

Islamic Law of Contracts

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Introduction

- ❖ The Islamic law of Contracts is the basis of all Islamic finance transactions.
- ❖ The Fiqh al muamalat (Islamic commercial jurisprudence): is a comprehensive body of principles and rules, designed to promote harmonious relations between contracting parties and avoidance of the kinds of problems in contracting that can result in falling-out of the contracting parties leading to costly litigation or other misfortunes.

Business Transactions in Islam

- The Prophet Muhammad (PBUH) was a trans-territorial trader
- Islam encourages people to earn a living through legitimate means
- Islam emphasises the right to lawfully acquire property and ensures that such rights are protected
- *Fiqh mu'amalat proclaims all transactions to be permissible if free of usury, deception, speculation, undue profits and engaging in prohibited items*
- The Sharī'ah does not limit profit amount in business

However:

- Commodities should be sold at market prevailing rates
- It is prohibited for a trader to exploit buyers not aware of the market price

The Islamic Law of contract

- The term used for 'contract' in Arabic is *aqd*, which means
 - To tie between two ends, to fasten, to link
 - In Islamic law, it means agreement, commercial arrangement, legal transaction, document or deed
- It is an agreement among parties concluded through an offer and acceptance with the consequences of binding legal obligation.
- ❖ The Aqd' (the contract)
- ❖ The Wa'd (unilateral promise)
- ❖ Muwaada or Mua'hida (bilateral promise)

The Islamic Law of contract WA'D (Promise)

- *Wa'ad is a binding unilateral contract where a party promises or undertakes to carry out a unilateral contract*
 - A unilateral undertaking or a promise by one party to do or not to do certain actions in the future . The primary difference between a promise and a contract is that the promise is binding only the maker whereas a contract binds both parties.
 - The concept of *wa'ad* is based on *fulfilment of promise* in all dispositions
 - Most jurists consider fulfilling *wa'ad* as **recommended** in financial transactions
 - Maliki scholars believe that fulfilling *wa'ad* is **obligatory** and enforceable

The Islamic Law of contract Bilateral Promise (Muwaada)

Muwa'adah: a conditional/unconditional bilateral contract

Example.

- A provides a unilateral promise to B that he will purchase B's house for US\$ 250,000 any time within the next 12 months.
- B gives a unilateral promise to A that he will sell his house to A for US\$ 250,000 any time within the next 12 months.

The Islamic Law of contract Aqd' (Contract)

Definition

“ is transaction that is executed between two or more parties for mutual benefit and with mutual consent”

The Islamic Law of contract -Aqd' (Contract)

Requirements of a valid contract :

- ❖ There must be at least two independent parties
- ❖ There must be offer and acceptance relating to both price and asset.
- ❖ Acceptance should match the offer.
- ❖ There must be a material effect (transfer of ownership) following exchange of asset and consideration (Payment or fee).

Example:

“A offers to sell his car to B for US\$ 15,000. B accepts the offer to purchase the car for US\$ 15,000”

The Islamic Law of contract

Aqd' (Contract)

Types of Aqd'

1. **Compensatory contracts:** where one person sells something to someone else for a price or other compensation. e.g. A sold his car to B for US\$ 5,000.
2. **Non-compensatory:** where one person gives something to someone else without any compensation e.g. Inheritance or Donation.

The Islamic Law of contract

Aqd' (Contract)

Components and Conditions Influencing Contracts:

- ❖ Contracting parties
- ❖ Subject matter
- ❖ Offer and acceptance.

The Islamic Law of contract Aqd' (Contract)

The **Contracting Parties** should fulfil the following conditions :

- ❖ Mature : Adult under Islamic law.
- ❖ Sane : mentally sound at the time of the execution of the contract both temporarily or permanently.

The Islamic Law of contract Aqd' (Contract)

The **Subject Matter** of a transaction needs to meet the following criteria for it to be valid:

- ❖ **Valuable in the eyes of Sharia'a** : Halal goods.
- ❖ **Existence** : at the time of entering into the contract with exception of Istisn'a and Salam.
- ❖ **Ownership** : must owned by the seller, either a physical ownership (the subject matter under the name of the seller) or constructive ownership (under the name of other who act as a trustee or agent to the seller).
- ❖ **Ability to Deliver** : can be absolute (can not be delivered) or non-absolute (cannot be delivered immediately to the buyer) , absolute make the contract invalid.
- ❖ **Specific** : without any uncertainty. Can be achieved through : the parties inspect the subject matter or described in sufficient detail in the contract.

The Islamic Law of contract Aqd' (Contract)

The following are the conditions that must be met for

Offer and Acceptance :

- ❖ Acceptance should be absolute.
- ❖ Connection of offer and acceptance
- ❖ Acceptance needs to take place before the offer is withdrawn.

The Islamic Law of contract Aqd' (Contract)

Sharia'a options of Sale :

- ❖ Buyer's option to Rescind: before the execution of contract.
- ❖ Option of Inspection.
- ❖ Option of Defect: right to return if defective.
- ❖ Option of Quality: as specified.
- ❖ Option of Price: fair price within the market range.

The Islamic Law of contract Aqd' (Contract)

A classification of contracts with respect to their effect could divide them into:

- ❖ **Valid (Sahih):** the components and conditions of sharia'a are met. Valid contract could be either : 1- Nafiz : enforceable contract or 2- Mawqoof : enforceable until authorised.
- ❖ **Voidable (Fasid):** sound in its essence , but is unlawful in its conditions.
- ❖ **Invalid (Batil):** not good in its essence or components.

The Islamic Law of contract Aqd' (Contract)

Unilateral contracts

- ❖ Gift (Hiba).
- ❖ Ia'ra : Borrowing and obtaining benefit of a tangible asset without consideration.
- ❖ Benevolent Loan (Qard Hasan)

Bilateral Contracts

- ❖ Contracts of Exchange (Muawadat).
- ❖ Contracts of partnership (Shirkah).
- ❖ Contracts of security (Damant).
- ❖ Wakala , Jual
- ❖ Wadia

The Islamic Law of contract

Contracts of Exchange

- Exchange or the transfer of ownership of specific objects or goods either by exchanging :
 - ❖ Good for good (barter trading).
 - ❖ Good for money (Sale)
 - ❖ Money for money (Sarf).

The Islamic Law of contract

Examples of exchange contract

- ❖ Cost plus profit sale (Murabaha).
- ❖ Foreign Exchange (Sarf).
- ❖ Short-term production finance (Salam).
- ❖ Long-term production finance or progressive finance (Istisn'a).
- ❖ Down payment (Arbun)
- ❖ Barter contract (Musawama).

The Islamic Law of contract Problematic Sales contracts.

Twin sales (Bai al-Inah)

Example:

X sells his car to Y for GBP 25,000 today. Y agrees that once he owns the car, he will sell it back to X against deferred payment GBP 26,000.

Note: Twin sales are akin to loans with interest and thus **prohibited**.

Twin Contracts (Bai'atayn fi Baia'h)

Example:

A agrees to sell goods at a discounted price to B conditional on B selling his house to A.

Note: the combination of two contracts into one where one contract is conditional upon the other is **disallowed**.

The Islamic Law of contract Other contracts

- ❖ The main contracts allowing the transfer of the usufruct is leasing contract (IJARA).
- ❖ Partnership contracts can be divided into Passive partnership (Mudaraba) and Joint ventures (Musharaka).

The Islamic Law of contract Security Contracts

- ❖ Transfer (Hawala): X who is based in England transfers GBP 200 to the account of Y who is based in Belgium. X instructs the bank to effect this transfer and the bank charges an administration fee of GBP 20.
- ❖ Guarantee (Kafala) : X has borrowed \$ 3,000 from Z to buy a car. X enters a Kafala Contract with Y (the guarantor) under which Y agrees to repay Z \$ 3,000 if X is unable to pay him. Y could charge X an administration fee for issuing a letter of guarantee on his behalf.

The Islamic Law of contract Security Contracts

- ❖ Collateral (Rahn) :
 1. Creditor/seller prefer to mitigate the risk of default by debtor/buyer by taking collateral.
 2. Any surplus proceeds in excess of the outstanding debt realised from the sale of the pledged asset must return to the debtor.
 3. The owner of the collateralised asset may continue to benefit from it while at the same time using it as collateral.

The Islamic Law of contract Wakala (Agency contract)

There are two types of agency contract:

1. Disclosed Agency: the agent disclose his role as agent to others. This is considered to be the preferred type.
2. Undisclosed agency: the agent does not disclose that he acts on behalf of another party and for all intense and purposes is acting as principal in dealing with third parties.

The Islamic Law of contract Foreign Exchange Transactions (SARF)

It is permissible to trade in currencies under the following Shari'a conditions:

- ❖ Immediate possession of the counter values.
- ❖ the counter values of the same currency must be of equal amount.
- ❖ The contract shall not contain any conditional option.
- ❖ Shall not aim to establish a monopoly position.
- ❖ Shall not be carried on the forward or futures market.

The Islamic Law of contract Foreign Exchange Transactions (SARF)

- ❖ Currency dealings cannot be done as forward sale contracts and consequently must be done as spot transactions.
- ❖ It is permissible to hedge against foreign currency , recourse to the following:
 1. Exchange of deposits without receiving or giving any extra benefit.
 2. Sell goods on credit (Murabah) in which the currency is not the seller's own currency.
 3. Buy goods on credit (Reverse Murabaha) in which the future payment is in a currency which is not the buyer's own currency.

The Islamic Law of contract Foreign Exchange Transactions (SARF)

- ❖ AAOIFI's Sharia'a standards on the sale of currencies:
 - Both parties take possession of the full amount of the counter value at the closing of the transaction (partial possession is not sufficient).
 - Possession may be either physical or constructive (tasaruf) : cash for cash, cheque and credit card slip.

The Islamic Law of contract Foreign Exchange Transactions (SARF)

- ❖ Foreign exchange contracts can be executed using an agent.
- ❖ The contract is not completed until acceptance by the offeree and taking possession of the counter values.
- ❖ Only a unilateral promise is permissible in Foreign Exchange.
- ❖ The parallel purchase and sale of currencies is not permissible (deferred sale and conditional offer).
- ❖ Settling amounts owed in different currencies between two parties are permissible.
- ❖ It is not permitted for customer to enter into currency trading for an amount of money exceeding the amount of money he owns using credit facilities.

Exercises

- 3.1 A bank has extended a Murabahah facility to a customer whereby the bank purchases from the vendor an asset at \$ 200,000. The bank subsequently sells the asset to a customer at \$ 250,000. payable within five years. Why is this additional payment permissible in Murabahah but not permissible in a loan contract.
- 3.2 A new Islamic bank has been established in your area. The bank accepts deposits on Islamic principles. It has received an application for financing from a customer who intends to purchase a factory that produces alcoholic liquor . This customer's application has been declined. The customer has asked you to explain why the application has not been accepted. How would you explain this to the customer?

Case Study : Pharmaceutical Society of Great Britain v Boots Cash Chemists

Boots Cash Chemists implement a new way to let the customers to shop for medicine. Instead of the old fashion way of a assistant over the counter to get the medicine the shoppers request, they let the customers to pick of drugs from the shelves themselves.

The problem came in when the Pharmaceutical Society of Great Britain object their new way of handling the business as under the Pharmacy and Poisons Act 1933 under section 18(1) a pharmacist is needed to be there at the point where the sales is taken place. The society argued that the display of drugs was an offer to the shoppers and when they put the drugs in the basket, it is a form of acceptance. And they argue that there isn't any pharmacist there at that point of time is a violation towards the law. But of course, Boots defended themselves by saying that the sales will only take place when the buyers are at the counter and is ready to pay. This case eventually was brought up to the court and both high court and court of appeal sided Boots. They said that the displays of the drugs or goods are not an offer but an invitation to treat. And when the customer decides to buy something and put the item into their basket, they are the one who make offer to buy the goods. Thus, this offer from the customer can be rejected or accepted by the cashier at the counter. The contract is completed at the cashier counter where there is a supervising pharmacist there. Thus, the result was that Boots was not violating the Law Act.

Case Study : Pharmaceutical Society of Great Britain v Boots Cash Chemists

- Having read the details of the Boots Cash Chemist case , explain what you would expect the Shari'ah perspective to be on this point of law.