Islamic Law of Contract & Business Transactions

Learning Outcomes

By the end of this unit the learner will be able to:

- ✓ Describe the general framework of Contracts
- ✓ Identify the Elements of a Contract
- ✓ Explore different types of Contracts

Islamic Law of Contract and Business Transactions

Introduction

Islam considers the property of people as sacred and inviolable as their life and honour. To ensure this, it forbids the unlawful devouring of others' property by way of theft, embezzlement, usurpation, bribery, cheating and all other unlawful means of acquiring wealth. These proscriptions are in addition to the main prohibitions like Riba, Gharar and Qim¯ar, which are considered major causes for usurpation of others' property. In addition, different transactions have different features that need to conform to the tenets of the Shari'a.

Contracts that do not conform to these tenets or that involve any of the above prohibited elements are regarded as invalid. As Islamic banks and financial institutions are dealing in goods by entering into contracts like sale, leasing, partnership, suretyship, agency, assignment of debt, mortgages, etc., it is worthwhile discussing in detail the overall framework of the Islamic law of contracts to ascertain the permissibility/validity or non validity of their operations.

This unit deals with the general principles of contracts, the elements of contracts, conditions of subject matter, qualification of contracting parties, classification of contracts with regard to validity, the nature of remuneration or compensation in contracts or consideration of the contracts and the causes and effects of invalidity.

Defining Various Related Terms

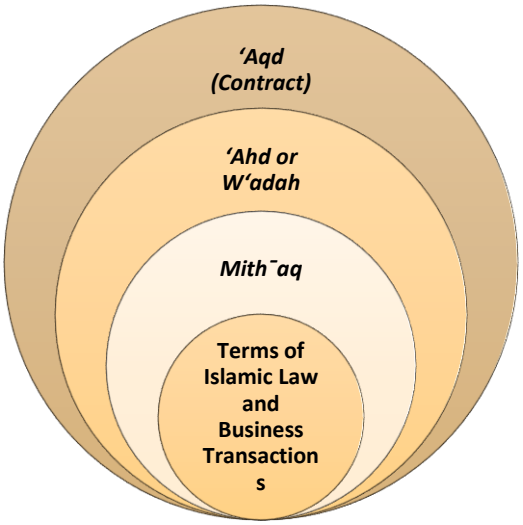

Fig 1.1

Various Arabic terms are used to denote transactions and contracts and convey the meaning of undertaking a contractual obligation. These terms are: Mith¯aq, 'Ahd or W'adah and 'Aqd.

Mith¯aq

Mith¯aq means a covenant and refers to an earnest and firm determination on the part of the concerned parties to fulfil the contractual obligations; it has more sanctity than ordinary contracts. The word Mith¯aq has been used in the Holy Qur'¯an in a number of places.

Examples of Mith¯aq are the treaties in the early Islamic era between Muslims and other nations and the contract of marriage. The Holy Qur'¯an refers to the covenant between God and human beings (13: 20), treaty between nations or groups (8: 72 and 4: 90) and the contract of marriage (4: 21). As such, this term has more relevance with religious and social covenants than with economic or financial contracts.

'Ahd or W'adah

'Ahd refers to a unilateral promise or an undertaking, although sometimes it also covers a bilateral obligation. The Holy Qur'¯an has used this word in both senses. The Qur'¯an says:

"And fulfil every 'Ahd, for every 'Ahd will be inquired into (on the Day of Judgement)" or "(But righteous) are those who fulfil the contracts, which they have made". 'Ahd is also termed W'adah in the Fiqh literature.

'Aqd (Contract)

'Aqd, which lexically means conjunction or to tie, is synonymous with the word "contract" of modern law. Murshid al-Hayran has defined it as the conjunction of an offer emanating from one of the two contracting parties with the acceptance by the other in a manner that it affects the subject matter of the contract. According to Majallah al-Ahkam al-Adliyyah, an 'Aqd takes place when two parties undertake obligations in respect of any matter. It is affected by the combination of an offer (Ijab) and acceptance (Qabul). Al 'Inayah has defined'Aqd as a legal relationship created by the conjunction of two declarations, from which flow legal consequences with regard to the subject matter. Among modern jurists, Abd al-Razzaq al-Sanhuri defines 'Aqd as the concurrence of two wills to create an obligation or to shift itor to relinquish it.

An analysis of the above definitions would reveal that a contract involves: the existence of two parties; the issuance of an outward act depicting internal willingness; an offer (Ijab) and acceptance (Qabul). Further, there must be a legal union between the two declarations regarding the subject matter or the contractual obligations.

'Aqd, therefore, implies obligation arising out of a mutual agreement. The term 'Aqd has an underlying idea of conjunction, as it joins the intention as well as the declaration of two parties. The Holy Qur'¯an has used the word in this sense: "O believers! fulfil your contracts

('Uqud)."

'Aqd is used in two senses: in the general sense, it is applied to every act which is undertaken in earnestness and with firm determination, regardless of whether it emerges from a unilateral intention

such as Waqf, remission of debt, divorce, undertaking an oath, or from a mutual agreement, such as a sale, lease, agency or mortgage. In this sense, 'Aqd is applicable to an obligation irrespective of the fact that the source of this obligation is a unilateral declaration or agreement of the two declarations. In the specific sense, it is a combination of an offer and acceptance, which gives rise to certain legal consequences.

Of the above three terms, Islamic law relating to business generally deals with 'Ahd/W'adah (promise) and 'Aqd (contract). Islamic financial institutions presently enter into promises in respect of a number of transactions, some of which are:

- Murabaha to Purchase Orderer, wherein the client places an order with the bank to purchase for him a well defined asset and promises to buy the same at cost plus the bank's profit margin.

- Ijarah Muntahia-bi-Tamleek, in which the bank or the client promises with the other party to sell or purchase the asset at the end of the lease period or transfer the ownership to the client through the contract of Hibah (gift). Similarly, the concept of W'adah is used while issuing Sukuk on the basis of Ijarah.
- Sale and lease-back is allowed subject to the fulfilment of certain conditions and in this transaction, promise is a crucial ingredient.

- Diminishing Musharakah, in which case the client promises to redeem the bank's investment by periodically purchasing the bank's share in the joint asset or the bank promises to sell its part of ownership in the asset.
- Disposal of goods purchased through Salam, in which case an Islamic bank, after executing a Salam contract for forward purchase of a well-defined product, gets a promise from any trader that the latter will buy it on stipulated terms and conditions. Islamic banks also take promises from their clients to sell the banks' Salam assets when received as their agents at any given price.

- Similarly, for disposal of assets manufactured/constructed under Istisna'a, banks take promises to buy from other parties.

'Aqd (contract) is the most crucial tool for Islamic banks for both deposits and asset sides. They enter into Am¯anah, Qard (loan), Shirkah, or Wakalah contracts with savers or depositors and Bai', Ijarah, Ujrah, Shirkah, Wakalah, Kafalah, Ju'alah and Hawalah contracts with those who avail themselves of the financing facility from them. It is, therefore, pertinent to discuss in detail the concepts of W'adah (promise) and 'Aqd (contract).

General Framework Of Contracts

Islamic law is related to the methodology of the Shari'a in dealing with Ib¯ad¯at (devotional acts) and Mu'¯amal¯at (transactions). Ib¯ad¯at are held to be universal truths that are unaffected by time and space. The Mu'¯amal¯at are matters pertaining to individuals interacting among themselves. They may change

with changes in time and space. Imam Ibn Taymiyah explains the difference between Ib¯ad¯at and Mu‘¯amal¯at in the following words:

“The acts and deeds of individuals are of two types: Ib¯ad¯at, whereby their religiousness is improved, and Ad¯at or Mu‘¯amal¯at (transactions), which they need in their worldly matters. An inductive survey of the sources of the Shari’a establishes that devotional acts are sanctioned by express injunctions of the Shari’a. Thus, what is not commanded cannot be made obligatory. As regards transactions, the principle governing them would be permissibility and absence of prohibition. So nothing can be prohibited unless it is proscribed by Allah (SWT) and His Prophet (PBUH) in the overall framework.”

This provides a reasonable degree of liberty to the jurists in finding solutions to emerging problems and issues in entering into contracts and transactions and business dealings with one another.

Mu‘¯amal¯at, in turn, pertains to two types of activities, i.e. social and economic and/or financial. This unit deals with the second category of activities, relating one way or another to transactions and human activities in respect of production, exchange and distribution of economic resources.

Income is generated either through production of goods or providing services by way of sale of goods, their usufruct or expertise. Businesses are conducted in various structures like that of sole proprietorship, partnership (Shirkah), agency (Wakalah) or labour (Ujrah) or forms like sale and lease. All such activities are subject to the observance of certain rules, making the transactions valid and legally enforceable. These rules together constitute the Islamic law of contracts.

A basic rule of Islamic law is that the factor to be considered in Mu‘¯amal¯at or social and economic contracts is the apparent wording, any format or writing of the contract. Only that will have legal consequences; any party who has entered into a contract cannot say that it was not his intent (Niyyah). The law will enforce what he has agreed with the other party.

In devotional acts (Ib¯ad¯at), on the other hand, it is the intent, meaning or Niyyah of the person doing any devotional act that matters and not mere words. The validity of the contract requires that its motivating and underlying cause should be according to the requirements of the Shari’a. All contracts which promote immorality or are against public policy, are harmful to a person or property of a third party or which are forbidden by law are deemed to be void. A sale or hiring of a weapon to a criminal who will use it to kill innocent people is invalid, when the seller or the lessor is aware of his intention.

Elements Of A Contract

A contract comprises the following elements: the existence of two parties who must be capable of entering into contracts, i.e. they must be mature and sane; an offer (Ijab) and acceptance (Qabul); a legal (Sharie) basis of union between the two declarations and the contractual obligations; and free from all prohibited factors. Muslim jurists in general hold that, intrinsically, the essential elements of a contract are threefold and if these elements are not found properly, the contract is invalid:

- the form, i.e. offer and acceptance (Sighah);

- the contracting parties (‘Aqidain);
- the subject matter (Ma‘qud ‘alayh).

There are seven components in a contract:

- the concurrence of offer and acceptance;
- the unity of the Majlis (session/meeting) of a contract;
- plurality of the contracting parties;
- sanity or the power of distinction of the contracting parties;
- subject matter susceptible to delivery;
- the object (Mahall) defined;
- the beneficial nature of the object, in that trade in it is permitted as per Shari’a rules.

Offer and Acceptance: Form of the Contract

The form (offer and acceptance) is the procedure or the means by which a contract is made.

Juristic rules require that the offer should be in clear language and unconditional. There should be conformity of the offer and acceptance on the subject matter and the consideration and issuance of the offer and its acceptance should be in the same session. We briefly discuss these rules in the following paragraphs.

An offer (Ijab) is the necessary condition of a valid contract. It has been defined as a declaration or a firm proposal made first with a view to creating an obligation, while the subsequent declaration is termed acceptance (Qabul). Ijab signifies the willingness of a party to do something positive.

Offer and acceptance can be conveyed in a number of ways, namely: by words, by gesture or indication or by conduct. There is no difference of opinion among jurists with regards to the conclusion of contracts through words. They have not fixed particular words for the formation of a particular contract. Whatever conveys the meaning with clarity is considered sufficient for the formation of a contract. It is all the same whether the words are explicit or implicit.

An offer is considered cancelled in the following cases:

- withdrawal of the offer by the maker;
- death of a party or loss of its capacity to enter into the contract;
- termination of the Majlis, i.e. contractual session, without concluding the contract;
- destruction of the subject matter;
- lapse of the time fixed for acceptance.

It is a requirement of Islamic law that acceptance should conform to the offer in all its details and that it should be accepted in the same meeting if the offer is made to be effective from that session. The

requirement of unity of session for "offer and acceptance" has been interpreted in different ways. This requirement is based on a saying of the Holy

Prophet (PBUH): "The contracting parties have the right of option (to finalize or not) until they separate."

Despite some minor differences of opinion, jurists are of the view that a contract must be completed by offer and acceptance in the same meeting until one party acquires for itself the right to think over, to ratify or to revoke the contract later. The option of stipulation (Khiyar al- Shart) is a mechanism provided by Islamic law to overcome the problem caused by the restriction of unity of the session. This option makes a contract nonbinding for the party which has acquired that right for a specified period.

If a seller makes an offer to a potential buyer: "I sell you this commodity for so much", but the buyer does not answer him before they separate, the sale is not concluded and the offer no longer exists. However, if the buyer gets a specified time from the seller, they can conclude the sale within that time on the basis of that offer.

It may be observed that the requirement of unity of session does not apply to the contracts of agency, gift and appointment of an executor for the property of any minor.

Elements of the Subject Matter

The subject matter of a contract may include the object of the contracts, a commodity or the performance of an act. The contractual obligation of one party according to Islamic law is the consideration for the contractual obligation of the other party. Detailed conditions in respect of subject matter in various types of contracts are different, but on the whole, the subject matter should be existing/existable, valuable, usable, and capable of ownership/title, capable of delivery/possession, specified and quantified and the seller must have its title and risk. If a nonexistent thing is sold, even with mutual consent, the sale is void according to the Shari'a.

Accordingly, short-selling has been prohibited by almost all scholars. Similarly, the subject of a contract should not be a thing which is not normally used except for a non permissible purpose. The subject matter of an exchange contract must have value of some kind. The "usufruct" of an asset is considered property and thus can be the subject matter of an exchange transaction. A commodity which has not yet come into existence or is not deliverable, and the seller does not know as to when it could be delivered (like an animal which is missing or a stolen car), cannot be sold in order to avoid Gharar.

On the same basis, a contract for sale of a debt or a receivable is not valid because the seller of the debt (creditor) does not know whether and when the debtor will pay the debt. But, if it is subjected to the rules of Hawalah (assignment of debt) with recourse to the original debtor, it is valid. In Salam (the sale of goods with prepayment and deferred delivery), the sale of a nonexistent commodity is allowed because all details about the commodity and delivery are pre-agreed and Gharar is removed.

Conditions regarding the subject matter are discussed below in some detail:

- The basic attributes of the merchandise should consist of pure materials, which should be objects of intrinsic/legal value having some use. The commodity, service or performance must not include things prohibited by the Shari'a like wine, pork and intoxicants. It must be ritually and legally clean and permissible. It is further required that the purpose of the contract and the underlying cause should also not be contrary to the objectives of the Shari'a. Therefore, a contract to operate a brothel or a gambling house is not valid because in the former case the contract is contrary to the preservation of the family unit, progeny and offspring, which is an objective of the Shari'a, and in the latter case, the objective is opposed to the preservation of property and amounts to devouring others' properties wrongfully. Further, since immortality is prohibited in Islam, any contract or transaction that entails these evils or promotes them is also forbidden.
- Legality of the subject matter requires that the commodities should be owned by someone. It also requires that it should be free from legal charge. Thus, an asset mortgaged with a creditor cannot be sold until redemption of the asset upon payment of the debt.
- The subject matter should fulfil the objective of the contract. Thus, perishable goods like vegetables cannot be the subject of a pledge. Similarly, public roads and parks cannot be the subject of a sale contract because these are meant for the benefit of the public and not for individuals.
- The subject matter should not be harmful to the contracting parties or the public in general. As such, producing and trading in intoxicants like heroin, etc. is not a valid subject for contracts.

Precise Determination of Subject Matter

The subject matter should be precisely determined with regard to its essence, quality and value. Determination can be made either by pointing or by detailed specification. In some cases, jurists allow a sale even if the goods have not been examined. In such a case the buyer is granted the option of sight after the contract. Thus, there can be two ways to determine the subject matter:

1. The subject matter is known and specified when the parties to the contract see and examine it at the time of the contract. If the subject matter is present in the session, the majority view is that its examination is necessary.

2. Sale by description. If the asset or property to be sold is known, like a house of the seller who has only one house, a description highlighting its specifications is deemed to be sufficient? However, if the seller has a number of apartments almost similar to each other, then identification of the specific unit is necessary for the contract to be valid. If an owner of a shopping mall says to a person: "I sell one of the shops to you" and the person accepts it, the contract is voidable unless the shop intended to be sold is specifically identified or pointed out to the buyer.

The consideration of a contract or the price must be agreed and fixed at the time of executing the exchange transactions. If the price is uncertain, the contract is void. For example, if the seller says to the buyer: “Take this (asset) and I will charge you its price in the market, or I shall tell you the price later”, or he says: “If you pay within a month the price will be $100, and if within two months you will be charged $105”, and the buyer agrees without stipulating any one final price, the transaction is not valid.

The measuring unit of the price should also be known, e.g. any legal tender or currency, etc. Special care is needed in barter sales because in cases of uncertain price, sales would not be valid. The ownership of the goods being sold remains with the seller until delivery is made. In this respect, there should be a formal event that signifies the point at which a contract is concluded, for example a handshake or a signature. At this point, ownership, along with its risk and reward, is transferred to the buyer, who is liable to pay the price either immediately or at a later specified date if the contract involves credit.

Possession and Certainty of Delivery of the Subject Matter

The capacity to deliver the subject matter of the contract at the time of the conclusion of the contract is an essential condition of a valid contract. If such a capacity is lacking, the contract is void. The holy Prophet (pbuh) is reported to have said: “He who buys foodstuff should not sell it until he has taken possession of it”. It is reported that the Companion Hakimibn Hizam (RA) had bought some commodities in the times of Umar ibn al-Khattab (RA), and intended to sell them to others. Umar(RA) ordered him not to sell the commodities before taking their possession. Zayd ibn Thabit(RA), Abdullah ibn Umar (RA) and Abdullah ibn ’Abbas (RA) held the same view as that of ’Umar(RA). Their interpretation implies that the vendor must be the real owner of the goods and, as such, the owner of their risk and reward.

Possession of the subject matter by the seller means that it must be in the physical or constructive possession of the seller when he sells it to another person. Constructive (Hukmi) possession means a situation where the possessor has not taken the physical delivery of the commodity, yet the commodity has come into his risk and control and all the rights and liabilities of the commodity are passed on to him, including the risk of its destruction. In the case of immovable assets, any legal notice of transfer or mutation is sufficient. **t**

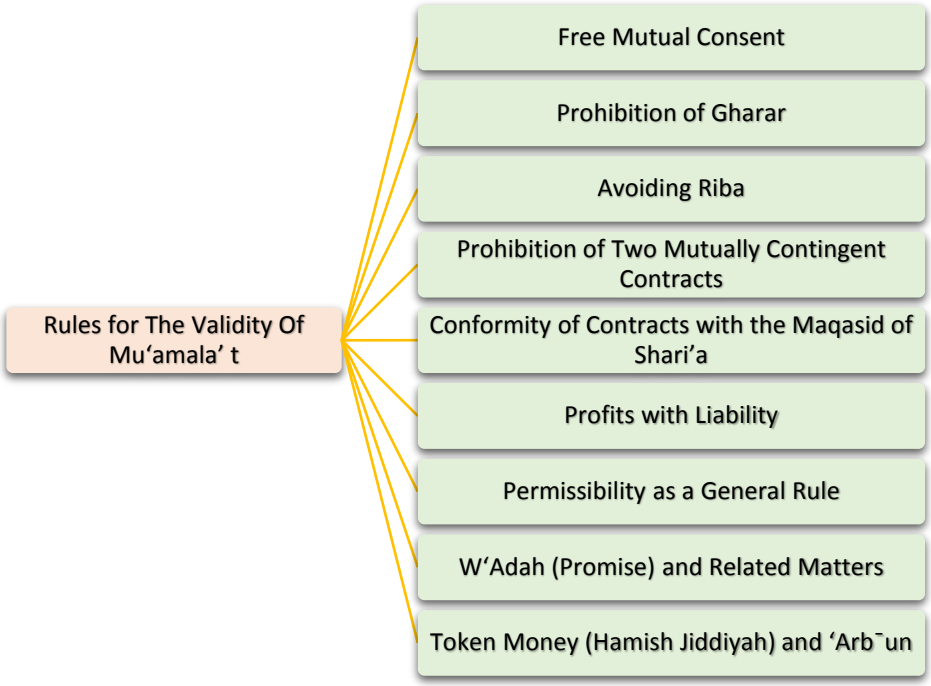

Fig 1.3

Free Mutual Consent

All transactions, in order to be valid and enforceable, must be based on free mutual consent of the parties. The consent that is required for the formation of a valid contract is free consent. Consent obtained through oppression, fraud and misperception renders a contract invalid as per Islamic law. It also requires that consenting parties have certain and definite knowledge of the subject matter of the contract and the rights and the obligations arising from it. Accordingly, inspection of the subject matter and proper documentation of the transaction, particularly if it involves credit, have been encouraged and emphasized.

Practices like Najash (false bidding to prices), Ghaban-e-Fahish (charging exorbitant prices while giving the impression that the normal market price has been charged), Talaqqi-al-

Rukban (a city dweller taking advantage of the ignorance of a Bedouin by purchasing his goods at a far lower price before the latter comes to the market) and concealing any material defect in the goods or any value-related information in trust sales like Murabaha have been strictly prohibited so that the parties can decide with free will and confidence.

Prohibition of Gharar

All valid contracts must be free from excessive uncertainty (Gharar) about the subject matter or the consideration (price) given in exchange. This is particularly a requirement of all compensatory or commutative contracts. In noncompensatory contracts, like gifts, some uncertainty is affordable. Gharar conveys the meaning of uncertainty about the ultimate outcome of the contract, which may lead to

dispute and litigation. Examples of transactions based on Gharar are the sale of fish in water, fruits of trees at the beginning of the season when their quality cannot be established or the future sale of not fully defined or specified products of a factory which is still under construction.

In order to avoid uncertainty, valid sales require that the commodity being traded must exist at the time of sale; the seller should have acquired the ownership of that commodity and it must be in the physical or constructive possession of the seller. Salam or Salaf and Istisna'a are the only two exceptions to this principle in Shari'a and exemption has been granted by creating such conditions for their validity that Gharar is removed and there is little chance of dispute or exploitation of any of the parties. These conditions relate to the precise determination of quality, quantity, price and the time and place of delivery of the Salam goods.

Other examples of Gharar-based invalid transactions are short-selling of shares, the sale of conventional derivatives and the insurance business. Futures sales of shares, in which delivery of the shares is not given and taken and only a difference in price is adjusted, trading in shares of provisionally listed companies or speculation in shares and Forex business , are other examples of Gharar-based transactions.

Avoiding Riba

As discussed earlier, Riba is an increase that has no corresponding consideration in an exchange of an asset for another asset. The increase without corresponding consideration could be either in exchange or loan transactions. As Islamic banks and financial institutions are involved in real sector trading activities as well as the creation of debt as a result of credit transactions, they must give special consideration to avoiding Riba lest their income might go to the Charity Account due to non-Shar¯ı´ah compliance. In the conventional sense, the cost of funds amounts to Riba and they have to make profit by way of pricing the goods or usufruct of assets and not by lending.

Qim¯ar includes every form of gain or money, the acquisition of which depends purely on luck and chance. Maisir means getting something too easily or getting a profit without working for it. All contracts involving Qim¯ar and Maisir are prohibited. Present-day lotteries and prize schemes based purely on luck come under this prohibition. Dicing and wagering are rightly held to be within the definition of gambling and Maisir. Therefore, Islamic banks cannot launch any such schemes or products.

Prohibition of Two Mutually Contingent Contracts

Two mutually contingent and inconsistent contracts have been prohibited by the holy Prophet(pbuh). This refers to

1. The sale of two articles in such a way that one who intends to purchase an article is obliged to purchase the other also at any given price.
2. The sale of a single article for two prices when one of the prices is not finally stipulatedat the time of the execution of the sale.
3. Contingent sale.

4. Combining sale and lending in one contract.

In order to avoid this prohibition, jurists consider it preferable that a contract of sale must relate to only one transaction, and different contracts should not be mixed in such a way that the reward and liability of contracting parties involved in a transaction are not fully defined.

Therefore, rather than signing a single contract to cover more than one transaction, parties should enter into separate transactions under separate contracts.

Islamic banks may come across a number of transactions in which there could be interdependent agreements or stipulations that have to be avoided. The combination of some contracts is permissible subject to certain conditions:

- Bai‘ (sale) and Ijarah (leasing) are two contracts of totally different impacts; while ownership and risk are transferred to the buyer in Bai‘, neither ownership nor risk transfer from the lessor to the lessee. It is necessary; therefore, that lease and sale are kept as separate agreements. In Islamic banks’ Ijarah Muntahia-bi-Tamleek (lease culminating in transfer of ownership to the lessee), the relationship between the parties throughout the lease period remains that of the lessor and lessee and the bank remains liable for the risks and expenses relating to ownership. Transferring ownership risk to the lessee during the lease period would render the transaction void. However, one of the parties can undertake a unilateral promise to sell, buy or gift the asset at the termination of the lease period.This will not be binding on the other party.
- Shirkah and Ijarah can be combined, meaning that a partner can give his part of ownership in an asset on lease to any co-partners. Jurists are unanimous about the permissibility of leasing one’s undivided share in a property to any other partner. However, sale of ownership units to the client in Diminishing Musharakah will have to be kept totally separate, requiring “offer and acceptance” for each unit.
- Musharakah and Mudarabah can also be combined. For example, banks manage depositors’ funds on the basis of Mudarabah; they can also deploy their funds in the business with the condition that the ratio of profit for a sleeping partner cannot be more than the ratio that their capital has in the total capital.
- Contracts of agency (Wakalah) and suretyship (Kafalah) can also be combined with sale or lease contracts, with the condition that the rights and liabilities arising from various contracts are taken as per their respective rules. As per present practice of Islamic banks, Wakalah is an important component of Murabaha, Salam and Istisna‘a agreements.
- Islamic banks can structure products by combining different modes subject to the fulfillment of their respective conditions. For example, they can combine Salam or Istisna‘a with Murabaha for preshipment export financing. Diminishing Musharakah is also a combination of Shirkah and Ijarah, added by an undertaking by one party to periodically sell/purchase the ownership to/from another partner.

Similarly, the exchange of two liabilities is prohibited. Transactions between two parties involve an exchange of any of the following types: corporeal property for corporeal property, corporeal property for a corresponding liability or a liability for another liability. Each one of these can be immediate for both parties or delayed for both or immediate for one party and delayed for the other. In this way, Ibn Rushd has identified nine kinds of sales. Out of the above categories of exchange, an exchange involving delay from both sides is not permitted as it amounts to the exchange of a debt for a debt, which is prohibited. That is why full prepayment is necessary for valid contracts of Salam.

Conformity of Contracts with the Maqasid of Shari'a

The injunctions of the Shari'aare directed towards the realization of various objectives for the welfare of mankind. The objectives of the Shari'ahave been emphasized in a large number of the texts of the Qur'¯an and Sunnah. Any contract or transaction that militates against any of these objectives is invalid in Shari'a. It is quite obvious that the rights of fellow beings have to be honoured in respect of all transactions. The rights of Allah (SWT) in Shari'aalso refer to everything that involves the benefit of the community at large. In this sense, they correspond with public rights in modern law. Therefore, any contract should not be against the benefits of the public at large.

Profits with Liability

This principle states that a person is entitled to profit only when he bears the risk of loss in business. It operates in a number of contracts such as the contract of sale, hire or partnership.

Any excess over and above the principal sum paid to the creditor by the debtor is prohibited because the creditor does not bear any business risk with regard to the amount lent. In sale and lease agreements, parties have to bear risk as per the requirements of the respective contracts.

Permissibility as a General Rule

Everything that is not prohibited is permissible. The principle of permissibility establishes the fact that all agreements and conditions contained in them are permissible as long as they do not contradict any explicit text of the Qur'¯an or Sunnah. Individuals are not always in a position to conduct exchange transactions on a spot payment basis. Many times, one of the two counter values to an exchange transaction is not exchanged simultaneously, as happens in credit (Mu'ajjal) or forward (Salam) transactions. The validity of these transactions requires certain rules.

W'Adah (Promise) and Related Matters

In W'adah or 'Ahd, one party binds itself to do some action for the other. 'Ahd generally does not create legal obligation but in certain cases it becomes legally binding and enforceable.This is where the promisee has incurred some expenses or taken some liability as a result of the promise. Contingent promises are also considered binding.

The Islamic Fiqh Academy of the OIC has made the promise in commercial dealings binding with the following conditions:

1. The promise should be unilateral or one-sided.
2. The promisor must have caused the promisee to incur some liabilities or expenses.
3. If the promise is to purchase something, the actual sale must take place at the appointed time by the exchange of offer and acceptance. Mere promise itself should not be taken as the actual sale.
4. If the promisor backs out of his promise, the court may force him either to purchase the commodity or pay actual damages to the seller. The actual damages will include the actual monetary loss suffered by him, but will not include the opportunity cost.

According to the majority of scholars, Muwa'adah or Mu'ahidah (bilateral promise) is not allowed in situations where 'Aqd is not allowed (e.g. forward currency contracts), and thus not enforceable by law. However, some scholars of the subcontinent consider bilateral promise as enforceable by law except for the bilateral promises in transactions like shortselling of currencies or shares of joint stock companies. Notwithstanding the binding nature of promise, the difference between a contract ('Aqd) and a bilateral promise is that the ownership in bilateral promise is not transferred at the time of signing the promise, while in 'Aqd, not only the ownership transfers but also the rules of inheritance apply as soon as it is executed.

The binding nature of promise has important implications for Islamic banks' operations in respect of Murabaha to Purchase Orderer, Ijarah-wal-Iqtina', Diminishing Musharakah, which is used by many Islamic banks in the world for housing finance, and for the disposal of goods purchased by banks under Salam/Istisna'a.

Token Money (Hamish Jiddiyah) and 'Arb¯un

In the case of binding promises, Islamic banks take token money from the promisee clients, which is the amount taken from them to convey seriousness in purchasing the relevant commodity/asset. In Arabic, this is called Hamish Jiddiyah – the margin reflecting the firm intention of the promisee. Banks hold token money as a trust and adjust it in price at the time of the execution of the sale. This means that Hamish Jiddiyah is taken before the execution of an agreement, as against 'Arb¯un, which is taken from the buyer as part of the price after execution of the sale agreement. In cases where the bank undertakes some activities and incurs expenses in purchasing the asset for onward sale to the promisee, and the latter fails to honour the "promise to purchase", the bank can recover the actual loss from the promisee; the excess/remaining amount of Hamish Jiddiyah will have to be given back to the client.

The actual loss does not cover the loss in respect of "cost of funds". 'Arb¯un is the earnest money given at the time of execution of the sale as part of the price.

Such amounts are also taken in tenders, in which the bidders show their intention to purchase an asset at a certain price and instantly give a part of it to the seller who has called the bid. If the bid is accepted, the amount becomes part of the price. So the amount is treated as a trust until the time of bidding and the

nonsuccessful bidders have the right to get it back. Bidders can cover actual damage sustained in the bidding process.

The seller, after execution of the sale against a part payment, has the right to retain the whole amount of 'Arb¯un if the other party has failed to perform within the period stipulated in the agreement. The AAOIFI, however, considers it preferable to refund the amount over and above the loss actually sustained by the seller.

Types Of Contracts

Contracts can be classified with respect to a number of perspectives. With respect to validity or otherwise as per Shari'a rules, jurists in general divide contracts into two types, namely: valid (Sahih) and invalid (Batil) contracts. A valid contract is one that satisfies all of its conditions, while an invalid contract is one in which one or more conditions for legality are violated.

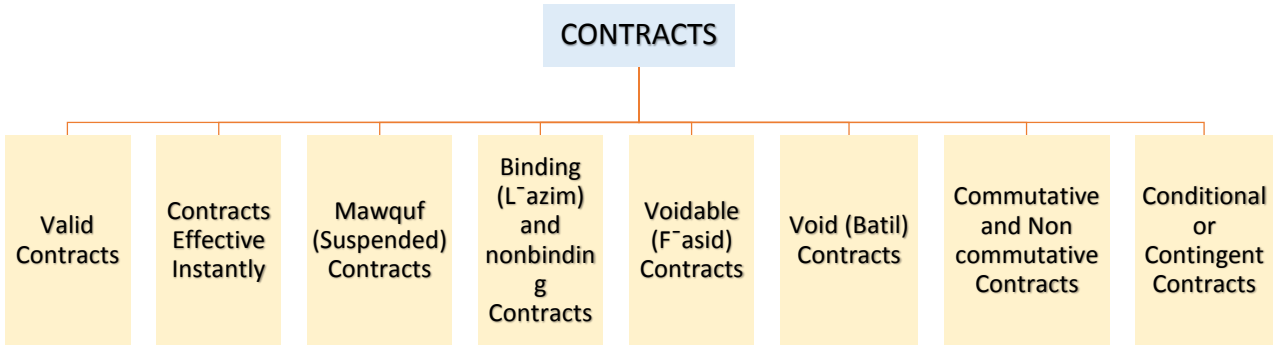

Fig 1.4

Valid Contracts

The validity of any contract depends on the legality or illegality of the subject matter, the existence and precise determination of the subject matter, delivery or the ability to deliver the subject matter without involvement of excessive uncertainty and precise determination of the price or consideration in a contract.

A valid contract is one which is in accordance with Islamic law, both as regards its 'Asl (fundamental components, nature or essence) and Wasf (accessory circumstances or external attributes). A contract is deemed valid when all elements of the contract (form or offer and acceptance, the subject matter and the contracting parties) are found to be in order; the conditions of each element have been met and it is free from external prohibited activities like Riba, Gharar, etc. The form of the contract requires conformity between offer and acceptance, their issuance in the same session and the existence of Ijab until the issuance of Qabul. It also requires that parties to the contract must be sane and mature in age and that the subject matter must be permissible, in existence, deliverable and known. (Petty purchases of edibles by children that do not create any rights or liabilities for any of the parties are exempt; however, the seller

has to ensure that the children do not get involved in harmful things. Similarly, day-to-day transactions in which offer and acceptance is implied are exempt.)

Contracts Effective Instantly or from a Future Date

Jurists allow the contracts of Ijarah and Istisna'a (manufacturing upon order) to become effective from a future date because a person does not own usufructs immediately as he does in the case of a sale contract, but he owns them gradually, so time is considered in such contracts. Kafalah (suretyship) and Hawalah (assignment of debt) are also considered to be contracts effective from a future date. A Kafil is not required to pay debt immediately when the contract is concluded. So it is valid if the surety were to say to the creditor: "If your debtor has not paid off his debt to you by the beginning of next month, I will make the payment". Similarly, agency, divorce and Waqf are valid from a future date. A contract of bequest, by its nature, also admits delay, as it cannot be enforced in the life of the legator.

The contract of Ijarah can be either immediately enforceable or made effective from any future date.

Mawquf (Suspended) Contracts

The following may be causes for suspending the effects of a valid contract:

1. Defective capacity of any of the parties, e.g. a transaction by a minor which has the likelihood of both benefit and harm is valid subject to ratification, which may be accorded by the guardian after the transaction and before the minor attains puberty, or by the minor himself after puberty if the guardian did not object before his attaining puberty. The status of such a contract is that if ratification is granted, it acts retrospectively from the date of the contract, but if ratification is refused, the contract becomes void.
2. Lack of proper authority, i.e. the person acting as agent does not have proper authority over the principal – the contract by a Fuduli (a person who is neither guardian nor agent, or if he is an agent, he transgresses the limits prescribed by the principal). It is also subject to ratification as in case 1 above.
3. The right of any third party. If the owner sells a property mortgaged by someone, it will be subject to ratification by the mortgagee. If a house owned by A is mortgaged with a bank, A cannot sell it, and if he enters into a contract to sell it, it will be a Mawquf contract. The bank would demand that his debt be paid first. It is important to observe that before ratification, the buyer has the right to revoke the contract but the mortgagor/seller has no right to revoke the contract of sale made by him.

Binding (L¯azim) and nonbinding Contracts

Contracts which are Sahih and Nafiz can be divided into L¯azim (binding) and Ghair L¯azim (nonbinding) contracts. A L¯azim contract is one in which none of the parties has the unilateral right to revoke (without the consent of the other) unless an option (Khiyar-al-Shart) has been granted to a party by virtue of which the right to revoke can be exercised. A contract is Ghair L¯azim if any of the parties has a right to revoke it without the consent of the other.

There are two reasons why a contract might be nonbinding or revocable:

1. The nature of the contract. Some contracts are nonbinding by nature; both parties are allowed to revoke independently. Examples of such contracts are Wakalah (agency),Kafalah (suretyship), Shirkah (partnership), Wadi'ah (deposits or Ama¯nah), and 'A¯ riyah (commodity given for use without any compensation or rent). These contracts are terminable by any of the parties. But if the parties mutually agree that none of them will terminate up to a specified period, the contract will no longer be revocable unilaterally.

   Accordingly, in Islamic banks' investment deposits based on the Shirkah principle, the banks can restrict the depositors to withdrawal before the settled date by putting a clause to this effect in the agreement, i.e. the account opening form. Shareholders of joint stock companies also cannot terminate their shareholding. They can simply transfer their part through the sale of shares in the market.

2. An option (Khiyar-al-Shart) stipulated in the contract prevents it from becoming L¯azim until the time of Khiyar is over. The party possessing the Khiyar of recession can revoke the contract within the period of the option without the consent of the other party.

Voidable (F¯asid) Contracts

A contract that is legal in its 'Asl, i.e. it has all the elements of a contract, but is not legal in its Wasf, i.e. with respect to external or nonessential attributes of the contract, will not necessarily be void, rather it will be voidable or F¯asid, and can be regularized or validated by removing the cause of irregularity.

If a contract is structured in a way that is prohibited, it can, under certain circumstances, be rectified by removal of the objectionable clause, or it may result in the entire contract being annulled. If conditions of less importance, like minute specifications of subject matter, are not fulfilled, the contract will be capable of ratification, but will be void due to defect until the defect is removed or compliance with the Shar¯ı´ah conditions is achieved. If the defect is rectified, the contract becomes valid.

Causes of Irregularity in Voidable (F¯asid) Contracts

Causes of invalidity are of two types:

1. Intrinsic causes which relate to the basic elements of the contract, such as unlawfulness or nonexistence of the subject matter, or the absence of contractual capacity in any of the parties.
2. Extrinsic causes that relate to Wasf, i.e. external attributes such as Riba or Gharar contained in the contract.

It is pertinent to note that Riba and Gharar are causes of irregularity of a contract in

Hanafi law, while in other schools they are causes of invalidity of a contract. However, even in Hanafi law, a Riba- or Gharar-based contract is not enforceable and only removal of the term involving Riba or Gharar would validate it.

Legal Status of the F¯asid (Voidable) Contract

A voidable contract must be revoked without the consent of either party. Therefore, no rights or obligations arise. However, if the cause of defect or irregularity is removed, the contract becomes valid. The legal position of such a contract depends upon whether the goods have been delivered or not. For example, if the subject of sale, not previously identified, is mutually identified, the sale contract is valid. If a lender has put the condition of interest in a loan contract, the condition of charging interest is invalid and if this condition is removed, the loan contract becomes valid and the debtor has to pay only the principal sum of the loan. Here, the rule may be kept in mind that non commutative contracts (like the contract of loan) do not become void with a void condition. Only the condition has to be removed.

As such, a valid contract can be differentiated from a voidable contract in the following manner:

- Ownership in a valid contract is transferred from the seller to the purchaser by mere offer and acceptance, whereas in a voidable contract it is transferred to him by possession taken with the consent of the seller.
- In a voidable sale, the value of the commodity, i.e. its market price, is admissible, whereas in a valid contract, an agreed price is paid. In a voidable lease contract, the lessor is entitled to equitable and proper rent (according to the market rate) and not to the rent specified in the original lease agreement. Similarly, in a voidable partnership, each partner gets the profit in proportion to his capital and not according to the agreement.

Void (Batil) Contracts

Contracts that do not fulfil the conditions relating to offer and acceptance, subject matter, consideration and possession or delivery, or involve some illegal external attributes are considered void (Batil).

A Batil contract does not give rise to any effect, i.e. the buyer will not have the title to the subject matter; the seller will not have the title to price or the consideration; ownership will not transfer and the transaction will be null and void. If delivery of the goods has already been made, the same would have to be returned to the other party regardless of whether such illegality was known to the parties. If the buyer sells the goods to a third party after taking delivery, the original seller cannot be prevented from claiming the goods. The reason is that ownership cannot be transferred through a contract that is Batil. This Hukm is clearly different from that of a F¯asid contract, which has been discussed above.

Commutative and Non commutative Contracts

With respect to the consideration or counter value in exchange, contracts are of two types.

The first are Uqood-e-Mu‘awadha, or compensatory/commutative contracts, as a result of which one party can get remuneration or compensation – like sale, purchase, lease and Wakalah contracts. The other kind is that of Uqood Ghair Mu‘awadha or non commutative contracts, wherein one cannot get any return or compensation – like contracts of loan

(Qard), gift (Tabarru/Hibah), guarantee (Kafalah) and assignment of debt (Hawalah). Any consideration in the contracts of loans, guarantee, against guarantee *per se* and assignment of debt would be illegal.

Uqood-e-Mu‘awadha (Commutative Contracts)

Among commutative contracts (sale, hire and manufacturing), sale contracts can be further classified as follows:

Classification according to object:

- Bai‘ Muqayadhah (barter sale);
- Bai‘ al H¯al (simultaneous exchange of goods for money, spot sale);
- Bai‘ al Sarf (exchange of money or monetary units);
- Bai‘ Salam (sale with immediate payment and deferred delivery);
- Bai‘ Mu’ajjal (deferred payment sale, commonly known as a credit sale);
- Bai‘ Mutlaq (normal sale of goods for money, also called absolute sale).

Classification according to price:

- Bai‘ Tawliyah (resale at cost price);
- Bai‘ Murabaha (resale at cost price plus profit – bargaining on profit margin);
- Bai‘ Wadhi‘ah (resale with loss); (The above three forms of sale are termed Buyu’al Amanator trust sales)
- Bai‘ Musawamah (sale without any reference to the original cost price-bargaining on price).

Ijarah or the contract of hiring is divided into:

- Ijarat al Ashkhas (rendering services);
- Ijarat al Ashya (letting things).
- Istisna‘a (contract of manufacturing).
- Wakalah can be both commutative and non commutative contracts.

Uqood Ghair Mu‘awadha (Tabarru‘) or Gratuitous Contracts

The main feature of these contracts is the donation of property. The donor transfers ownership of any property to a party without consideration. The following contracts fall under this category:

- Hibah (gift);
- Wasiyyah (bequest);
- Waqf (endowment);
- Kafalah (guarantee);
- ‘A¯ riyah (loan of usable item free of any charge);
- Loan (Qard);
- Hawalah (assignment of debt).

Among these contracts, Kafalah, Qard and Hawalah are directly relevant to Islamic banking operations, but they cannot charge any profit against these contracts *per se*. However, they can charge fees for other services provided on the basis of Wakalah or Ju‘alah. For example, while issuing L/Cs, guarantees, etc., banks can charge for their services depending upon expenses incurred for issuing guarantees. These charges can be amount-based (possibly slabs) but not time-based.

Legal Status of Commutative and Noncommutative Contracts

Compensatory/commutative contracts like sale, purchase, lease and other remunerative agreements become void by inserting any void condition. Non compensatory/voluntary agreements do not become void because of a void condition. The void condition itself becomes ineffective. For example, a person enters into an interest-based loan; the condition of charging interest on the loan would be void but the loan contract will remain effective, the debtor will have to repay the loan/debt as it becomes due. Similarly, Gharar (uncertainty) does not invalidate non compensatory contracts; for example, jurists indicate that donation of a stray or unidentified animal or fruit before its benefits are evident or a usurped commodity is permissible, but their sale is not valid.

Conditional or Contingent Contracts

As a general rule, conditional contracts are not valid. This, however, requires some detail and some conditions could be acceptable. We find discussion in the Fiqh literature on three types of stipulations/conditions:

1. T‘aliq – conditions which suspend a contract to any future event.
2. Idafa – an extension that delays the beginning of any contract until a future time.
3. Iqtiran (concomitance) that varies the terms of the contract.

In all these cases the contract may or may not be void even if the condition is void. Various jurists differ with regard to the result of stipulation. Both Hanafis and Hanbalis allow some delay in beginning contracts like lease of agency (where property is transferred only over time) until any future event, but not for sale.

However, they do not approve a condition that the buyer will never resell the object. The conditions that pose problems are those by which any of the parties gets an additional benefit.

Here, jurists differ but Ibn Taymiyah has taken a practical approach by rejecting only those conditions which are in contradiction with the Qur'¯an and Sunnah or the Ijma'a, or which contradict the very object of the contract.

As regards the overall view of different schools of thought, Hanbali jurists emphasize the supremacy of the discretion of contracting parties and allow every condition and stipulation as long as it does not contradict any text from the Qur'¯an or the Sunnah. The Hanafi, Sh¯afi'¯I and Maliki jurists divide conditions into valid, irregular and void.

A void condition is any condition which directly infringes any rule of the Shar¯ı´ah, or inflicts harm on one of the two contracting parties or derogates from completion of the contract. We can therefore conclude our discussion on the subject of conditions in contracts by stating that a condition or stipulation which is not against the main purpose of the contract is a valid condition. Similarly, a condition which has become a normal practice in the market is not void provided it is not against any explicit injunctions of the Holy Qur'¯an or Sunnah. For example, a condition that the seller will provide five years' guarantee and one year's free service is not void, neither is the availability of a warranty against defective goods a problem. Similarly, conditions may be imposed in a sale regarding the service or repair of any manufactured item sold to a buyer. The parties can give each other an option to cancel a transaction during a given period after the conclusion of that transaction.

Further Reading:

- ✓ ***Understanding Islamic Law: From Classical to Contemporary By Hisham M. Ramadan***
- ✓ ***Intent in Islamic Law: Motive and Meaning in Medieval Sunnī Fiqh By Paul R. Powers***