

# THE APPLICATION OF *TANĀZUL* AND ITS SHARĪAH ISSUES IN EQUITY-BASED *ŞUKŪK*

*Azman Mohd Noor*<sup>1</sup>, *Muhamad Nasir Haron*\*\*  
*Sri Zuraihan Mohammad*\*\*\*

## **Abstract**

*There are number of product innovations in Islamic capital market instruments particularly in Şukūk using the equity based contract; mushārahah, muḍārahah and wakālah bi al istiḥmar. Within the Islamic parameter of these contracts, there is not to be determination of return or possible arrangement for these that may lead to guaranteeing the return of any partners in mushārahah and muḍārahah. Conventional bond usually offers a fixed income determination for their bond structures and issuance. This raises issue as to whether the şukūk equity based structure may have the same implication. This is where the tanāzul may play its role to give effect in şukūk structuring using mushārahah, muḍārahah and wakālah bi al istiḥmar contracts to offer a similar feature of fixed income instrument. This paper attempts to ascertain the status of tanāzul in equity based şukūk from the Shariah perspective. The paper will analyze the use of the concept of tanāzul in şukūk structures and its implications on the validity of the equity based şukūk transactions.*

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<sup>1</sup> Assoc Prof Dr Azman Mohd Noor is lecturing at International Institute of Islamic Banking and Finance International Islamic University Malaysia. Previously, he was the Head of Department, Department of Fiqh and Usul al-Fiqh, International Islamic University Malaysia. He can be contacted at azzmann@hotmail.com or via website: drazman.net

\*\* Muhamad Nasir Haron is Sharī'ah Researcher, Sharī'ah Management at Maybank Islamic Berhad. He can be contacted at mnasir.h@maybank.com.my or muhamadnasirh@gmail.com.my

\*\*\* Sri Zuraihan Mohammad is Sharī'ah Reviewer and Researcher at Syarikat Takaful Malaysia Berhad. She can be contacted at raihan\_m@hotmail.com.

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## 1. Introduction

Sukuk has been known to be a Shariah compliance alternative to the conventional capital market fixed instruments especially bonds. The market for this is growing as the demand is increases around the globe. This paper begins with an examination of the overview of the concept *tanāzul*, and its status under the Islamic legal perspective. This is followed by discussion on the application of *tanāzul* in equity based *ṣukūk*, which includes *mushārahah*, *muḍārahah* and *wakālah bi al istithmar ṣukūk* from Sharī‘ah perspectives.

## 2. Concept of *Ṣukūk*

*Ṣukūk* is an Arabic term, and it is the plural form for the word *ṣakk*. In *Lisān al-Arab*, the oldest meaning for the term *ṣakk* -as found in the Qur’an, Hadith and Arabic literature-means “to strike” or “to hit” as in ‘to strike one’s seal on a document’.<sup>2</sup>

Ibn Manzur mentions a hadith on which the Prophet (peace be upon him) warns against taking the *ṣukūk* of a ruler (a legal tender or government undertaking to payment obligation) because it is related to selling what one does not possess. The term “*ṣakk*” was used in the following *athār* :

عن أبي أيوب سليمان بن يسار أن أبا هريرة قال لمروان أحللت بيع الربا  
فقال مروان ما فعلت فقال أبو هريرة أحللت بيع الصكاك وقد نهى رسول الله عن  
بيع الطعام حتى يستوفى فخطب مروان فنهى عن بيعها<sup>3</sup>

Sulayman bin Yasir reported that ‘Abu Hurayrah said to Marwan, “You have permitted the sale by *riba*.” Marwan replied, “What did I do?” “You permitted the

<sup>2</sup> Ibn Manzūr, Abū al-Faḍl Jamāl al-Dīn Muḥammad bin Mukrim. *Lisān al-‘Arab*. Vol.8, (Beyrūt: Dar Ṣādir, 2005).4<sup>th</sup> Edn., 263.

<sup>3</sup> Al-Naisābūrī, ‘Abū al-Ḥusain Muslim bin al-Hajjāj. *Ṣahih Muslim*. Vol.10, (Beyrūt: Dar al-Kutub al-‘Ilmiyyah, 2003). The Book of Sales, Hadith 1528, 146.

sale of *sakk* (plural *sikak*), and it was forbidden by the Messenger of God to sell food before you take possession of it.” Then Marwan sermonized to the people, forbidding this practice.

Al-Nawawi defines *şukūk* as a paper which is considered as an evidence of indebtedness. It is a certificate produced by a person charge will selling food products that allows him to sell before he possesses it.<sup>4</sup>

The Islamic jurists have different views on this issue, and these differences are as stated below:

1. Some jurists opined that it is forbidden to sell *şakk*, because it represents something which is not in existence or is a debt-related as narrated by Abu Hurayrah.
2. Some jurists opined that it is permissible to sell *akk* based on the interpretation of Abu Hurayrah’s narration, that it is allowed if the buyer buys from the one who produces the *şakk*. However, it is forbidden if he sells it to a third party before possessing it. There is no prohibition for the initial sale because it is from the owner who has the commodity (foodstuff) in his custody.<sup>5</sup>

Originally, “*şukūk*” was traditionally used by Muslims in the Middle Ages as papers representing financial obligations originating from trade and other commercial activities. However, the present structures of *şukūk* are different from the original *şukūk* used and the current form of *şukūk* differs from the conventional concept of securitization, a process in which the ownership of the underlying assets is transferred to a large number of investors through certificates representing the proportionate value of the relevant assets.<sup>6</sup> Accordingly, the ruling in the aforementioned hadith does

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<sup>4</sup> Al-Nawāwī. ‘Abū Zakariyyā Muḥyi al-Dīn Yahya bin Sharf. *Şahīh Muslim bi Sharḥ al-Nawawī*. Vol.10, (Al-Qaerah: n.p.,n.d). Book of Invalid sale of things before possession of it. 1<sup>st</sup> Edn, 171.

<sup>5</sup> *Ibid*.

<sup>6</sup> Global Islamic Finance Magazine, March 2011, 13. <<http://content.yudu.com/Library/A1r8kv/GlobalIslamicFinance/resources/27.htm>> (retrieved 18<sup>th</sup> March 2011).

not prevent the sale of modern *ṣukūk* which represents the ownership or possession of assets.<sup>7</sup>

Technically, *ṣukūk* may refer to any securities, notes, papers or certificates, which have the features of liquidity and tradability.<sup>8</sup> According to the Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI)<sup>9</sup>, *ṣukūk* is defined as:

Certificates of equal value representing undivided shares in ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity.<sup>10</sup>

The Islamic Fiqh Academy has defined *ṣukūk* as the following;

Issuance of financial certificates (securities) based on the investment project that may generate income.<sup>11</sup>

Yet, in the Malaysian context, the Securities Commission has its own definition of *ṣukūk* which differs from the definition given by AAOIFI:

*Ṣukūk* refers to certificates of equal value which evidence undivided ownership or investment in the assets using Sharī'ah principles and concepts endorsed by the SAC.<sup>12</sup>

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<sup>7</sup> Adam, Nathif J. & Thomas, Abdulkader. *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Ṣukūk*. (United Kingdom: Euromoney Books, 2004), 43.

<sup>8</sup> Refer to Securities Commission Malaysia, *The Islamic Securities (Ṣukūk) Market*, p.8.

<sup>9</sup> AAOIFI is an international autonomous non-profit corporate body that prepares accounting, auditing, governance, ethics and Sharia Standards for Islamic financial institutions and the Islamic finance industry. Refer to AAOIFI website at <http://www.aaofi.com>.

<sup>10</sup> AAOIFI. *Sharī'ah Standards for Islamic Financial Institutions*. Sharī'ah Standard No. (17): Investment Ṣukūk. (Bahrain: AAOIFI, 2010). 307.

<sup>11</sup> *Majelle Majma' Al-Fiqh Islami*. Vol.2, (n.p: 2004) No. 15, 309.

<sup>12</sup> Securities Commission, *Guideline on Ṣukūk 2012* <[http://www.sc.com.my/wp-content/uploads/eng/html/resources/guidelines/bondmkt/ṢukūkGuidelines\\_08012014.pdf](http://www.sc.com.my/wp-content/uploads/eng/html/resources/guidelines/bondmkt/ṢukūkGuidelines_08012014.pdf)>, (accessed 28 September 2015).

From the above definitions, it is clear that the definitions differ based on the context of *şukūk* underlying assets. The AAOIFI's and Islamic Fiqh Academy's definitions emphasize more on the tangible assets of a particular project as underlying asset with less highlights on debts owed by the issuer which may be issued for a pool of receivables.<sup>13</sup> Whereas *şukūk* as defined by the Securities Commission represents ownership claims on a pool of assets or right to receivables or participation.<sup>14</sup> It is the evidence of the value of any asset that may involve debt as well as non-debt.<sup>15</sup> In other words, *şukūk* may represent debts arising from the deferred sale price of goods, goods to be received under a purchase order (*salam* contract), undivided common ownership of tangible assets under a lease contract, shares in the enjoyment of usufructs obtained under a lease contract, rights in a project under a *muḍārabah* or *mushārahah* partnership as well as a portfolio of assets combining debt receivables arising from deferred sale contracts.<sup>16</sup>

### 3. The Concept of *Tanāzul*

*Tanāzul* is a term commonly used by contemporary scholars who write on Islamic financial system. However, according to the classical Islamic jurists' discussion on *tanāzul*, the term *tanāzul* itself is associated with various interchangeable terms such as *al-isqāt* (drop), *al-ibrā'* (absolution), *al-`afw* (forgive), *al-hibah* (gift) and other related terms. Therefore, the technical meaning of *tanāzul* varies according to different modes and situations in which it is used.

As for this topic of *tanāzul* among the closest connotation of *tanāzul* refers to the use of *tanāzul* in debt which connotes the meanings of *ibrā'* or *isqāt*. This is based on the opinion of Nazih Hammad which tends to define the term *tanāzul* as *isqāt*:

قوله (أسقط) أي من الدين, وقوله (وهب) أي من العين, فإذا أقر له

<sup>13</sup> Nathif J. Adam & Abdulkader Thomas, *supra* note 7 at 43.

<sup>14</sup> Bank Negara Malaysia & Securities Commission Malaysia, *Malaysian Debt Securities and Şukūk Market: A Guide for issuer and investors*, (n.p:n.d), 29.

<sup>15</sup> Securities Commission, *supra* note 8 at 11.

<sup>16</sup> *Ibid.*, 13.

بعين فأسقط من الدين أو وهب البعض من العين وترك الباقي صح,  
 وهذا مذهب جماهير العلماء لما تقدم في حديث كعب بن مالك,  
 وليس فيه إلا أن صاحب الحق قد تنازل عن شيء من حقه برضى  
 منه فكان ذلك جائزا.<sup>17</sup>

The author's phrase *asqātā* (dropped), means a drop from debt, and *wahabā* (give) means from a tangible asset, if a (person) confirms with a tangible asset, and drops another from indebtedness or he gives some of the asset and leaves the rest, the transaction is valid. This is the view of the majority of scholars based on the hadith of Ka'b ibn Malik, and there is nothing, unless the owner of the right waives (*tanāzul*) something from his right with his consent, and the ruling for this is permissible.”)

From this text, it is understood that the word *tanāzul* is quite general in foregoing one's rights, but can also draw the meaning of *'isqāt*. In brief, *Isqāt* means dropping literally while technically -according to Muslim jurists- it is defined as relinquishing ownership or rights, not to the owner and also not to the person who has the right.<sup>18</sup> As stated in *al-Mawsu'ah al-Kuwaytiyyah*, it is found that *isqāt* is closely related to the concept of *'ibrā'* (absolution). Interestingly, the AAOIFI *Sharī'ah* Standard uses the term *tanāzul* interchangeably with *'ibrā'* in the *Sharī'ah* Standard No. (8) Murabahah to the Purchase Orderer, clause 5/9:

يجوز للمؤسسة أن تتنازل عن جزء من الثمن عند تعجيل المشتري

سداد التزاماته إذا لم يكن بشرط

<sup>17</sup> Hammad, Ibn 'Abdullah al-Hammad. *Sharḥ Zād al-Mustaqna*. Vol.14, (n.p: 2012). 19.

<sup>18</sup> Wizarah al-Awqaf wa al-Shuun al-Islamiyah. *Al-Mawsu'ah al-Fiqhiyyah*. Vol.4, (n.p: 1986) 2<sup>nd</sup> Edn., 225.

### متفق عليه في العقد<sup>19</sup>

It is permissible for the institution to give up part of the selling price if the customers pay early, provided this was not part of the contractual agreement

In this vein, generally `ibrā' refers to an action where one party drops another's liability towards him. *Ibrā'* does not only imply the dropping of a legal right, but it also implies a transfer of ownership.<sup>20</sup>

Hence, based on the above definitions it may be quoted that the jurists discussion on the issues of *tanāzul* only happens in the case of debt which is in existence and established. Meanwhile, as for this topic *tanāzul* in equity based contract it relates to the act of waiving the rights which are yet to be established. Nevertheless, based on the above deliberation it is sufficient to surmise that definition of *tanāzul* in equity based *şukūk* refers to an upfront agreement made by the partners or a partner, wherein one or more partner agrees to waive the rights in receiving profit or to bear all the losses that the partnership might incur.<sup>21</sup> Typically, the concept of *tanāzul* is widely used in equity based instruments such as *mushārahah*, *mudharabah* as well as *al-wakālah bil istithmār* based *şukūk*.

#### 4. The Application of *Tanāzul* in Equity-Based *Şukūk*

As the application of *tanāzul* may occur in several *şukūk* issuance based on equity contracts such as *mushārahah*, *muḍārahah* and *wakālah bil istithmār*, it is appropriate to highlight and analyze the issues of *tanāzul* in each structure respectively.

Most of the *şukūk* traded in the market are sharing the same features of conventional bonds, such as giving a fixed return, to be

<sup>19</sup> AAOIFI, *supra* note 8 at 116.

<sup>20</sup> Al-Zuhaylī, Wahbah. *Financial Transactions in Islamic Jurisprudence*. Vol.2, (Damascus: Dar al-Fikr al-Mouaser, 2003). 236.

<sup>21</sup> Aznan Hasan. *Fundamentals of Sharī'ah in Islamic Finance*. (Kuala Lumpur : IBFIM, 2011), 671.

ranked as priority over other debt obligations, with no voting rights, regardless of the instruments used like *mushārahah*, *muḍārabah* and *wakālah bil istīhmār*. As for the fixed return, if the profit realized in the venture is higher than the expected return or indicative rate, the *ṣukūk* holders shall forgo any profit exceeding that rate. However, if the actual profit is less than the indicative percentage, then the manager in this case shall waive his right to claim the profits by giving priority to the *ṣukūk* holders to receive the profit and take it upon himself to pay out the difference (between the actual profits and the indicative percentage) to the *ṣukūk* holders.

### 5. Sharī'ah Opinions on Upfront *Tanāzul* for Future Underlying Right

Among the main concern on *tanāzul* is that one or some of the partners waive certain rights in favor of another contracting party for something that is yet to be known and to be realized in the future. As some quarters regard *tanāzul* similar to *ibrā'*, it is a condition of *ibrā'* that it must take place after the underlying right is established because *ibrā'* essentially involves waiving an established right. There is no dispute on its permissibility since the absolution only happens after the realization and confirmation of the established profit.

Principally, the concept of *ibrā'* must take place after the underlying right is established. This follows the fact that *ibrā'* essentially involves dropping an established right or liability. Thus, jurists have agreed that *ibrā'* prior to the establishment of the underlying rights is considered as invalid. Such dropping of right is impossible prior to the establishment of those rights, and thus the absolution is merely a non-binding promise. According to the majority of Muslim scholars, the practice of *tanāzul* to be given upfront is not permissible under Islamic law, and even if it took place, it is ineffective in nature.<sup>22</sup> This view is based on the

<sup>22</sup> Al-Humām, Muḥammad ibn Abd Al-Wāhid. *Sharḥ Faṭḥ al-Qadīr ala al-Hidāyah*. (Beirut: Dar al-Fikr, n.d). Vol.7, p.41,44 onwards; Al-Kasānī, 'Alā'u al-Dīn Abi Bakr bin Su'ūd. *Badā'i' al-Ṣanā'i' fi Tartīb al-Sharā'i'*. Vol.6, (Beirut: Dar 'Iḥyā' al-Turāth al-'Arabī, 1998). 2<sup>nd</sup> Edn.. 45,50,118; Al-Dardīr. 'Abū al-Barakāt 'Aḥmad bin Muḥammad. (1989). *Al-Sharḥ al-Saghīr 'alā 'aqrab al-Masālik 'ilā Mazhab al-'Imām Mālik*. Vol.2, (Wizārah al-'Adl wa al-Shu'ūn

condition of *ibrā'*, where *ibrā'* must take place only after the underlying right is established, as *ibrā'* essentially involves dropping an established liability. This view is agreed upon by all schools except the *Maliki* jurists since they relied on the saying of the Prophet (peace be upon him):

لا طلاق إلا فيما تملك, ولا عتق إلا فيما تملك

You cannot divorce someone to whom you are not married, and you cannot free a slave that you do not own<sup>23</sup>

The jurists have highlighted a number of examples of invalid *ibrā'*, among others, that include absolving a husband from his liability for his wife's expenses before they are married, and *ibrā'* of the buyer from the price of what he has not yet bought.<sup>24</sup> The jurists also give another example of such premature *ibrā'*. For instance, they listed the case of a wife or soon-to be wife who may not absolve her husband of her alimony expenses until they are established as a liability on him. In this case, the liability underlying the *ibrā'* was not established prior to *ibrā'*. Therefore, this premature *ibrā'* of future alimony is considered as invalid.<sup>25</sup>

Another example that they provide pertains to the case where a buyer absolves the seller of his guarantee of the merchandise against destruction prior to its receipt. In this case, the guarantee was non-existent prior to *ibrā'*, and hence the *ibrā'* is null and void.

However, they also listed some exceptional cases in which premature *ibrā'* can be considered valid and binding. One such exception is the case of a man who digs a well in another person's

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al-Islāmiyyah wa al-'Awqāf, 1989), 307. Al-Buhuti, Mansur bin Yunus bin Idris, *Kasysyaf al-Qina' 'An Matn al-Iqna'*. Vol.4 (Riyadh: Dar 'Alam al-Kutub, 2003), Ibn Qudāmah, 'Abū Muḥammad 'Abdullah bin Aḥmad bin Muḥammad. *Al-Mughnī*. Vol.4. (Al-Riyadh: Dar 'Ōlim al-Kutub, 1997), 483.

<sup>23</sup> This is a hadith, narrated by Al-Sajastanī, Abu Dawud Sulayman bin al-Ash'ath al-Azdī. *Sunan Abī Dawūd*. Vol.2, (Beyrut: Dar Ibn Hazm, 1997). Book of Divorce. Chapter in Divorce before Marriage. No. 2190., 444.

<sup>24</sup> Al-Zuḥaylī, *supra* note 20 at 255.

<sup>25</sup> *Ibid.* Al-Zuḥaylī, *supra* note 20 at 255.

property without the owner's permission. In this case, if the land's owner absolves him of his transgression and agrees to keep the well, the unauthorized digger of the well is absolved of his responsibility if any individual or animal falls in it.

On the other hand, the Malikites have two reported opinions regarding the validity of *ibrā'* prior to the establishment of the underlying liability. For instance, a woman's *ibrā'* of her future husband's responsibility for her future expenses is valid and binding according to the preferred view. Another example is the dropping of a preemptive right (*haqq al-shuf'ah*) prior to the sale; it is valid according to one view and invalid according to another. They are also divided over the application and validity of *ibrā'* for future injuries, and *ibrā'* by future heirs of rights to the estate of a terminally ill person to another future heir or a third party for more than one third of the estate.<sup>26</sup>

Based on the above opinions of Islamic classical jurists, it is observed that the majority of Islamic jurists -except Maliki jurists- do not allow the practice of *tanāzul* upfront for the right that is yet to exist in the future. As far as *tanāzul* in *ṣukūk* is concerned, by analogy, one can argue that waiving ones right over something which is not in existence or established yet also takes place in *ṣukūk* structuring. A question has arisen on the validity and abidingness of the undertaking of some partners to waive their right to claims over certain profits that is yet to be realized. Another question is whether this practice will violate the principal of *mushārah* which is based on profit and loss sharing according to the agreed profit sharing ratio.

## 6. *Tanāzul* in *Mushārah*

This section will highlight the application of *tanāzul* within the contract of *mushārah* only. As mentioned earlier there is no specified definition given by classical jurists on this topic, but some contemporary scholars have discussed it to facilitate the *ṣukūk* structures and other Islamic financing products.

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<sup>26</sup> Al-Humām, *supra* note 22 at 41. Al-Kasānī, *supra* note 22 at 45. Al-Dardīr, *supra* note 22 at 307. Al-Buhuti, *supra* note 22 at 305. Ibn Qudāmah, *supra* note 22 at 483.

The Sharī'ah Advisory Council of Securities Commission allows and take into consideration the concept of *tanāzul* in *mushārah* if a partner waives his right on profit payment from a *mushārah* venture upfront, if he so desires.<sup>27</sup> There is another definition provided by Aznan Hasan that application of *tanāzul* in *mushārah* refers to an upfront agreement made by the partners of the partnership, wherein one or more partner agrees to waive the right in receiving profit or to bear the losses that the partnership might incur.<sup>28</sup>

The issue of *tanāzul* in *mushārah* also has been discussed by AAOIFI, not in the context of *Şukūk*, but in preference shares as stated in its Sharī'ah Standard No. (12) *Sharīkah (Mushārah)* and Modern Corporations, item 4/1/2/14:

It is not permitted to issue preference shares i.e. shares that have special financial characteristics that give them a priority at the date of liquidation of the company or at the date of distribution of profit. However, it is permissible to grant certain shares, in addition to being entitled to rights attached to common shares, certain procedural and administrative privileges, such as a right to vote.<sup>29</sup>

The Islamic Fiqh Academy also discussed this issue in the application of preference shares and its ruling under the Islamic legal law. Their resolution is as follows:

The International Council of Fiqh Academy, which is an offshoot of the Organization of Islamic Conferences (OIC), in its 14th session in Doha, Qatar, which was held from 8–13 of Dhulqaadah which corresponds to 11–16 January 2003, after reviewing the research papers that were presented to the Council

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<sup>27</sup> Securities Commission (2011). *Islamic Securities Guidelines (Şukūk Guidelines)*. Effectively on 12<sup>th</sup> August, 2011. p.15.

<sup>28</sup> Hasan, Aznan. *Perlaksanaan Tanāzul di dalam Kontrak Berdasarkan Mushārah: Perspektif Syarak*. < <http://muis.ismaweb.net/2011/07/perlaksanaan-tanāzul-di-dalam-kontrak-berdasarkan-mushārah-perspektif-syarak/>>, (accessed 12 July 2011).

<sup>29</sup> AAOIFI, *supra* note 8 at 213.

regarding the issue of modern companies: holding companies and others, and the relevant Shari'ah rulings, and after listening to the discussions that revolved around it, resolved the following:

1. It is not permissible for a company to issue shares enjoyed or preference shares or debentures;
2. In occasions when the company suffers losses, it is compulsory for every shareholder to bear his share of the loss, in proportion to his capital contribution

However, the practice of upfront *tanāzul* has been treated differently by the Sharī'ah Advisory Council of Securities Commission Malaysia which allows the practice of preference shares<sup>30</sup> by using the principle of *tanāzul*. It is as stated:

The SAC ruled that non-cumulative preference shares are permissible based on *tanāzul* where the right to profit of the ordinary shareholder is willingly given to a preference shareholder. *Tanāzul* is agreed upon at an annual general meeting of a company which decides to issue preference shares in an effort to raise new capital. As it is agreed at the meeting to issue preference shares, this means that ordinary shareholders have also agreed to give priority to preference shareholders in dividing the profits, in accordance to *tanāzul*.<sup>31</sup>

The basis of the aforesaid decision by the Council in using *tanāzul* to be given upfront is based on one of the views from the Maliki School in which a woman's *ibrā'* of her future husband's responsibility for her future expenses is valid according to the preferred view.<sup>32</sup>

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<sup>30</sup> A preference share is among the hybrid instruments that combine equity and debt in a capital market. It is in the form of hybrid equity that its holders receive a fixed dividend not enjoyed by ordinary shareholders. Usually, this fixed dividend is described as a percentage of the nominal value. See Securities Commission, *Resolutions of the Securities Commission Sharī'ah Advisory Council*. (Kuala Lumpur, 2006) 2nd Edn, 71.

<sup>31</sup> *Ibid.*, p.72.

<sup>32</sup> Ibrahim, Ahmad Basri. *Islamic Preference Shares: An Analysis in Light of the Principles of Mushārah and Tanāzul*. (International Conference on Islamic Banking and Finance: Cross Border Practices and Litigations, 15-16 June 2010),.19.

Nonetheless, there are many examples given by the Hanbalī school of thought whereby *tanāzul* that is agreed upfront fulfills the need of the contracting parties in making a framework of their future obligation and responsibility in order to avoid *gharar*.<sup>33</sup> This is similar to the view of Ibn Hazm whereby mutual consent must exist prior to the contract and not after the contract. If *tanāzul* is not determined clearly upfront of the contract, it might cause uncertainty to one party which may lead to ignorance or *gharar*. This stance is in line with many evidences from the *Qur'ān* and *Sunnah*, for example:

O you who believe! Eat not up your property among yourselves in vanities, but let there be amongst you traffic and trade by mutual good-will nor kill (or destroy) yourselves: for verily Allah hath been to you Most Merciful!<sup>34</sup>

In this verse, Ibn Hazm firmly states that consent may happen when someone knows the effect of the matter, and it might not happen due to ignorance.<sup>35</sup> There is also a Prophetic text:

المسلمون على شروطهم إلا شرطاً أحل حراماً وحرم حلالاً<sup>36</sup>

Muslims are bound to their conditions as long as they do not validate the *haram* or invalid things or vice versa.

There is also a legal maxim:

الأصل رضى المتعاقدين ونتيجته هي ما التزماء بالتعاقد<sup>37</sup>

<sup>33</sup> Ngadimon, Md Nurdin. *Şukūk Muḍārabah dan Şukūk Mushārahah untuk Keperluan Modal Tahap Kedua (Two-Tier Capital) untuk Institusi Kewangan Islam*. (Paper presented in Muzakarah Penasihat Syariah Kewangan Islam Kali ke-5, 2 August 2010, Nikko Hotel, Kuala Lumpur)., 12.

<sup>34</sup> Surah Al-Baqarah : verse 29

<sup>35</sup> Ibn Ḥazm. 'Abū Muḥammad 'Alī bin 'Aḥmad bin Sa'īd bin Hazm. *Al-Muḥalla*. Vol.9, (Beyrūt: Dar al-Fikr, 1984)., 21.

<sup>36</sup> Narrated by Al-Tirmidzi, Source: Al-Tirmidzi, 'Abu 'Isā Muḥammad bin 'Isā bin Saurah. *Sunan At-Tirmidzī*. Vol.2, (Beyrūt: Dar al-Kutub Al-'Ilmiyyah, 2000). Chapter. 17, Hadīth 1352, 343. Abū Isā said this Hadīth is in category of Hassan Saḥīh, while al-Albanī validated this chain of hadith.

<sup>37</sup> Al-Zarqa', Ahmad bin Muhammad. *Sharḥ al-Qawā'id al-Fiqhiyyah*. (Damsyik: Dar al-Qalam, 1989), 2<sup>nd</sup> Edn., 482.

The original rule of a contract is mutual consent or agreement by both contracting parties, and the consequence of the contract is based on (rights and responsibilities) agreed in the contract.

It is also argued that the permissibility of this exercise should be based on many proofs such as through the practices which have been done by the classical jurists in leaving the original ruling, especially in case where there is a need of *'urf* on the related matters. The need for *'urf* is synonymous with the current market situation.<sup>38</sup>

## **7. Application of *Tanāzul* in *Mushārahah Şukūk***

Basically, *tanāzul* in *şukūk mushārahah* is applied in several scenarios:<sup>39</sup>

### **1) Priority to an expected and specified profit rate**

In this arrangement, there is a possibility that the *şukūk* holders may receive 100%. This can happen if the actual profit is less or up to the expected and defined profit rate that is to be given to the *şukūk* holders. However, if the actual profit is more than such rate of expected profit, there is a possibility that the common shareholders may get some rate of profit. There are two scenarios under this category that requires further clarification:

- a) *Tanāzul* in the case where the realized profit is equal or less than the expected rate of profit.

The issuer agrees to waive his right to a share of the profit until the *şukūk* holders receive their expected rate of profit. This kind of *tanāzul* is given upfront at the time of the contract in order to determine that it will have the intended effect if the actual profit is equal or less than the expected profit.

This practice of *tanāzul* is contentious because it is considered by many scholars to be against the actual nature of

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<sup>38</sup> Ngadimon, *supra* note 33 at 13.

<sup>39</sup> Hasan, *supra* note 28.

*mushārahah* which requires some elements of profit-sharing among the partners which also include the issuer. In this type of *tanāzul*, there is a possibility which is agreed upfront at the time of contract, that some of the partners (issuer) will not get any share of the profit, i.e., in the event that the realized profit is equal or less than the expected profit rate. In this scenario, all the profits will go to the *şukūk* holders only.

According to AAOIFI, it is not allowed for the issuers to waive their rights to a share of the profit until the *şukūk* holders get their expected rate of profit. The AAOIFI Sharī'ah Standard is as below;

Item 3/1/5/3: It is a requirement that the proportions of losses borne by partners be commensurate with the proportions of their contribution to the *Sharīkah* capital. It is not permitted therefore to agree on holding one partner or a group of partners liable for the entire loss or liable for a percentage of loss that does not match their share of ownership in the partnership. It is, however, valid that one partner takes without prior condition the responsibility of bearing the loss at the time of the loss.<sup>40</sup>

- b) *Tanāzul* in the case when the realized profit exceeds the expected rate of profit.

The *şukūk* holders agree to take their profit share at a rate that is fixed at an agreed cap (the expected profit rate) and any profit above the cap-rate will be waived and given to the issuer/obligor as an incentive payment. This principle of *tanāzul* to waive such a right to the profit is specified as a condition of the contract. For example, in the case where the expected profit rate is 6% and the actual return (based on the profit sharing ratio) is 10%, the *Şukūk*holders will take 6% and forego the excess 4% to the obligor as an incentive for good performance. The *tanāzul* arrangement for distribution of the

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<sup>40</sup> AAOIFI, *supra* note 8 at 207.

excess profit above the expected profit rate is provided upfront in the *mushārah* agreement.

This could be in the form of granting him part of or the entire premium above a certain benchmark profit. This has been supported by the AAOIFI that allows such stipulation in the contract of *mushārah*. This is evident in the AAOIFI resolution in *Sharī'ah* Standard No. (12) on *Sharīkah (Mushārah)* and Modern Corporations, regarding the outcome of *Sharīkah* investments (profit and loss):

3/1/5/9: It is permissible to agree that if the profit realized is above a certain ceiling, the profit in excess of such a ceiling belongs to a particular partner.<sup>41</sup>

This arrangement is considered a valid condition because it is still consistent with the notion of profit-sharing and is in line with *muqtadha al-'aqad* of the contract which is based on profit sharing.

**2) Priority in the return of capital in the event of liquidation (winding up) is given to senior *Ṣukūkh*holders over junior *Ṣukūkh*holders.**

Generally, the priority of some *Ṣukūkh*holders over others sharing the same *Ṣukūk* portfolio is not permissible since the loss must be divided between the partners and shareholders exactly in accordance to the ratio of investment as discussed earlier in relation to the maxim. It is not permitted for the partners to agree on holding one partner or a group of partners liable for the entire loss or liable for certain parts of the loss that are not proportionate to their ratio of capital contribution. However, any of the partners can agree to absorb all the losses after they have been realized. This is reflected in the *Sharī'ah* Standard issued by AAOIFI that reads:

3/1/5/4: It is required that the proportions of losses borne by partners be commensurate with the proportions of their contributions to the *Sharīkah* capital. It is not permitted therefore, to agree on

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<sup>41</sup> *Ibid.*

holding one partner or a group of partners liable for the entire loss or liable for a percentage of loss that does not match to their share of ownership in the partnership. It is valid that one partner takes -without any prior condition- the responsibility of bearing the loss at the time of the loss.”)

However, if there are two different portfolio between senior and junior *şukūk*, even though both have been issued by the same issuer, one can argue that both are independent in terms of underlying assets and undivided interest of ownership, bearing in mind that the junior *şukūk* holders agree to be ranked second in priority upon liquidation from the very beginning; hence there is no justification to regard it as not permissible from the Sharī'ah perspective.

### **8. Application of *Tanāzul* in *Muḍārabah Şukūk* Application of *Tanāzul* in *Wakālah bil Istūhmār Şukūk***

This section will be focusing on the application of *tanāzul* within the contract of *muḍārabah*. In this structure, the issuers include a condition in the contract which states that if the actual profit from the enterprise exceeds the percentage based on interest rates, then that amount of excess shall be paid in its entirety to the enterprise manager (*mudārib*) as an incentive for good management. Therefore, at this stage the capital providers (*rabb al māl*) waive their right to claim the excess amount of profit which exceeds their indicative rate. This paper aims to analyze the permissibility of this practice of *tanāzul* from the Sharī'ah perspective.

AAOIFI has permitted this kind of arrangement as stated in its Standard for *muḍārabah* approved by the Sharī'ah Council. This is as mentioned below:<sup>42</sup>

If one of the two parties should stipulate for itself a specific amount (of profit), the *muḍārabah* will be void. This prohibition, however, is not inclusive of an agreement by the two parties that if the profits exceed a certain percentage then one of those two parties will receive the excess exclusively such that the distribution will be according to what the two have agreed.

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<sup>42</sup> *Ibid.*, 245.

## 9. Application of *Tanāzul* in *Wakālah bil Istūhmār Şukūk*

### Sharī'ah Issue 1: Stipulating an Incentive for the Manager

With regards to the stipulation of an incentive for the manager of the enterprise, its justification may be found in what certain jurists have mentioned regarding the lawfulness of offering incentives in contracts of *wakālah* or in brokerage.<sup>43</sup>

This kind of arrangement in *wakālah* actually has been discussed by the jurists, as narrated by Al-Imam al-Bukhārī on the authority of the Companion Ibn `Abbās and Ibn Sīrīn:<sup>44</sup>

("Ibn `Abbās said:"There is no impediment to one's saying, 'Sell this cloth and whatever is in excess of this or that will be yours.'" Ibn Sirin said: "When someone says, 'Sell it for this much and whatever profit that is realized beyond that will be yours or will be shared between us,' then there is no problem with that.")

Scholars dispute on this issue with two different opinions:

1) First opinion: It is permissible. This is the opinion of Ibn Abbās (r.a), Al- Zuhri, Qatādah, Ayyūb, Ibn Sīrīn<sup>45</sup>, Al-Sya'bī<sup>46</sup>, Al-Ḥasan<sup>47</sup>, Ishāq and one of the isolated opinions of the Hanbalī school of law<sup>48</sup>: When a *muwakkil* says to the *wakil*: Sell this shirt of mine for such and what exceeds belong to you. The *wakil* has the right to the exceeding portion, if he sells it higher than the stipulated price mentioned, this is strengthened by the following:

- i. As narrated from Ibn Abbās, it is permissible, in the situation when a man gives another man a shirt or other merchandise, and tells him: "Sell this for such and you can

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<sup>43</sup> Usmanī, Taqī. *Şukūk and their Contemporary Applications*. <<http://www.kantakji.com/media/7747/f148.pdf>>.(accessed 12 July 2011), 5-7.

<sup>44</sup> *Ibid.*

<sup>45</sup> Al-Şan`ānī, Abd Al-Razzaq ibn Hammam. *Al-Musannaf*. (Africa: Al-Majlis Ilmi, 1970). no. 15018.

<sup>46</sup> *Ibid.*, 15019.

<sup>47</sup> *Ibid.*, 15020.

<sup>48</sup> Ibn Qudāmah, *supra* note 22 at 557.

keep what exceeds<sup>49</sup>”, there is no argument raised against this practice during his time; therefore, it can be considered as consensus among the companions (*ijmā`*)<sup>50</sup>.

- ii. In this case, a merchandise grows because of someone's efforts like in *muḍārabah*. With respect to this particular issue, Imam Aḥmad said: “This practice is similar to *muḍārabah*?”
- iii. It is also based on expending for someone else that which is not binding; therefore it is as if one is returning something which is lost/or has run away.

Muhammad Ibn Uthāīmīn (rahimahullah) was questioned about the following:<sup>51</sup>

“My brother gave to a trader honey and he said to him: ‘The price of each of it is three hundred riyal, and if you sell them with a higher price, then what exceeds belong to you’. The trader then sells each quantity for three hundred and fifty riyal. What is the *hukm* of this transaction? May Allah reward you with the best”

He answered: When a person appoints another in selling something, honey, food, or others, and he says to the *wakīl*, “Sell this for such and what exceeds belong to you,” this transaction is permissible on the condition that the seller who is appointed knows the market price of the merchandise, and in the instance that he does not know, he may claim a profit. This is because when one has a belonging and wants to dispose of it, he can appoint another person to sell the commodities on his behalf with a stated price. What exceeds it belong to the *wakīl*, without having to question the market price of the commodity since the price may have risen tremendously. So when the *muwakkil* says; “Take this commodity and sell it for one

<sup>49</sup> Al-Şan ‘ānī, *supra* note 45 at 15020.

<sup>50</sup> Mansūr bin Yūnus bin Idrīs al-Buhūtī, *Kasysyāf al-Qinā` ‘an Matn al-Iqnā`*. (Riyadh: Dar ‘Alam al- Kutub, 2003). : The *isnād* are *jayyid*.

<sup>51</sup> See [islamport.com/w/amm/web/2522/12711.htm](http://islamport.com/w/amm/web/2522/12711.htm).

hundred and what exceeds that price belongs to you,” the *wakīl*, knowing that the *muwakkil* is unaware of the market price of the commodity therefore has the responsibility to inform him (owner of commodity/*muwakkil*) by saying: “This commodity is priced around two hundred, and if the *muwakkil* says: “ Even if it is so, sell it for a hundred and what exceeds it will belong to you.” In this situation, Muhammad Uthāīmīn opines that the commodity should be sold at its price range in the market, even if it is priced at three hundred or four hundred, and the hundred which is conditioned earlier should be returned to the *muwakkil*.

2) Second opinion: It is not permissible. This is the opinion of Ibrahim al-Nakha`i , Ḥamad.<sup>52</sup> Ibn Qudamah related that this is the opinion of Abū Ḥanīfah, Al-Thaūrī, Al-Shafī`ī and Ibn al-Munzīr. The main reason for the prohibition is the unknown wage/fee which has a degree of uncertainty (*wujūd and adam*)<sup>53</sup>. The invalidity of this situation is very well known in the *Hanaḥī* school of thought. It is stated in (1202) of *Majallah al-aḥkam al- adlīyyah*, if the remuneration is unknown then *ajr mithl* (standard market price) applies. Fatwa al-Saghdī states: “(And the fifth is) The reward for brokers (*ijārah al-simsār*) is not permissible, if he says: “Sell this shirt for ten dirham and what exceeds that price will belong to you.” In this situation, he is entitled for *ajr al-mithl*”.<sup>54</sup>

With that, it is concluded that *wakālah bi al-ujr* takes the ruling of *ijārah*, with the condition that the *ujrah* needs to be known. The Shafī`is state that the contract of *wakālah* is a binding contract<sup>55</sup> when it is related to *ujr*. It is like when a *wakīl* starts to represent in trials<sup>56</sup>. Malikis view that if the *wakil* turns against the *muwakkil* in

<sup>52</sup> Al-Ṣan`ānī, *supra* note 45 at 15022.

<sup>53</sup> Ibn Qudāmah, *supra* note 22 at 557.

<sup>54</sup> Abu Al-Ḥassan Ali Ibn Al-Ḥusīn Ibn Muḥammad Al-Sughdī, *Al-Nuṭf fi al-Fatawa*. Vol.2. (Jordan: Dar al-Furqān, 1984), 575..

<sup>55</sup> They view that when a *wakālah* is pronounced with *ijarah* it is binding, if it is pronounced with *wakālah* then it is not binding. See Ibn Qudāmah, *supra* note 48 at 217.

<sup>56</sup> Al-Sharbīnī, Shams al-Dīn Muḥammad bin Muḥammad al-Khaṭīb. *Mughnī al-Muḥtāj ilā Ma`rifah Ma`ānī Alfāz al-Minhāj*. Vol.3, (Beyrut: Dar al-Kutub al-`Ilmiyyah, 2000), 257.

trial, the *muwakkil* is not able to dismiss<sup>57</sup> the *wakālah* contract between them as it is not binding(*jaiz*)<sup>58</sup>.

The Malikis differentiate between *wakālah*, ruling for *ijārah* and *wakālah* for the ruling of *ju`ālah*. In *Ḥāshiyah al-Dusūqī ala al-Sharḥ al-Kabīr*: “The appointment in collecting debt may at times involve *ijārah* or *ju`ālah*. In the case of *ijarah*, it is a must to know the *muwakkil*'s actual amount for debt collection and also to identify who owes the *muwakkil* the debt: the debtor is one who is rich, poor or one who delays or not. For example: “I appoint you to act on my behalf to collect such an amount from this person and you will get this amount of fee.” In *ju`ālah*, one of the two needs to be known, either the amount or who the debtor is”<sup>59</sup>.

### **Sharī'ah Issue 2: The Condition to Know the *Ju`l*:**

Al-Mausu`ah al-Fiqhiyyah al-Kuwaitiyyah, volume fifteen of the *ju`ālah* article, states the following:

Malikis define *ju`ālah* as: Compensation of a person to another person with a known reward and is not differentiated between a known or unknown time, benefitting the offeror. The worker deserves the reward, and if he does not complete the work, he is not entitled to anything, which does not benefit the offeror until the completion of work.

Shafī`is define it as: An obligation to pay a determined compensation against a specific work or unknown work for the determination of which is difficult.

Hanbalis define it as: The entitlement of a known amount to one who has worked for the offeror a permissible work (*mubāh*), even though it is unknown or who has worked for a specified, period even though it is unknown.

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<sup>57</sup> Al-Kharsyī, Ahmad bin ‘Abd Allah, *Syarh Mukhtasar Khalīl lil Khurāsīyī*. Vol.6 (Mesir: Matba’ah al-Kubra al-Imiriyyah, n.d.), 96.

<sup>58</sup> Al-Dusūqī, Syams al-Din Muhammad, *Hasyiah al-Dusūqī ‘Ala al-Sharḥ al-Kabīr*. Vol.3, (Beyrut: Dar al-Fikr,n.d), 396.

<sup>59</sup> *Ibid.*, 397.

It can be concluded that Mālikis, Shāfi`is and Ḥanbālis all agree on the permissibility of *ju`alah*<sup>60</sup>. This is with the condition that the *ju`l* (reward/compensation) is known. They directly state this saying that it is a condition to make the *ju`alah* contract valid that the reward be known in terms of classification and evaluation (*jins wa qadr*) because the unknown state of an exchange shall abrogate the meaning of the *ju`alah* contract, as no one would want to work not knowing what the compensation/reward is. The recognition of *ju`l* is through witnessing or describing it if it is tangible (*ain*), and by describing it if it is a debt.

### **Sharī`ah Issue 3: *Ju`l* which does not need to be known:**

The Shāfi`is hold that there are two conditions in which the known state of *ju`l* is excluded:

Firstly: In the event that the imam or leader of the army rewards one who shows the gate of fortress of the enemies during wartimes, by rewarding a horse from them, for example, or others. In this situation it is permissible for the exchange to be unknown in accordance to the condition of war.

Secondly: When a person says to another: “Perform hajj for me and the expenses is on me.” The expenses being unknown is permissible. However, Al-Mawārdī from the Shāfi`ites views that it is a *fāsid* (defective) *ju`alah*.

Ḥanbalis view that it is permissible for the *ju`l* to be unknown if the unknown state does not lead to failure in delivery, for example, the *jā`il* (offeror) says: “Who is able to bring me back what I lost will get one third of it,” or when the leader of the army says in the battle, “Who comes with ten leaders, he shall be one of them,” or to reward one who shows a fortress or an easier path, for example, and

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<sup>60</sup> Hanafīs forbid the *ju`alah* contract except in returning something which is lost/ran away.

the reward is from the property of the enemies, it is allowed for the *ju`l* to be unknown, for example, a horse determined by the worker.

Malikis, on the other hand, allow unknown results of *ju`ālah* in three situations:

Firstly: Rewarding someone to plant for him until it grows to a certain stage, therefore what exceeds the stage of growth shall be rewarded.

Secondly: Rewarding a portion of a debt after obtaining the payment of the debt since it is unknown how much he will get, for example one third or one fourth of what was obtained. This is permissible according to Mālikis.

Thirdly: Rewarding someone a portion after the gathering of cultivation or plucking dates on the portion which is mentioned. There is no dispute among the scholars in the permissibility of giving rewards using these as both are unpredictable.

This particular issue falls under the realm of *ju`ālah* and not based on *ijārah*. The unknown state is permissible in *ju`ālah* whilst not in *ijārah*. However, it is proven by Ibn Abbas (r.a) that he allowed it. Some contemporary scholars argue that the concept can also be applied the other way round; for instance, in the case of determining a reward for an agency to purchase. A customer who wants to buy gold bars for example can say: "Purchase for me a certain amount of gold with the announced price. Whatever reduction/discount you get, the difference is yours." This concept can provide alternatives for purchasing gold without immediate delivery, where the *qabadh* is done by the *wakīl*. In case of *šukūk* liquidation through auction, the selling price can be capped at a particular nominal price, where the excess is foregone. The same is true with the *wakālah* saving investment account. The excess of the predicted profit can be waived upfront by the investors for the benefit of the *wakīl*.

The majority of contemporary scholars, among others, Taqī Usmanī and Alī Muhyīddīn al-Qurrah Daghī<sup>61</sup>, are of the opinion that there is nothing in Sharī'ah law that prevents the payment of incentives to an agent in addition to his fee as it is similar to the lawfulness of offering incentives in contracts of *wakālah* (agency) or in brokerage.

## 10. Conclusion and Recommendation

Based on the discussion above, one may conclude that the practice of giving *tanāzul* to effect the distribution of profit is permissible in case the *tanāzul* is made once the profit is established. Nevertheless, there are various opinions given by a majority of jurists that prohibit the practices of giving *tanāzul* upfront or forgoing a portion of the profit after securing the expected return. The authors are of the view that such practice can be considered tolerable and acceptable on the basis of performance incentive. This permissibility is taken into account as there is no violation of the spirit of partnership as all the partners of the equity contracts may have obtained their indicative portion of profits, even though they surrendered the right to claim the excess amount of profits (profit which exceeds the indicative profit) to other partners. However, it is not allowed if the upfront *tanāzul* by one or more partners aims at making good the shortfall of the expected rate of return. This can amount to a guarantee in the payment of profit according to the fixed profit rate which contributes a similar effect on the conventional interest bearing bonds.

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<sup>61</sup> Al-Qurrah Daghī, Muhyīddīn, *Review of Fatwas Issued During al-Baraka Banking Group Symposium (The Second Part)*.