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Form and Substance in Islamic Finance: from the Perspective of Islamic law of Contract

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Abstract

This paper aims to analyse the issues of form and substance from the perspective of the Islamic law of contract, particularly in light of the alleged mimicking of conventional financial products and services by the Islamic financial industry. We attempt to analyze the approaches of jurists and fuqaha[1] from different schools of Islamic law in this regard, with emphasis to the issue of hiyal: one scholarly view considers the legal form to be more important than substance, while the majority considers both to be equally important, and rule that all hiyal are not prohibited – some are allowed with certain conditions. Shifting our focus to the Islamic banking practices of organized tawarruq, and asset-based and asset-light sukuk, we conclude that they are classic examples of fulfilment of form over substance, and do not reflect the true spirit of the Shari'ah according to majority of scholars. Therefore, it is suggested that it is the collective responsibility of all the stakeholders in the Islamic finance industry to revise these contemporary practices from Islamic law perspective and ensure the Islamicity of the prevalent transactions through the achievement of the higher objectives of Shari'ah.

Keywords: *Form and substance, hiyal, legal stratagems, tawarruq, bay al-inah, sukuk, asset-based, asset-backed*

Introduction

The conventional financial system revealed the shakiness of its foundations in the severity of the 2007-08 global financial crisis, with widespread bank defaults, bankruptcies, and the economies of several countries nose-diving; and yet, Islamic financial markets and institutions remained relatively unharmed, or rather, *flourished* – showing better performance and more stability by exhibiting less risk, ostensibly due to the uniquely different structures of Islamic financial contracts and arrangements, and their requirement of *Shari'ah*-compliance[2]

This anomalous imperviousness to the vulnerabilities of the economic system in vogue today led scholars and experts in the field to examine the

workings of Islamic banks vis-à-vis their conventional counterparts, and trying to answer the intriguing fundamental question – why did Islamic banks show so much resilience, and how much substance does that "resilience" have? Perhaps the Islamic financial system could provide the answer where its older and much bigger "conventional" interest-based cousin had failed.[3]

However, contemporary Islamic finance also has its fair share of critics, who bemoan the fact that Islamic Banking practices do not live up to the ideal, and stick closely to the techniques of conventional banking – in essence, mimicking conventional financial products, and so, are 'interest-based', rather than 'interest-free'. Islamic banking and finance, therefore, is alleged to be a meaningless "distinction of form without substance" and forever doomed "to be an inefficient replication of conventional finance, always one step behind [conventional] developments".[4]

Consequently, despite its rapid growth and increasing global acceptability, the Islamic financial industry still faces great criticism in terms of its *Shari'ah* legitimacy. Due to purportedly excessive reliance on *hiyal* and legal stratagems, Islamic financial products and services are allegedly not dissimilar to those of their conventional, interest-based counterparts in substance, with the only real difference being in the form. However, notwithstanding the criticism directed at the so-called duplicity of modern Islamic finance, the question is: how important is the *Shari'ah*-compliance of form in Islamic financial practices, and does it take precedence over substance? This question, in our humble opinion, needs to be answered in view of all considerations and debates of the scholars of Islamic *fiqh* (both classical and contemporary) from the perspective of Islamic law of contract, while simultaneously weighing them against the features and constraints of the modern-day financial systems in vogue, which is the objective of this paper.

This paper is divided into three parts. The first part discusses different *fiqhi* issues from the classical *fiqh* literature, in order to analyze the views of jurists on form and substance. In section two, we discuss the topic of legal stratagems and *hiyal,* based on the sources of *Shari'ah* as well as from the writings of scholars. Lastly, section three will examine some current practices and products of Islamic finance from the perspective form and substance in light of the analyses of jurists.

Form and Substance: what is the Debate?

Before one can delve into the intricacies of scholars' arguments on the topic, there are two questions that first need to be answered briefly; first: what is construed by "form" and "substance" in Islamic law of contract, or what are the *fiqh* terminologies used for form and substance?; and second: what is the approach adopted by scholars with regard to validity and permissibility of contract? The answer to the first question can be derived from the following legal maxim[5] which discusses the validity of contract:

"العبرة في العقود للمقاصد والمعاني لا للالفاظ والمباني"

"In contracts, the primary consideration will be given to objectives and underlying meanings, not to their words and forms" (Haider, 1991).[6]

It may be said that the word "form" is equivalent to the *fiqhi* terms '*al-alfaz*' (الالفاظ) and '*al-mabani*' (المبانى), while the word "substance" is equivalent to '*al-maqasid*' (المقاصد) and '*al-ma'ani*' (المعاني) in this legal maxim. In general, from the viewpoint of Islamic law, when only the legal *Shari'ah* requirements of a contract are fulfilled without the intention of attaining its ultimate objective, it is said that the 'form' of the contract is in conformance with the *Shari'ah*, while the substance is neglected. Conversely, if the contracting parties genuinely intend to realize the ultimate objectives of the contract while simultaneously fulfilling all its legal requirements, then the substance of the contract is considered to be treated equally important to its form.

As for the second question above, the afore-mentioned legal maxim coupled with the following shall suffice:

"الامور بمقاصدها"

"Matters are determined by their objectives" (Nujaim, 1968).[7]

The commentator of *Majallah al-Ahkam al-'Adliyyah*[8], *Allamah Haydar* further explains these legal maxims and states:

> *"The words used by contracting parties during the execution of a contract are not considered, but the real objectives and true intentions behind the spoken words will be taken into account. This is because, the real objective (of the contract) is the meaning (behind the words) and not the words or the form. The words are only ways to express the meanings" (Haider, 1991).*

However, this principle has not been accepted unanimously by the jurists, with scholars differing in the sufficiency of mere legal form for the validation of a contract. In the following section, views of different scholars in this regard have been explained in a detailed manner.

Shafe'i school of *fiqh*

Imam al-Shafe'i is of the view that the validity of legal form is more important than substance and true underlying intentions. He very famously stated[9] that we are not obliged to judge or examine the underlying objectives or intended meanings of the contracting parties, rather, *Shari'ah* rulings should be based on appearances and the words expressed in front of the judge or ruler. The intention and underlying objective is hidden and consequently beyond our capacity to gauge – only Allah (SWT) knows what the true intentions of the contracting parties would be. Therefore, it would be unfair to blame anyone for their actions based on a mere assumption, without any proof of the contracting parties' intentions – for all we know, their intentions may be entirely different from what we assume. If the contract fulfills legal requirements, it cannot be invalidated because of the mere assumption of bad

intention (Al-Shafe'i, 1973).[10] In *Ibn Qayyim*'s words, when there is no *haram* element present in a contract and it is executed with fulfillment of all conditions such as offer and acceptance, the legal capacity of contracting parties and suitability of subject matter etc., then it must be declared as a valid contract, since these are the effective causes for permissibility, as opposed to the hidden intentions (Ibn Al-Qayyim, 2008).[11]

Imam al-Shafe'i supported his view from the hadith of the Prophet PBUH:

> *"It is narrated from Umme Salamah that the Prophet PBUH said: "I am a human being. You people present your cases to me and some of you may be more eloquent and persuasive in presenting their arguments. So, if I give someone's right to another (wrongly) because of the latter's (tricky) presentation of the case, I am really giving him a piece of fire; so, he should not take it" (Bukhari, 1987).*[12]

Imam al-Shafe'i uses the above hadith to also argue that it is not permissible for a judge to issue a ruling on something that is hidden, such as the intention or underlying objective. The Prophet (PBUH) clearly mentioned that he issues rulings based on what is presented to him, rather than assuming a hidden meaning.

Maliki school of *fiqh*

Maliki jurists are of the view that merely fulfilling the legal form is not enough for the validity of a contract, and that it is important to judge whether the hidden meaning and intention behind the contract is in line with the essence of the *Shari'ah* or not. We take two examples from the rulings of *Maliki* jurists on different *fiqhi* issues in order to clarify their position.

Divorce by an ill person:

Hypothetically, if a person divorces his wife on his death bed through one "*bāin*" divorce (in which he cannot return to her without a new contract of marriage), jurists are unanimous in their opinion that the divorce will occur. However, would the divorced wife get a share of her husband's inheritance? *Imam Malik* held the opinion that she would indeed, regardless of whether the latter died before the passage of the *'iddah* – period of waiting[13]" or after, basing his opinion on the argument that by his action, this person actually intended to remove his wife from the list of his heirs, which is not permissible in the *Shari'ah*. As opposed to this ruling, under normal circumstances, the divorced woman is entitled to inherit from her deceased husband if he dies during her period of *'iddah*, and not otherwise. The difference between the two rulings, therefore, lies in the bad intention as the underlying cause of her husband's act. Therefore, this act would not affect her entitlement to the latter's inheritance (Anas, 1994).[14]

Gift of debtor:

Imam Malik is of the view that if a debtor gives any gift to his creditor, the latter is not allowed to receive the gift unless they habitually used to exchange gifts before affecting this loan contract, and the creditor knows that the gift has not been given to him in order to gain some flexibility in terms of loan repayment. The hidden intention and intended goal of the debtor is therefore of utmost importance: where there is no indication that the gift has been given primarily because of obtaining the loan, the creditor is allowed to receive it, but not otherwise (Anas, 1994).

Hanbali* school of *fiqh

The *Hanbali* school of Islamic law is similar to the *Malikis* in this issue. They have taken the same view in case of divorce by an ill person to his wife on his death bed (Ibn-Qudamah, 1983).[15] In the following, we would like to explain one more example from their *fiqh* literature.

Amanah Sale:

An *Amanah* sale is a kind of sale of a commodity in which the buyer and seller mutually agree that when the seller returns the price paid for the commodity, the buyer shall return the same commodity to the former, while the buyer is entitled to benefit from the commodity during this period. The *Hanbali* jurists are of the view that this sale in invalid, since they consider it as a legal stratagem for consuming *riba*, where the underlying objective is not the sale, but to get money for some period. Therefore, in reality, this is a loan contract that has been disguised as a sale (even though the requirements of a valid sale may be seemingly fulfilled), and is invalid due to the fact that enjoying any sort of benefits from the subject matter in this case is considered as *riba* (Al-Bahuti, 1982).[16]

Hanafi* school of *fiqh

Generally, the Hanafi jurists focus more on the legal form and words of contracting parties rather than examining the intended meaning and substance of contract. However, we find some *fiqhi* issues in *Hanafi fiqh* literature in which the intended meanings and underlying objectives of contracting parties are also considered. Some illustrative examples are given below.

Nikah al-muhallil:

If someone divorces his wife three times, then it is not permissible for him to remarry her unless she first marries another person, they consummate the marriage, and then the second husband divorces her. This marriage is called *nikah al-muhallil*, because the second marriage and the subsequent divorce make this woman *halal* (permissible) for her first husband. However, it is not permissible for the woman to enter into a temporary marriage or stipulate that the second husband will divorce her immediately after they

consummate the marriage (for the purpose of *tahleel*[17]). This is because, *Imam Abu Dawood* narrated the Prophet (PBUH) to have said: "Allah (SWT) has cursed the *muhallil*[18] and *muhallal lahu*[19]".

In this scenario, *Hanafi* jurists are of the view that if someone stipulates or mentions the purpose of *tahleel* clearly in the marriage contract, then this marriage would not be valid. However, if they do not do so, the marriage would be valid even if their underlying objective is *tahleel*. Therefore, the hidden intention does not matter when all conditions of the valid contract are fulfilled (Ibn-e-Humam, 1995).[20]

Declaration of ill person for his heir:

In case someone declares on his deathbed that he is indebted to a particular heir, there is a possibility that he may have lied in order to deprive others of their rightful shares in his property, since he had made no such mention before his illness. *Hanafi* jurists are therefore of the view that it will not be valid or affected unless other heirs verify his declaration. In this case, we see that importance is given to the intended meaning and substance of the declaration. Therefore, from our analysis, it may be concluded that although *Hanafi fuqaha* focus more on the legal form, they do consider intended meanings and underlying goals in various situations as well, so the position of the *Hanafi* school is somewhere in between that of *Shafe'is* and others (*Malikis and Hanbalis*).

After this detailed discussion of different schools of Islamic law, we have reached two main views. The first view is that intended meanings and substance are equally important to legal form and apparent words, while the second view is that if the contract fulfills all relevant conditions and there is no issue in its legal form, then we do not invalidate it merely on the grounds of its apparent shortcomings with regard to substance or intended meanings.

***Hiyal* in Islamic jurisprudence**

Before we move on to examine the practical examples of Islamic finance from the perspective of form versus substance, a discussion of *hiyal* from classical *fiqh* literature is pertinent. *Hiyal* are generally perceived in a negative light as legal tricks intended for illegitimate purposes, and therefore, to be prohibited under all circumstances. Consequently, critics of Islamic banking and finance (IBF) often assert that IBF is largely based on various *hiyal* which should ideally be prohibited. In an attempt to shed light on the issue, we shall endeavour to explain the views of various jurists regarding *hiyal* and then examine the legitimacy of current Islamic finance practices in light of their opinions.

Definition of *Hiyal*

Hiyal is the plural of *hilah*, meaning legal trick or stratagem. Linguistically, *hilah* is defined as the skill or ability needed to manage something in an appropriate manner (Manzoor, 2013).[21] Technically, the most

suitable definition for the term has been provided by *Ibn Ashur,* who defines *hilah* as doing some prohibited thing in a form which is permissible in *Shari'ah* in order to achieve a certain objective (Ashur, 2006).[22] Khir et al. (2015) state that jurists have used *hilah* in both positive and negative meanings. Generally, it is observed that *Maliki* and *Hanbali* jurists use the term in a negative meaning while *Hanafi* and *Shafe'i* scholars usually employ the term for positive intents and purposes.[23] The Holy Quran and Hadith contain mention of both types of *hiyal* i.e. permissible and prohibited, some examples of which are provided below.

Hiyal in Holy Quran:

First example:

In various verses of the Quran, Allah (SWT) describes the punishment for Jews who used tricks and *hiyal* to violate the orders of Allah (SWT). Allah (SWT) says:

وَسْـَٔلْهُمْ عَنِ ٱلْقَرْيَةِ ٱلَّتِي كَانَتْ حَاضِرَةَ ٱلْبَحْرِ إِذْ يَعْدُونَ فِي ٱلسَّبْتِ إِذْ تَأْتِيهِمْ حِيتَانُهُمْ يَوْمَ سَبْتِهِمْ شُرَّعًا وَيَوْمَ لَا يَسْبِتُونَ لَا تَأْتِيهِمْ ۚ كَذَٰلِكَ نَبْلُوهُم بِمَا كَانُوا۟ يَفْسُقُونَ [الأعراف:163]

> *"Ask them about the town situated by the sea, when they used to transgress in the matter of Sabbath, when their fish came to them openly on the Sabbath, and did not come when they did not have Sabbath. In this way, we put them to a test, because they used to act sinfully." (7: 163).*

Allah (SWT) had made fishing on Saturdays prohibited for Jews. However, they used *hilah* to violate this ban by setting their fishing nets on Fridays in such a manner that the fish would get caught in them when they came in on Saturdays. Later, they would collect the fish on Sundays. As a result, Allah (SWT) gave them severe punishment, because of their use of this *hilah* and violation of the ruling of Allah (SWT).

Second Example:

Allah (swt) says in the Holy Quran:

وَخُذْ بِيَدِكَ ضِغْثًا فَٱضْرِب بِّهِۦ وَلَا تَحْنَثْ ۗ إِنَّا وَجَدْنَٰهُ صَابِرًا ۚ نِّعْمَ ٱلْعَبْدُ ۖ إِنَّهُۥٓ أَوَّابٌ [ص:44]

> *"And (We said to him) Take (a bundle of) thin twigs in your hand, and strike with it, and do not violate your oath. Surely, we found him very enduring. He was really an excellent servant. Surely, he was great in turning (to Us, in penitence and praise)." (38: 44).*

Allamah Ibn Kathir explained the background of this verse by saying that "Prophet *Ayyub* scolded his wife and vowed to give her 100 strikes if Allah cured him from his illness. When he was cured, he could not bear to strike his wife; thus, Allah gave him the idea of using a bunch of grass containing 100 reeds and to strike her only once. Prophet *Ayyub*'s act is considered an exit (*makhraj*) to execute his oath and avoiding violating it".

According to *Tafseer Ma'ariful Quran*, "this was said in the background

when *Sayyidina Ayyub* intended to fulfill the oath he had taken. But, as his wife had taken good care of him, and had done nothing to deserve being chastised (with one hundred strokes of some stick as sworn by him), Allah (swt) in His mercy, showed him the way-out as to how he could do it symbolically and still fulfill his oath" (*Shafi*, 2005).[24]

This is an example of permissible *hilah* and legal stratagem that Allah (SWT) showed his Prophet (*Sayyidina Ayub*) as an exit and way to fulfill his oath without hurting or injuring his wife. The great *Mufassir* and commentator *Allamah Alusi* has stated that based on this verse, *Imam Shafe'i, Imam Abu Hanifah* and *Imam Zufar* are of view that this *hilah* applies to whoever is faced with a difficult situation of this kind (subject to the fulfilment of certain conditions that will be explained later). He further said that a great number of Scholars have taken the view of permissibility of *hiyal* based on this verse. In his opinion, if *hilah* or legal device leads to negation or alteration of a particular *Shari'ah* ruling (*ibtal e hukum*), then it is not permissible, otherwise its use would be permissible (Al-Baghdadi, 1990).[25]

Hiyal in Ahadith:

> *"Imam Bukhari reported that Abu Sa'id Al-Khudri and Abu Huraira have narrated: Allah's Apostle appointed somebody as a governor of Khyber. That governor brought to him an excellent kind of dates (from Khyber). The Prophet asked, "Are all the dates of Khyber like this?" He replied, "By Allah, no, O Allah's Apostle! But we barter one Sa' of this (type of dates) for two Sa's of dates of ours and two Sa's of it for three of ours." Allah's Apostle said, "Do not do so (as that is a kind of usury) but sell the mixed dates (of inferior quality) for money, and then buy good dates with that money" (Bukhari, 1987).*

In this hadith, the Prophet (PBUH) first prohibited the practice of the governor of Khyber because of *riba* and then explained the exit and permissible way to do this kind of transactions. *Imam Burhanuddin Ibn Maza* has discussed this hadith in his book (*Kitab ul Hiyal*) and said:

> "هذا تعليم الحيلة وانه نص في الباب"
>
> *"This is the teaching of hilah (from the Prophet (pbuh) and this is clear evidence in permissibility of hilah" (Musa, 1978).*[26]

Discussions of Scholars on *hiyal*

The jurists and *fuqaha* have discussed the issue of *hiyal* in light of the texts and sources of *Shari'ah*, outlining different types of permissible and non-permissible *hiyal*. *Imam Abu Bakar Khassaf*, a famous *Hanafi* jurist, has written a detailed book on the topic of *hiyal* (*Kitab al-Hiyal*). He narrated from *Imam Shahbi*:

> *"There is no issue in (the use of) permissible hiyal. This is because one can try to save himself from sin and haram and find the way out to halal. Therefore, this kind of hiyal are permissible. However, there are (certain)*

makrooh and non-permissible hiyal which are used to cancel the right of the other, or make some prohibited thing permissible by circumventing the spirit of Shari'ah" (Al-Khassaf, 1314 hijri).[27]

This view has also been upheld by *Imam Burhanuddin ibn Maza* in his famous book *al-Muheet*, adding that "the permissibility of this kind of *hiyal* has been derived from the statement of Allah (SWT) to the Prophet *Ayub*" (Musa, 1978). The famous *Hanbali* jurist *ibn al Qayyim*, on the other hand, focuses on the impermissibility of *hiyal* in "circumventing the *haram* and prohibited thing. The *hukum* does not change because of the mere change in words or title unless there are real changes in substance" (Ibn Al-Qayyim, 2008).

Three types of *Hiyal*

From a study of the texts of the *Shari'ah* and scholarly discussions on the issue of *hiyal*, we may say that there are three types of *hiyal*:

1. *Hiyal* or legal stratagems that are prohibited and would have no effect on the original ruling from a *Shari'ah* perspective if someone performs them. Consequently, the underlying objective in the use of the *hilah* would not be fulfilled and that thing will remain prohibited. A good example of this case is the prohibition of animal fat for Jews, as highlighted earlier. The Prophet (PBUH) is reported to have said about this kind of legal stratagems:

"Do not repeat what the Jews had done to violate Allah's prohibitions by using deceitful legal tricks" (Bukhari, 1987).

2. The second type of *hiyal* are those which will be effected from a *Shari'ah* point of view. However, if the person intends to shirk from any obligation by using a *hilah*, he will be deemed to have sinned because of his bad intention, but the obligation will be removed from him nonetheless. For example, if someone gives his property as a gift to his wife or buys some assets that are not subject to *Zakah* just before the completion of one year on his property, the *hilah* he used will be effected, and as a result *Zakah* will not be applied on such assets. However, if his intended objective behind the use of this legal device or *hilah* was to shirk from the payment of *Zakah*, he will be sinful for this act.
3. The third type of *hiyal* are those which are effected from a *Shari'ah* point of view and the doer will not be deemed sinful for their execution. In other words, the underlying objective of the *hilah* is permissible and the way it has been executed is also acceptable in the *Shari'ah*. The examples of this kind of *hiyal* are those that we quoted from the Holy Quran and Hadith earlier in this paper.

Hiyal to avoid _Riba_ in Islamic Finance

An analysis of classical *fiqh* books reveal lengthy discussions on the rulings for legal devices and *hiyal* that are meant to avoid *riba*. In a nutshell, there could be two possible scenarios. First, a person has a genuine need for a particular commodity and wishes to avoid *riba*, so he enters into a genuine contract that fulfils all *Shari'ah* requirements, for the acquisition of that commodity. This is not a matter of concern from a *Shari'ah* point of view, since the alternative contract is in itself intended, is not artificial, and all *Shari'ah* conditions are fulfilled. For instance, sale with deferred payment (*Bai al-muajjal*) is widely practiced in Islamic finance, where the Islamic bank purchases a commodity from its supplier, and sells the same to its customer on deferred payment and at a higher price. Since the end-buyer genuinely intends to purchase the commodity in question, this contract will not be considered as *hilah* or legal device.

The only issue of concern to *Shari'ah* arises when someone enters into an artificial contract in order to seemingly avoid *riba*, but reap the same benefits, which is the second possible scenario that could arise above. A *hilah* is used to render the transaction *halal*, but the underlying transaction itself is not the ultimate objective. There are three major views of scholars in this case, which can be elaborated by taking examples from various contractual arrangements employed by Islamic financial institutions. We first begin with organized *tawarruq*.

Organized _tawarruq_

Tawarruq is a mode of financing that is used to get liquidity, and can be classified into two types: namely, individual or classical *tawarruq* (*tawarruq fiqhi*) and organized *tawarruq* (also called *tawarruq al-munazzam* or banking *tawarruq*).

The case of classical *tawarruq* has been explained earlier in the discussion of *ibn al-Humam* on *bay al-inah*, and it is permissible as per the preferred view of the four schools of Islamic law. However, some scholars from *Hanafi* and *Hanbali* schools consider it *makrooh* (Usmani, 2013).[28]

As far as organized *tawarruq* as practiced by Islamic financial institutions is concerned, the following process is followed. The customer approaches the Islamic bank for financing, after which the bank purchases a commodity from the international (or local) market, to be sold to the customer on credit. Subsequently, with prior agreement, the bank sells the commodity as an agent of the customer in the market to another broker for cash (at a price lower than the credit price above). The sale proceeds are then transferred to the customer in order to fulfil his cash needs.

This practice of *tawarruq* is highly critiqued by various scholars and academicians in current Islamic finance literature. Mansoori says that this is only a legal device to circumvent the *riba* transaction and make it *halal*. Moreover, since various conditions for real sale such as possession of

commodity, risk of ownership and liability etc. are not fulfilled in this fictitious transaction, this is just an interest-bearing loan transaction rather than a sale contract.[29]

The main difference between classical and organized *tawarruq* is the pre-arrangement between the bank and its customer to sell the commodity as the latter's agent in the market and provide cash to the customer. This involvement of the bank makes this transaction similar to *bay al-inah* and just a legal trick in order make the interest-bearing loan transaction *halal* (Mohamad, N. & Ab Rahman, A., 2014).[30]

The Bahrain-based standard setting body "Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)" has issued a complete standard on "*tawarruq*". The standard allows Islamic banks to use *tawarruq* as a mode of financing for their special needs, for liquidity management and personal financing purposes. However, it has put very strict conditions in order to make sure that the requisite conditions for the validity of *tawarruq* are not compromised.

AAOIFI *Shari'ah* standard on *tawarruq* (No. 30) states:

> *"(4/7) The client should not delegate the institution or its agent to sell, on his behalf, a commodity that he purchased from the same institution and, similarly, the institution should not accept such delegation.*
> *(4/8) The institution should not arrange proxy of a third party to sell, on behalf of the client, the commodity that the client purchased from the institution" (AAOIFI, 2010).*[31]

However, it is worth mentioning that the current practice of *tawarruq* in a majority of Islamic banks are not in line with the guidelines of the AAOIFI *Shari'ah* standard above. Therefore, Islamic *Fiqh* Academy of the Organization of Islamic Cooperation (OIC) has ruled in its 17th meeting in 2003 that organized *tawarruq* as practiced in Islamic banks, is not permissible. It is worth noting that the Islamic *fiqh* academy had allowed the *tawarruq* transaction earlier in its 15th meeting held in 1998. The Resolution of OIC *fiqh* Academy (issued in 2003) states:

> *"It is not permissible to execute both organized and reverse tawarruq because simultaneous transactions occur between the financier and the Mustawriq (the party seeking finance), whether it is done explicitly or implicitly or based on common practice, in exchange for a financial obligation. This is considered a deception, i.e. in order to get the additional quick from the contract. Hence, the transaction is considered as containing the element of Riba"*[32].

It may be concluded from this discussion that classical *tawarruq* is acceptable from a *Shari'ah* point of view and it is an example of permissible *hiyal*. However, the current practices of organized *tawarruq* in Islamic banks are not fulfilling the requirements of *Shari'ah* according to the majority of scholars. This is due to the fact that they fall into the first category of *hiyal* that are used to make something that is prohibited, *halal,* by mere changes in apparent form without any material changes in substance.

Form vs Substance in Sukuk:

Definition of Sukuk:

A highly popular capital market instrument used in Islamic finance today are *Sukuk*. *Sukuk* are very attractive instruments for both corporations and investors alike – they are particularly useful in large-scale financing arrangements that are beyond the ability of a single party to finance, and provide an easily liquefiable avenue for investment for investors with surplus cash. As far as IFIs are concerned, they can efficiently use *Sukuk* in managing their liquidity – by purchasing the instruments when in need of deployment of excess liquidity and selling them when in need of cash.[33]

Technically, AAOIFI defines *Sukuk* in its *Shari'ah* Standard No. 17 as follows:

> *"Certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services, assets of particular projects or special investment activity" (AAOIFI, 2010).*[34]

In other words, it may be said that *sukuk* are investment certificates which represent the ownership of the *sukuk* holder in an underlying asset.

Asset-backed vs Asset-based sukuk:

Sukuk can be classified in different categories from different perspectives which may be the underlying *Shari'ah* contract, or the underlying asset, or the technical features of the contracts. However, *sukuk* are also broadly categorized into asset-backed and asset-based *sukuk*. The asset-backed *sukuk* has defined by Moody's (the well-known rating agency) as follows:

> *"In asset-backed sukuk, investors enjoy asset-backing; they benefit over some form of security or lien over the assets, and are therefore in a preferential position over other, unsecured creditors. In other words, in the event the issuer were to default or become insolvent, the noteholders would be able to recover their exposure by taking control of and ultimately realizing the value from the asset(s). It also requires the element of securitizations to be present – true sale, bankruptcy remoteness and enforceability of security" (Lotter, P. & Howladar, K., 2007).*[35]

To the contrary, asset-based *sukuk* are defined by Moody's in the following manner:

> *"In asset-based sukuk, the originator undertakes to repurchase the asset from the issuer at maturity of the sukuk, or upon a predefined early termination event, for an amount equal to the principle repayment. In such a repurchase undertaking, the true market value of the underlying asset (or asset portfolio) is irrelevant to the Sukuk noteholders, as the amount is defined to be equivalent to the notes. In this case, noteholders have no special rights over the asset(s) and rely wholly on the originator's creditworthiness for repayment, either from internal sources or from is ability to refinance. Thus, if the originator is unable to honour*

> *its obligation to repurchase the assets, the noteholders are in no preferential position to any other creditors, or indeed in no weaker position to any other unsecured creditor, stressing the importance that the purchase undertaking ranks pari passu with any other of the originator's senior unsecured obligations" (Ibid).*

There are various issues in asset-based *sukuk* which could compromise the substance of *sukuk* and raise serious concerns with regard to their *Shari'ah* compliance status. Some of them are summarized in a brief manner below.

Beneficial ownership.

In asset-based *sukuk*, the underlying asset is not transferred to the *sukuk* holders by virtue of a true sale transaction, while it is a basic *Shari'ah* requirement that the underlying asset must belong to *sukuk* holders. Instead of full, legal ownership, only beneficial ownership is transferred to *sukuk* holders just to fulfill the *Shari'ah* requirements. With differences of opinions among *Shari'ah* scholars, the validity of beneficial ownership has still not been fully settled yet.[36]

Manjoo (2014), meanwhile, states that a true sale is absent when originators or issuers sell certain underlying assets to investors, and hence, "no transfer of legal ownership from originators to investors – as required by *Shari'ah* – takes place", a concern echoed by al-Amine (2014) and Dusuki & Mokhtar (2010). The core issue, in Manjoo's (2014) opinion, is in the approaches of both issuers and investors, with the latter wishing to earn profits without ever "putting their capital at risk". Since entitlement to profit comes with risk, the *Sukuk* holders' wish is not in line with the theory of profit in Islam, in the writer's view.[37]

It is noteworthy to mention here that there is no distinction in the classical *Shari'ah* texts between beneficial and legal ownership – the *Shari'ah* merely defines the conditions for any asset to be owned, and those for the validity of its sale. Once these conditions are met, ownership of the sold asset would have been deemed to be transferred from the seller to the buyer, regardless of the registration of legal title in the buyer's name. However, since this issue has arisen in modern Islamic finance, particularly in *Sukuk* issuances, it is imperative for *Shari'ah* scholars to analyse the features of beneficial ownership as embodied in such *Sukuk*, against the criteria for valid *milkiyyah* (ownership) prescribed by the *Shari'ah*, in order to arrive at the correct *Shari'ah* ruling concerning the matter.

Therefore, despite arguments from scholars like al-Shubayli (2013) in support of beneficial ownership being the true ownership, this matter is still contentious and unresolved. Until it is positively established that beneficial ownership confers full ownership-related rights, rewards and risks to the *sukuk* holders, the issues identified above shall stand, and therefore, one can safely say that *Shari'ah* requirements are being fulfilled only in form, and the real substance of the sale contract has been neglected (Dusuki, & Mokhtar, 2010).[38]

Recourse to originator rather than asset

In a related issue to the one identified above, in case of default, the *sukuk* holders in an asset-based *sukuk* do not have resource to underlying asset, but rather only to the issuer, as a result of whichthey do not have any interest in underlying asset. Consequently, even if the asset is not generating income, the issuer still has to pay the expected return to *sukuk* holders, and if the issuer defaults in his obligations, the *sukuk* holders do not have the right to sell the asset to a third party (ISRA, 2016).[39] As already highlighted above, this is in violation of the basic features of a true sale contract, by virtue of which, all rights, rewards, responsibilities and risks pertaining to the object of sale should pass on to the buyer, in this case, the *sukuk* holder.

Usage of purchase undertaking.

It is highlighted by various scholars that purchase undertaking in equity based sukuk makes them similar to conventional bond. Because, the purchase undertaking at par guarantees the principal. It may be allowed when it is arranged by its own. However, in current practices of sukuk structuring, it is used with other credit enhancement features that changes the nature of equity-based contract and makes them similar conventional bond (Herzi, A. A., 2016).[40]

It may be summarized that the substance is totally neglected in asset-based sukuk and only legal requirements are fulfilled just to get compliance in form. Therefore, it is suggested to review the current practices of asset-based sukuk and initiate serious efforts to move towards the asset-backed sukuk which are reflecting the true spirit of *Shari'ah*.

The rise of 'asset-light' sukuk

The story of the evolution of *Sukuk* does not culminate at the creation of the asset-based *sukuk*. Due to the fact that most corporate issuers would be unable to produce enough *Shari'ah*-compliant physical assets, the concept of "blended" assets came to the fore – a mix of physical assets and *Shari'ah* compliant receivables[41], since debt combined with physical assets in a single portfolio could theoretically be sold at any price, provided that the physical assets are larger in proportion to the receivables. What percentage would constitute a majority was a rather contentious issue however – some *Shari'ah* scholars preferred a minimum of 51%, while others stipulated physical assets to constitute at least two-thirds of the entire portfolio. However, a serious *Shari'ah* concern was raised with the inclusion of Murabaha contracts into *Sukuk,* which brought into question the issue of the sale of debt, or *Bai' ud-Dayn*.

In cases where corporate issuers had little or no *Shari'ah*-compliant debt or receivables, the *Sukuk al-Musharaka* was employed, where the issuing corporate and SPV entered into a *Musharaka* for the construction or development of a particular project, with the corporate providing capital in kind (in the form of physical assets such as land), and the SPV contributing

cash raised through *Sukuk* issuance to investors. Naturally, the physical assets in such cases would constitute a small part of the overall value of the project, usually 10%-20%, with the large part represented by cash. Known as "asset-light" *Sukuk*, these were traded in much the same way as *Sukuk al-Ijarah*, and represented the latest stage in the evolution of these Islamic securities.[42]

Nevertheless, these *Sukuk* were no strangers to controversy and serious *Shari'ah* objections. A recurring problem was the case of ownership – the underlying assets in the asset-light *Sukuk* could be shares of corporations that do not transfer real ownership to the *Sukukholders* but merely offer them a right to the returns of the company or any of their particular projects. Moreover, the fact that these Sukuk did not represent substantial physical assets (and even failed to meet the highly lenient 30% criteria for constituting a majority), brought into question the *Shari'ah* permissibility of trading them at a premium or discount.

An analysis of various *Shari'ah* screening criteria for equity investments reveals that the total liquid assets (including cash and receivables) of a company must not exceed 33%, otherwise the shares of the company would be considered to represent cash or *dayn* (since the majority assets would be liquid), which can only be traded at face value from a *Shari'ah* perspective. Consequently, the sale of shares of such companies would constitute *Bai' ud-Dayn*, as outlined above, and would be impermissible according to an overwhelming majority of *Shari'ah* scholars. Using the same criteria in the case of asset-light *Sukuk* would therefore show that trading *Sukuk* with lesser than 33% or 30% of its underlying assets in physical form, at other than face value, would also be impermissible. Realistically, in any *Sukuk al-Musharaka* created for the construction of a particular project, the instruments should not be traded at a premium or discount until the project is completed. However, that is almost never the case, with the *Sukuk* being declared tradable at the outset.

Turning our attention to the issue of capital or face value of the instrument in such an asset-light *Sukuk al Musharaka* as highlighted above, it is evident that the return of the principal to the investors is guaranteed by the corporation raising funds, in the form of a binding undertaking or promise to repurchase the underlying assets of the *Sukuk* from the *Sukukholders* at face value, or the same price at which the assets were sold to the investors. This *irrevocable* "Purchase Undertaking" or "Promise to Purchase", as is commonly known in Islamic financial markets, could also be invoked at the occurrence of an Event of Default, or if the bank fails to make the periodic, pre-agreed sums in lieu of "profit" to its customers and is legally enforceable by the SPV or investors regardless of whether the Musharaka venture is running in profit or loss. This irrevocable undertaking provided by the corporate to its investors is nothing less than a capital guarantee, which goes against the very core of the principles of the *Shari'ah* regarding partnership contracts, but is widely acceptable in the Islamic capital markets today. Ideally, the repurchase of the

assets by the corporate must be effected on the basis of the market value of the assets.

What is the justification provided for the use of this capital guarantee? Failure to furnish the profit amounts to the investors would be treated as "negligent behavior" by the corporate, who acts as the manager of the Musharaka venture. After all, the manager had provided a feasibility study for the project, which it had prepared after conducting due diligence, and the investors had relied on this feasibility study, and the manager's credibility and confidence in being able to achieve the targeted revenues from the project. Therefore, if the project were to run into losses, the manager would be to blame – the "due diligence" may not have been done very diligently. As a result, the manager would be liable to bear the losses in their entirety and return the capital of the investors, because it was the former's negligence that was responsible for these losses.

At first, this logic seems reasonable, and as would be argued, also perfectly permissible in the *Shari'ah*. However, a close look at the justification provided above, reveals the following flaws in the argument:

a. Under common practice, none of the investors have access to the feasibility study or business plan prepared by the corporate, which means that they only rely on the corporate originator's "credit rating" and reputation in the market.
b. Despite the fact that the *Shari'ah* principles regarding the negligence of one partner leading to loss in a Musharaka have been made full use of, the other side of the coin has been completely ignored – the *Shari'ah* also allows the partner accused of being negligent to prove himself innocent – whereas no such opportunity is afforded to the corporate originator in a *Sukuk*. In other words, the originator of the *Sukuk* or the manager of the Musharaka venture would automatically be assumed to be negligent, if the forecasted revenues from the project are not realized.
c. When it comes to the feasibility study of the project, what the common structure of a *Sukuk al-Musharaka* overlooks is the fact that all prudent business managers conduct feasibility studies for their prospective projects, whether on a large or small scale. However, not all projects are able to realise the expected revenues, in fact, many of them fail, even though the projects looked viable at the outset. These failures could be caused by a myriad of reasons ranging from weakened economic conditions, unanticipated and unfavourable shifts in government policy, or even changes in consumer preferences – holding the manager of an unsuccessful project responsible for failing to anticipate changes in consumer preferences (even though the project was executed according to plan) would not

only be illogical, but also downright unfair. This is not how business is conducted in the world; however, *Sukuk* investors seem to live in a world of their own that has its own rules. Consequently, Islamic Financial Institutions are left with no realistic choice but to resort to the use of *hiyal* such as those outlined above, in order to furnish the kinds of products that their customers demand and are accustomed to.

Conclusion

In this paper, we have analyzed the issue of form and substance from the perspective of Islamic law of contract by discussing various *fiqh* issues from classical *fiqh* literature of four major schools of Islamic law namely *Hanafi, Shafe'i, Maliki* and *Hanbali*. There are two general views with minor differences among the *fuqaha:* the first view states that legal form is more important than substance, with *Imam Shafe'i* among the foremost scholars who have taken this view. They argue that when legal requirements of *Shari'ah* are fulfilled, the contract cannot be declared invalid only because of the hidden intended meaning or substance, which is beyond our purview. The second view is that both form and substance are equally important, which is supported by the majority of scholars. They are of the view that *Shari'ah* rulings not only rely on words or legal form, but are also based on the underlying objective and intended meanings. This is because words only mean to express the intention and underlying objective. If the hidden intention or substance is different from the apparent or legal form, then the transaction would not de declared as valid.

In order to study the issue of form and substance in more depth, we also discussed the topic of *hiyal,* or legal stratagems, with some detail from the sources of *Shari'ah* (i.e. the Quran and the Sunnah) and the writings of *fuqaha*. It may be summarized from the details presented in this paper that not all *hiyal* or legal devices are prohibited, but there are categories of permissible and non-permissible *hiyal*. Indeed, it is the beauty of *Shari'ah* that it recognizes legal devices in order to overcome inconvenience and facilitate the practices of Islamic law for humanity. However, the permissibility of *hiyal* does not mean that one gets the license to undermine or neglect the substance or true spirit of the *Shari'ah*. *Hiyal* are only permitted when the underlying objective and substance is acceptable from a *Shari'ah* point of view and the way the *hilah* or legal device is being used is also permissible from a *Shari'ah* perspective. Therefore, it is clear from the discussions of *hiyal* that the substance or underlying objective is equally important from the view of *Shari'ah* as is supported by majority of Scholars.

Finally, we have analysed the modern-day Islamic banking products of *tawarruq,* asset-based and asset-light *sukuk* from the perspective of form and substance. It is evident from our analysis that these practices are not reflecting the true spirit of *Shari'ah* according to a majority of scholars, and only legal

requirements are being fulfilled just to make them compliant in form rather than substance. Ideally, *Sukuk* should be issued for new, rather than established, ventures. However, in case they are made use of for the latter type, then "the *Sukuk* must ensure that *Sukukholders* have complete ownership in real assets". However, most *Sukuk* today fail to live up to this "ideal", which, to be fair, is also due to considerable legal, tax, and regulatory constraints that financial institutions face all over the world in the issuance of *Sukuk* (Radzi and Lewis, 2015), not to mention lack of investor appetite, since "it is the Islamic bank's *Shari'ah* conscious ethical depositors that effectively drive the current choice of products rather the Islamic banks or their regulators". Till the time favourable legal and regulatory frameworks are established for Islamic securitization, and investor preferences and risk appetite undergo a major shift in the positive direction, *Sukuk* may be expected to continue on the same trajectory as they are on now – any expectation of conformance to the *Shari'ah* "ideals" would only be too unrealistic. It is therefore suggested that it is a collective responsibility of all the stakeholders of the Islamic finance industry to ensure the Islamicity of the prevalent transactions and the higher objectives of *Shari'ah*. It may seem a tall order, but the first step needs to be taken, sooner, rather than later.[43]

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[1] Plural of *faqih*, meaning jurists.

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[5] *"Much more general in scope than ordinary rules of law, legal maxims commonly formulate a legal policy or ideal that judges are supposed to consider in deciding cases."* See https://www.britannica.com/topic/legal-maxim for details.

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[7] Nujaim, Ibn. (1968). "Al-Asybah wa al-Nadzair." Beirut: Dar al-Kutub al-ilmiyya.

[8] The *Majallah* "is a legal code of Islamic civil transactions drafted under the auspices of the Ottoman" empire -

[9] The Arabic text is reproduced below:

وأن الشافعي قال في كلام له وقد أمر الله نبيه أن يحكم بالظاهر والله متولي السرائر وكذا قال ابن عبد البر في التمهيد: أجمعوا أن أحكام الدنيا على الظاهر وأن أمر السرائر إلى الله

[10] Al-Shafe'i, Muhammad al-Idris. (1973). Kitab al-umm. Dar Al-Marifa.

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[13] This is the period in which a Muslim widow or divorced woman cannot remarry.

[14] Anas, Ibn-Malik. (1994). Al-Mudawwana al-Kubra. Maktaba al-Sa'ada.

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[17] *Tahleel* refers to making the wife permissible for her first husband.

[18] The second person who marries the woman merely for the purpose of *tahleel*.

[19] The first husband who wishes to remarry his previous wife and is pushing for the *tahleel*.

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