

## ***Authoritative Position of Investor and Scope of liability in Modarabah contract: Classical and Contemporary Jurists Perspective***

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### ***Abstract:***

*The position of investor is always questioned once capital is handed over to a working partner (Mudarib). The concerns of investor along with series of liabilities cannot be ignored because Modarabah losses are always transferred or born by him/her. The study highlights the authoritative position of Investor and suggests that investor has full access to impose conditions on Mudarib to safeguard his interest as per shariah rulings. The study debates investor's position to impose geographical restrictions to restrict the scope of trade, trade policy of working partner (Mudarib) and fixation of time. Besides, the study discourses the concept of limited liability in context of Islamic law where creditors hold right to personal wealth of the debtors.*

***Keywords:*** working partner, scope of trade, geographical restrictions, limited liability, istidanah, istiqrad (raising a cash loan), credit purchase

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### **Introduction:**

Islamic economic system provides two extremely viable commercial contracts based on Modarabah and Musharakah. These two contracts are based on the model of profit and loss sharing (PLS). The model of Profit and loss sharing is different from conventional interest based setup as former provides a risk sharing principle whereas the latter provides a guaranteed profit. In contract of Modarabah the focus point is the investment of rabb-al mal's (investor's) money by a reliable business person in a reliable business venture. In case of profit, the amount will be distributed among all the parties in a pre-decided ratio whereas in case of loss it will be solely born by the rabb-al mal (depositor). The mudarib (entrepreneur) will have to bear the loss of his time and efforts. In this

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regard the authoritative position of Rabbul Mall is questioned once he hands over his capital in reliable hands on the basis of Modarabah.

***The authority of rabbul mall (investor) in Modarabah:***

All the jurists are unanimously agreed on the topic that investor (Rabbul mall) have authority to impose conditions on Mudarib provided that these conditions must be useful, practical and are not counterproductive to the scope and the purpose of the Modarabah and not limit the flexibility of the work of the agent manager.

Udovitch states<sup>1</sup>:

“These specific restrictions could appear in a limited as well as in an unlimited mandate commenda, and could relate to the place, object, or methods of trade. The only requirement was that the restriction be what Sarakhsi terms a “beneficial stipulation,” that is, a useful and beneficial condition from the investor’s point of view”.

**Imposition of a geographical restriction:**

Jurists are unanimously agreed that an investor can specify a certain location for the conduct of business activities. In this way He can restrict him geographically to conduct the business activities in a specific area<sup>2</sup>. In this scenario, an agent manager cannot transfer the capital of Modarabah out of the specific area, or transfer it to anyone else who would do so. By specifying the area the investor might have a desire of quick access to his capital and close observation of business activities. The investor has a right to adopt preventive measures for the safety of his capital. The specification of a geographical area or the specification of a market such as ‘trade at Kufah market’ demonstrates the consciousness of the investor about his capital and he specifies the market perhaps due to well awareness about the ups and downs of ‘Kufah market’ and about the persons who trade there thus investor can minimize the chances of fraudulent activities that usually cause loss to the investment. Inclusion of geographical restriction may also facilitate financing for local trade or to the investors who want to invest for short term period. As the investor may have a quick access to his capital and to convert it in to cash form when required.

In this regard Udovitch states<sup>3</sup> :

“The legal treatment of this type of commenda also provides us with a clue to its economic motivation. It permitted the investor quick access to his capital, i.e., instead of waiting for the agent to return from a journey of undetermined duration, the investor could at any time instruct the agent to convert the investment into cash, retrieve his capital and hopefully some profit, and then invest it elsewhere or use

it for some other purpose. Such an arrangement would also involve less risk and uncertainty since trade would be carried on in economic circumstances and within a price structure with which the investor was familiar.”

**Right to restrict the scope of trade:**

The right of investor to impose restrictions on the trading activity regarding the object of trade to limit it up to certain commodities such as wheat, barley, or to a category of merchandise such as textiles, electronics, foodstuffs, etc. is questioned by the jurists. The Hanafis and Hanbalies permit the investor to limitize the scope of business and category of goods to be traded by the agent manager<sup>4</sup>. Hanafis allow this to investor in order to minimize the risk in the contract of Modarabah. An agent manager may have specialization in certain forms of business. So in order to confine his specialty to a specific business and to exclude his other specialties an investor is allowed to restrict the scope of business<sup>5</sup>.The Shafi’iis and Malikies do not allow an investor to restrict the object of trade for the agent manager as it will confine the flexibility of the agent manager to conduct the business and to earn profit which is ultimately goal of Modarabah contract<sup>6</sup>.

**Right to impose restrictions on the agent’s trade policy:**

The investor has a right to designate some parties to whom the agent manager is entitled to deal regarding the buying and selling of goods and to conduct other business activities. Thus an investor confines the trading activities of an agent manager up to the extent of his trustworthy people. This condition is a ‘beneficial stipulation’ in context to ensure the reliability, trustworthiness of some people to whom the agent manager is to deal<sup>7</sup>.

The Hanafis and Hanbalis allow the investor to specify some parties whom the agent manager is entitled to deal<sup>8</sup>. Whereas Malikis and Shafi’iis do not permit to impose such a condition as such a condition will confine the flexibility of agent manager<sup>9</sup>. Dealing with a specific person not only confines the flexibility of work for agent manager but also minimize the scope of profit.

**Fixation of time :**

An investor has a right to fix the time limit for the Modarabah. Hanafis and Hanbalis<sup>10</sup> permit the condition to stipulate the duration of the Modarabah contract where as Malikis and Shafi’iis<sup>11</sup> do not permit the investor to restrict the operations of the contract for a specific period.

Here we can conclude the above discussion about the rights of the investor

1. Time limit to conduct the operations of the business may be fixed by the Investor.
2. The commodities to be traded or avoided to be traded may be specified by him.
3. He may restrict the worker (Agent manager) not to deal with a specific person or a company.

4. Investor has a right to specify a place for conducting the operations of trade or he can restrict him to travel to a particular place to carry on the trading activities.
5. He may ask the worker to make sure to fulfill his fiduciary responsibilities (but not profitability)<sup>12</sup>.
6. In case the worker wants to hold the commodities to earn more profit or due to any other concern, some jurists give this right to investor to compel the worker (agent manager) to sell the goods if investor is eyeing a profitable activity.
7. The investor has a right to ban the worker from entering into a parallel contract of Modarabah with any other party.

The conditions imposed by the financier's (investors) must be regarded by the worker (agent manager) and he is bound to follow these conditions. If the agent manager violates the instructions and restrictions imposed by the investor he will be held responsible for any loss caused to the capital of the investor. Agent manager is not permitted to sell the goods at price which is less than the prevailing market price. In the same way he is not entitled to buy goods at a price higher than the prevailing market price. An agent manager is also not entitled to waive off debts of the business or to make donations from the Modarabah funds without the clear permission and consent of the investor.

***The nature and scope of liability of Rabb-al-mal and Mudarib:***

Liability of a partner usually arises due to loan and credit purchases. In modern law the concept of limited liability is well known for the corporations and for the limited partnerships. This concept demonstrates that the creditors have no access to the personal wealth of the debtors or towards the wealth that have not been contributed towards the capital. In contrary to it, in Islamic law there is only a single form of liability (unlimited liability) there is no concept of limited liability as is in modern law<sup>13</sup>. Thus in Islamic law the creditors have full access to the personal wealth of the debtors, for the satisfactions of the debts other than the assets of the business the personal wealth of debtor i.e. House, personal land, ornaments etc. can also be liquidized for the recovery of debts.

***Liability of Rabbul mall and Mudarib:***

After discussing the concept of limited and unlimited liability we are in a position to discuss the liability of Rabbul Mall and Mudarib for the debts of a Modarabah.

It is clear that in the contract of Modarabah loss is always transferred/born by the investor (Rabbul Mall) however there may be a case where a Mudarib exceeds from the limits of his lawful authority and so held liable for the debts of Modarabah.

A Mudarib has a right and power to buy and sell on credit by virtue of the contract however his right to purchase on credit cannot go beyond the amount of capital employed in Modarabah. His right to buy on credit by virtue of contract belongs to him only when his purchases are not beyond the amount of capital employed in Modarabah and if in a case he plans to exceed the limit of

the capital amount, he has to take special permission of Rabbul Mall for doing so. On acquiring permission from Rabbul mall to exceed the limit of the capital if Rabbul mall permits him to make purchase on credit beyond the limit of the capital, his permission will be termed as “Wilayat al-istidanah”.

Wilayat al-istidanah is a term used for the authority given by the investor to Mudarib for raising debts beyond the limit of the capital invested in the Modarabah.

Explaining the distinction between *Istidanah* and *Istiqrad* (raising a cash loan) al-Sarakhsi states<sup>14</sup>:

“If he authorizes him to raise money against the capital of the firm (istidanah) or to raise it against the (credit-worthiness of the) rabb al-mal, and he purchases a slave girl for the Modarabah and thereafter the mudarib raises 1000 against the (assets of the) Modarabah and purchases (another) slave girl with this, This second purchase is deemed to be for his personal account and he is personally liable for qard. Among the jurists are those who say that istidanah pertains to purchase on credit, and raising of loans (qard) is something different. It therefore , is not included in an unqualified authority of istidanah. The correct view is to say that granting the authority to raise loans is batil.”

The Sarakhsi’s statement demonstrates two main points one is that a mudarib (working partner) have no right to raise loans (debt financing) thus he cannot make liable to the investor (Rabbul mall) for the amount of loan he has raised for the firm through debt financing.

The second important point is that any authority granted for raising loans is in itself a null and void. Nyazee describes the reason why al-Sarakhsi say this? Are business loans not allowed in Islamic law? The answer is yes, they are not allowed, but this statement has to be qualified. Raising of loans with a fixed period of repayment are not permitted in Islamic law even when there is no interest (riba) involved. The only loan acknowledged by Islamic law is called a qard. hasan, which is a loan that resembles a gift or charity. The reason is that the use of the amount of money is gifted to the beneficiary for an undetermined period. It is not permitted to fix the period or repayment in such a loan, and it is preferred that the lender wait till the beneficiary enjoys a period of financial ease. The lender, however, has the legal right to recall the loan any time he likes<sup>15</sup>.

Thus the liability of Rabbul maal and Mudarib raised by the credit purchase offers us two situations for analysis.

1. Liability before wilayat al-istidanah
2. Liability after wilayat al-istidanah

### **Liability before wilayat al-istidanah:**

Liability of Rabbul maal and Mudarib before wilayat al-istidanah offers us two further situations for analysis.

#### **I. Before the commencement of the transactions**

There could be a situation that after entering in contract of Modarabah as soon as the Rabbul Maal hands over the entire capital to Mudarib, before that Mudarib commence the business and invests the capital amount to purchase goods for Modarabah unfortunately he lost entire capital. In such a case the contract of Modarabah becomes void because of the loss of capital as it was the subject matter of the contract and in the absence of the subject matter a contract becomes void. Explaining the above situation al-sarakhsi states<sup>16</sup>:

“If the investor gives him a thousand dirhams by way of Modarabah, concluded on half profits, and this capital is lost before he could buy anything with it, the Modarabah becomes void, because of the loss of its subject-matter.”

Mudarib will not be held liable for the loss of capital if negligence is not found on his end and it will be treated as a loss of the Rabb ul mall.

#### **II. After the commencement of the transactions.**

It is clear that a Mudarib has a right and power to buy and sell on credit by virtue of the contract. However, his right to buy on credit cannot exceed beyond the limit of the capital employed in Modarabah. It means that at any moment the entire accounts payable should not exceed from the capital of Modarabah. Thus the liability raised by the credit purchase up to the extent of the capital has two cases for analysis. The first case of liability is concerned with a state where after the commencement of the business no profit has been realized. For instance, there may be a case that for the commencement of Modarabah, Rabbul maal hands over the entire capital 1000 dirhams to Mudarib. Mudarib plans to invest the amount so he buys goods on credit up to the limit of the capital but unfortunately he lost the entire amount of capital 1000 dirhams before he could make payment to the seller. This situation arises prior to the emergence of the profit from the purchase, he has made on credit and all the goods were in the possession of the Mudarib. In this scenario, the Rabbul maal has total and unlimited liability as the working partner has followed the restrictions to purchase on credit to the extent of the capital as should be in the state before the authority of wilayat al-istidana. The loss of capital was due to unforeseen circumstances like fire etc. and there is no negligence of Mudarib. Al-Sarakhsi describes this as follows<sup>17</sup>:

“If a person gives to another a thousand dirhams by way of Modarabah on a 50:50 ratio, and he (the mudarib) buys something with this amount, but the thousand are lost before the mudarib could pay the seller. The mudarib will have a right to recover this (lost) amount from the rabb al-mal . . . . If he takes them (a second time)

from the rabb al- mal and he has not made payment to the seller when the amount is lost (again), he is to recover the same amount (again). . . . He is to have recourse (to the rabb al-mal ) again and again till the amount reaches the seller.”

It is obvious that the liability of Rabbul maal is unlimited and in this case Mudarib has a right to go back to the rabbul maal and claim for a similar amount. This right of Mudarib to go back to the rabbul maal and claim for a similar amount extends further until he makes the payment to the seller.

To settle the claims of the seller whatever the amount is received by Mudarib from Rabb ul maal is added towards the capital, as much as money will be taken by the Mudarib to settle the claims of seller the capital of Modarabah will be increased to that extent and thus the emergence of Net profit and loss of Modarabah will also be affected.

Nyazee explains it as<sup>18</sup>:

“Whatever the mudarib receives this way is added to the capital. Thus, if the mudarib takes another thousand to pay the seller, the capital increases to 2000 and so on. If the mudarib sells the thing purchased for 1500, there is no profit, even though it was bought for 1000. The net profit and loss will be taken into account here.”

The second case is concerned with a state where after the commencement of business the profit has been realized and re-employed in Modarabah. Thus in this case liability rose after the emergence of profit. For instance, there may be a case that Rabbul maal hands over 1000 dirhams to Mudarib by way of Modarabah on a 50:50 ratio. Mudarib invest the amount to buy goods valued 2000 dirhams. (Thus he violates his authority to buy goods up to the limit of the capital so the excessive purchase is from his personal account). After taking possession of these goods, he sells these for 3000 dirhams and thus earns a profit of 1000 dirhams. He then purchases some other goods valued 2000 dirhams on credit but unfortunately he lost it before he could make payment to the seller. Here in order to settle the claim of the seller the Mudarib have a right to claim an amount up to the extent of his share capital which is now 1500 Dirhams whereas remaining 500 dirhams will be compensated from the personal wealth of the Mudarib.

From the above discussion, we cannot say that it is likely to yield the concept of limited liability, this is unlimited liability and in no way liability of Rabbul maal is being limited. The liability of Rabb ul maal is not limited to the extent of his capital; it remains unlimited till the settlement of all the claims. Same position will remain with Mudarib, His liability is also unlimited to the extent of this share in profit re-employed in the business.

In this regard Al-Sarakhsi states as follows<sup>19</sup>:

“He gives to a person one thousand dirhams as Modarabah for half profits and this worker buys a slave with them whose value is two thousand (dirhams). He then takes possession and sells him for two thousand. With the two thousand he purchases a slave girl, but has not paid the amount of two thousand when it is lost. The mudarib has recourse to the rabb al-mal for one thousand five hundred and compensates from his personal wealth the remaining five hundred. The reason is that the mudarib is acting for himself in the purchase of one-fourth of the slave girl in consideration of his share of the profits. He, therefore, has no recourse to the rabb al-mal for the part of the agreement that pertains to him with respect to this fourth. For the remaining three-fourths he is still working for the rabb al-mal according to the agreement.”

**Liability after Wilayat al-istidanah:**

Wilayat al-istidanah is a term used for the authority given by the investor to Mudarib for raising debts beyond the limit of the capital invested in Modarabah. Thus istidanah is the process of raising credit (not loans) during trading. In the contract of Modarabah when Rabbul maal grants wilayat al-istidanah to the Mudarib, it gives birth to a new contract of Sharikat al-wujuh based on the inan form, thus the new contract is one layer above the existing Modarabah contract. However this new contract remains dependent upon the underlying contract of Modarabah. Shirkat al-wujuh has its own rules which are different from the contract of Modarabah. It is a form of partnership where profit is earned on the basis of credit worthiness and not on the basis of the capital contributed or on the basis of work. Granting wilayat al-istidanah to Mudarib is quite similar to the case where profits are reinvested in the Modarabah. Thus it would lead to combine two separate yet related contracts. Here, both of the partners will be held liable for the credit purchase to the extent of their ownership in the goods purchased. Their liability in credit purchases is of several types and is joint as both have equal shares in the ownership of goods and in profits. This condition has been stated also by Malikies in the following words<sup>20</sup>

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“If they got together for a bargain and purchase a slave against their credit worthiness, without having capital, it is permissible and the slave is jointly owned by the two partners. This is what Imam Malik, has said. The reason is that in the example in question both the partners are

together and stand sureties to each other before the seller.”

The credit purchases through *istidanah* require sharing of profit on equal basis between the partners. Al-Sarakhsi explains it as follows<sup>21</sup>:

“The rest is shared by them in equal ratios, because the authority of *is tidanah* is absolute, and the commodity purchased on credit is owned (jointly and) equally by them. This equality between them, with respect to the purchased item, does not permit an inequality of profit.”

Profit sharing on equal basis is in a case when their ownership in credit purchase is not specific. In such a case, their ownership will be treated as equal. However if the ratio of their ownership is specific, profit will be shared accordingly<sup>22</sup>.

The liability of both partners is unlimited however for settlements of the credit claims transacting partner will be asked or will be subjected to ‘*mutalabah*’. It is because the rights of the transaction are reverted to him. Transacting partner has a right to call upon the principal partner (*Rabbul maal*) to share in his liability<sup>23</sup>. If the transacting partner fails to settle the claims of the creditors, they cannot file a suit against the principal for the settlement of their claims<sup>24</sup>.

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