Deutsche Bank Academic Paper

# Pioneering Innovative Shari'a Compliant Solutions

A Passion to Perform.

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In comparison with conventional financial markets, until relatively recently there have been few Shari'a-compliant investment products which can offer investors:

1 access to other asset classes (such as commodities, fixed income or hedge funds)

2 different pay-offs (such as capital guarantees, range accruals)

3 liquidity (transferable at market value)

Deutsche Bank AG ("DB") has developed an investment structure intended to facilitate the issuance of Shari'a-compliant securities overcoming these issues (the "Structure"). The Structure utilises research provided by Dar Al Istithmar Limited ("DI"), a Shari'a consultant partly owned by DB, and has been approved by the Shari'a supervisory committee of DI (the "Shari'a Board").[1] In addition, Islamic scholars of a number of other banks and financial institutions have approved the Structure. The purpose of this document is to summarise some of the relevant features of the Structure.

The Structure enables the issue of Shari'a compliant securities (such as certificates) referenced to the performance of a wide range of potential underlying reference assets, whether shares, indices, other securities, fund shares, commodities, foreign exchange rates and/or other assets (the "Securities"). The Securities are issued by Deutsche Bank AG, and may reflect the performance of the underlying reference asset on a delta-one basis (i.e., track such underlying reference asset exactly) or alternatively reflect certain structuring features (such as maximum upside caps). In the opinion of the Shari'a Board, however, the Structure cannot be used to offer capital protected Shari'a-compliant investment products and therefore DB has developed a variation of the Structure for use in connection with such capital protected products.[2] In addition, the Structure permits the structuring of investment products providing that periodic distributions be paid to investors.

In this paper, we will briefly introduce the Structure (parties, contracts, economic effects) and analyse its Shari'a aspects in detail.

# The Structure

## The Relevant Documents

1 Prospectus

2 Investment Management Deed Poll

3 Unilateral Promise ("Wa'd") to Sell a Basket of Shares

4 Unilateral Promise (Wa'd) to Purchase a Basket of Shares

5 Shari'a Monitoring Agreement

## The Parties

In relation to the investor, DB's principal role is as issuer of the relevant Securities described in the Prospectus. In order for the relevant Securities to be approved as Shari'a-compliant, the Structure must be established and therefore Deutsche Bank needs to enter into the other documents specified above. DB therefore is required to:

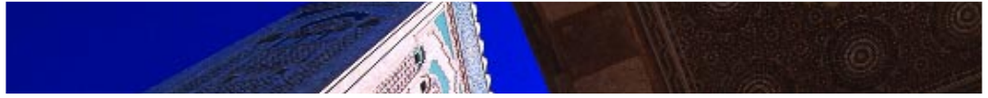
**(a)** enter into the Investment Management Deed Poll for the benefit of investors in the relevant Securities (the "Investors") (the "Deed Poll"). Pursuant to the Deed Poll, DB undertakes to Investors to, among other things, act as Investment Manager and credit amounts provided by the Investors (the "Commitment Amounts") to a separate account, and use such amounts to purchase Shari'a compliant assets ("the Shares");

**(b)** in its capacity as Investment Manager, appoint DI as its Shari'a Monitor in accordance with the Shari'a Monitoring Agreement;

**(c)** enter into the relevant promise (Wa'd) arrangements with the Islamic Account, and, where applicable, enter into transactions on the terms of either the Wa'd Share Purchase Agreement or the Wa'd Share Sale Agreement; and

**(e)** act as Calculation Agent in respect of the relevant Securities to calculate any profit or loss to the Investors in respect of the relevant underlying asset in accordance with the terms of the relevant Securities (as set out in the Prospectus).

[1] The biographies of the scholars of the Dar Al Istithmar Shari'a Board can be found in Annex 1.
[2] The reasons for this are given in "The Derivatives Aspect" section on p 4.



## The Structure

In accordance with the terms of the relevant Prospectus, DB issues Securities to Investors upon receipt of their relevant Commitment Amounts and DB credits such Commitment Amounts in respect of each product into a separate account (the "Islamic Account").[3] The Islamic Account is separate from other DB accounts and assets held therein remain separate from other DB assets. DB operates the Islamic Account in its capacity as Investment Manager pursuant to the Deed Poll. The Investment Manager then uses the Commitment Amounts in the Islamic Account to purchase Shari'a-compliant assets (at prevailing market prices and in consultation with the Shari'a Monitor). In most cases the assets will be shares selected from a Dow Jones Islamic benchmark or shares that qualify applying the same screening as used by Dow Jones to obtain their Islamic universe.

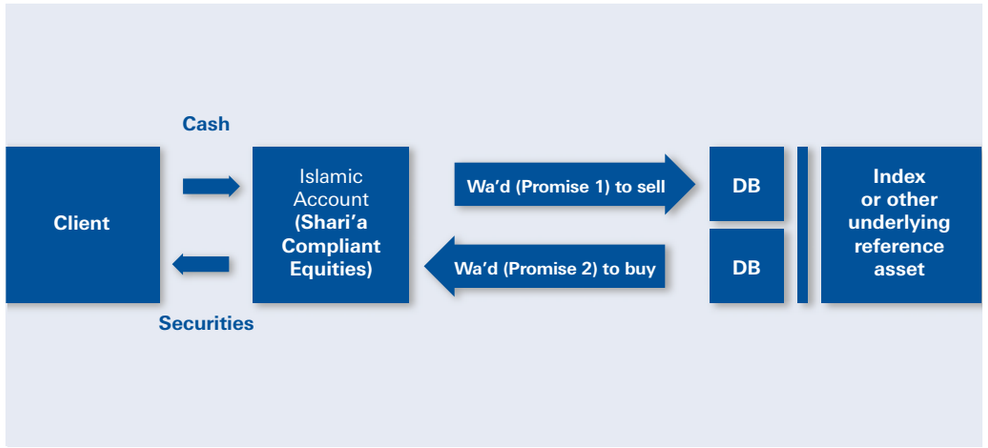
The Investors will receive a profit or loss on their investment in the Securities based on the performance of the specified underlying reference asset or index (the "Reference Asset" or "Index") rather than the performance of the Shares in the Islamic Account.

In accordance with the relevant promise (Wa'd) arrangements, the Islamic Account gives a unilateral promise to DB ("Promise 1") to sell a number of Shares (the "Relevant Shares") selected from a basket (the "Basket") at a predefined price (the "Settlement Price") and DB gives a unilateral promise to the Islamic Account ("Promise 2") to buy the Relevant Shares at the Settlement Price.

The purpose of Promise 1 or Promise 2 is to enable the exchange, upon settlement of the Securities, of the Relevant Shares for the cash amounts required to be paid to Investors in respect of the Securities at such time.

It is worth noting that as Promise 1 and Promise 2 are mutually exclusive (only one of either the Wa'd Share Sale Agreement or the Wa'd Share Purchase Agreement will be executed in accordance with the relevant notice), they can be entered into between the same counterparties.

Following receipt of the relevant notice to perform the obligations of either Promise 1 or Promise 2 (the "Notice"), the Islamic Account and DB shall be deemed to enter into an agreement on the terms of the form of either the Wa'd Share Sale Agreement or the Wa'd Share Purchase Agreement, as applicable, and including the details set out in the Notice.




[3] Please note that although the account is held by DB, it is necessary for Investors to have rights in respect of this account (which may be provided using a trust structure or through the involvement of separate legal vehicles).



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The Settlement Price is determined in the following way:

| | |
|---|---|
| **Settlement Price:** | $\text{Final Reference Level} \left(1\text{-Fees}^* \frac{\text{Days}}{365}\right)$ / Initial Reference Level / $\text{Basket}_0{}^*$ |
| **Where:** | |
| **$\text{Basket}_0$:** | Price of the Basket at $t_0$, i.e. the date of the Promise or if not a trading day, the first trading day thereafter. |
| **Initial Reference Level:** | The closing level of the Index on the date of the Promise. |
| **Final Reference Level:** | The closing level of the Index on the date of the sale of the Basket. |
| **Days:** | Number of days between when the Final Reference Level and the Initial Reference Level are determined. |
| **Index:** | Determines the price of the Basket and can be any financial reference. |
| **Redemption Value:** | Notional Amount |

## The Economic Effect

The economic effect of the Structure is as follows:

**Scenario I:** The value of the Relevant Shares goes up more than the performance of the Reference Asset:

In this case, DB can purchase the Relevant Shares from the Islamic Account at a price lower than the market value for such Relevant Shares at that time. DB would hold the Islamic Account to its promise given under Promise 1.

The Islamic Account will not be interested in holding DB to its promise given under Promise 2 as selling a Basket of Shares at a value which is lower than the market value at that time would incur a loss.

**Scenario II:** The value of the Relevant Shares goes up less than the performance of the Reference Asset:

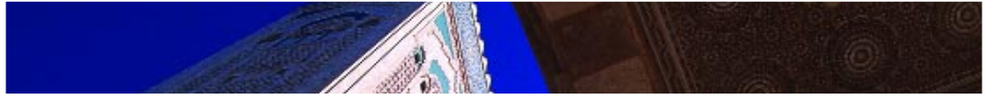
In this case, DB can purchase the Relevant Shares from the Islamic Account at a price higher than the market value for such Relevant Shares at that time. However, as this would incur additional expense, DB will not hold the Islamic Account to its promise given under Promise 1.

On the other hand, the Islamic Account will be interested in holding DB to its promise given under Promise 2, as it can then sell the Relevant Shares in the Basket at a value higher than the market value for such Relevant Shares at that time.

Therefore, in both Scenario I and Scenario II noted above, the Islamic Account will sell the Relevant Shares to DB in return for the Settlement Price as determined on the basis of the performance of the Reference Asset or Index. Any such sale would effectively be a transfer from the Islamic Account to a DB conventional account.

## An Example

An Investor invests USD 100 million (Notional Amount) in DB-issued Securities, which DB credits to the Islamic Account and uses such amount to purchase Shari'a compliant Shares with a value of USD 100 million. The Islamic Account promises to sell the relevant Shares to DB prior to the maturity date of the relevant Securities at a price (the relevant Settlement Price as noted below) benchmarked to the performance of the underlying reference asset (in this case let us assume the Dow Jones Industrial Index™).



The exact formula agreed would be:

| | |
|---|---|
| **Settlement Price:** | $\text{Final Reference Level}\left(1\text{-Fees}^{*}\frac{\text{Days}}{365}\right)$ / $\text{Initial Reference Level}$ / $\text{Basket}_0^{*}$ |
| **Where:** | |
| **Price of the Basket at $t_0$:** | USD 100 million (i.e. Notional Amount). |
| **Initial Reference Level (IRL):** | The closing level of the Index on the date of the Promise. |
| **Final Reference Level (FRL):** | The closing level of the Index on the date of the execution of the sales transaction of the Basket. |
| **Fees:** | Assume 0 |
| **Days:** | Number of days elapsed between when the IRL and the FRL is determined. In our case 365 days. |
| **Redemption:** | USD 100 million (i.e. Notional Amount). |
| **Index:** | Dow Jones Industrial Index |

DB would also promise on the same day to purchase from the Islamic Account within the maturity from the date of such purchase the same Shares at the same Settlement Price (benchmarked to the Index).

As a result, suppose:

**Scenario I:** The Index goes up from the current level (assume 100) to 110 within one year from now (10% increase in value) and the value of the Shares in the Basket decreases from USD 100 million now to USD 90 million in a year from now (10% decrease in value).

The Settlement Price can be calculated as (USD 100 million * 110/100) = USD 110 million.

In this case DB can purchase from the Islamic Account (since the Islamic Account has promised to sell) Shares worth USD 90 million at a price of USD 110 million. Clearly in these circumstances, DB would NOT hold the Islamic Account to its unilateral promise.

The Islamic Account would, however, hold DB to its promise as it can sell the Shares (since DB has promised to purchase them) at a price of USD 110 million while the Shares are only worth USD 90 million.

So, the Islamic Account will sell its shares to DB at a price of USD 110 million.

**Scenario II:** The Index falls from the current level (assume 100) to 90 within one year from now (10% decrease in value) and the value of the Shares in the Basket increases from USD 100 million now to USD 110 million in a year from now (10% increase in value).

The Settlement Price can be calculated as (USD 100 million * 90/100) = USD 90 million.

In this case DB can purchase from the Islamic Account (since the Islamic Account has promised to sell) Shares worth USD 110 million at a price of USD 90 million. Clearly, DB will hold the Islamic Account to its unilateral promise as it can make a profit by buying the Shares from the Investor at USD 90 million and selling them in the market at USD 110 million.

The Islamic Account will NOT hold DB to its promise as it would lose money if it sold the Shares (DB promised to purchase) at a price of USD 90 million while the Shares are worth USD 110 million on the market.

So, the Islamic Account will sell its Shares to Deutsche at a price of USD 90 million.

### The Derivatives Aspect

In addition to delta-1 investment products, the Structure also works for all products or cashflows (specified by coupon dates or at maturity) that have an option type of pay-off. As has already been mentioned, however, it does not work for capital protected products. This is due to the fact that the arrangement or relationship between the Investors and DB is based either on *wakala* (agency), where DB is *wakil al-istithmar* (investment agent), or on *mudaraba*, where DB is *mudarib* (investment manager). Under Shari'a law, a *wakil* (agent) cannot guarantee the capital of the principal (absent fraud, negligence, etc). Similarly a *mudarib* cannot guarantee the principal of the *rabb al-mal* (capital provider). If a *wakil* or *mudarib* do so, the capital will be considered a loan and the rules relating to loans will apply. One of the rules is that loans/debts can only be transferred at par (according to the majority of jurists). Thus the reclassification of the capital as debt will make the Securities illiquid.

Outperformance options are not generally considered to be Shari'a compliant from a legal perspective. However, from an economic/derivative perspective, the Promises can be viewed as outperformance put or call options paying the outperformance of one asset (the Shares) versus another asset (the Index). It can be proven[4] that at all times the change in value of the Islamic Account (i.e. the Shares, Promise 1 and Promise 2) is equal to the change in value of the Index. Therefore at all times (such as, for example, in the secondary market) the value of the Islamic Account (and hence the relevant Securities) will reflect the value of the Index.

## The Shari'a Related Issues

Essentially the technique that DB has developed is the Shari'a equivalent of a total return swap.[5] Obviously, a conventional swap is a non-Shari'a compliant product and as such the technique DB uses has the same economic result as a total return swap but is structured differently. In essence we arrange for the client to invest in liquid Shari'a compliant assets (Shari'a-compliant equity shares) and we "swap" away his return (total return swap) for another return (for example a hedge fund linked return). As the investment of the client is Shari'a-compliant (since he only invests in Shari'a-compliant assets) and as the swap transaction is conducted in a Shari'a-compliant manner, we have found a Shari'a-compliant method to make an investment pay-off (or exposure to an asset class) that would not normally be Shari'a-compliant.

### Dissecting the Structure

As simple as the technique appears to be, it has been carefully constructed following extensive research, both internally and through commissioning research reports from leading scholars and universities. In putting together the Structure, a number of Shari'a related issues had to be addressed. The main ones are:

1. Promises and contracts in the Shari'a;
2. The permissibility of compensation for failure to fulfil a promise;
3. The validity of promising to sell an asset at a price other than the market price and which is not known at the time of the promise. Related to this is the validity of promising to sell or selling an asset at a price benchmarked to the performance of a different asset or index.

### Promises and Contracts in the Shari'a

It is generally accepted that a unilateral promise creates a moral obligation and it is advisable for the promisor to observe it. Its violation is reproachable. The majority of classical jurists uphold that fulfilling this promise is neither mandatory nor enforceable through courts.[6]

More recently, it is Chehata who seems to have introduced the idea that in Islamic law a promise is not legally binding.[7] Others argue that promises in Islamic law are like social promises in common law, which may have moral force in that breaking such promises may provoke opprobium, but which do not entail legal obligation or legal sanction for non-fulfilment.[8]

If promises are binding in Islam at a moral level, why is it that to the earlier jurists they were not legally enforceable, especially in relation to commercial dealings? After all, in canon law, a promise was enforceable: the *ratio peccati* was added to the *ratio delicti* and thus the obligation of conscience resulting from a promise was converted into a legal obligation.[9]

[4] The mathematical proof for this can be found in Annex 2.

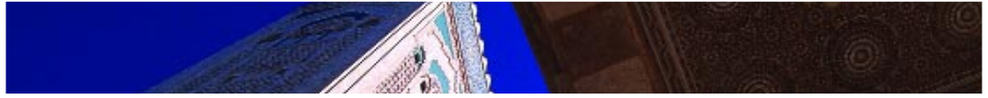
[5] The combination of an outperformance put and call with the same strike is indeed a total return swap.

[6] al-Ghamrawi, *al-Siraj al-Wahhaj 'Ala Matn al-Minhaj li al-Nawawi*, p 243; and also Ibn Hazm, *al-Muhalla*, vol. 8, p 377.

[7] C. Chehata, "Le Concept de Contrat en Droit Musulman", 13 *Archives de Philosophie du Droit* (1968) 129, 136.

[8] F.E. Vogel and S.L. Hayes, *Islamic Law and Finance: Religion, Risk and Return* (The Hague, 1998) 125.

[9] For a further discussion of this issue see C. Chehata, "Le Concept de Contrat en Droit Musulman" (1968) 13 *Archives de Philosophie du Droit* 129.



We remember that in Islamic law, a simple promise seems to be different from a contract in that a contract is always effective in the present, while the simple promise seems to involve the future. Nothing actual or tangible is fulfilled by the act of promising. Rather, an obligation to do arises on the part of the promisor at a purely moral level, as there is no object in actual existence at the time of promising. Thus, Islamic law does not recognise a contract which has as its object a future thing, or an agreement to agree, or the exchange of an obligation for an obligation (*bay'al-dayn bi al-dayn*).[10] In fact the contract of hire (*ijâra*), in so far as it concerns an object which is fulfilled as and when it is used, was only admitted as an exception. Similarly, *bay'salam* (forward purchase) and *istisnâ'*(contract of manufacture), both of which are contracts where one of the counter values is absent at the time of contracting, are only allowed where an exact description of the absent counter values is given.[11] This failure, nay, stubborn refusal to give any legal weight to the promise in contracts is an inevitable result of the prohibitions on *riba* and *gharar*. The need to ensure that all transactions are free from these prohibitions means that it is necessary, whenever a transaction involves the exchange of two counter values: "(a) that exchange, if it has to take place under conditions which could result in *riba al-nasi'a* (*riba* by way of deferment), should be concluded immediately, and (b) these counter values must be in existence, in their essence at least, and known to the contracting parties."[12]

We will argue that this early view is incorrect because it is based on two failures. The first is the failure to distinguish between the enforceability of promises because they are promises (i.e. bare promises) and the enforceability of promises on the basis of some other value. Elsewhere, DB has shown that in Islamic law a promise is ***legally*** enforced not because it is a promise as such, but because doing so protects the values of commutative justice and liberality.[13] This, however, does not mean that the source of the obligation is therefore commutative justice or liberality. The law will normally intervene on behalf of these two values only after a promise has been made and not in the absence of a promise.

The second failure is the lack of a clear definition of promise and what distinguishes promise from contract in the work of early jurists, and the consequent confusion among later scholars. Confusion is evident in the agreement of all those who write on contracts in Islamic law all of whom argue that consent is a requirement, indeed a pillar, of the law of contract. At the same time most of them also argue that promises are not binding.[14] They take no notice at all of the very close relationship between consent and promise, a relationship so close that one may say that promising may be reducible to a species of consent.[15] Had they taken notice of this relationship they would surely have realised that promises, which they say are not legally enforceable, are narrower than consents, which they say are legally enforceable. Consent is a broader and more basic source of obligation. The failure to articulate clearly the concepts of consent and promise is the basis of the assertion that the one clear distinction between contract and promise is that the latter is not enforceable. This may be true only if one means that the jurists say that bare promises are not contracts and are not legally enforceable. In an extended analysis of consent, Qaradaghi has recently shown that, for the majority of jurists, contracts are the most serious types of promises.[16] This is in effect saying that not all promises are enforceable, but some are.

In fact, in relation to commercial dealings the matter was resolved by the Islamic Fiqh Academy, Jeddah. After discussing the issue, they declared that the fulfilment of a promise made in commercial transactions is obligatory, not only in the eyes of God, but also in a court of law with the following conditions:

1 It should be a unilateral promise.

2 The promise must have caused the promisee to incur some liabilities.

[10] N.A. Saleh, "Financial Transactions and the Islamic Theory of Obligations and Contracts" in *Islamic Law and Finance* (ed. C. Mallat, 1988) 13-29, 22.

[11] ibid.

[12] ibid at p 22.

[13] See H. Hassan, "Islamic Contract Law: Between Commutative Justice and Liberality", 13 (3) *Journal of Islamic Studies* (2003).

[14] S.E. Rayner, *The Theory of Contracts in Islamic Law* (London, 1991) 174. For the Shi'i position see P. Owsia, *Formation of Contract: A Comparative Study under English, French, Islamic and Iraninan Law* (London, 1994).

[15] P.S. Atiyah, *Promises, Morals and Law* (Oxford, 1981) 177-184.

[16] A. Qaradaghi, *Mabda al-Ridha, fi al-'Uqud* (Beirut, 1985) esp vol. 1, 105-134.





3 If the promise is to purchase something, the actual sale must take place at the appointed time by the exchange of offer and acceptance. A mere promise itself should not be taken as the concluded sale.

4 If the promisor backs out of his promise, the court may force him either to purchase the commodity or pay actual damages to the seller.[17]

The *Wa'd* in the Structure are structured to conform to this resolution of the Islamic Fiqh Academy. They are also structured to be unilateral in nature as they are each given by one party only and they are each based on different conditions. The condition that the promise should be unilateral is there because bilateral promises are contracts, or like contracts, and would therefore be invalid unless they satisfy the conditions that are normally required for contracts. These include knowledge of the price plus possession or ownership of the subject matter of the promises/contract.

Nevertheless, given that the binding character of the unilateral promise is a cornerstone of the Structure, we think it worthwhile to look at the issue in more detail. The Academy has alluded to the idea that promises are binding as a matter of faith and also legally binding without indicating whether the basis of them being legally binding is also to be found in faith or in something else. This could be the need to prevent harm or reward reliance as they base the damages for breach of promise on actual damages, which is a way of ensuring that harm is compensated.

We therefore propose to look at the issue in more detail seeking to answer the following questions: (1) what exactly is a promise in Islam and how is it unique (or the nature of promise)? (2) are promises binding and if so why (or the obligation to keep a promise)? (3) are all promises ***legally*** enforceable and if not, which ones are and why (or the different nature of contract)? In a previous article,[18] we have dealt with the third question, and will therefore limit the discussion to the first two.

## The Nature of Promise[19]

In Arabic the most common words used for the idea of promise are *'ahd* and *wa'd*. *'Ahd* has many meanings[20] the most common of which are promise, covenant, pact, pledge, vow, oath, treaty, agreement. All these words convey the idea of commitment or obligation hence Schacht says it means an "injunction, command; thence: obligation, engagement; thence agreement, covenant, treaty."[21] (He also says: "the basic concrete concept is "joining together", whereas the synonym *'akd* derives from the concrete idea of "binding." In later usage, the latter term is commonly used of civil engagements and contracts, whereas *'ahd* is generally restricted to political enactments and treaties …") *Wa'd* also has a number of meanings but the most common are to promise, pledge or firmly intend.[22] Both terms occur frequently in the Qur'an.[23]

This distinction between a contract (*'aqd*) and a promise (*wa'd*) is also found in juristic literature, even though one finds no precise definition of promise in the treatises of the law.[24] What is clear is that to the early jurists a contract was legally binding while a promise was not.[25] The promisor is not bound to complete his undertaking even if the promisee has already signified his acceptance. The exception concerns the vow and the promise made under oath. However, this type of promise is binding in religion only and not in law (*qada'*), and even then, the oath may be broken, for good reason, and an expiation made in its place.[26] A promise cannot be enforced even though all jurists are agreed that the failure

[17] Resolution no. 2, and 3 of the Fifth Conference of the Islamic Fiqh Academy held in Kuwait, 1409 H. See *Majallat Majma' al-Fiqh al-Islami*, no. 5, vol. 2, p 15998.

[18] H. Hassan, "Islamic Contract Law: Between Commutative Justice and Liberality", 13 (3) *Journal of Islamic Studies* (2003).

[19] This section benefits immensely from the very lucid account provided by Pall S. Ardal in "Ought We to Keep Contracts because they are Promises" 17 *Valparaiso University Law Review* (1983) 655 and J. Raz, "Voluntary Obligations and Normative Powers II", in 46 (suppl. vol.) *Proceedings of the Aristotelian Society* (1972) 79; "Promises and Obligations", in P. Hacker and J. Raz (eds) *Law, Morality and Society: Essays in Honour of H.L.A. Hart* (Oxford, 1977) 210 and "Promises in Morality and Law", 95 *Harvard Law Review* (1982) 916.

[20] See Lane, *Lexicon*, vol. 1, pp 2182-2184 and H. Wehr, *Arabic-English Dictionary* (ed. J.M. Cowan, 4th edition, 1994) pp 763-764.

[21] J. Schacht, "'Ahd" in *Encyclopaedia of Islam* vol. 1 p 255.

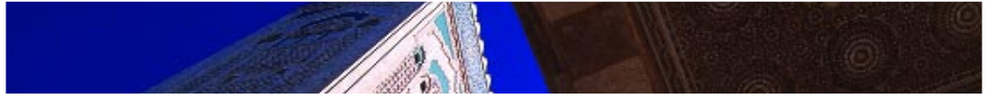
[22] See H. Wehr, *Arabic-English Dictionary* (ed. J.M. Cowan, 4th edition, 1994) 1266-67.

[23] The number of verses that mention promising in the Qur'an usually using either of these two words is about 125. See J. Carson, K. El-Fadl and F. Walker, *An Exhaustive Concordance of the Meaning of Qur'an* (Baltimore, 2000) pp 636-637.

[24] C. Chehata, "Le Concept de Contrat en Droit Musulman" (1968) 13 *Archives de Philosophie du Droit* 129, 136.

[25] See F.E. Vogel and S.L. Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (1998) 125.

[26] See al-Misri, *Reliance of the Traveller* (1997) 623.



to perform a promise is reprehensible at the moral level.[27] The parallel in Western legal systems would be the social promise, which, when broken, may be cause for disapproval but is unenforceable.

There is no doubt that within an Islamic ethos promises are regarded as binding. In his Ihya', the great theologian al-Ghazali (d.1111) quotes Ahadith which demonstrates this.[28] He concludes that making a promise without intending to keep it is a sin. So too is the failure to keep it out of the provocation of the carnal soul. The failure to keep a promise is not a sin only where such failure is due to some unavoidable necessity. Clearly what is more pertinent for our discussion is whether the failure to keep a promise should be liable to legal sanction. To fully pursue this discussion, we have recourse first to reflections on the subject in contemporary philosophy.

Why should contemporary philosophical reflections have any bearing in a quest to understand the nature of promises in Islamic law?

To begin with, there is no reason to expect the ***nature*** of promises in Islam to be so culture-specific that modern reflection could have no bearing. By contrast there are grounds for expecting that the ***reasons*** that explain why one feels bound to keep a promise are culture-specific. Nevertheless the fact that the reasons are culture-specific does not mean that those in one culture are not helpful in understanding the reasons in another. More generally, keeping in mind the nature of the readership of this paper, if appropriate tools to do a job within the Islamic context are only available outside that context, it makes no sense to deny oneself the use of them without some very good reason. This point was famously made by, again, al-Ghazali:

*"If they [i.e. the statements of the philosophers] are reasonable in themselves and supported by proof, and if they do not contradict the Book [i.e. the Qur'an] and the Sunna, then it is not necessary to reject them. If we open this door, if we adopt the attitude of rejecting every truth that the mind of a heretic has apprehended before us, we should be obliged to reject much that is true."*[29]

As we have not come across the work of any Islamic thinker in which the nature of promises is adequately discussed, either directly or obliquely, we have availed ourselves of a discussion which, although outside the Islamic milieu, appears to us to be helpful in explaining promises within the Islamic milieu.

There are two main conceptions of the nature of promise in contemporary philosophy: the "intention" conception of promises and the "obligation" conception of promises.[30] Under the "intention" conception of promises the central feature of a promise is a communication of a firm intention to do something or to act in a certain way when one knows or is aware that this may be relied on by the addressee or promisee or when the promisor intends to induce such reliance or at least to encourage it. On the other hand the central feature of the "obligation" conception of promises is the intention to undertake, by that very act of communication, an obligation to do something or to perform a certain action and to give the promisee the right to the performance of this action. These two conceptions are easily confused by those not trained in philosophical disciplines and thus some elaboration is called for.[31]

It is suggested that the "intention" conception brings in the principle of estoppel. This means that if the promisee has actually relied on the communication, the promisor must avoid harming him by not performing. However, for estoppel to apply, actual detrimental reliance is necessary.

Under the "obligation" conception, the promisor communicates to the promisee the belief that he, i.e the promisor, knows that he will be under an obligation and that he in fact wishes to be so obligated just by communicating this intention to the promisee. This intention can be communicated in a number of conventional ways and in turn these conventions help in deciding which acts can reasonably be taken to communicate the intention to undertake an obligation and to confer a right to the promisee for the performance of the obligation. None of this should be taken as a denial of the fact that the intention to undertake an obligation can be expressed even in a society which does not have or does not recognise the practice of promising.

[27] Kasâni, *Badâ'i al-Sanâ'i fi tartîb al-Sharâ'i*, vol. V, 2.

[28] *Ihya' Ulul al-Din* (Beirut, n.d.) vol. III, 107-164.

[29] Al-Ghazali, *al-Munqidh min al-Dhalal*, translated by W.M. Watt as *The Faith and Practice of Al-Ghazali* (London, 1953) pp 41, 53

[30] See J. Raz, "Promises and Obligations", in P. Hacker and J. Raz (eds) *Law, Morality and Society: Essays in Honour of H.L.A. Hart* (Oxford, 1977) 210.

[31] A helpful analysis and critique of these conceptions is provided by P. Benson, "Contract" in D. Patterson (ed) *A Companion to Philosophy of Law and Legal Theory* (Oxford, 1996) 24 at 33–37.





This analysis of the nature of a promise does not take us very far as it does not tell us what it is that promising requires. That question should not be confused with the one we will address next, namely, why anyone should obey the rules of promising, i.e. why are they binding. In order to complete the present analysis we will consider various theories which attempt to explain what it is that rules of promising require.[32] The theories fall into two broad categories: the first holds that promises provide exclusionary reasons for action, the second holds that promises provide additional reasons for action.

### Promises and Exclusionary Reasons for Action[33]

It has been argued that some practices, including promises, are defined so as to make certain arguments no longer available to those acting within the practice. What this means is that, once a promise has been made, it is not possible for the promisor to refuse to perform the promised act merely because he or she simply prefers not to. While it is better not to promise at all, once the promise has been made, the rules of promising prevent the promisor from arguing that non-performance is preferable to performance. Of course, this does not commit the promisor to perform the required act irrespective of any and all circumstances.

In similar vein others have argued that once a promise has been made, the promisor is constrained by the promise from considering arguments that might have been relevant had no promise been made to begin with.

### Promises and New or Additional Reasons for Action[34]

The theorists in this camp argue that the nature of a promise is not that it prevents the promisor from giving weight to particular considerations for refusing to fulfil the promise. Rather, the promise actually gives rise to new or additional reasons for fulfilment of the proposed act. One such reason is the frustration of the expectation, on the part of the promisee, engendered by the promise. Another example is if the non-fulfilment may leave the promisee who relies on the promise in a worse position than if the promise had not been made. As with those who hold that a promise is an exclusionary reason for action, those who maintain that it is an additional or new reason for action do not mean to say that the promisor is bound to perform the promised action no matter what.

## The Obligation to Keep a Promise

One of the most pervasive arguments as to why promises are binding is founded on the premise that the promisor has some norm-creating power. To present and critique this argument we will use an interlocutor whom we will call Ali.[35]

Ali begins by drawing upon basic liberal notions of respect for individual autonomy to develop the principle that a promise is morally binding on the promisor. He asserts that the promise principle is "the moral basis of contract law."[36] A contract is an enforceable promise or set of promises, and whatever the legal consequences of his failure to perform, a person who has made a contract is morally obliged to keep it because he has promised to do so. This is a self-imposed obligation i.e. it is one that the promisor voluntarily assumes by committing himself to behave in a certain way at some future date. Ali argues that neither the other party's reliance on the promise nor the benefit which the promisor himself gets from the arrangement explains why he has a moral obligation to perform. To Ali, a promisor is bound because he has done or said something which as a matter of convention signifies commitment. According to Ali, whilst reliance and benefit may provide additional reasons for enforcing a promise, neither is a necessary condition for promissory liability. As he himself says, "[t]o enforce a promise as such is to make a defendant render a performance (or its money equivalent) just because he has promised that very thing."[37]

### Promises and Conventions

Why does a promise bind its maker? Since one can be obliged to keep a promise even where some other course of action would produce greater happiness (or better consequence, as measured by some other

[32] See also R. Craswell, "Contract Law, Default Rules, and the Philosophy of Promising", 88 *Michigan Law Review* (1989) 489.

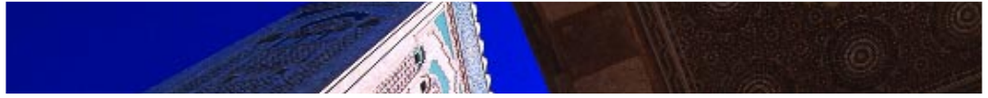
[33] J. Rawls, "Two Concepts of Rules", 64 *Philosophy Review* (1955) 3.

[34] N. MacCormick, "Voluntary Obligations and Normative Powers " 46 (suppl. vol.) *Proceedings of the Aristotelian Society* (1972) 59.

[35] By far the most explicit and rigorous treatment of this idea is in the relatively recent work of C. Fried, *Contract as promise* (1981). We will make extensive use of the work of Fried by using a fictional interlocutor.

[36] Fried, 1.

[37] Fried, 4.



standard), the obligation to keep a promise cannot be derived simply from the beneficial consequences of doing so. In order to explain this obligation, many philosophers[38] have been drawn to the idea that promising is a social practice whose rules, including the rule that promises must in general be kept, we are bound to obey.[39] They argue that promises depend on the existence of a convention, although some accounts differ from most modern accounts in that they emphasise the virtue of fidelity rather than a duty or obligation.

Sometimes practice-based accounts of promises have been seen as a way of reconciling utilitarian and apparently non-utilitarian intuitions. Thus some argue[40] that (1) promise-making, like a move in a game, is an action that presupposes the rules of a certain practice, and (2) while the practice as a whole can be given a utilitarian justification, actions within it can be justified only in ways that its rules specify. Therefore, the fact that breaking a promise would produce more happiness than keeping it does not count as a justification for breaking it.

Typically, practice-based accounts of promising involve two parts: an account of the social practice of promising and an explanation of the moral authority for this practice. Ali's account falls within this tradition. According to Ali, a promise has a moral force which is independent of non-promissory elements like reliance or benefit. He thus distinguishes reliance, benefit and promise, and discusses each separately so as to examine the moral significance of each in isolation. Some examples may help clarify the analysis.[41] The first situation is that where there has been reliance without any accompanying benefit to the party upon whom reliance has been placed or any promise by him to the party who has acted in reliance. Thus, if I move into a flat next to yours because I enjoy listening to you train with the other members of your string quartet, I may feel disappointed if, after some time, you decide to train elsewhere. What I do not have is grounds for complaint, and certainly none for compensation. Thus, reliance does not in itself give rise to any moral or legal obligation. To do so, it needs to be supplemented by a promise or the failure to observe a standard of due care that is socially recognised.

The second situation is where there is a benefit only. The bare fact of benefit is not enough to make the person benefited either morally or legally responsible to compensate the person from whom the benefit was received. Thus, if without any request you decide to play a Beethoven sonata under my window, I have no obligation to pay you if you present me with a bill even though I greatly enjoyed listening to you play and you knew that I would. My duty to pay you may only arise if I promised to pay you or in some other way encouraged the belief that you would be paid.[42]

These two examples seem to illustrate that neither reliance nor benefit are, in themselves, sufficient bases of liability.[43] In the absence of any accompanying promise, or some duty to observe a certain standard of care, neither reliance nor benefit gives rise to an obligation to make compensation. The real issue though concerns those situations in which there has been a promise but neither reliance nor benefit. Take as an example the situation where A promises to deliver a tonne of wheat next week to B and B in return promises to pay A £100 when the wheat is delivered. Before B does anything in reliance on A's promise and before A receives any benefit from the contractual arrangement, A informs B that he has no intention of performing his promise. Does A violate a moral duty even though B has not relied and A has not benefited? Ali has no doubts whatsoever that A has violated a moral duty. For Ali, A's promise in itself is sufficient as a ground for liability even if it is unaccompanied by either reliance or benefit. This position of course needs an independent argument for it cannot follow from the mere fact that neither reliance nor benefit are themselves sufficient grounds for liability. What argument then does Ali provide as justification for the sufficiency of promise as a ground of obligation?

[38] Such as Hume. See his, *A Treatise of Human Nature* (edited by L.A. Selby-Bigge, 1960) book 3, part II, sections 1,2,5.

[39] Others who have dealt with promises in the same way include H.L.A. Hart in "Definition and Theory in Jurisprudence", (1954) 70 LQR 37; and "Legal and Moral Obligation" in *Essays in Moral Philosophy* (ed. Melden, 1958) 101; J. Rawls, "Two Concepts of Rules",(1955) 64 *Phil.Rev.* 1; J.R. Searle, "How to Derive 'Ought' from 'is'", (1964) 73 *Phil.Rev.* 43.

[40] J. Rawls, "Two Concepts of Rules",(1955) 64 *Phil.Rev.* 3-32.

[41] See A.T. Kronman, "A New Champion for the Will Theory" (1981) 91 *Yale L.J.* 404, 406–408. Hereinafter referred to as "Kronman."

[42] Kronman, 408.

[43] Here one is not dealing with situations where there is what may be called a 'persistent benefit', for example if A mistakenly pays into B's account £100. One is also not concerned with those situations of 'free acceptance', for example, where A listens to the Sonata knowing that B expects to receive payment but does nothing to either stop B or let him know that he does not intend to pay.





Ali's argument, as with the arguments of many other philosophical accounts of promising since Hume's writings on the moral force of promises,[44] rests on the position known as conventionalism. Ali argues:

*"The invocation of benefit and reliance are attempts to explain the force of a promise in terms of two of its most usual effects, but the attempts fail because these effects depend on the prior assumption of the force of the commitment. The way out of the puzzle is to recognise the bootstrap quality of the argument. To have force in a particular case promises must be assumed to have force generally. Once that general assumption is made, the effects we intentionally produce by a particular promise may be morally attributed to us. This recognition is not as paradoxical as its abstract statement here may make it seem. It lies, after all, behind every conventional structure: games, institutions and practises, and most important, language."*[45]

Thus, the convention of promising enables a person to commit himself to a future course of conduct[46] and for others to count on him to behave in accordance with the promise. Ali asserts that a mere promise commits a person to future conduct.[47] Thus when one makes a promise, one is committing oneself to do an act in the future. One's promise is more than the truthful reporting of one's present intention.[48] Ali argues that since without a way of binding people to future conduct all transactions would have to be present exchanges, people find it useful to accept that promises have force in general, and apply this conventional understanding to particular cases. According to Ali, this facilitated mutually beneficial exchanges over time, and, furthermore, it increases one's freedom. As he argues, "In order that I be as free as possible, that my will have the greatest possible range consistent with the will of others, it is necessary that there be a way in which I may commit myself."[49] Clearly promising restricts the promisor. However, according to Ali, this restriction is self-imposed so as to increase one's options in the long run, and thus, it is perfectly consistent with the principle of autonomy. Ali further argues that in order for me to commit myself in this way and to "put my future into your hands", all that is required is a convention for signalling commitment, a device which we both invoke, which you know I am invoking when I invoke it, which I know that you know I am invoking, and so on.[50]

It would therefore appear that the argument is that the convention of promising is like a kind of game whose aim is the increase of freedom for individuals and the facilitation of exchange.[51] A concrete or specific promise is like a move within the game and has to follow the rules of the game, the main rule being that a promise has independent moral force and creates an obligation to behave in a certain way without the need for any reliance or benefit.

There are two points that are important in analysing theories of promissory obligation based on the institution of promising. Firstly, the institutionalist argument is meant to be a challenge to those who argue that because of the dependence of contractual obligation upon rules, the search for an explanation as to why contract law is binding is doomed to fail. As:

*"the law can only provide us with the facility to undertake contractual obligations if its rules defining both the circumstances under which they are to be held as being undertaken and the sanctions which non-performance entails are observed, the question of why a particular contract generates an obligation can only be answered by pointing at these rules."*[52]

Secondly, and more importantly for our purposes, it is important to keep in mind that the explanations or justifications are on two levels.[53] There are those which attempt to provide support for the convention itself, and those that only support particular moves

[44] D. Hume, *A Treatise of Human Nature* (1896). For a summary of Hume's views on promising see R.S. Downie "Three accounts of promising" (1985) 35 *Philosophical Quarterly* 35.

[45] Fried, 11-12.

[46] My italics. This aspect of promising is one that should be kept in mind especially when analysing promises in Islamic law.

[47] Fried, 11-14.

[48] See D. Harris, "Contract as Promise—A Review Article Based on Contract as Promise: A Theory of Contractual Obligation" (1983) 3 *Int. Rev. of Law and Econ.* 69, 69.

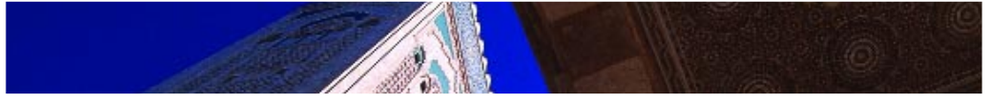
[49] Fried, 13.

[50] Fried, 14.

[51] See Kronman, 410.

[52] A. De Moor, "Are Contracts Promises?" in *Oxford Essays in Jurisprudence* (Third Series, 1987, edited J. Eekelaar and J. Bell) 103, 105.

[53] Rawls, "Two Concepts of Rules"(1955) 64 *Phil.Rev.* 3; M.S. Quinn, "Practice Defining Rules" (1970) 86 *Ethics* 76.



within that convention. Thus, it could be that within the promising convention, the obligation to keep a promise is held to derive from the promise itself irrespective of whether or not there has been any reliance or benefit. Where this is so, a basic rule of the game of promising would be that a promise is sufficient as a ground of liability. However, it by no means follows that the game as a whole, i.e. the institution of promising, can be explained or justified without resorting to notions such as reliance and benefit. For this reason, it has been said that there may be very good administrative reasons for enforcing individual promises even where there has been no evidence of reliance. Nevertheless, the adoption of a reliance-free rule of promissory liability is fully compatible with the view that the purpose of promising, as an institution, is to encourage people to rely on one another and that it does so by protecting their reliance interest.[54] Thus, one may want to argue that specific promises should be enforced even in the absence of reliance but that in general, promise-keeping is a moral or legal duty only because it is wrong to encourage the reliance of others and then to disappoint them.

Ali himself places a lot of emphasis on the notion of trust in the elaboration of his theory. We will dwell on Ali's use of the trust notion because not only is it essential to his theory but also because those who have recently written on Islamic contracts and on the binding nature of promises in Islam have quoted with approval the notion of trust as expounded by Ali. For example, as recently as 1999 one finds eminent scholars of Islam such as Professor Makdisi stating: "It is not difficult to see why Islam as a religion encouraged the keeping of one's promise. A promisor established a situation of trust."[55] Professor Makdisi goes on to quote in full, in support of his argument, the statement that:

*"To renege is to abuse a confidence he was free to invite or not, and which he intentionally did invite. To abuse that confidence now is like lying (but only like) lying: the abuse of a shared social institution that is intended to invoke the bonds of trust. A liar and a promise-breaker each use another person…."*[56]

Let us therefore examine this use of the notion of trust by Ali in more detail.

## Conventionalism and Trust

Ali says that promising is "a device that free, moral individuals have fashioned on the premise of mutual trust, and which gathers its moral force from that premise."[57] He also says that it is only possible for people to serve each other freely if they trust each other. He says:

*"When my confidence in your assistance derives from my conviction that you will do what is right (not just what is prudent), then I trust you, and trust becomes a powerful tool for our working our mutual wills in the world. So remarkable a tool is trust that in the end we pursue it for its own sake; we prefer doing things cooperatively when we might have relied on fear or interest or worked alone."*[58]

It is surprising if not inconsistent that after having argued so strenuously against basing promissory liability on reliance-related conceptions, Ali then grounds the convention of promise-making on the notion of trust, which is a notion that some have found to be closely related to reliance.[59] Perhaps because of his awareness of this inconsistency, Ali attempts to associate trust with personal autonomy, which is a concept that Ali elaborates without any reference to reliance. He makes the notion of trust an essential feature of his thesis but he uses it in a way that is very problematic.

Ali argues that one violates the autonomy of another, i.e. uses him in a way that is inconsistent with his status as a moral person, by making a promise and then failing to keep it without excuse. But is this in any way incompatible with the view that reliance is a necessary condition for promissory liability?[60] No doubt it is wrong for a promisor to disappoint the legitimate expectations of the promisee by failing to keep his promise just because it is more convenient for him to do so.[61] However, the question is what are the legitimate expectations of the promisee? Can the promisee rightfully expect the promisor to keep

[54] Kronman, 411.
[55] J. Makdisi, "The Islamic Origins of the Common Law" (1999) 77 *North Carolina Law Rev.* 1635, 1655 and footnote 90.
[56] Fried, 16.
[57] Fried, 17.
[58] Fried, 8.
[59] Kronman, 411.
[60] S.A. Smith, "Towards a Theory of Contract" in J. Horder, (ed), *Oxford Essays in Jurisprudence* (4th Series, 2000) 107, 112–115 concludes that Fried does not succeed in providing a justification for his promise theory which does not depend on reliance.
[61] See A.S. Burrows, "The Will Theory Revived – Fried's Contract as Promise" (1985) 38 *CLP* 141.





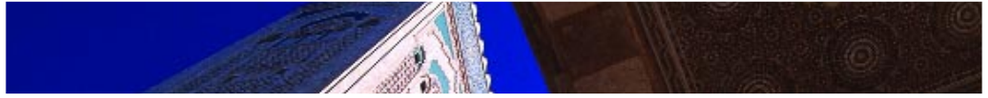
his promise even where the promisee has not relied on it and it will be inconvenient for the promisor to perform? It may well be that one is only entitled to trust others not to encourage one's reliance on promises that they then fail to keep. Ali offers no reason for construing trust and the duty of promise-keeping based on trust in a different way from this perfectly valid position. Ali tries to bolster his argument by using the Kantian injunction against using other persons as means for promoting our own welfare. But it is doubtful that this use of the Kantian injunction helps Ali. Is it clear, for example, that by failing to keep a promise on which another has not relied I use another person in a way inconsistent with his moral status? Or is he the one using me in a way inconsistent with my moral status because instead of recognising that under such circumstances he owes me a duty of release,[62] he insists that I have a duty to keep my promise? Thus, even if one accepts that it is generally wrong to use another person, one may well argue that one's obligation not to use another is founded upon the other's reliance.

Furthermore, Ali is not at all clear on the issue of whether or not his principle of individual autonomy can ground an obligation to keep a promise in the absence of an institution or convention of promising.[63] Even if we were to take the Rawlsian argument we would not get very far. Rawls argues that promising is a social institution on par with other social institutions set up to provide and distribute various 'public goods'. All such institutions face the risk of 'free riding' by people who would like to get the benefits without bearing their share of the costs. Rawls construes the breaking of a promise as an instance of the more general wrong of 'free riding'. It is not at all obvious that the wrongs involved in breaking a promise, or making a deceitful promise are wrongs to the institutions. It is arguable that they are wrongs to the person to whom the promise is made rather than to all those who contribute to keeping the institution going.

In discussing the notion of trust, Ali also argues that contract law is not to be formulated in the service of collective aims, other than the maintenance of the integrity of the practice of promising and the enhancement of trust relationships. Here Ali's argument is again less than convincing and is sometimes incoherent. Ali, for example, draws a distinction between intrinsic value and instrumental value. States of affairs are intrinsically valuable when they are sought for their own sake, and they are instrumentally valuable when they are sought for the sake of something which is intrinsically valuable. Thus, Ali thinks that the enhancement of trust in a social setting is intrinsically valuable and that the practice of promising is instrumentally valuable, because "[t]he device that gives trust its sharpest, most probable form is promise."[64] Thus, the important point is that the practice of promising is not to be justified in terms of its contribution to social welfare. This theory, however, has difficulties. It is not clear that the distinction between intrinsic value and instrumental value can be supported.[65] If every state of affairs is in fact sought not for its own sake but, at least in part for the sake of something else, then the distinction breaks down and so does the type of argument that Ali employs. In any case, it has been argued[66] that it is not evident that social trust is a type of state of affairs that is intrinsically desirable. It may be plausible to argue that social trust is sought in order to increase social welfare and to deepen individual self-respect. In this case, it is not clear why the practice of promising must be justified in terms of trust inducement, rather than directly in terms of social welfare and individual self-respect.[67]

In his discussion of the concept of trust and in an attempt to meet some of the problems discussed above, Ali changes tactics and suggests that the promise principle is not the exclusive basis of contractual liability[68] but that it has priority and overrides other principles.[69] These other principles may supplement the promise principle, but they do not displace it. This point is central to the promise theory but neither does Ali attempt to justify it, nor does it flow directly from the promise principle itself. Ali's argument is that a contract is binding because of trust; my moral

[62] Kronman, 412.
[63] See De Moor, "Are Contracts Promises?" in *Oxford Essays in Jurisprudence* (Third Series, 1987, edited J. Eekelaar and J. Bell) 103, 108.
[64] Fried, 8.
[65] M.S. Quinn, (1981) 35 *Southwestern Law Journal* 1125, 1132.
[66] ibid.
[67] ibid.
[68] Fried, 27 and 62.
[69] Fried, 117 and 132.



obligation to perform my promise is based on the fact that I have given the other party grounds to trust that I will do so. However, the other party is surely not entitled to trust that I will perform my promise if doing so will violate another moral rule or principle that is weightier than the promise principle. What is it within the promise principle that precludes the possibility that promises are subject to other overriding moral principles? The fact that the promise principle may be valid does not establish that it is paramount.

The final flaw regarding Ali's discussion of the notion of trust and its relation to promising relates to the simple fact that the promise principle does not elaborate the condition under which promises must be performed. Ali therefore argues that promises are binding because of the notion of trust which is invoked. But whilst one may then conclude from this that the promisor must respect this institution, one cannot infer from it what the rules of that institution are. To give an example,[70] one may make the following statement, "I promise to give you £100 tomorrow." If this statement constitutes a commitment, the speaker is morally bound to fulfil it. But the question is what exactly is the commitment that the speaker has made? One may well imagine several possible meanings that different social groups would attach to the statement:

I intend to give you £100 tomorrow, and if you rely on the commitment, I will not retract it.

I will give you £100 tomorrow, unless you exhibit ingratitude, or unless my finances change for the worse.[71]

I will give you £100 tomorrow unless doing so would decrease general utility.[72]

I will give you £100 tomorrow, come what may.

Whichever meaning a particular society gives to the promise, the promise principle imposes a corresponding moral duty. Thus, the principle itself is consistent with any of the possible interpretations of the promise, and cannot, by itself, give grounds for preferring one over the others. The most that the principle says is that "persons who voluntarily invoke their society's rules about promises are morally bound by those rules, whatever they may be."[73]

What all this shows is that conventionalist arguments like Ali's do not show that the institution of promising rests upon the belief in the sufficiency of promise as a ground of moral obligation. Whether it makes sense within the convention to enforce all promises is, as has been observed already, a different question altogether the answer to which will not depend upon moral principles and thus cannot provide the ethical foundation for the promise principle that Ali seeks. Ali thus fails to establish even a theory of the moral obligation to perform promises.

## Representative

Ali's view of the moral obligation to respect the rules of promising is similar to the views of other theorists[74] who argue that the rules of promising must rest on some norm-creating power possessed by the promisor, i.e. the power to create a moral obligation by making a promise. However, bringing into play a norm-creating power simply pushes the normative question back one step as one now has to answer the question "what justifies the existence of this norm-creating power?" Although different answers can be and have been given to this question, as far as the philosophical implications are concerned, the conclusion is the same, i.e. that individuals ought to have the norm-creating power represented by promising.

One may take the reliance of the philosophical literature on the practice or institution of promising as suggesting that the exact nature of any promissory obligation is a matter of sociological fact.[75] As with all sociological facts, the nature of promissory obligation would then be discoverable by careful investigation into the practice of promising as it exists in the relevant community. As with any sociological inquiry, such an approach would probably identify several diverse forms of promising, even within the same community,[76] all of which have their own different

[70] This example is from Farber, (1982) 66 *Minnesota L.Rev.* 561, 564.

[71] According to Dawson this is the position in German law. See J. Dawson, *Gifts and Promises* (1980) 140.

[72] This would be the promise of the utilitarian. See Fried, 15-16.

[73] D.A. Farber, (1982) 66 *Minnesota L.Rev.* 561, 565.

[74] Such as J. Raz, "Voluntary Obligations and Normative Powers" 46 *Aristotelian Society* (suppl. vol., 1972) 79.

[75] In this context sociological is used in its widest possible sense as including existing rules of contract law as well as extra-legal promissory practices. See R. Craswell, "Contract Law, Default Rules, and the Philosophy of Promising" (1989) 88 *Michigan L.Rev.* 489, 506.

[76] Theorists including Finnis and Raz have recognised this. See J. Finnis, *Natural Law and Natural Rights* (1980) 308-310; J. Raz, "Promises and Obligations" in *Law, Morality and Society* (P. Hacker and J. Raz eds. 1977) 210, 227-28.





rules and assumptions. This probability of more than one kind of promise of course greatly complicates the problems involved in interpreting the sociological data about a society's practices. For example, one question that arises relates to the issue of the number of people who must follow a set of rules for those rules to be accepted as a legally relevant practice. Another concerns the issue of whether an institution must be recognised in the community prior to its invocation in any particular transaction, or can any two parties create a custom-made form of promising on the spur of the moment, as is suggested by some.[77] How is the individual who appears to be in breach of the rules of an existing practice to be judged: "Is he merely an ordinary rule-breaker, or a path breaking pioneer in the creation of a new, perhaps more desirable form of promising?"[78]

There are, of course, other well-known problems that exist in inferring morally relevant legal categories from purely empirical data. However, even if we were to assume that it is possible for sociologists to identify the set of promises available to members of a given society, there will still be further work for the sociologist to do. This is because in order to reach a decision about any particular case, the courts will need to have some method of determining which kind of promise was actually made by the parties to any given transaction. There may be societies where this could be done easily. Thus a society could have a system of formal devices, such as requiring a seal for binding promises, by which individuals could indicate their choice of institution. The reality though is that, perhaps for good reasons, most societies do not use such methods.

One difficulty, even if there were only two kinds of promises from which to choose, relates to the idealism of expecting all lay people to understand the use of the seal and the harshness of enforcing a set of rules against a party who obviously intended a different set of rules but forgot to use the appropriate formality.[79] The more the kinds of promises from which to choose, the more the difficulties that will arise. One can well imagine the difficulty of designing a different seal for each of one hundred possible sets of promissory rules, and the even more serious difficulty of getting people to actually remember which seal to use for which purpose. In such situations, it would be necessary to appeal to sociology, not only to identify the set of promises recognised in a particular society, but also to identify the complex indicators for the invocation of the different kinds of promises. Even if it was possible for sociology to do all this work, all that this would suggest for the promise principle is that "the philosophy of promising can[not] by itself yield definite implications for the content of contract law."[80] In fact, it is sociology that is performing all the work required to meet the needs of contract law.

The real objection though to this dependence on sociology and sociological data is that it is devoid of any normative perspective from which to either criticise the existing promissory practices or to propose reforms in those practices. Whereas one could take issue with specific legal rules for non-conformity to the practices, one would have no way of taking issue with the practices themselves. The alternative is to look to the substantive values or virtues which justify the binding force of promises.[81]

## Promising and the Avoidance of Harm

There exists a different approach which seeks to base the binding nature of a promise on the fact that the failure to fulfil a promise usually causes harm to the promise, and especially the promisee who has changed his position by relying on the promise. Since the harm principle is a widely accepted and even intuitive moral principle, it is easy to see why some may argue that whenever the breaking of a promise may cause harm then it is to be sanctioned on the basis of the harm principle. However, it is unlikely that the moral force of the harm principle can itself explain the binding nature of promises because promising adds an extra element which the mere presence or possibility of harm does not. Thus the fact that Amr has formed an expectation that Zayd will give him $10 and has therefore taken a loan from Umar of $10 may encourage Zayd to actually give Amr the $10. However, if Zayd had promised Amr that he would give him $10 there is a stronger reason for him to do so. Thus the promise generates a stronger reason for Zayd's giving the $10 to Amr then Amr's bare reliance.

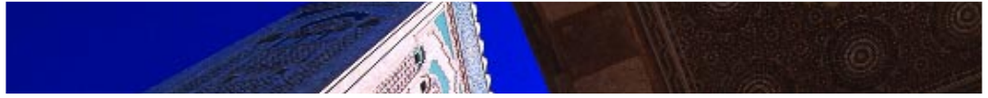
[77] Raz, "Promises and Obligations" in *Law, Morality and Society* (P. Hacker and J. Raz eds. 1977) 210, 214-15.

[78] R. Craswell, "Contract Law, Default Rules, and the Philosophy of Promising" (1989) 88 *Michigan L.Rev.* 489, 506.

[79] See D. Kennedy, "Form and Substance in Private Law Adjudication" (1976) 89 *Harv.L.Rev.* 1685, 1697.

[80] Craswell, "Contract Law, Default Rules, and the Philosophy of Promising" (1989) 88 *Michigan L.Rev.* 489, 508.

[81] Possible values could be economic efficiency or commutative justice. I have discussed both of these elsewhere.



Where the expectation and reliance are not bare, i.e they are the result of Zayd's promise, then, some argue, this is enough to explain the binding force of promising.[82] Here then, the principle is not that there is an obligation to prevent harm to others but that there is an obligation not to actively harm others. This obligation is, we believe, stronger than the former but is still weaker than the obligation that a promise gives rise to. To explain the stronger force of a promise the following example is useful.[83] A person tells his friend that he will definitely be able to give his friend a lift to town. Let us presume that the probability of his being able to do so is high enough for it to be relied on by his friend who then decides not to make alternative arrangements for getting into town. Let us now suppose that he tells the friend "remember, I do not promise anything, I am merely advising you." Clearly the friend's reliance on the statement by not making other arrangements is understandable and justified and is something he ought to bring into consideration in deciding whether or not to stick with his original plans. Nevertheless, if he had promised that he would go to town, there is some extra force in his going to town. Thus the principle of harm cannot explain the binding nature of promises as it fails to capture this extra force that a promise adds.

## Back to Fidelity

An analysis of the verses of the Qur'an and the Ahadith dealing with promises suggests that we need to look for the binding nature of promises elsewhere. The Qur'an contains several verses enjoining believers to guard their trusts and to keep their promises and covenants.[84] Sura 4 verse 122 says: "Allah's promise is the truth, and whose word can be truer than Allah's?" Sura 9 verse 111 says: "The promise of Allah is true" whilst verse 55 of the same sura asks metaphorically: "Is it not (the case) that Allah's promise is assuredly true?" Sura 11 verse 45 says: "And thy promise is true" and verse 65 of the same sura says: "(behold) that is a promise not to be belied!" This association of promises with truth is also to be found in Sura 7 verse 44, Sura 14 verse 22, Sura 16 verse 38, Sura 17 verse 108, Sura 18 verses 21 and 98, Sura 21 verses 97 and 104, Sura 28 verse 13, Sura 30 verse 60, Sura 31 verses 9 and 33, Sura 35 verse 5, Sura 36 verse 52, Sura 40 verses 55 and 77, Sura 46 vese 16, Sura 51 verse 5. Similarly, the promises of Satan are connected with deceit in Sura 4 verse 120 and Sura 17 verse 64.[85]

These verses show that it is the virtue of fidelity, i.e. the duty to tell the truth that counts. Thus, the breaking of a promise is taken to be one of the marks of a hypocrite. In a famous Hadith it is related that the Prophet stated: "The marks of a hypocrite (*munafiq*) are three: when he speaks he lies, when he makes a promise he breaks it, and when entrusted with something he betrays the trust."[86] The Muslim lexicographers such as Ibn Durayd[87] (d.933) relate the etymology of the word *nifaq* (hypocrisy) to the word '*nafiqa*'' which is the escape hole of the gerbil.[88] The gerbil enters the burrow through one hole and secretly exits through another.[89] Similarly, al-Isfahani (d.1108) suggests that the synonym of the word is *nafidh* (passing through). He goes on to say that *nifaq* is entering by one door and exiting through another. It is, he says, like *fisq*, i.e. deviating from the right way.[90] The breaking of a promise, being one of the core components on *nifaq* (hypocrisy) involves the same wrong-doing. Thus, in Islamic law, promising is not a social practice defined by certain rules that exist only in so far as the members of the community accept as normative. The community cannot decide to do away with promising or decide that it is not wrong to fail to keep one's promise. The obligation generated by a promise derives from the obligation imposed by God that people must keep their word when they have given it. The wrong or wrongs involved in breaking a promise, or making a deceitful promise, belong to a broader class of wrongs having to do

[82] N. MacCormick, "Voluntary Obligations and Normative Powers " 46 (suppl. vol.) Proceedings of the *Aristotelian Society* (1972) 59, 66.

[83] See J. Raz, "Voluntary Obligations and Normative Powers", 46 *Aristotelian Society* (suppl. vol., 1972) 79, at 99.

[84] See Qur'ân 23:8; 70:32; 76:7 and many others.

[85] There may well be a few other verses dealing with the connection between promises and truth, which the author has missed, but these verses are adequate in showing that a strong connection exists.

[86] Reported by Muslim in his *Sahih* (transl. By A.H. Siddiqi) vol. 1, ch. xxvi. For a discussion of this Hadîth see A.J. Wensick *et al, Concordance et indices de la tradition musulmane* (1967) vi.

[87] Ibn Durayd, *al-Ishtiqâq*, (ed. A.S.M. Harun, n.d. Cairo) 198.

[88] See also A. Brockett, *"al-Munâfikûn"* in the *Encyclopaedia of Islam*, vol. VII, 561.

[89] A. Brockett, *"al-Munâfiqûn"* in the *Encylopaedia of Islam*, vol. VII, 561.

[90] al-Râghîb al-Isfahânî, *Mu'jam Mufradât alfâz al-Qur'ân*, (ed. N.Mar'ashî, n.d. Beirut) 524.





with our duty to keep our word and in doing so to obey a divine command. Thus a promise is binding as a matter of truth (*veritas*), honesty (*honestas*) and faith (*fidelitas*). The duty to keep our word is binding not because it is a mechanism for generating expectations or reliance, for once we have given our word, we are bound to keep it even if no one relies on it and even if no expectations are created by it and even if no one believes in it. This is why there is no difference between giving our word to a fellow man and giving our word to God. The latter neither relies on our word nor are any expectations created by our word, and knows when we give our word whether we will keep it or not and whether we intend to keep it or not. The wrong in breaking a promise is therefore akin to, if not the same, as the wrong in lying and in betraying a trust. These in turn are wrongs because they amount to disobeying a divine command. They are wrong as a matter of faith.

This understanding of why promises are binding of course follows from the general understanding that religious systems, such as Islam, have of the morally good life as being grounded in the obedience to the will of God. This issue is the subject of a vigorous and on-going debate[91] in philosophy whereby one group has devoted considerable attention arguing for recognition of the principle that there is and should be a close relationship between religion and morality. This group feels that the moral life requires a commitment to "absolutes" that can only be provided by a religious perspective. The second group has, on the other hand, found the notion that there is and should be a relationship between religion and morality deeply offensive. To them, it is important to protect the "autonomy" of ethics. This is undoubtedly an interesting debate but one which we have no need to enter into here for obvious reasons. Whatever may be the better position, the fact of the matter is that we are dealing with a religious system.

In Western law, a number of thinkers and philosophers have written on the relationship and similarity of the duty to fulfil one's promises and the duty to tell the truth or to keep one's word. Thus, Richard Price[92] in the middle of the eighteenth century and more recently G.J.Warnock[93] and Pall Ardal[94] have offered such accounts. Aristotle[95] and Aquinas[96] offered similar accounts of the basis of the obligation to keep one's promises. Even Ali says that:

*"To renege is to abuse confidence he was free to invite or not, and which he intentionally did invite. To abuse that confidence now is like (but only like) lying: the abuse of a shared social institution that is intended to invoke the bonds of trust. A liar and a promise-breaker each use another person."*

Based on this analysis it is understandable why a second group of jurists[97] have advanced strong arguments as to why promises, or at least some of them, are legally enforceable, as well as being morally binding. Among these are Samura bin Jundub, who was a Companion, 'Umar bin 'Abd al-Aziz, Hasan al-Basri, Said bin al-Ashwa, Ishaq bin Rahayawh, Ibn Shubrumah, Imam Bukhari and Ibn Arabi, Ibn al-Shat. They maintained that fulfilling a promise is not only recommendable but far more than that it is a legal obligation of a promisor.

However, unfortunately in elaborating their arguments, many of the jurists do not consistently distinguish between the enforcement for promises based on the duty not to harm others and the duty to enforce promises based on the virtue of fidelity. Thus al-Ghazali, the Shafi'i jurist cum theologian (who also believes that a promise is binding if made in absolute terms), discusses the duty to keep one's promise as part of the virtue of fidelity. Thus he discusses this in his *Ihya'* in the section of the "Evils of the Tongue" and in the *Bidayat al-Hidaya* in the section on "Guarding against Lying, Breaking Promises, Backbiting, Disputing, Self-Glorification, Cursing, Invoking Evil Towards Others, and Jesting."[98]

[91] The literature on this subject is very wide indeed. A few useful works that present both sides of the argument include: P. Helm (ed.), *Divine Commands and Morality* (1981); P.L. Quinn, *Divine Commands and Moral Requirements* (1978). A brief survey of the arguments may be found in the *Routledge Encyclopedia of Philosophy* under the chapter "Religion and Morality" by R.J. Mouw.

[92] R. Price, *Review of the Principal Questions in Morals*, cited by M. Clark in "Obligations", 53 *Proceedings of the Aristotelian Society* (1972/3).

[93] G.J. Warnock, *The Object of Morality* (1971).

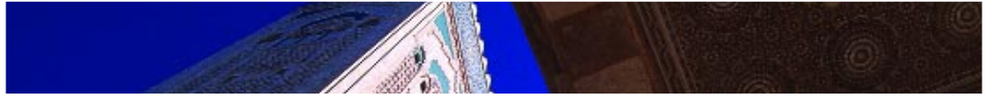
[94] P.S. Ardal, "Ought we to Keep our Contracts Because they are Promises?" (1983) 17 *Valparaiso Law Rev.* 655.

[95] Aristotle, *Nichomachean Ethics*, IV, 1127a-1127b.

[96] Thomas Aquinas, *Summa Theologica*, II-II, q.110, a.3, and 5.

[97] Ibn Hajr al-'Asqalani, *Fath al-Bari Sharh Sahih al-Bukhari*, vol. 1, p 89; al-Qurtubi, *al-Jami' li Ahkam al-Qur'an* known as *Tafsir al-Qurtubi*, vol. 18, p 29; Ibn Hazm, *al-Muhalla*, vol. 8, p 28; Ibn 'Arabi, *Ahkam al-Qur'an*, vol. 4, p 1799.

[98] al-Ghazali, *Ihya' 'Ulum al-Din* (Beirut, n.d.) vol. III 107–164.



Notably these are chapters to do with the virtues of fidelity and harm to others. On the other hand, other jurists, such as those of the Maliki school argue that the promisor is legally bound to fulfil his promise if he has caused the promisee to incur some expenses or undertake some labour or liability on the basis of promise, i.e. on the basis of the principle of reliance and the need to avoid harming others.[99] The Malikis opined that a promise can be legally binding if the promise is made qualified with a reason (*sabab*) for the promise to materialize, more so if the promisee has satisfied the reason (*sabab*). This is again to prevent harm or fraud on the promisee as a result of the promise. The Hanafis also say that a promise is binding if it is tied up (*mu'allaq*) with the occurrence of a certain/specified condition (*shart*). This is to prevent detriment or fraud on the promisee.

As mentioned previously, in commercial dealings and more specifically in Islamic finance, the view adopted is the latter, i.e. that the promises are legally binding when they are relied upon. Even though not all promises are binding, in commercial dealings the other party will have made some arrangement based on that promise, and any violation to this promise will definitely bring harm to the promisee. In these circumstances, they hold that this promise should be considered binding. Although far from satisfactory from a philosophical basis, one may well understand the reason why detrimental reliance or the harm principle are more attractive to the Islamic finance specialists as bases for making promising binding. They are much easier to justify, from the Islamic legal perspective, and to calculate damages based on reliance and harm than it is based on fidelity or expectation.

## Damages for Breach and Compensation to Unwind Promises

We have thus far discussed the concepts of promises and contracts in Shari'a. The second issue that required investigation in creating the Structure was the consequences of a failure to perform a promise. We have already alluded previously to the fact that it is easier to justify the view that promises are binding based on the principle of reliance and harm as this makes easier the calculation of damages for failure to perform. It is worth noting that although the majority of jurists who view promises as being binding (including the Fiqh Academy) do so on the basis of reliance, they then base damages for breach of promise on the avoidance or removal of harm. It is clear that the jurists often equate reliance with harm although logically there is no reason why this is so.

Islamic law generally bases damages on the principle of *darar haqiqi* (actual loss). There is in fact a *qa'ida fiqhiyya* (legal maxim) that *al-darar yuzal*, i.e. harm is to be removed. This means, the promisor has to compensate for whatever damage that has actually been caused to the promisee. The loss of expectation is not considered to fall within this. In keeping with this general principle, the damages from failure to keep a promise in a commercial undertaking are also based on *darar haqiqi*.

Another way of looking at this is to say that breach of promise leads to a right to claim negative damages which mean that the promise has a right to be compensated such that he is put in the position he was at the time the damage occurred.

The Shari'a also allows for the promisee to release the promisor from his promise as a promise is an obligation of a promisor and therefore a right of the promise (*haq*). This release is known as *al-ibra' 'an al-huquq* (release of right: the dropping of right against others with or without exchange).[100]

The release of right can be with or without exchange. If it is with exchange, it is called *ibra' bi 'iwad*. Both the Shafi'is[101] and the Hanafis have expressly allowed this. The Hanafis' term for this is *sulh bi al-mal* (reconciliation with a consideration).[102]

[99] al-Qarafi, *al-Furuq*, vol. 4, p 25; *Fatawa Shaykh 'Ulayyish*, vol. 1, pp 256, 258.
[100] al-Bahuti, *Kashshaf al-qina'*, vol. 4, pp 344 ff; al-Suyuti, *al-Ashbah wa al-Nazair*, p 152.
[101] *Hashiyah al-jumal 'ala Sharh al-Minhaj*, vol. 3, pp 781 ff.
[102] *Hashiyah Durr al-Mukhtar*, vol. 4, p 495.





## *Jahala* (Ignorance) of Price at the Time of Promising

The third issue that Deutsche Bank sought to resolve was the fact that at the time the promises are given, and given that these promises are binding on the promisor, the price at which the subject matter of the promises would be transferred was not yet known or fixed.

Jurists have differed on the issue of when exactly should the exact price of the subject matter of a contract of sale be known. The later Hanafis allowed a fair degree of *jahala* as is clear in their acceptance of *bay' al-Istijrar*, which they base on the doctrine of *istihsan* (juristic preference).[103]

The Hanbalis have also allowed obligations to arise prior to the sale price being exactly known.[104] Ibn Taymiyyah argues that it is not even a Shari'a requirement to state the price in the contract.[105]

In fact we find examples of similar views in most of the schools as most later jurists allow the validity of *bay' bima yanqati' bihi si'r* (sales concluded at market price). These sales will be valid even when at the time of offer and acceptance the exact market price is not known.

In fact that this was not an issue with regards to our Structure. As opposed to *bay' bima yanqati' bihi si'r* and *bay' al-Istijrar* where the sale is concluded now but the price is determined later, in our structure no sale is entered into or concluded at all until the exact settlement price is known. The two unilateral promises do not amount to a sell. The issue of *jahala* over the price does not arise in relation to promises. When either promise is enforced, the price is first determined and subsequently the actual contract of sale and purchase occurs.

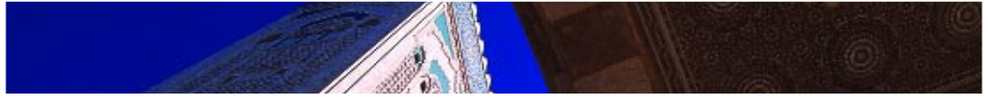
The prohibition of *gharar* (uncertainty) and also *jahala* (ignorance) refers only to the sale contract and not to promises. Therefore, it is acceptable for a promise to purchase or sell to be given and to be binding without knowing the price at the moment of making the promise as long as this price becomes known at the time of contracting the sale. The proof for this is:

1. The acceptability of the promise to purchase a commodity for its cost plus a profit which is defined as a percentage of the cost. Here the price is not known at the time of giving the promise, because the cost, and therefore the profit also, is not known. Rather the promisor may, for example, say: "I promise to buy the commodity from you for its cost plus Libor", whereby Libor becomes known at the time of contracting the sale.
2. The acceptability for a lessee to promise the lessor to buy the object of the lease for the market price in case he does not fulfil the obligation to pay the lease payments. At the same time the lessor promises the lessee to sell to him the object of the lease at the end of the lease period in case the lessee fulfils his obligations or before that, if the lessee asks him to do so. The object of both promises is one and the same, i.e. the object of the lease. However, the promise to purchase given by the lessee is given for one condition, while the promise to sell given by the lessor is made for another condition. The purchase price and sell price are obviously unknown at the time of giving the promise as they are based on the market price which is only known at the actual time of the sale or purchase.

A related issue is the fact that the price that the asset is sold or purchased for is not necessarily the market price of the asset. This requires us to discuss the issue of ***'just price'*** which is what the market price is normally considered to be.

The idea that contracts ought to be concluded at a just price has a long history in Islam. It is reported that the Prophet characterized overcharging of a trusting customer as riba.[106] Another term, *qimat al-'adl* (fair price or fair measure) sometimes appears in the Ahadith. It is used, for instance, in a Hadith about the case of a master who frees part of a slave,[107] who becomes a free man when the master is compensated for the remaining at *qimat al-'adl* (a fair price).[108]

[103] Ibn 'Abidin, *Hashiyah Radd al-Mukhtar*, vol. 4, p 516.
[104] Ibn Taymiyyah, *Nazariyyat al-'Aqd*, p 1272, Ibn al-Qayyim, *A'lam al-Muwaqqi'in*, vol. 4, p 8.
[105] Ibn Taymiyyah, *Nazariyyat al-'Aqd*, 65, 72.
[106] Muslim, *Sahih, k. al-'Itq"* and *k. al-Buyû`* (Cairo, n.d.) part 4, pp 212–13; see also Ibn Hanbal, *Musnad* (Beirut, n.d.) vol. II, pp 11, 15, 156.
[107] It is relevant to note that the manumission of a slave is itself a contract in Islamic Law.
[108] Ibn Hanbal, *Musnad*, vol. V, p 327.



The doctrine of just price plays a role in realizing justice rather than in determining price.[109] The question of just price (*thaman al-mithl*) seems to come, in Islamic law, under the larger doctrine of just compensation (*'iwad al-mithl*), although some believe that the two are distinct.[110] *'Iwad al-mithl*, which may be read as either 'just compensation' or 'compensation of the equivalent', arises as an issue in relation to the discharge of moral or legal obligations generally. Thus, it may arise, for example, in relation to cases where an individual is held responsible for causing injury to the person or property or profit of another.[111] The Hanbali jurist, Ibn Taymiyya (d. 1328) says that it is also involved in those situations where a person is required to settle invalid contracts or valid contracts that have some defect. *Thaman al-mithl*, or price of the equivalent, on the other hand, is specifically an issue in those situations where there is an actual sale, purchase or exchange of goods. Thus, *thaman al-mithl* is defined as 'the rate at which people sell their goods and which is commonly accepted as equivalent for it and for similar goods at that particular place and time.'[112] It is therefore the market price.

While the concept of just price has a long history, it was Ibn Taymiyya who subjected it to detailed analysis—the formal distinction between *'iwad al-mithl* and *thaman al-mithl* is attributed to him. He says that the measure is assessed by its equivalence and this is the essence of justice (*nafs al-'adl*).[113] Throughout an elaborate discussion, he uses 'just' and 'equivalent' interchangeably.[114] He concludes that just price is the market price of a commodity in a competitive market. He says, for example: "If people are dealing with their goods in the normal way without any injustice on their part and the price rises either due to shortage of the goods (i.e. decrease in supply) or due to increase in population (i.e. increase in demand), then it is from Allâh."[115] In much the same way as the Muslim jurists do, Aquinas links unjust prices with fraud: "It is sinful to practise fraud for the express purpose of selling a thing for more than its just price, in as much as a man deceives his neighbour to his loss" (Summa II 2nd Question LXXVII, art.I). Thus just price is the current market price established in the absence of fraud and monopolistic trading practices.

The Muslim jurists are concerned to ensure that contracts are concluded at a just price which is the market price. They focus on fraud because, assuming a normal competitive price, "individual deviations are hardly possible except through fraudulent representations about the quantity and quality of goods."[116] Where there is a significant disparity between the price of the contract and that of the equivalent, the presumption is, in the absence of fraud, that one party was practising the virtue of liberality (i.e. choosing to enrich the other party).

We do realise that there is an ongoing debate about what exactly the concept of just price meant in medieval times and how it was calculated. Some seemed to equate it with the normal competitive price; others thought that it was the price quoted beforehand and was determined by custom or communal estimate.[117] In fact the medieval scholars were more concerned with how to arrive at a just price than why prices ought to be just. Among jurists, the departure came with Ibn Taymiyya who extended and refined the discussion. In contrast to Aquinas who hardly touches on the question of just wage—except to say (Summa I: 2nd Question CXLIV, art.I) that it is subject to the same rules as just price—Ibn Taymiyya describes it as the wage of the equivalent (*ujra al-mithl*) and links it to the price on the labour market, making detailed definitions of quantity and quality. He eventually concludes that the wage of the equivalent is governed by the same rule as the price of the equivalent.[118]

Ibn Taymiyya also discusses just profit or the profit of the equivalent. It is the normal profit which is generally earned in that particular type of trade without harming others. He of course sees nothing wrong with earning a normal profit[119] but disapproves of abnormal or exploitative profit (*ghabn fahish*), especially where

[109] A.A. Islahi, *Economic Concepts of Ibn Taimiyah* (Publ. Details, 1988) p 75.
[110] Ibid, p81.
[111] Ibn Taymiyya, *Majmû' Fatâw~* (Publ. Details, 00 vols., 1929) vol. XXIX, p 520.
[112] Ibid, p 345.
[113] Ibid, p 521.
[114] Islahi, *Economic Concepts of Ibn Taimiyah*, p 81.
[115] Ibn Taymiyya, *al-Hisba* (Publ. Details, 1976) 25
[116] Schumpeter, *History of Economic Analysis*, p 93, note.
[117] For a brief discussion of these different positions, see Islahi, *Economic Concepts of Ibn Taimiyah*, pp 76–80.
[118] Ibn Taymiyya, *al-Hisba*, p 34; see also *al-Masâ'il al-Mardîniyya* (Publ. Details, 1964).
[119] Ibn Taymiyya, *al-Hisba*, p 37.





people are not aware of the normal conditions of the market (*mustarsil*).[120] He is particularly concerned to ensure that needy persons are not exploited.[121]

All the thinking about just price, just wages, just profit and related concepts indicates marked concern to maintain justice in commutative dealings.[122] But the earlier scholars and writers who did this thinking did not raise the question that we are bound to raise: since the market price is by nature fluctuating, how can just price preserve equality?

One argument is (i) that an exchange conducted at the market price is not really unequal even if the seller does not recover his loss. The other is (ii) that such an exchange is unequal but this inequality is not one of concern to commutative justice.[123]

It does not matter, the first argument goes, that in any single transaction a seller fails to recover his costs. What matters is that over a number of contracts, the final outcome will level out to equal. Moreover, the seller who (in one transaction) received something less than his production costs could (in principle) just as well have received more. Contracts are therefore best viewed as a series of 'fair bets', whose outcome, if the series is sufficiently long, will be equality. Equality is here understood in an actuarial sense, i.e. the person who received more had the same chance of doing so as any of the other players. The argument can be made more sophisticated by including, within production costs, the risk of price fluctuations as well as labour and other expenses. The fundamental idea remains that "a price can be fair, not because sellers actuarially recovered the value of their labour and expenses, but because, as they might have recovered more, they might also have recovered less."[124]

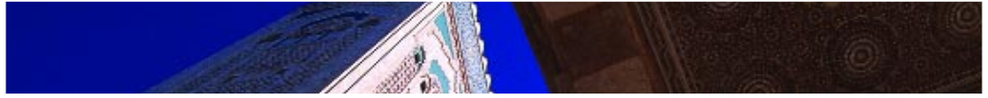
The second argument is content with the possibility of particular transactions being unequal, in the belief that it is not the task of commutative justice to rectify every inequality and that, in part, prices do and must fluctuate in response to supply and demand of particular commodities. This is then coupled with the view that, if particular fluctuations are preventable, it is up to the public authorities to attempt to set prices so that they apply equally to everybody. On the other hand, where the parties do not contract at the market price, there is usually a bad reason, such as one party being unaware that he could get a better price in the market, or being prevented from using the market. Whatever the case, there is a good reason for not allowing him to be disadvantaged. In short, what commutative justice demands is that avoidable inequalities be corrected, not that perfect equality be preserved.

Of course the Muslim jurists do not make either of these arguments explicitly. However, they may be supposed to favour the second argument because they believed that there is a good reason why market prices fluctuate and ought to be allowed to do so, and that, apart from the virtue of liberality, there is no good reason for parties not to contract at the market price.[125]

Clearly there is a lot to be said of this position of the medieval jurists, but there are strong arguments for taking a different view. It is clearer today that one cannot meaningfully speak of equality in exchange and, that even if one could, the terms of the exchange are a matter the contracting parties should be free to decide.

The argument that one cannot speak meaningfully of equality in exchange is based on the idea that value is not an intrinsic property of things but derived from the judgement of the contracting parties. From the nineteenth century, it has been argued that the value of a thing 'must be in its nature fluctuating and will depend upon ten thousand different circumstances. One man, in the disposal of his property may sell it for less than another would.'[126] In effect, it is clear to us today that the value of all things contracted for is measured by the appetite of the contractors, and therefore the just value is that which they are contented with to give.[127] The market value is considered as being helpful but ultimately irrelevant as it reflects the judgement of a third party not directly engaged in the transaction. The only determinant of value really

[120] Ibn Taymiyya, *Majmû` Fatawa*, vol. XXV, p 299.
[121] Islahi, *Economic Concepts of Ibn Taimiyah*, p 86.
[122] Ibid, p 87.
[123] Gordley, 'Equality in Exchange' (see note 26 above), pp 1587, 1609–17. Hereafter cited as *Gordley*.
[124] Ibid.
[125] For the view of the Muslim jurists see Islahi, *Economic Concepts of Ibn Taimiyah*, pp 88–102; for those of Aquinas see *Gordley*, pp 1611–17.
[126] Ibid., pp 1587, 1598, where Gordley cites J. Story, *Commentaries on Equity Jurisprudence as Administered in England and America* (Publ. Details, 14th edn., 1918) p 339.
[127] The relevant passage is found in F. Pollock, *Principles of Contract* (Publ. Details, 4th edn., 1885), p 172.



is the subjective view of the transacting parties themselves. That being so, the argument for autonomy of contract and hence consent follows as a corollary. Since value is subjective, one has no measure, other than the agreement and consent of the concerned parties, by which to evaluate the fairness of the exchange or 'just price'.

What this means, therefore is that there are no reasons, in the Shari'a, why an asset may not be sold at a price linked to the performance of a separate asset or index or other benchmark which may itself be Shari'a compliant or not. This is of course subject to the requirement that the exchange respects the rules on *riba*, *gharar*, etc. This view has now been adopted in commercial matters and the current position is succinctly captured by Justice Taqi Usmani. Shaykh Usmani is clear that the use of any benchmark, even a conventional interest-based benchmark (such as LIBOR) to determine the mark up and therefore the price under a murabaha is justifiable. So long as the murabaha fulfils all the conditions of a genuine sale, merely using a benchmark, which is not related to the market price of the goods themselves, to determine the price does not render the transaction invalid. The example he gives is now famous and quite illustrative. He gives the example of the brothers A and B. A trades liquor, which is of course prohibited in the Shari'a. B decides to trade Shari'a compliant soft drinks. However, he wants his business to be as profitable as his brother's and therefore charges the same rate of profit for his soft drinks as his brother does for the alcohol. Whereas, as a matter of morality we may question the propriety of this approach, there is clearly no legal wrong or moral wrong, i.e. *haram*, that he is engaged in.

Thus, whereas it is not ideal to use conventional benchmarks, it is nevertheless acceptable, so long as the transaction itself satisfies all the conditions of valid obligations under the Shari'a.

# Conclusion

The Islamic financial markets are developing from what is perceived as an exotic niche market into a mainstream financial market. With a potential market of 1.5 billion people worldwide (as well as non-Muslims who turn to Islamic products for ethical reasons), the current estimates of the size of the Islamic finance industry (which range anywhere from $250 billion to $750 billion) are but a starting part in comparison to what is to come. Paradoxically, we believe development of the Islamic financial market is not in fact a function of demand, despite clear evidence of such demand.

Instead development of the Islamic financial markets is driven by the ability to remove the constraints on the supply side. Such constraints are mainly related to capacity (the number and quality of bankers involved and their Islamic structuring capabilities).

We believe that the Structure will eventually be viewed as a significant milestone in the development of the Islamic finance industry as it provides Islamic investors exposure in a liquid and cost-efficient way to new asset classes and pay-outs, removing one of the main structuring barriers. Variants of the technique have been developed to offer Islamic investors hedging instruments (such as currency or profit rate exposure hedging). The Structure itself is the result of close cooperation between academics, bankers and of course scholars.

By publishing this paper, Deutsche Bank intends to meet the following objectives:

- To allow other financial institutions to use the fundamental elements of the Structure for the benefit of their clients, thus increasing the size of the market;
- To set a quality benchmark. Too often, "innovation" is achieved by pushing the barriers and/or abusing *fatawa* by taking them out of their context. Innovation ideally should be the result of a well documented and fundamental discussion on Shari'a. Deutsche Banks wishes to encourage the use of academic resources to assist the industry in developing new products, an attribute of the industry which has thus far been lacking.
- To encourage the use of the Structure in its correct context, with an understanding of its legal foundations, logic and inherent restrictions. In particular, our latest research suggests that the Structure may not be applied to the provision of capital protection for Shari'a compliant structured products.



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In summary, we believe that those institutions with the vision, creativity, innovation, courage and commitment to develop the Islamic financial markets will be recognised for their hard work and ideas. Shari'a itself has inherent flexibility and fewer constraints than is often assumed by the financial services industry. Fundamental research is the key to unlocking this inherent flexibility, thus allowing this market to grow to its full potential.

# Annex 1

## The Dar Al Istithmar Shari'a Supervisory Board

The information below consists of information provided by DI.

### Dr. Hussain Hamed Hassan (Chairman)

Received his PhD from the Faculty of Shari'a at Al Azhar University in Cairo, Egypt in 1965. He also holds two degrees in law from the International Institute of Comparative Law, University of New York and two degrees in Law and Economics from Cairo University. He served as Assistant Professor, Associate Professor and Professor of Shari'a in the Faculty of Law and Economics at Cairo University between 1960 and 2002. Currently member of the Shari'a supervisory committees of many Islamic financial institutions including Emirates Islamic Bank, Dubai Islamic Bank, National Bank of Sharjah, Islamic Development Bank, Dubai Islamic Insurance and Re-Insurance (Aman), Tamweel, AMLAK, the Liquidity Management Centre and Accounting and Auditing Organization for Islamic Financial Institutions. Dr. Hassan is the author of 21 books on Islamic law, finance, economics, social studies and art, in addition to more than 400 research articles on these subjects.

### Dr. Ali Al Qaradaghi

Received his PhD in the area of contracts and financial transactions from Al Azhar University in Cairo, Egypt in 1985. He is currently a Professor of Islamic financial contracts and heads the department of Islamic jurisprudence in the college of Shari'a and Islamic studies at the University of Qatar. Dr. AlQaradaghi presently serves on the Shari'a Boards of many Islamic financial institutions in and outside Qatar including Emirates Islamic Bank and Dubai Islamic Bank in the UAE, Investment House and Investors Bank in Bahrain and First Investment in Kuwait.

### Dr. Abdul Sattar Abu Ghuddah

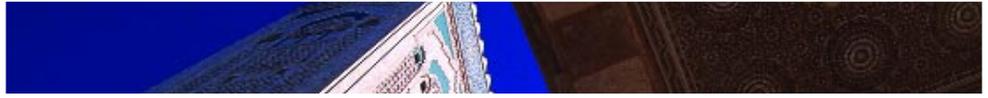
Dr. Abdul Sattar Abu Ghuddah holds a PhD in Islamic law and comparative Fiqh from Al Azhar University Cairo, Egypt. He has taught at various institutes, including at Imam Al Da'awa Institute (Riyadh), Religious Institute (Kuwait), and at the Shari'a College of the Law Faculty in Kuwait University. He holds the positions of Shari'a Advisor and Director of Department of Financial Instruments at Al-Baraka Investment Co., Saudi Arabia. He is an active member of Islamic Fiqh Academy and the Accounting & Auditing Organization of Islamic Financial Institutions and is also the Secretary General of the Unified Shari'a Supervisory Board of Dallah Albaraka Group, Jeddah.

### Dr. Mohamed Elgari

As an established Islamic economist, Dr. Elgari teaches, writes and works with several institutions in the field. Dr. Elgari received his PhD in economics from University of California (USA), and is currently serving as a Professor of Islamic economics at King Abdulaziz University (Jeddah), Saudi Arabia. He is a Shari'a advisor to many Islamic financial institutions including HSBC Amanah, Abu Dhabi Islamic Bank, Bahrain Islamic Bank, Dow Jones Islamic Index, National Commercial Bank, Saudi American Bank and Saudi Fransi Bank. As a prolific writer, he has published in a number of scholarly journals and authored several books.

### Dr. Mohd. Daud Bakar

Dr. Mohd. Daud Bakar received his Ph.D. from University of St. Andrews, UK. He was the former Associate Professor in Islamic law and Deputy Rector at the International Islamic University Malaysia. Dr. Bakar is the Chief Executive Officer of the International Institute of Islamic Finance. His areas of specialization include Islamic legal theory, Banking and Finance, Law of Zakat and Medieval Law. Dr. Bakar is a member of the Shari'a supervisory committees of many financial institutions in Malaysia and around the world, including the Central Bank of Malaysia, Securities Commission of Malaysia, International Islamic Financial Market, Accounting and Auditing Organization for Islamic Financial Institutions and numerous other institutions. He has published more than 30 articles in academic journals and presented more than 120 papers in various conferences.



# Annex 2

## Mathematical Proof

We need to prove (in words) that at all time (t) the value of the basket of Shari'a Shares (S1) with the given promise (promise to sell at Settlement price the Sharebasket) (Promise 1) and a received promise (promise to buy at Settlement Price) (Promise 2) is equal to the value of the Index (more correctly the performance of a (same) notional moving with the performance of the Index) (S2)

S1(t)-Promise 1(t)+Promise 2(t)=S2(t)

Where;

Promise 1(t) = Promise to sell the basket of Shares at Settlement Price

Promise 2(t) = Promise to buy the basket of Shares at Settlement Price

Settlement Price = Performance of Index S2 on the notional

= S1(0)x(S2(T)/S2(0))

Since Promise 1 and Promise 2 are both unilateral promises, which will only be executed if they have value to the Promisee, i.e. the Promisee under Promise 1 will only hold the Promisor to his/her Promise if, S1(0)x(S2(T)/S2(0))>S1(T), and the Promisee under Promise 2 will only hold the Promisor to his/her Promise if, S1(0)x(S2(T)/S2(0))<S1(T). Therefore, Promise 1 and Promise 2 can be deduced to have the following values at Maturity ("T"):

Promise 1(T) = Max{0, S1(0)xS2(T)/S2(0)-S1(T)}; and

Promise 2(T) = Max{0, S1(T)-S1(0)xS2(T)/S2(0)}

Hence, the value of Promise 1 and Promise 2 at any time, t, between the inception date and Maturity can be computed as follows:

Promise 1(t) = E[Max{0, S1(0)xS2(T)/S2(0)-S1(T)}]xPV(T-t); and

Promise 2(t) = E[Max{0, S1(T)-S1(0)xS2(T)/S2(0)}]xPV(T-t)

Where the following definitions are given;

E[ ] = Expected value

PV(T-t) = Present value factor for a tenor equivalent to (T-t)

Hence, we can expand the left hand part of the primary equation as follows:

S1(t)-E[Max{0, S1(0)xS2(T)/S2(0)-S1(T)}]xPV(T-t) + E[Max{0, S1(T)-S1(0)xS2(T)/S2(0)}]xPV(T-t)

This equates to

S1(t)+ABS{E[S1(0)xS2(T)/S2(0)-S1(T)]}xPV(T-t)

With the following definition:

ABS { } = Absolute value

In addition to this, we can mathematically infer that at any time t E[S2(T)]=S2(t)/PV(T-t), and that E[S1(0)]xS2(T)/S2(0)]=(S1(0)xS2(t))/(S2(0)xPV(T-t))

Hence, the left hand part of the primary equation simplifies to S1(t)+ABS{S1(0)xS2(t)/S2(0)-S1(t)}.

Given that S1(0)=S2(0) we have proven that the left hand sight of the primary equation is equal to S2(t) which needed to be proven.



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