CHAPTER 10

MUSHARAKAH

Hadiths-e-Qudsi

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

In another Hadiths-e-Qudsi, it is stated:

“Allah’s hand is with both the partners unless any one of them indulge in cheating and when any one of them indulges in cheating than Allah takes back his hand from both the partners.”

Definition and classification of Musharakah

The literary meaning of Musharakah is "sharing". The root of the term "Musharakah" in Arabic comes from the word ‘Shirkah’, which means 'being a partner'. It is used in the same context as the term "shirk" meaning "partner to Allah".

Under Islamic jurisprudence, Musharakah means "a joint enterprise formed for conducting some business in which all partners share the profit according to a specific ratio while the loss is shared according to the ratio of the contribution". It is an ideal alternative for the interest based financing with far reaching
effects on both the production and distribution of wealth in the economy. The connotation of this term is limited than the term "Shirkah", more commonly used in the Islamic jurisprudence. For the purpose of clarity in the basic concepts, it is pertinent at the outset to explain the meaning of each term, as distinguished from the other. "Shirkah" means "Sharing" and in the terminology of Islamic Fiqh, it has been divided into two kinds:

1) Shirkat-ul-Milk (Partnership by joint ownership)

It means joint ownership of two or more persons in a particular property. This kind of "Shirkah" may come into existence in two different ways:

a) Optional (Ikhtiari): At the option of the parties. For example, if two or more persons purchase equipment, it will be owned jointly by both of them and the relationship between them with regard to that property is called "Shirkat-ul-Milk Ikhtiari" Here, this relationship has come into existence at their own option, as they themselves have opted to purchase the equipment jointly.

b) Compulsory (Ghair Ikhtiari): This comes into existence automatically without any effort/action taken by the parties. For example, after the death of a person, all his heirs inherit his property, which comes into their joint ownership as a natural consequence of the death of that person.

There are two more types of Joint ownerships (Shirkat-ul-Milk)

- Shirkat-ul-Ain
- Shirkat-ul-Dain

A property in shirkat-ul-milk is jointly owned but not divided,
is called “Musha.” Undivided asset can be utilized in the following manner:

a) Mushtarik Intifa’ (Mutual Utilization): Mutually or jointly using an asset alternatively under circumstances where the partners or joint owners are on good terms.

b) Muhaya (Alternate Utilization): Under this arrangement the owners will fix the number of days within a specific time interval for each partner to get usufruct of the asset. For example one may use the product for 15 days and then the other may use it for the rest of the month.

c) Taqseem (Division): This refers to division of the jointly owned asset. This may be applied in cases where the asset that is owned can be divided permanently. For example, jointly taking a 1,000 sq. yards plot and making a house on 500 sq. yards by each of the two owners.

d) Under a situation where the partners are not satisfied with alternate utilization arrangement, the property or asset jointly held can be sold off and proceeds be distributed between the partners.

2) Shirkat-ul-Aqd (Partnership by contract)
This is the second type of Shirkah, which means, "a partnership effected by a mutual contract". For the purpose of brevity, it may also be translated as "joint commercial enterprise." Shirkat-ul-Aqd” can further be classified into three kinds:

(i) Shirkat-ul-Amwal (Partnership in capital): where all the partners invest some capital into a commercial enterprise.
(ii) **Shirkat-ul-Aamal (Partnership in services):** where all the partners jointly undertake to render some services for their customers, and the fee charged from them is distributed among them according to an agreed ratio. For example, if two people agree to undertake tailoring services for their customers on the condition that the wages so earned will go into a joint pool which shall be distributed between them irrespective of the size of work each partner has actually done, this partnership will be a shirkat-ul-aamal which is also called Shirkat-ut-taqabbul or Shirkat-us-sanai or Shirkat-ul-abdan.

(iii) **Shirkat-ul-Wujooh (Partnership in goodwill):** The word Wujooh has its root in the Arabic word Wajahat meaning goodwill. Here, the partners have no investment at all. They purchase commodities on deferred price, by getting favorable credit terms because of their goodwill and sell goods at spot. The profit so earned is distributed between them at an agreed ratio.

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

a) **Shirkat-Al-Mufawada (Capital, Labor & Profit at par):** All partners share capital, management, profit, risk & reward in absolute equality. It is a necessary condition for all four categories to be shared amongst the partners; if any one category is not shared in absolute equality, then the partnership becomes Shirkat-ul-'Ainan. Every partner who shares equally is a Trustee, Guarantor and Agent on behalf of the other partners.

b) **Shirkat-ul-Ainan:** A more common type of Shirkat-ul-Aqd where capital, management or profit ratio is not equal in all respect.
All these modes of "Sharing" or partnership are termed as "Shirkah" in the terminology of Islamic Fiqh, while the term "Musharakah" is not found in the books of Fiqh. This term (i.e. Musharakah) has been introduced recently by those who have written on the subject of Islamic modes of financing and it is normally restricted to a particular type of "Shirkah", that is, the Shirkat-ul-Amwal, where two or more persons invest some of their capital in a joint commercial venture. However, sometimes it includes Shirkat-ul-Aamal elsewhere partnership takes place in the business of services.

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

Rules & Conditions of Shirkat-ul-Aqd

The common conditions of Shirkat-ul-Aqad are three which are as follows:

a) The existence of Muta'qidain (Partners):

b) Capability of Partners: The partners must be sane & mature and capable of entering into a contract. The contract must take place with free consent of the parties without any fraud or misrepresentation.

c) The presence of the commodity: This means the price and commodity itself.

There are also three special conditions which are as follows:
a) **The commodity of partnership should be capable of an Agency:** As each partner is responsible for managing the project, therefore he will directly influence the overall profitability of the business. As a result, each member in Shirkat-ul-Aqd should duly qualify as legally being eligible of becoming an agent and of carrying on business. For example, 'A' has written a book and owns it, 'B' cannot sell it unless 'A' appoints 'B' as his agent.

b) **The rate of profit sharing should be determined:** The share of each partner in the profit earned should be identified at the time of the contract. If however, the ratio is not determined beforehand, the contract becomes void (Fasid). Therefore, identifying the profit share is necessary.

c) **Profit & Loss Sharing:** All partners will share in the profit as well as the loss. By placing the burden of loss solely on one or a few partners makes the partnership invalid. A condition for Shirkat-ul-Aqd is that the partners will jointly share the profit. However, defining an absolute value of profit is not permissible, therefore only a percentage of the total return is allowed.

**The basic rules of Musharakah**

Musharakah or Shirkat-ul-Amwal is a relationship established by the parties through a mutual contract. Therefore, it goes without saying that all the necessary ingredients of a valid contract must be present here also. For example, the parties should be capable of entering into a contract; the contract must take place with free consent of the parties without any duress, fraud or misrepresentation, etc. But there are certain elements, which are peculiar to the contract of "Musharakah". They are summarized here:
1) Basic rules of Capital

The capital in a Musharakah agreement should be:

a) **Quantified (Ma’loom):** Meaning how much money is invested.

b) **Specified (Muta’aiyan):** Meaningspecifiedintermsof currency.

c) **Not necessarily be merged:** The mixing of capital is not required.

d) **Not necessarily be in liquid form:** Capital share may be contributed either in cash/liquid or in the form of commodities. In case of a commodity, the market value of the commodity shall determine the share of the partner in the capital.

2) Management of Musharakah

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

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

3) Basic rules of distribution of Profit

1. The ratio of profit for each partner must be determined in respect of the actual profit earned by the business and not
in proportion to the capital invested by him. For example, if it is agreed between them that 'A' will get 1% of his investment, the contract is not valid.

2. It is not allowed to fix a lump sum amount for anyone of the partners or any rate of profit tied up with his investment. Therefore, if 'A' & 'B' enter into a partnership and it is agreed between them that 'A' shall be given Rs.10,000/- per month as his share in the profit and the rest will go to 'B', the partnership is invalid.

3. If both partners agree that each one will get percentage of profit based on his capital proportion, whether both take part in the management of the business or not, it is allowed.

4. It is also allowed that if an investor is working, his profit share (%) could be more than his capital share (%) irrespective of whether the other partner is working or not. For example, if 'A' & 'B' have invested Rs.1,000/- each in a business and it may be agreed that only 'A' will work will get 2/3rd of the profit while 'B' will only get 1/3rd. Similarly, if the condition of work is also imposed on 'B' in the agreement, then the proportion of profit for 'A' can be more than his investment.

5. If a partner has put an express condition in the agreement that he will not work for the Musharakah and will remain a sleeping partner throughout the term of Musharakah, then his share of profit cannot be more than the ratio of his investment. However, Hanbali school of thought considers fixing the sleeping partners profit share more than his investment share to be permissible.

6. It is allowed that if a partner is not working, his profit share
can be established as less than his capital share.

7. If both are working partners, the share of profit can differ from the ratio of investment. For example, ‘Zaid’ & ‘Bakar’ both have invested Rs.1,000/- each. However, Zaid gets 1/3rd of the total profit and Bakar gets 2/3rd, this is allowed. This opinion of Imam Abu Hanifa is based on the fact that capital is not the only factor for profit distribution but also labor and work. Although the investment of two partners is the same but in some cases, quantity and quality of work might differ.

4) Basic rules of distribution of Loss
All scholars are unanimous on the principle of loss sharing in Shariah, based on the saying of Syednna Ali Ibn Talib that is as follows:

"Loss is distributed exactly according to the ratio of investment and the profit is distributed according to the agreement of the partners."

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

5) Powers & Rights of Partners in Musharakah
After entering into a Musharakah contract, partners have the following rights:
a) The right to sell the mutually owned property since all partners are representing each other in Shirkah and all have the right to buy & sell for business purposes.

b) The right to buy raw material or other stocks on cash or credit, using funds belonging to Shirkah, to put into the business.

c) The right to hire people to carry out business, if needed.

d) The right to deposit money and goods of the business belonging to Shirkah as depositor trust where and when necessary.

e) The right to use Shirkah's fund or goods in Mudarabah.

f) The right of giving Shirkah's funds as hiba (gift) or loan. If one partner for purpose of investing in the business has taken a Qard-e-Hasana, then paying it becomes liable on both.

6) Termination of Musharakah

Musharakah will stand terminated in the following cases:

1. If the purpose of forming the Shirkah has been achieved. For example, if two partners form a Shirkah for a certain project such as buying a specific quantity of cloth in order to sell it and the cloth is purchased and sold with mutual investment, the rules are simple and clear in this case. The distribution of profit will be as per the agreed rate, whereas in case of loss, each partner will bear the loss according to his ratio of investment.

2. Every partner has the right to terminate the Musharakah at any time after giving his partner a notice that will cause the
Musharakah to end. For dissolving this partnership, if the assets are liquidated, they will be distributed between the partners on the following basis:

a) If there is no profit and no loss to the assets, they will be distributed on pro rata basis.

b) In case of loss as well, all assets will be distributed on pro rata basis.

3. In case of the death of any one of the partners or any partner becoming insane or incapable of effecting commercial transaction, the Musharakah stands terminated.

4. In case of damage to the share capital of one partner before mixing the same in the total investment and before affecting the purchase, the partnership will stand terminated and the loss will only be borne by that particular partner. However, if the share capital of all partners has been mixed and could not be identified singly, then the loss will be shared by all and the partnership will not be terminated.

Termination of Musharakah without closing the business
If one of the partners wants termination of the Musharakah, while the other partner or partners like to continue with the business, this purpose can be achieved by mutual agreement. The partners who want to run the business may purchase the share of the partner who wants to terminate his partnership, because the termination of Musharakah with one partner does not imply its termination between the other partners. However, in this case, the price of the share of the leaving partner must be determined by mutual consent. If there is a dispute about the valuation of the share and the partners do not arrive at an agreed
price, the leaving partner may compel other partners on the liquidation or on the distribution of the assets themselves.

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

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

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

"المسلمون على شروطهم الاعترافة. حالاً أوالح حراماً" [المجمع الكبير، ص 2، حديث 2613]

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

Dispute Resolution

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

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

The difference between interest based financing and Musharakah

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<th>Interest Based Financing</th>
<th>Musharakah</th>
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<tr>
<td>A fixed rate of return on a loan advanced by the financier is predetermined irrespective of the profit earned or loss suffered by the debtor.</td>
<td>Musharakah does not envisage a fixed rate of return. The return is based on the actual profit earned by the joint venture.</td>
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<tr>
<td>The financier cannot suffer loss.</td>
<td>The financier can suffer loss, if the joint venture fails to produce fruits.</td>
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Issues Relating to Musharakah
Musharakah is a mode of financing in Islam. Following are some issues relating to the tenure of Musharakah, redemption in Musharakah and the mixing of capital in conducting Musharakah.
Liquidity of Capital

A question commonly asked in the operation of Musharakah is whether the capital invested needs to be in liquid form or not. The answer as to whether the contract in Musharakah can be based on commodities only or on money, varies among the different schools of thought in Islam. For example, if ‘Zaid’ and ‘Bakar’ agree to invest Rs.1,000/- each in a garment business and both keep their investments with themselves. Then, if ‘Zaid’ buys cloth with his investment, will it be considered belonging to both Zaid and Bakar or only to Zaid? Furthermore, if the cloth is sold, can Zaid alone claim the profit or loss on the sale? In order to answer this question, the prime consideration should be whether the partnership becomes effective without mixing the two investments profit or loss. This issue can be resolved in the light of the following schools of thought of different fiqhs:

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

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

- If in case of redistribution of share capital to the partners, tracing back each partner's share becomes difficult. If the share capital was in the form of commodities then redistribution cannot take place because they may have been
Imam Shafi has an opinion dividing commodities into two:

- **Dhawat-ul-Amthal (Homogenous Commodities)**
  Commodities which if destroyed can be compensated by similar commodities in quality and quantity. Example rice, wheat etc.

- **Dhawat-ul-Qeemah (Heterogeneous Commodities)**
  Commodities that cannot be compensated by similar commodities, like animals.

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

The illiquid goods can be made capital of investment and the market value of the commodities shall determine the share of the partner in the capital. It seems that the view of Imam Malik is more simple and reasonable and meets the need of the modern business therefore this view can be acted upon.

We may therefore conclude from the above discussion that the share capital in a Musharakah can be contributed either in cash or in the form of commodities. In the latter case, the market value of the commodities shall determine the share of partner in the capital.
Mixing of the Capital

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

According to Imam Abu Hanifa, Imam Malik and Imam Ahmed bin Hunbul, the partnership is complete only with an agreement and the mixing of capital is not important. They are of the opinion that when two partners agree to form a partnership without mixing their capital of investment, then if one partner bought some goods for the partnership with his share of investment of Rs.100,000/-, these goods will be accepted as being owned by both partners and hence any profit or loss on sale of these goods should be shared according to the partnership agreement.

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

Since in Hanafi, Maliki and Hanbali schools of thought mixing of the capital is not important, therefore, a very important present
day issue is addressed with reference to this principle. If some companies or trading houses enter into partnership for setting up an industry to conduct business, and they need to open LC for importing the machinery. This LC reaches the importer through his bank. Now when the machinery reaches the port and the importing companies need to pay for taking possession, the latter need to show those receipts in order to take possession of the goods.

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

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

a) In case of loss the burden of loss will not fall upon one partner rather, it will be shared by all partners of the firm.

b) If the capital is provided at the time of the agreement, it stays blocked for the period during which the machinery is being imported. While if the capital was not kept idle till the actual operation could be conducted with the machinery, the same
capital could have been used for something else as well.

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

**Tenure of Musharakah**

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

a) The partnership is fixed for such a long time that at the end of the tenure no other business can be conducted.

b) Can be for a very short time period during which partnership is necessary and neither partner can dissolve the partnership.

Under the Hanafi school of thought, a person can fix the tenure of the partnership because it is an agreement and an agreement may have a fixed period of time. In the Hanbali school of thought, the tenure can be fixed for the partner as it is an agency agreement and an agency agreement in this school can be fixed. The Maliki school however says that Shirkah cannot be subjected to a fixed tenure. Shafi school like the Maliki consider fixing the tenure to be impermissible. Their argument is that fixing the period will prohibit conducting the business at the end of that period which in turn means that the fixing will prevent them from conducting the business.

**Uses of Musharakah / Mudarabah**

These modes can be used in the following areas (or can replace them according to Shariah rules)
Asset Side Financing
- Short/medium/long-term financing
- Project financing
- Small & medium enterprises setup financing
- Large enterprise financing
- Import financing
- Import bills drawn under import letters of credit
- Inland bills drawn under inland letters of credit
- Bridge financing
- LC with margin (for Musharakah)
- Export financing (Pre-shipment financing)
- Working capital Financing
- Running accounts financing / short term advances

Liability Side Financing
- For current/saving/mahana/amdani/investment accounts (Deposit giving Profit based on Musharakah/Mudarbah - with predetermined ratio)
- Inter-Bank lending / borrowing
- Term Finance Certificates & Certificate of Investment
- Securitization for large projects (based on Musharakah)
- Certificate of Investment based on Murabahah (e.g: Meezan Riba Free)
- Islamic Bank Musharakah bonds (based on projects requiring large amounts - profit based on the return from the project).

Risks in Musharakah Financing
Some of the measure risks and problems that are being faced by Islamic Banks in extending Musharakah or Mudarbah based financing are as follows:

1) **Business Risk:** In Musharakah Financing, the bank is sharing
the business risk with the customer since the return in Musharkah financing is dependant on the actual performance of the business. The bank should make a feasibility study of the business of the customer and should prudently evaluate all the risks of any business before making Musharakah financing decisions, since exposure of bank is on the business performance and not on the customer, unless and until fraud or negligence is established on part of the customer.

2) **Risk of Proper Book Keeping:** Another problem in Musharkah transaction is lack of transparent book keeping practices adopted by various companies due to taxation reasons. Due to this lack of transparency, it is difficult to evaluate the actual performance of any business since it is not completely portrayed in the disclosed accounts of the company and in the absence of such information, it is difficult to enter into a Musharkah arrangement with the customer.

3) **Customer Mindset:** In Musharkah financing the actual profits and loss of the business are shared between the partners therefore if the business performs higher then the expectation then it will generate higher profits. If high profits are generated by the business then Bank will also be getting high profits as per the profit sharing arrangement but many customers are hesitant in providing profit that is more than the average market benchmark rate of financing.

4) **Dishonesty:** Another apprehension against musharakah financing is that the dishonest clients may exploit the instrument of musharakah by not paying any return to the financiers. They can always show that the business did not earn any profit by manipulating the records of the company. Indeed, they can claim that it has suffered a loss in which case
not only the profit, but also the principal amount will be jeopardized.

5) **Operational Risk:** Success of Musharakah depends upon better management of the factors of operational risks, which include:

a) Control over management  
b) Transparency in income  
c) Commitment by management

Islamic Banks can take following steps for proper management of Operational risks in Musharakah.

By appointing bank’s representatives in:

- Company’s BOD  
- Finance  
- Internal audit

These representatives should be given proper authority & will be directly reporting to Bank’s management.

6) **Credit Risk:** In Musharakah, the Musharik bank is exposed to similar credit risks if some amount is payable by customs under the Musharakah Agreement, as other banks, which include: Risk of default and Party risk.

Credit risk can be mitigated by:

- Proper evaluation of the customers financial position  
- Any Shariah Compliant security can be taken to secure
the bank against any dishonesty or act of negligence by the customer.

- Evaluation of customers credit history
- Past relationship with bank.