

## Chapter 10

# SHARI'AH COMPLIANT CONTRACT: A NEW PARADIGM IN MULTI-NATIONAL JOINT VENTURE FOR CONSTRUCTION WORKS

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### 10.1 INTRODUCTION

In the traditional design-bid-build system of procurement, construction works are carried-out by a contractor who entered into a contractual relationship with the client. The client on his part entered into further contractual relationships with an architect, quantity-surveyor and engineers to enable these individuals to act as his professional advisers. Similarly, the contractor too would enter into a series of contractual relationships with sub-contractors, suppliers, assignees, etc. There are alternatives to the traditional design-bid-build system of procurement, such as the design-build or turnkey and the management approaches systems of procurement (see, for example, Khairuddin, 2002).

A contractor may (in an effort to increase his potential in winning a tender for a project, to mitigate risk, or to fulfill a client's requirement) form a joint venture with one or more firms of contractors, funders or others. Such a joint venture may be national or multi-national in nature (see Kobayashi, Khairuddin, 2005; Khairuddin, 2006).

Notwithstanding the system of procurement used or the style of risk management adopted by the client or contractor, the contractual relationship between them and others is among the key features of construction works. A contract provides evidence that a legal relationship exists between the parties; it facilitates construction business transactions; it outlines the rights, duties and responsibilities of each party in relation to the construction works being undertaken and describes among other things how the works are to be performed, payments to be made and disputes to be settled.

In most countries in the world construction contracts are modeled after conventional or western-style business and contractual practices. A contract is normally based upon a set of documents and the contract is administered in accordance with the country's statutes on contractual relationships, common law and her customs and traditions.<sup>1</sup>

In Islam, the way people lead their lives including in conducting personal and business transactions falls under the precepts of *Shari'ah*<sup>2</sup>. In the context of business transactions, among the applicable broad principles within the *Shari'ah* is *al-mu'amalat*. The *al-mu'amalat* (or transaction between people) emphasizes the need for business transactions to apply the concept of justice, moral obligation, accountability, and equality; these aspects are in line with the Islamic belief (*al-iman*), practices (*al-amal*) and value system. Consequently, the subject matter, terms and nature of the contract or covenant in a business transaction should not be contrary to the *Shari'ah*; hence the term '*Shari'ah* compliant.'

In countries where some forms of Islamic jurisdiction are in place (for example, Malaysia, Brunei, Pakistan and some Middle-Eastern and Northern African (MENA) countries) *al-mu'amalat* in the areas of banking, insurance, finance and capital markets has shown phenomenal success (Parker, 2006; Executive Business Magazine, 2007; Muhammad Ashraf, 2007). In these countries dual economic systems – conventional or

<sup>1</sup> For example, in Malaysia a construction contract is a branch of private law. It is governed under the Contracts Act 1950 and practiced in accordance with the customs and traditions of business transactions peculiar to Malaysia, such as the use of standard forms of contract

<sup>2</sup> The *Shari'ah* will be defined in the following section of this paper

western style business practices and *al-mu'amalat* – operate hand-in-hand. Muslims and non-Muslims conduct business transactions in the style that suits their faith or requirements.

In Malaysia the practice of *al-mu'amalat* is considered advanced. According to the Sun (2007) Malaysia's position as the world's centre for Islamic banking and finance is indisputable; its Islamic bond market is the world's largest, accounting for about US\$47 billion or two-thirds of total Islamic bonds outstanding worldwide, while its Islamic finance industry is worth some US\$38 billion in assets comprising stocks, insurance, home loans and pawn-broking<sup>3</sup>. In Islamic banking, Malaysia's Islamic banking assets represent over 12% of total bank assets. The endeavor in *al-mu'amalat* is supported by the Government, governed by statutes and supervised by Malaysia's central bank (Bank Negara Malaysia).

Despite the phenomenal success mentioned above, there are gaps in *al-mu'amalat*, such as in the area of construction procurement. The author observes that while it is common for construction clients and contractors to procure funding from Islamic banking, finance or capital market systems and insure against risks using the various Islamic insurance (*takaful*) schemes, they continue to use the conventional or western style contract when entering into contractual relationships for construction works.

The above phenomenon led to the author's contention that *al-mu'amalat* in the area of construction procurement in general and construction contract in particular is incomplete or is in its infancy. However, the enthusiasm shown by Muslim scholars and professionals to translate relevant Islamic theories and principles contained in the *Qur'an* and the *Sunnah* of the Prophet Muhammad *s.a.w* into working models suggests this phenomenon is set to change.

This chapter reports on a study on *Shari'ah* compliant contract for construction works.<sup>4</sup> The objective of the study and of the chapter is to promote understanding of the concept of the *Shari'ah* compliant contract and to bring to attention its potential as a new paradigm in multi-national joint venture contracting for construction works.

In line with the above objectives, this chapter is structured into four parts. Firstly, this chapter discusses the concept of *Shari'ah*, its sources and its significance in Islam. The second part discusses the characteristics and application of *Shari'ah* in *al-mu'amalat* and in contracts. In the third part of this chapter a discussion on how *Shari'ah* compliant contract differs from the conventional or western style contract is provided, followed by a conclusion.

Typically, the methodology for studies related to *fiqh* or Islamic jurisprudence, in the context of searching for *Shari'ah* compliance of a phenomenon, comprises three steps<sup>5</sup>:

1. Firstly, identify and examine the presence of the phenomenon;
2. Secondly, identify the textual sources (*nass*) from the revealed sources i.e. the *Qur'an* and the *Sunnah* of the Prophet Muhammad *s.a.w* and reasons (*aqil* through *ijtihad* and *ijma*) including discussions with experts in *al-mu'amalat*; and
3. Thirdly, establish the rule (*istinbat*) concerning the said phenomenon.

However, in the current study the methodology used a comprised review of literature and discussions with experts on the *al-mu'amalat*. The relatively simple approach is considered appropriate for the purpose of the study because (i) the study is preliminary; and (ii) is meant to promote understanding on the concept of *Shari'ah* compliant construction contracts, not to establish a rule (*istinbat*) on any phenomenon.

<sup>3</sup> US\$1=RM3.53 on 22<sup>nd</sup> August 2007

<sup>4</sup> The study is on-going and it represents an initial attempt by the author to promote understanding on the subject of *Shari'ah* compliant contract for construction works in Malaysia and elsewhere

<sup>5</sup> The description of the methodology presented in this paper has been simplified

## 10.2 THE SHARI'AH AND ITS IMPORTANCE IN ISLAM

### 10.2.1 The Meaning of Shari'ah

Islam is *ad-deen*, a way of life. Islam also means surrender, obey or submit to Allah the Almighty. Put simply, the *ad-deen* covers three key aspects of human life, namely belief (*al-iman*), worship (*al-ibadah*), and the way in which people conduct their personal and business transactions (*al-mu'amalat*). The *ad-deen* is governed by the *Shari'ah*.

In Arabic the term *Shari'ah* refers to 'way' or 'path'. According to the Guardian (2007) the term *Shari'ah* is "the path to a watering hole," implying that it denotes an Islamic way of life. The *Shari'ah* according to the Guardian "is adopted by most Muslims to a greater or lesser degree as a matter of personal conscience, but it can also be formally instituted as law by certain states and enforced by the courts. Many Islamic countries have adopted elements of *Shari'ah* law, governing areas such as inheritance, banking and contract law" (Guardian, 2007).

According to Wikipedia (2007) "*Shari'ah* is not a strictly codified uniform set of laws... but it is a system of devising laws... based on the *Qur'an*, the *Sunnah* of the Prophet Muhammad *s.a.w* and ... centuries of debate, interpretation and precedent."

### 10.2.2 Sources of the Shari'ah

*Shari'ah* is derived from three principal sources. The first two sources – the *Qur'an* and *Sunnah* – are referred to by Muslim scholars as 'revealed' or primary sources. The third source – *fiqh* -- is referred to as a non-revealed or secondary source.

#### 1. The *Qur'an*.

The *Qur'an* is the direct word of Allah the Almighty. It is the first and the most important source of guidance and rulings. Allah commands thus: "...When My guidance is revealed to you, he who follows it shall neither err nor be afflicted..." (*Qur'an, Taha:123*).

#### 2. The *Sunnah* of the Prophet Muhammad *s.a.w*

The *Sunnah* of the Prophet Muhammad *s.a.w* is the second source of guidance and rulings. The *Sunnah* is revelation from Allah but relayed to mankind through the words and actions of the Prophet Muhammad *s.a.w*. The *Sunnah* affirmed the rulings of the *Qur'an*; elaborated some of the concepts, laws and practical matters mentioned in the *Qur'an*; and provided further guidance on matters not expressly mentioned in the *Qur'an*.

#### 3. *Fiqh*.

In Arabic *fiqh* means knowledge and understanding. In the context of the *Shari'ah* *fiqh* refers to the rulings designed by the Muslim scholars, based on their knowledge, understanding and interpretation of the *Qur'an* and *Sunnah*. The science of *fiqh*<sup>6</sup> started in the second century after *Hijrah*, when the Islamic state expanded and faced several issues which were not explicitly covered in the *Qur'an* and *Sunnah*.

In Islam the *Shari'ah* is a way of life, a set of guidance prescribed by Allah the Almighty to be followed by his servants, the 1.2 billion Muslims worldwide. The requirement for Muslims to observe the *Shari'ah* is stated in the *Qur'an*: "To each among you, we have prescribed a law and a clear way." (*Qur'an, Al-Maida:48*).

<sup>6</sup> *Fiqh* comprises several methods that can broadly be referred to as *al-ijtihad*. The key methods include *ijma'* or unanimous view expressed by Muslim scholars, *qiyas* or analogy, *uruf* or custom and *al-maslahah* (public interest)

### 10.2.3 Shari'ah in Business Transactions (*Al-Mu'amalat*)

Islam requires Muslims to work to earn their sustenance and abhors laziness. In the *Qur'an* Allah commands: *"we created orchards of date trees and grape plants, and made springs to flow in them, so that they (human beings) would be able to eat from their fruits and from the labour that their hands do. Won't they express their gratitude for this?" (Qur'an, Yasin:24-25).*

There are numerous verses in the *Qur'an* that command Muslims to work, to practice good and ethical working cultures and to refrain from doing the opposites (for example see *Qur'an*, *Al-Ra'd*:20; *Qur'an*, *Al-Jumu'a*:9). In addition, excellent working cultures and ethical business transactions were demonstrated by the Prophet Muhammad *s.a.w* whereby the Prophet himself was active in businesses plying the route between Mecca and Sham and other places. Furthermore, such habits were also the practices of his close companions (Mohd, 2006).

In *al-mu'amalat* or business transactions Islam requires parties thereto (as well as in other or non-business matters) to apply the concept of justice, moral obligation, accountability, and equality; these concepts are in line with the Islamic belief (*al-iman*), practices (*al-amal*) and value system. The following verses from the *Qur'an* and the *Sunnah* reiterate the importance of these concepts (Muhammad Rawwas Qal'ahji, 2005 p7; Mohd Ma'sum Billah, 2006, p18-19):

*"If your debtor be in straits (in difficulties), grant him a delay until he can discharge his debt; but if you waive the sum as alms, it will be better for you, if you knew it."* (*Qur'an*, *Al-Baqara*: 280).

*"O ye who believe! Eat not your property among yourself in varieties: but let them be amongst you traffic and trade by mutual good-will."* (*Qur'an*, *Al-Nisa*:29).

*"Give measure and weigh with (full) justice."* (*Qur'an*, *Al-An'am*:152).

*"So we establish weigh with justice and fall not short in balance."* (*Qur'an*, *Al-Rahman*:9).

*"And fulfill (every) engagement, for (every) engagement will be enquired into (on the day of reckoning.)"* (*Qur'an*, *Al-Isra*':34).

*"A trustworthy and an honest and truthful businessman will rise up with martyrs on the day of judgement"* (The Prophet Muhammad *s.a.w*, quoted by Ibn Maja and al-Hakim).

Muslim scholars have studied the *Qur'an*, *Sunnah* and the *fiqh* and identified the broad *Shari'ah* principles of the *al-mu'amalat* (Muhammad Rawwas Qal'ahji, 2005 p1-12) as:

- Business transactions are not forbidden unless otherwise specified by the *nass* (textual evidence found in the *Qur'an* and the *Sunnah*);
- The *Shar'ah* facilitates (not constrains) people in conducting their daily personal and business lives (*maslahah*);
- *Al-ihthikar* (hoarding, black marketeering) and *talaqqi al-rukban* (middle person; not *al-ijarah* or one who serves others) leading to deception or inflated prices of goods/commodities are forbidden;
- Business transactions that involve elements contrary to the *Shari'ah* such as *riba* (interest charges), trading in alcohol, gambling, prostitution, etc. are forbidden;
- In the interest of the general public (*ummah*), business transactions that are monopolistic in nature must be avoided;
- Business transactions should be conducted with patience, tolerance and with the intention to facilitate, not to constrain;
- In conducting businesses, the concepts of truthfulness, ethics, integrity and accountability must be upheld at all times;

- *Gharar* (uncertainty) such as gambling, market manipulation and harmful speculation are forbidden;
- Parties in a contract or covenant must fulfill their respective obligations. Allah's commands on this matter are very clear: "*O ye who believe! Fulfill the contractual obligations.*" (Qur'an, *Al-Maida*:1).
- Be diligent and persevere in conducting businesses in such a way that all responsibilities and obligations are discharged in accordance to one's best ability.

In summary, Islam sees business transactions as among the essential activities as people must work to earn their sustenance. In addition, the *Shari'ah* requires that Muslims should conduct their business transactions in line with the Islamic belief, practice and value system. Furthermore, Islam views conducting businesses that comply with the *Shari'ah* as general worship, with such activities receiving rewards from Allah the Almighty.

### 10.3 SHARIAH IN CONTRACTS<sup>7</sup>

The *Shari'ah* precepts on contract or covenant between people, its binding on the parties, etc. both in personal and in business transactions (the *al-mu'amalat*) are outlined in the *Qur'an* and the *Sunnah* of the Prophet Muhammad s.a.w., for example:

*"But do not make a secret contract with them except that you speak to them in terms honourable, nor resolve on the tie of the marriage till the term prescribed is fulfilled."* (Qur'an, *Al-Baqara*:235).

*"O ye who believe! Fulfill the contractual obligations."* (Qur'an, *Al-Maida*:1).

*"And fulfill your covenant with me and I fulfill my covenant with you."* (Qur'an, *Al-Baqarah*:40).

Abu Huraira' reported: "*Allah's messenger was saying, there are three signs of a hypocrite: when he speaks he lies, when he makes a promise he breaks it, and when he is trusted he breaches his trust*" (Bukhari and Muslim in Mohd Ma'sum Billah, 2006, p4-7).

The foundation of the *Shari'ah* on contracts comprises belief in Allah as God, the sole creator (*al-iman*), god consciousness (*al-tawwakal*), knowledge (*al-ilm*), sincerity (*al-ikhlas*), that the sources of law are derived from both divine (*Qur'an* and *sunnah*) and non-divine sources, and that a contract must involve people (*ummah*) as parties thereto (Mohd, 2006). As a starting point, therefore, a *Shari'ah* compliant contract must acknowledge and incorporate these aspects into its subject matter, agreement, terms and the conditions thereto.

In Arabic, the term contract is referred to as *al-'aqad*. It means to tie, to knot, to conjunct (Mohd, 2006). The *al-'aqad* refers to a contract or a covenant between two or more parties on a subject matter (personal or business) based on an offer (*ijab*) made by the first party (say the contractor) and accepted (*qabul*) by the second party (say the client). Consistent with the conventional way of entering into a contractual relationship, a contract between the parties exists once an offer (*ijab*) is accepted (*qabul*).

The contractual relationship entered by the parties must be by mutual consent. In addition, the subject matter of the contract and its terms and conditions must not be contrary to the *Shari'ah*. Furthermore, the consideration shall be something of value and certain and the time frame for the parties to fulfill their obligations must be specified in the contract (Mohd, 2006).

In terms of the contracting parties, the persons shall possess the following qualifications or else the contract is void: (i) has a sound mind, (ii) has reached puberty, (iii) is free to enter into a contract, and (iv) is not bankrupt. Once a contract exist the parties must abide by all the terms and conditions agreed thereto and one party may sue the other should the latter breach the contract (Muhammad Rawwas Qal'ahji, 2005).

<sup>7</sup> The onward discussion on *Shari'ah* in contract is general and somewhat simplified. The author acknowledges that there are various types of contracts (Islamic or conventional) and that the practice of contracting is not standard across the world

*Shari'ah* requires that a contract between parties should be signed and witnessed. These requirements are stated in the Qur'an thus: "O ye who believe! When ye deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing... and get two witnesses..." (Qur'an, *Al-Baqarah*:282).

The application of *Shari'ah* in business transactions is not easy to understand. The difficulty is exacerbated by the presence of varying *Shari'ah* compliance standards across the world. There is no universally accepted model on it, and countries developed models that suit their own business environments. The complexity and higher demand for *Shari'ah* compliant business transactions (in Muslim and non-Muslim countries) have been acknowledged by many, for example:

"... *sukuk*—asset-backed securities that are employed in growing numbers for securitization operations with real estate as underlying assets—have ballooned into 17 different varieties on record with the Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI). The first modern *sukuk* was issued as simple arrangement about five years ago by the government of Malaysia. In the retail market, the contracts and models for Islamic real estate finance have sprouted from relatively simple *mudaraba* transactions (in which a bank purchases a property and resells it to its client at a fixed higher price payable in installments) to multi-layered deals that include leasing (*ijara*), diminishing joint ownership (diminishing *musharaka*), and parallel and mixed leasing agreements. The United Kingdom has acted as center for developing these *shari'ah*-compliant products, said Tariq Hameed, a partner in British law firm Norton Rose. However, when pressed for numbers and the UK market size for the Islamic product marvels, he estimated the number of existing contracts at 5,000 home finance deals—out of 410,000 Muslim households in the country. "Many Muslim families in the UK don't trust that the contracts really are *shari'ah* compliant," he offered as explanation" (Executive Business Magazine Online, 2007).

"As a result of the economic growth and development of many Islamic countries, triggered, in part, by the high oil prices of recent years, a concerted effort is being made by financial institutions that choose to conduct their business in accordance with *Sharia'a* to reconcile the complexities of the secular financial system with the principles and ethics of Islam. There is now an increasing need to apply Islamic principles to complex financial transactions. Indicative of this need is the fact that the size of deposits held by nearly 300 Islamic financial institutions worldwide is growing on average at 23.5 per cent per annum and totals approximately US\$262 billion. The value of Islamic investment transactions has grown to almost US\$200 billion" (Norman, Schmidt, 2007).

In relation to Malaysia; "... its Islamic bond market is the world's largest accounting for about US\$47 billion or two-thirds of total Islamic bonds outstanding worldwide while its Islamic finance industry is worth some US\$38 billion in assets comprising stocks, insurances, home loans and pawn-broking" (The Sun, 2007).

Consequently, and in effort to achieve *Shari'ah* compliance in the banking, insurance and finance and the capital market sectors, organizations set up *Shari'ah* Advisory Committees comprised of *Shari'ah* experts and professionals who advise their respective organizations on whether their products or services comply with the *Shari'ah*. Table 10.1 lists of some of the general Islamic banking, insurance and finance and capital markets' contracts/products that are currently in compliance with *Shari'ah*.



Table 10.1: Contracts/Products currently considered being Shari'ah Compliant<sup>8</sup>

Product	Style of Contract	Descriptions
<i>Al-Mudaraba</i>	Partnership	A contract of partnership between parties, the borrower ( <i>mudareb</i> ) borrows money from the financier ( <i>rab-al-amal</i> ). The proceeds or otherwise from the venture are to be shared among the parties in accordance with the terms and conditions of the contract
<i>Al-Bai' bithaman Ajil</i>	Sale and purchase	A contract of sale and purchase of goods whereby payment is delayed to a later date or to be paid in installments. The price and the style of payments must be agreed at the onset of the agreement, without interest payment
<i>Al-Murabahah</i>	Sale and purchase on a cost plus basis	A contract of sale and purchase whereby one party agrees to buy an asset from a third party (in the market) and then sells it to the other party at a price that includes his original purchased price, administrative costs and a reasonable profit. The second party pays the first party through an agreed style of payments usually deferred to a later date
<i>Al-Musharakah</i>	Equity financing	This contract is similar to the <i>al-mudaraba</i> except that the <i>mudareb</i> provides part of the equity. Profits and losses are shared between the parties
<i>Al-ijarah</i>	Lease	In this contract the principal purchases and leases out an asset or equipment required by his client for an agreed rental fee. This fee can be fixed in advance or be subject to occasional reviews. During the rental period the leased asset remains under the control of the principal
<i>Salam</i>	Advance purchase	The <i>salam</i> contract is defined as the advance purchase of specified goods with full pre-payment
<i>Ju'ala</i>	Some sort of a reward contract	For example, a contract for bringing back fugitives or lost property. The contract is binding once the object is realized
<i>Istisna'</i> or <i>Al-Muqawalah</i>	Manufacturing contract	A contract to make, produce something of which the subject matter is clearly specified and the terms of payment agreed at the onset
<i>Takaful</i>	Insurance	A contract between the insurer and the insured
<i>Sukuk</i>	Bonds	Asset backed securities issued in line with the <i>Shari'ah</i>

In summary, the concept of *Shari'ah* compliant contract refers to a contractual relationship that embraces the Islamic belief, practice and value system. The key principles of a *Shari'ah* compliant contract absent in the conventional or western style contractual relationships are the following (Mohd, 2006):

- A *Shari'ah* compliant contract is subject to divine sanctions;
- The subject matter must be in conformity with divine laws; and
- Contracting in accordance to the *Shari'ah* is considered a general worship.

<sup>8</sup> Sources: Muhammad al-Bashir, 2001; Muhammas Rawwas Qal'ahji, 2005; Mohd Ma'sum Billah, 2006; Norman and Schmidt, 2007; Islamic Development Bank, 2007; Kamalpour, 2006, etc

#### 10.4 SHARIAH IN CONSTRUCTION CONTRACTS

A construction contract is unique. Typically in a project there exist a myriad of parties and activities that encompass the construction industry's supply chain: from initiation of a project to funding, construction, completion and maintenance of the completed facility. Therefore, a myriad of primary and secondary contractual relationships also exist where parties entered into contracts in which the subject matter is non-existent at the time of the contract except as provided in the contract documents.

Contracts are entered by the parties to provide evidence that a legal relationship exists between them; contracts outline the rights, duties and responsibilities of each party in relation to the construction works being undertaken and describes among other things how the works are to be performed, payments to be made and disputes to be settled. Figure 10.1 provides an illustration of contractual arrangements in a construction project with a *Shariah* compliant contract, in this case involving Islamic debt securities.

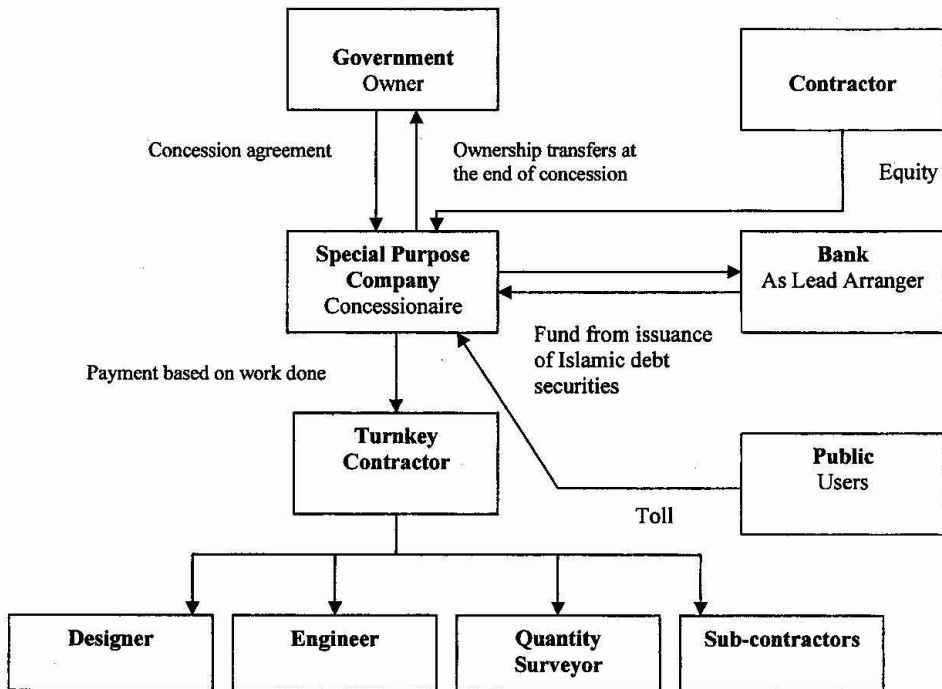


Figure 10.1: Contractual Arrangements in a Typical Privatized BOT Project  
(Source: Khairuddin, 2006a)

In relation to a contract for construction works, many Muslim scholars and professionals concur that from among the various styles of *Shari'ah* compliant contracts (see Table 10.1) the *Istisna'* or *Al-Muqawalah* is considered most appropriate (for example see Muhammad Al-Bashir, 2001; Muhammad Rawwas Qal'ahji, 2006, Parker, 2006).

In Arabic the term *Istisna'* means "making, manufacturing, or constructing something." An *Istisna'* contract is therefore "a contract with a manufacturer to make something..." (Muhammad Al-Bashir, 2001, p6-7).

*Istisna'* as a term denoting the act of making or manufacturing can be found in the *Quran* and *Sunnah* (Muhammad Al-Bashir, 2001, p6) i.e. "The work of Allah who perfected all things" (*Qur'an, Al-Naml:27*); and



it was reported that the Prophet Muhammad *s.a.w* had ordered a craftsman to make a ring for him. *Istisna'* as a form of contract was practiced by the Arabs during the pre-Islamic era.

The conditions for the legality of the *Istisna'* were outlined by Muhammad Al-Bashir (2001) and Muhammad Rawwas Qal'ahji (2006) i.e.

1. Principles of the *al-mua'amat* are applicable in an *Istisna'* contract;
2. For a contract to be valid the contracting persons must possess all the qualifications (has a sound mind and has reached puberty, is free to enter into a contract and is not bankrupt); that the process of offer (*ijab*) and acceptance (*qabul*) takes place; and that the subject matter and the consideration is of value, is certain (*gharar* or un-certainty is prohibited) and one that is not prohibited by the *Shari'ah*;
3. The specific conditions for the *Istisna'* are the following:
  - a. The object, in this case the construction of the structure to be built, must be clearly defined, illustrated, quantified and specified so as to avoid ambiguity or misrepresentation that could lead to dispute;
  - b. The structure to be built should be that which people customarily deal with;
  - c. The time of completion must be specified;
  - d. The materials to be used in the works should be supplied by the contractor (if the materials are supplied by the client the contract is not *Istisna'* but *Ijara*); and
  - e. Advance payment is not a condition but is permissible, or payment may be made in installments or at the end of the contract;
4. In addition to the above, it is permissible in an *Istisna'* contract to include provisions such as the following:
  - a. Liquidated damages, being a prior agreement between the parties to a contract about a sum payable in the event of one party failing to complete or delaying performing his obligations under the contract;
  - b. Circumstantial changes and their effect such as exceptional events or unforeseeable events arising from general circumstances that occurred during the contract; and
  - c. Dispute resolution through arbitration;
5. An *Istisna'* contract is terminated once the contractor completes the project and hands it over to the client and the latter pays the former. However, termination during the progress of the works may take place upon the death of one of the parties (should the party who suffers death be a sole proprietor).

The concept of *Istisna'* is currently being practiced. Box 1 provides a description on the concept of *Istisna'* as practiced by the Islamic Development Bank (IDB). In addition, Muhammad A-Bashir (2001, p135-149), Parker (2006) and Mc Millen (2001) indicated that *Istisna'* contracts are already in place and that this concept is practiced in some MENA countries, the UK, and the US.

In a project it is possible for contractual relationships encompassing a combination of several *Shari'ah* compliant contracts (see Table 10.1) to be present. Thus, the client may enter into an *Istisna'* contract with a main contractor for the latter to execute the works. The client may in turn enter into several contractual relationships: *sukuk* or *al-mudaraba* or *al-musharakah* with his financiers and *al-ijara* with his lease-holders. Similarly the contractor may enter into an *al-mudaraba* or *al-musharakah* joint venture contracts with his joint venture partner, *al-bai' bithaman ajil* or *al-murabahah* with his suppliers of goods and materials, *al-ijarah* with his equipment suppliers and *takaful* with his insurer, etc. The *Istisna'* therefore becomes the main contract agreement with several other contracts as the secondary contract agreements.

**“Definition**

*Istisna'a* is a contract whereby a party undertakes to produce specific goods and services, made according to certain agreed-upon specifications at a determined price and for a fixed date of delivery. The production of goods includes any process of manufacturing, construction, assembling or packaging. In *Istisna'a*, the work is not conditioned to be accomplished by the undertaking party alone, and this work or part of it can be done by others under his control and responsibility. *Istisna'a* could also be used in pre-shipment financing of the acquisition of capital goods. In addition, the *Istisna'a* mode can be used to finance intangible goods such as gas and electricity for which Leasing or Installment Sale modes are not suitable.

**Objectives**

The main objective of the *Istisna'a* mode of financing is to promote manufacturing and construction capabilities in the IDB member countries. This may relate to manufacturing of complete assets in the form of capital goods or construction of certain infrastructure projects such as rail, roads, schools, bridges, buildings, etc. This mode of financing can also be applied to Export Financing Scheme (EFS) to enhance intra-trade among IDB member countries.

**Scope and Eligibility**

*Istisna'a* provides medium-/long-term financing to meet financing requirements for manufacturing/constructing/supplying/sale of identified goods and assets, such as, industrial/construction equipment, machinery, cargo vessels, oil tankers, trawlers, dredgers, locomotives, etc., transport equipment, pipelines for water and oil distribution, gas and electricity and their transmission/ distribution lines, electric generators and transformers, telecommunication equipment, oil rigs, hospital equipment, buildings, etc. Under the *Istisna'a* mode, it is also possible to finance intangible assets like gas, electricity, etc. Additionally, unlike under Leasing and Installment Sale, *Istisna'a* can be used to finance working capital. *Istisna'a* financing period is determined by the time required for procurement of the necessary materials and actual manufacture of the goods according to the agreed contract.”

*Box 10.1: Istisna' as practiced by the Islamic Development Bank (Source: IDB, 2007)*

## **10.5 SHARI'AH COMPLIANT CONTRACTS AND CONVENTIONAL CONTRACTS: WHAT'S THE DIFFERENCE?**

Broadly, many of the practices found in the conventional or western style contracts for construction works are not contrary to the *Shariah*. The concept of justice, moral obligation, accountability and equality can be found in both the conventional and *Shariah* compliant contracts.

The key differences between the *Shari'ah* compliant contract and the conventional contract are in the area of faith or one's belief system i.e. that in a *Shari'ah* compliant contract:

- Its validity is subject to divine sanctions;
- The subject matter, considerations, etc. must be in conformity with divine laws;
- Elements of usury or bribery render the contract void; and

- Contracting is considered part and parcel of the religious belief and practices of Muslims.

## 10.6 CONCLUSION

This chapter reports on a study of the concept of the *Shari'ah* compliant contract for construction works. In relation to the key objective of the chapter, i.e. to promote understanding of the concept of the *Shari'ah* compliant construction contract, the following are the key findings of the study:

1. The concept of *Shari'ah* compliant contract embraces Islamic doctrines that reiterate all of the Islamic belief, practice and value system;
2. Features in the *Shari'ah* absent from the conventional or western style contractual relationships are the following:
  - a. The validity of a *Shari'ah* compliant contract is subject to divine sanctions;
  - b. The subject matter, considerations, etc. must be in conformity with divine laws; and
  - c. Contracting is considered part and parcel of the religious belief and practices of the Muslims
3. In relation to contracting for construction works, the *Shari'ah* compliant contract identified is known as the *Istisna'*; and
4. In a construction project, several *Shari'ah* compliant contractual relationships may be present, i.e. an *Istisna'* as the main contract agreement with several contracts of *al-mudaraba*, *al-murabaha*, *al-bai' bithaman ajil*, *al-ijara* etc as secondary contract agreements.

In addition, the findings of the study suggest that the market and the potential for *Shari'ah* compliant construction contracts are on the rise. It is the desire of Muslims across the world to apply *al-mu'amalat* in total when they procure construction works. In the context of multi-national joint-venture contracting for construction works, the phenomenon of having *Shari'ah* compliant contracts is already happening in the areas of funding and in the supply of goods, services and equipment, etc.

Consequently, key players operating in the global construction market should prepare to embrace this new challenge. Capacity building in the specialized area of *Shari'ah* compliant construction contract must begin in earnest.

The study reported herein represents a small part of an overall study on the concept of the *Shari'ah* compliant construction contract. Consequently, further and in-depth study is required and is currently underway.

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