Essential Shari'ah Requirements For Major Exchange Contracts

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What is Shari'ah Law?

Shari'ah law is the body of rules which were prescribed in the Quran, Sunnah or other sources of Shari'ah, and lay for the believer's specific conduct and prescribes punishment which is inflicted on him who violate this conduct. This punishment is sometimes worldly awarded by the authorities, and sometimes, in the hereafter or both.

Rules of Shari'ah are settled but their application to the incidents and events may change as a result of Fatwa (legal opinion) while the rules remain the same.

Subject matter of Shari'ah is not only relations between believers, but also acts of devotion and submission to Allah like prayers and fasting. Including in the first part is the Shari'ah rules of contract.

Principles of the Islamic law of contract.

Shari'ah restrictions on certain financial and trade transactions is the raison d'être for the emergence of Islamic banking. It is, therefore, important for any student of Islamic banking to grasp the basic elements of the Shari'ah law of contract.

Meaning of contract

Contract in Shari'ah, Aqd, means a tie or a knot binding two parties together. The contract is a declaration of offer and acceptance. Unlike English law which developed through the work of judges, Islamic law of contract developed through the work of Fugaha (jurists), based on the principle laid down by the Quran and the narrations from the Prophet (P.B.U.H).

The Quran contains mention of a number of contracts, and axioms of wide application in the area of contractual relationships. These include various commercial contracts such as sale, hire, guarantee, security and deposits. In some of the verses of the Quran where such contracts are stated, foundation for rules of new contracts were initiated, in others recognition and legitimization of already existing practice at the advent of Islam are confirmed.

The Islamic contract law is wider in scope than the English or French because it embraces some dispositions which are not

considered “contract” in either English or French legal systems. Endowment is an example of such dispositions.

Contrary to some western writings, Shari'ah does have a general theory of contract. Therefore, Shari'ah has facilities to accommodate uncatalogued agreements. Contracting an arrangement that is not falling in the categories of recognized nominate contracts is not forbidden in Shari'ah. Furthermore, conditions attached to a contract have been used by Muslims to extend the applications of such contracts.

Moreover, declaration of intention and consenting is central to the law of contract in Shari'ah. Though contracts in Shari'ah are not as cosensualistic as ones in English law, consenting is central to the law of contract in Islam, for without consent a contract will not have a binding force. Further more, the intention to create a contract is actually more important in Shari'ah than the formalities of a contract. This shows that Shari'ah’s capability to respond to peoples needs is limited only by people's ability to understand its rules.

Forms Vs Substance:

Form means the manner or order to be observed in contracts formation which contains necessary principles or proper terms or phrases to make the contract *formally* correct.

While substance means the essence, the true reality. The substance of contractual relationships is mostly economical, doing with what accountant call the "bottom line". While, form is mostly legalistic, doing with procedures, arrangements and methodical order.

Theory of contract in Shari'ah does give emphasis to the formality of the contractual relationship. However, there exist strong tendency in the jurisprudence literature that give more importance to substance.

Classification of contracts in Shari'ah.

There are several classifications for contracts in Shari'ah. What we are concerned with, however, are those doing with Islamic banking.

a- Definitive and suspensive contracts:

A contract is definitive when the offer and acceptance are both categorical and the contract is validly concluded. A contract is suspensive when the offer and acceptance are kept in suspense i.e. for future effect. The latter is not permitted in Shari'ah, particularly in sale contracts. Hire contracts, to majority of scholars, may be suspensive.

b- Binding (or obligatory) and facultative (or permissible):

Some contracts are binding, Lazim, once concluded they cannot be revoked except by mutual consent of the two parties. Some are facultative, Jaiez, which can be revoked by either party, and in some cases by a given party.

An example of the binding contracts are the contracts of sale, hire and lease... etc. An example of the permissible contracts are agency, deposit, and Mudarabah. These can be revoked by either party any time. While the contract of security (rahn) can be revoked any time, this can only be done by the beneficiary, i.e. the creditor.

Some contracts start as facultative and then turn to be binding such as donation. Donation becomes binding only after delivery. Distinguishing obligatory from facultative is important. However, such classification is it self subject to Ijtihad. For example, the Mudarabah contract in Islamic banking is no longer facultative but binding for the duration of the contract. Contemporary jurists think that it was quite logical for Mudarabah to by facultative in the old days since it had no time limit. Once a maturity has been agreed on by the two parties, it makes no sense to give either one the right, still, to revoke any time without the consent of the other. Furthermore, most investment opportunities require time, which means that, unlike the old days, investment assets cannot be liquidated before maturity.

c- Correct and corrupt contracts:

A contract is correct (sahih) when it is valid, effective and enforceable. A contract is considered corrupt (fased) when it is none of the above and referred to as a void one. Some contracts are salvageable when they become corrupt. For example if the reason for corruption is a non-permissible condition in the contract, then removal of such condition will correct it. For example a Mudarabah contract with a condition that the agent guarantees capital for rub-ul-mal is corrupt. It can be valid again by just removing this condition. If the reason for corruption is

the object of the contract, like purchase of non-permissible goods such as wine then it can’t be salvaged.

d- Contracts of Exchange and Contracts of Gratuities:

Contracts of exchange are those where the two parties interchange price on the one hand and a good or a service sold on the other. Sale, hire...etc. are all examples of exchange contracts. Contracts of gratuities are those which are done for benevolence purposes such as donation which is considered in Shari'ah a contract. Distinction between the two is important particularly when Gharar is present.

e- Specific or nominate contracts:

Shari'ah includes certain pre-designed contracts derived from the Quran, Sunnah and Ijma. These are, basically, sale hire, agency, guarantee, donation, partnership and Mudarabah.

Islamic Shari'ah, nevertheless does have its own theory of contract and hence, allows contracting arrangement not falling in the categories of recognized nominate contracts, given that they are within the parameters of Shari'ah. A new contract may not be completely new, but an amalgamation of a number of nominate contracts. The modern Murabaha contract may be considered an example.

Essential requirements for major contracts of exchange.

The Murabaha Contract:

Murabaha is a sale contract. However unlike standard sale contract what is negotiated between buyer and seller (in addition to other terms) is not price but the rate of profit of the seller (the markup). Price is set as cost plus a mark-up.

Essential requirements for Murabaha

1. The seller (S) in this contract is the bank, and the buyer (B) is called al-Amer bil *Shira*.

2. Pre-sale Order: The pre-sale agreement (the order) is not binding on B, but if he fails to fulfill his promise, S is entitled to compensation for actual damages incurred. These may NOT include foregone profit opportunities.

3. The agreement must specify the quantity, quality and place of delivery of goods, the mark-up, terms of payment of sale-price, items that will be included in the cost, etc.

4. Before consummating the sale contract, S must have owned and possessed the goods in question.

5. Mark-up must be known at least at the time of concluding the sale contract or even before. It may be fixed percentage of the cost, or a fixed absolute amount. While it is permissible to use a bench mark like LIBOR, the price must be known as a fixed amount.

6. To satisfy the requirement of the seller's *possession* of goods before reselling them, a seller must bear the cost of loss, damage and storage before delivery to B.

7. S can ask B for any guarantees and collateral's against the debt outstanding and against possible debtor's delinquency.

8. The seller may not increase the outstanding debt in case of delinquency. In such case S can foreclose on the collateral's or go to court.

9. The bills of trade arising out of the above transaction cannot be sold, but must be kept until maturity. However, such bills can be transferred at face value.

The Istisn'a Contract:

The Istisn'a is a pre-production contract. It is considered a mode of finance as the bank enters in one (as seller) and another (as buyer), selling on differed payment basis, and buying cash.

Essential requirements for Istisn'a

1. *Istisn'a* is a sale contract. It is a pre-production sale.

2. The subject of the contract can be any manufactured good.

3. It is acceptable for the price to be paid at the time of contract, at the time of delivery or at any time afterwards, in lump sum or on installment basis.

4. The seller can manufacture the goods himself, and he is also allowed to subcontract.

5. Price has to be known as a fixed amount, goods sold must also be described fully at the time of contracting.

6. Seller is fully liable *vis a vis* buyer for quantity, quality and potential hidden defects of goods sold. If seller has subcontracted the works to a 3rd party, he may specify that any claims must be made against such party. But seller must remain a guarantor of last resort.

The Mudarabah Contract:

Mudarabah is a contract of partnership in profit between a financier and an agent (or manager). Capital is provided by one party and management by other. They share profit.

Essential requirements for Mudarabah

1. The financier can claim neither fixed amount of money as profit nor a fixed percentage of the capital. Nor can be ask for a guarantee of the principal.

2. The contract must spell out the ratio of division of profit between the two parties. They can agree on any ratio but it has to be known at the time of contracting.

3. Only accounting loss is recognized by Shari'ah. It has to be born by the participants according to their capital contributions.

4. The mudarib (manager) may have an escalating share of profit in accordance with the level of profit achieved.

5. Profit (or loss) can be recognized only after liquidating of the assets of the Mudarabah. Such liquidation need not be actual sale, but can be an accounting procedure (Constructive Liquidation).

6. Mudarabah contract can be for any term, at the end of which the contract is liquidated.

7. While it is not permissible to take guarantees for achieving a certain level of profit or against loss, it is allowed to take such guarantees against negligence, mismanagement and for prompt repayment of capital and profit (if any) at the end of contract.

8. The Mudarabah can be a vehicle to finance any legitimate profit-making activity. Such activity can be specified in the contract or left to the desecration of the Mudarib (manager).

The Musharakah Contract:

Musharakah is a simple partnership between providers of capital.

Essential requirements for Musharakah

1. The basic difference from Mudarabah is that in Musharakah *both* parties are *entitled* to participate in management.

2. It is permissible to have an escalating (or variable) profit-sharing ratios depending on the level of profits achieved.

The Rent Contract:

Rent (and lease) is a sale contract the subject of which is the usufructs of an asset.

Essential requirements for Leasing and Operating Lease

1. Only durable goods can be the subject of a leasing contract.

2. Owner of the asset is entitled to lease payments (rentals) as long as the usufruct of the asset is available to the lessee.

3. The lease contract must spell very clearly who bears the maintenance costs. As a general rule responsibility against total loss and accidental damage must be at cost of the owner.

4. Owner of the leased asset may sell it to a third party, or to the lessee himself. In either case, the sale may include or exclude the prospective (uncollected) future rentals.

5. The lessee may sub-lease at more or less rental rate to a third-party, unless expressly prohibited from doing so by the terms of the lease contract.

6. The owner of the asset can sell the leased asset and hence transfer the lease contract to the new owner. It is possible to sell asset to third-party conditional on his retaining all the benefits of the old lease.

Shari'ah Parameters for Financial Lease

A financial lease should be considered a sale contract for a deferred price. Hence, the I.O.U's of future "rental" payments represent money debt that cannot be sold but had to be kept by the creditor till maturity. The I.O.U's may be transferred (for their face value and stated terms).