

MUSHARAKAH

Definintion Of Musharakah

What is a Musharakah?

A Musharakah is the partnership of two or more individuals engaged in the rights and ownership of an asset or a service. It is a business partnership set up to make profit, where all partners contribute capital and effort to run the business.

There are two types of Musharakah partnerships: *Shirkat ul Haq* and *Shirkat ul Ayn*. *Shirkat ul Haq* is the partnership of individuals in sharing the benefits of an asset and *Shirkat ul Ayn* is a partnership between individuals for the purpose of property ownership. There are two types of *Shirkat ul Ayn*:

1. *Shirkat ul Milk* refers to participating in the ownership of property that is consumed or is meant for individual use. It begins in one of two ways: either by the compulsion of law, as in the case of inheritance, in which the legal heirs of the deceased are the joint owners of the property; or by the willful act of the partners, as in the case of most financings.
2. *Shirkat ul Aqd* is a partnership for the purpose of a joint venture of trade. In addition to the above it is also important to note the following: It is only permissible to execute a Musharakah with a client once his credit worthiness is established. This credit worthiness is determined by the credit assessment department of the bank and serves to mitigate credit risk. This is a key aspect of a partnership because one partner cannot guarantee the principal or the profit of another partner in a Musharakah.

Musharakah: Partnership Financing

What is a Musharakah agreement?

A Musharakah agreement creates a partnership of shared capital, management and risk in which partners share profit according to an agreed upon percentage, and share loss according to the proportion of their initial capital investment.

Musharakah are a kind of *Shirkah*, or sharing, agreement. *Shirkahs* are of different kinds of which *Musharakahs* are one. *Musharakahs* enjoy greater popularity among the class of *Shirkah* products because the Muslim investor increasingly seeks a means to share in a joint commercial enterprise with capital, rather than with more traditional forms of partnership.

Shirkah tul Milk

What is meant by Shirkah tul Milk? How does it work in practice?

Shirkah tul milk is partnership in property. Two or more individuals may jointly purchase or inherit land or equipment in such a partnership. They may choose to divide the property, either physically by distributing it equally among owners (e.g. land is divided into 4 parts among four individuals), or sequentially by sharing the number of days that the property is used (e.g. a tractor is used one day by one owner and the next day by the other owner).

The owners may also choose to share the asset without any clear division if it can be done so amicably. In the event of an agreed upon sale, proceeds distribute in proportion to ownership.

Shirkah tul Aa'maal

What is meant by Shirkah tul Aa'maal? How does it work in practice?

Shirkah tul Aa'maal is a partnership in services. Under Shirkah tul Aa'maal, two or more individuals enter into a partnership to provide a service. While there may or may not be an initial capital contribution to determine the size of the partners' share, an agreed-upon ratio determines how profits distribute.

For example, ten partners enter into an agreement to publish a magazine. The six freelance writers and four full-time managers may decide to distribute profits so that writers receive 8% each of profits and the managers receive 13% each of profits.

In a service partnership partners may act on behalf of one another as agreed upon (e.g. buying, selling, managing, etc.) and no partner may refuse participation in the provision of agreed upon services.

Profit Shares Need Not Be Proportionate To Investment Ratios

Must profit shares be proportionate to investment amounts, as is the case with the sharing of loss?

Profit shares need not be proportionate to investment amounts and may reflect varying amounts of time, effort and risk undertaken by different partners, but silent partners may not take a greater percentage than their investment amount, though they may take less. For example, two working partners each provide 50% of the capital, and one may take 60% of the profits while the other takes 40%. If one partner were to remain silent having provided 50% of the capital, he may take up to, but not more than 50% of the profits.

Rules Of Profit Distribution For Silent Partners

May a silent partner receive profit in a ratio more than the ratio of his investment?

Silent partners may not receive more profit than is proportionate to their investment, but they may receive less. For example, it will be invalid if one silent partner invests \$90,000 (as 90% of the initial investment) while a working partner invests \$10,000, but agrees to pay 95% of all profits to the silent partner.

Rules Of Profit Distribution For Working Partners

May working partners receive profit proportionately higher than the ratio of their investment?

Working partners may receive more profit than is proportionate to their investment, as agreed beforehand with other partners. For example, one silent partner puts up 90% of the investment while the working partner puts up the remaining 10%. It is agreed that the working partner receives 70% of all profits.

Liability For Loss May Not Be Absolute

May one of the partner's willingly agree to bear all the losses?

It is impermissible for any partner to bear all losses, even if done so willingly, unless there is negligence.

Immediate Cancellation Of Invalid Partnership

What should be done if a partnership is found to be invalid?

If a partnership is found to be invalid, it is cancelled immediately. Profits and losses are distributed in proportion to investment sizes rather than agreed upon amounts (due to the invalidity of the agreement); the partners are then entitled to enter into a new agreement that is valid.

No Investment, No Musharakah

One of the partners promises to bring her capital to a halal farming business, without having specified the quantity, and an exact date the capital will be brought into the business, but would like to share in profits and losses immediately?

It would be invalid for her to do so, without having specified the quantity of the capital, and the exact date it will be brought into the business.

Guidelines For Capital And Commodity Investment

Of what form should the capital investment be?

Capital investment may be contributed in cash, in kind, or a mix of both to be used in the business, in which case the in kind asset's market value is assessed and agreed upon, forming the contributing partner's share in the business.

Guidelines Regarding Mixing Of Capital

What are the basics of the mixing of capital in a Musharakah arrangement?

Capital may be mixed or left unmixed between partners when invested. It is valid if partners decide to mix the capital by holding a joint account, or leave it unmixed by holding separate bank accounts. However, it will be invalid if two partners, both acting as managers, deposit capital into a pool but only one of them is allowed access. Non-fungible, unmixed capital should not be divided until all the partners (or their representatives) are present, though mixed capital or fungible, unmixed capital may be divided in the partners' absence.

Division Of Capital: Before Loss/Damage/Theft

What guidelines are to be followed in the event of loss, damage or theft before the distribution of capital among partnership?

In the event of loss, damage or theft before capital is distributed among the partnership or before partners invest their capital, the partnership is cancelled and, if so agreed, renewed; because the loss occurs before mixing capital, partners sustain losses individually.

Division Of Capital: After Loss/Damage/Theft

What guidelines are to be followed in the event of loss, damage or theft after the distribution of capital among partnership?

In the event of loss, damage or theft after capital is distributed among the partnership, partners share in the loss in proportion to their partnership stake; though for unmixed capital, only the partner whose capital is lost, damaged or stolen is responsible.

When Good Or Service Contributed Is Unrelated To Business

Can a Musharakah be formed with one of the partners contributing a good or service unrelated to the business?

For a partner to form a valid partnership, the commodity he brings has to be directly related to the direct affairs of the business. Three partners bring \$1,000 each to set up a medical dispensary. A fourth partner agrees to spend \$1,000 in fuel transporting the other three. This arrangement is invalid because the transportation, while helpful to the partners, is not a commodity related directly to the business of dispensing medicine.

Events That Terminate Musharakah For Partner

What are some of the factors that render the Musharakah terminated for a partner?

Among the partners, death, insanity and incapacity to conduct business render the Musharakah terminated for that person.

Right Of Heirs Of Deceased Partner To Continue Partnership

In case of a partner's death, can heirs of the deceased continue the Musharakah?

Yes. The heirs of the deceased are entitled to remain partners in the Musharakah if they decide not to liquidate their share and exit the Musharakah, though the remaining Musharakah partners are entitled to purchase the share.

Musharakahs As Going Concern

What do scholars recommend to ensure that a Musharakah remains a going concern?

Since every going concern relies on some level of stability and continuity, scholars recommend that the Musharakah contract clearly state at the outset:

1. That individual parties may not compel the entire partnership to terminate the business unless there is a majority favoring such a move; and

2. Whether the Musharakah terminates after a fixed period of time or whether the Musharakah terminates after the fulfillment of a specific objective, like the sale of an inventory of goods or the construction of a building.

Home Financing Through Diminishing Musharakah

How does one finance the purchase of a home using Diminishing Musharakah?

Two partners, one a client and the other a financier, buy a home for \$100,000. The client makes a deposit of \$10,000 and lives in the home, while the financier invests \$90,000. We assume that the two agree to the client paying a monthly rent as a percentage of the financier's share. It is also agreed that every six months the client buys \$10,000 of the financier's share. The rent can be pegged as a percentage where the rent is calculated as 1% of the financier's share, or some other amount that reflects the client's increasing ownership. After 54 months, or four and a half years, the client owns the house entirely.

Leasing Out Property And Equipment In Diminishing Musharakah

May the property or equipment held in a Diminishing Musharakah be leased out to one of the partners, or to a third party?

The property and equipment may be leased out to one of the partners, but not to a third party.

Musharakah With Party Engaged In Interest-Based Transactions

Is it permissible for a bank to enter into a Musharakah agreement with a party that is known to deal in interest-based transactions, in particular borrowing funds on interest?

It is permissible to enter into a musharakah agreement with such a party provided that:

- Proceeds from capital purchases should be divided according to the share in the partnership, thus freeing the bank from any responsibility with regards to the manner in which the partner is utilizing his funds.
- No guarantee on proceeds or principal should be provided.
- The bank may purchase the shares of the other party according to the principles of diminishing Musharakah
- The bank may not enter into a borrowing transaction whether as a borrower or guarantor of an interest-based loan.
- The bank may not provide resettlement agreements for an interest-based loan.

- No mortgage agreement should be entered into for the benefit of an interest-based loan.

Deposit Of Bank's Investment In Musharakah

Is it necessary for a bank entering into a Musharakah to contribute its share of capital when entering into the contract?

It is necessary for a valid Musharakah that all partners deposit their contributions when entering into the contract.

Investment In Musharakah In Form Of Letter Of Surety

Is it permissible for a bank to contribute letters of surety as its share of investment in Musharakah?

It is not permissible for the bank to consider letters of surety as investment in Musharakah. Musharakah capital may take only two forms: cash and in-kind investments.

Converting Debt Into Musharakah Capital

Is it permissible for a Musharakah to accept a person as partner in exchange of liabilities owed to that person?

It is not permissible for a partner to be admitted in exchange for money owed to him. Investment in a Musharakah may only be made in either cash or kind. Debts may not be converted into capital.

Accruing Expenses Based On Capital Invested

Is it permissible for partners to charge expenses to the Musharakah by estimating the expenses as a percentage of the capital?

It is not permissible to charge expenses to a Musharakah based on the capital invested. Rather, expenses may only be charged in accordance with prevalent market prices.

Investment In Musharakah Capital In Form Of Murabaha

Is it permissible for a client of a bank to contribute his share of investment in a Musharakah by means of a Murabaha, while the bank makes its investment in cash?

It is not permissible for a client to contribute his share of investment in the Musharakah by means of a Murabaha. It is a condition for a valid Musharakah that both parties make investment in either cash or in-kind, whereas a Murabaha is a sale transaction. In such a case, the bank will be considered the sole investor, with all investment yields accruing to it alone. The Murabaha transaction, if entered into with the client, will be kept entirely separate from Musharakah.

Musharakah With Conventional Bank

Is it permissible to enter into a Musharakah with a conventional bank?

It is permissible to enter into a Musharakah with a conventional bank, provided that the business conducted is lawful in the Shariah and no impermissible transactions are entered into.

Partners' Individual Liability In Respect Of Transactions Of Musharakah

Is it permissible to hold a partner in a Musharakah personally liable for a transaction entered into on that partner's recommendation or judgment in case the Musharakah suffers a loss due because of the transaction?

In such a case, it will be determined whether the partner exercised due care and diligence. If the partner made a gross error in judgment or did not take due precautions, he will be held responsible. If the partner omitted consultation with an expert for a transaction that is ordinarily referred to experts, the partner will be held liable. If however, the shortcoming in the transaction was undetectable, or if the transaction was prudent at the time it was entered into, the partner may not be held liable and the Musharakah will bear the loss.

Property Bought Under Musharakah Registered In Name Of Partner

In the case of a Musharakah contracted for the purpose of financing the purchase of property, is it permissible that the property be registered in the name of the partner who will be the eventual owner?

It is permissible to register such a property in the name of one of the partners to the Musharakah contract. This will not affect the validity of the Musharakah contract.

Registration Expenses Of Property Bought Under Musharakah

In the case of a Musharakah contracted for the purpose of financing the purchase of property, is it

permissible to make the partner who will be the eventual owner liable to bear registration and other ancillary expenses?

It is permissible to make such a partner liable to bear registration charges and other ancillary expenses in light of the fact that such a partner will be the eventual owner of the property.

Insurance Of Property Bought Under Musharakah

In the case of a Musharakah contracted for the purpose of financing the purchase of property, is it permissible to make the partner who will be the eventual owner liable for insuring the property?

Insurance is the responsibility of both partners and it will not be permissible to make one of the partners liable to bear insurance premiums. However, the bank may consider recovering its insurance expense by building them into the amount of rent payable to it by the other partner.

Definition Of Diminishing Musharakah

What is a Diminishing Musharakah?

A Diminishing Musharakah is a temporary partnership where an asset or property is jointly purchased by two partners. Eventually, one partner acquires ownership of it through a series of property share purchases. The title of ownership of the property in a Diminishing Musharakah should ideally be in both the co-owners names. However, for regulatory reasons or to make use of available exemptions, it may be in the client's name since he will be the eventual owner at the end of the tenure. Islamic banks use Diminishing Musharakahs to extend long term financing to consumers and corporate clients. It substitutes conventional mortgage financing by providing fixed asset financing, capital project financing and home financing. The return on investment in a Diminishing Musharakah is calculated based on the frequency of the established tenure with the client. For instance if in a five year Musharakah, payments are made on a quarterly basis, the bank establishes its profit ratio as three month LIBOR. On the other hand, it is permissible to make early payments for a Diminishing Musharakah in order to gain complete ownership of the bank's share before the contract term ends. The price of the Diminishing Musharakah is a combination of the payment for the client's utilization of the usufruct of the Musharakah asset and the price of the bank's unit shares of ownership.

Home Financing Under Diminishing Musharakah

What is the method of home financing under a Diminishing Musharakah?

Home financing under Diminishing Musharakah is as follows:

The bank and the client contract a Musharakah agreement under which the property is purchased, with each party contributing a specified percentage of funds. The bank subsequently sells its share of the property to the client in installments spread over a number of years.

The bank's earnings will be accounted for yearly and will be calculated on the basis of usufruct of its share of the property that is in the client's use. In case of default by the client, the bank will have the option of either selling the property in order to realize its share in the investment, or annulling the transaction.

Musharakah For Construction Of Property

Is it permissible to contract a Musharakah for construction of property, where the client share is the value of land he owns and the bank's share is the value of the building to be constructed?

Furthermore, is it permissible to contract an agreement that the bank will sell its shares to the client upon completion of the contract and that the client will be appointed contractor for the project?

It is permissible to enter into a Musharakah contract for construction on the property that is in the ownership of the client. The client's share in the Musharakah will be equal to the value of the land while the bank's share will be equal to the value of the building to be constructed. It is further permissible that both parties agree that the bank will sell its share of the Musharakah to the client upon completion of the project, making the client the sole owner of the land and building. Both parties may also agree to appoint either one of them—in this case, the client—as contractor for the purpose of construction, provided that such a contract will be completely independent and separate from the Musharakah contract.

Accounting Of Musharakah

Is it permissible to account for a Musharakah in the way that conventional banks account for their financing, which would consist of operating an account with debits and credits, and netting these off at the end of the period to arrive at either profit or loss?

It will not be permissible to account for a Musharakah in the same manner as conventional banks account for their financing, for the latter is debt-based and the former is equity-based. The method described in the question is not permissible.

Minimum Account Balance

Is it permissible to fix the minimum Musharakah account balance so that if the balance were to fall below a specified level, the client would not be entitled to profits?

It is permissible to fix the minimum Musharakah account balance. If the balance falls below that level, the account will be treated as a current account with no profit or loss.

Guarantee In Musharakah

In case of a Musharakah contract, is it permissible for the bank to require the client to submit guarantees?

Each partner in a Musharakah has the right to make use of the collective funds of the Musharakah in a way that is of benefit to partners. Therefore, in general, no partner may be held liable for any loss that accrues from a transaction that partner entered into, unless it is established that the partner acted with negligence or committed fraud.

Therefore, the bank may require a guarantee from its client but only to the extent of fraud or negligence on the part of the client. In pursuance of such a guarantee, it will be permissible for a bank to require collateral from its client, provided that the collateral will remain in the possession of the client, with the bank having a claim on it.

Third Party Guarantee

Can a third party guarantee be obtained in a Musharakah?

A third party guarantee may be obtained in a Musharakah as long as it has not been stipulated as a condition in the contract. The third party may not possess 50% or more of a share in the ownership with the party it is serving as guarantor. Since it is a voluntary contract, remuneration for it may not be received. However, administrative costs for providing it may be charged.

Liability Of Expenses Of Musharakah

In a Musharakah that is managed by a single partner is it permissible to make this partner liable for administrative expenses of the Musharakah in return for a certain fee in consideration of his management?

It is not permissible to make one of the partners liable for the expenses of the Musharakah. Such expenses will be charged to the Musharakah in actual, whenever possible, or a reasonable estimate.

Profit Distribution In Proportion To Capital Investment

Is it permissible to grant a partner in a Musharakah a percentage of profits that is greater than his investment in capital?

It is permissible for the partners in a Musharakah to agree upon any formula for distribution of profits that is a percentage of returns. It is not necessary that each partner receive profits only in proportion to his investment in capital.

Fixing Amount Of Profit To Be Distributed

Is it permissible for the partners in a Musharakah to agree to a clause which states that profits up to a specified amount will go to one partner, while any profits exceeding that specified amount will be divided among all the partners according to an agreed-upon formula?

It is permissible to agree upon a clause as described in the question. This entails that a threshold of profits is specified, up to which only one partner will profit. Any amount of profit exceeding that threshold will then be divided among all partners. For example, in a Musharakah between A and B, if the amount of profit earned is 30 and the threshold for Partner A is 10, Partner A will receive 10, while the remaining 20 will be distributed among both partners A and B according to any agreed-upon ratio.

Purchase Of Machinery For Running Business

Will the purchase of machinery for a running business be considered a partnership for assuming ownership or one for trade?

If a commercial enterprise wishes to purchase a machine for using it in its business activity and not for sale, the Diminishing Musharakah that will be executed for it will fall into the category of a partnership for assuming ownership and not a partnership for trade.

Silent Partner's Profit Share In Business

What proportion of profit may the silent partner be granted in a business?

The silent partner's proportion of profit may be any ratio that does not exceed his ratio of investment in the business.

Investment Capital In A Musharakah

What are the restrictions for investing capital in a Musharakah?

The share capital of a Musharakah may be in the form of cash or as a commodity. If the capital is a commodity, its market availability and value must be determined in order to establish the ratio of investment.

The restrictions for establishing investment capital in a Musharakah are:

- Debt may not be established as capital in a Musharakah
- One partner may not guarantee the return on capital for another partner
- The ratio of profit received by the working partner may exceed his investment capital. The maximum ratio of profit for the silent partner may be equivalent to but not exceed his investment capital

Additionally, there are criteria to be followed for the sharing of profit and loss:

- The profit share cannot be stated as a lump sum or a percentage of the investment capital
- The proportion of profit is allocated between partners based on mutual consent. However, the silent partner may not receive a proportion of profit greater than his capital investment
- Loss in a Musharakah is shared based on the ratio of capital investment of each partner

Early Termination In A Shirkat Ul Milk Or Shirkat Ul Aqd

Will a Shirkat ul Milk or a Shirkat ul Aqd be terminated by the withdrawal of one partner?

In the case of a Shirkat ul Milk, the withdrawal of one partner does not terminate a partnership. On the other hand, in the case of a Shirkat ul Aqd, the withdrawal of one partner does terminate the partnership. His share is liquidated and sold at market value.

Termination Of Musharakah

How is a Musharakah terminated?

A Musharakah may be terminated unilaterally provided that a term has not been specified for it.

Alternatively, in some cases it may only be terminated by mutual consent if unilateral termination is disallowed at the time of the contract's execution.

Difference Between Musharakah And Mudarabah

What is the difference between a Musharakah and a Mudarabah?

Both the Musharakah and the Mudarabah are partnership contracts. In a Musharakah, all the members make a contribution to the business and have the right to work for it. In a Mudarabah, one partner makes the investment and the other partner provides the investment management expertise. Furthermore, the investor in a Mudarabah is not permitted to actively participate in the running of the business.

Musharakah Capital

Why can Musharakah partners make unequal capital investments and why must the Musharakah use existing currencies?

Capital is unequal to enable partners with different financial capacities to invest, and using an existing currency allows departing partners to monetize easily.

Role Of Musharakah Partners

What is the Musharakah partner's role in the Musharakah contract? What are the permissible and impermissible parameters of the contract?

There are numerous preconditions and integrals in a Musharakah contract which you can review in Ethica's CIFE™ program. In brief, partners all invest capital in various forms (i.e. cash, in-kind, etc.) and profit may be agreed upon between partners while losses must be proportionate to capital invested.

Practical Application of Musharakah

What are the practical applications of the Musharakah at the Islamic bank?

Musharakah structures are used by Islamic banks in investment accounts where depositors act as investors and the bank acts as a partner in identifying and investing in various target investments (e.g. project financing, client businesses, shares on the capital markets, etc.)

Profit Ratio For Sleeping Partner

Why is the profit ratio for a sleeping partner not allowed to exceed his investment ratio in a joint venture contract?

The wisdom behind such rulings may encompass several explanations; however one explanation may be that limiting the ratio of the sleeping partner ensures that one party is not overly rewarded for the mere provision of capital, while work may be rewarded with an increase commensurate with the amount of work done.

Profit Distribution Ratios In Musharakah And Mudarabah

Why does the ratio of profit distribution differ in Musharakah and Mudarabah contracts?

Profit distribution in a Musharakah is between partners who are both providing investment capital, while in a typical Mudarabah one party provides the capital and the other party only provides the work.

Suitable Islamic Finance Mode

What Islamic finance mode is most suitable to sustain an IT business/software company which must meet working capital needs such as salary and remuneration and vendor payments?

Only Musharakah and Mudarabah.