

## 13. MUSHARAKAH

### Hadees-e-Qudsi

Allah has declared that He will become a partner in a business between two Mushariks until they indulge in cheating or breach of trust (Khayanah).

### Definition and Classification of Musharakah

The literal meaning of Musharakah is sharing. The root of the word Musharakah in Arabic is Shirkah, which means being a partner. It is used in the same context as the term “shirk,” meaning “partner to Allah.” In Islamic jurisprudence, Musharakah means a joint enterprise formed for conducting some business in which all partners share the profit according to a specific ratio while the loss is shared according to the ratio of the contribution. It is an ideal alternative to interest based financing with far reaching effects on both production and distribution. The connotation of this term is more limited than the term Shirkah more commonly used in Islamic jurisprudence. For the purpose of clarity in the basic concepts, it will be pertinent at the outset to explain the meaning of each term as distinguished from the other. Shirkah means sharing and in the terminology of Islamic jurisprudence, it has been divided into two kinds:

1. **Shirkat-al-Milk (Partnership by Joint Ownership):** It means joint ownership of two or more persons in a particular property. This kind of Shirkah may come into existence in two different ways:
  - a) **Optional (Ikhtiari):** At the option of the parties (e.g. if two or more persons purchase equipment, it will be owned jointly by both of them and the relationship between them with regard to that property is called Shirkat-al-Milk Ikhtiari). Here this relationship has come into existence at their own option, as they themselves elected to purchase the equipment jointly.
  - b) **Compulsory (Ghair Ikhtiari):** This comes into operation automatically without any action taken by the parties. For example, after the death of a person, all his heirs inherit his property, which comes into their joint ownership as a natural consequence of the death of that person.

There are two more types of joint ownerships (Shirkat-al-Milk):

- Shirkat-al-Ain
- Shirkat-al-Dain

A property in Shirkat-al-Milk that is jointly owned but not divided yet is called Musha. In Shirkat-al-Milk undivided shares or other assets can be used in the following manner:

- a) Mushtarik Intifa': Mutually or jointly using an asset by taking turns under circumstances where the partners or joint owners are on good terms.

- b) **Muhaya:** Under this arrangement the owners will set turns in days. For example, one may use the product for 15 days and the other may use it for the rest of the month.
  - c) **Taqseem:** Referring to division of the jointly owned asset. This may be applied for property where the asset that is owned can be divided permanently. For example, jointly taking a 1,000 square yard plot and making a house on 500 square yards by each of the 2 owners.
  - d) Under a situation where the partners are not satisfied with a Muhaya arrangement, the property or asset jointly held can be sold off and proceeds divided between the partners.
2. **Shirkat-al-Aqd (Partnership by Contract):** This is the second type of Shirkah, which means, “a partnership effected by a mutual contract.” For the purpose of brevity it may also be translated as a “joint commercial enterprise.” Shirkat-al-Aqd is further divided into three kinds:
- (i) **Shirkat-al-Amwal** (Partnership in capital): Where all the partners invest some capital into a commercial enterprise.
  - (ii) **Shirkat-al-Aamal** (Partnership in services): Where all the partners jointly undertake to render some services for their customers and the fee charged by them is distributed according to an agreed ratio. For example, if two people agree to undertake tailoring services for their customers on the condition that the wages so earned will go to a joint pool which shall be distributed between them irrespective of the size of work each partner has actually done, this partnership will be a Shirkat-al-Aamal. It is also called Shirkat-at-Taqqabul or Shirkat-as-Sana'i or Shirkat-al-Abdan.
  - (iii) **Shirkat-ul-Wujooh** (Partnership in Goodwill): The word has its root in the Arabic word *Wajahat* meaning goodwill. Here the partners have no investment at all. They purchase commodities on deferred price, by getting capital on loan because of their goodwill and sell them at spot. The profit so earned is distributed between them at an agreed ratio.

Each of the above three types of Shirkat-al-Aqd are further divided into two types:

- a) **Shirkat-al-Mufawada** (Capital and labour at par): All partners share capital, management, profit and risk in absolute equals. It is a necessary condition for all four categories to be shared amongst the partners that if any one category is not shared, then the partnership becomes Shirkat-al-Ainan. Every partner who shares equally is a trustee, guarantor and agent on behalf of the other partners.
- b) **Shirkat-al-Ainan:** This is a more common type of Shirkat-al-Aqd where equality in capital, management or liability might be equal in one case but not in all respects, meaning either profit is equal but not labour or vice versa.

All these modes of Sharing or partnership are termed as Shirkah in the terminology of Islamic jurisprudence, while the term Musharakah is not found in the books of jurisprudence. Musharakah has been introduced recently by those who have written on the subject of Islamic modes of financing and it is normally restricted to a particular type of Shirkah that is Shirkat-al-Amwal, where

two or more persons invest some of their capital in a joint commercial venture. However, sometimes it includes Shirkat-al-Aamal also where the partnership takes place in the business of services.

It is evident from this discussion that the term Shirkah has a much wider sense than the term Musharakah as is being used today. The latter is limited to Shirkat-al-Amwal only (i.e. all the partners invest some capital into a commercial enterprise), while the former includes all types of joint ownership and those of partnership.

### **Rules and Conditions of Shirkat-al-Aqd:**

Common conditions are three which are as follows:

- a) The existence of partners (Muta'aqideen).
- b) The capability of partners: Must be sane and mature and be able to enter into a contract. The contract must take place with the free consent of the parties without any fraud or misrepresentation.
- c) The presence of the commodity: This means the price and commodity itself.

Special conditions are also three which are as follows:

- a) The commodity should be capable of an agency: The object in the contract must qualify as a commodity having value and not as a free good which is accessible to all. For example, grass or wood cannot be made the subject matter. As each partner is responsible for managing the project, he will directly influence the overall profitability of the business. As a result, each member in Shirkat-al-Aqd should qualify as legally being eligible of becoming an agent and carrying on business (e.g. A has written a book and owns it. B cannot sell it unless A appoints B as his agent).
- b) The rate of profit sharing should be determined: The share of each partner in the profit earned should be identified at the time of the contract. If, however, the ratio is not determined beforehand the contract becomes void (Fasid). Therefore, identifying the profit share is necessary.
- c) Profit and loss sharing: All partners will share in profit as well as loss. By placing the burden of loss solely on one or a few partners makes the partnership invalid. A condition for Shirkat-ul-Aqd is that the partners will jointly share the profit. However, defining an absolute value is not permissible, therefore only a percentage of the total return is allowed.

### **The Basic Rules of Musharakah**

Musharakah, or Shirkat-al-Amwal, is a relationship established by the parties through a mutual contract. Therefore, it goes without saying that all the necessary ingredients of a valid contract must be present here also. For example, the parties should be capable of entering into a contract; the contract must take place with the free consent of the parties without any duress, fraud or misrepresentation, etc.

But there are certain ingredients, which are peculiar to the contract of Musharakah. They are summarized here.

### **The Basic Rules of Capital:**

The capital in a Musharakah agreement should be:

- a) Quantified (Ma'loom): Meaning how much etc.
- b) Specified (Muta'aiyan): Meaning specified currency etc.
- c) Not necessarily be merged: The mixing of capital is not required.
- d) Not necessarily be in liquid form: Capital share may be contributed either in cash/liquid or in the form of commodities. In the case of a commodity, the market value of the commodity shall determine the share of the partner in the capital.

### **Management of Musharakah**

The normal principle of a Musharakah is that every partner has a right to take part in its management and to work for it. However, the partners may agree upon a condition that the management shall be carried out by one of them, and no other partner shall work for the Musharakah. But in this case the sleeping partner shall be entitled to the profit only to the extent of his investment, and the ratio of profit allocated to him should not exceed the ratio of his investment, as discussed earlier.

However, if all the partners agree to work for the joint venture, each one of them shall be treated as the agent of the other in all matters of business. Any work done by one of them in the normal course of business shall be deemed as authorized by all partners.

### **The Basic Rules of Distribution of Profit**

1. The ratio of profit for each partner must be determined in proportion to the actual profit accrued to the business and not in proportion to the capital invested by him (e.g. if it is agreed between them that A will get 1% of his investment, the contract is not valid).
2. It is not permissible to fix a lump sum amount for anyone of the partners or any rate of profit tied up with his investment. Therefore if A and B enter into a partnership and it is agreed between them that A shall be given Rs.10,000 per month as his share in the profit and the rest will go to B, the partnership is invalid.
3. If both partners agree that each will get a percentage of the profit based on his capital percentage, whether both work or not, it is allowed.
4. It is also allowed that if an investor is working, his profit share (%) could be more than his capital base (%) irrespective of whether the other partner is working or not. For example, if A and B have invested Rs.1000 each in a business and it is agreed that only A will work and will

get 2/3rd of the profit while B will get 1/3rd. Similarly if the condition of work is also imposed on B in the agreement, then the proportion of profit for A can be more than his investment.

5. If a partner has put an express condition in the agreement that he will not work for the Musharakah and will remain a sleeping partner throughout the term of the Musharakah, then his share of profit cannot be more than the ratio of his investment. However, the Hanbali school considers fixing the sleeping partners share to more than his investment to be permissible.
6. It is allowed that if a partner is not working, his profit share can be established as less than his capital share.
7. If both are working partners, the share of profit can differ from the ratio of investment. For example, Zaid and Bakar both have invested Rs.1000 each. However Zaid gets 1/3rd of the total profit and Bakar 2/3rd; this is allowed. This opinion of Imam Abu Hanifa is based on the fact that capital is not the only factor for profit but also labour and work. Therefore, although the investment of two partners is the same in some cases the quantity and quality of work might differ.
8. If only a few partners are active and others are only sleeping partners, then the share in the profit of the active partner could be fixed at a ratio higher than his ratio of investment. For example, A and B put in Rs.100 each and it is agreed that only A will work, then A can take more than 50% of the profit as his share. The excess he receives over his investment will be compensation for his services.

### **The Basic Rules of Distribution of Loss**

All scholars are unanimous on the principle of loss sharing in the Shariah based on the saying of Syedna Ali ibn Talib that is as follows:

*“Loss is distributed exactly according to the ratio of investment and the profit is divided according to the agreement of the partners.”*

Therefore the loss is always subject to the ratio of investment. For example, if A has invested 40% of the capital and B 60%, they must suffer the loss in the same ratio, not more or less. Any condition contrary to this principle shall render the contract invalid.

### **Powers and Rights of Partners in Musharakah:**

After entering into a Musharakah contract, partners have the following rights:

- a) The right to sell the mutually owned property since all partners are representing each other in a Shirkah and all have the right to buy and sell for business purposes.
- b) The right to buy raw material or other stock on cash or credit using funds belonging to the Shirkah to put into business.
- c) The right to hire people to carry out business if needed.

- d) The right to deposit the money and goods of the business belonging to the Shirkah as a depositor trust where and when necessary.
- e) The right to use the Shirkah's fund or goods in Mudarabah.
- f) The right to give the Shirkah's funds as hiba (gift) or loan. If one partner for the purpose of investing in the business has taken a Qard-e-Hasana, then paying it becomes liable on both.

### **Termination of Musharakah**

Musharakah will stand terminated in the following cases:

1. If the purpose of forming the Shirkah has been achieved. For example, if two partners had formed a Shirkah for a certain project (e.g. buying a specific quantity of cloth in order to sell it and the cloth is purchased and sold with mutual investment, the rules are simple and clear in this case). The distribution of profit will be as per the agreed rate whereas in case of loss, each partner will bear the loss according to his ratio of investment.
2. Every partner has the right to terminate the Musharakah at any time after giving his partner a notice that will cause the Musharakah to end. For dissolving this partnership, if the assets are liquidated, they will be distributed pro-rata between the partners. However, if this is not the case, the partners may agree to either:
  - a) Liquidate the assets, or
  - b) Distribute the assets as they are.

In case of a dispute between partners whether to seek liquidation of assets or distribute non-liquid assets, the distribution of non-liquid assets will be preferred. Because after the termination of the Musharakah, all the assets are in the joint ownership of the partners and a co-owner has a right to seek partition or separation and no one can compel him on liquidation. But if the assets are in a form that cannot be distributed such as machinery, then they shall be sold and the sale-proceeds shall be distributed.

3. In case of the death of any one of the partners or any partner becoming insane or incapable of effecting commercial transactions, the Musharakah stands terminated.
4. In case of damage to the share capital of one partner before mixing it in the total investment and before affecting the purchase, the partnership will stand terminated and the loss will only be borne by that particular partner. However, if the share capital of all partners has been mixed and could not be identified singly, then the loss will be shared by all and the partnership will not be terminated.

### **Termination of Musharakah Without Closing the Business**

If one of the partners wants termination of the Musharakah, while the other partner or partners would like to continue with the business, this purpose can be achieved by mutual agreement. The

partners who want to run the business may purchase the share of the partner who wants to terminate his partnership, because the termination of the Musharakah with one partner does not imply its termination between the other partners.

However, in this case, the price of the share of the leaving partner must be determined by mutual consent. If there is a dispute about the valuation of the share and the partners do not arrive at an agreed price, the leaving partner may compel the other partners on the liquidation or on the distribution of the assets themselves.

The question arises whether the partners can agree, while entering into the contract of the Musharakah, on a condition that the liquidation or separation of the business shall not be effected unless all the partners or the majority of them wants to do so. And that a single partner who wants to come out of the partnership shall have to sell his share to the other partners and shall not force them into liquidation or separation.

This condition may be justified, especially in the modern situations, on the ground that the nature of business, in most cases today, requires continuity for its success, and the liquidation or separation at the instance of a single partner only may cause irreparable damage to the other partners.

If a particular business has been started with huge amounts of money which has been invested in a long-term project, and one of the partners seeks liquidation in the infancy of the project, it may be fatal to the interests of the partners, as well as to the economic growth of society, to give him such an arbitrary power of liquidation or separation. Therefore, such a condition seems to be justified, and it can be supported by the general principle laid down by the Prophet (Allah bless him and give him peace) in his famous hadith:

“All conditions agreed upon by the Muslims are upheld, except a condition which allows what is prohibited or prohibits what is lawful.”

### **Dispute Resolution**

There shall be a provision for adjudication by a review committee to resolve any difference that may arise between the bank and its clients (partners) with respect to any of the provisions contained in the Musharakah agreement.

### **Security in Musharakah**

In the case of Musharakah agreement between the bank and the client, the bank shall in its own right and discretion, obtain adequate security from the party to ensure safety of the capital invested/financed as well as for the profit that may be earned as per the profit projections given by the party. The securities obtained by the bank shall, also as usual, be kept fully insured at the party's cost and expenses till Islamic mode of insurance (i.e. Takaful) becomes operational. The purpose of this security is to utilize this only in the case of the damage or loss of the principal amount due to the negligence of the client.

The difference between interest based financing and Musharakah:

Interest based financing	Musharakah
A fixed rate of return on a loan advanced by the financier is predetermined irrespective of the profit earned or loss suffered by the debtor.	Musharakah does not envisage a fixed rate of return. The return is based on the actual profit earned by the joint venture.
The financier cannot suffer loss.	The financier can suffer loss, if the joint venture fails to produce a profit.
Results in injustice either to the creditor or to the debtor. If the debtor suffers a loss, it is unjust on the part of the creditor to claim a fixed rate of profit. Also, if the debtor earns a very high rate of profit, it is injustice to the creditor to give him only a small proportion of the profit leaving the rest for the debtor.	The returns of the creditor are tied up with the actual profits accrued through the enterprise. The greater the profits of the enterprise, the higher the rate of return to the creditor. If the enterprise earns enormous profits, all of it cannot be secured by the debtor exclusively but will be shared by the bank's depositors.

### Issues Relating to Musharakah

Musharakah is a mode of financing in Islam. The following are some issues relating to the tenure of Musharakah, redemption in Musharakah and the mixing of capital in conducting a Musharakah. These were discussed previously and are explained in detail here.

### Liquidity of Capital

A question commonly asked in the operation of a Musharakah is whether the capital invested needs to be in liquid form or not. The answer as to whether the contract in Musharakah can be based on commodities only or on money varies among the different schools of thought in Islam. For example, if Zaid and Bakar agree to invest Rs.1000 each in a garment business and both keep their investments with themselves, then if Zaid buys cloth with his investment will it be considered belonging to both Zaid and Bakar or only to Zaid? Furthermore, if the cloth is sold, can Zaid alone claim the profit or loss on the sale? In order to answer this question the prime consideration should be whether the partnership becomes effective without mixing the two investments' profit or loss. This issue can be resolved in the light of the following schools of thought:

Imam Malik is of the view that liquidity is not a condition for the validity of a Musharakah. Therefore, even if a partner contributes in kind to the partnership his share can be determined on the basis of the evaluation according to the prevalent market price at the date of the contract. However, Imam Abu Hanifa and Imam Ahmad do not allow capital of investment to be in kind. The reason for this restriction is as follows:

- Commodities contributed by one partner will always be distinguishable from the commodities given by the other partners so they cannot be treated as homogenous capital.

- If in the case of the redistribution of share capital to the partners and tracing back each partners' share becomes difficult, if the share capital was in the form of commodities then redistribution cannot take place because they may have been sold at that time.

Imam Shafi'i has an opinion dividing commodities into two:

- Dhawat-al-Amthal: Commodities which if destroyed can be compensated by similar commodities in quality and quantity. For example, rice, wheat, etc.
- Dhawat-al-Qeemah: Commodities that cannot be compensated by similar commodities like animals.

Imam Shafi'i is of the view that commodities of the first kind may be contributed to Musharakah in the capital while the second type of commodities cannot be a part of the capital. In case of Dhawat-al-Amthal redistribution of capital may take place by giving to each partner the similar commodities he had invested and earlier the commodities need to be mixed so well together that the commodity of one partner cannot be distinguished from commodities contributed by the other.

Therefore, it should be remembered that illiquid goods can be made the capital of investment and the market value of the commodities shall determine the share of the partner in the capital.

### **Mixing of the Capital**

In the case of illiquid capital being used the mixing of capital is an issue. According to Imam Shafi'i, partners' capital should be mixed so well that it cannot be discriminated and this mixing should be done before any business is conducted. Therefore, the partnership will not be completely enforceable if any kind of discrimination is present in the partners' capital. His argument is based on the reasoning that unless both investments will be mixed the investment will remain under the ownership of the original investor and any profit or loss on trade of that investment will be entitled to the original investor only. Hence, such a partnership is not possible where the investment is not mixed.

According to Imam Abu Hanifa, Imam Malik and Imam Ahmed the partnership is complete only with an agreement and the mixing of capital is not important. They are of the opinion that when two partners agree to form a partnership without mixing their capital of investment, then if one partner buys goods for the partnership with his share of investment, these goods will be accepted as being owned by both partners and hence any profit or loss on the sale of these goods should be shared according to the partnership agreement.

However, if the share of investment of one person is lost before mixing the capital or buying anything for the partnership business, then the loss will be borne solely by the person owning the capital and not be shared by the other partners. However, if the capital of both had been mixed and then a part of the whole had been lost or stolen the loss would have been borne by both.

Since in the Hanafi, Maliki and Hanbali schools the mixing of the capital is not important, a very important present day issue is addressed with reference to this principle. If some companies or

trading houses enter into a partnership for setting up an industry to conduct business they need to open letter of credit for importing the machinery. This letter of credit reaches the importer through his bank. Now when the machinery reaches the port and the importing companies need to pay for taking possession the latter need to show those receipts in order to take possession of the goods.

In the Shafi'i school, the imported goods cannot become the capital of investment but will remain in the ownership of the person opening the letter of credit because at the time of opening the letter of credit the capital has not been mixed and without mixing the capital the Musharakah cannot come into existence. Under this situation if the goods are lost during shipment the burden of loss will fall upon the opener of the letter of credit, even though the goods were being imported for the entire industry. This is because even though a group of companies had asked for the machinery or imported goods the importers had not mixed their capital at the time of investment.

Contrary to this since the other three schools believe that a partnership comes into existence at the time of agreement rather than after the capital has been mixed, the burden of loss will be borne by all. This has two advantages:

- a) In case of loss the burden of loss will not fall upon one partner, but rather will be shared by all firms of the partner.
- b) If the capital is provided at the time of the agreement it stays blocked for the period during which the machinery is being imported. While if the capital was not kept idle till the actual operation could be conducted with the machinery the same capital could have been used for something else as well.

This shows that the decision of the three combined schools is better equipped to handle the current import export situation.

### **Tenure of Musharakah**

For conducting a Musharakah agreement, questions arise about fixing the period of the agreement. For fixing the tenure of the Musharakah the following conditions should be remembered:

- a) The partnership is fixed for such a long time that at the end of the tenure no other business can be conducted.
- b) The partnership can be for a very short time period during which a partnership is necessary and neither partner can dissolve the partnership.

Under the Hanafi school a person can fix the tenure of the partnership because it is an agreement and an agreement should have a fixed period of time.

In the Hanbali school the tenure can be fixed for the partnership as it is an agency agreement and an agency agreement in this school can be fixed. The Maliki school however says that Shirkah cannot be subjected to a fixed tenure. The Shafi'i school like the Maliki school considers fixing a tenure to be impermissible. Their argument is that fixing the period will prohibit conducting the business at

the end of that period which in turn means that the fixing will prevent them from conducting the business.

### **Uses of Musharakah / Mudarabah:**

These modes can be used in the following areas (or can replace them according to the Shariah rules).

#### **Asset Side Financing**

- Short/medium/long term financing
- Project financing
- Small and medium enterprises setup financing
- Large enterprise financing
- Import financing
- Import bills drawn under import letters of credit
- Inland bills drawn under inland letters of credit
- Bridge financing
- Letter of credit without margin (for Mudarabah)
- Letter of credit with margin (for Musharakah)
- Export financing (Pre-shipment financing)
- Working capital financing
- Running accounts financing and short term advances

#### **Liability Side Financing**

- For current / saving / mahana amdani / investment accounts (deposit giving profit based on musharakah / Mudarabah – with predetermined ratio)
- Inter bank lending / borrowing
- Term finance certificates and certificates of investment
- Treasury bill and federal investment bonds / debenture
- Securitization for large projects (based on Musharakah)
- Certificate of Investment based on Murabaha (e.g. Al Meezan Riba Free)
- Islamic Musharakah bonds (based on projects requiring large amounts – profit based on the return from the project)