

The Status of Preference Shares from Islamic Perspective

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Abstract

The formation of preference shares involves *musharakah* contracts or companies in Islam. However, preference shares have different specifications with ordinary shares. This distinction of specification prevents the law of preference shares to accept disputes between Muslim scholars both locally and globally. The objective of this study is to analyze the status of preference shares from Islamic perspective. The content analysis method was chosen as the design of this study. The qualitative data is collected through document analysis. Meanwhile, the process of analyzing is done by using descriptive approach. The finding shows that the concept of preference shares is appropriate for adoption but requires modification in the structure of the contract.

Keywords: Shares, Preference Shares, *Musharakah*

Introduction

Shares can be generally divided into two main types, namely common shares and preference shares. Common shares are the shares that give their holders the right to gain profit after profits are divided among preference shareholders. Owners of common share have the right to vote at the Annual General Meeting, appoint a proxy, issue rights, assets and the right to open their account book. In addition, common shareholders will be also held accountable based on the value of shares held in a company. In contrast to common shares, preference shares represent shares that give privileges or preferences to their holders rather than common shares such as having preference rights, fixed income and returns, less capital losses, flexibility in capital structure, no financial burden and no charges on company assets.

Following this, preference share received a dispute over its imperative law among Islamic scholars following its principles that have violated the principle of *musharakah* applied in share concepts. This article will examine some of the questions on the principles of *musharakah*. How do preference shares violate the principles of *musharakah*? What rulings and Shariah resolutions that are related to the preference shares issued?

Definition of Preference Shares

Preference shares are shares that give preferences or privileges to their holders over the common shareholders. The priority given is based on the perspective of acquisition of a company, in which the preferred shareholders will get their dividend in advance with a fixed rate at the time of issuance regardless of the profit or loss of the company (Madhurima Dutta, 2013). In the economic system, preference shares serve as a less risky financial instrument than other common shares. In fact, preference shares can give investors the advantage of seeking maximum returns with lower risks than the common shares. Preference shares are also seen attractive to investors through the range of priority risks offered (Hossein Askari, 2012).

It is observed that the issues related to share concept have been debated by earlier researchers either among classical or contemporary *fuqaha* (Islamic jurists). In fact, the concept of share itself is not a new thing since it has long been discussed by earlier researchers such as Al-Kasani (1993), Al-Khayyat (1989), Nyazee (2006) and Fahd (2007). They examined the shares in *musharakah* chapter of partnership or company.

Although preference shares are issued based on *musharakah* and equity principles, there are features of preferred shares that resemble debt properties such as fixed dividend distribution and privileged treatment of preference shareholders during the liquidation of company, whereas the concept of *musharakah* involves profit sharing and loss where profits will be shared in accordance with the ratio of participating capital contributions as well as losses incurred in accordance with the contributed capital ratio. In addition, participants in the *musharakah* have the right to vote in the company they are participating, while participants in the preferred stocks have no such right despite the fact that they are also partners in the *musharakah* contract that are duly qualified to speak up and vote at the company's Annual General Meeting.

Profit and Loss Sharing in *Musharakah* Contract as Basic Requirements in *Musharakah*

The concept of company or *musharakah* involves the participation of two or more parties in a particular business with each participant filing a certain amount of capital for them to equip the business and equally share profits and incur losses according to their capital contribution rate. In fact, the share of profit and loss is a specific trait in *musharakah* contracts (Usmani, 2005). Basically in a *musharakah* contract, profits will be distributed at the agreed rate in the contract in percentage form and there is no fixed amount that can be determined by the partners. Partners in *musharakah* contracts are only entitled to claim their share when the company profits in its business. Meanwhile, if a company loses its business, then it will be borne by them according to the percentage of invested capital. Consequently, any party offering a definite capital will not escape the risk of losses in the investments they incur based on its contributed capital rate.

In terms of profit distribution in the *musharakah* contract, the share or rate of profit distributed among the partners must be agreed at the time the contract is concluded. In fact, if no rate is determined at the time the contract is agreed, the *musharakah* contract is considered invalid on the Islamic legal side. Meanwhile, profit ratio for each partner should be determined according to the actual profit rate accruing in the *musharakah*, and not according to the fixed

return of the capital invested in the *musharakah* contract. Shariah does not allow any participant or partner to set up any amount of profits to be earned or bind to any profit rate in investment made (Usmani, 2005).

All scholarly scholars agreed that the distribution of profits in the *musharakah* contract cannot be determined as a fixed amount. However, these scholars have different views on the division of profits for *musharakah* contracts (Al-Jaziri, 1986). The scholars of Hanafi and Hanbali view that *musharakah* partners are permitted to determine any proportion of profit by mutual agreement as they perceive profits as a direct impact or as a result of *musharakah* business ventures using capital, while the loss is as a shrinkage of *musharakah* capital. Hence, Shariah principle distinguishes between the advantages and disadvantages as well as the underlying principles. Meanwhile, scholars from Shafi'i and Maliki stated that the distribution of profits in *musharakah* should reflect the proportion of invested capital. According to them, profit sharing must be based on the capital ratios contributed in the *musharakah*, which is also considered as one of the compulsory conditions in the contract, while any change in this case may lead to the facade or cancellation of *musharakah* contract. The profit or *al-nama'* in the *musharakah* contract is the result of capital contributed by the *musharakah* partners (Al-Jaziri, 1986). Nonetheless, the Hanafi and Hanbali scholars agreed with Shafi'i and Maliki scholars in this regard, except for the distribution of profits, which according to them may differ from capital contribution in certain circumstances as follow:

I. When work or management is carried out jointly by the joint venture participants. In this case, profits are based on the amount of their capital contributions in the contract.

II. When the *musharakah* work is carried out only by part of the *musharakah* participants, while the other participants only involved in donating capital. In this case, those who do the work are entitled to request a certain portion of the business profit they have agreed upon during the contract as a wage for management performed in the *musharakah* contract.

If observed, profit sharing is not merely for the contributors of capital, but also for those directly involved in managing the *musharakah* business. Therefore, if one of the *musharakah* partners does the job, then the other partners are entitled to negotiate on allocating a certain amount of profit as a wage. The same applies when both partners work, one of them is also entitled to gain more profit because it is possible that one of the *musharakah* partners performed more work than other partners. In terms of profit distribution ratio, there is a difference between profit ratio and capital ratio in *musharakah* contract and this led to some differences in opinion among scholars. In this case, Maliki and Shafi'i scholars are with the view that each partner should receive a profit ratio based on the capital contributions invested by them (Ibn Qudamah 1972). For example, if a partner has invested 60% of the total capital, then they should receive 60% of the *musharakah* profit. Any agreement other than that, which permits the partner to receive more or less than 60% of the profits, will cause the contract to be invalid on Shariah principle side.

Meanwhile, Hanbali scholars have different views on what the Maliki and Shafi'i scholars put forward in which the profit ratio may differ from the investment ratio if the agreement is made between *musharakah* partners without any conditions. Therefore, according to Hanbali

scholars, the Shariah principle allows one of the partners to receive a profit exceeding the ratio invested. For example, an investor with a 30% ratio can receive profits with a 50% or 60% ratio although partners who invest at a 70% ratio only earn 40% or 50% of the profit ratio in *musharakah*. Meanwhile, Imam Abu Hanifah give his view that in most cases, the profit ratio may differ from the investment ratio, but if one partner has put clear conditions in the *musharakah* agreement that he will not work and only remain as a capital partner only during the period of time, his share of profits shall not exceed his investment ratio (Al-Kasani, 1983).

Muhammad Nejatullah Siddiqi assumed that the views of the Hanafi and Hanbali scholars are stronger and convincing because they are more flexible in the scope of business in the form of *musharakah* (Muhammad Nejatullah Siddiqi, 1991). In his rationale, he explained that in distributing profits fairly, it is important to empower partners to establish the principles of profit distribution through mutual agreement. This is because through this mutual agreement, the *musharakah* partners are able to consider their stock investment and capabilities. If profit calculation is done based on the contributed capital ratio, it is considered unfair as each partner who works in the *musharakah* certainly has the capabilities, qualifications and experience that vary from one another. Thus, if all of them work together in *musharakah*, profit calculation will be unfair to those who are more qualified and experienced. In the context of preferred shares, priority in the payment of certain dividends will be given by common shareholders to preferred shareholders. In this case, there is a probability that these preference shareholders receive all profits if the actual profit is less or exceeds the expected profit to them as agreed to be given to the preference shareholders. However, if the actual profit exceeds the expected profit, there is a probability that common shareholders will receive a certain ratio of profits. Therefore, in the context of preference shares, the profit ratio does not necessarily meet the *musharakah* investment ratio.

Hence, the three views of the scholars are applicable in this regard where Imam Malik and Imam Shafi'i said that such profitability ratio is not allowed by Shariah principle, while on the other hand, Imam Ahmad proposed that it is allowed. However, Imam Abu Hanifah is of the opinion that such profitability is not permissible as he thinks that the ratio of the non-working partner's profitability cannot be more than its investment ratio. When referring to the Standard Shariah by AAOIFI, it was found that the standard follows Imam Abu Hanifah's view on this matter. According to Article 3, partners may agree to make a profit sharing that does not match their capital contributions, provided that the percentage of profit increase exceeds the percentage of capital contribution and is not in favour of the non-working partners. However, there is an exception in the article, that is, "if the partner does not impose the condition that he becomes a partner who does not work, then he reserves the right to set one share of additional profits out of his capital contribution percentage even though he does not work" (AAOIFI, 2003).

In summary, it can be concluded that the priorities in the payment of certain dividends given by common shareholders to preference shareholders are in line only with Imam Ahmad's view. Such priorities may be justified by other scholars if the major shareholders do not impose the condition that such preference shareholders are merely partners who sleep in the *musharakah* contract.

Liability Towards Loss in *Musharakah* Contract

In *musharakah* contract, losses refer to the part of the capital being eliminated. Therefore, the loss is distributed based on the proportion of capital invested in *musharakah* and is borne by the capital owner, which is the *musharakah* partner. Shams al-Din al-Sarakhsi, the scholar of the Hanafi, stated that the loss indicates the part of the capital that was abolished (Al-Sarakhsi, 1998), while Ahmad al-Dardir added that 'profit and loss under the company (*musharakah*) will be distributed between the two parties according to their investments' rating (Al-Dardir, 1997). Similarly, the Shafi'i scholars believe that the same profit and loss will be distributed according to the proportion of invested capital whether the partner's business activity is equal or vice versa (Al-Nawawi, 1999). Ibn Qudamah, a scholar from Hanbali's school also shared the same view in this regard (Al-Nawawi, 1999; Ibn Qudamah, 2000).

Hence, it can be concluded that all scholars agreed that the loss should be shared by the *musharakah* partners in accordance with the proportion of capital invested by them. In this case, they agreed that any conditions contrary to the principle of loss will be declared invalid and will not be implemented (Al-Khafif, 2000). Since all the *fuqaha* (Islamic jurists) agreed on the same view, then each partner should bear the loss according to the ratio of the *musharakah* investment. For example, if a *musharakah* partner has invested 30% of the company's capital, this partner must bear 30% of the loss, no more, no less and any conditions contrary to it are considered illegal in the Shariah principle side. This principle has been agreed upon by the consensus of the *fuqaha* by unanimous consent among them although they are from different schools. In a business as well, it is impossible to avoid the risk of loss when capital investment has been made. Consequently, the loss is a partial write-off of capital and due to elimination; when the loss occurs, the liability of the loss is against the owner of the capital itself.

Preference shares are shares that give priority to major shareholders rather than common shareholders to recover capital in the event of liquidation of the company. The priority given contradicted with the *musharakah* concept because losses must be borne among the *musharakah* partners according to their investment ratio in the contract as discussed earlier.

Based on the Standard Shariah from AAOIFI, it was found that the standard follows the view of the scholars on this subject. According to Article 4, it is not permissible for partners to agree on holding a couple or a group of partners responsible for all losses or exceeding the percentage of losses not to their share of ownership in the partnership. However, there is an exception in the article, that is, "however, it is valid if a partner takes responsibility for incurring losses at the time of the loss without any conditions" (AAOIFI, 2003).

Therefore, in conclusion, the priority in returning the capital in the event of company liquidation provided by common shareholders to the preference shareholders is not permitted by the Shariah principle unless one of the *musharakah* partners is liable to incur losses at the time of such loss. So, here comes the issue of *tanazul*, which is an agreement made between the *musharakah* partners upon the conclusion of a *musharakah* contract where one or a part of the partner agrees to release his or her right to profit or to assume all possible losses from the *musharakah* contract.

The Status of Preference Shares

The Shariah Advisory Council (MPS), the Securities Commission Malaysia at the 20th Meeting on 14 July 1999 has decided that non-cumulative preference share law is necessary and is allowed to be based on the concept of *tanazul*. *Tanazul* in the context of *muamalat* means to release one's rights (Bank Islam Malaysia Berhad, Glossary of Terms BIMB, 2011). The intention to discharge a person's right is to release a person's right or property, not to the owner and not to the person entitled to receive the rights.

The SAC decided that based on the principle of *tanazul*, the right to receive profits by the common shareholders is voluntarily granted to the preference shareholders. The approval for *tanazul* is agreed at the Annual General Meeting of a company, which decides to issue priority shares in an effort to obtain new capital. This principle is also known as *haq isqat* in the Islamic jurisprudence.

However, cumulative preference shares are contrary to the concept of profit sharing or *musharakah*. This is because these cumulative terms have resulted in the cumulative preference shareholders entitled to receive dividends regardless of profit. The consent of the shareholders in a *musharakah* contract where one of the shareholders will not share the profit or loss, or only a few partners will bear the loss or some of the partners are covered from bearing any loss has also contradicted the principles of Shariah (Al-Khayyat, 1989). This is supported by the jurisprudence method, namely (Al-Nadawi, 2000):

الغنم بالغرم

Meaning:

The profit is through risk coverage.

Cumulative preference shares are shares that allow the preference shareholders of the claim to receive unpaid dividend in the previous year such as accrued or overdue dividends in which they are given preference in dividend payments over common shareholders. In the case of non-cumulative preference shares, any unpaid or accrued dividends in the previous year shall not be brought forward or into that year or the following year and disposed of by the shareholders. (Mayo, Herbert B., 2003).

Therefore, based on the arguments stated, cumulative preference shares are not allowed in Islam as it contradicts the purpose of profit sharing and loss in *musharakah* contracts.

In addition, there are preference shares issued for redemption. It refers to one type of preference shares of the company that has the right to be repurchased on a certain date for a certain price. One of the key resolutions made by the SAC, the Securities Commission Malaysia in 2006, is that redeemable preference shares are in accordance with the principles of Shariah. To ensure that it is in harmony with the principles of Shariah, the purchase price set at the time of issuance of shares must be based on the principle of *wa'd* in which the issuer (the company) undertakes to repurchase the preferred shares from the shareholders at a future date based on the purchase price enclosed on the date of publication. In short, the term *wa'd* is known as a one-side pledge and refers to the commitment made by someone to another person to do an act or to dispose the benefits verbally to the other party (Mohamad, 2010). The primary

purpose of this binding pledge is to secure the promise that the plaintiff will fulfill its obligations as stated in the pledge (Al-Ziyadat, 2008).

Fatwa and Shariah Resolutions on Law of Preference Shares

There are various fatwa submitted by some organisations such as the Shariah Resolution by MPS, the Securities Commission of Malaysia, AAOIFI, Islamic Fiqh Conference (*Majma 'Fiqh Islami*) and Arab Conglomerate, *Dallah Al-Barakah*, on the law of preferred shares in Islam. MPS by the Securities Commission of Malaysia at the 20th Meeting on 14 July 1999 has decided on the non-cumulative preference share based on the concept of *tanazul* as follows:

“The Shariah Advisory Council ruled that non-cumulative preference shares are required based on the principle of *tanazul* whereby the common shareholder's profitability is freely granted to the preference shareholders. *Tanazul* is agreed at the Company's Annual General Meeting, which decided to issue priority shares to acquire new capital. When this meeting agrees to issue a preference share, it means that common shareholders have agreed to prioritise preference shareholders in the distribution of profits according to *tanazul*” (Securities Commission Malaysia, 2006).

According to the Shariah Resolutions submitted by the MPS, which is the Securities Commission Malaysia, non-cumulative preference shares are the preference shares where the period of shareholders or investors to hold such shares is unrestricted or permanent. The preference shares of this type are the same as common shares except that they are fixed and non-cumulative dividends. In addition, these shares also have the same characteristics as common shares, which have no maturity period and dividends that are not accumulated. Non-cumulative preference shares are included in the equity group with fixed dividend rates (Securities Commission Malaysia, 2012).

However, only the Shariah Resolution by the Securities Commission of Malaysia allows the non-cumulative preferred shares. In addition, all global fatwa organisations and organisations such as AAOIFI, Islamic Fiqh Conference (*Majma 'Fiqh Islami*) and Arab Conglomerate, *Dallah Al-Barakah* decided that preference shares are illegal in Islam. AAOIFI has decided that preference shares are illegal as in Shariah Standard No. (12) *Sharika (Musharakah)* and Modern Corporations, items 4/1/2/14:

“It is not permissible to issue priority shares, which are stocks that have special financial features that give them priority at the date of company liquidation or on the date of distribution of profits. However, it is permissible to give certain shares in respect of rights related to ordinary shares, matters relating to procedures and administration such as the right to vote” (AAOIFI, 2010, pp. 213).

Similarly, the Islamic Fiqh Conference (*Majma 'Fiqh Islami*) and the Arab Conglomerate, *Dallah Al-Barakah* have also decided on the banning the preference shares in their respective resolutions. At the 14th session of the Fiqh Islamic session in Doha, Qatar, held on 8 to 13 Zulkaedah, 11 to 16 January 2003, after studying the papers presented to the council on issues of modern companies, companies and others, shariah decisions related, and after hearing the discussion, they have decided on the following:

“It is not permitted for companies to issue enjoyed shares or preference shares or debentures. In a situation where the company is losing, it is mandatory for each shareholder to bear its share of losses according to their respective capital contribution within the company” (Resolution and Recommendation of the Islamic Fiqh Conference Council 1985-2000 at the 7th Conference, 2000, Resolution No. 6/94, pp. 140).

In addition, the ban on preference shares was also approved by a resolution issued by the Arab Conglomerate, *Dallah Al-Barakah*. Arab conglomerate, *Dallah Al-Barakah* in the 6th Islamic Economic Symposium in Algeria, believes that special services are not permitted in certain cases as it may result in the dissolution of the shariah contract (*Dallah Al-Barakah* Group, 2003, Resolution No. 6/28). In addition, *Dallah Al-Barakah's* Shariah Resolution in the 17th Islamic Economic Symposium held in Algeria also presented some impressions and views on the issuance of preferred shares by joint stock companies involving Islamic fund investments (*Dallah Al-Barakah* Group, Resolution No. 17/4). Through this resolution, preference shares involving preference shareholders that receive priority over common shareholders in terms of profits such as placing conditions on certain profit percentages are not allowed as well as in the case of liquidation of the company where the preference shareholders can get their priority to regain capital compared to common shareholders, which were also banned as it was against the company policy. This resolution also prohibited preference shares as it involves a fixed rate of profit and capital gains as it is considered to resemble lending and interest.

Meanwhile, in accordance with the resolution of the 14th *Al-Barakah* Islamic Economic Symposium, if the value of preference shares and loans in a company exceeds 30% of the value of the company's assets, ordinary shares should be banned as preference shares are deemed to be similar to the loan with interest. However, preference shares whose holders do not obtain voting rights are permitted as the preference shareholders have released their respective voting rights. In addition, preference shares are also permitted if such preference shareholders retain the right of redemption at current market value based on the period specified since the procedure does not violate the company's principles. This is because the company's procedure does not involve the right of preference for gains or guarantees of capital return during liquidation of the company.

Meanwhile, the Shariah Resolution in the 10th Islamic *Al-Barakah* Islamic Symposium also banned redeemable preference shares based on Resolution No. (65- / 1/7 Article 6) by the International Islamic Fiqh Academy in which it is illegal to issue preference shares with financial privileges or capital guarantees or certain profit values as well as preference of paying capital during liquidation of the company or profit distribution (*Dallah Al-Barakah* Group, Resolution No. 10/9). Nonetheless, the resolution requires the issuance of preference shares with privileges in the procedure and administration of the company such as preference to its holders for profit, percentage of profits or redemption right, provided that the shares must have included profits with its nominal value that is not to be redeem.

Completely, based on the rulings and resolutions, it is evident that the majority of the *fuqaha* (Islamic jurists) have banned most of the preference shares except the Shariah Resolution issued by the MPS, the Securities Commission of Malaysia. Through this resolution, the MPS is of the opinion that non-cumulative preference shares should be based on the

concept of *wa'd bi al-tanazul*. The concept of *tanazul* is used in three different situations, which are *tanazul* granted by common shareholders to preference shareholders, where common shareholders agree to release their right to profit only until the preferred shareholders gained their benefit based on a certain rate, which the *tanazul* is given at the beginning of *musharakah* contract for the sake of ensuring the occurrence of such matter in the future. In other circumstances, *tanazul* is granted by the common shareholders to the preferred shareholders by agreeing to limit their profits only to certain rates. In addition, *tanazul* is also granted by common shareholders to preference shareholders in the event of a liquidation situation of the company in which the preference shareholders are given the priority to recover their contribution capital before other common shareholders.

Conclusion

The concept of shares has been adopted and recognised by contemporary scholars today based on its equality with the *musharakah* concept. However, as time goes with advancement of this age, there are new products in the Islamic stock market to meet the market demand and the current economic role. Preference shares are among the stock products that have their own advantages. Nevertheless, the concept of preferred shares appears to be contrary to the principles of the *musharakah* contract outlined by Shariah such as capital guarantee, guaranteed returns, no voting rights and preferential or special treatment compared to other common shareholders. Thus, there is a need to identify the position of preference shares that comply with the principles of Shariah.

Similar to the common shares, preference shares also have an economic impact. From one dimension, preference shares give advantages to investors and stock companies. Advantages such as having preference rights, fixed income and return, less capital losses, have flexibility in capital structure and no financial burden have attracted the Islamic stock markets in Malaysia. Hence, its existence is also seen as significant in the economic and financial development of Muslims in Malaysia.

The Companies Act 1965 and the principles of Shariah recognised the issuance of different types of share in accordance with the rights attached to the shares. In assessing the law of preference shares, Islam takes into account the rights included together with the types of share regardless the classification used. Law of preference shares depends on the issue of whether or not there are any priority rights that are in harmony with the principles of Shariah. Cumulative preference shares are illegal in Islam. However, the Companies Act 1965 does not require that preference shares issued must be cumulative. In fact, the issuance of preference shares with no cumulative characteristics does not conflict with the Companies Act 1965 or the principles of Shariah.

The law of preference shares has been debated by scholars and Shariah scholars globally through the rulings and Shariah resolutions issued by organisations and fatwa bodies worldwide. Nevertheless, the majority of global leaders have decided that preference shares are illegal. Local Islamic scholars have required non-cumulative preference shares based on the concept of *tanazul* through the Shariah Resolutions issued by the MPS, the Securities Commission Malaysia. Although resolution has been issued, the concept of *wa'd bi al-tanazul* in

use is still argued among the scholars. This is due to its use involving *wa'd* to perform *tanazul* in the distribution of profits and losses by common shareholders to preferred shareholders. The *Wa'd* done is related to *gharar* because the profit and loss cannot be ascertained at the beginning of the *musharakah* contract.

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