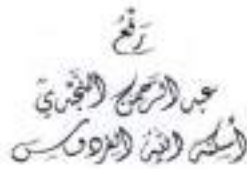


رَفْعُ  
عبد الرحمن النجدي  
أسكنه الله الفردوس

Shari'a Standard No. (13)

**Mudaraba**





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In the name of Allah, the Benevolent, the Most Merciful  
Peace be to Allah and peace be upon His messenger, and his family and the companions

## Preface

The aim of this standard is to explain the Shari'a rulings for restricted and unrestricted Mudaraba, whether the Islamic financial institution (institution/institutions)<sup>(1)</sup> is acting in the capacity of a mudarib (entrepreneur) or in the capacity of an investor.

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(1) Referred to hereafter as institution or institutions to describe Islamic financial institutions including Islamic banks.

## Statement of the standard

### 1. Scope of the standard

This standard is applicable to Mudaraba contracts between the institution and the other entities or individuals. It is also applicable to joint investment accounts and special purpose investment accounts if these accounts are administered on the basis of Mudaraba.

The standard is not applicable to Mudaraba sukuk or to other types of partnership contracts, as these are covered by separate standards.

### 2. Definition of Mudaraba

Mudaraba is a partnership in profit whereby one party provides capital (rab al-maal) and the other party provides labour (mudarib).

### 3. Agreement of Mudaraba financing

3/1 It is permissible, on the basis of a general framework or a Memorandum of Understanding, to conclude Mudaraba 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 Mudaraba 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 Mudaraba 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 Mudaraba 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. Mudaraba contract

4/1 The Mudaraba contract may be concluded using terms such as Mudaraba, Qirad or Mu'amala.

4/2 Both parties should possess the legal capacity to appoint agents and accept agency. Therefore, a Mudaraba 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 Mudaraba contract is not binding, i.e. each of the contracting parties may terminate it unilaterally except in two cases:

- (a) When the mudarib has already commenced the business, in which case the Mudaraba contract becomes binding up to the date of actual or constructive liquidation.
  - (b) 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 Mudaraba contract is one of the trust-based contracts. Therefore, the mudarib is investing Mudaraba 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 Mudaraba fund, negligence and breach of the terms of Mudaraba contract. In committing any of these, the mudarib becomes liable for the amount of the Mudaraba capital.

#### 5. Types of Mudaraba

Mudaraba contracts are divided into unrestricted and restricted Mudaraba.

- 5/1 An unrestricted Mudaraba contract is a contract in which the capital provider permits the mudarib to administer a Mudaraba 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 Mudaraba is when the capital provider says, "do business according to your expertise". However, such unrestricted business freedom in an unrestricted Mudaraba must be exercised only in accordance with the interests of the parties and the objectives of the Mudaraba contract, which is making profit. Therefore, the actions of the mudarib must be in accordance with the business customs relating to the Mudaraba operations: the subject matter of the contract.
- 5/2 A restricted Mudaraba 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 Mudaraba contract

The capital provider is permitted to obtain guarantees from the mudarib that are adequate and enforceable. This is circumscribed with 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 Mudaraba 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 Mudaraba capital. The valuation of the assets may be conducted by experts or as agreed upon by the contracting parties.

- 7/2 The capital of Mudaraba 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 permitted to use a debt owed by the mudarib or another party to the capital provider as capital in a Mudaraba contract.
- 7/4 For a Mudaraba 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 Mudaraba contract. However, it is permissible for the two parties to construct a separate agreement independent of the Mudaraba contract assigning one party to perform, for a fee, a business activity that is not by custom part of Mudaraba 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 Mudaraba.
- 8/3 The parties should 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 should 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 Mudaraba 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 Mudaraba 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 Mudaraba is maintained intact. Whenever a Mudaraba operation incurs losses, such losses stand to be compensated by the profits of future operations of the Mudaraba. 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 Mudaraba 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 Mudaraba expenses are equal to the total Mudaraba 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 Mudaraba 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 Mudaraba 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 Mudaraba 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 Mudaraba contract.

#### 9. Duties and powers of the mudarib

The mudarib should employ his best efforts to accomplish the objectives of the Mudaraba 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 Mudaraba 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 Mudaraba 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 Mudaraba contract and a partnership (Sharika) contract, irrespective of whether this takes place at the outset of the contract or after the commencement of Mudaraba 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 Mudaraba basis if this new contract will not affect his investment and management responsibility in respect of the first Mudaraba 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, Mudaraba operations may be restricted to a specified time and place, so that the mudarib may only invest the Mudaraba funds during a particular time period or in a specified country or in a market of a particular country. In addition, the Mudaraba 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 Mudaraba 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 Mudaraba contract being achieved. For example, the commodities to which the Mudaraba is restricted must not be scarce, seasonal (and out of season) or in very limited supply with the consequence that the objectives of the Mudaraba contract cannot be achieved.

- 9/3 The capital provider is not permitted to stipulate that he has a right to work with the entrepreneur (mudharib) and to be involved in selling and buying activities, or supplying and ordering. However, the mudharib 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 mudharib, such as a stipulation that the mudharib must enter into a partnership with others or a stipulation that the mudharib must mix his personal funds with the Mudaraba funds.
- 9/4 The mudharib must carry out all the work that any similar asset or fund manager would be liable, by custom, to do. In this case, the mudharib is not entitled to a fee for this work as this is part of his responsibilities. If the mudharib 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 mudharib and not from the Mudaraba funds. The mudharib may hire against the account of Mudaraba funds another party to execute work that is not by custom the responsibility of the mudharib.
- 9/5 The mudharib is not entitled to sell items for the Mudaraba operation at less than the common or market price, or to buy items for the Mudaraba 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 Mudaraba.
- 9/6 It is not permissible for the mudharib to make a loan or a gift or a charitable donation out of the Mudaraba funds. Likewise, the mudharib is not entitled to waive a right associated with the Mudaraba operation unless the capital provider has consented to his doing so.
- 9/7 If the mudharib has a right to receive living expenses from the Mudaraba 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 mudharib should take living expenses in accordance with custom and reason. The mudharib is also entitled to travelling expenses in accordance with custom and reason.

#### 10. Liquidation of a Mudaraba contract

- 10/1 A Mudaraba contract can be liquidated in the following manner:
- Being a non-binding contract, it can be liquidated by unilateral termination of the contract by one of the parties (see item 4/3).
  - With the agreement of both parties.
  - On the date of maturity if the two parties had earlier agreed to set a time limit for it (see item 3/4).
  - When the funds of Mudaraba contract have been exhausted or have suffered losses.
  - The death of the mudharib or the liquidation of the institution that acts as mudharib.

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

**11. Issue date**

This standard was issued on 4 Rabi I 1424 H corresponding to 16 May 2002.

### **Adoption of the standard**

The Shari'a Standard on Mudaraba was adopted by the Shari'a Board in its meeting No. (8) held in Madina al-Munawwarah on 28 Safar – 4 Rabiul Awwal 1423H corresponding to 11-16 May 2002.

### Appendix C: Brief history of the preparation of the standard

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

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

In its meeting held on 18 Muharram 1422H corresponding to 12 April 2001, the Fatwa and Arbitration Committee discussed the exposure draft of the Shari'a Rules for Mudaraba 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 al-Akhir 1422 H corresponding to 8 December 2001 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'a Board in its meeting No. (7) held in Makkah al-Mukarramah on 9 to 13 Ramadan 1422 corresponding to 24 to 28 November 2001. The Shari'a 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 on 29 -20 Dul-Hija 1422H corresponding to 2-3 February 2002. The public hearing was attended by more than thirty participants representing central institutions, institutions, accounting firms, Shari'a scholars, academics and others who are interested in this field. Some of the members of the Shari'a 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'a Standards Committee in its meeting held on 21-22 Dul-Hija 1422H corresponding to 6-7 March 2002 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'a Board in its meeting No. (8) held on 28 Safar - 4 rab'ul al-Awwal 1423H corresponding to 11-16 May 2002 in Madina Al Munawwarah discussed the amendments made by the Shari'a 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'a Board, while the other paragraphs were adopted by the majority vote of the members, as recorded in the minutes of the Shari'a Board.**

## Appendix B: Basis of the Shari'a rulings

### The permissibility of Mudaraba and its rationale

- Mudaraba, 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 as *rab al-Maal* and the investor is known as *mudarb* or *'Amil* (lit. worker) or *Muqarid*.<sup>(2)</sup>

Mudaraba contract derives its permissibility from the following:<sup>(3)</sup>

- (a) From the Qur'an is the saying of Allah, the Almighty **others travelling through the land, seeking of Allah's bounty**.<sup>(4)</sup> 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 tradition that says al-Abbas Ibn Abd. al-Muttalib used to pay money for Mudaraba and to stipulate to the *mudarb* that he should not travel by sea, pass by valleys or trade in livestock, and that the *mudarb* 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.<sup>(5)</sup> Among the traditions regarding the validity of Mudaraba is the case that states that Umar Ibn al-Khattab gave one man the funds belonging to an orphan for the purpose of Mudaraba and the man was trading with these funds in Iraq.<sup>(6)</sup>
  - (c) Ibn al-Mundhir mentioned that there is generally consensus among the scholars in respect to the validity of a Mudaraba contract.<sup>(7)</sup>
- 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 Mudaraba 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 Mudaraba contract so as to combine the interests of the two parties.<sup>(8)</sup>

(2) al-Marghinani, al-Hidayah Sharh Bid'ayat al-Mubtadi, 3/202; al-Kasani, Bada'i al-Sana'i 656, 57; Ibn Rushd, Bid'ayat al-Mujtahid, 2/236; Ibn Qudamah, al-Mughni 3/26.

(3) Taisiri al-Majmu' 14/357-366, Subul al-Salam 3/76; Bid'ayat al-Mujtahid 2/236; al-Hidayah 2/202; al-Mughni, 3/20; al-Muhaddeb printed with al-Majmu' 14/357.

(4) Surah al-Muzammil verse 20.

(5) The hadith is reported by al-Bayhaqi 9/111.

(6) The hadith is reported by al-Bayhaqi in al-Ma'rifah (see al-Zafar, Naba' al-Rasul).

(7) al-Mughni 7/133-134.

(8) Taisiri al-Majmu' 14/371.

Moreover, a Mudaraba 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.

- (c) The business philosophy of conventional banks depends on the concept of renting out money and making profit in doing so, while Shari'a prohibits this philosophy because of its being *riba*. The Mudaraba 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.

#### Contract of Mudaraba

- The basis for the rule that both parties to a Mudaraba 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 Mudaraba contract.
- The basis for regarding a Mudaraba 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 Mudaraba contract binding once the work has commenced is that a unilateral termination of the contract at this stage<sup>(9)</sup> 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 Mudaraba contract is that a Mudaraba contract is, in essence, an agency contract, which is subject to a designated duration.<sup>(10)</sup> The International Fiqh Academy has issued a resolution in this respect.<sup>(11)</sup>
- The basis for considering the *mudarib* as a trustee with respect to the Mudaraba 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 Mudaraba funds.

#### Guarantees in a Mudaraba contract

- The basis for allowing guarantees in a Mudaraba that would be used in case of misconduct and negligence of the *mudarib* is that in such a case the *mudarib*

(9) Al-Maghn 7/133-134  
(10) Resolution No. 122 (5/13).

then becomes liable for losses and must bear the consequences of these actions.<sup>(11)</sup>

#### Requirements relating to the capital

- The basis for it being permissible that the capital of Mudaraba may be constituted by the value of tangible assets contributed is that the objective of Mudaraba 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.<sup>(12)</sup>
- The basis for the requirement that the capital of Mudaraba 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 Mudaraba contract is because, as a principle, Mudaraba capital must be (at the conclusion of a Mudaraba contract) an asset that is available and cannot be used on the spot for the Mudaraba 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 Mudaraba 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 Mudaraba.
- The basis for the requirement that the Mudaraba operation is valid only if the capital is presented to the mudarib is because the mudarib is the manager of the Mudaraba operation, and the trustworthy trustee for the Mudaraba 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 Mudaraba contract.<sup>(13)</sup>

#### 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 Mudaraba 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 Mudaraba 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 Mudaraba 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.

(11) This is the opinion of the Shar'ah Board of Al-Rajhi Company, see *al-Mudharika al-Tabeeriyah*. It is also endorsed in the First Al-Sarakah Forum.

(12) *Hashiyat al-Dassaq*: 3/517; *al-Mughni*: 5/17.

(13) *Al-Hidayah*, 3/203; *Hashiyat al-Dassaq*: 3/517.



- The basis for the impermissibility of simultaneously receiving a share of profit and a fee for managing a Mudaraba is likewise that the fee is provided in the form of a lump sum and the Mudaraba 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.<sup>(14)</sup>
- The basis for nullifying a Mudaraba 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 Mudaraba contract is profit. The lack of knowledge as to the subject matter nullifies contracts.
- The basis for nullifying a Mudaraba contract when one party stipulates entitlement to a lump sum is because a Mudaraba 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.
- 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 (pbuh) said: *The instance of a Musali (a person who performs solat) is that of a businessperson who will not secure profit unless the capital is secured. Likewise, a supererogatory solat (prayer) is not acceptable unless the obligatory solat is performed.*<sup>(15)</sup> 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.<sup>(16)</sup>

(14) See al-Barakah's 11th Forum, Fatwa No. 8; Al-Barakah's Fourth Forum, Fatwa No. 5. This is also recorded by the Fatwa of the Shar'ia Board of Faisal Islamic Bank, Sudan, p. 107 which was published in *Dalil al-Fatwa al-Shar'iyya fi al-'amal al-Masrifiyya* (Islamic Economic centre, International Islamic bank), p. 53.

(15) The hadith is reported by al-Bayhaqi in his Sunan and was narrated by Ali bin Abi Talib and stated that there is a weak narrator in the chain of the hadith, *al-Mawsul al-Fiqhiyya* 38/74.

(16) The 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-Barakah's 8th Forum, Fatwa No. 2.

#### **Duties and Powers of the mudarib**

- The basis for allowing the mudarib freedom of action in an unrestricted Mudaraba 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 Mudaraba operations is because such a stipulation would curtail the freedom of the mudarib, limit the investment scope and hinder the mudarib in achieving the objective of the Mudaraba contract, i.e. making profit.
- The basis for not allowing the mudarib to make a loan, gift or charitable donation from the Mudarabas fund is because these actions do not benefit the Mudaraba operation, rather, they involve potential loss to the capital provider.
- The basis for allowing the mudarib, when acting in the interest of the Mudaraba and in the event that the parties did not specify an amount of money for expenses, to obtain personal expenses from the Mudaraba 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 Mudaraba contract**

- The basis for allowing liquidation of a Mudaraba contract unilaterally or by agreement of the parties or at the maturity date is because a Mudaraba contract is non-binding if the parties did not stipulate a term for its maturity.
- The basis for allowing constructive valuation is because Shari'a has endorsed the concept of valuation. In addition, this is allowed because it is a valid tool that passes on 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 Mudaraba 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 Mudaraba is no longer in existence, thus entailing the termination of the Mudaraba contract.
- The basis for allowing termination of a Mudaraba contract due to the death of the mudarib is that a Mudaraba 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

### Sharika

Sharika 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 Mudaraba contract is distinguished from a Sharika (Musharaka) contract in the following respects:

- (a) The basis for earning a share of profit in Sharika 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 Mudaraba, 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 Sharika capital. The second element is the work done by the mudarib that is different from the capital of the venture.
- (b) In Sharika, the work, as a general rule, is to be done jointly by the parties, whereas in Mudaraba it is the mudarib who works.

