ISLAMIC LIABILITY (ḌAMĀN)AS PRACTICED BY ISLAMIC FINANCIAL INSTITUTIONS

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I. INTRODUCTION

Islamic liability principles and rules (*aḥkām al-ḍamān*) have significant implications for the practice of Islamic finance. Indeed, one of the philosophical underpinnings of Islamic finance lies in a famous *ḍamān* principle: "gains follow the risk of loss" (*kharāj bil-ḍamān*), which is sometimes expressed in the form of a prohibition of any profits unaccompanied by risk (*ribḥ mā lā yuḍman*). In addition, a number of Islamic prohibitions limit the legal protection and remedies available to Islamic financiers offering these two different sets of instruments. Most notable among such prohibitions are the prohibition of unjust enrichment (*akl al-māl bil-bāṭil*), the proscription of usury (*ribā*; which according to most contemporary scholars, includes any element of interest or increase over the principal amount of a loan), and the restrictions against excessive uncertainty or speculative risk-taking (*gharar fāḥish*). Undoubtedly, operating within a legal environment characterized by such a limited scope of remedies represents a major challenge to Islamic financial institutions ("IFIs"), i.e., financial institutions offering Islamic law (*Sharīʿa*)-compliant financial products.

The implications of *aḥkām al-ḍamān* extend to the two models dominating contemporary Islamic financial practices: (1) the partnership or profit/loss sharing ("PLS") financing (equity instruments) model, which was adopted mostly during the early stage of contemporary Islamic finance; and (2) sale and lease-based financing (debt instruments) model, which is currently prevailing in Islamic financial markets.

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This Article explores the implication of the rules of *ḍamān* for the practice of Islamic finance by examining the implementation of such rules in contemporary Islamic financial contracts. From a *ḍamān* perspective, such contracts can be grouped under two opposing categories: (1) contracts of trust (*ʿuqūd al-amāna*), including silent partnership (*muḍāraba*), partnership (*mushāraka*), and agency (*wakāla*); or (2) contracts of implied guarantee or liability (*ʿuqūd al-ḍamān*), including sale (*bayʿ*) and its derivatives such as: pre-manufacturing sale (*istiṣnāʿ*); forward sale(*salam*); commissioned sale (*murābaḥa*); loan (*qarḍ)*; and lease (*ijāra*).[1]

ʿUqūd al-amāna are contracts in which possession of a property transfers from one contracting party, the entrusting party (*musta'min*), to another, a trustee or fiduciary (*amīn*), who holds such a property on behalf of the former. In the context of Islamic finance, *amāna* contracts are contracts under which the financing party bears the risk of loss of the financed assets while the financed party ("IFI customer") is considered a trustee or fiduciary (*amīn*) acting on behalf of the capital provider ("IFI").[2] As an *amīn,* the financed party is exonerated from the risk of loss of the property held by him under the *amāna* contract.

Unlike the case in *amāna* contracts, the transfer of possession pursuant to a contract of *ḍamān* is always accompanied by a simultaneous shift in the responsibility for the risk of loss of the subject matter. Under a *ḍamān*-based financial contract, the financed party bears the risk of loss, i.e., unless such a party can prove otherwise, he is presumed liable (*ḍāmin*) for the loss of the financed assets.

While the majority of IFI financing is offered through financial instruments belonging to the *ḍamān*–contract category, a relatively small percentage of such financing is offered through *amāna*-based financial instruments. IFIs' preference for *ḍamān*-based financing reflects the excessive risks to which the financing party in *amāna* financing is exposed. *Amāna* financing involves high agency cost, moral hazard, and incentive problems. These

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1 *ʿUqūd al- ḍamān* includes also the contract of *ṣarf* (currency exchange).

2 It is more appropriate to use the term *amāna* financing rather than profit and loss sharing ("PLS"), because while both partnership and *muḍāraba* incorporate the PLS principle, a *wakāla* contract allows for the payment of a fixed fee in exchange for a service provided by the agent.

problems are further intensified by the lack of appropriate organizational and regulatory support at the IFI level. In the following pages, we shall explore the *ḍamān*-related risks, i.e., risks related to the Islamic liability status of the party receiving financing, associated with both *amāna* and *ḍamān* contracts. This exploration will be followed by an analysis of *ḍamān* provisions in a selected sample of Islamic financial contracts obtained from a number of IFIs.[3] The objective of this analysis is to assess the validity and effectiveness of the techniques used by IFIs to mitigate the *ḍamān*-related risks associated with the practice of Islamic financial contracts.

II. *ḌAMĀN* IN IFIs' *AMĀNA* FINANCING

The rules of *ḍamān* applicable to *amāna* contracts, specifically the lenient standard of liability applicable to the *amīn* and the limitations on security and remedies, are some of the important factors contributing to the general lack of *amāna*-based financial transactions (*amāna* financing) in current Islamic financial markets. These rules of *ḍamān* increase the risks associated with *amāna* financing and make it difficult for IFIs to mitigate such risks. As Islamic finance authors, Lewis and Algaoud, have noted, the lack of collateral under the rules of *ḍamān* "may aggravate the adverse selection problem" inherent in this type of financing.[4]

Amāna financing, commonly referred to as Profit Loss Sharing ("PLS"), represents only a small percentage of total financing offered by IFIs. According to the International Association of Islamic Banks, the percentage of PLS financing is less than 20

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[3] IFIs are generally reluctant to disclose sample contracts. The difficulty in obtaining such samples represents a challenge for researchers in the field and an impediment to shedding light on the practice of Islamic finance. Even when such samples can be obtained, they generally come along with the proviso that the confidentiality of the identity of the IFI must be maintained. Finally, the number of *amāna* or equity-based financial contracts that are available for the researcher's examination, such as *mushāraka* and *muḍāraba*, are even more limited in comparison with the availability of *ḍamān*-based contracts. This is understandable in light of the fact that, as we shall see in the following section, most IFI financing is offered through *ḍamān*-based instruments as opposed to equity financial instruments.

[4] Mervyn K. Lewis & Latifa M. Algaoud, Islamic Banking 167 (2001).

percent.[5] According to another study on *Dār al-Māl al-Islāmī* ("DMI"), one of the largest Islamic banking groups with more than twenty-five IFI affiliates, on average, the use of *muḍāraba* and *mushāraka* in 1997 was limited to 5.45 percent and 3.85 percent, respectively.[6] As more recent literature observes, there is no evidence that these figures have changed significantly since the publication of the above-referenced studies.[7]

The lack of *amāna* financing continues to be heavily criticized by commentators who consider *amāna* financing more consistent with Islamic principles. The renowned Islamic scholar Muhammad Taqi Usmani, a strong supporter of Islamic finance and a member of many IFI *Sharīʿa* boards, goes so far as considering *amāna* financing "the basic philosophy of Islamic banking," which has been neglected by IFIs.[8] Another Islamic finance author, Gohar Bilal, writes, "[e]quity finance is considered the backbone of Islamic finance. Yet, in the last two decades [1980s and 1990s], debt finance, i.e., short-term *murābaḥa*, has been the most popular mode of financing for Islamic banks."[9] Indeed, the lack of *amāna* financing causes Islamic finance practitioners some uneasiness in light of the fact that *amāna* financing has been presented in Islamic finance literature as the Islamic alternative to socio-economic ills associated with interest-based financing. Thus, by failing to fully embrace *amāna* financing with its benign risk-sharing aspects and emphasis, the Islamic finance industry could be accused of not practicing what it preaches.

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5 Humayun A. Dar & John R. Presley, *Lack of Profit Loss Sharing in Islamic Banking: Management and Control Imbalances*, Int'l J. Islamic Fin. Services, July-Sept. 2000, at 3, 3, *available at* http://www.iiibf.org/journals/journal6/art1.pdf; *see also* Mohammad Omar Farooq, Partnership, Equity-Financing and Islamic Finance: Whither Profit-Loss-Sharing? (forthcoming) (manuscript at 2-3, *available at* http://www.globalwebpost.com/farooqm/main.htm).

6 Percentages are calculated by taking an average percentage of the total use for each instrument across the fourteen DMI banks included in the study. See Lewis & Algaoud, *supra* note 4, at 137 tbl.6.6.

7 *See generally* Farooq, *supra* note 5, at 2-3 (suggesting that the 1996 figures cited by Dar & Presley, *supra* note 5, are still accurate); Muhammad Taqi Usmani, An Introduction to Islamic Finance (2002).

8 Usmani, *supra* note 7, at 113. Mohammad Farooq included this quotation in his forthcoming work. Farooq, *supra* note 5, at 5.

9 Gohar Bilal, *Islamic Finance: Alternatives to the Western Model*, Fletcher F. World Aff., Winter / Spring 1999, at 145, 157; *see also* Ḥasan Yūsuf Dāwūd & Yusuf Kamal Muhammad, al-MaṢārif al-Islāmiyya fi al-Tanmiyya al-Sha'iyya 50 (1998).

Some commentators defend, or at least find legitimate excuses for, the lack of *amāna* financing and for the IFI fixation on trade finance instruments, such as mark-up sales (*murābaḥa*) and credit sales (*bay' bi-thaman ājil*). First, it is argued that such debt instruments are sanctioned by the *Sharī'a* and any sound financial system must offer investors both debt and equity options. One Islamic economist writes:

> As economists started from the principle of interest prohibition, they thought that an Islamic economy would be devoid of all debt. As we know, finance can be optimal only through a combination of debt and equity. Profit-sharing puritans would have the Islamic economy unintentionally deprived from such advantage. As economists learned more about the jurisprudence of transactions in Islam, they realized that either the price or the delivery of the commodity could be postponed. When the former is postponed, a debt is automatically created. To ignore that would be an unfortunate misunderstanding.[10]

It is true that Islamic law sanctions debt instruments such as credit sales and *salam*; however, the above argument does not address IFIs' categorical and persistent failure to implement equity financing along with debt financing.

Some authors also suggest that the lack of *amāna* financing is due to the practical problems it poses "especially in the present atmosphere where [IFIs] are working in isolation, and mostly without the support of their respective governments."[11] The problem with this suggestion is that it does not explain why *amāna* financing has also failed in countries such as Pakistan, Iran, and Sudan, where Islamic finance is fully endorsed by the government and the entire financial system has been officially Islamicized.

Another reason for IFIs' resistance to *amāna* financing, which has been pointed out by a number of economists and Islamic bankers, is the agency costs and moral hazard problems associated

[10] Mabid Ali al-Jarhi, Islamic Banking and Finance in the 21st Century, Keynote Address 3 (August 9-12, 1999), *in* International Conference: Islamic Economics in the 21st Century 1, 4 (on file with author).

[11] Usmani, *supra* note 7, at 113. The unfair tax treatment of profit compared to interest, which is in many cases tax-exempt income, is a related reason suggested by some authors. However, *amāna* financing remains at low levels even in countries that apply the same tax exemptions offered to interest to the profits earned through the use of Islamic finance instruments. Malaysia is an example of one such country.

with *amāna* financing.[12] From an *ex-ante* perspective, it is argued that financial institutions offering *amāna* financing are subject to adverse selection problems as they are more likely to attract borrowers who realize that their projects are highly risky and may, therefore, be inclined to present to their financers inflated pro-forma numbers about their expected profits.[13]

In addition, and from an *ex-post* perspective, *amāna* financing is condemned for exposing capital suppliers to moral hazard and corruption risks in the form of underreporting of shared profits by borrowers.[14] According to this argument, IFIs are not able to adequately implement partnership financing due to the low ethical standards that dominate today's Muslim societies. Sāmī Ḥummūd, a well-known Islamic finance author and banker, notes:

> Islamic banks that cautiously offered *muḍāraba* financing in the early years of contemporary Islamic finance history did not, unfortunately, find trustworthy *muḍāribs*, neither did they find a legal system that defines the relationship between the *muḍārib* and the capital provider. In addition, there was no Islamic public opinion that can impose pressure on the *muḍāribs* and expose their wrongdoings.[15]

Indeed, many major IFIs offered this form of financing in the early stages of Islamic finance in response to the early rhetoric in Islamic economics literature about the benevolent aspects of *amāna* financing. Unfortunately, many of them failed. Underreporting and fraud in general have been emphasized by many bankers as reasons for this failure and for discouraging IFIs from using *amāna* instruments. During an extended interview with Mr. Maḥmūd al-Ḥelw, the former Chairman of the FIBE, Mr. Ḥelw explained with some bitterness how FIBE lost its enthusiasm about offering financing to its clients on *mushāraka* and *muḍāraba* bases.[16] He indicated that a large percentage of FIBE's *mushāraka* and *muḍāraba*

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[12] The agency problems of *amāna* financing are particularly important in light of the relatively poor market infrastructure, institutional underdevelopment, and lack of transparency and adequate regulations from which the financial markets of most Muslim countries suffer.

[13] *See* Volker Nienhaus, *Profitability of Islamic PLS Banks Competing with Interest Banks*, J Res. Islamic Econ., Summer 1983, at 37, 42-44.

[14] Paul S. Mills & John R. Presley, Islamic Finance: Theory and Practice 27 (1999).

[15] 'Abd al-Mun' im Abū Zayd, Naḥwa Taṭwīr Niẓām al-Muḍārabah fi al-Masarif al-Islāmiyya 106 (2000).

[16] Interview with Maḥmūd al-Ḥelw, Former Chairman, Faisal Islamic Bank of Egypt, in Cambridge, Mass. (Dec. 7, 1997).

clients forged their financial records to show that their FIBE-financed businesses made only marginal profits or even losses while in reality such businesses were making substantial profits.[17]

Mr. al–Helw's statements are consistent with the results of an empirical study of the *amāna* financing offered by Islamic Banks in Egypt during the 1980s. The study attributed the high risk involved in such financing in the Egyptian Market to the dishonesty which characterizes many Islamic banking clients.[18] A similar study conducted by Faisal Islamic Bank of Sudan ("FIBS") also concluded that the lack of honesty and the systematic breach of trust by their customers were responsible for increasing the risk of *muḍāraba* financing offered by FIBS to prohibitive levels.[19]

While it is true that corruption in contemporary Muslim societies is considered extremely high by international standards, it is utopian to suggest that we must wait for an ideal Muslim society before IFIs can safely practice *amāna* financing. In addition, it is unreasonable to place all the blame for the failure of *amāna* financing on IFIs' corrupt and uneducated Islamic clients. IFIs are partially responsible for the negative outcome of their *amāna* financing experiences. Moreover, such experiences do not prove the impracticality of *amāna* financing in general. They only provide some empirical evidence of the failure of *mushāraka* and *muḍāraba* financing under the current organizational and legal structure of IFIs.

Evidence of the great potential of *amāna* financing, particularly in the context of microfinance, can be drawn from one of the earliest IFI initiatives, the Mit Ghamr Local Savings Bank. In this initiative, the concept of *amāna* or PLS financing was successfully implemented by Aḥmad al-Najjār, an Egyptian economist and the acclaimed founder of the first modern IFI, in his micro-finance experiment that took place in the early 1960s in Mīt Ghamr, Egypt.

Najjār's Mīt Ghamr Local Savings Bank was able to offer PLS, unsecured credit to farmers and small entrepreneurs living in the bank's vicinity. Despite the incentive and moral hazard problems usually associated with equity finance, the bank was able

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17 *Id.*

18 Abū Zayd, *supra* note 15, at 107.

19 *Id.* at 106.

to maintain a very low default rate. This was possible through the adoption of a relational approach based on establishing close and long-term relationships with the bank's customers. In addition, the Bank and its small branches were located within close proximity to the financed projects, which enabled the Bank to monitor such projects effectively and efficiently. Furthermore, the rural environment in which the Bank operated was a high-trust environment where honesty and trustworthiness were socially and economically rewarded, while dishonesty and fraud were severely punished by social and economic isolation. Despite the lack of effective legal protection for PLS financiers under Islamic law, Najjār was able to capitalize on the non-legal sanctions available in such trust- and relationship-based communities in order to minimize the financial and operational risks to which his bank was exposed.

In order to assess the challenges faced by IFIs in implementing the rules of *ḍamān* in their *amāna* financing, the following section offers an analysis of the application of the rules of *damān* in a sample of *amāna* contracts. The examined samples are silent partnership *(muḍāraba)*, partnership *(mushāraka),* and agency *(wakāla)* contracts.[20] As indicated earlier, the financed party, who is considered an *amīn*, enjoys a non-conclusive presumption of honesty and competence with respect to the property entrusted to him pursuant to the *amāna* contract, as long as he does not commit a breach (*taʿaddī*; lit., trespass) or negligence (*taqṣīr*).[21] Because of the presumption of honesty, trustworthiness, and competence enjoyed by the *amīn*, the burden of proving his *taʿaddī* is on the accusing party. An example of a contractual provision that reflects these rules is Article 8 of the *Muḍāraba* standard contract used by Jordan Islamic Bank, which stipulates that, "the bank is solely responsible for any loss in the *muḍāraba* capital, while the *muḍārib* loses only his effort, except in the case of *taqṣīr* or *taʿaddī* by the latter."[22]

As we shall see from the following examination of the *ḍamān* aspects of these *amāna* contract samples, IFIs are not always

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[20] While *muḍāraba* and *mushāraka* are the most common forms of IFI *amāna* financing, many Islamic financial transactions incorporate the concept of *wakāla* in their structures.

[21] ʿAlī al-Khafīf, al-Ḍamān fī al-Fiqh al-Islāmī 107 (Cairo, Maʿhad al-Buḥūth wa al-Dirāsāt al-ʿArabiyah 1971).

[22] Abū Zayd, *supra* note 15, at 81.

willing to allow their *amāna* finance customers to benefit from the presumption of innocence granted to them under the above principles. In some instances, IFIs reverse this presumption by including in their standard contracts provisions that impose on the IFI customer the burden of proving that he did not commit *taʿaddī*. There is also a tendency in these contracts to require the *amīn* to provide guarantees and other forms of security to cover losses resulting from his *taʿaddī* or, as in some cases, any other cause.

A. Managing *Ḍamān* Risks in IFI *Muḍārabas*

1. Rules of *Ḍamān* in *Muḍāraba* Contracts

A *muḍāraba*, also known as *qirāḍ*, is a contract between a capital provider (*rabb al-māl*) and an entrepreneur (*muḍārib*), whereby the latter undertakes to invest and manage the capital provided by the former in exchange for an agreed percentage of the profit generated from investing such capital.[23] Although the *muḍāraba* parties may negotiate the percentage allocated to each of them, neither party may stipulate a fixed sum of money as a guaranteed return on his *muḍāraba* contribution.

A *muḍāraba*, therefore, involves the transfer of only the possession of the *muḍāraba* capital to the *muḍārib*, while ownership of such capital remains with *rabb al-māl*. As mentioned earlier in connection with theour discussion of the distinction between *yad al-amāna* and *yad al-ḍamān*, a *muḍārib* receives the *muḍāraba* capital as a trust (*amāna*) property for the sole purpose of investing and managing such funds on behalf of *rabb al-māl*. A *muḍārib* acts as an agent or a trustee on behalf of the capital provider. Once the *muḍārib* realizes profits, he becomes a partner with the capital provider with respect to the distribution of such profits. As Baghdādī explains in his book *Majmaʿ al-Ḍamānāt*: the amount paid to the *muḍārib* is an *amāna*, in his possession, because he manages it upon an authorization from its owner, not on a reciprocal basis or for surety purposes. The *muḍārib* is an agent

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[23] While classical scholars offer different definitions for *muḍāraba*, this definition covers main the elements of *muḍāraba* which are commonly agreed among the Sunni schools. *See* Ṣafiyya ʿAbd al-ʿAzīz al-Sharqāwī, al-Takkayuf al-Sharʿī li-Sharikāt al-Muḍāraba al-Isālmiyya 13-24 (1991) (discussing the different definitions offered in classical *fiqh* literature).

(*wakīl*), with respect to his dealing with the *muḍāraba* capital, and becomes a partner (*sharīk*) if he realizes profit [as a result of such dealing].[24]

This rule is reiterated by Abū Isḥāq al-Shīrāzī, the renowned classical scholar of the Shāfiʾī school, who states:

> *al-ʿāmil* [*muḍārib*] is an *amīn* (trustee) in relation to the [*muḍāraba*] capital in his possession. He is not liable if such capital is lost [partially or in its entirety] without his *tafrīṭ* (negligence or abuse) for he is acting, in relation to such capital, as an agent of *rabb al-māl*.[25]

On the other hand, if the *muḍāraba* does not generate any profit, or suffers loss, the *muḍārib*'s status remains a *wakīl*, who is not liable for the lack of profit or the occurrence of loss, provided he does not breach this trust by committing an act of transgression (*taʿaddī*). However, the *muḍārib* is not entitled to any compensation for his time or effort.

Therefore, under a *muḍāraba* contract, a transfer of risk does not accompany the transfer of possession. The *muḍārib* bears no responsibility for the partial or total loss of the *muḍāraba* capital, provided he has exerted reasonable care in preserving and investing such capital. It should be noted that if the *muḍāraba* money is lost before the *muḍārib* is able to make any investment, the *muḍāraba* would be terminated.[26]

Any stipulation purporting to shift the transfer of loss of the *muḍāraba* capital is invalid. For example, if the *muḍārib* is required to guarantee the *muḍāraba* capital or a minimum return on the *muḍāraba* investment, the requirement is unenforceable and the contract would be construed as a voidable *ijāra* (*ijāra fāsida*).[27] In this case, the *muḍārib* would be entitled to a *quantum meruit* rent (*ajr*

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[24] Abu Muhammad Baghdadī, Majmaʿ al-Ḍamanat fī Madhhab al-Imām al-Azam Abī Hanīfa al-Nuʿmān 303 (Cairo, al-Maṭbaʿah al-Khayriyah 1890).

[25] 1 Abū Isḥāq Ibrahīm ibn ʿAlī ibn Yūsuf Firūzabādī al-Shīrāzī, al-Muhadhdhab fī Fiqh al-Imām al-Shāfiʿī 508-09 (Muḥammad ibn Aḥmad Battal & Zakariya ʿUmayrāt eds., Beirut, Dār al-Kutub al-ʿIlmiyya 1995); *see also* 8 ʿAlī ibn Aḥmad ibn Ḥazm, al-Muḥallā 248 (Egypt, Maktabat al-Jumhūriyya al-ʿArabiyya 1967-1971) (on file with author).

[26] BaghdādĪ, *supra* note 24, at 308.

[27] 5 Muwaffaq al-Dīn ʿAbd Allāh ibn Aḥmad Ibn Qudāma, al-Mughnī 72 (Khaṭṭāb Muḥammad Sharaf al-Dīn Ṣādiq Ibrāhīm & Sayyid Muḥammad eds., Cairo, Dār al-Hadīth 1996); 2 Abī al-Walīd Muḥammad ibn Aḥmad ibn Muḥammad ibn Rushd al-Qurṭubī al-Andalusī (Averroes), Bidāyat al-Mujtahid wa-Nihāyat al-Muqtaīd 292 (ʿAbdul Rahīm Muḥammad ʿAbdul Ḥalīm ed., 2d ed., al-Azahar, Dār al-Tawfīq al-Namūdhajiyya lil-Ṭibāʿa 1983) (on file with author); Baghdādī, *supra* note 24, at 304.

al mithl) and any profit realized from investing the *muḍāraba* capital will be for the capital provider.[28] Some contemporary scholars including Sheikh ʿAbd al-Wahhāb Khallāf, Sheikh ʿAbd al-ʿAẓīm Baraka, and recently, Muḥammad Sayyid Ṭanṭāwī, Mu ammad Sayyid. *MuʿĀmalāt Al-Bunūk Wa-Aḥkāmuhā Al-Sharʿiyya.* al-ʿAbbāsiyya, al-Qāhirah: M.S. Ṭanṭāwī have challenged the guaranteed fixed return restriction arguing that there is no explicit text in the *Sharīʿa* to support such restriction.[29] In their opinion, the capital provider's need to stipulate a guaranteed minimum return can be justified in the interest of protecting the public in light of the increasing corruption in today's society.[30] Khallāf argues that since stipulating such a provision benefits both side of the transaction, i.e., the *muḍārib* and *rabb al-māl*, it should be allowed because God does not forbid people from doing that which benefit them and does not harm (*ḍarar*) anyone else. According to Khallāf, prohibiting people from practicing this form of business would result in *iḍrār* (deliberate or unnecessary collective harm, which is against the Prophetic *ḥadīth* of *lā ḍarar wa-lā ḍirār*).[31] In support of Khallāf's public interest argument, Ṭanṭāwī cites an analogy to the prohibition of setting price limits in the market. Although the prophet refused to impose such limits during his life time, many scholars who came after the death of Prophet Muhammad allowed the ruler or government to impose such limits if necessary to protect the public interest.[32]

2. Muḍārib's Taʿaddī

Although a *muḍārib* does not bear the risk of loss of the funds he invests on behalf of the capital owner, nor does he

[28] Baghdādī, *supra* note 24, at 304.

[29] Muḥammad Sayyid Ṭanṭāwī, Muʿāmalāt al-Bunūk Wa-Aḥkāmuhā Al-Sharʿiyya 134-35 (Cairo, M.S. Ṭanṭāwī 1991).

[30] At least, Ṭanṭāwī argues, this type of transaction should be construed as a *muḍāraba fāsida*, not a loan with interest. Ṭanṭāwī, supra note 29, at 134-43, 154, 183; *see also* Muḥammad Sayyid Ṭanṭāwī, Grand Sheikh, al-Azhar University, Fatwfatwa (Dec. 2, 2002) (declaring conventional savings deposits as a lawful form of investment when both parties agree in advance that the bank guarantees a fixed return) (on file with author).

[31] Ṭanṭāwī, *supra* note 29, at 135. Ṭanṭāwī references 11 ʿAbd al-Wahhāb Khallāf, Majallat Liwāʾ al-Islām (1951).

[32] 4 Burhān al-Dīn ʿAlī ibn Abī Bakr al-Marghīnānī, al-Hidāya: Sharḥ bidāyat al-Mubtadī 93 (Bulaq, al-Maṭbaʿa al-Kubrā al-Amīriyya 1315H) (on file with author); Ṭanṭāwī, *supra* note 29, at 137.

guarantee a certain level of return, he is required to invest and manage the *muḍāraba* capital in accordance with the terms of his *muḍāraba* and the relevant custom. Failing to follow such terms or custom exposes the *muḍārib* to liability in the event of loss. For example, if he is instructed to limit investment to a certain product or a specific region, it would be considered an act of *taʿaddī* if he invests in a different product or region. A breaching *muḍārib* (*mutaʿaddī*; lit., transgressor) becomes *ḍāmin* as to the property subject of the *muḍāraba*.[33] A *muḍārib* who commits *tafrīṭ* or *taʿaddī* is *ḍāmin* and fully responsible for any loss of or damage to a tangible property (*māl*) suffered by the *muḍāraba* during the *muḍārib's* breach, even if the loss was not caused by the breach.[34] The criteria used to determine whether a *muḍārib* (or an *amīn*, in general) has committed *taʿaddī* are objective criteria based entirely on the relevant custom. In his *Majmaʿ al-Ḍamānāt*, the Hanafi medieval scholar, Baghdadi, provides many examples that demonstrate the reliance of custom (*ʿurf*):[35]

> Example (1): A muḍārib may sell for cash or credit because merchants usually do so (dhālika min ṣunʿ al-tujjār). However, if he sells for credit, he may not offer a payment term or schedule that is not customarily acceptable among merchants because his authority is limited by what is customary among people (al-amr al-maʿrūf bayn al-nāss).[36]
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> Example (2): A *muḍārib* may buy an animal to use it for transportation. He may not buy a ship to use it for that purpose. He can, however, rent a ship because it is customary among merchants to rent ships for transportation.[37]
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> Example (3): If *rabb al-māl* did not explicitly say to the *muḍārib* "invest the *muḍāraba* capital as you wish, or as you would invest your money" (*iʿmal bi-ra'yik*), the *muḍārib* would not be *ḍāmin* if he mixes the *muḍāraba* capital with his own, provided that it is customary for the *muḍāribs* in the relevant community to do such mixing. The *muḍārib* would not be liable even if it were common for the capital providers in that community to prohibit

33 8 Abū Bakr ibn Masʿūd Kasānī, Bada'iʿ al-Sana'iʿ fī Tartib al-Shar'iʿ 27 (Lebanon 1986) (on file with author).

34 Kuwait Ministry of Awqāf and Islamic Affairs, *al-ḍamān*, *in* 28 al-Mawūʿa al-Fiqhiyya 52-54, 250 (Kuwait, Tibāʿat Dhāt al-Salāsil 1986) (on file with author).

35 Baghdādī, *supra* note 24, at 305–12.

36 *Id.* at 305.

37 *Id.*

> *muḍāribs* from mixing the *muḍāraba* capital with the *muḍārib's* own money. Therefore, if there is a conflict between the relevant customary rules the benefit of the doubt is given to the *muḍārib*.[38]

As seen in the above examples, classical jurists relied on the *ʿurf* relevant to the *muḍāraba* transaction. This reliance on *ʿurf* in determining whether a *muḍārib* has committed *taʿaddī* is consistent with the role *ʿurf* occupies as a recognized source of Islamic law.[39] In fact, *muḍāraba* itself is an example of a pre-Islamic *ʿurf* that whose practice was approved by the Prophet, who himself acted as a *muḍārib* for his wife Khadīja.

In addition, using custom as a measure of *taʿaddī* adds a built-in protection to *rabb al-māl*, particularly in a non-restricted *muḍāraba* (*muḍāraba muṭlaqa*).[40] This added protection distinguishes the Islamic measure of breach from common law's reasonable person standard and its civil law equivalent, *bon père de famille*. One can imagine certain cases where the *muḍārib's* action may be reasonable and prudent but inconsistent with local custom. In such cases, the *muḍārib* would still be *ḍāmin*. For example, a *muḍārib* in a non-restricted *muḍāraba* may be found liable if he invests the *muḍāraba* capital trading in foreign stocks while it was not customary for *muḍāribs* and investors, in the business community in which the *muḍāraba* took place, to invest in foreign stocks.

B. Risks Associated with *Muḍāraba* Financing

Under *muḍāraba* financing, the capital provider cannot interfere in the management of the *muḍāraba* investment. He can only give instructions to the *muḍārib* at the outset of the *muḍāraba*, such as requiring the latter to limit investment to a certain geographic area or economic sector. In practice, however, IFIs

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38 *Id.* at 312.

39 *ʿUrf* is classified in Islamic jurisprudence literature as a non-textual or *ijtihād*-based source of law. To be valid as a source of law, *ʿurf* must not violate a text from the Quran or Sunna or a unanimous position of Muslim Scholars (*ijmāʿ*). It also must be long-established (*muṭṭarid*). Yūsuf Qāsim, Uīūl al-Aḥkām al-Sharʿiyya 205-10 (Cairo, Dār al-Nahda al-ʿArabiyya 1985).

40 *Rabb al-māl* may choose to impose on the muḍāraba certain restrictions such as limiting the *muḍāraba* to trading in a certain type of good or a specific market or territory, in which case the *muḍāraba* is considered a restricted *muḍāraba* (*muḍāraba muqayyada*).

offering equity financing do not use their management and monitoring rights effectively.

In order to overcome these agency problems in Islamic equity finance, IFIs will have to undertake substantial project appraisal and monitoring operations.[41] One of the challenges facing IFIs is that in order to effectively manage their equity finance assets, they will have to incur the added costs of such operations. These are costs which are not usually incurred by conventional banks. This may increase the price of Islamic finance and render it uncompetitive; however, IFIs can lower the costs of management and monitoring by adopting a number of changes in their organizational structures and implementing appropriate investment strategies.

C. Practice of *Ḍamān* Provisions in IFI *Muḍārabas*

Some of the *muḍāraba* samples show adherence to the *ḍamān* principles governing the risk of loss and the *muḍārib's* status liability. For example, Article 8 of a *muḍāraba* contract used by Jordan Islamic Bank ("JIB") stipulates that "the bank is solely responsible for any loss in the *muḍāraba* capital, while the *muḍārib* loses only his effort, except in the case of *taqṣīr* or *taʿaddī* by the latter."[42] Another clause of this JIB *muḍāraba* contract provides "any losses to the *muḍāraba* capital shall be deducted from the profits [realized from the *muḍāraba* investment] and if losses exceed such profits shall be deducted from the *muḍāraba* capital."[43] The language and terminology of these two provisions indicate clear intention by (JIB) to adhere to rules of *ḍamān* as referenced in classical *fiqh*.

In order to protect the bank from any misuse of the *muḍāraba* assets, JIB's *muḍāraba* contracts include provisions that limit the investment of the *muḍāraba* to a specific project or economic sector and restrict the *muḍārib*'s ability to mix the *muḍāraba* capital with other funds or lend any of it to any person without the bank's approval. Therefore, JIB and other IFIs use this form of restricted *muḍāraba* in order to mitigate the moral hazard

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41 Mills & Presley, *supra* note 14, at 27.

42 Abū Zayd, *supra* note 15, at 81.

43 Muḥammad Uthmān Shibīr, al-Muʿāmalāt al-Māliyya al-Muʿāṣira fī al-Fiqh al-Islāmī 356 (Amman, Dār al-Nafā'is 2007) (on file with author).

and agency problems associated with *muḍāraba* financing. What remains a question, of course, is how would JIB be able to monitor the *muḍārib*'s adherence to these restrictions? The experience of some IFIs shows that the ability to monitor *muḍārib*'s behavior was extremely difficult due to lack of adequate organizational skills and effective monitoring techniques. An example of the difficulty to monitor IFI *muḍāribs* has already been provided in the above-mentioned experience of Faisal Islamic Bank of Egypt.

1. IFI Legal Tactics to Mitigate *Muḍāraba* Risks

In an attempt to avoid abusive practices by their *muḍāribs*, some IFIs resort to a contractual provision that reverses the presumption innocence, which Islamic law grants to the *muḍārib*, if the *muḍāraba* fails to reach its projected profits or if the *muḍārib* fails to abide by the terms of the *muḍāraba*. For example, the standard *muḍāraba* Faisal Islamic Bank of Egypt ("FIBE") provides that:

> [A]ccording to the [feasibility] study, he total profits are projected to be [.] % annually. The contract also requires the *muḍārib* to hold proper accounting books for the *muḍāraba* project and imposes on him a penalty, in the form of a reduction in the percentage of profits given to the *muḍārib*, if he fails to hold such books.[44]

As an additional protective measure, some IFIs require their *muḍāribs* to provide either direct security (e.g., pledge or personal guarantee), or security by way of a third-party guaranty. Typically, such security is taken against any potential *taʿaddī* or breach by the *muḍārib*.

Contemporary juristic opinions (*fatwās*) differ as to the validity of obtaining guarantees from the *amīn* (such as a *muḍārib* or lessee) for potential loss of *amāna* property in his possession. While some *fatwās* do not approve such guarantees,[45] other *fatwās* allow the party dealing with the *amīn* to obtain such guarantees provided that they can be used only to mitigate the loss caused by the *taʿaddī*

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[44] Abū Zayd, *supra* note 15, at 432.

[45] Aḥmad Muhī al-Dīn Aḥmad, Fatawā al-Muḍaraba 75 (Jeddah, Dallat al-Baraka 1996) [*hereinafter* Fatawā al-Muḍaraba].

of the *amīn.*[46] Although the *fatwās* permitting the inclusion of such guarantees in *amāna* contracts do not expressly cite their underlying reasoning or the authority they are relying upon, they seem to be relying on the famous exception of public service providers (*al-ajīr al-mushtarak*). Under this exception, classical jurisprudence imposed the risk of loss for the customer's properties on the *al-ajīr al-mushtarak,* for the purpose of providing services or repairs to properties.[47] This analogy between *al-muḍārib al-mushtarak* and *al-ajīr al-mushtarak* has been challenged by many scholars who argue that the risk involved in investing the *muḍāraba* capital is much greater than the risk involved in protecting the goods given to the *ajīr mushtarak* against loss or damage.[48] Other authors argue that holding *al-ajīr al-mushtarak* as *ḍāmin* as to the *muḍāraba* capital is an exception that is not based on a text from the Quran, *Sunna*, or *Ijmā*ʿ (consensus) and, therefore, cannot be in itself a basis for *qiyās.*[49] In addition, these *fatwās* may be based on a decision issued by the Fiqh Academy, permitting the guarantees of third parties to cover any loss in a *muḍāraba* contract. The Fiqh Academy decision requires that the third party offering such guarantees not receive any fee or reward for his act, which is considered gratuitous.[50]

In any event, the guarantee requirement is allowed as an exception to the general rules and is limited to *ta*ʿ*addī.*[51] The purpose of such guarantee is to enable the capital provider to collect damages from the *muḍārib* in the event the latter is found liable for the loss of the *muḍāraba* capital. As explained above, this liability can be only be established if the capital provider can prove that the *muḍārib* has committed *ta*ʿ*addī* and an actual loss of property has been established. Accordingly, a collateral or

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46 *See, e.g.* Aḥmad Muhī al-Dīn Aḥmad, Fatawā al-Ijāza 147 (Jeddah, Dallat al-Baraka 1995) (on file with author) [*hereinafter* Fatawā al-Ijāza].

47 Sāmī Ḥasan Aḥmad Ḥummūd, Taṭwīr al-Aʿmāl al-Maīrifiyya bi-ma Yattafiqu wa-al-Sharīʿa al-Islāmiyya (Cairo, Dār al-Ittiḥād al-ʿArabbī lil-Ṭibāʿa 1976); *see generally* Abū Zayd, *supra* note 15, at 128-37 (discussing scholarly views on imposing the risk of loss on the *muḍārib*).

48 Ḥasan ʿAbd Allāh Amīn, al-Wadā'iʿ al-Maīrafiyya al-Naqdiyya 247 (Jeddah, Dār al-Shurūq 1983).

49 *Id.*

50 Islamic Dev. Bank & Islamic Fiqh Acad., Resolutions and Recommendations of the Council of the Islamic Fiqh Academy: 1985-2000, at 65 (2000), *available at* http://www.irtipms.org/opensave.asp?pub=73.pdf.

51 Symposium, Kuwait Fin. House, Aʿmāl al-nadwa a- Fiqhiyya al-Rābiʿa li-Bayt al-Tamwīl al-Kuwaitī 392-93(Oct. 30-Nov. 1, 1995).

guarantee obtained from the *muḍārib* will only cover losses caused by the *muḍārib's taʿaddī* and does not extend to the failure to achieve a certain level of performance expectations, such as a minimum rate of return on investment in a *muḍāraba* contract. Also, some of the *fatwās* that allowed the IFI to obtain guarantees from their *amīns* imposed certain guidelines on the IFI with respect to the handling and enforcement of such guarantees.[52] As can be seen from the following examples of *ḍamān* provisions, which are adopted in IFIs' standard *amāna* contracts, the above rules and guidelines are not always observed in the current practice of Islamic finance.

However, in some cases the language of the security provision does not specify the event or circumstances in which the security can be enforced by the IFI. An example of such a provision is Article 9 of the standard *muḍāraba* used by Faisal Islamic Bank of Egypt ("FIBE"), which states that:

> In the event the Bank considers the guarantees (*ḍamānāt*) provided to it not sufficient, the *muḍārib* undertakes to provide the Bank with whatever additional guarantees within one week of requesting such guarantees by the Bank through a certified letter.[53]

The reference in this provision to "additional guarantees" implies that some guarantees are usually required by FIBE at the execution of the *muḍāraba* contract. Because the provision does not define or specify the type of security required from the *muḍārib* or the situation to which this provision applies, it is not clear if both the initial and subsequent guarantees will be used exclusively in the event of a *taʿaddī* committed by the *muḍārib*. However, the language of this FIBE's provision is excessively broad. It does not limit the use of the guarantees required from the *muḍārib* in the event of

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52 *See* 1 Fatawā al-Ijāza, *supra* note 46, at 147. According to this *fatwā*, a lessor who keeps a security deposit against the lessee's *taʿaddī* will benefit from any return on such deposit and will be able to decide at the end of the lease how much of the original amount of the security deposit he can keep and how much, if any, he should return to the lessee. Allowing the lessor to hold possession of the security deposit puts the lessor in a stronger position than the lessee. In order to protect the lessor against possible *taʿaddī* by the lessee without allowing the latter to abuse his possession of the security deposit, the amount of the security deposit should be held by a third party (a trustee). In addition, the lessor should not have the right to decide whether the lessee committed a breach that resulted in damage to the leased property. In order to prevent any abuse by the lessor, this matter has to be determined by third party (a court or arbitral tribunal).

53 Abū Zayd, *supra* note 15, at 431.

proving the *taʿaddī* or breach, which is a pre-condition for holding the *muḍārib* liable (*ḍāmin*) for the loss of the *muḍāraba* capital. The rules of *ḍamān* impose the burden of proving the *muḍārib's taʿaddī* on the capital provider.

The way this provision is drafted may suggest that the Bank can demand such further guarantees in any case where the *muḍārib* fails to meet the Bank's expectations regarding the return on the *muḍāraba* investments, without having to prove that the *muḍārib* committed a breach. Adopting this type of broad language in a *muḍāraba* contract may lead to disputes and abuses in the event of a loss unrelated to the *muḍārib's taʿaddī*—such as adverse market conditions or unforeseeable events of *force majeure*. If a dispute arises regarding the enforcement of this provision, a court applying Islamic law is likely to interpret the provision in accordance with the current prevailing view among contemporary *Sharī'a* boards and scholars, which limits the supplemental guarantee requirements to cases proving *taʿaddī*.[54] Another *muḍāraba* sample obtained from Dār al-Māl al-Islāmī offers an example of a provision that is consistent with the *ḍamān* rules:

> It is required by the *Sharī'a* that the *muḍārib* is held liable (*ḍāmin*) for the *muḍāraba* capital if it is proven that he breached the terms of the *muḍāraba* or that he was negligent or imprudent in safekeeping such capital.[55]

It is important to note that in the latter example, the IFI was a *muḍārib*, while in the former it was a capital provider. This may suggest that IFIs are more willing to apply the rules of *ḍamān* when such application places them in a favorable position vis-à-vis their customers.

Given that the *muḍārib* is absolved of any liability for loss if he abides by the terms of the *muḍāraba* and does not breach his trust or *amāna* duties, it is important to know the standard of care that IFIs impose on their *muḍāribs*. A *muḍāraba* contract reviewed during this study provided that, "[t]he *muḍārib* shall use reasonable [effort] to

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[54] *See, e.g.*, *fatwā no. 2, in* Nadwat al-Baraka al-Ūlā (on file with author). Other Islamic finance *fatwās*, including one issued by the Board of Fatāwa and Sharīʿa Supervision of Dubai Islamic Bank, generally discourage IFIs from requiring such guarantees from their *mudaribs*. *See, e.g.*, Fatawā al-MuḌaraba, *supra* note 45, at 77.

[55] Standard Muḍāraba Contract between Dār al Māl-Islāmī and Islamic Insurance Companies art. 18 (on file with author) [*hereinafter* Muḍāraba Sample No. 1].

ensure the proper use of the [*muḍāraba* capital]."[56] Another provision of the same contract released the *muḍārib* from any liability for the loss of the *muḍāraba* capital unless such loss was "caused by [the *muḍārib's*] gross or willful misconduct."[57] The standard of care required from the *muḍārib* was set to be "the standard of care . . . it will normally exercise in handling . . . its own [funds/assets]."[58] Thus, the standard of care adopted by this contract is closer to the civil law's *bon père de famille* and the common law's "reasonable man" standard than the Islamic Law's standard of what is customarily acceptable in the relevant market.

Although the three standards of care are objective in nature, the *muḍāraba* contract's standard is more restrictive than the other two because it expressly relies on Islamic custom. One can imagine instances where despite acting within the parameters of a reasonable person, a *muḍārib* may step outside what is customary in his immediate surroundings, in which case he would only be liable under Islamic rules. For example, a *muḍārib* may be considered *mutaʿaddī* and, therefore, *ḍāmin*, if in a non-restricted *muḍāraba* (*muḍāraba muṭlaqa*), he invests the *muḍāraba* capital in a geographical location or economic sector that was not customary for people in the country in which the *muḍāraba* originated. Applying the Islamic rules, the *muḍārib* will be *ḍāmin* even if he was prudent both in choosing the investment location or sector and in managing such investment. Requiring the *muḍārib* to abide by the relevant custom adds a layer of protection to the capital providers. This additional protection is particularly important in light of the otherwise lenient standard of liability granted to the *muḍārib* under Islamic law.

Because of the variation between the Islamic standard of care, on the one hand, and the common law and civil law standards, on the other hand, it is important to specify in the contract which standard of liability applies. The lack of such specificity is particularly concerning given the inherent conflict of laws that exist in most contemporary Islamic financial contracts. Typically, these contracts include a governing law provision that subjects them to both the Islamic legal principles and the law of another secular legal system.

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56 Muḍāraba Agreement art. 6.2 (Oct. 11, 2000) (on file with author) [*hereinafter* Muḍāraba Sample No. 2].

57 *Id.* art. 6.3.

58 *Id.* art. 6.4.

2. Emphasis on Security in IFI *Mushārakas*

A common feature of *mushāraka* transactions is the complex nature of the underlying documents. In these transactions, the IFI obtained multiple forms of security to guarantee the consumer's performance of its obligations arising out of its financial relationship with the IFI. In a standard *mushāraka* agreement used by one of the largest IFIs in Saudi Arabia, the customer was required to provide: (1) a pledge over of some of the consumer's real property, which is not related to the facilities agreement; (2) a promissory note for the entire amount of the facility; and (3) a third-party guarantee.[59]

The documents underlying this *mushāraka* facility included general provisions indicating that such guarantees are obtained from the consumer as security against his breach of any of his obligations toward the IFI. It is clear from the documents that the IFI treats its investment in the transaction as a secured debt investment extended to the consumer rather than an equity contribution to the *mushāraka*. The focus on guarantees was also apparent upon examination of another type of a *mushāraka*-based financial instrument known as a declining *mushāraka* (*mushāraka mutanāqiṣa*) used by a major IFI in the United States.[60] In this example, the IFI also obtained personal guarantees and a promissory note from the consumer as security against the consumer's obligation to pay, among other things, the monthly installments due under the *mushāraka* agreement, which is composed of the principal amount and profit amount (paid by the consumer for the consumer's enjoyment of homeownership), property taxes, and property insurance premiums.[61]

Clause 8 of the same *Mushāraka* Agreement imposed the following indemnity obligations on the consumer:

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59 Saudi Mushāraka Contract (on file with author) [*hereinafter* Mushāraka Sample No. 1].

60 A declining *mushāraka* is a financing arrangement under which the IFI contributes the majority of the funds needed for acquiring an asset while the customer contributes only a minority stake of equity but increases his equity over the life time of the *mushāraka*. During the term of the *mushāraka*, the customers pays rent to the IFI in proportion to the latter's ownership percentage of the asset. As the customer continues to increase its ownership percentage in the asset, the rent payment decreases. Ultimately, the mushāraka ceases to exist when the customer owns 100 percent of the asset.

61 Mushāraka Co-ownership Agreement cl. 5.1 (Aug. 26, 2002) (on file with author) [*hereinafter* Mushāraka Sample No. 2].

> [I]ndemnify and hold [the IFI harmless] from and against any and all damages, claims and liability arising from or connected with Consumer's control or use of the Property, or from the conduct of its business or from any activity or work which may be permitted or suffered by Consumer in or about the Property, including, without limitation, any damage or injury to persons or property and costs and liabilities arising from such claims. If [IFI], without fault, shall become a party to litigation in connection with the Property commenced by or against [IFI], then Consumer shall indemnify and hold [IFI] harmless. The indemnification provided by this paragraph shall include all legal costs and attorney's fees incurred by [IFI] in connection with any such claim, action or proceeding. Consumer hereby releases [IFI] from all liability from any accident, damage or injury caused to persons or property on or about the Property and notwithstanding whether such acts or omissions be active or passive.[62]

With respect to the risk of loss, another provision of the *mushāraka* contract imposes the obligation to purchase and maintain an insurance policy against the loss or damage of the entire property on the consumer—as an equity partner and co-owner of the real property.[63] Apart from the fact that the permissibility of conventional insurance is controversial under contemporary *fiqh* views, this provision is also inconsistent with the rules of *ḍamān*. As co-owners of the property, both the IFI and the consumer should share the risk of loss, and any costs related to mitigating such risk, in proportion to their respective percentages of ownership. The same principle of cost sharing should apply to the maintenance of the jointly-owned property.

In defiance of this principle, another provision of this *mushāraka* contract charges the consumer with total responsibility for the cost of caring for the property and maintaining it. [64] In the contract, it is provided that:

> [T]he Consumer shall not destroy, damage or impair the Property, or allow the Property to deteriorate or commit waste on the Property, and shall maintain the Property to prevent it from deteriorating or decreasing in value. If damaged, Consumer shall promptly repair the Property.[65]

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[62] *Id.* cl. 8.
[63] *Id.* cl. 5.4.
[64] *Id.* cl. 5.5.
[65] *Id.*

Another provision of this contract that is inconsistent with the PLS feature of *mushāraka* provides that:

> [T]he Consumer shall have all of the tax benefits and burdens related to the Property . . . [and] shall pay one-hundred (100%) percent of the amount of all the taxes due although Consumer will be a partial owner of the Property until the completion of this Co-Ownership Agreement.[66]

Mixing features of both secured debt and equity financing in one contract raises questions about the true nature of the transaction and the validity of taking such guarantees, since the rules of *mushāraka* do not permit a partner to obtain such guarantees from the consumer (except for the limited purpose of mitigating the consequences of any event of *taʿaddī* by the partner). In an attempt to avoid the consequences of this rule, IFIs often use stand-alone forms of guarantees, such as the promissory note and the third party guarantee. These independent forms of guarantees are difficult to challenge by invoking any defense related to the validity of the underlying contracts between the IFI and the Consumer. Therefore, it is possible for the IFI to enforce any such guarantees against the Consumer without any need to establish *taʿaddī*, as otherwise required under the rules of *ḍamān*.

3. Wakāla

Islamic Law's contract of agency (*wakāla*) is classified as an *amāna* contract because the agent (*wakīl*) acts on behalf of and in the interest of his principal (*aṣīl* or *muwakkil*). The agent's possession of his principal's property is covered by the rules of *yad al-amāna* (fiduciary or trust possession). These rules exonerate the agent from liability for the loss of such property, provided that he acts within the course and scope of his authority and does not commit *taʿaddī*. The standard agency agreement used by a major Islamic bank in the Gulf uses provisions that are inconsistent with the rules of *ḍamān*, similar to those in the previously-examined *muḍāraba* and *mushāraka* contracts. First, the contract requires the agent to provide guarantees for security against third party risks. In an agency (*wakāla*) contract, a similar provision states:

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66 *Id.* cl. 5.1.

> Sometimes, the IFI may also look to strengthen the performance/credit risk of the *Wakīl* [(agent)] itself by either seeking a parent guarantee or collateral letter of credit in respect of both the payment obligations of the Customer [to whom the *Wakīl* sells goods on behalf of the IFI] and in respect of the performance/ payment obligations of the *Wakīl*. If a letter of credit is required, it may be either a commercial or a standby letter of credit and will be in an amount up to the *Minimum Sales Price* [which is the minimum price at which the *Wakīl* is authorized to sell the goods].[67]

As indicated earlier in connection with the FIBE *muḍāraba* provision, this *wakāla* provision grants the IFI an unrestricted right to obtain various forms of guarantees against both performance and credit risks from its *Wakīl*. The risks covered by this provision include not only the risks pertaining to the *Wakīl's* performance of its obligations toward the IFI, but also the risks pertaining to obligations of third parties with whom the *Wakīl* is expected to enter into sale transactions on behalf of the IFI.[68]

In contradiction to the rules of *ḍamān*, this provision imposes liability on the *Wakīl* even if he did not commit any breach or *taʿaddī*. For example, if the *Wakīl* fails to sell the goods at the Minimum Sales Price set by the IFI or collect the price from the buyer, the *Wakīl* will be liable and the IFI would be able to enforce the guarantees despite the *Wakil's* exertion of reasonable effort.[69] This possible outcome contradicts the substantive nature and requirements (*muqtaḍā al-ʿaqd*) of a true agency (*wakāla*) relationship where a *wakīl* acts on behalf of a principal and not for his own interest or account, where any funds he receives from that principal, pursuant to this *wakāla*, are considered a trust (*amāna*) and not debt owed by the *wakīl*.

Another provision of the Agreement provides a justification for imposing credit risks pertaining to third party credit and performance obligations on the *Wakīl*:

> [The IFI] will require the *Wakīl* to take the performance/credit risk of the Customer [potential buyer of the financed goods] and, therefore, to guarantee the Customer's] payment

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[67] Master Wakāla Agreement arts. 2.2, 2.3 (on file with author) [hereinafter Wakāla Agreement].

[68] *Id.* art. 1 (emphasis added).

[69] According to the contract, the Minimum Sales Price is "the aggregate of the *principal* advances [the Purchase Price] and *the cost of funding over the period to the Payment Date*." *Id.* art. 7.4 (emphasis added).

> obligations. This is for two reasons: (a) The *Wakīl* is responsible for identifying the Customer and agreeing [to] the terms of sale; [and] (b) The identity of the Customer is not normally known at the time the master *Wakāla* Agreement is signed.[70]

Imposing the above risks on the *Wakīl* implies an underwriting by the *Wakīl* of all third party debts resulting from the sale of goods on behalf of the IFI and reveals the true financing nature of the transaction. In fact, very little is done to conceal this feature. Article 1 of this *Wakāla* Agreement explicitly indicates that the purpose of the Agreement is to:

> [P]rovide the *Wakīl* with a means of *obtaining finance* through the actual purchase and sale of goods [pursuant to] individual *funding* transactions from time to time.[71]

Additionally, the *Wakāla* Agreement includes an indemnity provision that is even more revealing:

> The Master *Wakāla* Agreement (MAW) contains a number of warranties, undertakings and indemnities,[that] are considered necessary by the IFI to protect its position as an undisclosed principal in a transaction which is *essentially a financing transaction*. Without them the IFI may be liable for acts of . . . the *Wakīl*, over which the IFI exercises little control. IF any liability arises due to the selection of the Goods or the structure of any particular transaction, including any liability for tax, these are to be paid by the *Wakīl* and should be priced into any [request for funding] that the *wakīl* intends to make.[72]

III. *ḌAMĀN* IN IFIs' DEBT FINANCING

The creditor in an Islamic debt contract contrasts with the financing party in an *amāna* transaction. As a matter of principle, the financing party in an *amāna* contract is not allowed to require security to guarantee either the return of the original capital or a minimum profit on investment. In a way, the Islamic creditor's disadvantage of not being compensated in the event of payment delay is balanced out by the advantage of being able to obtain security. An Islamic trade-creditor is supposed to take all

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[70] *Id.* art. 1 (emphasis added).

[71] *Id.*

[72] *Id.* art. 14.

precautions against credit risks, including asking for collateral, because he does not have the right to charge interest or enforce any kind of financial penalties against his debtor in the event of default. Contrary to *amāna* financing, in Islamic debt financings the financier is not expected to rely merely on the trustworthiness of his debtor and can require his debtor to provide security or a third party guaranty; however, he will have to rely on his own ability to monitor the debtor's use of the loan proceeds as well as the financed object.

As Dr. Mohamed Elgari suggests, the mere fact that IFIs offer their financing through sale, leasing, and partnership contractual arrangements, while conventional banks offer theirs primarily through loans, does not, in itself, mean that Islamic finance involves higher risks than those of conventional banking.[73] Like its conventional counterpart, Islamic debt financing entails both market and credit risks. As a conventional debt financier faces the risk of changes in economic conditions such as changes of interest and inflation rates, the Islamic debt financier faces the risk of changes of prices of the financed property.[74] For example, in both conventional and Islamic secured credit transactions, the financing provider is always exposed to the risk of the diminution of the market value of its collateral.

To mitigate credit risk associated with Islamic debt financing, Islamic law offers the creditor the right to require collateral, third-party guarantees, or other forms of security. As we shall see in the following examples of *ḍamān* applications in the context of debt financing, requiring security in debt financing is a standard practice of IFIs. As for *salam* and *istiṣnā*ʿ transactions, some studies indicate that IFIs tend to "include a third-party performance guarantee (usually from a bank) on the part of both the producer and the ultimate goods purchaser. In *murābaḥa* transactions, a third-party guarantee in the form of an Islamic letter of credit is also common."[75] Another study on Egyptian

[73] Mohamed Ali Elgari, *Credit Risk in Islamic Banking and Finance*, Islamic Econ. Stud., Mar. 2003, at 1, 20.

[74] *See id.*

[75] Frank E. Vogel & Samuel L. Hayes, III, Islamic Law and Finance: Religion, Risk, and Return 199 (1998).

Islamic banks revealed that over ninety percent of the financing offered by such banks is secured.[76]

Although the requirement of security may reduce some of the risks associated with the IFIs' extension of Islamic credit, it does not eliminate such risks. In an Islamic credit sale transaction secured by a pledge, the financier still faces the risk of the deterioration of the economic value of the property subject to the pledge. In the event of foreclosing on the collateral, the creditor must have sufficient experience in managing and trading the collateral assets or he may face further diminution in their value. Thus, IFIs offering Islamic debt financing must maintain a reasonable level of commercial expertise to enable them to successfully manage the risks associated with Islamic debt financing. Like conventional banks, IFIs are not equipped to deal with the above risks because they lack the expertise and specialization required to manage non-financial assets such as real estate and commercial commodities.

As for remedies in the event of default, virtually all *ḍamān* contracts include a penalty clause that entitles the IFI to collect fines from the customer in case of any payment default. The payment of such fines is tolerated by contemporary scholars provided that: (1) the creditor can show that the debtor unjustifiably delayed the payment of his debt despite being financially-capable of doing so (*madīn mumāṭil*), and (2) the fines collected are spent on charitable causes.[77] Most of the penalty clauses indicate that any fines collected from the customer will be disbursed to charitable causes. For example, one of the examined contracts provided:

> The Bank shall not impose fines in the event of a payment delay but shall impose such fines on the [Customer] if the delay in paying any amounts due to the Bank *is proven to be* unjustifiable (*mumāṭala*). Such fines [collected from the Customer] shall be disbursed on charitable causes, after *all amounts due* to the Bank have been paid.[78]

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[76] Elias G. Kazarian, Islamic Versus Traditional Banking: Financial Innovation in Egypt 208 tbl.9.9 (1993).

[77] *See, e.g.* Islamic Fiqh Council, Decision No. 8 (Feb. 19-26, 1989); Kuwait Fin. House, *supra* note 51, at 240-41; *see generally* Muṣṭafā Zarqā, Ḥawla Jawāz Ilzām al-Madīn al-Mumāṭil bi-Taʿwīḍ lil-Dā'in (1996) (on file with author).

[78] Murābaḥa Agreement to Finance the Purchase of Stocks, Purchase Order and Promise cl. 7 (on file with author) [*hereinafter* Murābaḥa Sample No. 2]. It is worth mentioning that in

However, some penalty clauses did not require the unjustifiable delay (*mumāṭala*) of the customer as a pre-condition for imposing the fine. For example, one clause stated:

> If the Customer fails to pay any of the Monthly Installments within ___ days after the same have become due, a penalty charge of ___% . . . shall be imposed on the Customer for every day in which a monthly installment is consider [sic] past due. The proceeds of the penalty will be paid to charity and shall not be considered as part of the bank's income.[79]

Another penalty clause in a *murābaḥa* contract stated:

> If any sum due payable by the Purchaser hereunder is not paid when due or, as the case may be, when the same is demanded by the Bank, then the Purchaser agrees to pay administrative charge to the Bank based on mutual agreement.[80]

In an Islamic lease, the parties typically agree to revise "the Profit Element of the Lease Payments" in the event of a payment delay by the lessee:

> If the lessee fails to make a Lease Payment or any part thereof on the relevant Lease payment Date, the lessor shall be entitled to increase the Profit Element of such Lease Payment by such amount as it considers appropriate but not exceeding an amount equal to (1%) of the defaulted amount multiplied by the number of days for which such sum is in default and divided by 360.[81]

A. Commissioned Mark-Up Sale (*Murābaḥa Lil-Āmir Bi-Al-Shirā'*)

A Commissioned mark-up sale (*Murābaḥa lil-āmir bi-al-shirā'*; lit., mark-up sale at the order of the party commissioning the purchase) is a modified modern form of the classical contract of *murābaḥa*. It is one of the most widely-practiced financial techniques in contemporary Islamic finance. A typical *murābaḥa lil-*

this example, the Bank's profit margin was said to be an annual profit rate of 8.1 percent. It is not clear how this percentage is calculated, i.e., on the basis of the cost price at which the Bank acquired the commodity from the original supplier, or on the basis of the balance due by the Customer at the end of year, month, or day.

79 *Id.* cl. 4.2.

80 Master Murabaha Agreement cl. 15 (on file with author) [*hereinafter* Murābaḥa Sample No. 1].

81 Islamic Lease Agreement art 3.5 (on file with author).

āmir bi-al-shirā' transaction involves the following legal acts: (1) a binding promise from one party (the customer) to purchase certain property goods from another (the bank) upon the latter's acquisition of such property goods from a third party; (2) a sale contract between the supplier of the goods and the bank; and (3) a *murābaḥa,* under which the bank sells such a property to the customer at a mark-up price payable in installments.[82] In addition to these three legal acts, some *murābaḥa lil-āmir bi-al-shirā'* transactions involve an agency contract between the bank, acting as principal, and the customer, acting as an agent appointed by the bank to purchase the goods, subject to the *murābaḥa,* from the supplier. In some *murābaḥa* contracts, the bank requires the customer to provide a third-party guaranty to ensure the customer's performance of its obligations under the *murābaḥa* arrangement.

IFIs' current practice of this form of *murābaḥa* has been subject to criticism in Islamic finance literature, mainly for its compelling similarity with conventional interest-bearing trade financing practices. While most contemporary jurists do not deny the validity of *murābaḥa* as a recognized form of business as practiced in the classical era of Islam, many question the validity of the modified version of *murābaḥa* practiced today.

Within the context of *ḍamān,* many *murābaḥa* contracts and other credit sale arrangements are structured in such a way as to minimize the period in which the IFI is legally responsible for the loss of the *murābaḥa* goods.[83] IFIs' *Sharīʿa* boards differ as to the minimum time in which the bank is required to hold ownership of the *murābaḥa* property before it can transfer th, at ownership to the customer. Some boards do not require any minimum time lapse between the acquisition of ownership of the *murābaḥa* property from its original supplier and its sale to the customer by the bank.[84] For example, some *murābaḥa lil-āmir bi-al-shirā'* contracts state that

[82] While some Islamic banks use the word "upon" (in Arabic, *bi-mujarrad*), others are required by their *Sharīʿa* boards to use the word "after" or similar verbiage to allow an interim period between the moment at which the bank acquires the goods from the third party (the supplier of the *murāba*ḥa goods) and that at which the goods are transferred to the customer. ʿAṭiyya Fayyāḍ, al-Taṭbīqāt al-Maīrafiyya li-Bayʿ al-Murābaḥa fī Daw' al-Fiqh al-Islāmī 155, 214 art. 9-12 (Cairo, Dār al-Nashr lil-Gāmiʿāt 1999).

[83] This field research was conducted at a number of IFIs in the following countries: Pakistan, Saudi Arabia, Kuwait, and Egypt.

[84] Fayyāḍ, *supra* note 82, at 139.

the *murābaḥa* sale between the IFI and the customer shall be executed as soon as, or at the same time (in Arabic, *bi-mujarrad or fī nafs al-waqt*), as the shipper of the financed goods receives the goods from the supplier. For example, one of the examined *murābaḥa* agreements provides that:

> The Purchaser has been extended a *Murābaḥa* Facility ('the Facility') by the Bank and pursuant to such Facility, the Purchaser wishes, from time to time, to enter into Agreed Transactions . . . upon the terms of [the Master *Murābaḥa* Agreement] whereby the Purchaser, acting as an undisclosed agent of the Bank purchases Goods . . . from the Vendor . . . and *simultaneously* the Bank shall sell such Goods to the Purchaser on deferred payment terms . . . .[85]

Another provision of the same Agreement states that:

> The Bank shall sell and the Purchaser shall purchase the Goods at the deferred Price simultaneously upon the purchase of the same by the Purchaser acting as an undisclosed agent of the bank from the Vendor . . . Title to the Goods shall pass from the Vendor to the Bank on the Settlement Date [date at which the Banks pays the Purchase Price to the Vendor] and, shall, unless otherwise [required by the Bank] pass simultaneously . . . to the Purchaser . . . .[86]

A similar provision from another *murābaḥa* contract to finance the purchase of stocks states that once (*bi-mujjarad* in the accompanying Arabic translation) the Stocks are received by the Bank, the Customer shall immediately fulfill his promise to purchase the Stocks from the Bank.[87]

This provision is arguably more acceptable under prevailing, contemporary views on *murābaḥa*, requiring some time lapse between the two sales even if the time lapse was a short period of time, or only few minutes. This minimal interval is required by most *Sharīʿa* boards to ensure that the IFI has acquired legal title of the *murābaḥa* goods to be sold to the customer.[88]

Unlike the former provisions, the latter provision does not necessarily lead to a situation where both sales (the first sale from the supplier to the IFI and the second sale from the IFI to the

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[85] Murābaḥa Sample No. 1 cl. 1, *supra* note 83 (emphasis added).
[86] *Id.* cl. 8(A).
[87] Murābaḥa Sample No. 2, Acceptance cl. 3, *supra* note 78.
[88] *See, e.g.*, Fatawā al-Muḍaraba, *supra* note 45, at 207-09.

customer) take place simultaneously. The two events that take place simultaneously are the first sale and the customer's binding and irrevocable promise to purchase the Stocks acquired by the Bank from the original owner of the Stocks. Technically, the Bank and the Purchaser may agree, in the Purchase Order and Promise, that the time of the second sale will take place at a time subsequent to the first sale.

In a third and more common example of a *murābaḥa* and *tawarruq* financing, the *murābaḥa* transaction is documented as a three-stage process:[89] (1) the irrevocable promise to purchase in which the customer "promises" to purchase an agreed number of units of an identified commodity upon receiving notification from the IFI that it has received the quantity requested; (2) the *murābaḥa* agreement under which the IFI sells the same quantity of commodity to the customer for a deferred price that includes the profit margin charged by the IFI;[90] and (3) an irrevocable power of attorney or agency agreement (*wakāla*) under which the customer irrevocably authorizes the IFI to sell the commodity the customer purchased from the IFI to any third party at the market cash price, and to deposit the proceeds of this sale into the customer's account with the bank.[91]

Despite documenting the transaction in three segments (the promise to purchase, the *murābaḥa*, and the *wakāla*), the execution of all three segments typically takes place in one meeting and all of the documents related to the transaction are signed by the IFI and the customer at once.[92] Since the customer's promise is irrevocable and all documents are signed at the same time, or at least in one meeting, the IFI is practically purchasing and reselling the commodity on the international commodity market for the account of the customer and at the latter's sole risk. If the value of the commodity decreases during the few minutes that lapse between such purchase and resale, the loss of value is borne by the customer. Of course, no actual or physical delivery of the

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[89] Commodity Purchase and Sale Agreement (al-Tawarroq) (on file with author) [*hereinafter* Murābaḥa Agreement No. 3].

[90] The profit margin in this case was said to be 8.1% annually. *See supra* note 78.

[91] Murābaḥa Agreement No. 3, *supra* note 89.

[92] Interview with *murābaḥa* purchaser, in Riyadh, Saudi Arabia (Mar. 15, 2006). Although the preamble of the *murābaḥa* agreement indicated that the IFI purchased the commodity requested by the customer in the ordered quantity, the reference to the specific inventory certificate, evidencing such purchase, was left blank.

commodity takes place at any stage of this transaction. Under the rules of *ḍamān* applicable to the contract of sale, the risk of loss transfers from the seller to the buyer upon delivery.[93] However, contemporary *Sharīʿa* views give the delivery of documents representing ownership of the subject matter (such as title or an inventory certificate) the same credence as physical delivery of the subject matter, including the effect of transferring the risk of loss to the buyer.

The above provisions practically eliminate any property risk to which the IFI would otherwise be exposed to from the moment it acquires title of the financed goods to the time the goods are ultimately delivered to the customer. To avoid any doubt, another *murābaḥa* provision expressly shifts the risk for loss of goods to the customer throughout the life of the transaction. "The Goods shall, at all times after the risks therein passes from the Vendor to the Bank, be at the sole risk of Purchaser."[94] Since the title, possession, and, therefore, risk of loss pass to the Purchaser at the same time they pass from the Vendor to the bank, it is guaranteed that the bank will never bare the risk for loss of the goods at any time in the transaction. Such risks will be borne either by the Vendor, prior to the transfer of title and possession to the Bank, or by the Purchaser from the moment such transfer takes place.

In light of increasing criticism against this simultaneous execution of the two sales (sale from the supplier to the IFI and the sale from the IFI to the customer), many boards now require a minimum time between the two sales. In an interview conducted by the author with the General Counsel of Devon Bank, a major IFI in the United States, he indicated that his bank's *murābaḥa* transactions allow for at least fifteen minutes to lapse before the second sale from the IFI to the customer is entered into. Thus, the Bank bears the risk of loss of the goods during such fifteen minutes. In addition, it is common that IFIs insure the goods

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[93] 2 Aḥmad ibn Idrīs al-Qarafī, A mad ibn Idrīs, Ibn al-Shat, Qasim ibn Abd Allah, and Muhammad `Ali ibn Husayn al-Maliki. Al-Furūq. Misr: Dār Iḥya' al-Kutub al-'Arabiyyah, 13441925-27). The *Mālikī* and Ḥ*anbalī* schools, however, adopt a different view distinguishing between the sale of generic goods and the sale of specific goods. In the former case, the risk of loss is transferred to the purchaser from the moment contract takes effect, while in the latter the risk remains with the seller until actual exchange of possession. Nazīh Ḥammād, al-Ḥiyāza fī al-'Uqūd fī al-Fiqh al-Islāmī 194 (Damascus, Maṭbī Quzma 1978).

[94] Murābaḥa Sample 1 cl. 8(A)(v), *supra* note 83.

against the risk of loss and add the cost of such insurance to the *murābaḥa* price payable by the customer.

Furthermore, there is usually a provision stating that the shipper acts as an agent (*wakīl*) of both parties as far as the receipt and possession of the goods are concerned. A *murābaḥa* agreement included the following provision:

> The Bank hereby appoints the Purchaser as its agent for the sole purpose of negotiating, as the undisclosed agent of the Bank, a Purchase Agreement. The purchaser shall have no authority to, and shall not negotiate nor enter into a Purchase Agreement prior to the time at which the conditions referred to in Clause 5 [which includes the Purchaser's signing a promissory note in the amount of the purchase price in favor of the Bank] have been duly satisfied. If notwithstanding this Clause, in relation to any Purchase Agreement, an Agreed Transaction does not arise then such Purchase Agreement shall be deemed to have been entered into by the Purchaser for its own account and the Bank shall be under no liability or obligation in respect thereof. [95]

Therefore, by appointing the customer (borrower) as double agent for both the supplier and the IFI for the purpose of purchasing the goods from the former, and simultaneously (or after few minutes) reselling the same goods to himself (customer), the IFI is able to practically avoid bearing the risk of loss during the shipping period. Acting as a double agent for both the IFI and the customer allows the shipper to receive the goods in his capacity as IFI representative and simultaneously accept the goods on behalf of the customer (*al-āmir bi-al-shirā'*). Therefore, when the IFI pays the supplier and the latter delivers the goods to the shipper (double agent), title and, therefore, the risk of loss, transfers from the supplier to the IFI and simultaneously to the customer. The outcome of such provisions is to circumvent the rules of *ḍamān* by shifting the property risk of the *murābaḥa* goods to the customer during the pre-delivery or shipping period, i.e., the time of their actual delivery to the customer. Including such provisions in *murābaḥa* contracts allows IFIs to comply formally with the minimum requirements of the rules of *ḍamān* while substantively avoiding the risk for loss of the *murābaḥa* goods. The rational

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[95] *Id.* cl. 3; *see also* Master Commodity Trading Agreement art. 5.02 (on file with author) [*hereinafter* Murābaḥa Sample 4); Symposium, Kuwait Fin. House, *Wa'd bi-al-Shirā' Contract* arts. 3, 9, *in* A'māl an-Nadwā al-Fiqhiyya al-Thālitha 83, 83 (Apr. 27-29, 1993) (on file with author).

explanation for IFIs' desire to avoid such risk is that as depository financial institutions, they are only equipped to manage and monitor financial assets and not the types of operational and ownership risks involved in true credit sales transactions, which only merchants are equipped to manage. The use of the above provisions, which are designed to make the *murābaḥa* instrument as risk-free as possible, was challenged and condemned in a number of *fiqh* conferences which declared any *murābaḥa* contract containing such provisions as void.[96] Despite such condemnation, IFIs continue to employ this questionable *murābaḥa* structure in their trade financing transactions.

Regarding the security aspect of the *murābaḥa* transactions practiced by IFIs, most agreements require the customer to provide, in addition to a promissory note as indicated above, a personal guarantee and, in the case of consumer finance *murābaḥa*, an assignment of the customer's salary or income. For example, a provision in a *murābaḥa* agreement executed in Saudi Arabia stated:

> The Customer shall, whenever requested by the Bank, provide a personal guarantee executed by a guarantor and in a form accepted by the Bank. The Customer shall provide, whenever requested by the Bank, an irrevocable and unconditional assignment of his salary and other employment entitlements duly acknowledged by the Customer's employer.[97]

It is noteworthy that in response to an inquiry by an IFI customer regarding the validity of offering such an assignment of salary as security for the *murābaḥa* debt, the Saudi Board of the Religious Elders (Hay'at Kibār al-'Ulamā') issued a *fatwā* declaring that such an assignment is impermissible, because the assignment involves a deposit of money by the customer in exchange for a benefit obtained by the customer from the IFI. This transaction, according to the *fatwa,* is similar to a loan in exchange for a benefit, which is prohibited in Islam.[98] The perplexing aspect of the *fatwā*, which was issued by one of the most powerful and authoritative *Sharīʿa* forums, not only in Saudi Arabia but also

[96] Kuwait Fin. House, *supra* note 95, at 79-102.

[97] Murābaḥa Sample 2 art. 3, *supra* note 80. In another *Murāba*ḥa Contract also executed in Saudi Arabia, the IFI obtained a letter of guaranty as a form of security. Murābaḥa Sample 4 art. 4, *supra* note 98.

[98] Board of Religious Elders, Riyadh, Saudi Arabia, Saudi Murābaḥa Fatwā No. 20959 (Sept. 9, 1999) (on file with author).

throughout the Islamic world, is that it defies the validity of a common practice usually associated with *murābaḥa*-based consumer financing.

In addition to the above guarantees, some *murābaḥa* agreements include warranties and representations from the customer that the *murābaḥa* goods conform to specifications indicated by the supplier and that the supplier has clean title to such goods. This provision is common in *murābaḥa* agreements where the IFI appoints the customer as its agent for the purpose of purchasing the goods from the supplier. In one example, the purchaser (an IFI customer) warranted and represented that:

> (i) The Goods conform with all conditions, warranties and representations given or made by the Vendor to the Purchaser under the Purchase Agreement or otherwise;
>
> (ii) To the best of its knowledge and belief the Vendor is the legal and beneficial owner of the Goods and has not sold, transferred, disposed of, changed, pledged, or otherwise encumbered or permitted to subsist any change, pledge, or encumbrance over the Goods, nor has it agreed to do so; and
>
> (iii) It is lawful for each party to an Agreed Transaction to perform the obligations expressed to be assumed by it thereunder.[99]

The effect of this provision is quite ironic. It is the customer (buyer) not the IFI (seller) who is responsible for ensuring that the supplier owns clean title to the goods and delivers goods that comply with the terms and specifications of the *murābaḥa* agreement; therefore, in the event that the goods do not conform to the specifications provided by the supplier, or if, for whatever reason, the supplier fails to deliver the goods free of encumbrances or rights of a third party, the customer will be held in default of his obligations under the *murābaḥa* agreement. A similar provision states:

> The Purchaser shall pay to the Bank on the Deferred Payment Date . . . the Deferred Price notwithstanding: (a) Any defect or deficiency in the Goods or any loss or damage thereto; (b) Any failure by the Vendor to comply duly with the obligations expressed to be assumed by it under the appropriate Purchase

[99] Murābaḥa Sample 1 art. 7(B), *supra* note 80.

> Contract [between the Bank and the Vendor]; (c) Total or partial loss of the Goods; and (d) Any other matter or thing whatsoever.[100]

Not only does reversing the parties' obligations stand against the rules of *ḍamān* applicable to the contract of sale, as discussed above, but it is also against the universally accepted rule of sale under most legal systems. Particularly, under the rules of *ḍamān*, the seller is responsible for delivering free title of the subject matter (*ḍamān al-istiḥqāq*) and for delivering such subject matter in accordance with the agreed specifications. Also, shifting the seller's obligations to the buyer is even more ironic in the context of a contract of *murābaḥa,* specifically because the mark-up or profit margin which the *murābaḥa* seller receives is justified by his effort to identify the goods, his bearing the risk of loss for such goods, and the cost of transporting them to the buyer. If all such duties are performed by the buyer, as is the case in the contemporary version of the *murābaḥa*, what justifies the profits received by the IFI? If the IFI's profit margin is justified by financing the purchase of the goods from the supplier, then it is clear that we are dealing with a pure commercial profit-bearing lending transaction without meaningful or substantive effect for the exchange of goods under the *murābaḥa* structure.

B. Ḍamān Rules in IFIs' Practice of *Ijāra*

Acting as lessors in both lease (*ijāra*) and hire purchase (*ijāra wa-ʿiqtinaʿ*) contracts, many IFIs avoid the risk of loss associated with their ownership of the leased or hired property by shifting the risk of loss to the lessee (customer).[101] Shifting the risk of loss to these parties contradicts the principle of *kharāj*. A common technique used by some IFIs, to shift the risk of loss to their lessees without explicitly stating so in the contract, is to insure the leased property and to add the insurance cost to the amount of rent.[102] The invalidity of such an insurance provision is not due to

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[100] *Id.* art. 8(A)(viii).

[101] *See, e.g.*, Saudi PAK Industrial & Agricultural Investment Company Standard Lease (on file with author) [*hereinafter* Saudi Pack Lease). The author is grateful to Mr. Munīr Shāh of Saudi PAK Industrial & Agricultural Investment Company, who generously provided this document.

[102] *See* Mahmoud A. El-Gamal, Islamic Finance: Law, Economics, and Practice 67-68 (2006).

Islamic law's position on insurance as a contract; rather, the lessor is the owner of the leased property and, therefore, it is his responsibility to bear the risk of loss of such property and any costs associated with reducing or managing such risk.

In addition, some of the examined *ijāra* contracts include provisions that impose all maintenance obligations on the lessee.[103] According to the prevailing opinions in all four Sunni schools, such obligations must be borne by the lessor.[104] According to these opinions, the lessee has the right to terminate the lease if the lessor does not perform his obligation to provide the necessary maintenance.[105] Those views are adopted by *Majallat al-Aḥkām al-ʿAdliyya*[106] and the Jordanian Civil Code.[107] As pointed out earlier, holding the lessor liable for the maintenance of the leased property is consistent with the *kharāj* principle. In line with this reasoning, the great classical scholar, Ibn Qudāma explains that any stipulation in a lease contract that imposes on the lessee the costs of maintaining the leased property is invalid (*fāsid*) because such property belongs to the lessor and, hence, the cost of its maintenance should be his responsibility.[108] Other scholars, such as the medieval jurist, Buhūtī, use *gharar* as the basis for invalidity of such a stipulation.[109] According to their view, a provision of this kind leads to *jahālat al-ujra* (uncertainty about the rent amount).[110]

IV. CONCLUSION

Complying with the rules of *ḍamān* represents a challenge for most IFIs. The implications of such rules affect both sides of

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103 *See, e.g.*, Sample Lease arts. IV, IX, XII (on file with author).

104 *See generally* Muḥammad Amīn ibn ʿUmar Ibn ʿAbdīn, Radd al-Muḥtār ʿAlā al-Durr al-Mukhtār: Sharḥ Tanwīr al-Abīār (Beirut, Dār al-Fikr 1979) (on file with author); *see also* Kuwait Fin. House, *supra* note 95, at 253-95 (discussing recent research regarding the consensus on this issue).

105 Ibn ʿAbdīn, *supra* note 104.

106 *See* The Mejelle: An English Translation of Majallat al-Aḥkāmm al-ʿAdliyya and a Complete Code of Islamic Civil Law art. 592 (Lahore, Pakistan Educational Press 1980).

107 13 Jordan, Mawsūʿat Sharḥ al-Qānūn al-Madanī art. 686 (Jamāl Mudaghmish & Yaḥyā Daḥmān eds., Amman, al-Markaz 2004) (on file with author).

108 Ibn Qudāma, *supra* note 27, at 449.

109 4 Manīūr ibn Yūnus ibn Idrīs Buhūtī, Kashshaf al-Qināʿ ʿan Matn al-Iqnāʿ 21 (Hilāl Muṣaylīḥī Muṣṭafā Hilāl ed., Riyadh, Maktabat al-Naṣr al-Ḥadītha 1968).

110 *Id.*

IFIs' balance sheets and cover both debt and equity financing. The *ḍamān* risks associated with both types of financings are significantly higher than the risks associated with conventional debt and equity financing. Under pressure to compete with conventional financial institutions, IFIs often resort to a number of techniques to avoid or minimize such risks. Although most of the criticism in Islamic finance literature focuses on IFIs' reluctance to engage in operations that involve *amāna* risks, IFIs are also reluctant to apply the Islamic rules, particularly those of *ḍamān*, when practicing Islamic debt financing. Although the success of the Mīt Ghamr experiment persuaded other IFIs to adopt the PLS model, such adoption quickly failed. Most IFIs who attempted to adopt the PLS model became vulnerable to the fraudulent and corrupt behaviors of their clients, over whom such IFIs had limited monitoring power or control. IFIs' failure to implement the PLS model was due to many factors, including the unsuitability of the regulatory framework, in which IFIs operate, and the lack of the adequate internal IFI resources for monitoring and managing risk sharing assets. The existence of such a framework and resources is crucial in light of the substantial incentive, moral hazard, and agency problems associated with this type of financing. Such problems are further aggravated by the lack of effective legal deterrents and remedies available to IFIs offering PLS financing under the classical jurisprudence (*fiqh*) of *ḍamān*. In this type of financing, the risk of loss is borne by the capital provider so long as the recipient of such capital does not commit a tortious act or omission (*taʿaddī*; lit., trespass or transgression). Furthermore, the rules of *ḍamān* grant the recipients of risk-sharing (or PLS) financing, and partners and other fiduciaries a presumption of honesty or trustworthiness (*amāna*). According to this presumption, the capital provider in equity or PLS financing has the burden of proving that the trustee or fiduciary (*amīn*) breached its fiduciary duties by committing *taʿaddī*.

Even when a capital provider is able to overcome the presumption of non-fault by providing an evidence of *taʿaddī* by the *amīn*, his ability to recover damages is far more limited under the rules of *ḍamān* than under any other contemporary liability system. Under prevailing *fiqh* views, the scope of recoverable damages is limited to actual damages, that is, damages that occur to an identifiable existing property (*māl mutaqawwim*). This excludes many of the elements of damages that may be recoverable under conventional liability rules, such as lost profit (even if this loss was certain to occur in the future), liquidated damages, judgment interest, moral damages, and punitive damages. The limitations on recoverable damages are based primarily on the above-mentioned principles of *akl al-māl bil-bāṭil*, *ribā*, and *gharar*.

The difficulties faced by IFIs in implementing the PLS model led them to shift to another financial model that offered as its foundation the utilization of less risky Islamic debt instruments; however, IFIs offering financing under this new model were not immune from *ḍamān*-related problems. For example, the Islamic restrictions on recoverable damages applicable to fiduciary liability, equally apply to non-fiduciary relationships including debt-based contracts such as credit sale and lease, which are central to the structures of most Islamic financial instruments offered today. Therefore, despite their shift from the PLS model to debt-based financing, IFIs are still exposed to *Sharīʿa* limitations that restrict their ability to collect interest or recover damages otherwise recoverable by conventional financiers. Additionally, IFIs offering debt-based operations are exposed to the risk of loss of the financed assets during the interim period between the execution of the contract and the delivery of such assets to the financed party.

While IFIs' reaction to the excessive risks of participatory financing was to simply minimize their practice of this type of financing, their reaction to the risks associated with debt-based financing, however, was to resort to exceptions or minority opinions available in the voluminous and centuries-old *fiqh* literature that would enable them to avoid, or at least limit, such risks. Contemporary scholars specializing in the field of Islamic finance find themselves under pressure from IFIs to find such exceptions or opinions. This pressure is expected to further intensify in light of the growing global demand for Islamic financial products and the unprecedented economic boom currently witnessed in many Muslim countries, particularly in the oil-rich Persian Gulf region. The ultimate objective such scholars and IFIs aim to achieve is to bring the level of IFI risk exposure as close as possible to the level of risks that are normally acceptable in conventional banking practices. The excessive reliance by IFIs on exceptional rules and weak minority opinions has spawned much criticism, particularly when such opinions employ legal techniques that are methodologically questionable according to the established Islamic legal principles.[111]

Some IFIs attempt to mitigate or reduce the risks associated with both their equity and debt-finance operations by structuring and documenting their transactions in such fashion that would allow them to avoid the implications of the *ḍamān* rules applicable to such transactions. Using such techniques often produces transactions that adhere to the *ḍamān* rules in form, but circumvent their substantive implications or objectives. The use of such techniques and stratagems persists despite criticism by many Islamic scholars.

The above findings indicate a common problem in IFIs' current practice: their inability to properly manage the legal effects of the rules of *ḍamān*. There are several propositions to address and mitigate this common problem. First, the early failure to practice PLS financing should not be considered as indisputable evidence of the impracticality of this type of financing, which after all is considered a distinctive feature of Islamic finance. *Najjār*'s early experience provides proof that PLS financing can be implemented successfully in small communities and trust-promoting environments. This proof is supported by evidence from similar microfinance experiences, albeit secular, such as the Grameen Bank of Bangladesh. Even outside the microfinance sector, equity finance has proved its viability as a mode of financing if the respective financial institutions are equipped with adequate managerial and monitoring skills and resources and are supported by suitable regulations. The German model of universal banks, for example, relies on extensive monitoring techniques to ensure that the projects in which such banks hold significant equity interests are managed properly and remain profitable. Both of the Grameen and the German universal bank models provide important lessons which if adopted by IFIs may improve their practice of PLS financing. In order to fully exploit these lessons, the two models deserve further studies by Islamic finance writers and practitioners.

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[111] *See, e.g.*, Aḥmad Muḥammad ʿAbd al-ʿAzīz al-Najjār, Ḥarakat al-Bunūk al-Islāmiyya: Ḥaqāʾiq al-Aṣl wa-Awhām al-Ṣura 587-99 (Cairo, Sharikat Sbrint 1993); Rafīq al-Miīrī, Buḥūth fī al-Maīārif al- Islāmiyya 253 (Damascus, Dār al-Maktabī 2001); Jamāl al-Dīn ʿAṭiyya, al-Bunūk al-Islāmiyya Bayna al-Ḥurriyya wa al-Tanẓīm, al-Taqlīd wa al-Ijtihād, al-Naẓariyya wa al-Taṭbīq, Kitāb al-Umma 114 (Doha, Riʾāsāt al-Maḥākim al-Sharʿiyya wa al-Shuʾūn al-Dīniyya bi-Dawlat Qatar 1986).