

Classical Jurists Perspective of Entitlement of Profit in Mudarabah: How and Who Really Deserves?

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The study aims to discuss the invalidity of amount of profit as percentage of capital and offers theoretical and practical implications from the Islamic perspective. Acquisition of profit is the basic goal of any business contract and it has always been a privileged sign for investor and entrepreneur to gain more profit from a venture. Profit earned by a business venture is shared among them as per the provisions of the contract. In partnership, the profit of venture cannot be stipulated only for the investor or only for the entrepreneur who runs the business. The paper aims to discuss the conditions of profit; the discussion of the classical jurists regarding the proportional division of profit and the methods of distribution. This paper intends to argue how and who should be entitled for the profit (either completely or partially) of a venture or investment from the Islamic perspective.

Key Words

profit acquisition, profit distribution, profit entitlement, classical Islamic jurists.

Introduction

The basic purpose behind the formation of any form of business organization is to earn profit and when business goes to set the struggle is made for its maximization. So profit is of key importance to run and regulate the economic activities successfully. In this regard the volume of profit determines the success and failure of business; it earns during the financial cycle. Wealth is a key factor to generate profit but it is not the only one which contributes, as wealth in itself do not possess the potential to grow until it is engaged with work; and to engage it with work needs another qualification that is ownership. The continuity of ownership must be retained with the wealth as long as it is retained or engaged with work to generate more wealth or to produce more goods. The determination of the continuity of ownership leads towards the sharia maxim of “daman al-mal”. The prophetic saying “Revenue is based upon the corresponding liability for bearing loss” is a central qualification to judge the validity for the entitlement of profit. This prophetic saying is a base for the famous sharia maxim “Al-Kharaj bi-al-Daman*” or “Al

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Ghunmbilghurm” a standard criteria to judge the legality of any return on the capital which means that one cannot entitles to profit until he bears the liability for loss. The creation of profit must be made by sharing risk and by the continuity of ownership either it is through the pricing of merchandise, services or by the usufructs of the real assets. Here, we will discuss the classical jurist’s perspective for the entitlement of profit.

Entitlement of profit in perspective to classical Jurists

According to Hanafi jurists one entitles to profit for three reasons namely wealth, work and daman (bear the liability for loss). If any of these is not found towards any return on capital, such a gain on capital cannot be justified as legal. These three bases also provide a justification to permit an excess amount of profit for a partner due to excess work performed by him in a joint venture.

Kasani among the Hanafis states: (1)

“The decree, in our view, is that entitlement to profit is either because of wealth or work or by bearing a liability for loss. As for entitlement due to wealth, it is crystal clear, because profit is a increase in wealth and goes to its owner. It is for this very reason that the rabb al-mal in a contract of mudarabah sanctioned profit and similarly the collaborator. In the case of liability for bearing loss, if the agent manager were made to bear the liability for loss, he would have the right for the entire profit (of the mudarabah). This just because of his liability for sharing loss, and it is the revenue of this liability. The Prophet (peace be upon him) said: “Revenue is based upon the corresponding liability for bearing loss.” So, if the liability for bearing the loss rests on him, the kharaj belongs to him too.”

Kasani statement demonstrates that *daman* is always associated with wealth to be entitled for profit as only the wealth do not possess the ability to grow until it joins hands with entrepreneur. An entrepreneur entitles to get the profit because he has invested the wealth and has also under taken the liability to bear for loss. This reveals that *daman* is a built in feature with wealth which cannot be separated from it. The Hadith ‘al-Kharaj bi-daman’ links the gain on capital to contractual liability so the clear reflection of this tradition for the entitlement of profit will be made when the contribution of wealth is made with bearing the liability for loss

and continuous retention of ownership. The principle of 'al-Kharaj bi-daman' is more general in its meanings thus it not only covers profit but includes rewards/revenues being its validity in the general law of contract and thus it is applied to other factors of production other than the wealth i.e. land and labour.

The Hanbalis opines are quite similar to those of the Hanafis, especially with respect to wealth.

IbnQudamah states:(2)

“In our view, daman is a basis for entitlement to profit on the argument of sharikat al-abdan. The acceptance of work involves daman for the person accepting work (as an independent contractor) and provides a basis for entitlement to profit. It is, therefore, similar to the acceptance of wealth in mudarabah. The worker through his work is entitled to profit; it is thus like a mudarabah.”

An analysis of IbnQudamah statement reveals that the concept of *daman* as stated by the Hanafisis also being acknowledged by the Hanbalies, although there is a difference in employing the reasoning as it was employed by the Hanafies. It is clear from the above passages that wealth, work and liability for bearing the loss are at least three reasons for the entitlement of profit. (3)

According to Malikis for entitlement to profit work is accommodated as a subservient to wealth. A partner is entitled to the profit on the basis of wealth; he has contributed in a venture whereas if he contributes work along with his wealth it will be considered subservient to wealth. Seemingly Malikis consider work not an independent variable for the entitlement of profit but it is not as. The analysis of Malikis jurists demonstrates that the legal source for the entitlement to profit is the contribution of either work or capital.

IbnRushd of Malikis states: (4)

“The third element is work which is subservient according to Malik, as we said, to wealth and is not treated as an independent basis. According to Abu Hanifah, it is treated as an independent basis with wealth.”

No doubt IbnRushd hails work as a source of profit subservient to wealth in the contracts where wealth accompanies labour and when work is not dependent on wealth it is a valid source for entitlement of profit. As we find that Malikis allow shirkat al-abdan and

Mudarabah where work in itself becomes a source of profit as there is absence of capital by the Mudarib.(5)

It is further to be noted that Sharikat al-wujuh is impermissible according to Malikis on the basis that partnership is firmly linked to wealth or work and both of these segments are absent in the case of Sharikat al-wujuh.(6)

According to Shafis entrepreneurial activities are permissible only on the basis of wealth thus all other organizations which are devoid of wealth are not seen as the legal basis for the entitlement of profit. *Sharikat al-wujuh* as it is based on *daman* and the *sharikatal-abdan* as it is based upon labour are impermissible because of the absence of the involvement of the wealth in their view. So far it is concerned to the question of the entitlement of the Mudarabah business where profit is shared by the entrepreneur without sharing his capital and he entitles to profit due to his work and management; they treated Mudarabah on the basis of analogy of muzaraah not as a form of partnership. (7)

Entitlement of profit in Mudarabah contract

The acquisition of profit is the basic goal of a Mudarabah contract and this has always been a privileged sign for Rabbul Mall and Mudarib to gain more profit. Profit earned by Mudarabah is shared among them as per the provisions of the contract. The profit of Mudarabah cannot be stipulated only for the investor or only for the worker.

Regarding the conditions of the Mudarbah profit, the discussion of the classical jurists can be allocated in two phases. The first phase relates to the proportional division of the Mudarabah Profit whereas the second phase relates with the method for the distribution of the profit. It is unanimously accepted by the jurists that the profit of Mudarabah must be expressed as a ratio or as a part of the total profit. The fraction or the proportion of profit must be expressed at the start of the contract at appropriate time when Mudarabah is being negotiated among the partners. The profit cannot be expressed as a percentage of Mudarabah capital or in form of fixed amount, if it happens it will invalidate the contract. The reason for the invalidity in form of fixed amount of profit is the creation of inequitable situation or uncertainty for sharing the proceeds of the business. Thus any condition that leads to uncertainty or inequitable situation will render the contract unenforceable. (8)

The creation of inequitable situation in case of fixed amount of profit can be stated in an example. Let's see if Rabbul Mall agrees to pay a fixed amount of Rs. 1000 to the agent manager at the beginning of the contract but unfortunately Mudarib fails to earn any profit during the period of the contract or he earns a profit equal to the guaranteed amount only, all the profit will go to the Mudarib and there will be nothing for the investor. And in case if the profit amount will be less than the guaranteed income Rs. 1000 to Mudarib it will be worse situation as compared to the previous one. Here the investor has to pay Rs. 1000 to Mudarib from his own money in order to keep up his word. Furthermore, knowing the guaranteed amount of profit will affect the efficiency of Mudarib and he will have no interest to maximize the amount of profit as there will be no incentive for him towards this maximization of profit as it will be for the sake of the investor only.

A similar position has been discussed by Malikis in al-Mudawwanah: (9)

[Sahnun]: What do you think if I take a palm grove on the condition that the entire produce that Allah may grant will belong to me? [Ibn al-Qasim]: There is no harm in this according to Malik. [Sahnun]: Did Malik permit this? [Ibn al-Qasim]: The reason is that it is the same as a bida'ah given to you on the condition that the entire profit is for you. Further, as it is permitted that he leaves half the produce for your labor; he can also leave the entire produce to you."

An accepted standard ratio of Mudarabah profit for the parties of the contract has not been determined by the classical jurists, they entirely let it on the discretion of the parties of the contract at the time when contract is being agreed upon. Jurists are unanimously agreed on the point that the profit of Mudarabah should be allocated in ratio or percentage. In sharing the amount of profit the general rule is "equality" (10) so in case if the ratio or the proportion of the profit has not been mentioned in the contract the profit will be shared on equal basis among the parties of the contract.

It will not be permissible for either side of the contractual parties to stipulate an amount of profit for the third party. It is only permitted for the slave of the rabb al-mal. IbnRushd states in this regard:

“Malik, al-Shafi‘i, and Abu Hanifah permitted this, while Ashhab, from among the disciples of Malik, said that it is not.”(11)

Our discussion regarding the proportional division of Mudarabah profit determines the following:

- Both parties of the Mudarabah have freedom of agreement on the division of the profit with mutual consent. They may come on equal division or to allocate different proportions however this ratio should be decided at the time the contract is concluded. For example they can agree on that 30, 50 or 60% profit will be for Rabbul-mal and the remaining 70, 50 or 40% will be for Mudarib but a lump sum of profit or return on investment cannot be allowed or agreed upon for either side of the parties of the contract. They may agree on equal sharing or destined to get different proportions.
- For different situations different proportions of profit can be agreed upon by the parties of the contract. For example a Rabbul Mall can offer a Mudarib that if he deals in Sugar he will be entitled to get 40% of the profit and if he deals in cloth he will get 50% of the profit.
- Parties of the contract have a right to change the ratio of profit at any time, but it will remain effective for the period for which it has been mutually fixed. If the ratio of the profit has not been predetermined in the contract the profit will be shared on equal basis or the customary practice of traders will be followed to determine the share of profit. In case there is no customary practice the contract will be regarded *void abintio* and the Mudarib will get remuneration for the services he has rendered.
- The parties of the contract may agree on the condition with mutual consent that if the profit of the Mudarabah will be over than a particular ceiling, a certain nominated partner will get a greater share of the profit and if the Mudarabah could not attain the particular ceiling as it remains below or stays to the predetermined boundary, allocation of profit will be done according to the stipulated ratio.

Above discussion determines the scope of proportional division of Mudarabah profit now we will discuss the second phase regarding the methodology of profit distribution.

The procedure of allocation of profit relies on the final outcome of the operations at the time of physical or constructive liquidation of the Mudarabah. Agent manager is bound to return the capital to the investor before the liquidation of the Mudarabah. Jurists are unanimously agreed that mudarabah cannot begin without relinquishing the control of the investor over his capital, thus mudarabah contract could not be liquidated unless the agent manager returns the capital to the investor. Physical possession of capital to the investor is essential in order to determine the surplus from the capital because the profit is defined as any surplus from the capital amount.

IbnQudamah states: (12)

“And there is no profit for the agent manager until he restores the capital. This means the agent manager is not entitled to anything from the business until he returns the capital to the investor, and when there is loss and profit, the former will absorb the latter irrespective of whether they occur at the same or different times. This is because profit means any surplus from the capital and anything which has no excess has no profit.”

It is recognized that the investor and the agent manager may take the probable return of the mudarabah business yet the contract is not dissolved. The partners can provisionally draw the profit without returning the capital; such a case will be treated as closing of the accounts but not the winding up of the business and original mudarabah will be continuing in force. However such a provisional draw of profit will be subject to adjustment at the time of finalization of the accounts. Explaining the position of HanafisSarakshi illustrate a case regarding this matter.

To regulate a mudarabah an investor handovers a 1000 dirhams to an agent manager. The agent manager earns a profit of 1000 dirhams from mudarabah capital. This accrual is shared by the parties of the contract on equal basis and each of them took 500 dirhams whereas the capital remains with the agent manager to carry on the mudarabah business. Unfortunately, after that business turned to losses. According to Sarakshi the former distribution of

profit will be considered as invalid and 500 dirhams taken by the agent manager as profit will be returned as a part of the capital. The provision of returning of the capital is based on the prophetic saying that 'A Muslim is like a trader, just as the trader's profit is not complete until his capital is restored, so too a recommended worship of a Muslim is incomplete until he performs the obligatory worship'. (13)

Shafiis also agreed on this ruling that agent manager has to return the amount of profit that have been taken previously as an expected return, in case if loss is incurred in themudarabah business. They argue that expected profit does not belong to the ownership of the agent manager and thus he has no right to keep it if there is loss. (14)

Hanbalies did not object to the position of the absolute ownership of the amount of profit taken from the running mudarabah business as an expected return. They recognized the absolute ownership of such a profit on the basis of analogy with *musaqah* contract where worker owns his share from the day when fruit reveals to grow on trees, thus the right of ownership from the expected return of mudarabah business goes to the agent manager.(15)

Malikis are too rigid in this regard. According to them, it is prohibited to take expected profit from running mudarabah business. The presence of investor and physical possession of capital is mandatory before the profit distribution process. An agent manager cannot take his expected share from the Mudarabah business without the presence of the investor and ensuring that the capital has been physically possessed to him. If the investor was present during the allocation process of profit but the capital has not been possessed physically to the investor the distribution of profit will not be considered as valid. (16)

Our discussion regarding the methodology of profit distribution determines the following:

- The process of the distribution of the profit is based on the finality of the operations and tasks of the Mudarabah business at the time of physical or constructive liquidation of Mudarabah.
- Either of the partner of the contract have a right to donate his share of profit to the other partner. A bonus can also be awarded by the investor to the agent manager (Mudarib).

Parties of the contract may create a reserves provision from the profit of the business with their mutual consent.

- If Mudarabah business suffers a loss it can be compensated by the profit of the future operation of the joint business or the reserves created in the past. If at the time of the liquidation of the business the losses are in excess than profits, the balance of losses will be settled with the capital. If some transactions have loss while some have profit, the profit can be put to use to balance these losses.
- The Profit of business is shared among the partners when it accrues, but this accrual does not mean a transaction- wise calculation of the profits; it means the overall adjustment of profits and losses over a particular period of time, which will be treated as the closing of the accounts but not necessarily the winding up of the business. However, the partners can provisionally draw the profit that will be subjected to adjustment at the time of finalization of the accounts.
- The realization of profit from the operations of Mudarabah entitles the agent manager to get his share of profit but it is not an absolute entitlement, as it is subjected to retain interim profits for the protection of the Mudarabah capital. It will become an absolute right of Mudarib only when distribution of profit took place.
- For determining profit, the receivables will be taken at their cost or net realizable value, whichever is lower. But while considering their cost, any related provision for bad debt should be deducted for this cost. While determining receivables, time value of money and discount on current value (usually given due to extension in payment period) should not be taken in to account.
- To realize net profit of Mudarabah all the expenses should be deducted in accordance to the customary practice and provisions of the contract.
- The distribution of profit will be undertaken against the net profits of the Mudarabah operations. The share of Mudarib becomes secure after the liquidation of the Mudarabah and the investor recovers its capital and share of profit.

Other than his share of profit as mutually agreed upon in the contract of Mudarabah a Mudarib cannot claim any remuneration, salary or fee for the work he has performed for the Mudarabah.

NOTES & REFERENCES

* '*Daman*' means to bear the liability for loss or to accept the accompanying risk of loss; it does not include potential loss or the loss due to the capital staying idle. Here it means loss in the original principal sum and same goes for labour, as the entire labour can be lost.

- (1) Al-Kasani, Badai al-Sanai, vol. 7, p. 3545.
- (2) Ibn Qudamah, al-Mughni, vol. 5, p.7.
- (3) Nyazee, Imran Ahsan Khan, Islamic Law of Business Organization (Partnership), pp.87
- (4) Ibn Rushd, Bidayat al-Mujtahid, vol. 2, p.253-254
- (5) Nyazee, Imran Ahsan Khan, Islamic Law of business organization partnership, p.72.
- (6) Muhammad Imran Ismail, Theories of profit and a juristic understanding of legitimate entitlement to profit, paper published by International Association for Islamic Economics, Review of Islamic economics, vol.11, No.2, 2007, p. 63.
- (7) al-Ramli, Nihayat al-Muhtaj, vol. 5, p. 245-46.
- (8) Al-Kasani, Badai al-Sanai, vol. 8, p. 3601
- (9) Sahnun, al-Mudawwanah al-Kubra, vol. 5, p. 6.
- (10) Al-Kasani, Badai al-Sanai, vol. 8, p. 3606.
- (11) Ibn Rushd, Bidayat al-Mujtahid, vol. 2, p. 239.
- (12) Ibn Qudamah, al-Mughni, vol.7, p.165.
- (13) Sarakshi, al-Mabsut, vol.22, p.105.
- (14) Sharbini, al-Mughni al-Muhtaj, vol.2, p.318. Al-Nawawi, al-Majmu, vol. 14.p.210.
- (15) Ibn Qudamah, al-Mughni, vol.7, p.164.
- (16) Al-Baji, Muntaqasharh al-Muwatta', vol.7, p.119.