of a Mudarabah operation, the assets should be liquidated in the manner explained in item 8/8.

11. Date of Issuance of the Standard

This Standard was issued on 4 Rabi' I, 1424 A.H., corresponding to 16 May 2002 A.D.

Adoption of the Standard

The Shari'ah Standard on Mudarabah was adopted by the Shari'ah Board in its meeting No. (8) held in Al-Madinah Al-Munawwarah during the period of 28 Safar to 4 Rabi' I, 1423 A.H., corresponding to 11-16 May 2002 A.D.

Appendix (A)

Brief History of the Preparation of the Standard

In its meeting No. (5) held in Makkah Al-Mukarramah during the period of 8-12 Ramadan 1421 A.H., corresponding to 4-8 December 2001 A.D., the Shari'ah Board decided to give priority to the preparation of a Shari'ah Standard on Mudarabah.

On Saturday 15 Dhul-Hajjah 1421 A.H., corresponding to 10 March 2001 A.D., the Fatwa and Arbitration Committee recommended to the Shari'ah Board the commissioning of a Shari'ah consultant to prepare a juristic study and an exposure draft on the Shari'ah Standard for Mudarabah.

In its meeting held on 18 Muharram 1422 A.H., corresponding to 12 April 2001 A.D., the Fatwa and Arbitration Committee discussed the exposure draft of the Shari'ah Rules for Mudarabah and asked the consultant to make amendments in light of the comments made by the members. The Committee also held a meeting on 20 Jumada II, 1422 A.H., corresponding to 8 December 2001 A.D., and made some amendments in light of the comments made by the members.

The revised exposure draft of the Standard was presented to the Shari'ah Board in its 7th meeting held in Makkah Al-Mukarramah during the period of 9-13 Ramadan 1422 A.H., corresponding to 24-28 November 2001 A.D. The Shari'ah Board made further amendments to the exposure draft of the Standard and decided that it should be distributed to specialists and interested parties in order to obtain their comments with the objective of discussing them in a public hearing.

A public hearing was held in Bahrain during the period of 29-20 Dhul-Hajjah 1422 A.H., corresponding to 2-3 February 2002 A.D. The public

hearing was attended by more than thirty participants representing central Institutions, Institutions, accounting firms, Shari'ah scholars, academics and others who are interested in this field. Some of the members of the Shari'ah Board responded to the written comments that were sent prior to the public hearing as well as to the oral comments that were expressed in the public hearing.

The Shari'ah Standards Committee in its meeting held during the period of 21-22 Dhul-Hajjah 1422 A.H., corresponding to 6-7 March 2002 A.D., in the Kingdom of Bahrain discussed the comments made on the exposure draft. The Committee made the amendments which it considered necessary in light of both the discussions that had taken place in the public hearing and the written comments that had been received.

The Shari'ah Board in its 8th meeting held on 28 Safar - 4 Rabi' I, 1423 A.H., corresponding to 11-16 May 2002 A.D., in Al-Madinah Al-Munawwarah discussed the amendments made by the Shari'ah Standards Committee, and made the necessary amendments, which it deemed necessary. Some paragraphs of the standard were adopted by the unanimous vote of the members of the Shari'ah Board, while the other paragraphs were adopted by the majority vote of the members, as recorded in the minutes of the Shari'ah Board.

The Shari'ah Standards Review Committee reviewed the Standard in its meeting held on Rabi' II, 1433 A.H., corresponding to March 2012 A.D., in the State of Qatar, and proposed after deliberation a set of amendments (additions, deletions, and rephrasing) as deemed necessary, and then submitted the proposed amendments to the Shari'ah Board for approval as it deemed necessary.

In its 41st meeting held in Al-Madinah Al-Munawwarah, Kingdom of Saudi Arabia during the period of 27-29 Sha'ban 1436 A.H., corresponding to 14-16 June 2015 A.D., the Shari'ah Board discussed the proposed amendments submitted by the Shari'ah Standards Review Committee. After deliberation, the Shari'ah Board approved necessary amendments, and the Standard was adopted in its current amended version.

Appendix (B)

The Shari'ah Basis for the Standard

Permissibility of Mudarabah and Its Rationale

- Mudarabah, known also as Qirad, is a contract that arranges cooperation in business investment between capital on one hand and entrepreneurship on the other, whereby the contracting parties jointly and commonly own the realised profit as per the agreement. The party providing the capital is known Rab al-Mal and the investor is known as Mudarib or 'Amil (literally. worker) or Muqarid.⁽²⁾

Mudarabah contract derives its permissibility from the following:⁽³⁾

- a) From the Qur'an is the Saying of Allah, the Almighty: ***{“Others travelling through the land, seeking of Allah's bounty”}***.⁽⁴⁾ This verse is interpreted to mean those who travel for the purpose of trading and seeking permissible income in order to provide for themselves and their family.
- b) From the Sunnah is the Hadith that says, “Al-'Abbas Ibn Abdul-Muttalib used to pay money for Mudarabah and to stipulate to the Mudarib that he should not travel by sea, pass by valleys or trade in livestock, and that the Mudarib would be liable for any losses if he did so. These conditions were brought before the Prophet (peace be upon him) and he approved them”.⁽⁵⁾ Among the Hadiths regarding the permissibility of Mudarabah is the case that states that “Umar Ibn

(2) Al-Marghinani, *“Al-Hidayah Sharh Bidayat Al-Mubtadi”* [3: 202]; Al-Kasani, *“Bada'i' Al-Sana'i”* [6: 56 and 57]; Ibn Rushd, *“Bidayat Al-Mujtahid”* [2: 236]; and Ibn Qudamah, *“Al-Mughni”* [3: 26].

(3) *“Takmilat Al-Majmu”* [14: 357-360]; *“Subul Al-Salam”* [3: 76]; *“Bidayat Al-Mujtahid”* [2: 236]; *“Al-Hidayah”* [2: 202]; *“Al-Mughni”* [5: 26]; and *“Al-Muhadhdhab”* Printed with *“Al-Majmu”* [14: 357].

(4) [Al-Muzzammil (The One Wrapped in Garments): 20].

(5) The Hadith has been related by Al-Bayhaqi [6: 111].

Al-Khattab gave one man the funds belonging to an orphan for the purpose of Mudarabah and the man was trading with these funds in Iraq".⁽⁶⁾

- c) Ibn Al-Mundhir mentioned that there is generally consensus among the scholars in respect to the permissibility of a Mudarabah contract.⁽⁷⁾
- The rationale for making this contract permissible includes the following:
 - a) Money cannot increase unless it is associated with work. It is also not permissible to provide money in return for a periodic pre-agreed payment (rent) to a person who is willing to invest it as this will constitute a debt with Riba.
 - b) The Mudarabah contract is made permissible to facilitate investment cooperation between capital providers who are not prepared to invest and manage their money themselves, and competent business or investment experts who lack adequate capital. In other words, there are some individuals who are rich but lack business or investment know-how and others who have business or investment expertise but lack money. This situation thus calls for the permissibility of the Mudarabah contract so as to combine the interests of the two parties.⁽⁸⁾

Moreover, a Mudarabah contract is an instrument that was commonly used in trade and which usage expanded in modern times to include business, services, and agricultural or horticultural and industrial activities.

- a) The business philosophy of conventional banks depends on the concept of renting out money and making profit in doing so, while Shari'ah prohibits this philosophy because of its being Riba. The Mudarabah financing instrument has been an essential instrument to develop Islamic financial Institutions (Institution/Institutions). This instrument is used by these institutions to attract unrestricted or restricted investment accounts and to reinvest these funds in various activities.

(6) The Hadith has been related by Al-Bayhaqi in "*Al-Ma'rifah*" (see: Al-Zayla'i, "*Nasb Al-Rayah*").

(7) "*Al-Mughni*" [7: 133-134].

(8) "*Takmilat Al-Majmu*" [14: 371].

Contract of Mudarabah

- The basis for the rule that both parties to a Mudarabah contract must be legally capable to appoint, or act as, an agent is because each party acts as an agent of the other party and appoints the other party to act on his behalf. The entitlement to appoint or act as an agent entitles one to conclude a Mudarabah contract.
- The basis for regarding a Mudarabah contract initially as a non-binding contract is that the Mudarib is using the capital provider's funds with his consent in a contractual relationship in which the Mudarib is just an agent, and an agency contract is not binding.
- The basis for making a Mudarabah contract binding once the work has commenced is that a unilateral termination of the contract at this stage might frustrate the objective of the parties to make profit and might cause damage to the Mudarib since he might not receive any compensation for his work.
- The basis for allowing a time limit for the operation of a Mudarabah contract is that a Mudarabah contract is, in essence, an agency contract, which is subject to a designated duration.⁽⁹⁾ The International Fiqh Academy has issued a resolution in this respect.⁽¹⁰⁾
- The basis for considering the Mudarib as a trustee with respect to the Mudarabah funds is that the Mudarib is using another person's money with his consent, and the Mudarib and the owner of the funds share the benefits from the use of the funds. In principle, a trustee should not be held liable for losses sustained by the funds. Rather, the risks of such losses must be borne by the Mudarabah funds.

Guarantees in a Mudarabah Contract

- The basis for allowing guarantees in a Mudarabah that would be used in case of misconduct and negligence of the Mudarib is that in such a case the Mudarib then becomes liable for losses and must bear the consequences of these actions.⁽¹¹⁾

(9) *"Al-Mughni"* [7: 133-134].

(10) Resolution No. 122 [5: 13].

(11) This is the opinion of the Shari'ah Board of Al Rajhi Company, see *"Al-Mudhakkirah Al-Tafsiriyyah"*. It is also endorsed in the First Al Baraka Forum.

Requirements Relating to the Capital

- The basis for it being permissible that the capital of Mudarabah may be constituted by the value of tangible assets contributed is that the objective of Mudarabah is to make profit. This objective can be realised whether the capital is contributed in the form of tangible assets or cash. This rule is based on the view of the Maliki and the Hanbali jurists.⁽¹²⁾
- The basis for the requirement that the capital of Mudarabah should be clearly known and should be defined in terms of quality and quantity in a manner that eliminates any possibility of uncertainty or ambiguity is because recognition of profit is dependent on the recovery of the capital on the date of liquidation. However, recovery of the capital cannot be ascertained if its amount was not known earlier, and this lack of knowledge may potentially lead to a dispute.
- The basis for not allowing a debt owed by the Mudarib to the capital provider be contributed as capital in a Mudarabah contract is because, as a principle, Mudarabah capital must be (at the conclusion of a Mudarabah contract) an asset that is available and cannot be used on the spot for the Mudarabah operations. A debt fails to meet this requirement, as it is a receivable that is not available for use when the contract is concluded. Moreover, considering a debt as capital of Mudarabah involves potential Riba. This is because the creditor may be suspected of having extended the debt tenure in order to get additional consideration (for the extension) from the debtor under the name of Mudarabah.
- The basis for the requirement that the Mudarabah operation is valid only if the capital is presented to the Mudarib is because the Mudarib is the manager of the Mudarabah operation, and the trustworthy trustee for the Mudarabah capital and income. Therefore, it is necessary that the capital be fully released to the Mudarib so that he will be able to protect and invest the capital and achieve the objective of the Mudarabah contract.⁽¹³⁾

(12) *"Hashiyat Al-Dusuqi"* [3: 517]; and *"Al-Mughni"* [5: 17].

(13) *"Al-Hidayah"* [3: 203]; and *"Hashiyat Al-Dusuqi"* [3: 517].

Rules and Requirements Relating to Profit

- The basis for the requirement that the profit ratio is known is because profit is the subject matter of a Mudarabah contract and a lack of knowledge as to the subject matter renders a contract void.
- The basis for the requirement that the profit share of each party be a percentage of the profit and not a lump sum is because a Mudarabah contract is a form of partnership for sharing profit. Any condition that allocates a lump sum to one party would not be consistent with the sharing of profit. This is because the Mudarabah operation may not realise a profit other than the lump sum which goes to one party, thus excluding the other party from partnership in profit.
- The basis for the impermissibility of simultaneously receiving a share of profit and a fee for managing a Mudarabah is likewise that the fee is provided in the form of a lump sum and the Mudarabah operation may not realise a profit other than the lump sum, thus precluding the sharing of profit.
- The basis for the permissibility of an agreement to change the ratio of profit distribution at any time is that the profit is a right belonging to the parties and an agreement in the manner described does not lead to a prohibited act, such as preclusion of sharing in profit. Rather, the agreement makes the parties partners in profit.⁽¹⁴⁾
- The basis for nullifying a Mudarabah contract when the contract is silent on the ratio of profit distribution and there is no customary practice according to which the profit is to be distributed to each party is that the subject matter of a Mudarabah contract is profit. The lack of knowledge as to the subject matter nullifies contracts.
- The basis for nullifying a Mudarabah contract when one party stipulates entitlement to a lump sum is because a Mudarabah is about sharing profit and this form of condition precludes sharing of profit and may potentially lead to one party being wrongfully deprived of his rights.

(14) See: Al Baraka's 11th Forum, Fatwa No. (8); Al Baraka's 4th Forum, Fatwa No. (5). This is also seconded by the Fatwa of the Shari'ah Board of Faisal Islamic Bank, Sudan (P. 107), which was published in "*Dalil Al-Fatawa Al-Shar'iyyah Fi Al-A'mal Al-Masrafiyyah*", Islamic Economic Centre, International Islamic Bank, (P. 53).

- The basis for not allowing an agreement that the Mudarib be entitled to the profit earned on one of two capital funds, while the profit earned on the other capital fund belongs to the capital provider, is that such an agreement may preclude the sharing of profit and may potentially lead to one party being wrongfully deprived of his rights.
- The basis for stating that profit is not realised unless the capital is recovered or maintained intact is the Hadith in which the Prophet (peace be upon him) said: *"The instance of a Musali (a person who performs prayer) is that of a businessperson who will not secure profit unless the capital is secured. Likewise, a supererogatory prayer is not acceptable unless the obligatory prayer is performed"*.⁽¹⁵⁾ This Hadith shows that distribution of profit prior to recovery of the capital, or unless the capital is maintained intact, is invalid. Moreover, profit is an addition to the capital and such an addition cannot be recognised or realised unless the capital that is the source of the profit is maintained.
- The basis for the requirement that the Mudarib is preliminarily entitled to a profit when realised, i.e. prior to distribution (an encumbrance right), and that the net profit earned will be known absolutely only after allocation through actual or constructive valuation, is analogous to the contract of sharecropping. The Mecca based Islamic Fiqh Academy has issued a resolution in support of constructive valuation.⁽¹⁶⁾

Duties and Powers of the Mudarib

- The basis for allowing the Mudarib freedom of action in an unrestricted Mudarabah is that the Mudarib has the aim of achieving the objective of the capital provider, which is making profit, and this is not possible unless the capital is vigorously put into operation.
- The basis for not allowing the capital provider to stipulate a right to work with the entrepreneur (Mudarib) or to be involved in acts relating to Mudarabah operations is because such a stipulation would curtail

(15) The Hadith has been related by Al-Bayhaqi in his *"Sunan"*, and was narrated by Ali Ibn Abu Talib. Al-Bayhaqi stated that there is a weak narrator in the chain of transmission of this Hadith, *"Al-Mawsu'ah Al-Fiqhiyyah"* [38: 74].

(16) Resolution No. (4) of the Islamic Fiqh Academy under the auspices of Muslim World League issued in the sixth session that was held in Mecca. This is also the view that was endorsed by Al Baraka's 8th Forum, Fatwa No. (2).

the freedom of the Mudarib, limit the investment scope and hinder the Mudarib in achieving the objective of the Mudarabah contract, i.e. making profit.

- The basis for not allowing the Mudarib to make a loan, gift or charitable donation from the Mudarabah fund is because these actions do not benefit the Mudarabah operation, rather, they involve potential loss to the capital provider.
- The basis for allowing the Mudarib, when acting in the interest of the Mudarabah and in the event that the parties did not specify an amount of money for expenses, to obtain personal expenses from the Mudarabah funds as per customary practice is because what is known by custom is deemed to apply as a condition even if the parties did not clearly stipulate it. Again, the permission for the Mudarib to obtain common personal expenses in these cases is granted by custom.

Liquidation of Mudarabah Contract

- The basis for allowing liquidation of a Mudarabah contract unilaterally or by agreement of the parties or at the maturity date is because a Mudarabah contract is non-binding if the parties did not stipulate a term for its maturity.
- The basis for allowing constructive valuation is because Shari'ah has endorsed the concept of valuation. In addition, this is allowed because it is a valid tool that passes rights to owners appropriately. The actual valuation of assets for distribution is based on a common sense because this is the principle.
- The basis for allowing a Mudarabah contract be terminated on the grounds of loss of capital is that when the capital has been lost, the Mudarib is not able to put it to work in a business, and that the fund that was assigned for the Mudarabah is no longer in existence, thus entailing the termination of the Mudarabah contract.
- The basis for allowing termination of a Mudarabah contract due to the death of the Mudarib is that a Mudarabah contract is similar to contract of agency or, at least, it includes agency and an agency contract is terminable by the death of the agent.

Appendix (C)

Definitions

Sharikah

Sharikah is an agreement between two or more parties to merge their assets or to combine their services, obligations and liabilities with the aim of making profit.

A Mudarabah contract is distinguished from a Sharikah (Musharakah) contract in the following respects:

- a) The basis for earning a share of profit in Sharikah is the required capital contribution of all parties, whether in the form of cash, commodities, services or liability in the case of reputation partnership and that the subject of the contract is based on a single element, i.e. capital. The basis for earning a profit in a Mudarabah, on the other hand, comes from two elements: the first element is the existence of capital that is subject to, and similar to, the conditions of Sharikah capital; the second element is the work done by the Mudarib that is different from the capital of the venture.
- b) In Sharikah, the work, as a general rule, is to be done jointly by the parties, whereas in Mudarabah it is the Mudarib who works.



