

COMMON MANAGEMENT OF INVESTMENT CAPITAL FROM DIFFERENT INVESTORS IN MUDARABAH: SCOPE OF VALIDITY AND CONSEQUENCES IN ISLAMIC LAW

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ABSTRACT

Elements of both mudārabah (fund management) as well as shirkah (partnership) in Islamic law are reflected in the operation of investment accounts offered by Islamic financial institutions. A number of partners pooling their funds together for running a business operation is possible under shirkah. Similarly, mixing mudārabah capital with funds of the mudārib (entrepreneur/fund manager) could be valid according to the majority of schools with express permission from the investor. In mudārabah, the schools of Islamic law have recognised the validity of several parties jointly investing funds with a common mudārib through a single contract. Such investment should take place jointly on a single occasion, so that the tenure of mudārabah could commence with regard to all capitals at the same time. Where the mudārib accepts investments from different individuals through individual contracts, the majority of schools require that the business of each capital be managed separately. This restriction is due to fundamental anomalies that may result from mixing different capitals, which, having mobilised in business separately, could be at different stages of profit or loss. However, jurists of the Hanafī school appear to have allowed the mudārib to mix funds of different investors together with their permission. This could possibly indicate permissibility of mixing funds invested at different stages when overall permission had been obtained. The procedure adopted in this regard in the investment accounts run by Islamic banks requires further research and scrutiny.

Keywords: mudarabah, capital, investment, accounts, investors, Islamic

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INTRODUCTION

In the contemporary arena of Islamic banking, joint investment accounts replace interest-based deposit accounts found in the conventional banking system. Provided as an alternative to conventional interest based accounts such as fixed deposit accounts and saving accounts, these facilitate clients to invest their surplus resources through the mediation of the bank for realising profits. Investment accounts serve the dual purpose of supplying necessary capital for investment by the bank in various projects, in addition to acting as the primary means through which the earnings of the bank are distributed among the public who do not happen to be shareholders of the bank, a vital function expected of Islamic banks that could be of great economic import. In conventional banking, consumer deposits form a major source of funds for the bank, that are cheaper than 'bought-in' funds from the money markets.¹ The term 'deposits' is often used to describe the money which customers leave with the banks on current, deposit, and other accounts. If a current account is defined as an account which is opened so that cheques may be drawn on it, then a deposit account can be defined as an account which is opened to earn interest.² In the conventional system, a wide variety of deposit accounts offers interest at different rates to clients.

MECHANISM OF EQUITY ACCOUNTS

Prior to embarking on a detailed analysis of individual issues, it would be relevant here to present a brief survey of the operational mechanism adopted by Islamic banks in general in joint investment accounts. Usually offered under the name of *mudārabah* accounts, these allow clients to make capital deposits at any point of time, subsequent to opening the account by signing the agreement with the bank, often referred to as a *mudārabah* agreement, and placing an initial deposit. These accounts could be opened in the name of individuals as well as joint investors such as husbands and wives, business firms and societies, and in some instances, legal entities such as companies and trusts. Many Islamic banks allow investment accounts in the name of minors, where the parent or guardian is required to represent their interests. Each depositor is treated as a financier (*rabb al-māl*) who hands over funds to the bank for investment in profitable activities against a share of the profits. The deposits are treated as *mudārabah* capital, the liability of which is borne by the depositors / investors. The bank represents the fund manager (*mudārib*) who receives funds from each depositor under a separate contract of *mudārabah* with each, and involves the funds in business ventures in an unrestricted or restricted form as agreed with the depositors. Although the funds are received separately, they are converged into a common pool for investment purposes, which fact is usually highlighted in the initial agreement. A ratio is agreed at the inception for distribution of profits between the bank and the joint pool of investors, such as 30 : 70 and 40 : 60. The agreements usually provide that loss affecting the pool would be solely borne by the depositors. There could be different investment pools created for different investment purposes.

¹ Philip Molyneux, *Banking: An Introductory Text*, London, Macmillan, 1991, p. 70.

² F. E. Perry, *The Elements of Banking*, 4th Ed, Singapore, Federal Publications, 1984, p. 322.

In many accounts, depositors are allowed to make withdrawals of the capital during the tenure of the contract and to make fresh deposits without major restrictions, except in the case of deposits involving some specific investment projects. At the end of the designated cycle, usually consisting of three months to one year, which could extend in some long term specific investment projects up to three years, the profit / loss situation of the joint pool is assessed. Any profits realised are divided between the bank and the pool of investors according to the agreed ratio. There could be different ratios applicable to different types of investment. Thereafter, profits accruing to the pool of investors is divided among individual investors taking into consideration the aggregate amounts invested by them during the cycle and the duration each deposit had remained in the pool, through a process known as the daily product method. Profits accruing to investors are usually credited to their accounts and are reinvested with the capital, unless if the depositors choose to withdraw them or had advised otherwise.

In shari'ah, deposit of funds into deposit accounts of conventional banks, similar to current deposits, falls under extending a loan (*qard*) to the bank.³ The major objection to such deposit accounts from an Islamic perspective is, of course, the interest element. As conclusively borne out by various individual scholars as well as a number of academic bodies and also the historic judgement delivered by the supreme court of Pakistan in December 1999, interest paid by the bank periodically on deposits in these accounts, being a stipulated excess on monetary capital, is *ribā*, and is impermissible.⁴ Therefore, deposit of funds into such accounts entail entering an interest based loan transaction. A minority of contemporary scholars have argued for the permissibility of bank interest, which, however, is negated by the overwhelming majority of contemporary Islamic jurists. This research does not intend to analyse the said debate as it falls outside the scope adopted, and instead follows the conclusion as upheld by the majority in its subsequent discussion.⁵

In their quest to offer an account similar to deposit accounts offered by conventional banks where clients could deposit funds for varying periods without forgoing the opportunity of availing of a return, Islamic banks have succeeded in introducing joint equity investment accounts. Instead of the platform of lending coupled with fixed interest adopted in conventional bank accounts, equity investment accounts are expected to operate on a profit and loss sharing basis. Although called *mudārabah* investment accounts, the modus operandi here comprises an admixture of *shirkah* and *mudārabah* both, as the bank's own funds too are activated along with deposits in these accounts. In most types of equity accounts, profit / loss is distributed periodically, at the end of a stipulated cycle such as six months or one year.

JOINT EQUITY ACCOUNTS AND MUDĀRABAH / SHIRKAH CONTRACTS

Although termed *mudārabah* investment accounts generally, joint equity accounts offered by Islamic banks do not totally conform to the fundamental *mudārabah* contract as put forth by jurists. Equity accounts as generally offered today by many Islamic banks manifest features that have been developed through a convergence of, as well as various additions to, the principles of both *shirkah* and *mudārabah*. These variations have been introduced in order to overcome issues faced in management of deposits from a large number of depositors at the same time and to face competition offered by the conventional banking industry. Thus, maturity of deposits is subject to a cycle common to all deposits in a category and the determination of profit and loss is carried out with regard to most assets by constructive liquidation, rather than actual liquidation. Some banks uphold the practice of holding reserves in order to meet potential losses. Investors are not allowed to provide guidelines concerning the particular avenues of investment favoured by them and are required to accept investment decisions made by the bank, except in the case of restricted or special *mudārabah* accounts, where they are allowed to do so. Deposits in joint equity accounts are usually involved in business ventures together with a part of the share capital of the bank.

It is evident that in operational details, Islamic banks are pressured to mimic conventional interest based banks in order to survive, due to the prevailing environment comprising the expectations of depositors, entrepreneurs and regulators, as well as the pre-existing legal and regulatory system.⁶ Thus, joint investment accounts are designed in general to facilitate deposit and

³ Al-Ittihād al-Duwali li al-Bunūk al-Islāmiyyah, *al-Mawsū'ah al-'Ilmiyyah wa al-'Amaliyyah*, vol. 5, p. 148, Muhammad Salāh Muhammad al-Sāwī, *Mushkilah al-Istithmār fī al-Bunūk al-Islāmiyyah wa Kayfa 'ārajaha al-Islām*, Jiddah, Dār al-Wafā, 1990, p. 438.

⁴ E.g. Resolutions No. 10(10/2), 2nd Session of the Islamic Fiqh Academy, Jeddah – 1985, Resolution Nos. 1, 2, 2nd Conference on Islamic Banking, Kuwait - 1983.

⁵ For a discussion on the topic, see *al-Mawsū'ah al-'Ilmiyyah wa al-'Amaliyyah li al-Bunūk al-Islāmiyyah*, vol. 5, pp. 146-56; Muhammad Taqī Usmānī, *The Historic Judgment on Interest*, Karachi, Idāratul Ma'arif, 2002; Mustafā 'Abdullāh al-Hamshari, *al-A'māl al-Masrafiyyah wa al-Islām*, al-Qāhirah, al-Shirkah al-Misriyyah li al-Tabā'ah wa al-Nashr, 1973, pp. 30-112; 'Alī Ahmad al-Sālūs, *al-Mu'āmalāt al-Māliyyah al-Mu'āsirah fī Māzān al-Fiqh al-Islāmi*, Kuwait, Maktabah al-Falāh, 1992.

⁶ Frank E Vogel and Samuel L Hayes, *Islamic Law and Finance: Risk, Religion and Return*, London, Kluwer Law International, 1998, p. 134.

Vogel has discussed some of the issues where the Islamic banking model, which to a large extent involves deposit taking on the basis of *mudārabah*, has to elaborate its functions from an Islamic point of view. He has grouped these under three headings, namely, problems in managing deposits, problems in organizing the Islamic bank using conventional legal forms and practices and problems arising from pressure on investment by the public along the lines of deposit accounts offered by conventional banks. The elementary reasoning appears to be that an Islamic investment account functioning drastically different from conventional deposit accounts would not be favoured by a public accustomed to the convenience of the latter, and thus would fail to attract sufficient capital for investment purposes. Due to this reason, operation of *mudārabah* investment accounts from a depositor's position is made essentially similar to maintaining a conventional deposit account.

In view of the diverse areas of *sharī'ah* importance relating to joint equity accounts, they remain a subject frequently taken up for consideration in conferences and forums on Islamic finance. Numerous *fatāwā* and resolutions have been issued on various aspects on the operation of such accounts. Collections of *fatāwā* issued by the *sharī'ah* boards of various Islamic banks and other bodies such as the Albaraka conference contain many relating to them.⁷ The Jeddah based Islamic Fiqh Academy had held a session (i.e. the 13th session held in Dec. 2001 in Kuwait) where the subject of joint investment accounts of Islamic banks was discussed extensively.⁸ The *Sharī'a* Standards of AAOIFI as well as their Accounting Standards are seen to have elaborated on guidelines concerning joint investment accounts⁹, where it has been attempted to regulate some of the anomalies inherent to their operation by providing specific rulings on the procedure to be followed in various instances.

Due to various aspects of *sharī'ah* importance pertaining to investment accounts offered on the basis of *shirkah* / *mudārabah* by Islamic banks, it would be pertinent here to evaluate the concept of joint equity accounts, the role played by the bank as *mudārib*, the nature of the relationship between the depositors and the bank.

SHARĪ'AH PERSPECTIVE OF THE CONCEPT OF JOINT INVESTMENT

As far as joint investment on the basis of *shirkah* is concerned, the possibility of a multiparty *shirkah* where a number of partners pool their funds together for running a business operation appears well supported by accepted texts of Islamic law. Since the concept of partnership refers in general to sharing of capital and profits, participation of even a large number of people for this purpose does not appear to be extraordinary. Thus, frequent mention of such multiparty relationships is found in Islamic texts. However, in the case of *mudārabah*, where capital is contributed by one party to another for investment and management, the usual format discussed is noted to be that of a two party relationship. However, rulings pertaining to *mudārabah* relationships involving a number of parties, is to be found in Islamic legal literature, which amply indicates that the such multiparty relationships are permissible in *mudārabah* in principle. The Hanafi jurist al-Sarkhasi,¹⁰ the Māliki jurist Ibn 'Abd al-Barr,¹¹ the Hanbali jurist Ibn Qudāmah,¹² the Shāfi'i jurist al-Nawawi,¹³ among others, have discussed instances where *mudārabah* involves more than two parties. The Shāfi'i jurist al-Māwardi has discussed in detail different variations of profit sharing when two individuals invest their funds with two *mudāribs*. Extending the same principle, there should be no bar to the contract involving a number of participants in both sides.

In spite of this, mention of an instance where the funds of a large number of people are pooled together for being invested in business ventures by another body of individuals or an organisation acting as *mudārib* is not to be found in the treatment of the topic. However, it may not be inferred from this that such an arrangement would be unacceptable or illegal, and that *mudārabah* could not be structured in this manner. Islamic jurists had devoted their texts to analyse and illustrate the basic concepts and rulings pertaining to different types of business relationships, based on which any form of activity could be carried out involving any number of people, as long as the fundamental principles expounded are not violated.¹⁴ The number of participants itself would not be treated as a factor affecting the contract adversely except in instances where the number of participants is specifically restricted, such as in the contract of marriage. Where this is not the case, a contract could be formulated with the association of any number of participants.

Islamic banks to frame deposits and investments to have risk and liquidity characteristics similar to those of conventional banks in order to compete.

⁷ E.g. *al-Fatāwā al-Shar'iyyah fī al-Masā'il al-Iqtisādiyyah* of the *Sharī'ah* Board of Kuwait Finance House, *Fatāwā Shar'iyyah Fī al-A'māl al-Masrafiyyah* of Dubai Islamic Bank, *A Compendium of Legal Opinions on the Operations of Islamic Banks* of the Institute of Islamic Banking and Insurance.

The Albaraka conferences on Islamic Economics that had issued resolutions on the subject include the 7th, 8th, 9th, 10th and 11th sessions. See *Fatāwā Nadwāt al-Barakah*, Jeddah, Albaraka Bank.

⁸ See Islamic Fiqh Academy, *Majallah Majma' al-Fiqhī al-Islāmī*, No.13, vol. 3.

⁹ AAOIFI, *Sharī'a Standards May 2002*, pp. 229-245.

¹⁰ Al-Sarkhasi, *al-Mabsūt*, vol. 22, pp. 30-31.

¹¹ Ibn 'Abd al-Barr al-Qurtubi, *al-Kāfī*, Bayrūt, Dār al-Kutub al-'Ilmiyyah, 1408H, vol. 1, p. 387.

¹² Ibn Qudāmah, *al-Mughni*, vol. 5, pp. 145, 146.

¹³ Al-Māwardi, *al-Hāwī al-Kabīr*, vol. 7, pp. 355, 356, al-Nawawi, *Rawdah al-Tālibīn*, vol. 4, p. 205.

¹⁴ Muhammad Taqi Usmani "al-Mudārabah al-Mushtarakah fī al-Mu'assasāt al-Māliyyah al-Islāmiyyah al-Mu'āsirah", in *Majallah Majma' al-Fiqh al-Islāmī*, 13th Session 2001, vol. 3, p. 11.

SIMULTANEOUS INVESTMENT BY ALL INVESTORS

According to the recognised norms of *mudārabah*, where several parties invest with a single *mudārib*, such investment is understood to take place on a single occasion, so that the tenure of *mudārabah* could commence with regard to all deposits at the same time.¹⁵ Juristic rulings on the topic indicate that although several parties were allowed to invest with a single *mudārib*, all of them were perceived to invest on the same occasion under a single contract, which requires the parties having agreed beforehand to invest their funds on *mudārabah*. As was referred to above,¹⁶ apart from the Hanafi school, there appears little room for merging of different investments made on different occasions. The Māliki position suggests the possibility of the *mudārib* combining funds received from different individuals under separate contracts, which need not have commenced at the same time. However, Māliki texts imply that in this instance, involvement of the funds in trade would take place after combining them, which ensures simultaneous commencement of operations with regard to all capital. As far as combining two investments made on different occasions in a single *mudārabah* is concerned, i.e. to combine a capital invested later to an existing *mudārabah* that is active, this has been held impermissible by Māliki jurists.¹⁷ Similarly, Shāfi'i and Hanbali jurists have indicated its unacceptability. The least restrictive on this issue appears to be the position adopted by the Hanafi school, which indicates that it is permitted for the *mudārib* to mix the *mudārabah* funds with his own or with the funds of another, when the investor grants overall permission to the *mudārib* to transact using the *mudārabah* funds as he wishes, or when such mixing is customary. This could mean that simultaneous commencement of *mudārabah* by all investors is not considered mandatory in the Hanafi school.¹⁸

With regard to modern investment accounts, if the majority position were to be adopted, observance of this aspect would demand that deposits for investment be taken at the same time. The *mudārabah* investment taking would have to be programmed in such a way that instead of a single cycle for all investors that accepts deposits at any point of time during its tenure, different cycles that run more or less concurrently are commenced at intervals, facilitating a group of investors to invest together in a single cycle that commences on a date convenient to them. Once an investment cycle had commenced with a defined group of investors, additional investment by fresh investors would not be possible. Thus, this could dictate the inception of multiple *mudārabahs*, which could partially resemble closed-end investment funds due to non-acceptance an increase in the original investors. However, this process could involve various difficulties with regard to managing each *mudārabah* investment portfolio separately, in addition to restricting the opportunity to invest anytime as found in conventional bank accounts, as those wishing to invest would need to wait until the date of commencement of a cycle, and would have to forgo the opportunity of involving their funds in business for that duration. Thus, this is an aspect that has been cited as a reason for identifying joint equity accounts as a novel variety of *mudārabah* where restrictions necessitating simultaneous investment have been relaxed, as shall be discussed subsequently.¹⁹ However, it can be noted that the Hanafi position indicated above provides some leeway for mixing of funds belonging to different investors, which could justify the practice adopted in modern equity accounts within the parameters of traditional *mudārabah* as far as this aspect is concerned.

THE NATURE OF THE MUDĀRIB (FUND MANAGER)

If investment on *mudārabah* is to materialise on a large scale, appointment of a single individual or a group of individuals as *mudārib* may involve unnecessary restrictions with regard to functionality and operations. Although a group of individuals acting as *mudārib* could be sufficient in operations of a relatively smaller scale, it would prove inadequate with regard to mass scale fund accumulation as is done in the course of commercial banking. Raising and management of such funds usually takes place through modern companies, which are identified as juridical personalities. In the case of investments on *mudārabah* basis involving a juridical person such as a limited company, it is necessary to verify the identity of the *mudārib*. Consequent to incorporation, a limited company becomes a legal person distinct from its members, i.e. the shareholders who, apart from a right to their shares, do not have any direct rights to the property of the company.²⁰ The board of directors are entrusted with the management of the company. The legal title to the company's property is vested in the company and not in the directors, who are servants of the company only if they have a separate contract of service.²¹ However, due to the fact that the company is represented by its board of directors, some contemporary scholars hold them in the position of *mudārib* for the funds of *mudārabah*.²² In this case the responsibility of managing the funds devolves on them clearly. Even if the shareholders or the juridical entity of the bank itself is identified as *mudārib*, in either situation, for practical purposes, the board of directors are seen to act on behalf of them in a representative capacity.

In the view of some other contemporary scholars, the Islamic bank itself, as a legal person, is the *mudārib*.²³ Some scholarly bodies concerned with Islamic banking have supported this opinion in their resolutions.²⁴ Although the shareholders are the

¹⁵ Al-Nawawi, *Rawdah al-Tālibīn*, vol. 4, p. 205, Ibn Qudāmah, *al-Mughni*, vol. 5, pp. 146.

¹⁶ See sections on mingling capitals invested by different investors and Hanafi position on mixing funds of different investors together above.

¹⁷ Al-Dardīr, *al-Sharh al-Kabīr*, vol. 3, p. 323.

¹⁸ Ibn 'ābidīn, *Radd al-Muhtār*, vol. 5, p. 649, 650.

¹⁹ Muhammad Taqi Usmani above.

²⁰ Abbot, *Company Law*, p. 39.

²¹ Ibid, p. 171.

²² Al-Siddīq al-Darīr, "Madā mas'ūliyyah al-mudārib wa majlis al-idārah 'ammā yahduth min al-khasārah", in *Majallah Majma' al-Fiqh al-Islāmi*, 1996, Year 8, vol. 10, p. 62.

²³ Muhammad Taqi Usmani, "al-Mudārabah al-Mushtarakah fi al-Mu'assasāt al-Māliyyah al-Islāmiyyah", in *Majallah Majma' al-Fiqh al-Islāmi*, 13th Session 2001, vol. 3, p. 16.

owners of the company, it is difficult to regard them as the *mudārib* in this instance, due to the distinction brought about by the involvement of the juridical person, which, on the whole, limits the relationship of the shareholders with the venture to ownership of their shares and entitlement to dividends. As far as the directors are concerned, their capacity is not seen to exceed management of the company. As such, the involvement of the directors in the *mudārabah* agreement is only for the purpose of representation. On this basis, the *mudārib* is held to be the juridical person involved, i.e. the company itself.

As the entity of *mudārib* as discussed in Islamic legal texts is invariably portrayed as a single individual or several individuals, it would be necessary to examine whether a juridical entity could be appointed as *mudārib*. The shari'ah perspective of the concept of legal personality being a subject requiring a separate discussion, it would not be feasible to cover this issue adequately within the scope of the current research. However, the topic has been studied by contemporary shari'ah scholars at some length, and despite of some objections,²⁵ it appears to be accepted by many that the concept of juridical personality is recognised in shari'ah, and that business institutions that are juridical persons could be formulated in a valid manner, with certain restrictions.²⁶ This research would proceed based on this postulation.

Accordingly, when funds are deposited with a company on *mudārabah*, the contract takes place between the company as a juridical person and the investors. Based on this, it has been held that changes occurring in the owners of the entity or the board of directors would not affect the relationship between the investors and the *mudārib*, i.e. the institution. Consequent to identifying the juridical entity as the *mudārib*, the relevant rights and liabilities would necessarily be associated with this entity.

COMMON MANAGEMENT OF CAPITAL BY MUDĀRIB THROUGH MIXING FUNDS WITH HIS OWN

In funds invested with financial institutions on *mudārabah*, involvement of funds in business operations is often carried out in common with the institution's capital. A portion of the share capital or other funds available with the institution is invested along with the *mudārabah* capital. It would be relevant to examine whether this process affects the nature of the *mudārabah* contract in any manner, due to the fact that investment always comes from one of the contracting parties in a *mudārabah* contract. Some jurists have recognised such mixing of funds by the *mudārib* only when the financier expresses his consent to it. If the *mudārib* mixes *mudārabah* capital with his own funds without such permission, he becomes liable for the capital. This could indicate that such unauthorised mingling of *mudārabah* funds with his own is counted as an act of transgression that abolishes the *mudārib*'s immunity from bearing liability. As explained by the Hanbali jurist Ibn Qudāmah, this is because *mudārabah* capital is considered to be *amānah*, i.e. funds given on trust, similar to a deposit for safekeeping (*wadī'ah*), which he is expected to manage separately.²⁷ However, if the investor had authorised the *mudārib* to manage the funds based on his own discretion, this has been considered sufficient by way of permission according to the majority of schools, as the *mudārib* may require such mixing in the course of operations.²⁸ Shāfi'i jurists do not regard such general authority sufficient for mixing capitals, and rule that the *mudārib* becomes liable for the funds in this event.²⁹ Even where the investor expressly allows mixing, another Shāfi'i principle becomes relevant, *viz.* that where there is investment from both contractors, profit sharing should necessarily be on the ratio of capital. The labour component ceases to play a role in entitlement to profits, when the capital is common.³⁰ However, it appears from some Shāfi'i texts that when the capital is mixed with funds of the *mudārib*, if there happens to be a separate *shirkah* contract in part of the investor's capital, where, evidently, profit is proportionate to capitals, while the remainder of the investor's capital is on *mudārabah*, the arrangement is valid. At the same time, with regard to common capital jointly owned by two partners, i.e. on *shirkah* al-milk, Shāfi'i jurists have allowed one of them to enter into a *mudārabah* with the other in his own share, provided the labour rests with the *mudārib* only. In this instance, the *mudārib* would be entitled to the profit of his portion of the capital, while sharing the profit of the other as agreed.³¹ Thus, the Shāfi'i position in this regard seems to be that where the *mudārib* mixes the *mudārabah* capital with his own funds with the approval of the investor for joint investment in business, profit sharing should necessarily be on the ratio of capitals. Otherwise, the *mudārib* should enter into a *shirkah* contract in part of his capital where the above guideline is observed, while contracting a *mudārabah* in the rest on any ratio as wished.³² Māliki jurists have allowed mixing even without the permission of the investor, provided any condition that necessitates such mixing is not stipulated.³³ The Hanafi position on the issue was mentioned above,³⁴ according to

²⁴ Shariah Board of Dallah Albaraka, *Fatāwā Nadawāt al-Barakah*, Jeddah, Dallah Albaraka, resolution No. 10/10, p. 181.

²⁵ For a summary of objections raised against a shari'ah recognition of juridical personality, see Muhammad Akram Khan, "Accounting Issues and Concepts for Islamic Banks", paper presented at the international seminar on financial accounting standards for Islamic banks and financial institutions, Bahrain, Jan 1993, pp. 7-11.

²⁶ Muhammad Taqi Usmāni, *An Introduction to Islamic Finance*, Karachi, Idaratul Ma'arif, 2000, pp. 223 -231; Wahbah al-Zuhayli, *Juhūd Taqīn al-Fiqh al-Islāmī*, Beirut, Mu'assasah al-Risālah, 1987, pp. 70-74, 84; Abd al-'Aziz al-Khayyāt, *Sharikāt fī al-Sharī'ah al-Islāmiyyah*, Bayrūt, Mu'assasah al-Risālah, 1994, vol. 1, pp. 208-246; Sālih ibn Zābin al-Marzūqi, *al-Shirkah al-Musāhamah fī al-Nizām al-Su'ūdī*, Jāmi'ah Umm al-Qurā, Markaz al-Baḥth al-'Ilmī, 1406H, pp. 195-238; al-Sayyid 'Alī al-Sayyid, *al-Hissah bi al-'Amal bayn al-Fiqh al-Islāmī wa al-Qānūn al-Wad'i*, al-Qāhirah, al-Majlis al-A'lā li al-Shu'ūn al-Islāmiyyah, 1973, pp. 49-67. Some resolutions of the Islamic Fiqh Academy such as resolution No. 63/1/7 on the permissibility of limited liability companies are also relevant in this regard.

²⁷ Ibn Qudāmah, *al-Mughni*, vol. 5, p. 162.

²⁸ *Ibid.*

²⁹ al-Nawawi, *Rawdah al-Tālibīn*, vol. 4, p. 224.

³⁰ *Ibid.*

³¹ al-Sharbīni, *Mughni al-Muhtāj*, vol. 2, p. 419, al-Nawawi, *Rawdah al-Tālibīn*, vol. 4, p. 220.

³² This inference needs further verification.

³³ Al-Dardīr, *al-Sharh al-Kabīr*, vol. 3, p. 523, al-Khurashi, *Hāshiyah al-Khurashi*, vol. 7, p. 157.

which the *mudārib* is permitted to mix the *mudārabah* funds with his own or with that of another when the investor had granted him overall permission to transact using the *mudārabah* funds as he wishes. Thus, mixing of *mudārabah* funds with the funds of the *mudārib* could be valid according to all schools other than the Shāfi'i when the investor grants express permission to the fund manager to do so.

It is evident from the above that where the investors in a joint *mudārabah* fund allow the institution (i.e. *mudārib*) to mix its own funds with *mudārabah* capital, it cannot be held contrary to the norms of *mudārabah* according to the majority of schools. Such mixing would alter the relationship of the institution to the investors slightly, which, however, would not be of any material importance. Subsequent to the admixture of funds, its relationship with the *mudārabah* investors would also reflect an element of *shirkah*, in view its own capital invested in the pool. Thus, the institution as a joint partner or *sharīk* would claim an amount of profit proportionate to its capital involvement in the pool, while also being entitled to a part of the proportion of profit accruing to the *mudārabah* capital, due to its role of fund manager (*mudārib*). The AAOIFI Shari'a standards have upheld the same position, stating that the *mudārib* in the event of such mingling of funds becomes a partner in respect of his funds and a *mudārib* in respect of the funds of the capital provider.³⁵

JOINT INVESTORS IN MUDĀRABAH

When the contract of *mudārabah* comprises more than a single individual on each side, it could be observed that the contract here comprise two types of relationships. The contract of *mudārabah* occurs between the group of financiers or investors and the fund manager, who too could be an entity comprising several individuals. It would be pertinent to examine the nature of the relationship between the investors themselves. Determining the relationship among the investors would depend to a great extent on whether they had invested jointly through a single contract or through separate contracts. All schools of Islamic law appear to have recognised the validity of several parties jointly investing funds that are commonly owned by them with a single *mudārib*, through a single contract.³⁶ The joint investment with the *mudārib* in this instance could indicate some similarity with *shirkah al-'aqd*, as funds are invested based on a common contract for earning a return. However, it is pertinent to note here that the investors had not entered into a contractual arrangement among themselves, resulting in agency to deal in the capital shares of each other, as necessary in the case of a proper *shirkah al-'aqd*.³⁷ Thus, if the funds invested commonly with the *mudārib* had belonged to them jointly, the *shirkah al-milk* that existed would remain even after the investment. The relationship among the investors here being different from a proper *shirkah al-'aqd* is further endorsed by the fact that even the Hanafi and Hanbali schools have required profit division among the investors here to take place based on the proportion of their capitals, any agreement to the contrary being void.³⁸

Where funds are invested by different investors at different points of time with a single *mudārib*, a relationship could be assumed to result if the *mudārib* mixes their capitals together for common management. Whether the investors had expressed their consent to such mixing too would be relevant in this regard. Therefore, we shall analyse below the position of Islamic schools of law on the *mudārib* combining capitals invested by different parties under different contracts.

MINGLING CAPITALS INVESTED BY DIFFERENT INVESTORS

From a perusal of Islamic legal texts, it is evident that the Shāfi'i and the Hanbali schools have shown the least acceptance to mingling capitals of different investors together. The restriction on this issue is such that combining capitals invested even by the same party at different occasions is considered unacceptable. This is because, after mobilisation in business, each capital acquires its own profit loss position, which may not be verified until liquidation. As such, fresh capital may not be added to it at this stage. Explaining the issue, the Shāfi'i jurist al-Nawawi states that after investing a sum of capital with the *mudārib*, if the same investor forwards another sum, it could be combined with the first sum only if the first sum had remained with the *mudārib* unutilised thus far. If the first sum had already been involved in trade, the later sum may not be combined with it, as the profit / loss status of the former capital had already become established. Each capital is separately entitled to its own profit or loss.³⁹ The Hanbali position on the issue is similar,⁴⁰ who add that if such combining is stipulated in the second contract, it would become invalid. However, if the first capital, after mobilisation in trade, had been restored to cash, the second amount could be combined with it without any objection, with the permission of the investor. As combining of capitals forwarded by the same investor on different occasions has been considered unacceptable after the former amount had been invested in trade, it follows that capitals of different investors forwarded on different occasions, i.e. through separate contracts, may not be merged. Thus, where the *mudārib* accepts investments from different individuals through individual contracts at various points of time, he is

³⁴ See section on Hanafi position on mixing funds of different investors together above.

³⁵ AAOIFI Shari'a Standards, Standard No. 13, 8/9.

³⁶ Al-Sarkhasi, *al-Mabsūt*, vol. 22, pp. 30-31, Ibn 'Abd al-Barr al-Qurtubi, *al-Kāfi*, vol. 1, p. 387, Ibn Qudāmah, *al-Mughni*, vol. 5, pp. 145, 146, al-Nawawi, *Rawdah al-Tālibīn*, vol. 4, p. 205.

³⁷ See Chapter 2, section on *shirkah al-'aqd*.

³⁸ Al-Sarkhasi, *al-Mabsūt*, vol. 22, pp. 30-31, Ibn Qudāmah, *al-Mughni*, vol. 5, pp. 145, 146. See for details section below on distribution of profit among *mudārabah* investors. In spite of investing jointly, if each investor agrees on a different profit allocation to the *mudārib* from his share of profits, Al-Sarkhasi considers the situation similar to two different contracts.

³⁹ Al-Nawawi, *Rawdah al-Tālibīn*, vol. 4, p. 224.

⁴⁰ Ibn Qudāmah, *al-Mughni*, vol. 5, pp. 175.

required to manage the business of each capital separately. If some mistake occurs inadvertently where the assets of different businesses are merged, the *mudārib* could be held liable for the capitals.⁴¹

Māliki texts indicate the permissibility of mixing capitals invested by two individuals with a *mudārib* even when each had invested separately. They consider that this may not result in harm to the interests of either party. Obtaining the permission of both investors for such mixing has not been deemed mandatory. Although not resulting in the liability of *mudārib*, arbitrary mixing has been deemed to be an offence requiring repentance.⁴² However, such mixing is permitted only before one of the two capitals is involved in operations, provided there is an assured benefit in mixing capitals. This indicates that mixing the capitals after involvement in operations is not accepted in the Māliki school.⁴³ Where mingling of the capitals occurs with the consent of the investors, i.e. before involvement in trading, as well as when their consent is not ascertained, based on the *shirkah* principle of dividing profits according to capital input, the profit, as well as the loss, should be divided based on the proportion of their respective capitals.⁴⁴ Therefore, arbitrary mixing by the *mudārib* is not materially effective as far as profit division is concerned. Where mixing is done with the consent of the investors, the relationship between the investors could reflect a partial semblance of *shirkah al-'aqd*.

Hanafi position on mixing funds of different investors together

According to Hanafi jurists whose position is distinct on this issue, when the investor grants overall permission to the *mudārib* to transact using the *mudārabah* funds as he wishes, (lit. by saying "Do as you see fit"), the *mudārib* is permitted in this event to mix the *mudārabah* funds with his own or with the funds of another.⁴⁵ Others have elucidated that such overall permission is necessary when such mixing is not customary in the land. If such mixing happens to be common among the people of the locality and is not objected to, the *mudārib* is permitted to mix even when a general permission has not proceeded from the investor.⁴⁶

The above only indicates that the *mudārib* is allowed to mix *mudārabah* capital with his own or with that of others, especially when permission for the purpose had been obtained. However, it is not clear from these texts whether the mixing referred to here takes place while the capital or capitals are still in cash form, or after some of them had been turned into assets after involvement in trade. The Hanafi jurist Ibn 'Ābidīn has provided an interesting reference from the Hanafi work *al-Tātarkhāniyyah*, which indicates that mixing may take place even after the capitals had been mobilised in trade. However, this reference only mentions an instance when the investments are from the same investor. Therefore, the ruling pertaining to mixing capitals of different investors together after some of them had been involved in trade can only be inferred from this, based on the overall recognition of mixing *mudārabah* capital by Hanafi jurists referred to above. According to Ibn 'Ābidīn's quotation from *al-Tātarkhāniyyah*, if the *mudārib* arbitrarily mixes *mudārabah* funds with another investment from the same investor, he would be held liable only if the mixing takes place after the appearance of profit, in which event he would be liable for the capital as well as the profit share of the investor. However, if the arbitrary mixing took place before, the *mudārib* would not bear any liability. If the *mudārib* had mixed the capitals with permission from the investor to do so with regard to each, he would not bear any liability irrespective of whether the mixing took place before the appearance of profit or afterwards.⁴⁷ This indicates that when the several investments are made by the same investor at different stages, i.e. after the previous investments had been mobilised in business, with individual permission to mix the particular investment with other funds, it is condoned by Hanafi jurists. Although specific reference is lacking, due to the *mudārib* being allowed by Hanafi jurists to mix funds of different investors together especially with the permission of the investors, it can be inferred from the above that mixing funds of different investors together at any stage of the business could be recognised as valid, when overall permission of the investors had been obtained for the purpose.⁴⁸ This could provide a justification for an Islamic bank, in its capacity as *mudārib*, mixing funds invested by different investors through different contracts, even when some funds had already been involved in trade and given rise to profit, when the consent of the investors had been obtained for the purpose.

When funds invested by several parties with a common *mudārib* are mingled with the consent of the parties, or when such mingling for earning profit is upheld by custom, according to the Hanafi position, the partnership among such investors could reflect characteristics of a *sharikah al-'aqd*. However, as explained above, it is questionable whether the relationship could be categorised as a full-fledged *shirkah al-'aqd*.

It should be noted that when such mingling takes place after the previously invested capital had been involved in operations, at the capital contribution of the late coming investor, the assets of the former investors are not evaluated so as to ascertain the value of their capital. It appears that upon liquidation of the whole venture, the profits would be shared on the basis of the capital

⁴¹ Ibid.

⁴² Ibn Rushd, *al-Bayān wa al-Tahsīl*, Beirut, Dar al-Fikr, 1405H, vol. 12, p. 350, as quoted by Muhammad Taqi Usmani above, p. 12.

⁴³ Al-Dardīr, *al-Sharh al-Kabīr*, vol. 3, p. 523.

⁴⁴ Although a clear reference to this effect could not be found in Māliki texts on *mudārabah*, due to lack of any other basis, it could be stated with reasonable certainty that the ruling here can only be similar to their position on *shirkah*, where profits are invariably divided on capital ratio.

⁴⁵ Hāfiz al-Dīn Muhammad ibn Muhammad Ibn al-Bazzāz al-Kurdi, *al-Fatāwā al-Bazzāziyyah*, printed with *al-Fatāwā al-Hindiyyah*, vol. 6, p. 76.

⁴⁶ Ibn 'ābidīn, *Radd al-Muhtār*, vol. 5, p. 649.

⁴⁷ See for details Ibn 'ābidīn, *Radd al-Muhtār*, vol. 5, p. 649, 650.

⁴⁸ As the relevant Hanafi text is not explicit on this important issue, this inference needs verification by experts on Hanafi jurisprudence.

contributed by each partner at his joining the pool.⁴⁹ Therefore, even when later joining of investors is accepted on the basis of a general permission granted by all the investors, the capital position existing at the entry of each new investor remains unverified. Moreover, since loss division in *shirkah* is to be done exactly on the basis of the capitals, allocation of loss may prove problematic. Such anomaly could be a major reason for the rejection of later mixing of capitals after commencement of operations in the other schools of Law.

Based on the above, according to the position adopted by Hanafī and Māiki schools, the relationship between the investors who invest at different times could bear some resemblance to *shirkah al-'aqd* in some situations. As far as Shāfi'i and Hanbali schools are concerned, investments done at different occasions may not be managed together. Also important is the fact that even where the relationship among the investors bears similarities to *shirkah al-'aqd*, due to the absence of the right of management and mutual agency to deal in the capital of each other, it may not be construed as *shirkah al-'aqd* in every respect.

CONCLUSION

Equity accounts manifest features developed through convergence of the principles of *shirkah* and *mudārabah*. When funds are deposited with a company on *mudārabah*, the contract is held by some contemporary scholars to take place between the company as a juridical person and the investors. A number of partners pooling their funds together for running a business operation is possible under *shirkah*. In the case of *mudārabah*, schools of Islamic law have recognised the validity of several parties jointly investing funds with a common *mudārib* through a single contract. Where several parties invest with a single *mudārib*, such investment should take place on a single occasion, so that the tenure of *mudārabah* could commence with regard to all deposits at the same time. Where the *mudārib* accepts investments from different individuals through individual contracts, the majority of schools require that the business of each capital be managed separately. The restriction is due to fundamental anomalies that may result from mixing different capitals.

However, Hanafī jurists appear to have allowed the *mudārib* to mix funds of different investors together with the permission of the investors. This could indicate permission for mixing funds invested at different stages when overall permission had been obtained. Similarly, mixing *mudārabah* funds with funds of the *mudārib* could be valid according to the majority of schools with express permission of investors. Thus the Hanafī position appears to accommodate to some extent the possibility of mixing funds belonging to different investors who had invested at varying points of time. The procedure adopted in this regard in the investment accounts run by Islamic banks requires further research and scrutiny.

⁴⁹ See section below on distribution of profit among *mudārabah* investors.