TKBB

Participation Finance Standards

Standard No: 5

MUDARABAH STANDARD

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MUDARABAH STANDARD

Scope of the Standard

This standard covers the nature of the mudarabah transaction applied in Islamic banking, the legal rules that must be observed during the transaction, and the Shariah bases for these rules. The profit and loss sharing account, which is based on the mudarabah transaction, has some special rules in addition to the general rules of mudarabah, so a separate standard will be prepared for profit and loss sharing accounts.

1. Definition and Types of Mudarabah

1.1. Definition of Mudarabah

Mudarabah, also known as a capital-labor partnership, is a form of partnership agreement where one party contributes capital and the other provides labor to manage that capital. The resulting profits are then shared according to the agreement. Participants in this agreement can be either natural persons or legal entities. The contributor of the capital is referred to as the capital provider (rabb al-māl), and the party managing the capital through his labor is known as the entrepreneur (muḏārib).

1.2. Types of Mudarabah

There are two types of mudarabah: unrestricted (unlimited) and restricted (limited).

1.2.1. Unrestricted Mudarabah

Unrestricted mudarabah is a type of mudarabah where the capital provider releases the entrepreneur (muḏārib) without imposing any restrictive conditions on the commercial activities. In this type of mudarabah contract, only the profit-sharing ratio is specified. The entrepreneur is authorized to engage in any commercial transaction, adhering to the principles and standards of participation finance, while acting prudently within the established framework of commercial practices.

1.2.2. Restricted Mudarabah

Restricted mudarabah is a type of mudarabah in which the capital provider imposes restrictions on the entrepreneur with regard to aspects such as time, place, sector, type of trade, persons and similar factors related to the entrepreneur’s activities. The entrepreneur is obliged to conduct his business activities within the limits set out in the agreement.

2. Rulings Related to Mudarabah

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2.1.1. The mudarabah contract can be established for a fixed period or structured to terminate upon accomplishment completion of the work undertaken.

2.1.2. The mudarabah contract can be arranged to become effective from a future date.

2.2. Rulings Related to the Capital

2.2.1. In a mudarabah arrangement, it is crucial that the capital is in the form of money, clearly specified in terms of amount and type. The parties may agree to consider the conversion of non-monetary value into money by the entrepreneur at its market price as capital. Similarly, it can also be agreed that the capital provider's receivable from a third-party debtor becomes capital after it has been collected by the entrepreneur.

2.2.2. For the validity and enforcement of mudarabah contract, it is essential that the entire agreed-upon capital or a sufficient portion enabling the conduct of business is delivered to the entrepreneur. Granting the entrepreneur the authority to manage the capital is also considered as its delivery.

2.2.3. Failure to deliver the capital to the entrepreneur within the period agreed upon in the contract or, if not specified, within a customary period after the establishment of the contract, gives the entrepreneur the right to terminate the contract and claim compensation for any actual damages incurred.

2.2.4. The entrepreneur is not liable for any losses incurred on the capital unless due to fault or breach of contract on his part.

2.2.5. The entrepreneur manages the capital as an agent of the capital provider; however, in the event of profit, he is entitled to a share of the profit as a partner.

2.2.6. The capital provider may withdraw a part of the capital with the consent of the entrepreneur. In this case, the mudarabah continues with the remaining capital. However, it cannot be stipulated as a condition in the contract that a part of the capital can be withdrawn at any time. Without the entrepreneur’s consent, the withdrawal of a part of the capital results in the complete termination of the partnership. In this case, the liquidation rules are applied.

2.3. Rulings Related to the Management of Capital

2.3.1. It is essential that the capital be managed in accordance with participation finance principles alongside commercial customs and practices, consistent with the objectives of the partnership. The entrepreneur should act prudently, similar to a diligent merchant, while conducting these activities, avoiding transactions and actions that could jeopardize the capital by taking market conditions into consideration.

2.3.2. In an unrestricted mudarabah, the entrepreneur is authorized to engage in any trade, production, or investment activities as long as he complies with the principles of participation finance.

2.3.3. In a restricted mudarabah, the entrepreneur is is not only obligated to adhere to the principles of participation finance but also to the terms specified in the contract. If the entrepreneur acts in violation of the terms of the contract, the capital provider has the option to either consent to these actions or terminate the contract and reclaim the capital. If the preference is to terminate the contract and if there has been a loss in the capital, the entrepreneur is liable for compensating that loss. If a profit is realized, it is shared according to the rates specified in the contract.

2.3.4. Capital providers and entrepreneurs can establish different mudarabah partnerships among themselves by freely determining profit-sharing ratios.

2.3.5. The entrepreneur is required personally manage the capital. However, with explicit permission from the capital provider and by assuming responsibility, he may authorize other individuals to manage a portion or all of the capital, or enter into sub-mudarabah contracts.

2.3.6. If the entrepreneur employs someone on a wage basis for tasks that should be personally performed by him, without the explicit approval of the capital provider, he is responsible for covering the wages from his own funds, not from the mudarabah capital.

2.3.7. The entrepreneur is permitted to handle tasks and transactions necessary for the conducted business that do not require personal execution, such as obtaining services or granting power of attorney. The costs and expenses of such transactions are covered by the mudarabah capital.

2.3.8. Within the scope of mudarabah transactions, the entrepreneur is allowed to procure goods and services from the capital provider, provided they are at market prices. Similarly, as long as it aligns with market prices and with explicit permission from the capital provider, the entrepreneur may procure such goods and services from himself.

2.3.9. The entrepreneur is not entitled to any compensation beyond his share in profits for the effort he puts into tasks directly related to entrepreneurial activities, which are expected to be performed personally.

2.3.10. The capital provider is not allowed to interfere in the management of the mudarabah without the consent of the entrepreneur. However, the capital provider has the right to obtain information regarding operations. Additionally, it can be agreed upon that the entrepreneur will be supervised for the protection of the capital.

2.3.11. The entrepreneur is not permitted to make gratuitous contributions or provide loans from the capital or profits without the consent of the capital provider.

2.4. Rulings Related to Profit-Loss Sharing

2.4.1. The profit-sharing between the parties must be determined as a percentage of the anticipated profit at the time of forming the contract. Profit cannot be predetermined as a fixed amount or as a certain proportion of the capital.

2.4.2. The profit-sharing ratios specified in the contract can be amended at any time through mutual consent of both parties, and they may also be subject to periodic revision.

2.4.3. In mudarabah contracts where profit-sharing ratios are not specified, the ratios will be determined according to the the customary practices in participation finance. Parties may later agree to modify the profit-sharing ratios, even if they were initially determined based on customary practices. In the absence of any customary practice regarding profit-sharing ratios, the mudarabah contract shall be deemed invalid.

2.4.4. In a mudarabah contract, it can be agreed that if a certain profit threshold is reached, any profit exceeding this amount shall be allocated to one of the parties.

2.4.5. Prior to the determination of final profit or loss, in cases of long-term contracts or for any other reason, payments may be made to the parties as advances and these advances will be settled upon the final calculation.

2.4.6. In the event of a loss in mudarabah, the capital provider shall bear the loss. The entrepreneur, without any breach of contract or fault on his part, cannot be held accountable for the loss, and any agreement to the contrary is not permissible. An entrepreneur with any breach of contract or fault shall compensate for the loss and shall not be entitled to any remuneration for his effort.

2.4.7. Without setting initial conditions, making promises, or establishing it as a customary practice, the entrepreneur or the capital provider may waive his share of the profit. Similarly, the entrepreneur can unilaterally assume all or part of the loss under the same terms.

2.5. Rulings Related to the Collateral

2.5.1. At the time of establishing the mudarabah contract, the capital provider may obtain a guarantee from the entrepreneur or a third party for the compensation of potential damages arising from the entrepreneur’s fault or any breach of the contract.

2.5.2. During the liquidation of the partnership, if the entrepreneur fails to pay the existing capital and any accrued profit (if any) to the capital provider, the capital provider may resort to the collaterals.

2.6. Rulings Related to the Termination of Mudarabah

2.6.1. Mudarabah terminates under several conditions: the complete loss or extinction of the capital, the death of either party, loss of legal capacity, or dissolution of legal personality, the occurrence of a terminating condition specified in the contract, or if a specified duration is stated in the contract, upon its expiry.

2.6.2. Either party in a mudarabah contract can terminate the contract at any time. The declaration of termination takes effect concerning the terminating party at the moment of his declaration, and for the other party, it takes effect once the declaration is received by him.

2.6.3. The party terminating the contract is obliged to compensate the other party for actual damages caused by the termination. However, if there is evidence of misconduct, negligence, or explicit violation of the contract by one of the parties, the terminating party is not liable for compensating damages caused by these reasons for terminating the contract.

2.6.4. The final profit-loss calculation in a mudarabah contract arises from liquidation of the assets, either through conversion into cash or valuation.

Shariah Bases for the Mudarabah Standard

Mudarabah contract, which is based on the principle of partnership, derives its legitimacy from several sources. These include certain hadiths, the practices of the Prophet’s companions, and the consensus of jurists. The principle of contractual freedom in Islamic law is another source of its legitimacy. According to this principle, individuals are free to establish contracts within the framework of basic rules, as long as these contracts dont controvene these rules. They can also determine the contents of these contracts within the limits set by these rules.

In the fiqh literature, the capital provider, one of the parties to the mudarabah contract, is generally referred to as “rabb al-māl”, while the labor provider is referred to as “muḏārib” or “āmil”.

Participation banks may establish participation accounts based on the mudarabah to raise funds. In this arrangement, the account holders become the capital providers, while the participation bank assumes the role of the entrepreneur. The profit generated from managing the funds accumulated in these participation accounts is shared according to predetermined ratios specified in the contract. In case of a loss, it is borne by the capital providers. Through the implementation of mudarabah-based participation accounts, a partnership is formed between the participation bank, acting as the entrepreneur, and multiple capital providers.

Furthermore, participation banks can offer financing based on mudarabah partnerships. In such financing arrangements, the participation bank acts as the capital provider, while the customer in need of funds assumes the role of the entrepreneur. The agreement between these parties can be set for either a specific or indefinite period. Specifying the type of mudarabah and the profit distribution as well as including provisions for guarantees against potential damages due to a breach of contract by the labor provider, serves as a preventive measure against disputes. This contract may also be formulated as a preliminary or framework agreement, which can then be integrated into partnership contracts for future projects.

As this Standard is dedicated to the general provisions of mudarabah, specific regulations related to participation accounts will be outlined in seperate standard.

1. Bases for the Types of Mudarabah

In a mudarabah contract, the entrepreneur, acting as an agent, manages the capital received from the capital provider and, upon generation of the profit, assumes the role of a partner (al-Zayla’ī, *Tabyīn al -ḥaqāiq*, Cairo, 1314/1895, V, 53). As the capital provider holds the position of a client (authorizer), he has the authority to determine and restrict the activities to be undertaken by the muḏārib, who acts as a proxy (ʻAlī Ḥaydar, *Durar al-ḥukkām*, Cairo, 1411/1991, III, 427).

When there is no restriction imposed on the actions of the entrepreneur concerning the capital and he is granted full discretion in commercial transactions, this arrangement is referred to as "unrestricted mudarabah" (*al-Majallah*, art. 1407). In unrestricted mudarabah, the entrepreneur, within the legitimate boundaries of partnership capital, is free to conduct any transactions under the mudarabah as long as he exercises prudence akin to that of a skillful merchant (*al-Majallah*, art. 1414). However, as specified in Standard article 2.3.5., transferring capital for operation via a sub-mudarabah to another laborer requires the permission or approval of the capital provider (al-Zayla'ī, *Tabyīn al-ḥaqāiq*, V, 59).

Determining profit-sharing ratios in unrestricted mudarabah is a precautionary measure aimed at preventing disputes between parties. The uncertainty regarding these ratios fundamentally compromises the contract's validity (al-Marghīnānī, *al-Hidāyah*, Beirut, n.d., III, 200; Mollā Husraw, *Durar al-ḥukkām*, n.d., II, 311). Though this is the general principle, if a mudarabah contract is formed without specifying profit-sharing ratios but if there exists a customary practice regarding profit rates in the relevant business field, the sharing is considered based on this custom, thus validating the mudarabah contract accordingly. Indeed, Standard article 2.4.3. covers this.

Mudarabah, in which the authority of the entrepreneur is restricted by the capital provider, is referred to as "restricted mudarabah". The capital provider may impose restrictions on the entrepreneur's dealings, which could pertain to the types of transactions conducted or, in certain instances, the individuals involved in these transactions. Generally, the entrepreneur is considered "trustworthy", meaning they will not conduct transactions that may adversely affect the capital provider, either intentionally or due to negligence. Hence, the entrepreneur is held accountable for any faulty conduct (al-Zayla'ī, *Tabyīn al-ḥaqāiq*, V, 53).

2. Bases for the Rules Related to Mudarabah

2.1. Bases for the Rules Related to the Determination of Time in Mudarabah

Mudarabah operates on the principle that the capital owner authorizes and appoints the entrepreneur as his agent to utilize and manage the capital. Therefore, the entrepreneur manages the capital as the agent of the capital owner, exercising authority over it. The capital owner, while conferring authority over the capital to the entrepreneur can restrict this authority with certain limitations, such as conducting trade in a specific region or engaging in particular branches of trade, or setting a limit on the duration of the contract (*al-Majallah*, art. 1407). Consequently, the entrepreneur's authority is confined to the specified duration. Upon its expiry, both the entrepreneur's authority and the mudarabah contract comes to an end.

The ability to establish mudarabah to be effective from a future date is also associated with its inherent nature as a contract embodying the principle of agency. This is because, in mudarabah, the capital is not transferred to the entrepreneur; instead, the entrepreneur is authorized to manage the capital. Therefore, the capital owner's limitation of the granted authority to a specific period does not contradict the structure of the contract, and also initiating mudarabah from a future date is also not contradictory. In such cases, even though the contract is established earlier, the entrepreneur's authority to manage the capital commences from the specified future date (Ibn al-Humām, *Fatḥ al-Qadīr*, Cairo, 1970, VIII, 447).

2.2. Bases for the Rules Related to the Capital

The mudarabah contract involves the transfer of capital to the entrepreneur for the purpose of engaging in income-generating activities. When the capital is in the form of cash, the entrepreneur can directly invest in commercial ventures for profit. The presence of cash as capital does not lead to uncertainty in determining the principal amount and profit. However, it is not the same situation for non-monetary assets, whether movable or immovable, to be considered as capital in the partnership. When they become capital, it is not the physical presence (*'ayn*) that matters but rather its value. The value, however, is a variable that may cause uncertainty in profit during the liquidation phase of the partnership. Uncertainty in profit within mudarabah is a factor that can nullify the contract. Nevertheless, a clear agreement between the parties allows the proceeds from the non-monetary assets' sale to be considered as capital, eliminating any uncertainty in profit and thus preserving the validity of the mudarabah contract. In such scenarios, the entrepreneur, as the capital provider's agent, sells the entrusted movable or immovable property, converting it into cash that forms part of the partnership's capital. This principle also applies to receivables collection, where the entrepreneur, acting for the capital provider, collects receivables to use as capital in the mudarabah (al-Kāsānī, *Badāi' al-ṣanāi'*, Beirut, 1986, VI, 59, 82; Ibn Rushd, *Bidāyah al-mujtahid*, Cairo, 1425/2004, IV, 21; al-Shirbīnī, *Mugnī al-muḥtāj*, Beirut, 1415/1994, III, 398; *al-Majallah*, art. 1338, 1409).

Given that mudarabah is founded on a labor-capital partnership, it is essential for the entrepreneur, who contributes labor to undertake commercial activities, to have the capital entrusted to him. This allows him to use it at his discretion or as needed (*al-Majallah*, art. 1410).

Failure to transfer the capital to the entrepreneur results in the absence of a trust-based relationship between the parties involved (al-Kāsānī, *Badāi' al-ṣanāi'*, VI, 84). Consequently, failing to transfer the capital to the entrepreneur impedes the enforcement of the contract. Even if the capital is not physically transferred, granting the entrepreneur authority to deal with the capital is considered as a legal transfer (*taslīm ḥukmī*). This is because it enables them to engage in commercial activities.

If the capital is not delivered to the entrepreneur within the agreed-upon period following the contract's establishment or within a reasonable period according to customary practices when the delivery period is not specified, the entrepreneur has the right to terminate the contract. Under these cases, the entrepreneur can terminate the contract and can also claim compensation for any actual damages incurred.

When the capital owner imposes conditions for the capital to remain under his control or prevent its delivery to the entrepreneur, this contradicts the fundamental nature of the contract, thus rendering the contract void.

In a mudarabah contract, the entrepreneur acts as the capital owner's representative operating it with the owner's permission. The responsibility of the representative is, according to the Islamic jurisprudence, to protect and utilize the entrusted capital. In mudarabah, the classification of the capital as entrusted (*amānah*) in the hands of the entrepreneur means that, without fault, the entrepreneur is not liable for any losses incurred in the capital or profit. However, if the entrepreneur fails to safeguard or manage the capital appropriately or fails to fulfill obligations arising from the contract, he is considered at fault and thus he is liable for any resulting losses.

In a mudarabah partnership, the entrepreneur initially has a claim only on the profit, not on the capital itself, until such profit is realized. Once the profit is realized, the entrepreneur then assumes a dual role, functioning both as a representative and a partner (al-Kāsānī, *Badāi' al-ṣanāi'*, VI, 83; *al-Majallah*, art. 1413).

Given that mudarabah is a contract centered, on the operation of capital, any partial or complete withdrawal of the capital constitutes a breach of the contract. Therefore, stipulating this as a condition contradicts the inherent nature of the contract (al-Kāsānī, *Badāi' al-ṣanāi'*, VI, 108; 'Alī Ḥaydar, *Durar al-ḥukkām,* III, 434). If the capital owner withdraws a portion of the capital with the consent of the entrepreneur, it implies the contract's continuation with the remaining capital. In this scenario, the provisions regarding the withdrawn portion of the capital are applied within the framework of settlement.

The partial or complete withdrawal of the capital without the entrepreneur's consent, considering mudarabah as a trust-based contract for operating capital, results in the termination of the mudarabah contract. In the event of such termination, the relevant settlement provisions come into effect.

2.3. Bases for the Rules Related to the Management of Capital

As an agent of the capital provider, the entrepreneur, upon receiving the capital for engaging in profit-generating transactions, has an obligation to act prudently in his dealings. It is essential to ensure that all his transactions, mandates, and business conducted on behalf of the mudarabah partnership are justifiable and align with commercial objectives that are in accordance with the purposes of the agency and mudarabah. It is essential that all actions of the entrepreneur in the mudarabah partnership be commercially explainable and aligned with the goals of the agency and mudarabah, taking into account the market conditions in which he operates. The entrepreneur fails to fulfill the duty of care if he engages in transactions that do not align with the purposes of the mudarabah contract, such as making donations or purchasing an item significantly above its market value, which does not comply with the necessities of trade and disregards market conditions. In such cases, these transactions are not valid under the mudarabah contract and are executed on behalf of the entrepreneur. Consequently, the expenses are covered by the entrepreneur's personal account rather than the partnership capital. If the mudarabah asset is sold significantly below the market price, in that case the entrepreneur is liable to compensate for the difference between the sale price and the market price of the asset.

In Islamic jurisprudence texts, the transactions conducted by the muḏārib (entrepreneur) are examined in three distinct sections, each governed by specific provisions:

a) Transactions that the entrepreneur can undertake, even without general authorization or explicit permission from the capital provider, are permitted under the mudarabah contract. Since the mudarabah contract is established for profit-making purposes, the entrepreneur can engage in transactions such as buying, selling, leasing, mortgaging, appointing agents, and other relevant dealings, provided they serve this objective and remain within the lawful framework.

b) Transactions that the entrepreneur can undertake with general authorization without requiring explicit permission, include various commercial activities. When authorized to operate commercial activities at his discretion, the entrepreneur is permitted to engage in a partnership, using either a portion or the entirety of the capital, with another person.

c) Transactions that, despite granting general authorization to the entrepreneur, cannot be undertaken without explicit permission from the capital provider. Such transactions include borrowing money (loan), lending from the mudarabah asset, making gifts (hibah), or pledging the mudarabah asset for debts not arising from the mudarabah. Without clear permission from the capital provider, these actions are valid for the entrepreneur individually but not for the mudarabah partnership (al-Kāsānī, *Badāi' al-ṣanāi'*, VI, 88; *al-Majallah*, articles 1414, 1416).

The entrepreneur is prohibited from engaging in production or investment that involves substances such as alcohol or pork, which are not permissible in Islam. Transactions related to these substances, due to their non-compliance with the principles of participatory finance, fall outside the scope of the mudarabah partnership. Hence, the entrepreneur alone bears the consequences of such actions.

The obligation for the entrepreneur to adhere to the terms of the contract is based on Islamic teachings such as the verse *"O you who believe! Fulfill your obligations!"* (Qur'ān, al-Mā'idah 5:1) and the hadith *"Muslims are bound by their conditions unless it involves making which is permissible forbidden and that is forbidden permissible"* (Tirmidhī, al-Aḥkām, 17). As violating the contract is impermissible, any such action holds the entrepreneur liable for compensating for resulting damages. This principle is unanimously accepted by all schools of Islamic law. In a mudarabah where the entrepreneur breaches the contract, Hanafi school posits that the entire profit belongs to the entrepreneur due to the principle "The benefit is in proportion to the burden" (*al-Majallah*, art. 85, 1421). However, this perspective could potentially be exploited by an entrepreneur seeking to claim the entirety of the profit. Conversely, the Shafi'i and Hanbali schools advocate that the entirety of the profit should belong to the capital provider. In standard article 2.3.3, the preferred view aligns with the Maliki school, which does not hinder the distribution of profits among partners according to the agreed ratios, even in the face of the entrepreneur's unjust actions (Ḥattāb, *Mawāhib al-Jalīl fī Sharḥ*

Mukhtaṣar Khalīl, Beirut, V, 365-366; Ibn Qudāmah, *al-Mughnī,* Cairo, V, 20). This preference expands the entrepreneur's responsibility in case of misuse, while simultaneously protecting the capital provider's share when profits are realized. This approach ensures a more balanced distribution of authority and responsibilities between the parties. Moreover, this perspective aligns with the principle of fairness and is consistent with the concept of "sadd al-dharī'ah" in Islamic jurisprudence. This concept refers to the prevention of actions that may lead to harmful consequences in juristic matters.

An existing mudarabah contract between two parties does not restrict them from entering into other mudarabah contracts. Each mudarabah agreement stands as an independent contract, allowing the parties to determine the terms, nature, and profit-sharing ratios independently of their other mudarabah contracts.

The entrepreneur, authorized by the capital provider as an agent for commercial activities, is primarily tasked with personally executing the agency role and managing the capital. Delegating this responsibility to another party contradicts the fundamental nature and obligations of the contract, making the entrepreneur accountable for any resulting damages. However, if the capital provider explicitly grants permission, the entrepreneur may engage another party through a sub-mudarabah contract (*al-Majallah*, articles 1415, 1416).

The capital provider entrusts the entrepreneur not only due to his capability in managing the partnership but also based on his specific knowledge, skills, and capabilities required for the venture's execution. Therefore, employing someone else, with remuneration from the mudarabah capital, for tasks that the entrepreneur should personally handle due to the contract's terms or the nature of the business, would not only contradict the essence of the contract but also create an unfair situation for the capital provider due to potential diminishment of the capital. To prevent such breaches and injustices, if the entrepreneur intends to engage another party for tasks he should personally undertake, he must obtain explicit approval from the capital provider or bear the employment costs personally. In cases where the entrepreneur employs someone without the capital provider's consent for tasks he should personally handle, leading to subsequent losses, the accountability lies with the entrepreneur.

The entrepreneur holds the right and authority to engage in various activities while managing the capital. This includes, but is not limited to, the procurement of goods and services. Tasks that the entrepreneur is not explicitly obligated to perform personally within the mudarabah agreement, such as repairing, storing, or transporting goods covered by the partnership, can be fulfilled through outsourcing or by appointing representatives. The expenses for this activities are covered from the partnerships' capital.

The entrepreneur, in managing the partnership capital, has the authority to procure goods and services externally for activities not requiring his personal involvement according the mudarabah agreement. Acquiring these goods or services from either the capital provider or from his own sources does not violate the mudarabah principles. When sourced from the capital provider, the capital provider assumes the role of a third-party supplier, not a direct partner of the mudarabah partnership. In this context, the capital provider functions as an external entity engaging in transactions with the entrepreneur. Therefore, any cost received by the capital provider for selling goods or rendering services to the entrepreneur are the costs for transactions that carried out by the capital provider as a third party and is not directly associated with the mudarabah contract (al-Kāsānī, *Badāi' al-ṣanāi'*, VI, 101).

The procurement of necessary goods and services by the entrepreneur from his own sources for the mudarabah partnership also falls within this context. Specifically, when the entrepreneur uses his own assets to acquire goods or services for the mudarabah, he acts as an entrepreneur. However, he is not obliged to undertake these tasks personally. This approach is more akin to the actions of a third party, distinguishing his role from the contractual obligations typically associated with the title of 'entrepreneur'. Consequently, receiving remuneration for goods obtained or services rendered does not contradict the rules governing the mudarabah. Practically, it is accepted that the entrepreneur manages the mudarabah capital as an agent of the capital provider. In Hanafi jurisprudence, there's a legal principle that prevents an appointed agent from representing both sides of a contract or engaging in a contract with himself on behalf of the appointor. Although, this principle generally restricts an agent from transacting with himself, certain other Islamic legal schools permit this practice for the facilitation of mudarabah operations. As a result, within these other legal perspectives, it may be deemed acceptable for the entrepreneur, acting as an agent, to make purchases from his own assets with the explicit consent of the capital provider. (Ibn Qudāmah, *al-Mughnī*, V, 86; al-Buhūtī, *Kashshāf al-Qinā' 'an Matn al-Iqnā'*, Riyadh, Vol. III, 473). However, to prevent potential abuses and consequent disputes, the contract should explicitly state or be subject to the capital provider's consent regarding the entrepreneur's ability to procure goods and services for remuneration. Moreover, the prices of goods and services obtained from the entrepreneur's own assets must not exceed the prevailing market prices.

Due to the nature of mudarabah, the capital provider becomes a partner in the profit as a return for his capital, while the entrepreneur gains a share in the profit as a return for his labor. When a profit is realized, the share allocated to the entrepreneur represents compensation for the labor he contributed in his capacity as an entrepreneur. However, it is inconsistent with the nature of the mudarabah agreement for the entrepreneur to receive a separate fee in addition to his profit share. Doing so would imply a dual role of both 'entrepreneur' and 'employee', contradicting the essence of the contract. Furthermore, providing an additional fee to the entrepreneur, alongside the profit share, could result in unfair outcomes for the investor. This is particularly concerning in scenarios where no profit is generated from the business or when the entrepreneur’s share is less than the predetermined fee.

The validity and effectiveness of the mudarabah contract, as stipulated in Article 2.2.2, depend on either the delivery of capital to the entrepreneur or the granting him the authority to control the capital. Subsequently, the exclusive responsibility for operating the business lies with the entrepreneur. The fundamental objective of the parties entering into this contract is to achieve profit through the combination of one party’s capital and the other party’s labor. The legitimacy of profit-sharing in mudarabah is contingent upon the parties’ adhering to their defined roles. Therefore, any intervention by the capital provider in the management of mudarabah contradicts the role defined as “investor” in the contract and hinders the entrepreneur’s ability to exercise his authority and responsibilities autonomously. On the other hand, if the investor’s interference leads to any losses, the entrepreneur will bear the burden of losses that are not a result of his own initiative. For this reason, throughout the contract duration, the capital provider is not allowed to interfere in operating and managing the capital entrusted to the entrepreneur.

The intervention of the capital provider in managing the partnership contradicts the fundamental nature and purpose of the mudarabah. Therefore, any condition that stipulates the capital provider’s involvement in the operation of the capital would invalidate the contract (al-Kāsānī, *Badāi’ al-ṣanāi’*, VI, 84-85).

The capital provider’s request for information about the business and examination of the expenditures or transactions by the entrepreneur to determine compliance with the contract are not considered as direct intervention. Seeking information and conducting reviews are means of monitoring whether the business operates in accordance with the contract terms and accepted commercial practices, rather than physically interfering with the operation. To safeguard the capital and ensure the secure continuation of the contract for both parties, conducting oversight can be considered important, preventing the emergence of challenging situations that would be difficult to rectify later on. In a restricted mudarabah, the significance of such oversight becomes even more apparent. Therefore, the parties have the authority to stipulate the auditability of the business and to establish the processes and methods for such audits as a condition of the contract. Such a stipulation does not conflict with the nature of the mudarabah contract. Hadiths indicating that things not explicitly prohibited can be subject to conditions and that such conditions are valid further confirm this ruling. (al-Bukhārī, "Ijārah", 14; Abū Dāwūd, "Aqḏiyah", 12; al-Tirmidhī, "Aḥkām", 17). However, these inspections should not reach a level that hinders the entrepreneur's ability to manage the capital freely within the framework of the agreed-upon contract.

As per the provisions of Standard 2.3.1, the entrepreneur is required to act with the prudence of a skillful trader while conducting business activities under mudarabah. This includes considering market conditions and avoiding any transactions or actions that could detrimentally affect the capital. Spending the entrusted capital beyond the scope of mudarabah and the limits specified in the contract constitutes a violation of the agreement. This holds true regardless of the charitable, benevolent, or gratuitous nature of such expenditures, as these actions do not align with the objective of mudarabah and do not provide any benefit to the business, resulting in clear harm to the capital. According to Standard 2.4.6., damages arising from the entrepreneur's actions or faults in violation of the contract are borne by the entrepreneur. Therefore, losses resulting from acts such as donations, giving alms, waiving receivables, exoneration, and gratuitous acts that jeopardize the capital will be directly the responsibility of the entrepreneur. It is important to note that small gifts or promotional expenses necessary for business according to commercial customs should be considered outside the scope of this rule.

2.4. Bases for the Rules Related to Profit-Loss Sharing

In mudarabah, profit sharing should be determined proportionally rather than as a fixed amount. This is because the main subject of the mudarabah contract is the profit, and the clarity of the subject matter is a condition for the validity of the contract. Therefore any condition or circumstances leading to uncertainty in the profit-sharing ratio invalidates the mudarabah contract.

The mudarabah transaction is fundamentally based on the principle of profit-sharing from the operation of capital and is inherently rooted in the concept of trade. Commercial transactions carry the possibility of both making a profit and incurring a loss. Therefore, specifying a fixed profit for one of the parties in the contract contradicts the nature of mudarabah (*al-Majallah*, art. 1412). A fixed profit share not only contradicts the essence of the mudarabah contract but also violates the fundamental principle of partnership in profits, which is a natural legal consequence of the contract. Moreover, a fixed profit share can lead to engaging in usurious transactions. Demanding a fixed profit share in addition to the principal at the end of the contract turns the mudarabah arrangement into an usurious transaction. Instead, the distribution of profits should be proportional, with the shares defined in advance, and upon realization of profit, it should be allocated according to these predetermined ratios. The purpose of determining the profit proportionally rather than as a fixed amount in the mudarabah contract is to ensure that the profit can be divided in accordance with the structure of the partnership contract. If the profit in the operation is only equal to the specified fixed amount, then that profit will belong to only one party, leaving the other party deprived. This situation is not consistent with the structure and purpose of the mudarabah contract based on the principle of profit and loss-sharing (al-Kāsānī, *Badāi' al-ṣanāi'*, VI, 80-81, 85-86; Mollā Husraw, *Durar al-ḥukkām*, II, 311; *al-Majallah*, art. 1411, 1412). Specifying a certain proportion of the capital as a condition for receiving a profit share has not been permitted within the scope of the Standard, as it would be tantamount to determining a fixed amount.

Mudarabah is established as a contract through mutual consent of the parties. The profit-sharing ratios within the scope of the agreement are determined by the parties themselves, according to their own will. The profit-sharing ratios determined by the parties when entering into the mudarabah contract can be periodically revised and modified based on the mutual consent and agreement of the parties. Since profit-sharing is fundamental aspect of mudarabah, the ability to adjust profit ratios periodically in response to changing conditions contributes to a fair distribution of profits. Therefore, there is no legal impediment preventing the capital provider and the entrepreneur from renewing the profit ratios during the term of the contract. The conditions set by the capital provider neither undermine the partnership in profit nor lead to disputes between the parties. As long as profit-sharing is maintained, the parties are free to propose such conditions within the scope of commercial practices. This renewal process can also be interpreted as a form of reconciliation. Alternatively, the parties may mutually decide to terminate and renew the mudarabah contract at specific intervals. In this case, each period's mudarabah contract would have an independent nature, allowing the profit-sharing ratio to differ from the previous period.

In a mudarabah contract where profit-sharing ratios are unspecified, these ratios are considered to be determined by customary practices prevalent in the Islamic finance market. If profit-sharing ratios are not explicitly specified, the determination of these ratios based on prevailing market practices among specific individuals and/or institutions in the current market conditions is deemed in accordance with Islamic legal principles. This approach is supported by the Islamic legal principle: *"That which is customarily recognized is deemed as stipulated"* (*al-Majallah*, art. 43). For example, if profit-sharing ratios are not explicitly defined in a mudarabah contract between an Islamic bank and its customer, the average ratios observed in mudarabah transactions with other customers of the respective bank or other Islamic banks could be considered. Furthermore, during the ongoing duration of the contract, both parties possess the right to mutually renegotiate and adjust the profit-sharing ratios. Indeed, either the capital provider or the entrepreneur can reduce the initially agreed-upon profit-sharing ratios (al-Shaybānī, *al-Aṣl*, Beirut, 1433/2012, IV, 248; al-Mawwāq, *al-Tāj wa al-Iklīl*, n.d. VII, 451). The parties' mutual agreement to adjust these ratios is viewed as a consensual settlement transaction. In instances where no established custom or practice exists, the mudarabah contract becomes null. This is because ambiguity regarding the profit that is the subject of the mudarabah contract, renders the contract void. However, if the parties engage in a mudarabah without specifying ratios, expressing something akin to *"Let the profit be shared between us"*, the profit will be distributed equally based on their statements (*al-Majallah*, art. 1411).

As stipulated in Article 2.4.1. of the Standard, requiring any of the partners to receive a fixed amount from the profit, not proportionate to the profit, renders the mudarabah contract invalid. However, as stated in the article, specifying that if the profit exceeds a certain amount, the portion exceeding that amount will belong to one of the partners does not mean that a fixed profit has been determined from the beginning. In this case, no fixed profit has been determined initially, and the stipulation only applies to the portion of the profit that exceeds a certain amount. This transaction is not contrary to the rules of stipulation in Islamic law ('Alī al-Hafīf, *Aḥkām al-mu'āmalāt*, Cairo, 1429/2008, 494; 'Īsā Manṣūr, *Naẓariyyah al-arbāḥ fī al-maṣārif al-İslāmiyyah*, Amman, 2007, 184; Islamic Fiqh Academy's Decision No. 123 (13/5)). If such a condition is stipulated in favor of the entrepreneur, it functions as an incentive bonus.

The final profit-loss calculation is conducted during the liquidation of the partnership. However, in the case of a long-term agreement, making advance payments to meet the parties' needs does not contradict the mudarabah rules. In this situation, if it is subsequently determined at final liquidation that a profit has been realised, the advance received is set off against the share due to the party that received the advance. If it is determined that a loss has occurred, the amount paid to the entrepreneur is subject to the rules of *qarḏ* (interest-free loan). It is crucial not to confuse the advance payment made to the capital provider in this context with the issue of reclaiming a portion of the capital, regulated in Article 2.2.5. of the Standard. Reclaiming a portion of the capital by the capital provider, with the consent of the entrepreneur, results in the termination of the contract concerning the reclaimed portion while continuing with the remaining portion. However, if the capital provider receives an advance payment in the nature of prepayment, it is considered a prepayment made based on the assumption that some profit has been earned on the business.

Mudarabah is a partnership based on the collaboration of labor and capital, where the entrepreneur risks his effort, and the capital provider risks his capital, anticipating the possibility of the entrepreneur not making a profit or incurring losses. The entrepreneur is not obligated to bear the burden of losses unless there is negligence on his part or a violation of contractual terms. In the event of losses, the entrepreneur will not receive any compensation for his efforts. It is not permissible to include a provision in the contract that assigns the loss, in whole or in part, to the entrepreneur contrary to this principle (Ibn Qudāmah, *al-Mughnī*, V, 28; Mollā Husraw, *Durar al-ḥukkām*, II, 312).

Mudarabah, being based on trust and agency, the capital delivered to the entrepreneur is considered as a trust in his hands (Shaykhīzādah, *Majma' al-anhur*, Beirut, n.d., II, 332). If the entrepreneur fails to comply with the contractual limits and deliberately exceeds his authorized scope, he assumes the risk of any resulting losses. The act of the entrepreneur making unauthorized transactions with the capital, transforms his custodianship over the capital into wrongful possession. In such a situation, the possession of the capital becomes subject to the rules of usurpation, including the regulations on misappropriation, in classical fiqh literature. If the entrepreneur did not engage in transactions with the property, he will be obliged to return it. In case of destruction or consumption of the property, he will be responsible for compensation (al-Sarakhsī, *al-Mabsūt*, Beirut, 1414/1993, XXII, 19; al-Marghīnānī, *al-Hidāyah*, III, 200). The principle *"Those who take responsibility for compensation deserve the rewards"* implies that the party assuming compensation responsibility is entitled to the profit. However, it was noted in the rationale of Article 2.3.3. that the view of the Maliki school on this matter was preferred.

The allocation of the burden of proof regarding the manager's compliance with the contract terms and the existence of any fault can be stipulated by the parties in the contract.

In the inherent nature of commerce, even if the entrepreneur fulfills all responsibilities and complies with contract terms, there may be no profit, and the business may incur losses. In such cases, since the entrepreneur willingly accepted this risk, he cannot demand compensation for his efforts. The sole income the manager can obtain is the share of profit as agreed upon in the contract in the event of making a profit (al-Sarakhsī, *al-Mabsūt,* Beirut, XXII, 27; al-Kāsānī, *Badāi' al-ṣanāi'*, VI, 86).

Persons with full legal capacity can make donations to individuals or institutions of their choice. Waiving a share of the profit and assuming the loss by the entrepreneur can also be considered as a form of donation. However, if these acts, which have the nature of a donation, are stipulated as a condition in the mudarabah contract, the quality of being a voluntary gift may be compromised. Considering the legal relationship between the donor and the recipient of the donation, it is essential to avoid these acts of waiving the profit and assuming the loss from being considered as a maneuver to bypass certain prohibitions in the principles and standards of Islamic finance. Such conditions should not be stipulated in the contract, promised, or turned into a customary practice by the donor.

The waiver of profit, if stipulated or promised in the contract, raises doubts as to whether it is a waiver based on consent and free will. As mentioned earlier, mudarabah is a contract where the entrepreneur risks his labor and time, and the capital provider risks his capital and time. Due to various reasons, either the capital provider or the entrepreneur may have joined this partnership with an expectation of a certain amount of profit, but despite both parties fulfilling their obligations, the profit may fall below expectations. In such a situation, the parties cannot impose a condition demanding a certain percentage or amount of profit from the other party to elevate the earned income to their expected level. They cannot request such a commitment, nor can they make waiving of this profit as a customary practice to induce the other party into such an expectation (al-Zayla'ī, *Tabyīn al -ḥaqāiq*, V, 54). Any behavior contrary to this would imply securing the risked capital and labor, which is not in line with the principles and standards of interest-free finance.

In cases where the entrepreneur is not at fault and there is no negligence, there is no obligation to compensate for the loss incurred in the capital (Shaykhīzādah, *Majma' al-anhur*, II, 324). However, provided that assuming the loss is not a precondition, is not promised, and is not made customary by the entrepreneur, the entrepreneur may voluntarily assume part or all of the loss as an act of goodwill.

Mudarabah is a contract that necessitates risk-taking by both parties; therefore, it is contrary to the spirit of this contract for the assumption of loss by the entrepreneur to become customary.

A capital provider engaging in mudarabah with knowledge of such customs cannot ignore this, and inevitably, there may be an expectation on his part that the entrepreneur will similarly assume a loss in the newly established mudarabah contract.

Indeed, as stated in Article 44 of *al-Majallah, "Whatever is customary among merchants is deemed as if it were stipulated among them"*. Therefore, the practice of assuming a loss as a customary agreement would become one of the conditions of the contract.

2.5. Bases for the Rules Related to the Collateral

In a mudarabah partnership, the responsibility of the entrepreneur is to manage the capital with due care, as stipulated in the contract (*al-Majallah*, Art. 1420). Therefore, as a principle, the manager does not participate in material losses arising from the operation of the capital. However, if the entrepreneur acts contrary to the contract or is at fault, in such cases, he is obligated to compensate for material damages resulting from the fault. Collateral may also be obtained for things eligible for compensation.

Essentially, collateral designated for compensating damages due to fault or breach of contract may be liquidated into cash during the mudarabah's liquidation. This occurs if the entrepreneur fails to distribute the capital and profits to the capital provider as stipulated by the contract terms.

2.6. Bases for the Rules Related to the Termination of Mudarabah

If the capital is depleted, it is obvious that the mudarabah will be terminated as there will be no business to continue the mudarabah. As stated in article 2.2.4 of the Standard, mudarabah is a contract based on an agency relationship. Should one of the parties pass away, lose legal capacity, or, in the case of a party being a legal entity, its legal personality ceases to exist, the legal relationship between the parties will be terminated. (al-Kāsānī, *Badāi' al-ṣanāi'*, VI, 78; al-Marghīnānī, *al-Hidāyah*, III, 206).

The death of the entrepreneur leads to the termination of the mudarabah contract, as there is no successor continuing the arrangement. Likewise, the death of the capital provider ends the agency relationship, leading to the discontinuation of the mudarabah. Following the death of the capital provider, legal transactions on his behalf become unfeasible. Therefore, the mudarabah does not automatically extend to the heirs upon the death. Similarly, the loss of legal capacity results in the termination of the legal relationship, as it hinders the ability to engage in new legal transactions. Nevertheless, with unanimous consent of all heirs of the deceased, the existing mudarabah contract may be continued.

Mudarabah, being subject to a specified duration, concludes when the agreed-upon period expires. Similarly, if mudarabah is conditional upon a specific terminating event, the contract terminates when the event occurs (al-Zayla'ī, *Tabyīn al -ḥaqāiq*, V, 60; al-Ḥaṣkafī, *al-Durr al-Mukhtār*, Beirut, 1423/2022, 546; 'Alī Ḥaydar, *Durar al-ḥukkām*, III, 454).

In the mudarabah, the legal relationship between the parties is established on the bases of agency, granting either party the option to unilaterally terminate the contract at their discretion. In Islamic law, contracts such as these are considered non-binding. This is due to the mutual trust between the parties and the assumption of responsibilities based on the initially agreed contract terms. Given that termination can impact the legal rights of the other party, it is incumbent upon the party initiating the termination to inform the other party. (al-Kāsānī, *Badāi' al-ṣanāi'*, VI, 109). The entrepreneur continues to manage the capital until he becomes aware of the contract's termination. The legal consequences of termination come into effect once the counterparty is notified (al-Marghīnānī, *al-Hidāyah*, III, 206).

Mudarabah, as a non-binding contract, allows the parties to terminate the agreement at their discretion. However, this flexibility does not permit termination in a manner that adversely affects the other party. The party terminating the contract at an inappropriate time, considering the nature of the work performed, is obligated to compensate the other party for any consequential damages. Consequential damages include actual losses incurred due to the non-fulfillment of a promise that was expected to be adhered to and fulfilled, as well as incidental damages resulting from public obligations, communication, travel, notary expenses, penalties paid to the seller, compensation, down payments, expenses related to returns, litigation costs, etc. *al-Majallah* art. 19, *"No harm shall be inflicted or reciprocated"* prohibits causing harm through contract violations and wrongful acts. Additionally, it emphasizes that the rights and powers permitted by law cannot be used limitlessly and should be exercised with care to avoid negative consequences for other individuals. In this context, in a mudarabah contract, the parties cannot use their termination rights in a manner that would harm their partners. After the establishment of the business-capital relationship, the termination of the contract by one of the parties without a justifiable reason would result in the loss of time and effort, or time and capital for the other party in a matter where they are not at fault. Islamic law, as mentioned earlier, prohibits the abuse of authority and rights to harm others and, in such situations, provides measures and remedies to address the damages and hardships suffered by others. The principle of *al-Majallah* art. 20, *"Harm must be eliminated"*, indicates that, in general, harm has to be eliminated. It implies that individuals are not only responsible for compensating for harm caused by unjust actions but also for damages resulting from not respecting legal limits while exercising their rights. In such circumstances, the party exercising the termination right bears the resulting losses.

When termination is executed with the consent of the counterparty, it constitutes a settlement (*iqālah*), relieving the terminating party of the obligation to compensate for damages. However, if one of the parties terminates the contract due to the fault or breach of the other party, the party terminating the contract is not obligated to compensate for damages. The counterparty, due to the presence of a fault, is considered to have failed to act in accordance with the requirements of the contract; therefore, the right to terminate the contract naturally arises for the aggrieved party. Consequently, the aggrieved party is not obligated to compensate for any incurred damages.

In the liquidation phase, to determine the financial position of the partnership in terms of profit and loss, the first step is to determine the amount of cash assets, if any, in the mudarabah. Subsequently, the cash equivalents of non-cash assets within the scope of the partnership are determined. Deferred and uncollected receivables are then added to this amount. Debts and expenses related to the mudarabah are deducted from the total amount, revealing the net profit. If there are any future developments, such as the emergence of taxes or penalties or the discovery of new assets, the previous liquidation will be updated accordingly. In the literature, the process of converting mudarabah assets into cash through actual sales is referred to as "actual liquidation". Conversely, the assessment of asset values without an actual sale and the identification of their monetary equivalents is termed "constructive liquidation".