EFFECTS AND REMEDIES FOR BREACH OF FINANCIAL CONTRACTS IN ISLAMIC BANKING TRANSACTIONS: A COMPARISON OF MODERN ISLAMIC BANKING PRACTICES WITH ISLAMIC LAW AND PAKISTANI LEGISLATION

By

Sadia Ashraf Baluch

Registration No. 91/FSL/LLMICL/F10

Under the Supervision of:

Professor Dr. Muhammad Tahir Mansoori, D.G. Shari'ah Academy IIUI

FACULTY OF SHARI'AH AND LAW

INTERNATIONAL ISLAMIC UNIVERISTY, ISLAMABAD

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A Thesis submitted in partial fulfillment

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By

Sadia Ashraf Baluch

Registration No. 91/FSL/LLMICL/F10

Master's (LL.M) Committee:

Professor Dr. Muhammad Tahir Mansoori, D.G. Shari'ah Academy IIUI

Internal Examiner: Dr. Abdullah Rizk

External Examiner: Dr. Amir Khalil-ur-Rahman


بسم الله الرحمن الرحيم

DEDICATED TO MY EVER-LOVING ABBA AND AAEI

رَّبِّ ارْحَمْهُمَا كَمَا رَبَّيَانِي صَغِيرًا

DECLARATION

I, **Sadia Ashraf Baluch,** hereby declare that this dissertation is original and has never been presented in any other institution. I, moreover, declare that any secondary information used in this dissertation has been duly acknowledged.

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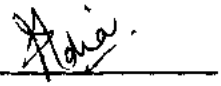
Signature: 

Date: 26-05-2014.

Supervisor: Dr. Muhammad Tahir Mansoori

Signature: _____

Date: _____

International Islamic University Islamabad

Faculty of Shari'ah & Law

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Approval Sheet

This is to certify that we evaluated the thesis entitled "Effects and Remedies of Breach of Financial Contracts in Islamic Banking Transactions: A Comparison of Modern Islamic Banking Practices with Islamic Law and Pakistani Legislation" submitted by Miss Sadia Ashraf Baluch, Reg. no. 91/FSL/LLMICL/F10 in partial fulfillment of the award of the degree of LL.M Islamic Commercial Law. The thesis fulfills the requirements in its core and quality for the award of the degree.

Professor Dr. Muhammad Tahir Mansoori, Supervisor _____

D.G. Shari'ah Academy

Internal Examiner _____

External Examiner_____

ACRONYMS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
BPRD	Banking Policy and Regulation Department
CA	Contract Act
CIB	Credit Information Bureau
CIR	Credit Information Report
DM	Diminishing Musharkah
ESC	Early Settlement Charges
FC/s	Financial Contract/s
FI/s	Financial Institution/s
FIRFO	Financial Institutions (Recovery of Finance) Ordinance
FSC	Federal Shari' at Court
IB/s	Islamic Bank/s
IBD	Islamic Banking Department
IBI/s	Islamic Banking Institution/s
IDB	Islamic Development Bank
IDBPO	Industrial Development Bank of Pakistan Ordinance 1961
IFI /s	Islamic Financial Institution/s
IFSB	Islamic Financial Services Board

IIFA	International Islamic Fiqh Academy
IMB	Ijarah Muntahia Bittamleek
ISA	Installment Sale Agreement
LPC	Late Payment Charges
OICFA	Organization for Islamic Conference (Fiqh Academy)
PBUH	Peace Be Upon Him (Muhammad, the last prophet)
PLS	Profit and Loss Sharing (Saving Account)
RFQ	Request for Quotations
SA	Shari'ah Advisor
SAB	Shari'ah Advisory Board
SBP	State Bank of Pakistan
SC	Supreme Court
SCM	Shariah Compliance Mechanism
SCSAB	Supreme Court Shariat Appellate Bench
SGA	Sale of Goods Act
SRA	Specific Relief Act
SRB	Special Review Board
SSB	Shari'ah Supervisory Board

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ABSTRACT

Fulfillment of contracts has been emphasized both in the Islamic law and Positive law. All laws are made to avoid any kind of harm or injury, but if it is inflicted, then it has to be removed. In case of the breach of financial contracts, the aggrieved party suffers the loss which has to be redressed. Speaking particularly about Islamic finance, where the remedies provided for such breach must be Shari'ah compliant, the focus of this research was to make an analysis of the remedies availed by the modern Islamic banks, with Shari'ah and Pakistani legislation.

The issue of alternative modes of remedies for avoiding interest (*Riba*) has been discussed in detail as the Islamic banks and Financial Institutions face problems because of the defaulting customers but they can not stipulate any kind of interest as a penalty, like conventional banking system. The thesis analyses the system of Islamic finance prevailing in Pakistan, specifically in providing the modes by which fulfillment of financial contracts can be secured; along with the remedies in case of breach of contractual obligations by the clients and customers in their contracts with Islamic banks and Financial Institutions.

The net conclusion of the thesis is the need for Shari'ah compliance mechanism and strengthening of regulatory framework to solve the issues of non-performance of obligations by customers and compensating the Islamic banks for loss suffered by the banks and financial institutions because of breach of financial contracts by their clients.

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INTRODUCTION

The Islamic Financial system is facing challenges and constraints in Pakistan. There are numerous problems faced by the system e.g. difficulty in enforcing contracts, inefficient system for early recovery etc.[1] These problems make the Islamic Banks (IBs) and Islamic Financial Institutions (IFIs) prone to several risks that can cause financial loss and damage in Financial Contracts (FCs) with clients. Unlike conventional banking system, where the defaulting clients have to pay the specific amount of interest, the IBs and IFIs can not demand interest as compensation as it is against the injunctions of Islam.[2] The IBs and IFIs must have their own set of principles, philosophy and conditions for financing which should be truly based on Shari'ah.

The sanctity of contracts has been recognized by Islamic law as well as positive law. Islam emphasizes its followers to follow the covenants and fulfill the promises.[3] The principle of *Pacta Sunt Servanda*[4] (the agreements must be kept) indicates the sanctity of contracts in the positive law. Whenever there is a contract, there is a risk of its breach which can cause loss to the aggrieved party. In case of FCs, the loss would be pecuniary which has to be redressed through some kind of remedy. The Islamic injunction of removing the harm is very clear by the principle الضرر يزال. By the breach of FC, a party

[1] Islamic Development Bank Group, *Member Country Partnership Strategy for Pakistan*, 2012-2015, pg. 117
[2] Quran 2: 275
[3] Quran 17:34 and 5:1
[4] The principle of pacta sunt servanda taken from <http://www.wisegeek.com/what-does-pacta-sunt-servanda-mean.htm> accessed on 01-04-2012 at 09:00 p.m. PST.

inflicts some harm upon the other which has to be removed through some remedy. In the positive law, the principle of *Ubi Jus Ubi Remedium*[5] (where there is a right, there is a remedy) also provides for remedy in case of infringement of any right.

In case of modern IBs and IFIs, they can not stipulate interest as a penalty for default. The problem arises that if nothing is charged from the defaulters, it may be a great incentive for a dishonest person to default continuously.[6] In such circumstances, there is a need of examining the remedies provided for the breach of contracts in modern Islamic banking transactions. The questions related to the contractual liabilities and the remedies for the breach of FCs are as follows:

1- What is the importance of contractual liability in Islamic law and Pakistani legislation?

2- Is there any codified law which governs the financial system of IBs and IFIs in Pakistan?

3- What guarantees are allowed by the law to be taken by IBs and IFIs as security in FCs? Are theses guarantees Shari'ah compliant?

4-In case of breach of FCs, what remedies are provided by Islamic law and Pakistani legislation?

5- Are the remedies provided in Pakistani legislation in conformity with Islamic law?

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[5] Bryan A. Garner, *Black's Law Dictionary*, (USA: West Group Publishing Co., 1999) 7th edition, 1695
[6] Muhammad Taqi Usmani, *Islamic Finance* (Karachi; Maktaba Ma'arif ul Quran, 2002), 137

6- Practically, which remedies are availed by modern IBs and IFIs in case of breach of contractual obligations by their clients? Are these remedies Shari'ah compliant or not?

These questions are discussed in detail in the chapters. The guarantees are discussed which are taken by the IBs before entering into any financial transaction. For the purpose of making an in depth analysis, not only the guarantees in Islamic law and Pakistani legislation are observed; but also those guarantees which are demanded by modern Islamic banks are taken into account to come to a conclusion about their being Shari'ah compliant or not. Guarantees taken by different modern IBs e.g. AlBaraka bank, Burj Bank Ltd, Meezan Bank etc were observed.[7]

The IBs demand the guarantees to secure the fulfillment of contracts by their clients and to prevent the cases of default. But in case of default, unlike the conventional banks, the IBs and IFIs first demand clarification from the defaulting client. If he fails to prove that he committed default because of some valid Shariah justification, then he has to make up for the loss that he caused because of his non-performance of the contract.

The remedies for the breach of contracts in Islamic law and those availed by the IBs are almost same. Only there are few issues related to the legitimacy of some remedies which are discussed in detail in the chapters.

[7] Information was collected by the branch Managers, Shariah Advisors and Shariah Coordinator of these banks to know the practical application of guarantees and remedies in case of breach of contracts in these Islamic banks in Pakistan.

The thesis not only discusses the remedies in modern IBs in Pakistan but also highlights some Islamic countries' civil laws to make a comparison of them and to elaborate and explain our relevant issue of the remedies.

LITERATURE REVIEW

Much has been written about the various aspects of the issues under discussion, by different scholars. The Shari'ah Standards framed by AAOIFI deal with different forms of guarantees in the standard no. 5. The legitimacy of the guarantees is discussed in the Appendix B of the Shariah Standards in detail. It also discusses the consequences of default in the payment of debt by the debtor, in the standard no. 3.

Hazik Mohammed in his research paper titled *Compensation for Breach of Contract: Conventional & Islamic Perspectives* has discussed the remedies in the Islamic law and Conventional system for the breach of contracts. He has discussed the remedies for breach of contracts in different legal systems and at the end he has discussed the distinguishing elements of the Islamic law with regard to the contracts and their breach.[8]

Muhammad Taqi Usmani, in his book *Islamic Finance,* has discussed different types of Islamic modes of financing. Discussing each of them separately, he has

[8] "Compensation for Breach of Contract: Conventional & Islamic Perspectives" by Hazik Mohammed taken from http://www.academia.edu/5612810/Compensation_for_Breach_of_Contract_Conventional_and_Islamic_Perspectives accessed on 5th April 2014 at 4.50 p.m. PST

discussed precisely some guarantees taken as security and the enforcement of them in case of breach. He has also discussed the problem of default and the legal issues involved with penalty for default by the debtor.[9] He has also given some alternative suggestions for stopping the dishonest persons from default.[10] His article is also available in the book titled *Fiqhi Maqalaat* by the same author.[11] He has also discussed the provision of 'Compulsory Charity' in the financial transactions, and its legitimacy.

Muhammad Ayyub, in his book *Understanding Islamic Finance,* has discussed *Hamish Jiddiyah* and *Arboun* as security to be paid to the bank.[12] He has defined and explained them in detail and he has also discussed the position of promise in different transactions e.g. in banking Murabaha.[13]

Muhammad ibn Adam al-Kawthari, in his article *'Legal status of late penalty payment in Islam'* has declared every type of additional amount in case of default by the debtor, unlawful.[14] According to him such additional amount is nothing but riba and can not be taken by Islamic banks and IFIs.

An article *'Rulings on Penalty Charges'* by Fakiha Azhari has elaborated the permissibility of 'compulsory charity' as it is greatly in the public interest and used for

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[9] Muhammad Taqi Usmani, *Islamic Finance* (Karachi; Maktaba Ma'arif ul Quran, 2002), 131
[10] Ibid,137
[11] Muhammad Taqi Usmani, Fiqhi Maqalaat (Karachi: maiman Islamic Publishers, 1994), 121
[12] Muhammad Ayyub, *Understanding Islamic Finance*, (England: John Wiley and Sons limited , 2007) ,116
[13] Ibid, 117
[14] Legal Status of Late Penalty payments in Islam by Muhammad ibn Adam al-Kawthari, UK taken from http://www.central-moaque.com/index.php/General-Fiqh/legal-status-of-late-penalty-payment-in-islam.html accessed on 2nd April 2014 at 4:30 p.m. PST

public welfare, provided that it is not used by the receiving banks or IFIs.[15] After discussing the legitimacy of penalty charges, she has discussed the rate of such charges which should be fair and according to the circumstances of the case. According to her, "the rate of the penalty charges to be imposed is dependent on many factors namely the Financier's cost of fund, the administrative charges, expenses, legal costs, etc. The principle in charging penalty charges is to compensate the Financier for any loss or injury suffered by the Financier".[16]

In Pakistani law, *The Contract Act (IX of 1872),* in its chapter VI deals with the consequences of breach of contracts. It describes the situations where a party to the contract is entitled to compensation by the one who has not performed his part of the contract. According to its section 74's explanation, increase in the amount of interest is permissible if such was stipulated in the contract. But any form of interest has been declared as unlawful by the Shariat Appellate Bench of the Supreme Court of Pakistan.

The order of the Court is available in the book the *Historic Judgment on Interest* by Muhammad Taqi Usmani; and also in the *Supreme Court judgment on Riba* by Justice (R) Khalil-ur-Rehman. They have discussed in considerate detail the interest

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[15] An article on "Rulings on Penalty Charges" by Fakihah Azahari (published in Islamic Finance News Asia, dated 28the July 2006, page 9)taken from< http://nfcfakihah.wordpress.com/2010/09/20/37/> accessed on 4th April 2014 at 5:40 p.m. PST

[16] Ibid

and its different forms. Finally, all those laws having provisions of *riba* in any of its forms were held to be repugnant to the injunctions of Islam, and thus declared as unlawful.[17]

The *Specific Relief Act (I of 1877)* deals with different types of reliefs given to the aggrieved party as remedy for breach of contracts. Likewise, the *Sale of Goods Act, 1930* provides for the remedies available to the sellers and buyers in case of breach of the contracts of sale. The *Financial Institution (Recovery of Finance) Ordinance 2001* provides for the remedies available to the Banks and FIs in case of default by the clients.

Thus, we notice that the remedies for breach of contracts are available in Islamic law and also in Pakistani legislation. Many authors have discussed some of them in detail but the remedies for breach of contracts in modern IBs and IFIs need to be discussed in the light of Islamic law and Pakistani legislation.

Hence, there is a need of an in depth analysis of such remedies which are availed by the modern IBs and IFIs, keeping in focus their legitimacy in Islam.

OUTLINE OF THESIS

For analyzing the issues related to the Shari'ah compliance of the remedies for breach of financial contracts in modern Islamic banking transactions, the thesis has been divided into five main chapters:

[17] Mr. Justice (R) Khalil-ur-Rehman Khan, *The Supreme Court's Judgement on Riba*, (Islamabad: Shariah Academy IIUI,2008), 357; the order of the Court can also be studied in *The Historic Judgement on Interest*, by Muhammad Taqi Usmani, 159

Chapter one defines financial contracts and elaborates the general and detailed classification of these contracts. After giving the definitions of all the different forms of financial contracts, the chapter explains the importance of fulfillment of contractual obligations in Islamic law and Pakistani legislation.

Chapter two discusses the breach of contract while elaborating different forms of breach and finally discussing and examining the effects and consequences of breach of financial contract, in detail.

Chapter three explains the different types of guarantees and securities taken by the Islamic banks and IFIs in order to secure the contractual liability of their clients. It explains and examines the different forms of guarantees and discusses how they help in providing remedy to the banks in case of breach by the clients. At the end, the chapter elaborates the meaning and position of 'promise' in Shari'ah and law, with specific reference to the financial contracts.

Chapter four analyses the remedies which are available in Islamic law and Pakistani legislation, for the breach of financial contracts. While discussing the remedies in Pakistani legislation, different statutes and Acts are mentioned e.g. Contract Act, Sale of Goods Act, Specific Relief Act and Financial Institutions (Recovery of Finance) Ordinance etc. the codified law of some Islamic countries have also been discussed for making the analysis e.g. the Egyptian Civil Law. At the end of the chapter, a comparative analysis of remedies in Islamic law and Pakistani legislation is done.

Chapter five, (the last chapter) deals with the existing prevailing and adopted remedies for breach of financial contracts by the modern IBs and IFIs. After discussing the general remedies, the chapter examines them specifically in different Islamic financial products. At the end, these remedies are examined in the light of those discussed in the fourth chapter.

These chapters are followed by a conclusion; and the findings of the study and recommendations are recorded in the precise manner.

Chapter One

FINANCIAL CONTRACTS AND CONTRACTUAL LIABILITY IN SHARI'AH AND LAW

INTRODUCTION

Contracts are an important part of commercial transactions and Financial Contracts (FCs) are the type of contracts that involve some measure of value as the subject matter of the contract. Since the preservation of property is considered to be of fundamental interest in Shariah and Law, any act that can result in violation of this fundamental interest is regarded as prohibited. The significance of the sanctity of contracts can be realized from the Ayāt and Ahadith emphasizing the fulfillment of contractual obligations. The principle of *'Pacta Sunt Servanda'* expresses the importance of contractual liability in the positive law. In this chapter, the definition and classification of the FCs shall be discussed. The contractual liability in Islamic Law and Pakistani Legislation shall also be discussed in detail.

1.1 Financial Contracts

FCs are generally defined as 'securities'. A security is generally a "fungible negotiable financial instrument representing financial value, normally issued by corporation, government, or some other organization"[1]. It is defined as "some type of financial instrument that is negotiable and

[1] Financial security taken from < http://www.investorwords.com/4446/security.html> accessed on 17-03-2012 at 2:15 p.m. PST

has a recognized financial worth".[2]. Securities are broadly categorized into Debt securities, Equity securities and Derivative Contracts e.g. Futures, Forwards, Options, Swaps etc.

Securities being the negotiable financial instrument of financial value also include shares, commercial papers, mutual funds etc. Therefore, all those contracts that are related to securities are termed as 'Financial Contracts'.

The term 'Financial Contracts' has been defined as an arrangement that involves "securities, commodities, currencies, interest or other rates, other measure of value or any other financial or economic interest similar in purpose or function."[3]

According to this definition, an FC is basically an enforceable contract that is concerned with any measure of value, any financial or economic interest whether in shape of securities, commodities, currencies, interest or any other rate. This general definition includes any commercial transaction which has some financial interest for the contracting parties. All kinds of persons whether individuals, companies or any other legal entities enter into FCs. People do not enter into such contracts only in general transactions but also in Financial Markets.

An FC in Financial Market is defined as "an arrangement that takes the form of an individually negotiated contract, agreement or option to buy, sell, lend, swap or repurchase, or

[2] Definition of security taken from http://www.wisegeek.com/what-is-a-financial-security.htm> accessed on 17-03-2012 at 2:30 p.m. PST

[3] Bryan A. Garner, *Black's Law Dictionary*, (USA: West Group Publishing Co., 1999) 7th edition, 321.

other individually negotiated transaction commonly entered into by participants in the financial markets."[4]

The requirement of 'individual negotiation' makes the FC in Financial Markets different from an ordinary one. The later is a mutually negotiated contract in which both the contracting parties have the right of bargain. But in Financial Markets, all the terms and conditions are set by the offerer and the offer is made to the general public. Anyone who finds some interest in the offer accepts it without having any bargaining rights.

In Financial Markets, financial securities, commodities and other fungible items of value are traded at low transaction costs. Securities include stocks, bonds etc while commodities include precious metals and agricultural goods etc.[5] There are some contracts that are entered into by parties " in response to a request from a counterparty for a quotation or they are otherwise entered into and structured to accommodate the objectives of the counterparty to such arrangements".[6] Such contracts are also termed as financial contracts.

The main ingredient, that is common in all the abovementioned definitions of FCs, is something of financial value or economic interest whether it is in the form of securities, commodities, currencies or other rates. Thus all types of transactions that have this main ingredient in them are FCs no matter they are transactions of sale, lease, partnership, repurchase or any other agreement.

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[4] Ibid

[5] 'Financial securities in Financial Markets' taken from <http://www.stanlib.com/Individuals/knowledgecentre/Pages/Moneymarketandmoneymarketinstruments.aspx> accessed on 27-03-2012, at 5:00 p.m. PST

[6] Bryan A. Garner, *Black's Law Dictionary*, (USA: West Group Publishing Co., 1999) 7th edition, 321.

1.2 Classification of Financial Contracts

Broadly speaking, the FCs are divided into two types:

1) Gratuitous contract
2) Commutative contracts

1.2.1 Gratuitous Contracts (عقود التبرّعات)

Gratuitous is a contract for the benefit of only one of the parties, the other party receiving nothing as consideration e.g. gifts, waqf, wills etc. According to English law, a mere promise does not itself create a legal obligation unless made under seal.[7] The absence of consideration from the promisee excludes it from being a legally enforceable and binding contract. According to the majority of Muslim jurists the promises are binding only morally but not legally. This topic shall be explained in the coming chapters.

1.2.2 Commutative Contracts (عقود المعاوضات)

Commutative is a contract in which both the promisor and the promisee have some consideration for them. There are so many kinds of commutative contracts that it is hard to discuss each of them. That is why a general classification of financial contracts is done in the light of the definitions of financial contracts discussed earlier.

1.2.3 Kinds of Commutative (Financial) Contracts

Broadly speaking the FCs are divided into seven types, which are as follows:

1) Contracts relating to securities

[7] A.G.Guest, *Anson's Law of Contract* (Oxford: Clarendon Press, 1984) 26th edition, 14

2) Contracts relating to currencies

3) Contracts relating to commodities

4) Contracts for quotations

5) Loan transactions

6) Repurchase agreements

7) Contracts involving some other measure of value

All the above mentioned kinds have numerous types which shall be discussed in detail.

1.2.3.1 Contracts relating to securities:

"Securities are written evidences of ownership giving their holders the right to demand and receive property not in their possession."[8] Since FCs are generally defined as securities, all the contracts relating to securities are included in financial contracts. Sale and purchase of securities, shares, bonds, unit trusts and all derivative contracts are included in this type. Derivatives include:

i) "Security derived from a debt instrument, share, loan, whether secured or unsecured, risk instrument or contract for differences or any other form of security.

ii) A contract which derives its value from the prices or index of prices of underlying securities."[9]

[8] J. N. Dhankar, *Pricing of Securities* (New Delhi: Bharat Publishing House, 1994) 18
[9] S.L.Gupta, *Financial Derivatives*, (New Delhi: Prentice, Hall of India pvt. Ltd. 2007) 4.

Derivatives further include Futures, Forwards, Options[10] and swap contracts. Other types of contracts relating to securities are Mortgage, Pledge, Assignment of debt, Suretyship and Guarantee. The detail of all the above mentioned kinds of security contracts is as under:

a) Futures

It is a "contractual agreement to sell or buy a particular commodity or financial instrument at a pre-determined price in the future."[11] Thus it is the "agreement between two parties for the deferred delivery of financial instruments."[12]

b) Forwards

"These are those contracts in which the counter-values are deferred with the legal effects of the contracts taking place at a determined future date, and delivery and possession take place at that time."[13] In the forward contract, the delivery or forward price is specified and determined at the time of conclusion of the contract and at that time the contract has no initial monetary value.[14]

c) Options

It is defined as "a right to buy or sell specific securities (futures) at a specified price within a specified time. For the right, the buyer pays a premium which naturally goes to the seller of the

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[10] Kinds of derivatives taken from <http://www.investorwords.com/1421/derivative.html#ixzz1tFP27tgX> accessed on 27-03-2012 at 6:30 p.m. PST

[11] Definition of Futures Contracts taken from http://www.investopedia.com/terms/futures/contracts. accessed on 30-03-2012 at 6:30 p.m. PST

[12] Nancy H. Rothsten and James M. Little, *The Handbook of Financial Futures*, (New York: McGraw-Hill Book Company, 1984) 36

[13] AAOIFI, standard no.20, 2/2/2

[14] Fred D. Arditti, *Derivatives* (Boston: Harward Business School Press, 1996), 149

option."[15] An option contract grants its owner the right to take some action, but not the obligation to take such action.[16]

d) Swap

It is "an exchange of one security for another. A financial transaction between two parties usually involving an intermediary or dealer, in which payments or rates are exchanged over a specified period and according to specified conditions."[17]

e) Mortgage/ Pledge(رهن)

It is the security for the satisfaction of a claim in respect of a debt.

f) Suretyship /Guarantee (كفاله)

It is the merging of one liability with another in respect for demand for performance of an obligation.

g) Assignment of debt (حواله)

It is the shifting of debt from the liability of the original debtor to the liability of another person. Apart from these kinds, all other contracts relating to securities are financial contracts.

1.2.3.2 Contracts relating to commodities

Followings are the kinds of financial contracts that involve commodities:

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[15] Ronald J.Frost, *Options on Futures, A Hands-on Workbook of market proven trading strategies*, (Chicago: Probus Publishing company, 1989) 5.

[16] Fred D. Arditti, *Derivatives* (Boston: Harward Business School Press, 1996), 3; Nancy H. Rothsten and James M. Little, *The Handbook of Financial Futures*, (New York: McGraw-Hill Book Company, 1984) 63

[17] Bryan A. Garner, *Black's Law Dictionary*, (USA: West Group Publishing Co., 1999) 7th edition, 1461.

Sale and all kinds of sale

i) Barter (مناقضه): Sale of commodity for commodity.

ii) Regular sale (بيع مطلق): Sale of goods for money.

iii) Salam (سلم): It is a contract in which whole price is paid in advance while delivery of the subject matter is postponed to specified time in future.[18]

iii) Istisna'a`(استصناع): It is ordering a manufacturer or artisan to make certain goods according to given description.[19]

iv) Murabaha (مرابحه): Sale of goods at purchase price plus profit margin agreed upon between the contracting parties.[20]

v) Credit Sale (بيع مؤجّل) : Sale of goods on deferred payment.

vi) Lease (اجاره): It is to transfer the usufruct of a particularly property to another person in exchange for a rent claimed for him.[21] Whether it is the lease of a house, car, machinery or lease of a bank locker, all kinds of lease contracts are included in financial contracts.

vii) Partnership Contracts: An agreement between two or more parties to combine their assets, labor or liabilities for the purpose of making profits. Mudarbah is the kind of partnership in profit whereby one party provides capital and the other party provides labor. All other modern kinds of partnership are also financial contracts e.g. Stock companies, Joint Liability

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[18] Dr.Mohammad Tahir Mansoori, *Islamic Law of Contracts and Business Transactions*,(Islamabad:Shariah Academy IIUI, 2005) 3rd edition, 200.
[19] Ibid, 209
[20] Ibid , 214
[21] Mohammad Taqi Usmani, *An Introduction to Islamic Finance*, (Karachi,: Maktaba Ma`ārif al -Quran, 2002), 158

Company, Partnership in commendams, Company limited by shares, Allotment / particular partnership, Diminishing partnership etc.

1.2.3.3 Contracts involving currencies

All kinds of contracts that involve currencies are financial contracts.

Surf (صرف): Sale of absolute price for absolute price or exchange of currencies.[22] Islamic law lays down some specific rules which are to be followed while entering into a surf transaction e.g. the condition of spot delivery and equality of weight and measurement in case of homogeneous things. However, if heterogeneous things are being exchanged, then equality of weight can be ignored, however the condition of spot delivery must be fulfilled.

1.2.3.4 Contracts involving some measure of value other than commodities or currencies

In these modern times, things related to transactions are not as they used to be in the past. History reveals that in the past, something having intrinsic value was used as money e.g. silver and gold. Afterwards fiat money took place for *dirhams* and *dinars*. Now-a-days there are certain things that have some measure of value and any contract that involves those things is known as financial contract e.g.

Debit Card: It is a card that is issued to a customer who has funds in his accounts. The holder has the right to withdraw cash from his account or to pay for goods or services that he has

[22] Dr.Mohammad Tahir Mansoori, *Islamic Law of Contracts and Business Transactions*,(Islamabad:Shariah Academy IIUI, 2005) 3rd edition,,199

purchased up to the limit of the available funds in his account. This card does not provide any credit to its holder.[23]

Charge card: "This card provides credit facility up to certain ceiling for a specified period of time, as well as providing a means of repayment."[24]

Credit Card: This card provides a revolving facility within the credit limit and credit period is determined by the issuer of the card. It is also a means of payment.[25]

1.2.3.5 Contracts relating to Loans and Debt transactions

All loan and debt transactions are include in financial contracts e.g.

Personal Loan Contracts: Personal loan is taken to meet personal financial needs.

Commercial Loan Contracts: Commercial loan is taken for commercial purposes e.g. for setting up business or industries etc.

Mudarbah Loan Contracts: Mudarbah loan is taken to make it the capital of *Mudarbah* after its investment in *Mudarbah* partnership.

1.2.3.6 Repurchase Agreements

Also known as a repo agreement, a repurchase agreement is a "strategy for acquiring a loan from a lender that involves the sale and repurchase of an asset or security. Essentially, the

[23] AAOIFI, Shariah Standard 2
[24] Ibid
[25] Ibid

lender agrees to make the loan, with the understanding that the debtor will sell the lender the security."[26] At an agreed upon later date, the debtor will regain control of the security, Once the loan is repaid in full, the debtor will regain control of the security at an agreed upon later date.[27] The word 'repurchase' itself indicates some kind of sale transaction. Since all kinds of sale transactions are financial transactions, so all the repurchase contracts are also termed as financial contracts e.g.

Bay bil wafa (بیع بالوفا): In this type of contract, a commodity is sold to a lender on the condition that whenever the seller wishes, the lender (buyer) would return the purchased commodity to him upon surrender of the price.[28]

Buy-Back agreement (بیع العینہ): It is a contract in which the commodity is sold on cash and then bought it back at a higher price to be paid on some specified time in future.

1.2.3.7 Contracts involving Request for Quotation

"A request for quotation (RFQ) is a document that an organization submits to one or more potential suppliers eliciting quotations for a product or service. Typically, an RFQ seeks an itemized list of prices for something that is well-defined and quantifiable".[29]

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[26] Repurchase Agreement taken from < http://www.wisegeek.com/what-is-a-repurchase-agreement.htm >accessed on 01-04-2012 at 4:00 p.m. PST

[27] Ibid

[28] Dr.Mohammad Tahir Mansoori, *Islamic Law of Contracts and Business Transactions*,(Islamabad: Shariah Academy IIUI, 2005) 3rd edition, 132.

[29] Definition of Request for Quotations taken from < http://searchcio.techtarget.com/definition/request-for-quotation> accessed on 01-04-2012 at 5:30 p.m. PST

In such contracts, a company decides to put workout to tender or seeks offer for certain goods or to seek services of a particular description. Potential contractors are invited to submit quotations. The invitation may be issued to the world or specific parties. Such is only an invitation to treat and the person making it will be free to accept or reject any of the responses. It has different types:

Muzayadah (مزایدہ)

If the invitation indicates that the highest bid will be accepted, whoever submits the highest bid will be entitled to insist that contract should be made with him.

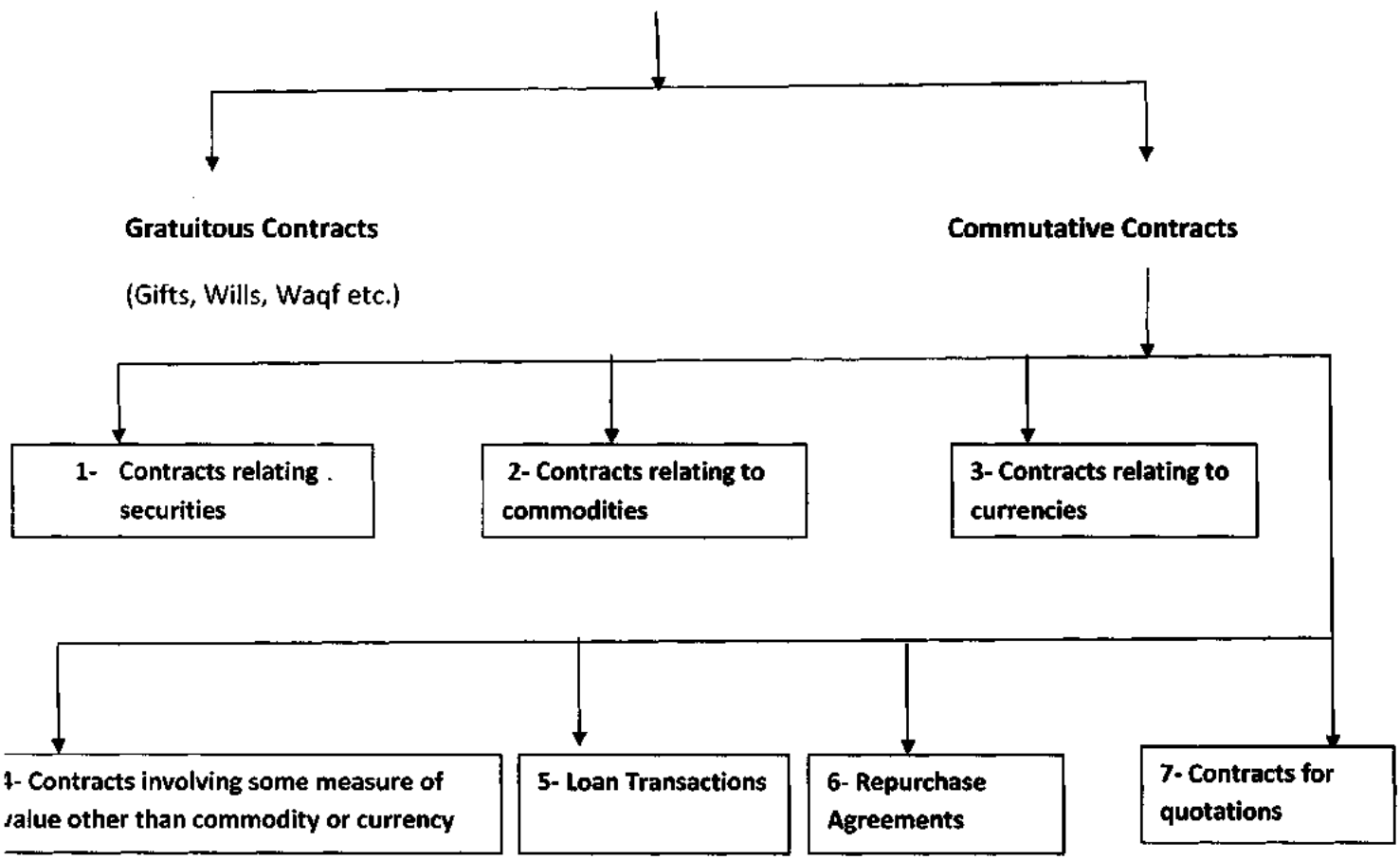
Munaqasah (مناقصہ)

If the invitation indicates that the lowest quotation will be accepted, the submitter of the lowest quotation will be entitled to insist that contract should be made with him.

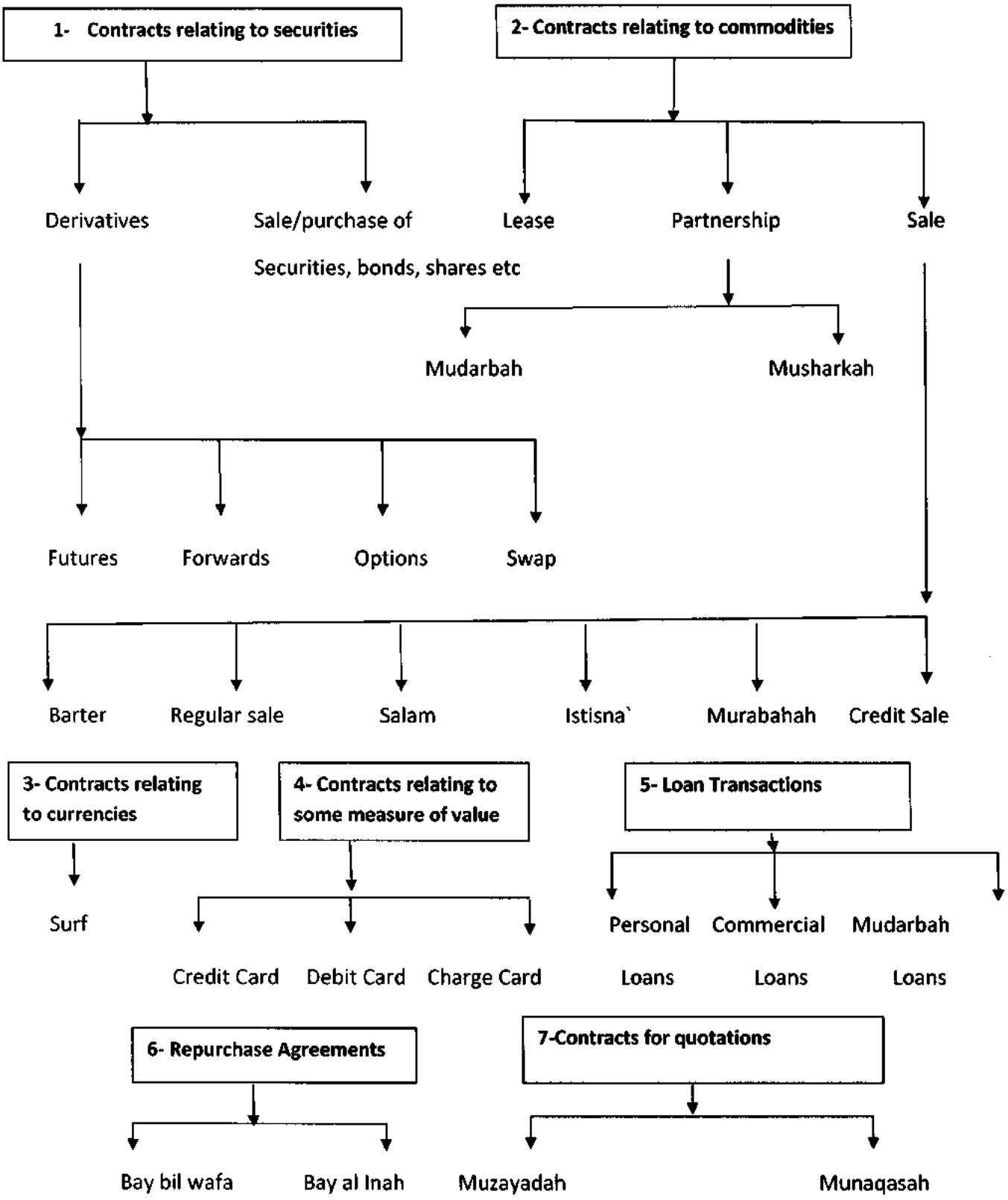
Apart from all the above-mentioned FCs, there are so many others that it is really hard to mention and describe all of them. However, the important ones relating to our topic are mentioned keeping in view the definition of "financial contracts".

The following tables of the classification of FCs shall help in understanding the general and detailed classification of FCs:

1.2.4 General Classification of Financial Contracts



1.2.5 Detailed Classification of Financial Contracts



1.3 CONTRACTUAL LIABILITY IN SHARIAH AND LAW

Contracts are always regarded as an important part of commercial transactions and the sanctity of contracts is emphasized not only in Islamic Law but also in Positive Law. The principle of '*pacta sunt servanda*' itself indicates the significance of contractual liability. *Pacta sunt servanda* is a Latin phrase which means that the agreements must be kept. It is "the rule that agreements and stipulations especially those created in treaties must be observed."[30] The principle refers to the idea that contracts, treaties and other legal agreements create an obligation between the parties to fulfill their contractual obligations. Parties are not allowed to back out of this legal obligation unless they prove that they have a compelling reason to do so. The parties involved in breach of contracts can be penalized for not honoring the contract.[31]The principle of *pacta sunt servanda* applies not only to contracts between individuals but also between companies or any other legal entity in case of being a party to the contract.

The sanctity of contracts is discussed in detail both in Islamic law and the Pakistani legislation:

1.3.1 SANCTITY OF CONTRACTS IN ISLAMIC LAW:

1.3.1.1 Quran

The word '*mas'ūliyah*' (مسؤلية) is used in the Holy Quran for conveying the meaning of 'liability'.

Allah Almighty says in the Quran;

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[30] Bryan A. Garner, *Black's Law Dictionary*, (USA: West Group Publishing Co., 1999) 7th edition, 1133.

[31]The principle of pacta sunt servanda taken from <http://www.wisegeek.com/what-does-pacta-sunt-servanda-mean.htm> accessed on 01-04-2012 at 09:00 p.m. PST.

وَقِفُوهُمْ إِنَّهُم مَسْئُولُون

"Detain them, for they are mas'ūlūn (liable/ answerable)."[32]

This word is not only used for the general liability of a person for all his acts but also for a liability incurred by a person when contracting. Allah says:

وَأَوْفُواْ بِالْعَهْدِ إِنَّ الْعَهْدَ كَانَ مَسْؤُولاً

"Fulfill your undertaking for you are liable there for."[33]

Allah Almighty has commanded His believers to fulfill their contractual obligations and this command indicates that this is an obligatory act for the contracting parties.

يَاأَيُّهَا الَّذِينَ آمَنُواْ أَوْفُواْ بِالْعُقُودِ

"O believers! Be true to your contracts"[34]

In Quran, Allah Almighty has declared the fulfillment of contractual obligations as one of the qualities of the righteous people:

وَالْمُوفُونَ بِعَهْدِهِمْ إِذَا عَاهَدُواْ

"(But righteous) are those who fulfill the contracts that they have made."[35]

For such righteous people, Allah has promised the reward of an end full of blessings and bounties:

الَّذِينَ يُوفُونَ بِعَهْدِ اللهِ وَلاَ يِنقُضُونَ الْمِيثَاقَ

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[32] Quran 37:24
[33] Quran 17:34
[34] Quran 05:01
[35] Quran 02:177

"Who keep faith with Allah and do not break their covenant.....(shall have a blissful end)."[36]

وَالَّذِينَ هُمْ لِأَمَانَاتِهِمْ وَعَهْدِهِمْ رَاعُونَ

"Who keep their trusts and promises.....(shall be laden with honors and shall dwell in fair gardens)."[37]

وَالَّذِينَ هُمْ لِأَمَانَاتِهِمْ وَعَهْدِهِمْ رَاعُونَ

"... (successful are those) who are true to their trusts and pledges."[38]

For those who do not act according to their sayings, or those who do not fulfill their promises, Allah says in the Quran:

يَا أَيُّهَا الَّذِينَ آمَنُوا لِمَ تَقُولُونَ مَا لَا تَفْعَلُونَ ۝ كَبُرَ مَقْتًا عِندَ اللَّهِ أَن تَقُولُوا مَا لَا تَفْعَلُونَ

"Believers! Why do you say what you do not do? It is most odious in Allah's sight that you should say that which you do not do."[39]

Since 'preservation of property' is one of the fundamental interests of man and one of the objectives of Shariah, Islam regards the property of a person as sacred as his life and honor.[40] A believer is prohibited from devouring the property of others unlawfully and all those acts that lead to this are prohibited acts e.g. theft, bribery, usurpation, usury, embezzlement or acts of fraud, cheating etc. In this regard, Allah says:

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[36] Quran 13:20
[37] Quran 70:32
[38] Quran 23:08
[39] Quran 61:02, 03
[40] Dr.Mohammad Tahir Mansoori, *Islamic Law of Contracts and Business Transactions*,(Islamabad: Shariah Academy IIUI, 2005) 3rd edition, ix(preface).

يَا أَيُّهَا الَّذِينَ آمَنُواْ لاَ تَأْكُلُواْ أَمْوَالَكُمْ بَيْنَكُمْ بِالْبَاطِلِ

"O you who believe! Devour not your property among yourselves by unlawful means."[41]

At another place, Allah enjoins upon the believers to return the trusts to their owners so that the violation of any right could be avoided:

إِنَّ اللَّهَ يَأْمُرُكُمْ أَنْ تُؤَدُّوا الأَمَانَاتِ إِلَى أَهْلِهَا

"Allah commands you to hand back your trusts to their rightful owners."[42]

In most of the commercial transactions, breach of financial contract results in monetary loss to one of the parties. Islam enjoins its believers not to inflict harm to anyone. In modern commercial transactions, mostly one party owes some financial obligation to the other party, creating a relation of debtor/creditor. Allah Almighty has set some principles in the Holy Quran for dealing a debt transaction:

يَا أَيُّهَا الَّذِينَ آمَنُواْ إِذَا تَدَايَنتُم بِدَيْنٍ إِلَى أَجَلٍ مُّسَمًّى فَاكْتُبُوهُ .....

وَلاَ تَسْأَمُوْاْ أَن تَكْتُبُوْهُ صَغِيرًا أَو كَبِيرًا إِلَى أَجَلِهِ ذَلِكُمْ أَقْسَطُ عِندَ اللهِ وَأَقْوَمُ لِلشَّهَادَةِ وَأَدْنَى أَلاَّ تَرْتَابُواْ

"O believers! When you contract a debt for a fixed period, put it in writing.....so do not fail to put your debts in writing, be they small or big, together with the date of payment. This is more just in the sight of Allah; it ensures accuracy in testifying and is the best way to remove all doubts."[43]

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[41] Quran 04:29
[42] Quran 04:58
[43] Quran 02:282

In sale transactions, the presence of witness is asked for, to avoid any dispute in the future. Allah says in the Quran:

وَأَشْهِدُوٓاْ إِذَا تَبَايَعْتُمْ

"See that witnesses are present when you sell one another."[44]

Islam strongly condemns all practices that inflict harm to any of the contracting parties. Some of the practices disapproved by Quran and Sunnah are frauds, cheating, deception, concealing of defects and adulteration in merchandise. Allah says:

وَيْلٌ لِّلْمُطَفِّفِينo الَّذِينَ إِذَا اكْتَالُواْ عَلَى النَّاسِ يَسْتَوْفُونo وَإِذَا كَالُوهُمْ أَو وَّزَنُوهُمْ يُخْسِرُونَo أَلَا يَظُنُّ أُولَئِكَ أَنَّهُم مَّبْعُوثُونَ o لِيَوْمٍ عَظِيمٍo

"Woe to those who deal in fraud, those who, when others measure for them, exact in full, but when they measure or weigh for others, defraud them! Do they not think that they will be called to account on a Mighty day?"[45]

The verse clearly indicates that there is warning for those who deal in fraud and give short measure or short weight. Such acts are prohibited in Islam to avoid the infringement of rights and infliction of harm to anyone.

1.3.1.2 Sunnah

Infliction of harm is prohibited in Islam. Holy Prophet (S.A.W) forbade from any act that causes harm to people. He asked the people to follow the rule of لا ضَرر و لا ضرار that means that no

[44] Ibid
[45] Quran 83:1-5

kind of harm is allowed to be inflicted upon anyone. However, in case someone has caused harm to any person, then it has to be removed following the principle الضرر يُزال.

Holy Prophet (S.A.W) has also emphasized upon the sanctity of contracts and their conditions. Fulfillment of conditions has been made obligatory upon those making them. Holy Prophet said regarding the fulfillment of conditions:

اَلمُسْلِمُونَ عَلى شُرُوطِهِم إلّا شَرطاً أحَلّ حَرَاماً أو حَرَّم حَلَالاً

"Muslims stand by what they have stipulated except those that make the unlawful, lawful or those which make the lawful, unlawful."

Keeping of promises has been emphasized at many occasions by the Holy Prophet (S.A.W) and at one occasion he said that who does not keep his promises has no religion:

لَا إيمَان لِمَنْ لَا أمانَةَ لَه وَلَادِيْنَ لِمَن لَا عَهدَ لَه

"He who is not faithful has no faith and he, who does not keep his promises, has no religion."

At another occasion, breaking a contract or non fulfillment of promise is regarded as a quality of hypocrites. Holy Prophet (S.A.W) said:

أرْبَع مَنْ كنّ فِيه كَان مُنَافِقاً خَالِصًا،وَمَنْ كَانت فِيهِ خَصْلَة مِنْهُنّ كَان فِيهِ خَصْلَة مِن النّفَاق حَتّى يدعها..إذا اؤتمِنَ خَانَ، وَإذَا حَدَثَ كَذَبَ، وَإذَا عَاهَدَ غَدَرَ، وَإذَا خَاصَمَ فَجَرَ

"There are four characteristics if found in a person, he will be considered as a true hypocrite. And if any one of them is found in him, it will be considered that he has one of the characteristics of hypocrisy until he gets rid of it. They are: when he is entrusted with something,

he is dishonest; when he speaks, he lies; and when he enters into a contract (or promises), he breaks it; and when he has any dispute with anyone, he plays foul."[46]

The message that has been conveyed in the verse of Surah An-Nisā about devouring the property of others is also conveyed in many Ahadith e.g.

مَن ظلم قيد شبرٍ مِن الأرض طوّقه من سبع أرضين

"Whosoever takes a measurement of a hand span of earth illegally (unjustly), will be punished by putting seven earths around his neck."

مَن أخَذَ أمْوَال النّاس يُرِيدُ أدَاء هَاأدّى الله عنه و مَن أخَذَ يُرِيدُاتلاَفهَا أتْلَفَهُ الله

"The one who takes loan from others with the intention of paying it back, Allah will help him to pay it and one who takes it with intention of not paying it back, Allah will not help him for paying back his loan."[47]

As mentioned earlier, the principles of a debt transaction are set by Almighty Allah in the Holy Quran[48], Holy Prophet (S.A.W) has declared the procrastination from a rich debtor as great injustice. He said:

مَطْلُ الْغَنِيِّ ظُلْمٌ

"Procrastination by a rich (debtor) is cruelty (injustice)."[49]

At another occasion such person is declared to be worthy of punishment:

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[46] Muslim ibn al-Hajjāj Muslim,*Sahīh, Bāb al Imān, fi khisāl al Munāfiq*,vol.1, p.46

[47] Bukhāri, *Sah īh,, Kitāb al-Istiqrāz*, part.10,p.193

[48] Quran 02:282

[49] Muslim ibn al-Hajjāj Muslim,*Sah īh,Bāb Tehreem Matl al–Ghani*, part10, vol.5,p.228; Bukhāri, *Sah īh,, Kitāb al-Istiqrāz*, part.10,p.201

لَيّ الواجديحلّ عِرضه وَ عُقوبته

"Procrastination by a person who has means to pay his debts renders him to be punished by censuring him and physically."

About the one who deals with fraud and cheating, Holy Prophet (S.A.W) said:

مَنْ غشّنا فليسَ مِنّا

"One who commits adulteration is not one of us."[50]

إنّ الغَادر يُنصَب لَه لِوَاء يَوم القِيامَة فيُقال هذه غَدْرَة فُلَان

"A cheater will be punished by posting a flag on him on the Day of Judgment and it will be said, 'This is the cheating of such and such person' ..."[51]

It is narrated by Abdullah bin Omar that a person came to the Prophet (S.A.W) and told him that he was always betrayed while purchasing. The Prophet advised him:

إذَا بَايَعتَ فَقُلْ لَا خِلَابَة

"At the time of purchasing, say: No cheating" [52]

i.e. he has the right to return it back if found undesirable. This right of returning the thing and other options given to the aggrieved party in the contract of sale indicate the importance of being fair in trading since cheating is a practice that can infringe the right of anyone.

All the above mentioned Ayāt and Ahādith explain the importance of contractual liabilities and set the basic principles of fair dealing in transactions.

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[50] Muslim ibn al-Hajjāj Muslim,*Sahih,Kitāb al-Buyū`*,vol.1, p.108

[51] Abu Dawūd, *Sunan, Bāb Wafa bil Ahad*, part.3,p.82

[52] Bukhāri, *Sahih,, Kitāb al- Buyū`, Bāb al-Khida`*,Juz 9, p.27; Muslim ibn al-Hajjāj Muslim,*Sahih,Bāb Man yukhda` fil Bai`*,Part.10, vol.5,p.176

1.3.2 CONTRACTUAL LIABILITY IN PAKISTANI LEGISLATION

Contractual liability or obligation being duty that is created by entering into a contract creates a liability on the contracting parties for the performance of their contractual obligations and they can not be excused from this liability without a reasonable cause. Just as Islamic law recognizes the sanctity of contracts, positive law also creates a liability on the contracting parties to fulfill their contractual obligations.

The word 'obligation' means duty in its general sense. According to some jurists, there is a slight difference between both the terms. 'Duty' is an act which a man ought to do while 'obligation' is some liability that a man takes upon himself by his own choice.[53] However both the terms are mostly used in the general sense. The duty has been defined as "a legal obligation that is owed or due to another and that needs to be satisfied; an obligation for which somebody else has a corresponding right." [54] All the contracts fall under obligation (*iltizam*) because they create mutual obligation and individual intention that create obligation because the word '*iltizam*' is applied where a man made binding on himself to perform.[55]

In Pakistan, the contract Act IX of 1872 is the law of contracts since the Act extends to the whole of Pakistan.[56]Section 2 of the Act defines contract as an "agreement enforceable by law" that creates a legal obligation which subsists until discharged. Section 10 states the conditions of enforceability of a contract which include the competence of the parties, lawful consideration, lawful object and free consent of the parties. Any contract lacking

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[53] P. J. Fitzgerald, *Salmond on Jurisprudence, (London: Sweet and Maxwell Limited, 1996) 12th edition,216*
[54] Bryan A. Garner, *Black's Law Dictionary,* (USA: West Group Publishing Co., 1999) 7th edition,521
[55] Hussain Hamid Hassan, *An Introduction To The Study Of Islamic Law,* (Islamabad: Shariah Academy IIUI,1997) 254
[56] Section 1, *Contract Act IX of 1872.*

any one of these conditions shall not be an 'enforceable' contract. In the Contract Act 1872, the obligations of contracting parties are discussed in section 37. It says that the parties are bound to perform their promises except in a case where such performance is dispensed with or excused under the provisions of the Contract Act or any other law.[57] This section creates a legal obligation upon the contracting parties to perform their contractual liabilities and they are discharged from these obligations only when they have completely and precisely performed the exact promise that they have undertaken in the contract.

The non-performance of a legally binding and enforceable contract amounts to its breach. After a valid contract is entered into, the impossibility of performance does not excuse the party from his contractual obligations. Even the circumstances that result in imposing some additional hardship on any of the parties do not create an excuse for breach of the contract if there is no such provision in the contract for such excuse. Section 37 indicates the importance of the sanctity of contracts by declaring that the contractual liability devolves and does not end with the death of any of the parties.[58] According to the section, the contractual liabilities of a person migrate to the representatives in case of his death. The substitution of a person by his representatives in case of his death indicates the significance of the contractual liability.

Thus, the law does not admit excuses from a person who is of full age, of sound mind, who entered into a valid contract with free consent, for a lawful consideration and lawful

[57] Section 37 of the *Contract Act 1872*: "The parties to a contract must either perform or offer to perform their respective promise, unless such performance is dispensed with or excused under the provisions of this Act, or of any other law."

[58] Ibid: "Promises bind the representatives of the promisors in case of death of such promisors before performance unless a contrary intention appears from the contract."

object[59] to escape from his contract on the ground that he had failed to understand its effects. So the parties are bound to fulfill their liabilities and the word 'obligation' includes every duty enforceable by law.[60]

For the banking transactions in Pakistan, the fulfillment of promises is made an obligation in the Financial Institutions (Recovery of Finance) Ordinance 2001. The word 'obligation' has been defined as the duty which has been imposed on the customer under the said Ordinance[61] and along with other financial duties, the performance of an undertaking and fulfillment of promise is also included in the definition of the term 'obligation'.

According to the Ordinance it is the duty of the customer to fulfill all his obligations to the Financial Institutions.[62] In case of default, civil and criminal liabilities shall be incurred upon him along with the cost of funds.[63] For all the suits relating to the Financial Institutions in Pakistan, the procedure of Banking Courts is laid down in the Ordinance. Any Financial Institution or a customer can file a suit in the Banking Court or High Court (as the case may be) for the recovery of finance from the defaulting party.[64] This right of filing a suit against the defaulter highlights the significance of contractual obligation.

In the Sales of Goods Act 1930, the term that is used for default or wrongful act is 'fault'. Though, while determining the standard of duty that is applicable to a contractual

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[59] See for detail of the conditions of contract, section 10 of the *Contract Act 1872*.
[60] Abdul Wahid Chaudhry, *Laws Relating to Agreements*, (Lahore: Law Times Publishers, 1996) 3.
[61] Section 2(e-iii) of *Financial Institutions (R of F) Ordinance 2001*.
[62] Section 3(1) of *Financial Institutions (R of F) Ordinance 2001*
[63] Ibid, Section 3(2):" Where the customer defaults in the discharge of his obligation, he shall be liable to pay, for the period from the date of his default till realization of the cost of funds of the financial institution as certified by the State Bank of Pakistan from time to time, apart from such other civil and criminal liabilities that he may incur under the contract or rules or any other law for the time being in force."
[64] Section 9 of Financial Institutions (R of F) Ordinance 2001

obligation, the lawyers avoid using the term 'fault'. Because this term can create misunderstanding in the minds of the laymen who will be surprised to know that the main issue is that the promisor is said to be at fault.[65]

In the contract of sale, the parties to the contract are normally the seller and the buyer. It is the duty of both of them to fulfill their contractual liabilities in accordance with the terms of the contract of sale.[66] If any of the party refuses to perform his contractual liability, he shall be liable for any loss suffered by the other party because of the non performance of his contractual duty e.g. the seller is duty bound to deliver and the buyer to take the delivery of goods. If any of them fails to do so, he shall be liable to the other for any loss occasioned by his default.

Chapter VI of the Sales of Goods Act deals with the remedies that are available for the breach of the contract of sale. A suit can be filed by the aggrieved party for breach of the contract of sale. Thus, the sanctity of the contracts is recognized by providing the remedies for breach of contract. Law does not only provide damages as remedy of breach of contract but in many cases, the Court can bind a person for the specific performance of the contract. And any person suing for the specific performance of a contract, may also ask for compensation for its breach, either in addition to or in substitution for such performance.[67]

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[65] J.W.Carter, *Breach of Contract*, (Sydney: Law book Company limited, 1984) 38.
[66] Section 31 of *the Sale of Goods Act 1930.*
[67] Section 19; *Specific Relief Act, 1877.*

Conclusion

It is inherent in the nature of human beings that they are inclined towards doing anything for their own interests even if it can violate the rights of others. The rules that are set by Allah Almighty in the Holy Quran and Sunnah are to achieve the objectives of Shariah. Since the preservation of property is one of the objectives, the fulfillment of contractual liabilities and observance of the principles of fair dealing in financial transactions have been made obligatory. Whether it is Islamic Law, English law or Pakistani legislation, the provisions for the sanctity of contracts can be found in each of them. The factor that establishes the fact that contractual obligations are to be fulfilled is the imposition of some kind of penalty upon the party who commits the breach of the contract. Thus, the principle of *'Pacta Sunt Servanda'* is adopted by all the legislative bodies in order to ensure the fulfillment of contractual liabilities. The law enjoins upon its subjects to take the promises and contracts as sacred. Because the non-fulfillment of promises and contracts will result into complete chaos and disaster and avoiding such chaos is the main objective of any law whether it is Islamic law or Positive.

Chapter Two

BREACH OF CONTRACTS; FORMS AND EFFECTS OF BREACH.

2.1 BREACH OF CONTRACTS

A contract is entered into with another to secure some advantage and when it is no more advantageous for the party, the breach is likely to occur.[1] The term 'Breach' is defined as "a violation or infraction of a law or obligation"[2] or it may be some kind of "failure to carry out the terms of an agreement."[3] A breach of contract occurs if any party refuses to perform or he fails to perform his part of the contract. If a party by his own act makes it impossible to perform his obligation under the contract, it is also termed as a breach. The Arabic term used for 'breach' is *'naqd'* (نقض)or *'nakth'* (نكث).[4] These terms are also used in the Holy Quran for breach of oath, covenant or some kind of obligation. Allah Almighty says in the Holy Quran:

الَّذِينَ يَنقُضُونَ عَهْدَ اللَّهِ مِن بَعْدِ مِيثَاقِهِ

"Those who break Allah's Covenant after it is ratified... (they cause loss only to themselves)."[5]

الَّذِينَ عَاهَدتَّ مِنْهُمْ ثُمَّ يَنقُضُونَ عَهْدَهُمْ فِي كُلِّ مَرَّةٍ وَهُمْ لَا يَتَّقُونَ

[1] Roger LeRoy Miller, Gaylord A. Jentz, *Fundamentals of Business Law,*(Texas: Thomson South-western west publishers, 2005) 232
[2] Bryan A. Garner, *Black's Law Dictionary*, (USA: West Group Publishing Co., 1999) 7th edition, 182
[3] P. H. Collins, *Dictionary of Law*, (England: Peter Collin Publishing Ltd., 1993), 2nd edition, 28
[4] Muneer Ba'alBāki, *Al-Mawrid al Qareeb*, (Lahore: Sabri Dār-ul-Kutub publishers), 58
[5] Quran 2:27

"They are those with whom you made a covenant, but they break their covenant every time, and they have not the fear (of Allah)".[6]

فَبِمَا نَقْضِهِم مِّيثَاقَهُمْ لَعَنَّاهُمْ وَجَعَلْنَا قُلُوبَهُم قَاسِيَةً

"But because of their breach of their covenant, We cursed them, and made their hearts grow hard."[7]

وَأَوْفُوا بِعَهْدِ اللَّهِ إِذَا عَاهَدتُّمْ وَلَا تَنقُضُوا الْأَيْمَانَ بَعْدَ تَوْكِيدِهَا

"Fulfill the Covenant of Allah when you have entered into it, and break not your oaths after you have confirmed them."[8]

الَّذِينَ يُوفُونَ بِعَهْدِ اللَّهِ وَلَا يَنقُضُونَ الْمِيثَاقَ

"Those who fulfill the covenant of Allah and fail not in their plighted word..."[9]

وَالَّذِينَ يَنقُضُونَ عَهْدَ اللَّهِ مِن بَعْدِ مِيثَاقِهِ

"Those who break the Covenant of Allah, after having plighted their word thereto...(on them is the curse; for them is the terrible home)"[10]

وَإِن نَّكَثُوا أَيْمَانَهُم مِّن بَعْدِ عَهْدِهِمْ

"But if they violate their oaths after their covenant..".[11]

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[6] Quran 7:56
[7] Quran 5:13
[8] Quran 16:91
[9] Quran 13:20
[10] Quran 13:25

فَمَن نَّكَثَ فَإِنَّمَا يَنكُثُ عَلَىٰ نَفْسِهِ ۖ وَمَنْ أَوْفَىٰ بِمَا عَاهَدَ عَلَيْهُ اللَّهَ فَسَيُؤْتِيهِ أَجْرًا عَظِيمًا

"Then any one who violates his oath, does so to the harm of his own soul, and any one who fulfils what he has covenanted with Allah, Allah will soon grant him a great Reward."[12]

As is evident from all the above mentioned verses of the Holy Quran, the breach of any obligation whether it is some kind of covenant, oath or any other liability, is disapproved by Almighty Allah. The Muslims are required to be very careful lest they should harm someone else or even themselves through their heedless conduct in business. Quran warns the Muslims that causing a definite and sure loss to someone is not only disapproved, but has been out rightly condemned by Allah.[13]

In Pakistani legislation, the breach of a contract not only entitles the aggrieved party for damages but in cases with the financial institutions, the breach of an obligation or representation made by a customer to the financial institution or breach of the terms of some instrument or document has been considered as an offence and is punishable with imprisonment and fine.[14]

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[11] Quran 9:12

[12] Quran 48:10

[13] Mushtaq Ahmad, *Business Ethics in Islam*, (Islamabad: The International Institute of Islamic Thought, 1995) 125

[14] Financial Institution (Recovery of Finance) Ordinance 2001,Section 20 (i),(ii) of dealing with provisions relation to certain offences

2.2 FORMS OF BREACH OF CONTRACTS

Breach of contract is a legal cause of action in which a binding agreement or bargained for exchange is not honored by one or more of the parties to the contract; or by non-performance or interference with the other party's performance. If the party does not fulfill his contractual promise; or has given information to the other party that he will not perform his duty as mentioned in the contract; or if by his action and conduct he seems to be unable to perform the contract, he is said to breach the contract. [15]

Breach of contract has been defined as "an unjustifiable refusal or failure by one party to a lawful and enforceable contract to implement any of the duties incumbent on him under the contract, normally by refusing to perform, failing to perform, performing late or performing badly."[16]Thus, a breach of contract occurs where a party totally or partially fails to perform his contractual obligation; the party makes the performance of the contract impossible by his own act; or where a party himself renounces his liability under the contract.[17]

So it can be said that the right of a party to treat himself as discharged from further performance may arise in any one of the above mentioned three ways. In each of these three cases he has repudiated his contractual obligations. In the first case, he has repudiated them by a total or substantial failure to perform; in the second, he has

[15] Breach of Contracts taken from < http://en.wikipedia.org/wiki/Breach_of_contract> accessed on 31st May 2012 at 5:30 p.m. PST
[16] David M. Walker, *The Oxford Companion to Law*, (Oxford: Clarendon Press Oxford, 1980), 149
[17] Avtar Singh, *Law of Contract*, (India: Mansoor Book House Publishers, 1993), 6th Edition,339

repudiated them by inability to perform; in the third, he has repudiated them by a refusal to perform.[18] The detail of the different forms of breach is as follows:

2.2.1 Failure of performance

As is evident itself from the word 'failure' which means "the omission of expected or required action or the state of not functioning",[19] if a party omits or does not perform the obligation, it amounts to the breach of contract by failure of performance. Failure of performance is the most common ground for the discharge of a party by breach. [20]

There are three types of failure to perform: i) non-performance; ii) late performance; and iii) defective performance.[21] For example a seller promises to deliver a specified quality of some goods in a specified quantity to be delivered on May 18th. He will be guilty of 'non-performance' if he fails to deliver any goods at all. If he delivers the goods on 20th May and the buyer accepts them, he will be guilty of 'late performance'. And in case he delivers the goods on May 18th as was promised by him and the buyer accepts them but finds the goods in less quantity or of some quality other than that which was specified, the seller will be guilty of 'defective performance'[22].The defective performance can also be termed as 'breach by non-conformance' which occurs when

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[18] A. G. Guest, *Anson's Law of Contract* (Oxford: Clarendon Press, 1984) 26th edition, 471
[19] Catherine Soanes and Angus Stevensons, *Concize Oxford English Dictionary*, (US: Oxford University Press, 2004),Eleventh Edition,511
[20] A.G.Guest, *Anson's Law of Contract* (Oxford: Clarendon Press, 1984) 26th edition,478
[21] J. W. Carter, *Breach of Contract*, (Sydney: Law book Company limited, 1984),21
[22] Ibid

the performance of a party is not in conformity with the terms of the contract, e.g. deviating from agreed date, place, manner of performance.[23]

However, according to the *"de minimis rule"*[24], the law does not regard the minute failures as departures from contractual obligation.[25] But in case the partial failure goes to the root of the contract, the *de minimis rule* shall not apply. The question whether the partial failure goes to the root of the contract or not is a question of fact in each case.[26]

Since failure of performance establishes the breach of contract, if it is proved that the promisor has failed to perform a contractual obligation in accordance with the standard of duty applicable to that obligation within the time stipulated for performance of the obligation, the breach of contract can be established.[27]

In order to get remedy for the non performance of the contract, the aggrieved party must prove that the breach is material. A material breach is "when there is a failure to perform a part of a contract that permits the other party of the contract to ask for damages because of the breach that has occurred".[28] To determine if a breach is material, courts consider the followings:

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[23] Sajid A. Qureshi, *Business Laws*, (Rawalpindi: Federal Law House Publishers,2001), 1st edition,121

[24] An accepted abbreviation of the expression *'de minimis non curat lex'* which is a Latin phrase meaning "the law does not concern itself with trifles". Something or some act which is 'de minimis' is one which does not rise to a level of sufficient importance to be dealt with judicially.

[25] J. W. Carter, *Breach of Contract*, (Sydney: Law book Company limited, 1984),22

[26] Avtar Singh, *Law of Contract*, (India: Mansoor Book House Publishers, 1993), 6th Edition ,348

[27] Ibid, 3

[28] Kinds of Breach taken from <http://www.lawfirms.com/resources/business/types-contract-breaches.htm > accessed on 4th June 2012 at 4:00 p.m. PST

"(1) the extent of actual performance or preparation;

(2)The defaulting party's good faith or lack thereof;

(3) Hardship, if any, resulting to the defaulting party;

(4) The adequacy of damages to compensate the non-defaulting party."[29]

Thus, by proving that the promisor has failed to perform his contractual obligation according to the terms of the contract, the promisee makes him entitled to the remedies for the breach of contract.

2.2.2 Inability to perform

Ability to perform is considered to be a part of readiness and willingness. In any type of breach, it was held in *Bashir Hussain Siddiqui v. Pan-Islamic Steamship Co. Ltd* that the complaining party must prove that he himself was always ready and willing to perform his part of contract.[30] A party can not claim to be ready and willing to perform his contractual obligation if he is in the position of being unable to perform.[31] If a party to a contract disables himself from performing his promise in its entirety, the promisee has option to put an end to the contract, unless he has signified his acquiescence in its continuance.[32]In case of reciprocal promises, the Contract Act 1872 provides that a

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[29] 'Material Breach' taken from <http://www.jamespublishing.com/articles_forms/civillitigation/elements_breach_contract_failure_preform.htm >accessed on 4th June 2012 at 4.50 p.m. PST

[30] PLD 1967 Karachi 222

[31] J. W. Carter, *Breach of Contract*, (Sydney: Law book Company limited, 1984),297

[32] Section 39 of the *Contract Act 1872*

promisor does not need to perform his promise in case the promisee is not 'ready and willing' to perform his reciprocal promise.[33]The requirement of seriousness also applies in the case of inability. There are different types of inability:

i) Declared inability

ii) Inferred inability

iii) Inability by positive act

iv) Factual inability

i) Declared inability

Declared inability is also known as repudiation.[34] If a promisor declares that he is unable to perform, it can be treated as a repudiation of obligation. However, this declaration will be treated as repudiation when it occurs after the arrival of the time of performance. Where the declaration precedes the time of performance, the repudiation will give rise to an anticipatory breach if the promisee elects to terminate performance.[35]

ii) Inferred inability

The principle of inferred inability applies only in commercial contracts. According to this principle, *"where, during the course of performance of a commercial contract, one party*

[33] Contract Act 1872, Section 52 "When a contract consists of reciprocal promises to be simultaneously performed, no promisor need perform his promise unless the promisee is ready and willing to perform his reciprocal promise."
[34] J. W. Carter, *Breach of Contract*, (Sydney: Law book Company limited, 1984), 299
[35] Ibid,300

to the contract reasonably draws the inference that the other party is wholly and finally disabled from performing his contractual obligations, the first party may terminate the performance of the contract."[36]

Unlike declared inability, the scope of the principle of inferred inability is narrow one. First, it operates in the context of frustrating event; it may not involve breach of contract from the promisor; this principle applies only when the time of performance has arrived; the proof of inability is extremely difficult in case the promisee has to prove the inferred inability; finally it is not sufficient to prove that the reasonable commercial man would have drawn the inference that the promisor would commit some breach, the requirement of seriousness also applies in this case.[37]

iii) Inability by positive act

Positive disabling act is a clear indication of an absence of readiness and willingness which gives rise to repudiation. This inability can be either permanent or temporary.[38] It is permanent when there is no possibility of the retraction of repudiation by the promisor. But it is temporary if after the repudiation, the promisor puts himself in a position to perform his obligation. In such a case, the promisee can either elect to accept the promisor's repudiation or can ask the promisor to perform his obligation. Same rule of declared inability also applies in inability by positive act when the promisor disables himself from performance before the time of performance, it will be treated as

[36] Ibid, 314
[37] Ibid,320
[38] Ibid

anticipatory breach. However, in case it happens after the time of performance, then it will be taken as repudiation to perform.

iv) Factual inability

Factual inability is a sufficient justification of termination of the contract. If a promisee proves that the promisor is in fact unable to perform, he can be able to justify an election to terminate the performance of the contract provided that he proves two things: "that the promisor was wholly and finally disabled from performing; and that this inability existed at the time of termination."[39] Just like the inferred inability, a factual inability may result from a frustrating event; the termination by the promisee does not indicate that the promisor is in breach.

2.2.3 Refusal to perform, repudiation and anticipatory breach

If the promisor refuses to perform his promise in its entirety, the promisee has the option of putting the contract to an end unless he has signified his acquiescence in its continuance.[40] The refusal to perform can be express or implied. It is express when the promisor refuses through words but it can be implied from his conduct, which is more difficult to prove. In the case of refusal to perform, the breach should be in entirety to enable the promisee to elect putting the contract to an end. If the refusal does not go to

[39] Ibid, 302
[40] Contract Act 1872, Section 39

the whole of the contract, the promisee would not be justified in putting the contract to an end.[41]

The refusal to perform a contractual obligation is almost same as 'repudiation' which is "clear indication of absence of readiness or willingness to perform if the absence of readiness or willingness satisfies the requirement of seriousness."[42] Thus, repudiation occurs when a party intimates either by his words or conducts to the other contracting party about his intention of not honoring the contractual obligations.[43] However, there is no rule of law stating that a refusal to perform is necessarily a repudiation of obligation. For example, *"an employee's willful refusal to carry out an employer's lawful order is not necessarily a repudiation of obligation by the employee."*[44] But every minor irregularity in the performance of a contract can not be seized upon as a repudiation so as to put an end to the contract.

The effects of breach are to be taken by the court as a whole. If repudiation exists prior to the time of performance, then it is termed as 'anticipatory breach'. Constructive or anticipatory breach occurs "when a party disables himself from performance when it is due; either by acting in such a manner or by declaring so that it is obvious to the other party that the promised performance will not be forthcoming when due." [45] The main requirement in repudiation and anticipatory breach is 'seriousness'. Not every absence of readiness or willingness to perform constitutes

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[41] Avtar Singh, *Law of Contract*, (India: Mansoor Book House Publishers, 1993), 6th Edition ,347
[42] J. W. Carter, *Breach of Contract*, (Sydney: Law book Company limited, 1984),222
[43] M. P. Furmston, *Chesire and Fifoot's Law of Contract*, (London: Butterworths Publications, 1981) 483
[44] J. W. Carter, *Breach of Contract*, (Sydney: Law book Company limited, 1984),273
[45] Sajid A. Qureshi, *Business Laws*, (Rawalpindi: Federal Law House Publishers,2001), 1st edition,120

repudiation or is capable of being treated as an anticipatory breach; the absence must be "serious" in character. The repudiation may be retracted by the party, provided he does that prior to any material change of position by the other party in reliance upon it. The retraction will simply be a notice that the promisor will perform the contract.[46]

2.3 EFFECTS AND CONSEQUENCES OF BREACH OF CONTRACTS

As was stated earlier, the breach of contracts has been condemned by Islamic law and Pakistani legislation. If the breach is inevitable and can not be avoided, the party in breach shall not be excused. He will be liable to pay damages or compensate for any loss that was caused to the other party because of his breach. The Civil laws of most of the Muslim states provide that in the binding contracts, if one of the contracting parties does not fulfill his liability, it is permissible for the other party when the debtor is unable to perform, to demand the performance of the contract or its revocation, along with remedies if they are required.[47]

In some cases, the courts order for specific performance of the contract. However, the remedies differ from case to case. But the common thing in all the cases that entitle the aggrieved party to end the contract is the requirement of breach being 'fundamental' in its nature that "it must affect the very substance of the contract or

[46] Robert Corley, Peter Shedd and Eric Holmes, *Principles of Business Law*, (New Jersey: Prentice-Hall publishers, 1986) 13th edition,250

[47] Article 157 of the Egyptian civil code, 177(1) of Iraqi civil law, 209 of Kuwaiti civil law quoted from Muhiyyud-Din Ismaïl Ilmud-Din, *Nazriyyat-al-Aqd*,(Egypt: Dār Nahda al-Arabiyyah Alim al Kutub, 1976), 3rd edition,635-6: see for detail of Article157 of Egyptian Civil law, Abdur-Razzāq Ahmad as-Sanhūri, *Al Wseet fi Sharh al-Qānūn al-Madni al-Jadeed*, (Egypt: Dār Ihyā at Turāthal Arabi,Bairut, Labenon, 1952), 697

frustrate the commercial purpose of the venture."[48] Breach is fundamental in its effect when it is of a type that it defeats the very purpose for which contract is made."It permeates deep into the contract and destroys its substance. In other words it hits at the root of the contract and bleeds its essence."[49] For example, time for completing the agreed performance can be fundamental in a construction or supply contract.[50]

The precise consequences of any breach of contract depend on the particular circumstance of the case. However, there are three main possibilities:

> First, the breach may be such as to entitle the promisee to claim damages from the promisor. Secondly, the breach may be such as to prevent the promisor from enforcing the promisee's contractual obligations. Thirdly, the breach may have the consequences of entitling the promisee to terminate the performance of the contract.[51]

The consequences of all types of breach are discussed as under:

2.3.1 Effects and consequences of failure of performance

When there has been a breach of contract by failure of performance, the injured party may bring an action for breach, but whether or not he is himself discharged from his

[48] A. G. Guest, *Anson's Law of Contract* (Oxford: Clarendon Press, 1984) 26th edition,480
[49] Sajid A. Qureshi, *Business Laws*, (Rawalpindi: Federal Law House Publishers,2001), 1st edition,124
[50] Ibid
[51] Ibid

performance depends on the nature of the contract and nature of breach.[52] The aggrieved party will be discharged if the breach is so serious that it goes to the root of the whole contract, or in case the act or conduct of a party amounts to an intimation of an intention to abandon and refuse the performance of the contract. However, if the breach is less serious, the injured party has a right to claim damages, but in this case he will not be liberated from the performance of his own promises.[53]

In case of interdependent promises, a breach by one party will discharge the other,[54] e.g. in a contract for sale of some specific goods, the buyer will be discharged from his obligation to pay for the goods if the vendor failed to deliver them on the specified time because of the condition in the contract that the payment and delivery shall take place on same time. While in case of a contract that consists of a number of divisible performances, the partial failure of the performance will not discharge the other party unless the default is as serious as to amount in fact to the repudiation of the whole contract.[55]

2.3.2 Effects and consequences of inability to perform

The inability of a party to perform his obligation discharges the other party, even though he has not, by words or conduct, renounced his intention to fulfill it.[56] If the promisee proves that the promisor is wholly and finally disabled from performing and

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[52] Perrins and Stuart, *Mercantile Law*, (London: HFL publishers limited, 1975), 14th edition, 74
[53] ibid
[54] See Articles 161 of Egyptian civil code, 219 of Kuwaiti civil code in Muhiyyud-Din Ismaeel Ilmud-Din, *Nazriyyat-al-Aqd*,(Egypt: : Dār Nahda al-Arabiyyah Alim al Kutub, 1976), 3rd edition,640
[55] Perrins and Stuart, *Mercantile Law*, (London: HFL publishers limited, 1975), 14th edition,75
[56] A. G. Guest, *Anson's Law of Contract* (Oxford: Clarendon Press, 1984) 26th edition, 475

that this disability existed at the time of termination of the contract, he is justified in electing to terminate the performance of the contract provided that the promisor was in fact unable to perform.[57]

Once termination has occurred, the promisee is under no obligation to prove an ability to perform since termination will discharge him from duty to perform his contractual obligations.[58] An inability existing prior to the arrival of the time of performance may give rise to an anticipatory breach, but would not be described as 'repudiation' unless the inability "stemmed from a positive act".[59] Declared inability and inability by positive act give rise to repudiation, the consequences of which shall be discussed later.

2.3.3 Effects and consequences of refusal to perform

When a party has refused to perform the whole of the contract, the other party has the right to put an end to the contract.[60] But the breach has to be in its entirety; otherwise the other party would not be justified in putting an end to the contract.[61] In case, a promisor has made an offer of performance to the promisee, but the promisee has refused to accept the offer, the promisor is not responsible for non-performance and he does not lose his rights under the contract, provided that the offer is unconditional;

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[57] J. W. Carter, *Breach of Contract*, (Sydney: Law book Company limited, 1984), 302
[58] Ibid,303
[59] Ibid, 307
[60] Section 39 of the *Contract Act 1872*
[61] Avtar Singh, *Law of Contract*, (India: Mansoor Book House Publishers, 1993), 6th Edition, 347.

made at proper time and place; and if the offer is to deliver something, the promisee must be given an opportunity of seeing that thing.[62]

But when no offer of performance has been made by the promisor, rather he has refused to perform his obligation before the time of performance, the promisee, if he pleases, may instead of putting an end to the contract, await the time when the contract is to be executed, and then hold the other party responsible for all the consequences of non-performance. But if he does so, he keeps the contract alive not only for himself but also for the benefit of the other party.[63]

On the other hand, if the promisee wants to put an end to the contract, he will be entitled to such damages as would have arisen from the non-performance of the contract. In such a case it is not open to the promisor to go back on his refusal and treat the contract as subsisting.[64]

2.3.4 Effects and consequences of repudiation

The breach by repudiation has the effect of allowing the innocent party the choice of whether to terminate the agreement or to allow it to continue. In all the cases, the innocent party has the possibility of electing to treat the contract as repudiated and

[62] Contract Act 1872 ,Section 38
[63] M.Farani, *The Contract Act (IX of 1872),(Lahore: Lahore Law Times Publications, 2005) 2nd revised edition,202*
[64] Ibid

terminate it; or to affirm the contract and possibly claim the damages.[65] The law relating to the sales of goods declares that in case before the date of delivery either party repudiates the contract, the other may have two options: treat the contract as subsisting and wait till the date of delivery; or he may treat the contract as rescinded and sue for the damages.[66] The law in this case, deals with repudiation by anticipatory refusal to perform the contract. If the promisee elects to treat the contract as subsisting, he keeps the contract alive for all purposes.[67]

The word 'rescission' used by the Sale of Goods Act for termination of the contract may be right for the contract of sales but in other cases the use of the word may not be correct. The reason is that this so-called rescission is quite different from rescission *ab initio*,[68] such as may arise, for example, in cases of misrepresentation or mistake. In these cases, the contract is treated in law as never having come into existence while in the cases of repudiatory breach; the contract has come into existence but has been put to an end or discharged.[69] Besides, for a repudiatory breach, there will always be a right to claim damages, whereas rescission (for example, in relation to a totally innocent misrepresentation) maybe a remedy in itself.

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[65] Richard Stone, *The Modern Law of Contract*,(England: Routledge.Cavendish publishers,2009), 8th edition,571

[66] Section 60 of the *Sales of Goods Act, 1930*

[67] Dinshah Fardunji Mulla,revised by Muhammad Muzammil, *The Sales of Goods Act,III of 1930*, (Lahore: Mansoor Book House, 2008), revised edition,107

[68] A. G. Guest, *Anson's Law of Contract* (Oxford: Clarendon Press, 1984) 26th edition, 483; also see Richard Stone, *The Modern Law of Contract*,(England: Routledge.Cavendish publishers,2009), 8th edition,572

[69] Richard Stone, *The Modern Law of Contract*,(England: Routledge.Cavendish publishers,2009), 8th edition,572

Thus under the general rule of law, the acceptance of a repudiatory breach does not bring about 'rescission *ab initio*'.[70] In case the promisor repudiates his prospective duty to perform, the non-repudiating party has the right to elect remedies. He has the option of treating the repudiation as an anticipatory breach and immediately seeking damages for breach of contract, rather than waiting until the time set for the repudiating party's performance.[71]

2.3.5 Effects and consequences of anticipatory breach

In case of anticipatory breach, the injured party can treat the repudiation as a mere threat and wait until the time of performance arrives or he can exercise the remedies for actual breach if the breach does not in fact occur.[72] In case the injured party disregards the repudiation treating the contract as still in force, the repudiation is nullified, and the injured party is left with his remedies, if any, at the time of performance.[73]

Anticipatory breach has certain effects upon the rights of the injured party e.g. innocent party is excused from further performance and he is given an immediate right of action which entitles him to an option either to sue immediately or wait till the time the act was to be done.[74]

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[70] Ibid
[71] Robert Corley, Peter Shedd and Eric Holmes, *Principles of Business Law*, (New Jersey: Prentice-Hall publishers, 1986) 13th edition,250
[72] Ibid
[73] Ibid
[74] Avtar Singh, *Law of Contract*, (India: Mansoor Book House Publishers, 1993), 6th Edition, 339.

Thus, the effects of anticipatory breach may be summarized as followed: The promisee may treat the notice of intention as inoperative, and wait for the time when the contract is to be executed. And then he can hold the other party responsible for all the consequences of non-performance; but in that case he keeps the contract alive for the benefit of the other party as well as his own; he remains subject to all his obligations and liabilities under it. Thereby he enables the other party not only to complete the contract, but also to take advantage of any supervening circumstances which would justify him in declining to complete it.

Once the aggrieved party has exercised the option, the party in default can no longer say that the contract still subsists.[75]If the aggrieved party has rejected the repudiation and the contract still subsists, the repudiating party may choose to perform when the time comes and the promisee will be bound to accept the same. But if the party keeping the contract alive has not performed his part of obligation, the repudiating party would escape liability because the affirming party is in breach of the contract.[76]

The Article 161 of the *Egyptian Civil Law* provides the same rule that in binding contracts, if the contractual obligations of both the parties are of such

[75] Ibid,341
[76] Ibid

nature that can be performed by them, it is permissible for both the parties to refrain from their performance if the other party has not performed his liability.[77]

Article 219 of Kuwaiti civil law also provides the same rule that a party is permitted not to perform if the other party has not performed his obligation, provided that it is not against the terms of the contract or against the custom.[78]

Conclusion

The breach of contract has been regarded as the non-compliance of the law and no party can be excused from liability if he is in breach of his contract. The breach of contracts has different forms. The effects and the consequences of breach differ from case to case keeping in view the facts of the cases individually. In most of the cases, the aggrieved party has the right of claiming damages or other remedies; however, there are certain cases in which the courts order the specific performance of the contracts. The breach of contracts gives rise to the claim of remedies which shall be discussed in coming chapters.

[77] Muhiyyud-Din Ismaeel Ilmud-Din, *Nazriyyat-al-Aqd*,(Egypt: : Dār Nahda al-Arabiyyah Alim al Kutub, 1976), 3rd edition,640
[78] Ibid

Chapter Three

GUARANTEES IN ISLAMIC BANKS AND IFIS FOR SECURING THE FULFILLMENT OF CONTRACTUAL OBLIGATIONS

The main feature that distinguishes an Islamic bank from a conventional one is the avoidance of interest (riba) in any of its forms. This feature makes the Islamic banks prone to many risks that can exist while entering into the financial transactions. However, Islamic banks need to protect the amount of debts, either from being uncollectible or from being in default. For this purpose, the Islamic banks require specific kinds of guarantees from the clients in order to secure the fulfillment of their contractual obligations. In this chapter different kinds of guarantees shall be discussed along with the position of promise in Shariah and Law at the end.

3.1 Meaning of 'Guarantee' and its importance in financial transactions

The Arabic word for guarantee is *"Damaan"* (الضمان), which means obligation or liability, (التزام)[1] or responsibility.[2] In the general sense it means a right that is proved to be in the liability of another.[3] So it is clear that guarantee is a kind of liability that is a proved right of another. It means that the person, who is under the liability, has to fulfill it and he can

[1] Abi Yahya Zakariyya Ansari al-Shafai, *Asna al-Mataalib,Sharh Raud at-Taalib*, (Bairut: Daar-al-kutub-al-Islamiyah ,Bairut, Labenon, 2001),583; Muhammad Fauzi Faizullah, *Nazriyyat ad-damaan fil Fiqh al Islami al-Aam*, (Kuwait: Maktabah at-Turaath al-Islami, 1981), 13; Muhammad Ashihaat al-Jindi, *Damaanal-Aqd wal Masuuliyyah al-Aqdiyyah*,(Qahirah: Daar an-Nahda al-Arabiyyah, 1990) ,21

[2] Muhammad Ahmad Siraj, *Damaan al-Udwaan fil Fiqh al-Islami*,(Qahira: As Saqafah linnashr wa al-Tauzii`, 1988),55

[3] Abi Yahya Zakariyya Ansari al-Shafai, *Asna al-Mataalib,Sharh Raud at-Taalib*, (Bairut: Daar-al-kutub-al-Islamiyah ,Bairut, Labenon, 2001),583

not be excused from it and if he does not fulfill the liability, he will be guilty of breach of his obligation.

3.2 FORMS OF GUARANTEES IN ISLAMIC BANKS AND IFIS

In Quran, three ways are prescribed for securing the contractual obligations in FCs: Putting the transaction into writing (الكتابه); presence of witnesses (الشهاده); and pledge (الرهن). However, Islamic Banks (IBs) and Financial Institutions (IFIs) have adopted many other ways to secure the fulfillment of contractual liabilities from their clients. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has discussed the guarantees in detail. These are:[4]

i) Written documentation and attestation (الكتابه و الشهاده)

ii) Personal guarantee (الكفاله)

iii) Pledge (الرهن)

iv) Stipulation of bringing forward future installments in case of default on payment

v) Stipulation of termination of a sale on deferred payment terms in case of failure to pay

vi) Use of cheques and promissory notes

vii) Insurance for doubtful or bad debts

viii) Freezing cash deposits(blocking withdrawals)

[4] AAOIFI, standard no. 5

ix) Third party guarantees(voluntary undertaking to compensate an investment loss)

x) Security deposits and earnest money

3.2.1 Written documentation and attestation

Shariah recommends written documentation of financial transactions regardless of these documents being ordinary or official ones. Allah Almighty has asked the believers to put their transactions into writing, no matter how big or small the transaction is.[5] Forging, concealing or destroying of documents in order to bring about the loss to people's rights is strictly prohibited in Islam.[6] Attestation of financial transactions is also recommended but it has to be done only in case of a valid transaction e.g. to scribe or witness in a contract that is based on interest is prohibited.

Islam emphasizes on avoiding disputes regarding financial transactions. Allah Almighty has laid down specific rules for entering into a debt transaction. Allah says in the Holy Quran:

يَا أَيُّهَا الَّذِينَ آمَنُواْ إِذَا تَدَايَنتُم بِدَيْنٍ إِلَى أَجَلٍ مُّسَمًّى فَاكْتُبُوهُ .....

وَلاَ تَسْأَمُوْاْ أَن تَكْتُبُوْهُ صَغِيرًا أَو كَبِيرًا إِلَى أَجَلِهِ ذَلِكُمْ أَقْسَطُ عِندَ اللّهِ وَأَقْوَمُ لِلشَّهَادَةِ وَأَدْنَى أَلاَّ تَرْتَابُواْ

"O believers! When you contract a debt for a fixed period, put it in writing.....so do not fail to put your debts in writing, be they small or big, together with the date of payment.

[5] Quran, 2:282
[6] AAOIFI, standard no.5; 2/4

This is more just in the sight of Allah; it ensures accuracy in testifying and is the best way to remove all doubts."[7]

The verse clearly indicates that in any financial transaction, contracting parties are required to put their contract into writing in order to avoid any dispute in the future. Documentation is one of the rules and is very important for proving one's rights in case of dispute between a creditor and debtor, because it takes the shape of evidence and it helps the judge in deciding the disputes according to the registers and attested documents.[8]

Apart from documentation, the presence of witnesses (الشهادة) is also a requirement of such transaction. The documentation, attestation or taking some guarantee in any financial transaction has many advantages which are as under:

i) Protection of properties and preservation of them from being wasted.
ii) Avoidance/ prevention from falling into disputes with the help of referring to these documents.
iii) Repelling and removing doubts about any of the matter e.g. the amount of debt, time of payment, the amount that has been paid and that which is left to be paid etc.
iv) It ensures accuracy in testifying as is clear from the sayings of Almighty.
v) Removal of errors and defects from contracts and rectification of such defects in case of dispute regarding the contracts.[9]

The requirement of attestation of documents is not only emphasized in Islam but also in Pakistani legislation. It was held in *Muhammad Yaqoob and others v. Naseer*

[7] Quran 02:282
[8] Saad Sulaiman al-Haamidi, *At-Tauseeq wa Ahkaamuhu fil Fiqh al-Islami* , (Egypt:Daarus-Salaam littabaa`h wa al-Nashr wa at-Tauzee`, 2010) 1st edition,29
[9] Ibid32, 33

Hussain and others that the documents that create financial liability have to be attested by two witnesses.[10]

3.2.2 Personal Guarantee (الكفالة)

The literal meaning of *al-Kafalah* is "responsibility, amenability or Suretyship; and legally it is the pledge given by the guarantor or a surety to the creditor, on behalf of the principle debtor, to secure that the guaranteed (the debtor) will be present at a definite place, e.g. to pay his debt, or fine or, in the case of retaliation *lex talionis*, to undergo punishment."[11] In the contract of guarantee, the liability of the guarantor is merged with the principal debtor. It was held in *Anwar-ul-Rehman v. Modarba Al-Mal* that it could not be said in the contract of guarantee that the liability of guarantor was not co-extensive withy that of the principal debtor.[12] Both have the same liability.

It is the right of the bank or FI to ask the debtor to provide some personal guarantee because it compels performance and prevents the contract from being breached. In financial transactions, IBs and IFIs make every person his own personal guarantor. However, it does not affect the right of the Bank to demand another person as a guarantor. In case, the debtor fails to provide a guarantor, the institution is entitled

[10] PLD 1995 Lahore 395
[11] Abdullah Alwi Haji Hassan, *Sales and Contracts in Early Islamic Commercial Law*, (New Delhi: Kitab Bhavan Publishers, 2006),142
[12] 1997 MLD 3132

to initiate a legal action to force the debtor to provide a guarantor; or to terminate the contract.[13]

Followings are the different rules of a *Kafalah* contract.

- Asking for guarantee or security in a fiduciary contract (that is based on trust), is prohibited.
- Fixing duration for the *Kafalah* contract is permissible according to all the jurists except Shafai.[14] According to Shafai jurists, fixation of time in the contract of personal guarantee makes it void.[15] However, the Islamic institutions and banks follow the views of the majority of the jurists. It is also permissible to stipulate a condition in the contract.
- For taking remuneration for providing a personal guarantee, or to pay commission for obtaining such a guarantee, there are three views of the jurists:[16]
    a) According to the majority of the classical jurists, it is not permissible because this contract is a fiduciary and gratuitous one, and taking remuneration for a gratuitous contract is not permissible.

    b) According to some of the new jurists, it is permissible because there is no prohibition of it in any of the sources of the Shariah. Besides, all contracts

[13] AAOIFI, standard 5; 3/3/5

[14] Abu Bakr Muhammad bin Abi Sehl sarakhsi, *Al-Mabsut*,(Bairut: Daar al-Fikr li-Tabaa`h wannashr wattauzee, Bairut, labenon, 2000),72 ; Muhammad Arfah ad-dasuq, *Hashiyah ad-dasuqi wa al-Sharh al-Kabeer*, 3/331 and Alauddin Abul Hassaan Ali bin Sulaiman al Damishqi, *Al-Insaaf fi Maarifat al-Raajeh min al- Khilaaf*,5/213 taken from Masdar al-kitaab: Mauqii al-Islam (Al-Maktabah al-Shamilah)

[15] Abi Yahya Zakariyya Ansari al-Shafai, *Asna al-Mataalib,Sharh Raud at-Taalib*, (Bairut: Daar-al-kutub-al-Islamiyah ,Bairut, Labenon, 2001),608

[16] Muhammad Rawaas Qalaa`h Ji, *Al-Muaamalaat al-Maaliyyah al-Muaasarah fi Dau al-Fiqh wa Shariah*,(Kuwait: Daar An Nafaes, Bairut,Labenon,1999), 109

are permissible if there is nothing that makes them clearly impermissible according to the rule of acceptability of conditions in Islam.

c) The third view is that of contemporary jurists who differentiate between personal guarantee and commercial guarantee. According to them it is not permissible to take remuneration for personal guarantee, but it is permissible for commercial guarantee because usually, the traders are rich people and they can afford it easily.[17]

The preferred view, however, that is adopted by the AAOIFI is the view of the classical jurists that taking remuneration for personal guarantee is not permissible.[18] The guarantor is, however, entitled to claim any expenses, incurred during the period of personal guarantee.[19]

- As for personal guarantee for unknown or future debts, all the jurists agree that it is permissible except for one of the views of Shafai, Abu Thaur and ibn Abi Lailah. According to these jurists, there is some financial liability for paying some debt and it is like paying the price for the thing bought, and unknown price makes the contract of sale invalid.[20] However, the AAOIFI has adopted the view of the majority of the jurists who give the authority of the permissibility of unknown debt from Quran :

[17] Ibid
[18] AAOIFI, standard 5; 3/1/5
[19] Ibid
[20] Abi Yahya Zakariyya Ansari al-Shafai, *Asna al-Mataalib,Sharh Raud at-Taalib*, (Bairut: Daar-al-kutub-al-Islamiyah ,Bairut, Labenon, 2001),593

"... For him who produces it, is (the reward of) a camel load and I will be bound by it."[21] Here, the guarantor has guaranteed a camel load which is not yet a debt.

- The creditor is entitled to claim the amount of debt from either the debtor or the guarantor according to his wish. However, the guarantor can stipulate that the creditor will ask the principle debtor first, but if he does not pay, then the guarantor can be asked to pay the debt.[22]
- In case, the debtor is discharged from the debt, the guarantor is also discharged automatically. But if the guarantor is discharged, the debtor remains liable.

In the contract of guarantee, if any conflict arises, the court shall decide the case keeping in view the terms of the contract. It was held in *Emirates Bank International Limited v. Fair, Commission Agency (Pvt.) Limited* that "the rights and liabilities of the parties have to be determined with reference to the terms and conditions of the contract of guarantee."[23]

3.2.3 Pledge (الرهن)

Al-Rehn literally means readiness or immutability and durability. [24]It is said in the Holy Quran: *"Every soul will be (held) in pledge for its deeds."*[25] Legally it means "to pledge or lodge a real or corporeal property of material value, in accordance with the law, as security for a debtor's pecuniary obligation, so as to make it possible for the creditor to

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[21]Quran, Yusaf: 72
[22] AAOIFI, standard 5, 3/3/1
[23] 1991 CLC 450
[24] Abdullah Alwi Haji Hassan, *Sales and Contracts in Early Islamic Commercial Law*, (New Delhi: Kitab Bhavan Publishers, 2006),146
[25] Quran:74:38

regain the debt or some portion of the goods or property."[26] Taking pledge as security for debts has been proved from the Quran and Sunnah. Allah Almighty says in the holy Quran:

وَإِنْ كُنْتُمْ عَلَى سَفَرٍ وَّلَمْ تَجِدُوْا كَاتِبًا فَرِهٰنٌ مَّقْبُوْضَةٌ

"If you are on journey and cannot find a person to write (your debt), then pledge in hand (shall suffice)."[27]

As for the Sunnah, Hazrat Ayesha narrated that the Prophet (PBUH) bought some foodstuff on credit from a Jew for a limited period and mortgaged him armour for it.[28]

Islamic banks and institutions (herein after referred to as IBIs) have the right to demand the debtor to provide a pledge of security to secure payment. The contract of pledge is binding on the debtor who provides it, even if the asset so pledged is not possessed by the creditor, and thus the debtor does not have right to revoke the contract.[29]

The main principle is that the pledged asset should remain in the possession of the creditor. And it is also permissible that the pledged asset remains in the possession of the debtor if the creditor allows that. But the jurists have disagreement regarding this matter of possession. The main issue of disagreement is whether the

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[26] Abdullah Alwi Haji Hassan, *Sales and Contracts in Early Islamic Commercial Law*, (New Delhi: Kitab Bhavan Publishers, 2006),147
[27] Quran 2:282
[28] *Bukhari, Sahih, Kitab al-Buyu, Hadith* no.2068, 2069
[29] AAOIFI, standard 5; 4/1/2

possession is considered to be a condition for the validity of a contract or the completion of a contract of pledge?[30] Some of the jurists have the view that possession is the condition for completion of the contract and without possession in the hands of the creditor, the contract of pledge remains incomplete. The pledgor, according to this view shall be forced to hand over the pledged asset to the creditor because of Allah's saying in this regard :(فَرِهَٰنٌ مَّقْبُوضَةٌ) Allah has made the 'possession' (of pledged asset in the hands of the pledge) a quality of pledged contract, which cannot be achieved if the asset remains in the hands of the pledgor.[31]

However, the other view is that of the majority of the jurists who declare the possession a condition for the validity of the contract and not for the completion of the contract. According to them, if the creditor himself agrees with the debtor that the pledged asset will remain in the possession of the debtor, then the contract is valid because of the option of the creditor to retain the possession or not.[32] AAOIFI has adopted the view of the majority of the jurists and regarding the possession of the pledged asset, IBIs are allowed to enter any type of the contract of pledge, be it 'possessory pledge', 'security or registered pledge' or ' borrowed pledge'. The difference between the three types is that 'possessory pledge' is where the possession of the pledged asset remains with the creditor. If it remains with the debtor, then it is a

[30] Saad Sulaiman al-Haamidi, *At-Tauseeq wa Ahkaamuhu fil Fiqh al-Islami* , (Egypt:Daarus-Salaam littabaa`h wa al-Nashr wa at-Tauzee`, 2010) 1st edition,,219
[31] Ibid
[32] Ibid,220

'security or registered pledge'. But if the debtor pledges an asset of a third party with the permission of the owner, it is called 'borrowed pledge.'[33]

As for the utilization of the pledged asset, it is permissible for the pledgor to use the pledged asset with the consent of the pledgee. But he is not entitled to use the asset that transfers the ownership and transfers the asset to some person other than the pledgee e.g. gift, sale etc.[34] However, the pledgee is not allowed to use the pledged asset even if the pledgor has consented to it.[35] The pledged asset is a trust no matter who possesses it. If it is destroyed by the pledgor, he remains liable for the debt to the creditor. If it is destroyed by the pledgee, he shall not be liable if it destroyed without his negligence or misconduct. But if he was guilty of negligence or misconduct, then the debtor shall be discharged from his debt.[36]

Thus, pledge is taken from IBIs to secure the contractual obligations from their clients. In case the customer fails to fulfill his obligation, the bank is allowed to file a suit in the Banking Court demanding the sale of the pledged asset in order to recover the amount of debt from the sale proceeds. And the surplus proceeds are returned to the debtor.[37] In case, the proceeds fail to cover the amount of the debt, the remaining balance is treated as an ordinary unsecured debt.

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[33] AAOIFI, standard 5, 4/3/2
[34] Ibn-e-Qudamah, *Al-Mughni*, (Bairut: Daar al-Kitaab al-Arabi, Bairut, Labenon, 1983), 197
[35] AAOIFI, standard 5; 4/6
[36] Abu Bakr Ibn Masood bin Ahmad Alauddin Al-Kasani, *Badai al-Sanai fi Tarteeb al-Sharai*, quoted from Al-Maktabah Shamilah
[37] Section 15 of the *Financial Institutions (recovery of Finance) Ordinance 2001*

The banks have the right to stipulate to be authorized by the debtor to sell the pledged asset, without the intervention of banking court in case of failure of the debtor to pay back the debt.[38] In case of payment of the debt by the debtor, the creditor does not have any right over the pledged property and he should hand over the asset to the debtor if it was possessed by him.

3.2.4 Stipulation of bringing forward future installments in case of default on payment

The IBIs have the right to stipulate in the financial contract where the customer has to make payment in installments, that if the customer fails to pay one or more installments, some or all the future installments shall fall due immediately. But this rule is not applied where the default in payment was caused because of some unforeseeable intervening event or *force majeure*.[39] In case of default without any good reason, the debtor shall be liable to pay all the remaining installments before their originally agreed due dates. This may take place in any one of the following ways:

a) The installments automatically become due as a result of a mere delay in a payment, no matter how short the period of delay is.
b) The installments become due after a delay in payment exceeding a specified time period.

[38] Section 19 of the *Financial Institutions (Recovery of Finance) Ordinance 2001*, provides for the sale of immovable mortgaged property, with or without the intervention of a court.
[39] AAOIFI, standard 5; 5

c) The installments become due after sending of a reminder notice by the institution to the seller giving a specified time period for payment.[40]

Stipulating such condition in a contract is permissible because Holy Prophet (PBUH) said: "*Muslims are bound by the conditions they made.*"

The permissibility of such a condition in a debt contract has been confirmed by the resolution no. 51 issued by the International Islamic Fiqh Academy (IIFA). [41]

Through this way the IBIs can secure the fulfillment of their contractual terms regarding a debt transaction.

3.2.5 Stipulation of termination of a sale on deferred payment terms in case of failure to pay

In the contract of sale on a deferred payment basis, the seller has been given the right to stipulate in the contract that if the buyer fails to pay the price within a specified time, the seller will be entitled to revoke the contract and he will have the right of repossessing the thing sold, without the intervention of the court.[42] The basis for permissibility of this condition is the Hadith that says that Muslims are bound by the conditions they made.

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[40] Ibid, standard 8; 5/1
[41] Ibid, standard 5; basis of the Shariah Rulings no.6
[42] Ibid, satndard5;7

3.2.6 Taking of cheques and promissory notes as securities

IBIs sometimes obtain cheques or promissory notes from the debtors as a means to force them to make timely payment of installments in cash. If the debtor makes the payment in due time, the cheques or the promissory notes are returned to him. But in case of default, they may be produced for recovery of the debt. The debtor may ask for an undertaking from the bank that it will use the cheques or the promissory notes only for timely recovery of its due debts without any addition.[43]

3.2.7 Insurance for doubtful or bad debts

The IBIs can subscribe to an Islamic insurance coverage. This is done to secure the debt obligations. But for securing the obligation from the debtor, the Islamic banks are not allowed to obtain conventional insurance.[44]

3.2.8 Stipulation of freezing cash deposits (blocking withdrawals)

In order to avoid default in payment by the clients on a single payment or on installment basis, the IBIs can stipulate in the contract that in case of default from the customer, the bank will freeze his investment account. Or there can be a stipulation that

[43] Ibid, standard 5; 7/3
[44] Ibid,7/4

his right to withdraw money from his account shall be revoked. But the preferred option is to block an amount in the account equivalent to the debt.[45]

3.2.9 Third party guarantees (voluntary undertaking to compensate an investment loss)

It is the voluntary undertaking by a third party, other than the mudarib or investment agent or one of the partners, to compensate the investment losses of the party to whom the undertaking is given. But the condition for such undertaking is that it should not be linked in any manner to the Mudarbah financing contract or investment agency contract.[46]

3.2.10 Security deposits, Earnest Money

Earnest money is the security that is deposited by the depositor in any contract with the condition that if the contract is performed, it will be taken as part of consideration. But in case of non performance by the depositor, the party who sustained loss will be entitled to deduct his amount from the earnest money.

[45] Ibid, 7/5
[46] Ibid,7/6

Islamic banks obtain different kinds of security deposits in different transactions e.g. they can ask for primary cash security for participating in the bids for tenders and final cash security that is to be paid by the successful bidder. Such amounts are considered to be held on trust basis and they are different from down payment.[47] Apart from such securities, there are different other types of guarantees that are taken by the Islamic banks to secure the obligations e.g. *Hamish Jiddiyah* (هامش جديه) and *Arboun* (العربون).

a) Hamish Jiddiyah

Hamish Jiddiyah which means "the margin reflecting the firm intention of the promisee"[48] is the sum of money that is taken in the case of a unilateral binding promise, from the customer in order to facilitate obtaining compensation for actual damages in case of breach of contracts. Since, at this stage no contract is established, this sum of money is held as trust. In case of failure of the customer to fulfill his promise, the bank does not have any right to retain the sum of money.

The bank is entitled only to deduce the amount of the loss that was to be borne by the bank because of the non-fulfillment of the promise from the customer. The excess or the remaining amount has to be given back to the client. While in case the promise is fulfilled by the customer, the amount shall be considered as a part of the

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[47] Muhammad Ayyub, *Understanding Islamic Finance*, (England: John Wiley and Sons limited , 2007) ,116 See also AAOIFI,7/8/1

[48] Ibid

consideration of the contract. This way, Hamish Jiddiyah is adjusted in the price at the time of execution of the sale.[49]

b) Arboun

Arboun is the earnest money that is taken from a buyer or a lessee when a sale or lease contract is concluded, on condition that, if the contract is not terminated within a specified time during which the parties have the right to terminate the contract, the amount will be considered as part of consideration of the contract. However, if the buyer or lessee fails to perform the contract within the specified time period, the seller or lessor is entitled to retain the price. [50]

The basis for obtaining the earnest money is the practice of Hazrat Umar Ibn Al-Khattab, may Allah be pleased with him, [51]in the presence of some companions of the Holy Prophet (PBUH) and it is permitted only by Imam Ahmad. Though it has been considered as invalid according to other jurists but AAOIFI; IIFA (Resolution no.72, 3/8, in respect of earnest money)[52] and most of the Civil Codes of Islamic states have adopted the rule as valid. Article 103 of the Egyptian, Article 107 of Jordan, 92 of Iraqi and 75-6 of Kuwaiti civil laws provide for the validity of *Arboun* sale.[53]

The Egyptian law says that paying the earnest money (*Arboun),* at the time of conclusion of sale contract, gives both the contracting parties, a right to terminate the

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[49] Ibid
[50] AAOIFI, standard 5; 7/8/3
[51] Ibid
[52] Ibid
[53] Muhiyyud-Din Ismaeel Ilmud-Din, *Nazriyyat-al-Aqd*,(Egypt: Daar Nahda al-Arabiyyah Aalim al Kutub, 1976), 3rd edition, 508,509

contract within a specified time except when there is an agreement not to do so.[54] However, it is preferable for the IBIs to refund to the customer any balance remaining after deducting from the *Arboun* the amount of any damage actually sustained by it. [55]

The majority of contemporary jurists are of the view that if the buyer or the lessee, as the case may be, stipulates by his free will and without any duress that he will either finalize the deal within specific time period or the contract will be considered cancelled, and the seller or lessor will get the amount given in advance, it could be considered legal.[56] If that is not the case, then *Arboun* is not permissible. But Islamic banks take Arbun as security from their clients and they have the right to retain the amount if the contract is terminated by the client.

3.3 POSITION OF 'PROMISE' (وعد) IN SHARIAH AND LAW

In *W`adah* or *'Ahad*, one party binds himself to do some action for other. Generally it does not create legal obligation but in certain cases it becomes legally binding and enforceable. It happens in those cases where the promisee has incurred some expenses

[54] Ibid; see also for detail Abd ar-Razzaq Ahmad al-Sanhuri, *Al Wseet fi Sharh al-Qanoon al-Madni al-Jadeed*, (Egypt: Daar Ihyaa at Turaathal Arabi,Bairut, Labenon, 1952),261
[55] AAOIFI, standard 5; 7/8/3
[56] Muhammad Ayyub, *Understanding Islamic Finance*, (England: John Wiley and Sons limited , 2007) ,117

or taken some liability as a result of the promise. [57] Breach of promises has been considered as a disapproved practice that is against business ethics in Islam.[58]

In the present day business, particularly, when conducted by IBIs, if the promise is regarded as non-binding, it leads to many problems and infringement of rights. That is why the contemporary Islamic scholars have reached the consensus that promise is enforceable by law until and unless the promisor is not in a position to fulfill it on account of any *force majeure.*[59]The rationale behind this consensus decision is that, in many cases, the fulfillment of binding promises becomes a requirement which does not violate any Shariah injunction.

Some scholars have criticized IBIs for treating the 'promise to purchase' by the client as binding, but since, it does not involve the violation of any major Shariah principle, it has been declared as binding by most of the jurists while keeping in mind the practical problems in finalization of contracts.[60] The *Mejelleh* declares those promises that take a conditional form as binding. For example, if someone says: *"you sell this property to such a person, if he does not give the money I will give it to you".* And the person who buys the property does not give the money, the payment of the money, by the person, who made the promise, becomes necessary and binding.[61]

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[57] Ibid, 114
[58] Mushtaq Ahmad, *Business Ethics in Islam*, (Islamabad: International Institute of Islamic thought, Pakistan, 1995), 114
[59] Muhammad Ayyub, *Understanding Islamic Finance*, (England: John Wiley and Sons limited , 2007) ,114
[60] Ibid
[61] Article 84 of *Mejellahel-Ahkam-i-Adliyah*

The Article 102 of the Egyptian Civil law also declares the promise as binding. It says that if a person promised to enter into a contract, but then refused to fulfill his promise, and the promisee asked him to fulfill it; if the promise is of such a nature that can be fulfilled by the promisor easily, and he is in a position to fulfill his promise, the *hukm* of promise becomes that of a contract.[62] It means that the promise shall be taken as a contract and breach of it shall be regarded as a breach of a contract, if the promisor is in a position to fulfill his promise. A promise in a sale contract can have three different forms:

i- Promise to sell

ii- Promise to buy

iii- Promise to sell and buy[63]

In the case of unilateral "promise to sell", a person promises to sell a specific thing belonging to him to the promisee within a specific time period, if the later showed his consent in buying it. The promise is binding in this case only on the promisor i.e. if the promisee shows his consent within the specified time, the promisor shall be bound to sell the thing to him, but if the promisee does not show any interest, then there is no sale. [64]

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[62] Muhiyyud-Din Ismaeel Ilmud-Din, *Nazriyyat-al-Aqd*,(Egypt: Daar Nahda al-Arabiyyah Aalim al Kutub, 1976), 3rd edition, 507 ; see for detail Abd ar-Razzaq Ahmad as-Sanhuri, *Al Wseet fi Sharh al-Qanoon al-Madni al-Jadeed*, (Egypt: Daar Ihyaa at Turaathal Arabi,Bairut, Labenon, 1952), 249-259

[63] Abd ar-Razzaq Ahmad as-Sanhuri, *Al Wseet fi Sharh al-Qanoon al-Madni al-Jadeed, Kitab al-Bai`* (Egypt: Daar Ihyaa at Turaathal Arabi,Bairut, Labenon, 1952) volume 4,55-56

[64] Ibid

In the case of unilateral "promise to purchase", the situation is vice versa. Here, the person who promised to buy a specific thing shall be bound if the other showed his consent in selling it to him. Otherwise there shall be no sale. [65]

The third case is that of "promise to buy and sell". In such a case if the promise is not unilateral, both the buyer and seller shall be bound by their promises if the other shows his consent to it. This kind of promise is considered to be the first stage of a contract (عقد الابتداءي) and when the contract shall be completed by offer and acceptance, it shall take the form of a complete and final contract (عقد النّهاءي). [66]

Many traditional jurists, particularly the Malikis, Hanblis and some Hanafi and Shafai, and almost all the contemporary jurists have accepted the legal effectiveness of promise *"if understanding between the promisor and the promisee takes place in commercial dealings with mutual consent."*[67] Accoding to the Maliki jurists, *"in normal conditions, promise is not binding, but if the promisor has caused the promisee to incur some expenses or undertake some labor or liability on the basis of the promise, it is mandatory on him to fulfill his promise for which he may be compelled by the courts."*[68] The IIFA has made the promise binding with the following conditions:

1. The promise should be unilateral or one-sided.
2. The promise must have caused the promisee to incur some liabilities or expenses.

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[65] Ibid
[66] Ibid
[67] Muhammad Ayyub, *Understanding Islamic Finance*, (England: John Wiley and Sons limited , 2007) ,115
[68] Usmani,2000a,pp.120-126, taken from Ayub, *Understanding Islamic Finance*, (England: John Wiley and Sons limited , 2007) ,115

3. If the promise is to purchase something, mere promise itself should not be taken as the actual sale. The actual sale must take place at the appointed time by the exchange of offer and acceptance.
4. In case, the promisor backs out his promise, the court may force him either to purchase the commodity or to pay actual damage to the seller. The actual damage will include the actual monetary loss suffered by him, but will not include the opportunity cost.[69]

In the cases of Murabaha to the purchase orderer (Banking Murabaha), *Ijarah-wa-Iqtina*, Diminishing *Musharkah*, and for disposal of goods purchased by banks under Salam or Istsna'a, the binding nature of promises has important implications for Islamic banks' operations.[70] Thus, it has become clear that in the present day business, the promises are considered to be binding and a party shall not be excused from fulfilling it except in the case of *force majeure*.

Conclusion

Guarantees are an important part of any financial transaction and they have been approved by the Holy Quran. The IBIs have the right of demanding any type of valid guarantee from their clients and in case of default, they can enforce them. Islam lays down the principles of securing the contractual obligations through different forms of guarantees and IBIs use them in different financial transactions to avoid the risk of loss from the breach of contracts by their customers.

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[69] OIC Fiqh Academy, 5th Conference, Resolution no. 2 and 3 c.f. Muhammad Ayyub, *Understanding Islamic Finance*, (England: John Wiley and Sons limited , 2007) ,115
[70] Muhammad Ayub, *Understanding Islamic Finance*, (England: John Wiley and Sons limited , 2007) ,116

Chapter Four

REMEDIES FOR BREACH OF FINANCIAL CONTRACTS IN ISLAMIC LAW AND PAKISTANI LEGISLATION

The Latin maxim "*Ubi jus, ibi remidium*"[1] (where there is a right, there is a remedy), clearly explains the importance of remedies in case of the infringement of any right. A contract should always foresee the possibility of nonperformance, intentional or unintentional, and there should always be some kinds of remedies for the aggrieved party for the loss that he has suffered because of the non-performance of the contract. Any law, whether it is Divine or man-made, recognizes the remedies as of the right of the aggrieved party. This does not only help in eliminating the evil of devouring others' property illegally but also ensures the fulfillment of the contractual liabilities by the parties.

4.1 REMEDIES FOR BREACH OF FINANCIAL CONTRACTS IN ISLAMIC LAW

As stated earlier, Islam strongly condemns the infliction of harm and if it is inflicted, then it has to be removed.[2] The remedies for breach of financial contracts in Islamic law are basically the main objects which distinguish the Islamic banks from the conventional ones because in the conventional banking system, the first and the most important remedy for breach of financial contracts is the imposition of '*Riba*' i.e. interest. Islam prohibits it in any of its forms,

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[1] Bryan A. Garner, *Black's Law Dictionary*, (USA: West Group Publishing Co., 1999) 7th edition, 1695

[2] The principles of " لا ضرر و لا ضرار " and " الضرر يزال " discussed in chapter one in detail.

whether it is taken directly or through the modes of legal devices. In Islamic law, the following remedies are available for the breach of contracts:[3]

1) "Rescission
2) Specific Performance
3) Injunctions
4) Restitutionary Remedies
5) Damages"[4]
6) Non material punishment in case of default in payment

4.1.1 Rescission

Rescission is the equitable right to put an end to a contract and have the status quo restored.[5] In simple words, it is the cancellation of a contract.[6] It is an action to "undo, or cancel, a contract----to return non breaching parties to the positions that they occupied prior to the transaction."[7] It can be understood to be the opposite of the 'contract'. A contract is an agreement which creates obligations whereas rescission is an agreement to end them.[8] Like any other bilateral contract, the contract of rescission requires the element of acceptance from the offeree. However, if both the parties agree at the time of making the contract that

[3] Dr. Liaqat Ali Khan Niazi, *Islamic Law of Contract*, (Lahore: Research Cell, Dyal Sing Trust Library,1991),309
[4] Ibid
[5] ibid
[6] P. H. Collins, *Dictionary of Law*, (England: Peter Collin Publishing Ltd., 1993), 2nd edition,209
[7] Roger LeRoy Miller, Gaylord A. Jentz, *Fundamentals of Business Law*,(Texas: Thomson South-western west publishers, 2005) 235
[8] Abdur Razzaq Ahmad al-Sanhuri, *Masadir al Haq fil fiqh al Islami*, (Egypt: Al Majmaah al Ilmi al Arabi al Islami, ,Beirut, Lebanon,),244

anyone of them has the right of rescinding the contract without the above mentioned requirement of acceptance, it can be rescinded unilaterally. In such a case, a notice has to be given to the other party by the party rescinding the contract at the time agreed by both e.g. in the lease contract, the lessor or the lessee may rescind the contract by giving notice to the other party at the time specified for such notice in the contract of lease.[9]

4.1.1.1 Conditions for the validity of rescission

Like any other contract, the contract of rescission has some conditions without which, it will not be a valid rescission and the party rescinding the contract will not be considered as having the right to rescind the contract.

These conditions are:

1) "Free consent.
2) The conclusion of contract in the same session. Since, the rescission is also a contract; the requirement of same session also exists for it like any other contract.
3) Existence of the subject matter at the time of the rescission. Thus, if it is destroyed at the time of rescission, or before returning it to the seller, there is no possibility of the contract of rescission."[10]

[9] Ibid, 245
[10] Ibid, 249

4.1.1.2 Effects of Rescission:

The rescission of the contract brings the contract to an end as if there were no contract between the parties. It restores the parties to the same position in which they were before the contract. All the obligations end by the rescission if the performance was not started. Both the parties have to make restitution to each other by returning anything e.g. goods, property or funds previously conveyed.[11] If however, one party has performed his part of the contract, the other party has lost his right of rescinding the contract, as the contract is performed.

4.1.2 Specific performance

Specific performance is the discretionary remedy in which the court makes an order to a person requiring him to perform the contract.[12] Granting the decree of the specific performance is governed by the following principles:[13]

1- "There must be an enforceable contract. Thus no specific performance of a contract may be granted for a contract that is rendered void at law.
2- The claimant must have given consideration or must have performed his part of the contractual liability.
3- Damages must be an inadequate remedy."[14]

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[11] Roger LeRoy Miller, Gaylord A. Jentz, *Fundamentals of Business Law,*(Texas: Thomson South-western west publishers, 2005) 236
[12] Dr. Liaqat Ali Khan Niazi, *Islamic Law of Contract,* (Lahore: Research Cell, Dyal Sing Trust Library,1991), 311
[13] Ibid
[14] ibid

The question whether damages are an adequate remedy or not differ from case to case depending on the nature of the case. In the cases of immovable property and land, the damages will always be an inadequate remedy because all land is unique. Thus where the contract of sale of land is breached, the seller may also sue for specific performance.[15] In the contracts of loans, the damages will always be an adequate remedy.

The specific performance is not the only remedy to the aggrieved party. He has also the right to sue for damages that he has incurred because of the non performance of the contract. However, the Courts have the discretion to award the remedies according to the facts of each case.

4.1.3 Injunctions

Injunction is the court's order compelling someone to stop doing something or not to do something.[16] Thus the court orders a person to do or refrain from doing a particular act.[17] The object of an injunction is to restrain the undue exercise of rights, to prevent threatened wrongs, to restore violated possessions and to secure the permanent enjoyment of the rights of property.[18]It has been laid down in the article of the *Mejelleh* that some persons, who are a public harm, are restrained from their act that is likely to cause harm to the public e.g. an unskilled doctor.[19] It means that a court in Islamic country has the power of granting injunction

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[15] Ibid
[16] P. H. Collins, *Dictionary of Law*, (England: Peter Collin Publishing Ltd., 1993), 2nd edition,122
[17] Dr. Liaqat Ali Khan Niazi, *Islamic Law of Contract*, (Lahore: Research Cell, Dyal Sing Trust Library,1991),312
[18] Raja Said Akbar Khan, *Commentary on The Specific Relief Act*, (Lahore: PLD Publishers, Lahore),102
[19] Article 964 of *Majallahel Ahkaam-i-Adliyyah*

to any person about whom the court is satisfied to be a public harm. The rule to repel a public damage is preferred over private damage in the *Mejelleh.* [20]

It is not a condition that the person who is intended to be restrained by a judge should be present. The order of injunction made in his absence is effective. The important condition is that the notice of the injunction should reach that person. As long as the information of the prohibition made has not reached that person, he is not prohibited, and his contracts and admissions made up to that time, are of force.[21] The court may grant any of the following injunctions:[22]

a) Mandatory: It is to compel the performance of some positive act e.g. if some of the owners of *Haqq shurb* desires to cleanse a public river, and someone refuses, he who refuses is compelled to keep up the river by common action with the others.[23]
b) Prohibitory: It is to restrain or prevent someone of doing of some illegal act.[24]

4.1.4 Restitutionary remedies

Islamic law also provides Restitutionary remedies for the breach of contracts which may be either by return (رد) of the thing or by delivery of a similar article (إعطاء مثله).[25] It means that if

[20] Ibid, Article 26
[21] Ibid, Article 962
[22] Dr. Liaqat Ali Khan Niazi, *Islamic Law of Contract*, (Lahore: Research Cell, Dyal Sing Trust Library,1991),312
[23] Article 1323 of *Majallahel Ahkaam-i-Adliyyah*
[24] P. H. Collins, *Dictionary of Law*, (England: Peter Collin Publishing Ltd., 1993), 2nd edition,122
[25] Dr. Liaqat Ali Khan Niazi, *Islamic Law of Contract*, (Lahore: Research Cell, Dyal Sing Trust Library,1991),313

the article in respect of which wrong has been committed is of the nature of similars, the court can order to the defendant to deliver a similar article to the plaintiff.[26]

4.1.5 Damages

By the breach of contract, the non breaching party is entitles to sue for damages.[27] Damages can be defined as "pecuniary compensation,[28]recoverable by the process of law by the person who has sustained an injury through the wrongful act or omission of another."[29] They can also be defined as the "disadvantage or loss which is suffered by a person as a result of the act or default of another person."[30]

In Islamic jurisprudence, damage is "any harm which befalls a person and causes him financial loss from his assets by destroying them, diminishing them or diminishing the benefits to be derived there from, or their special properties."[31]

The basic object of an award of damages is to compensate the person who has suffered the loss or injury. Islam emphasizes over the principle of الضرر يزال which makes it clear that the harm has to be removed. According to the Egyptian Civil law, the debtor shall be

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[26] Ibid
[27] Roger LeRoy Miller, Gaylord A. Jentz, *Fundamentals of Business Law,*(Texas: Thomson South-western west publishers, 2005) 232
[28] Harvey McGregor, *McGregor on Damages,* (London: Sweet & Maxwell Limited, 1980) , 03;
[29] C. Kameshwara Rao, *Treatise on Law of Damages and compensation,* (India: Law Publishers India Pvt. Ltd., 1992), 19
[30] Ibid
[31] Jamal Addin Muhammad Mahmoud, Article " *Compensation for Damages and it's elements in the Islamic Shariah in Contractual Liability*" taken from Arab *Comparative & Commercial Law* by Graham & Trotman Publishers, 51

compelled to perform his obligation;[32] and "if it is impossible for the debtor to perform his obligation in kind, damages are to be awarded against him for failure to discharge the said obligation".[33] The damages arising out of breach of the contractual liability may be either material or corporal.[34] The different types of damages are discussed in detail as under:

i. Compensatory - damages arising naturally from the breach. Compensation for the loss of the benefit of the bargain. It requires that injuries must be actually sustained by the plaintiff, and it must arise directly from the loss of the bargain.

ii. Consequential - monetary awards beyond the standard measure (compensatory damages) due to the special circumstances and expenses incurred because of the injury. For the innocent party to be entitled to consequential damages, when entering into the contractual relationship, she must make the other party aware of special losses that might result from a breach of contract. In this manner, the promisor can decide whether or not to enter into the contractual relationship. Defendant must be able to reasonably foresee injury as a probable result.

iii. Punitive (*ta'azir*) - monetary awards granted by a court for a breach of contract that involves very unusual circumstances. Exemplary damages are intended not only to compensate the injured party but to punish the breaching party. Punishment is not a usual aspect of contract law. As a consequence, for a party to be entitled to punitive damages there must be some statutory basis for the award under the state's law or governing jurisdiction.

iv. Nominal - awarded only for the namesake of technical injury only. No actual damages were suffered but only an injury. Nominal Damages are used to vindicate a Plaintiff's right when (a) that right has been violated; (b) no loss is sustained; or (c) the injury cannot be measured (it is too speculative).

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[32] The Egyptian Civil Code, Article 199

[33] Ibid, Article 215

[34] Jamal Addin Muhammad Mahmoud, Article " *Compensation for Damages and it's elements in the Islamic Shariah in Contractual Liability*" taken from Arab *Comparative & Commercial Law* by Graham & Trotman Publishers, 49

v. Liquidated damages - reasonable damages that the parties themselves have agreed to in the contract itself. Normally, parties to a contract would specify liquidated damages if it would be difficult or impossible to compute compensatory damages because of the uncertain nature of the contract or the subject matter. It cannot be punitive, as already noted, penalties have no place in contract law.[35]

4.1.6 Non material punishment in case of default in payment

Islamic law provides some non material punishments to the defaulting debtors who do not make timely payments of their debts without any legal justification. Such punishment is to stop the defaulter from his habitual and invalid default in the future. The Holy Prophet (PBUH) has declared the procrastination from a rich debtor as great injustice. He said in this regard:

مَطْلُ الْغَنِيِّ ظُلْمٌ

"Procrastination by a rich (debtor) is cruelty (injustice)."[36]

In order to avoid such cruelty and injustice, certain kind of punishment is prescribed in Islam for such persons:

لَيّ الواجديحلّ عِرضه وَ عُقوبته

"Procrastination by a person who has means to pay his debts renders him to be punished by censuring him and physically."

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[35] "Compensation for Breach of Contract: Conventional & Islamic Perspectives" by Hazik Mohammed taken from http://www.academia.edu/5612810/Compensation_for_Breach_of_Contract_Conventional_and_Islamic_Perspectives accessed on 5th April 2014 at 4.50 p.m. PST

[36] Muslim ibn al-Hajjaj Muslim,*Sahih,Baab Tehreem Matl al–Ghani,* part10, vol.5,p.228; Bukhari, *Sahih,, Kitab al-Istiqraz*, part.10,p.201

Jurists have different view about the punishment prescribed in the above Hadith. The views and conditions for the punishments are as follows:

> From the above *Hadith*, the word "dishonored" means to be complained about (by the creditor), and "be punished," means to be imprisoned[37]. Therefore, the person procrastinating in paying his debts deserves discretionary punishment and imprisonment. He is to be repeatedly punished in this manner until he fulfills his debts. But if the debtor bears punishments but still refuse to pay, the authority are to intervene by selling his property to cover the debts. This is according to the *Hadith* where the Prophet (PBUH) says:
>
> *"One should not harm others nor should one seek benefit for oneself by causing harm to others."*[38]
>
> Abu Hanifah also recommends imprisonment of a well-to-do debtor until he himself settles his debts. If that necessitates the sale of the debtor's properties, only that debtor may perform the sale. If he refuses he will remain in prison at the judge's discretion. But to be able to imprison the debtor, the following conditions must be met:
>
> (1) The debt must be clearly fixed on the liability of the debtor;
> (2) The debtor is shown to be capable to pay but does not want to pay;
> (3) The debtor refuses to comply with the order of the court;
> (4) The debt is due already;
> (5) The plaintiff asks for the debtor to go to jail; and
> (6) The debtor is of full legal capacity.[39]

This non-material punishment prescribed for the defaulter indicates the importance of fulfillment of contractual liability in Islam.

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[37] Salih Al-Fawzan, *A Summary of Islamic Jurisprudence,* (Riyadh:Al-Maiman Publishing House, 2009) 91

[38] Ibid, 92.

[39] "Compensation for Breach of Contract: Conventional & Islamic Perspectives" by Hazik Mohammed taken from http://www.academia.edu/5612810/Compensation_for_Breach_of_Contract_Conventional_and_Islamic_Perspectives accessed on 5th April 2014 at 4.50 p.m. PST

4.2 REMEDIES FOR BREACH OF CONTRACTS IN PAKISTANI LEGISLATION

In Pakistani legislation, almost all the remedies for the breach of FCs can be found that are available in the Islamic law. Different types of remedies which are available in Pakistani law for the breach of FCs are discussed as under:

4.2.1 Remedies under Specific Relief Act (I of 1877)

The ordinary relief, by way of damages, so far as civil wrongs are concerned, is a general relief; as opposed to the different reliefs provided by the Specific Relief Act (SRA), which are called specific inasmuch as they lie outside the ordinary order of legal redress.[40]Under the Act, specific relief is given:

a) by taking possession of certain property and delivering it to the claimant (recovery of possession of movable and immovable property);
b) by ordering a party to do the very act which he is under the obligation to do (specific performance);
c) by preventing a party from doing that which he is under an obligation not to do (injunction);
d) by determining and declaring the rights of parties otherwise than by an award of compensation (declaratory decree) ;or
e) by appointing a receiver. [41]

The detail of these remedies is as follows:

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[40] Raja Said Akbar Khan, *Commentary on The Specific Relief Act*, (Lahore: PLD Publishers, Lahore), i
[41] *Specific Relief Act(I of 1877)* , Section 5

4.2.1.1 Recovery of possession of immovable or movable property (as the case may be)

Any person, who is dispossessed of immovable or movable property otherwise than in due course of law, has the right to recover its possession.[42] In this case, the plaintiff must be entitled to the possession even if he is not the owner of the property.[43] Thus, law entitles a tenant to file a suit for recovery of possession of the leased house in case he is evicted by the lessor without his consent before the expiry of the lease period. Likewise, a mortgagee can sue the mortgagor for recovery of the mortgaged property from which he is dispossessed with, before the payment of the debt by the mortgagor. Thus it is evident that any person who has the right of possession can sue the one who has dispossessed him and can recover the same regardless of the fact whether he is the owner of the thing or not.

4.2.1.2 Rescission of contract

Rescission, as explained earlier, is putting an end to a contract and having the status quo of the contracting parties restored. There can be no rescission if restoring the parties to the same position in which they would have been if the contract had not been made, is not possible.[44]The right of rescission is a matter of discretion of the court which is decided according to the facts of the case. The courts may adjudge the rescission in any of the following cases only:

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[42] Ibid, Section 9, 10
[43] Raja Said Akbar Khan, *Commentary on the Specific Relief Act*, (Lahore: PLD Publishers, Lahore),15
[44] Raja Said Akbar Khan, *Commentary on The Specific Relief Act*, (Lahore: PLD Publishers, Lahore),79

i) Where the contract is voidable or terminable by the plaintiff; or

ii) Where the contract is unlawful for causes not apparent on its face, and the defendant is more to blame than the plaintiff; or

iii) Where a decree for specific performance of a contract of sale, or of a contract to take a lease, has been made, and the purchaser or lessee makes default in payment of the purchase money or other sums which the Court has ordered him to pay.[45]

Thus, the law makes it clear that rescission is not a remedy to be provided in each and every case. The plaintiff can seek the remedy only in the case where he has the authority to do so. And he is granted this authority:

a) Where the contract is voidable or terminable by him. A contract is said to be voidable when it is enforceable by law at the option of one or more of the parties thereto, but not at the option of the other.[46] A contract is voidable *ab initio* where the consent to such agreement is caused by any act which makes a contract voidable e.g. fraud, undue influence, coercion or misrepresentation.[47] A terminable contract is the one which reserves to one or both of the contracting parties a power to rescind the contract in certain specific circumstances[48].

b) The plaintiff can also seek the remedy of rescission if the contract is unlawful for causes not apparent on the face thereof and if the defendant is more to be blamed than the plaintiff.

c) The third case is the default by a purchaser or lessee in fulfilling the terms of a decree for specific performance of a contract of sale or to take a lease, the other party is granted the right to relief by rescinding the contract of sale or lease, as the case may be.

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[45] *The Specific Relief Act*, (I of 1877) ,section 35

[46] Raja Said Akbar Khan, *Commentary on The Specific Relief Act*, (Lahore: PLD Publishers, Lahore),79

[47] The Contract Act, IX of1872, Sections 19, 19-A

[48] Raja Said Akbar Khan, *Commentary on The Specific Relief Act*, (Lahore: PLD Publishers, Lahore),80

4.2.1.3 Declaratory decree

This type of relief granted by the court to the plaintiff is just to ensure the rightful claim of him over some property or document. This remedy entitles a person to enjoy the status of being the rightful owner or possessor of the subject matter for which the suit for declaratory decree is instituted. If a person is entitled to any legal character, or to any right to any property, he has the right to institute a suit against the person who is denying, or who can likely deny his title to such character or right. Thereupon, the court may, in its discretion, make a declaration that he is so entitled.[49] Since the granting of this relief is discretionary, the courts must exercise it with great caution. There are two main requirements to be satisfied before granting the relief:

a) The plaintiff must be entitled to any legal character or to any right to any property.
b) The defendant must have denied or be interested in denying the plaintiff's status or right.

The declaration made by the court is binding only on the parties to the suit or persons claiming through them.[50] The banking laws delegate some powers to some banks to decide the cases regarding banks, it is not necessary that declaration must only be sought by any of the parties. For example, the State Bank of Pakistan (SBP) is given the power to make a declaration where it is of the opinion, after making such inquiries, that a company or firm or a person is transacting in any manner or form whatsoever the business of banking; or is receiving or has received deposits of money, without holding a license

[49] *The Specific Relief Act*, (I of 1877) ,section 42
[50] Ibid, section 43

from the SBP.[51] Here, the declaration takes the form of 'injunction' because the purpose of such declaration is to stop the company, firm or person from transacting their business.

4.2.1.4 Specific performance of contract

The court has the discretion to award a decree for the specific performance of the contract. Under the SRA, a party can be compelled to perform his part of obligation for which he had made a promise in the agreement, instead of accepting monetary compensation.[52] However, the decree is only to be awarded in specific cases where no standard exists for ascertaining the actual damage caused by the non-performance of the act agreed to be done.[53] It is also to be awarded if the act agreed to be done is of such nature that the pecuniary compensation for its non-performance would not afford an adequate relief for the aggrieved party or when it is probable that the pecuniary compensation can not be got for the non-performance of the agreed act.[54]

Traditionally it is said that damages are an inadequate remedy for the breach of a contract for the sale of land.[55] However, it does not follow that specific performance of the contract will necessarily be granted because damages are not an adequate compensation since it is a discretionary remedy.[56] The court has the right of discretion to decide whether such type

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[51] *Banking Companies Ordinance,* 1962, sections 43(B) and 27(A).
[52] Sajid A. Qureshi, *Business Laws*, (Rawalpindi: Federal Law House,2001) 130
[53] The Specific Relief Act (I of 1877), section 12 (b)
[54] Ibid, section 12(c and d)
[55] A.G.Guest, *Anson's Law of Contract,* (New York: Clarendon Press Oxford, 1984),517
[56] Ibid

of remedy is to be awarded or not keeping in view the facts of the case. This type of decree is awarded only if the following conditions are satisfied:

1) "The contract must be fair and just as between the parties.
2) The contract must be enforceable by both the parties.
3) The Court must be able to supervise and enforce the execution. Thus contracts of personal services do not fall within the ambit of the rule."[57]

The SRA provides the cases in which this remedy can be sought by the aggrieved party. Thus, the specific performance of the contract may be enforced:

1) "When the act agreed to be done is in the performance of a trust;
2) Where there is no standard for ascertaining damages caused by non performance;
3) Where damages would not afford adequate relief; or
4) Where pecuniary compensation can not be got for the non performance of the act agreed upon by the parties."[58]

The Law gives the aggrieved party not only the right to sue any person for specific performance of the contract, but also he can ask for compensation for the breach of the contract, either in addition to or in substitution for, such performance.[59] Thus, the court is to decide whether to award for the specific performance of the contract or for compensation for the breach of the contract, or both. It is purely in the discretion of the court to decide according to the facts of the case.

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[57] R.E.G.Perrins and P.R.O.Stuart, *Mercantile Law*, (London: HFL Publishers Ltd, 1975), 81
[58] The Specific Relief Act (I of 1877), *section* 12
[59] Ibid, section *19*

In a case where it is not possible for a party to perform the whole of the contract, however the part which must be left unperformed bears only small proportion to the whole in value, and it admits of compensation in money, the court has the discretion to direct the specific performance of so much of the contract that can be performed, and ask the defendant to pay the compensation in money for the deficiency.[60]

There is no hard and fast rule to determine whether the part which has to be left unperformed is essential or not. It is a question of fact depending upon the desire of the disappointed party at the date of the contract.[61] The aggrieved party has the right of asking the court for the specific performance of the contract, even though a sum is named in it as the amount to be paid in the breach of the contract, and the party in default is willing to pay the same.[62] It means that the liquidation of the damages is not a bar to the right of asking for the specific performance of the contract.

Thus, the parties to the FCs have been granted with the remedy of specific performance of the contract in the above-mentioned cases, in order to avoid any kind of loss.

4.2.1.5 Injunction

As defined earlier injunction is the court's order compelling someone to stop doing something or not to do something.[63] Injunction has the same meaning in positive law as it has in Islamic

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[60] Ibid, section 14
[61] Raja Said Akbar Khan, *The Specific Relief Act*, (Lahore: PLD Publishers Lahore),30
[62] *The Specific Relief Act (I of 1877)*, section *20*
[63] P. H. Collins, *Dictionary of Law*, (England: Peter Collin Publishing Ltd., 1993), 2nd edition,122

law. The injunction is ordered by the court to "restrain the undue exercise of rights, to prevent threatened wrongs, to restore violated possessions and to secure the permanent enjoyment of the rights of the property."[64]

It is a discretionary relief and it can not be granted where question of public health demands otherwise.[65] This kind of specific relief is called preventive relief as it is a remedial order in a preventive rather than curing capacity. Injunctions are of different types and they have the same meaning as injunctions according to Islamic law. Some types are mentioned below:

a) Temporary or Interlocutory: This is the injunction that is to continue "until a specified time, or until the further order of the court".[66] It continues until a specified time pending litigation.

b) Perpetual injunction: "It is granted by way of final relief".[67] Such a relief may be granted to prevent the breach of an obligation that exists in favor of the applicant.[68] Where the plaintiff's right of enjoyment of the property is invaded or threatened to be invaded by the defendant, the court may order the perpetual injunction.[69] The defendant is thus perpetually enjoined from the assertion of a right, or from the commission of an act, which would be contrary to the rights of the plaintiff.[70]

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[64] Raja Said Akbar Khan, *Commentary on The Specific Relief Act*, (Lahore: PLD Publishers, Lahore),102
[65] Ibid
[66] Ibid, section 53
[67] Dr. Liaqat Ali Khan Niazi, *Islamic Law of Contract*, (Lahore: Research Cell, Dyal Sing Trust Library,1991),312
[68] *The Specific Relief Act*, (I of 1877) ,section 54
[69] Ibid
[70] Ibid, section 53

c) Mandatory injunction: This type of injunction is ordered by the court where it is necessary to compel the performance of certain acts which the court is capable of enforcing, in order to prevent the breach of an obligation.[71] Thus, breach complained is prevented and performance of the requisite acts is compelled by the court by granting the mandatory injunction.

Injunction, being the discretionary right of the court, can not be granted in certain cases which are discussed in section 56 of The SRA. One of the cases where injunction can not be granted is to prevent the breach of a contract the performance of which would not be specifically enforced.[72] In case of an obligation arising out of a contract, rules relating to specific performance regulate the granting of injunction in such cases.[73]

Whenever the court grants an injunction restraining the breach of the terms of the contract, it in fact specifically enforces the performance of the contract.[74] Whereas in a case where a contract comprises two separate agreements i.e. an affirmative agreement to do a certain act; and a negative express or implied agreement not to do a certain act, "the inability of the court to compel the specific performance can not preclude it from granting an injunction to perform the negative agreement; provided that the plaintiff has not failed to perform the contract so far as it is binding on him".[75]

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[71] Ibid, section 55
[72] Ibid, section 56 (f)
[73] Raja Said Akbar Khan, *The Specific Relief Act*, (Lahore: PLD Publishers, Lahore),118
[74] Ibid, 108
[75] *The Specific Relief Act*, (I of 1877) ,section 57

4.2.2 Remedies under the Financial Institutions (Recovery of Finance) Ordinance 2001

The Financial Institutions (Recovery of Finance) Ordinance 2001 hereinafter referred to as FIRFO, also provides certain remedies for the breach of FCs where one of the parties is Bank or a Financial Institution (FI). It delegates power to the Banking Courts established by the Federal Government,[76] to decide cases in which the claim does not exceed fifty million rupees while in respect of any other case, the High Court will have the jurisdiction to decide the case.[77]

If a customer or an FI commits default in the fulfillment of obligation with regard to any finance, the aggrieved party has the right to institute a suit in the Banking Court which shall decide the case according to the procedure prescribed by the FIRFO.[78] The remedies provided for the breach of financial obligations in the said Ordinance are as under:

4.2.2.1 Enforcement of a pledge or mortgage

'Mortgage' has been defined in the FIRFO as "the transfer of an interest in specific immovable property for the purpose of securing the payment of the mortgage money or the performance of the obligation which may give rise to a pecuniary liability."[79] If a suit is filed by some FI before the Banking Court for the enforcement of a mortgage of immovable property in case

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[76] *The Financial Institutions (Recovery of Finance) Ordinance 2001,* Section 5

[77] Ibid, Section 2(b) i, ii

[78] Farani, M. *Manual of Banking Laws.*(Lahore: Nadeem Law Book House, 2010), 81

[79] *The Financial Institutions (Recovery of Finance) Ordinance 2001,* Section 15

where the institution has the right to sell that property, the Court shall directly pass an interim or final decree for foreclosure or sale. [80]

The FIs are granted the power under the rules laid down by FIRFO for selling the mortgaged property without intervention of the court in case of default in the payment by the customer.[81] But in such a case, a certain procedure has to be adopted by the FI which is discussed as under:

i) In case of default in payment by a customer, the Institution is required to send a notice on the mortgagor, demanding that mortgage money be paid within 14 days from the service of notice.[82]

ii) If the mortgagor fails to pay within the specified time, a second notice will be sent to demand the payment of money within 14 days from the service of the notice.[83]

iii) In case the mortgagor defaults in the payment and does not respond after the second notice, a final notice shall be served by the institution demanding to make the payment within 30 days from the service of the final notice.[84]

iv) When the 30 days have elapsed, the FI has the right to sell the mortgaged property or any part thereof by public auction without the intervention of the Court.[85]

v) Before exercising the afore-mentioned right, the Institution shall arrange to publish a notice in reputable English and Urdu newspapers with wide circulation in the

[80] Ibid, section 14
[81] Ibid, section 15
[82] Ibid, section 15 (2)
[83] Ibid
[84] Ibid
[85] Ibid,15(4)

province where mortgaged property is situated, specifying all the particulars of the property and indicating the intention of selling the property.[86]

vi) If the mortgagor or any person does not voluntarily gives possession of the property to the Institution, the Banking Court shall cause to put the Institution or the purchaser in possession of the property.[87]

vii) For the execution and the registration of the sale-deed, the Institution shall be deemed to be duly authorized attorney of the mortgagor.[88]

viii) Upon execution and registration of the sale-deed, the purchaser shall have all the rights in the property free from all encumbrances.[89]

ix) The net sale proceeds of the property shall be distributed among all the mortgagees in accordance with their rights and priorities, after deducting all the expenses of the sale. In case any surplus is left, it shall be paid to the mortgagor.[90]

Thus, the law provides the aggrieved Banks or FIs, the right to get back the amount from the defaulting customer by sale of the mortgaged property. It does not only secure the fulfillment of the FCs but also makes it safe for the aggrieved parties to have the remedy for the breach of any contract.

All the banks have the right to use the collaterals in order to compensate them from defaults. The Industrial Development Bank of Pakistan Ordinance 1961 (IDBPO) provides that in case an industrial concern commits default in payment or fails to comply with the terms of

[86] Ibid
[87] Ibid, 15(6)
[88] Ibid, (7)
[89] Ibid, (8)
[90] Ibid, (9)

the agreement with the Bank, the said bank has the right to sell or realize any property that was pledged, mortgaged, hypothecated or assigned by the concern to the Bank in order to secure its liability of performing the contract.[91] Thus, the collaterals are to be used in case of default by any bank and it is entitled to the sale proceeds according to the extent of the loss suffered.

4.2.2.2 Punishments for certain offences against Banks or FIs

The Banking law provides for certain kinds of penalties for certain offences.[92] Breach of an obligation made to the FI on the basis of which finance has been granted is considered as an offence.[93] And the Banking Court trying the offence will order to deliver up or refund to the FI, the property or the value of the property or security.[94] Same punishment prescribed for the afore mentioned offence is for a person who dishonestly alienates or parts with possession of the property that was mortgaged in favor of the FI, without the written permission of that institution.

In order to avoid fraud from the part of the customer, the FIRFO prescribes punishment for an applicant who obtains a finance by making a false statement, or applies the amount of the finance towards a purpose other than that for which the finance was obtained by him or

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[91] *The Industrial Development Bank of Pakistan Ordinance 1961*, section 40

[92] *The Financial Institutions (Recovery of Finance) Ordinance 2001*, Section 20

[93] Ibid, Section 20 specifies the punishment for such an offence which is imprisonment of either description for a term which may extend to three years and fine which may extend to the value of the property or security as decreed by the court; or the market value whichever is higher.

[94] Ibid

falsely denies his signatures on any banking document before the Banking Court, shall be guilty of an offence which is punishable by law.[95]

The Ordinance further gives right to the Banks and FIs to enjoy the free execution of the decrees made by Courts against the customers by prescribing punishment for those judgment-debtors who resist or obstruct, through the use of force, the execution of decree.[96] Any person who dishonestly issues a cheque towards repayment of finance or fulfillment of an obligation which is dishonored on presentation is punishable according to the FIRFO.[97]

The IDBPO also provides for the punishments in case of offences. According to it, if any person willfully makes false statement in any document given to the bank by way of security through which financial aid is sought, shall be punishable with imprisonment for a term of two years; or with fine of two thousand rupees; or both.[98]

Thus, hereby the Ordinances secure the fulfillment of obligations by the customers and clients in order to avoid breach of FCs. The punishment prescribed for the offences relating to Banks and FIs can ensure the rights of Banks and FIs to start proceedings against any person in violation of their rights.

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[95] *The Financial Institutions (Recovery of Finance) Ordinance 2001,* Section 20(2), the punishment prescribed for such an offence is imprisonment of either description for a term which may extend to three years, or with fine, or with both.

[96] Ibid, section 20(3) which prescribes the punishment which is imprisonment which may extend to one year, or with fine, or both.

[97] Ibid, section 20 (4), Such an offence is punishable with "imprisonment which may extend to one year, or with fine, or with both, unless he can establish, for which the burden of proof shall rest on him, that he made arrangements with his bank to ensure that the cheque would be honored and that the bank was at fault in not honoring the cheque."

[98] *The Industrial Development Bank of Pakistan Ordinance 1961*, section 43

4.2.3 Remedies under Sale of Goods Act 1930

The law provides remedy for breach of any kind of contract. The Banks and FIs, whether they are conventional or Islamic, enter into contracts with their customers and clients and in case of breach, there is a remedy. In the case of a contract of sale, both the seller and the buyer are duty bound to fulfill their part of promises i.e. the seller must deliver the goods and the buyer must accept the delivery and pay for them according to the terms of the contract.[99]

Chapter VI of the Sale of Goods Act 1930 (SGA), describes the remedies provided by law for the breach of the contracts of sale. Under the law, these are the remedies:

i) Suit for price.

ii) Suit for damages by the seller against the buyer for non-acceptance of the goods.

iii) Suit for damages by the buyer against the seller for non-delivery of goods according to the terms of the contract.

iv) Suit for specific performance.

v) Suit by the buyer for breach of warranty

4.2.3.1 Suit for price

A seller is entitled to bring a suit for price in two cases:[100]

i) When the property in the goods has passed to the buyer:

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[99] *Sale of Goods Act, 1930*, sections 31 and 32

[100] Dinshah Fardunji Mulla, *Commentary on the Sale of Goods Act (III of 1930)*, (Lahore: Mansoor Book House,2008), 103

If the goods have come into the actual possession of the buyer, the seller has the remedy to bring a suit for the price against the buyer.[101] However, if the property in the goods has passed to the buyer, but the goods have not yet come into the actual possession of him, the seller has the right of lien and stoppage in transit.[102]

ii) When the property in the goods has not passed to the buyer:

In such a case, the remedy to the seller is usually to institute a suit for damages for non-acceptance and non-payment of the goods[103] but section 55 entitles the seller to bring a suit for price against the buyer. It is a case in which the price is payable on a specific day irrespective of the delivery. In this case, when the fixed day expires, the seller has the right to file a suit for price even though the goods have not been delivered to the buyer yet.

4.2.3.2 Damages for non-acceptance and for non-delivery

The seller and the buyer both have been granted the right of claiming damages from the other party in certain cases. The seller has the right of filing a suit for damages in the case of failure of buyer to accept goods. When the seller is ready and willing to deliver the goods, but the buyer does not take the delivery of the goods even after the request being made to him by the

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[101] *Sale of Goods Act, 1930*, section 55

[102] Ibid, sections 46, 47 and 50 which specify that "unpaid seller of goods has, in addition to other remedies, a right of withholding delivery similar to and co-extensive with his rights of lien and stoppage in transit where the property has passed to the buyer." The seller's lien is his right to retain possession of the goods until payment or tender of the price. It depends on actual possession and not on title. While in case of insolvency of the buyer, "the unpaid seller has the right of stopping the goods in transit, i.e. he may resume possession of the goods as long as they are in the course of transit, and he may retain them until payment or tender of the price."

[103] Ibid section 56

seller, he is liable to the seller for any loss occasioned by his neglect, or his refusal to take delivery.[104]

The buyer has the right of claiming damages where the seller wrongfully neglects or refuses to deliver the goods to him.[105] The parties to the contract have the right to sue for damages for the breach of the contract where any one of them repudiates the contract of sale before the date of delivery. In case of repudiation by anticipatory refusal to perform the contract, the aggrieved party may either treat the contract as subsisting, and wait till the date of delivery; or elect to treat the contract as rescinded. In such a case he has the right to sue for damages. [106]

4.2.3.3. Specific performance

The SGA provides the purchaser the right to sue the seller and ask for the decree of specific performance in case the contract to deliver specific or ascertained goods is breached.[107] The remedy is provided to the buyer only and not to the seller. However, the court has the discretion to direct for the contract to be specifically performed if it decides it according to the facts of the case. In normal circumstances, the statutory presumption is that the breach of a contract to transfer movable property can be adequately relieved by pecuniary compensation.[108]

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[104] Inns of court school of Law, *Sale of Goods and Consumer Credit in Practice*, 9 London: Blackstone Press Limited, 1997),63 , see also section 56 of the Sale of Goods Act, 1930

[105] Section 56 of the Sale of Goods Act, 1930

[106] *Sale of Goods Act, 1930*, section 60

[107] Ibid, section 58.

[108] Dinshah Fardunji Mulla, *Commentary on the Sale of Goods Act (III of 1930)*, (Lahore: Mansoor Book House,2008), 106

Thus, the remedy of specific relief is awarded only when the compensation in money would not afford the adequate relief for the loss of the goods or when the actual damage caused by their loss is extremely difficult to be ascertained.[109] In commercial transactions, it is difficult to draw a dividing line between the terms 'difficulty' and 'impossibility'.[110] However, in cases where the specific goods sold are unique or particularly unusual; it would be easier for the Courts to decide whether the decree for the specific performance of the contract is to be awarded or not.[111] In case it is awarded, the failure to obey the order would amount to the contempt of the Court.[112]

4.2.3.4. Remedy for breach of warranty

Warranty is defined as a 'guarantee'[113]; it is the 'contractual term which is made secondary to the main purpose of the contract'. Thus breach of warranty is 'failing to do something which is the part of the contract.'[114] A breach of warranty by the seller does not entitle the buyer to reject the goods.[115] In such a case he may have any one of the following remedies according to the facts of his case:

i) If the loss occasioned by the breach of warranty is less than the price, he may claim a deduction from the price.

ii) If the loss equals the price, he may refuse to pay the price altogether.

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[109] Ibid

[110] Inns of court school of Law, *Sale of Goods and Consumer Credit in Practice*, 9 London: Blackstone Press Limited, 1997),79

[111] Ibid

[112] Ewan Macintyre, *Learning Texts: Commercial Law* (London: Blackstone Press Limited, 1998) 152

[113] P. H. Collins, *Dictionary of Law*, (England: Peter Collin Publishing Ltd., 1993),254

[114] Ibid

[115] *Sale of Goods Act, 1930*, section 12 which states that "a warranty is a stipulation collateral to the main purpose of the contract, the breach of which gives rise to a claim of damages but not to a right to reject the goods and treat the contract as repudiated."

iii) If the loss exceeds the price, he has the right of claiming the excess while refusing to pay the price.

iv) In all the above-mentioned cases, he has the option of paying the price and suing the seller for damages for the breach of warranty.[116]

4.2.3.5. Interest by way of Damages and Special Damages

The seller and the buyer have the right of claiming for interest or special damages in any case where interest or damages are recoverable by law.[117] The paid money can also be recovered where the consideration for the payment of it has failed.[118] Thus, the buyer will be able to recover any money that he had paid to the seller, upon a total failure of consideration if there has been a lawful rejection.[119] Damages can be either 'General' or "Special'. In *Iqbal Hasan Burney v. Ameen Tareen,*[120] the Court made the distinction between the two types by holding that:

> General damages with reference to proof "are such as the jury may give when the judge can not point out any measure by which they are to be assessed, except the opinion and judgment of a reasonable man...Special damages are given in respect of any "consequences reasonably and probably arising from the breach complained of. The type of general damage is usually concerned with non-pecuniary losses, which are difficult to estimate, the principle examples being the injury to reputation in defamation...."[121]

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[116] Dinshah Fardunji Mulla, *Commentary on the Sale of Goods Act (III of 1930),* (Lahore: Mansoor Book House,2008), 106
[117] *Sale of Goods Act, 1930,* section 61
[118] Ibid
[119] Inns of court school of Law, *Sale of Goods and Consumer Credit in Practice,* 9 London: Blackstone Press Limited, 1997),78
[120] PLD 1967 Karachi 840
[121] Ibid

Though interest is against the injunctions of Islam, and all the provisions in Pakistani legislation allowing interest are repealed by the Shariat Appellate Bench of the Supreme Court (SCSAB), still we find the provision of interest contained in the SGA, and not clearly repealed or modified by SC judgment. However, it will be discussed later in detail.

4.2.4. Remedies under Contract Act (IX of 1872)

The Contract Act (IX of 1872), (Hereinafter referred to as CA) chapter VI deals with the remedies for the breach of contracts. These remedies can not be asked in the cases where there is no breach or in cases where the contract is void.[122] Thus, the plaintiff asking for remedy must prove that there was a valid agreement between the parties and that there was breach of the contract by the defendant.

The following remedies are discussed under the CA:

i) Enforcement of Pledge

ii) Guarantor or surety's liability

iii) Compensation for loss or damage

iv) Compensation where penalty stipulated for

v) Compensation in case of rightful rescission

[122] Section 30-B of the Contract Act, 1872 states that no suit or proceeding shall lie for the recovery of any sum of money paid or payable in respect of any void agreement.

4.2.4.1 Enforcement of Pledge

The bailee under a contract of pledge is said to have special property as he is not the owner of the pledged asset but only has possession and right to possess that property.[123]The condition of completing a pledge contract is the delivery of the pledged asset which can be any kind of goods, documents or valuable things.[124] The contract is to secure not only the payment of the debt but also the performance of the promise and the pawnee (pledgee) has the right to retain the goods to get the payment of the interest of the debts also.[125] However, the pawnee is restrained by law from retaining the goods for debt or promise other than that for which the goods were pledged.[126]

In case of default in the payment of the debt or the performance of a promise, the pawnee has three rights: to bring a suit against the pawnor; to retain the goods as a collateral security till realization of debt; or he has the option of selling the pledged goods after giving the pawnor a reasonable notice of sale.[127] All these rights are not alternative remedies but are concurrent.[128] After the sale of the goods, the pawnee is bound to pay back the surplus of the proceeds of sale to the pawnor if the amount of the proceeds is greater than the amount so due. But in case, the sale proceeds are less than the amount due in respect of the debt or promise, the pawnor is still liable to pay the balance.[129]

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[123] M. Farani, *Commentary on the Contract Act IX of 1872*, (Lahore: Lahore Law Times Publications, 2005) 410
[124] Ibid
[125] *The Contract Act IX of 1872*, Section 173
[126] Ibid, section 174
[127] Ibid, section 176
[128] M. Farani, *Commentary on the Contract Act IX of 1872*, (Lahore: Lahore Law Times Publications, 2005) 414
[129] *The Contract Act IX of 1872*, Section 176

Thus a pledgee Bank or FI acquires a lien over pledged goods for the recovery of the dues against the debtor. It can sell the goods after giving the debtor a notice about the sale and thus reimburse itself by the proceeds of the sale. It was decided in *Muhammad Siddique Muhammad Umar v. The Australasia Bank Ltd* that the sale proceeds can be adjusted against the amount claimed by the Bank or financial institution.[130]

If a person pledges goods in which he does not have but a limited interest, the pledge shall be considered to be valid to the extent of that interest.[131]By the contract of pledge, though the pawnee does not become the owner of the goods but he steps in the shoes of the pawnor in having the right to use all remedies that the owner has the right, in case any third person wrongfully deprives the pawnee of the use of possession of the goods or cause them any injury.[132]

Thus, we find out that the CA provides the creditor the right to ask for pledge or mortgage of property as a security of the debt and in case of default the creditor has the right of selling the property and getting the amount due on the mortgagor or pawnor.

4.2.4.2 Guarantor or surety's liability

The contract of guarantee is a "contract to perform the promise, or discharge the liability of a third person in case of default".[133] This kind of liability is enforceable at law.[134] The liability of

[130] PLD 1966 Supreme Court 684
[131] Ibid, section 179
[132] Ibid, section 180
[133] Ibid, section 126

the surety is co-extensive with the liability of the principal debtor[135] and thus the latter is not discharged by the contract of guarantee. In case of default in the payment of debt or the performance of the promise, the creditor has the right of asking anyone of the surety or the principal debtor to fulfill their obligation. In case, he elects to ask the surety to pay the debt or perform the promise, the surety is invested with all rights which the creditor had against the principal debtor, upon the payment or the performance.[136]

4.2.4.3 Compensation for loss or damage

When a contract is breached, the aggrieved party is entitled to receive compensation for any loss or damage caused to him thereby, from the party who has caused the breach of the contract.[137] The damages are compensatory and are based on loss suffered by the plaintiff. However, such compensation is only awarded for direct loss and not for any indirect or remote loss or damage.[138] In *A.Z. Company, Karachi v. Government of Pakistan,*[139] it was held by the SC that compensation is only given for the loss that flow directly from the breach of the contract. "No compensation is to be awarded for any remote or indirect loss or damage sustained by reason of breach. Mere general assertions are not enough to establish that the loss flowed directly as a consequence of breach".[140]

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[134] M. Farani, *Commentary on the Contract Act IX of 1872*, (Lahore: Lahore Law Times Publications, 2005) 355
[135] *The Contract Act IX of 1872*, Section 128
[136] Ibid, section 140
[137] Ibid, section 73
[138] ibid
[139] PLD 1973 Supreme Court 311
[140] Ibid

In case of anticipatory repudiation, the communication of the intention of non-performance of the contract is regarded as the breach of the contract. In such a case, it was held in *Punjab Vegetable and General Mills Ltd v. Hussain Brothers* that the measure of damages is the difference between the contract price and the market price prevailing on the date on which the contract was to be performed. Since, the breach actually takes place on that day, the measure of damage is to be calculated according to that date no matter the intention was communicated earlier.[141]

The Court held in *Sadruddin v. Mitchell's Fruit Farms Ltd. Karachi* which is also provided in the Section 73 of the CA that the compensation is awarded only for any loss which 'naturally arose in the usual course of things from such breach, or which the parties knew, when they made the contract, to be likely to result from the breach of it'.[142] Same decision was taken by the court in *Aslam Saeed & Co. v. Trading corporation of Pakistan* and the Court further held that where no amount was stipulated as damages for breach of the contract, the compensation would be determined according to the facts of the case and damages have to be assessed strictly according to the loss accrued to either party.[143] Even to claim interest as damages, the plaintiff has to show on evidence that he is entitles to such compensation foe loss or damages caused to him in the natural course of things from breach of contract on

[141] PLD 1967 Karachi 83
[142] PLD 1979 Karachi 694
[143] PLD 1985 SC 69

defendant's part.[144] The Court held in *Kassamali v. Shakra Begum* that the interest is not to be granted for no such evidence on the point.[145]

If in a case of the breach of contract, the plaintiff is unable to give sufficient evidence to show certain details of damages it was held in *Pakistan Industrial Development Corporation v. Aziz Qureshi* that the Court will not only grant nominal damages, but it may ascertain the actual damages and decree in favor of the plaintiff after being satisfied that there was a breach.[146] Whereas, the claim for damages is not sustained where the party complaining can not adduce evidence showing loss or inconvenience due to the breach of the contract. The Court held in *Shaukat Ali v. The Trustees of the Port of Karachi* that "the damages are awarded only for some loss or detriment to the party prejudiced by the breach of the contract".[147]

The law aims at remedying the actual loss by any party and it does not entitle any party to ask for an amount greater than the loss caused to him by the breach. Thus a party can not be awarded compensation which is exceeding the amount of damage. It was held in *Tanzeem Overseas v. Zainab Bai* that In case of illegal rescission by the vendee, the vendor was entitled to forfeit the earnest money paid to her but only as much of it which should make up the loss suffered by her on account of the breach of the contract.[148] Therefore, if a land is sold to another party at a lesser price, only that amount is to be forfeited from the earnest money which makes up the loss and the balance is to be refunded to the vendee.[149]

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[144] M. Farani, *Commentary on the Contract Act IX of 1872*, (Lahore: Lahore Law Times Publications, 2005) 318
[145] PLD 1968 Karachi 307
[146] PLD 1965(W.P) Karachi 202
[147] PLD 1975 Karachi 1096
[148] PLD 1965 Karachi 274
[149] Ibid

In case of the deposit of earnest money, there is no need for a specific clause of forfeiture in case of breach. It was held in *Ahmad v. Abdul Habib Haji Muhammad Co.* that "the primary object of the term 'deposit money' and the 'earnest money' is to serve as security for the performance of the contract."[150] Thus in case of breach, the depositee is entitled to retain the amount to make up for his loss; even if there was no such clause in the contract. In case where the seller failed to adduce any damages suffered by him, it was held in *Muhammad Amin Muhammad Bashir Ltd v. Muhammad Amin Bros. Ltd* that there is no material on the record to enable the Court to make any assessment of damages, the Court can award to the plaintiff only interest on earnest money from the date of the agreement.[151]

The remedy of compensation or damages is not the only remedy for the breach of the contract. The aggrieved party may ask the Court to award the decree of specific performance and compensation for the breach of contract at the same time.

4.2.4.4 Compensation where penalty stipulated for

The contract, being the law of the parties,[152]entitles the party claiming the breach to receive from the party who has broken the contract reasonable compensation, if a sum was named in the contract as the amount to be paid in case of such breach.[153] The party complaining the breach "has to be compensated regardless of proof of actual damage or loss, and is entitled to

[150] PLD 1957 (W.P) Karachi 819
[151] PLD 1969 Karachi 233
[152] Article 147(i) of the Egyptian Civil Code
[153] *The Contract Act IX of 1872*, Section 74

receive from party breaking contract reasonable compensation not exceeding amount so named, or penalty so stipulated".[154]

Where default clause in agreement did not mention anything about damages, it was held in *Aslam Saeed and Co. v. Trading Corporation of Pakistan Ltd* that the complaining party is not entitled to receive any amount exceeding amount as provided in contract itself in circumstances.[155] In the *Province of West Pakistan v. Mistri Patel,* the SC held that "in case of penalty, the Court refuses to enforce it and awards the aggrieved party reasonable compensation." It further held that the " award of compensation by the Court under section 74 of the Contract Act will depend upon its findings as to what is the facts and circumstances of the case is reasonable compensation subject to the limit of the amount mentioned in the contract."[156]

A party can stipulate in the contract an increased interest from the date of default which will entitle him to that increased rate if the other party commits the breach of the contract.[157] But in order to claim the penal interest, there has to be an express agreement by the party. It was held in *National Bank of Pakistan v. Chaudhry Ilam Din* that "mere practice of plaintiff Bank to charge penal interest in cases of default in liquidation of loan within a particular period would not afford a lawful basis for allowing same------ such interest could only be claimed if it was agreed between parties through an express contract."[158]

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[154] M. Farani, *Commentary on the Contract Act IX of 1872,* (Lahore: Lahore Law Times Publications, 2005), 348
[155] PLD 1985 Supreme Court 69
[156] PLD 1969 SC 80
[157] Ibid, Explanation to section 74
[158] PLD 1985 Lahore 117

4.2.4.4.1 Penalties and Liquidated Damages

The Common Law allows the parties to name a penal sum as due and payable in case of the breach of the contract. In such a case, only the real damages are recoverable.[159] On the other hand, if a fixed measure of damages is to be assessed in case of breach, it would not be a penalty but 'Liquidated Damages'.[160] Liquidated means "determined, settled or fix".[161] In simple words, liquidated damages are 'the specific amount which has been calculated as the loss suffered'[162] or they are 'the sum (fixed by the parties) that represents a genuine pre-estimate of the probable damage that is likely to result from the breach of the contract.' [163] Liquidated damages are defined as the amount of the damages which has been ascertained by the judgment in the action, or "when a specific sum of money has been expressly stipulated by the parties to a bond or other contract as the amount of damages to be recovered by either party for a breach of the agreement by the other".[164]

Unlike liquidated damages, penalty is a sum which is named in order to secure the performance of the contract and the whole amount mentioned is not always recoverable; whereas the liquidated damages consists of a sum 'named to be paid as damages for the breach of the contract'.[165] The question whether a sum stipulated is a penalty or liquidated

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[159] M. Farani, *Commentary on the Contract Act IX of 1872*, (Lahore: Lahore Law Times Publications, 2005) 335

[160] Ibid

[161] Roger LeRoy Miller, Gaylord A. Jentz, *Fundamentals of Business Law*,(Texas: Thomson South-western west publishers, 2005) 232

[162] P. H. Collins, *Dictionary of Law*, (England: Peter Collin Publishing Ltd., 1993),142

[163] Avtar Singh, *Law of Contract*, (India: Mansoor Book House Publishers, 1993), 387

[164] "What is liquidated damages" taken from http://thelawdictionary.org/liquidated-and-unliquidated-damages/ accessed on 6th April 2014 at 4.40 p.m. PST

[165] Raja Said Akbar Khan, *Commentary on The Specific Relief Act*, (Lahore: PLD Publishers, Lahore),39

damages is to be decided according to the terms of each particular case.[166] To decide whether a sum is penalty or liquidated damages, various tests have been suggested:

> a) It will be held to be penalty if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach.
> b) It would be a penalty if the breach consists only in not paying a sum of money and a sum stipulated is a sum greater than the sum which ought to have been paid.
> c) There is a presumption (but no more) that it is penalty, when 'a single lump some is made payable by way of compensation, on the occurrence of one or more or all of several events, some of which may occasion a serious and others but trifling damage.[167]

Thus, if the sum fixed by the parties is proved to be liquidated damages, then the entire amount of it is recoverable whereas it is not the case with penalty stipulated in the contract.[168] For awarding of liquidated damages, the quantum of actual loss and evidences are required.[169] In the case *Hitech Metal Plast (Pvt.) Ltd. v. Habib Bank Limited*,[170] there was a suit for recovery of bank loan plus specified liquidated damages were also demanded. But the Bank failed to provide evidences suggesting the quantum of the actual loss that was claimed to be suffered by the Bank because of the default on the part of the defendant. The Court held that "without proving actual loss, even fixed amount stipulated for liquidated damages would not become

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[166] Avtar Singh, *Law of Contract*, (India: Mansoor Book House Publishers, 1993), 387
[167] Ibid, 388
[168] ibid
[169] Saali8m Salam Ansari, *Manual of Banking with Leading* Cases (Karachi: Asia Law House, 1998) 280
[170] PLD 1997 Quetta 87

automatically payable."[171] Thus the demand of specified liquidated damages by the Bank was not justified and was not decreed against the defendants.

In case the penalty clause is stipulated to cause threat or terror for the party to perform his contract, it is not enforceable. It was held in *Abdullah v. Karim Haider*:

> Penalty clause or stipulation in contract *in terrorem* ---Unenforceable----Sale of truck by *A* to *B* on condition that *B* would make payment by installments and on failure to pay installments *A* is entitled to take back the truck and forfeit all payments made to him by *B*---Forfeiture clause is in nature of penalty clause and as such un enforceable.[172]

So SC does not allow the entire amount of the deposits to be forfeited as penalty as was its decision in *Sibte Raza v. Habib Bank Ltd.*[173]

It is important that the use of the expressions 'penalty' or 'liquidated damages' by the parties does not conclude the matter.[174] The Court has to decide the case upon the terms and inherent circumstances of each particular contract.

4.2.4.5 Compensation in case of rightful rescission

Any person, who rightfully rescinds a contract, has the right of claiming compensation for any damage which he has sustained when the fulfillment of the contract has been refused or prevented by the other party.[175] When the contract is rescinded, the parties have to make

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[171] Ibid
[172] PLD 1975 Karachi 385
[173] PLD 1971 SC 743
[174] M. P. Furmston, *Chesire and Fifoot's Law of Contract*, (London: Butterworths Publications, 1981)556
[175] *The Contract Act IX of 1872*, Section 75

restitution to each other which prevents the unjust enrichment of the parties.[176] Thus the goods, property or any funds are to be returned which were previously conveyed.[177]

4.2.5. THE HISTORIC JUDGMENT OF SUPREME COURT (SHARIAT APPELLANT BENCH) ON INTEREST.

Federal Shariat Court (FSC) of Pakistan had declared the laws allowing interest repugnant to Islam in 1991 as a response to the petitions filed to challenge such laws. It was stated in *Mahmood-ur-Rehman v. Secy. Ministry of Law* that "Laws relating to interest and mark-up are repugnant to injunctions of Islam and will cease to have effect as on and from 1st July 1992".[178] The Federal Government of Pakistan and certain banks and FIs filed 67 appeals against this judgment in the Shariat Appellate Bench of the Supreme Court.[179] The SCSAB started hearing these appeals in 1999. The appellants gave their arguments against the prohibition of *Riba* the summary of which is as under:

1) The verses of the holy Quran which prohibited *Riba* were revealed in the last days of the life of the Holy Prophet (PBUH).Therefore the term *Riba* was not interpreted properly and being ambiguous term, it falls under متشابہات. Thus, the prohibition should

[176] Roger LeRoy Miller, Gaylord A. Jentz, *Fundamentals of Business Law,*(Texas: Thomson South-western west publishers, 2005) 240
[177] Ibid
[178] PLD 1992 FSC 1
[179] "The text of the historic judgment on interest" taken from http://www.albalagh.net/Islamic_ecnomics/riba_judgment.Shtml.top accessed on 7th October 2012 at 09:00 p.m. PST.

be restricted to the limited transactions expressly mentioned and it can not be extended to the modern banking system.[180]

2) The word '*Riba*' refers to the usurious loans on which an excessive rate of interest is charged by the creditors which is nothing but the exploitation. Whereas the modern banking interest can not be termed as *Riba* if the rate of interest is not excessive or exploitative.[181]

3) The word '*Riba*' used in the Holy Quran is restricted to the increased amount charged on consumption loans that was used to be taken and consumed by the poor people for their needs. But so far as the modern commercial loans are concerned, the Holy Quran has not addressed them while prohibiting *Riba*. Thus, in the commercial and productive loans where debtors are not poor, an increase by their creditor does not amount to *Zulm* (injustice) which is the basic cause of the prohibition of *Riba*.[182]

4) The Quran has prohibited only the '*Riba al Jahiliyyah*' that was a particular transaction of loan where there was no stipulation in the contract for the increased amount over and above the principal debt. But in case, the debtor could not pay back the loan at the due date, the creditor would charge an additional amount for giving him rebate. Thus, if an additional amount is stipulated in the agreement, it does not constitute *Riba al-Quran*. If it falls under the *Riba al-Fadl*, which was prohibited by Sunnah, its prohibition

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[180] Muhammad Taqi Usmani, *The Historic Judgement on Interest*, (Karachi: Idaratul-Ma'arif, Karachi, 2001), 16
[181] Ibid
[182] Ibid

is of lesser degree which makes it makruh rather than haram. In case of genuine need, the prohibition has to be relaxed.[183]

5) The next argument advanced by some Appellants is that the basic cause behind the prohibition of Riba is *Zulm* (injustice).[184] And there is no Zulm at charging interest from a rich person who earns a huge profit by the borrowed money. In the commercial interest charged by the modern banks, the basic *illat of* prohibition is missing, therefore, it can not be held as prohibited.
6) The commercial interest is the back-bone of the modern economic activities throughout the world. Islam, being the practical religion recognizes the principle of necessity which should be applied to the interest based transactions.[185]

In order to resolve the issue (whether the commercial interest of modern financial system is *Riba* prohibited by Islam or not, and if it is, whether it can be allowed on the basis of necessity) a number of experts as juris-consults consisting of scholars, *ulemas*, economists, bankers accountants and representatives of modern business and trade were invited who assisted the Court in their respective areas of specialization.[186] After studying the Quranic verses dealing with *Riba* and making the historical analysis of them, the Appellate Bench gave answers to all the objections raised by the appellants which are discussed as under:

1) The first argument that the *Riba* falls under متشابهات is fallacious on the face of it. *Riba* is considered as a grave sin and crime and Almighty Allah declared war in the Holy Quran

[183] Ibid, 17
[184] Ibid, 78
[185] Ibid,18
[186] Ibid

against those who do not avoid the practice of *Riba*.[187] How can one imagine that Allah Almighty can wage war against a practice, the meaning of which is still unknown to the addresses? A practical rule of Shariah can not be termed as متشابهات.[188]

2) The argument that only exorbitant amount of *Riba* is prohibited while the modern banks and FIs only charge a nominal amount of interest, is not acceptable. Allah has ordered the believers to fear Him and give up "whatever remains of *Riba*"[189] which clearly indicate that every amount (big or small) over and above the principal debt has to be given up.[190] Allah has further made it clear that if a believer repents from the practice of *Riba,* then he is entitled to get back only the principal amount. Further, it is reported by Hazrat Ali that Holy Prophet (PBUH) has said:

'Every loan that derives a benefit (to the creditor) is *Riba*'.

Here, it is not mentioned that whether the amount is big or small. The word 'every' clarifies all the ambiguities regarding the amount of interest being charged by anyone, if it is exceeding the principal debt, it is Riba and so prohibited.

3) The third argument by the Appellants that differentiates between consumption and productive loans is not acceptable for the fact that the validity of a financial or commercial transaction does not depend on the financial position of the parties while it depends on the intrinsic nature of the transaction itself.[191] A transaction which is valid by its nature shall be considered to be valid irrespective of the fact whether the parties are poor or rich. And a prohibited transaction is invalidated because of the intrinsic

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[187] Quran, 2:279
[188] Muhammad Taqi Usmani, *The Historic Judgement on Interest*, (Karachi: Idaratul-Ma'arif, Karachi, 2001),40
[189] Quran 2:278
[190] Muhammad Taqi Usmani, *The Historic Judgement on Interest*, (Karachi: Idaratul-Ma'arif, Karachi, 2001),65
[191] Ibid, 46

nature of it and not on the basis of the financial position of the parties.[192] Moreover, the verses of the Holy Quran which prohibit *Riba* do not differentiate between consumption or commercial loans. The general term which is used in the Holy Quran include all the forms of *Riba* whether they were prevalent at the time of revelation or not.[193]

4) The argument by the Appellants that *Riba al- Jahiliyyah* was different in the sense that there was not stipulation of the increased amount in the contract. But at the due date, if the debtor failed to pay, the creditor would charge additional amount. In modern transactions, if a stipulation is made at the time of making the transaction, it would amount to *Riba al-Fadl* which is not haram but *makruh*. The answer to this point is that it is established that the lexical meaning of the term '*Riba*' is 'increase'. All the different forms of *Riba* are prohibited and there is no difference whether a stipulation is made at the time of transaction or not. However, if at the time of payment, the debtor on his own gives an additional amount to the creditor, without the demand or stipulation by the creditor, it would not be termed as *Riba*.

5) The argument is weak that the basic *illat* behind the prohibition of *Riba* is *Zulm* and this *illat* is missing in the modern banking interest where it is being charged on the borrower who has earned huge profit. The weakness of the argument is the misunderstanding of the Appellants between the *Illat* and *Hikmat*. "The *illat* is the basic feature of a transaction without which the relevant law can not be applied to it whereas the *Hikmat* is the wisdom and the philosophy taken into account by the

[192] Ibid, 47
[193] Ibid, 49

legislator while framing the law."[194] In the case of riba, the *Zulm* is mentioned as a *Hikmat* or philosophy of the prohibition. But it does not allow lifting the prohibition if the element of *Zulm* is missing. The illat on which the prohibition of *Riba* is based is the excess claimed over and above the principal in the transaction of loan. If this *illat* is available, the prohibition will follow regardless of the fact whether the *Hikmat* is visible or not.[195]

6) The Appellants tried to attract the doctrine of necessity to *Riba* by arguing that the interest-based system has become a universal necessity.[196] The implementation of the prohibition of *Riba* at the country level is called a suicidal act by some but they have not properly understood the criteria which are expounded by the Muslim jurists in the light of the Holy Quran and Sunnah.[197] The Quranic commands can be relaxed only on the basis of emergent situation where "necessity is real and not exaggerated by imaginary apprehensions and that the necessity can not be met with by any other means than committing an impermissible act."[198] In the case of interest, *Riba* can not be allowed as there is no emergent situation and there is a great deal of exaggeration in the apprehension that the economy will collapse by eliminating Riba from the country.[199]

For the detailed reasons recorded in separate judgments, it was held by the SCSAB of Pakistan that "Any amount, big or small, over the principal, in a contract of loan or debt is

[194] Ibid, 80
[195] Ibid, 82
[196] Ibid, 122
[197] ibid
[198] Ibid, 123
[199] Ibid

'*Riba*' prohibited by the Holy Quran, regardless of whether the loan is taken for the purpose of consumption or for some production activity."[200] The Court further explained in its order that so far as the prohibition of *Riba* is concerned, there is no difference between types of loan. It also does not matter whether the additional amount is big or small.[201]

Therefore, all the prevailing sources of interest in the banking transactions or private ones were held to be falling within the definition of the term *Riba.* It was held that the present financial system which is based on interest is clearly against the injunctions laid down by the Holy Quran and Sunnah.[202] Therefore, a variety of Islamic modes of financing which has been developed by Islamic scholars, economists and bankers may be served as best alternate to the present interest based banking system. About 200 IFIs are practicing these modes in different parts of the world.

The Court, held the provisions of different statutes dealing with *Riba* repugnant to the injunctions of Shariah and therefore be repealed or be substituted with Shariah compliant alternatives. As for those who claim that the elimination of *Riba* will cause the collapse of the economy, Islam has not denied the productivity of the capital and elimination of *Riba* does not mean zero-return capital.[203] Islam has forbidden the "predetermined return for a certain factor or production i.e. one party having assured return and the whole risk of entrepreneurship to be shared by others."[204] The permissible approach in Islam is the one in which the factors

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[200] Mr. Justice (R) Khalil-ur-Rehman Khan, *The Supreme Court's Judgement on Riba,* (Islamabad: Shariah Academy IIUI,2008), 357; the order of the Court can also be studied in *The Historic Judgement on Interest,* by Muhammad Taqi Usmani, 159

[201] Ibid

[202] ibid

[203] Khurshid Ahmad, *Elimination of Riba from the Economy,* (Islamabad: Institute of Policy Strudies, 1994), 6

[204] Ibid

receive the variable return based on actual performance.[205] Thus, it is clear that *Riba-free* economy can exist and flourish by acting upon the injunctions of Shari'ah.

4.3. COMPARISON AND ANALYSIS OF THE ABOVE REMEDIES IN ISLAMIC LAW AND PAKISTANI LEGISLATION

In this chapter, we discussed the remedies which are provided for the breach of FCs in Islamic law and Pakistani legislation. While discussing the remedies in Pakistani law, we focused on those which were provided in the Contract Act (CA), Sales of Goods Act (SGA), Financial Institutions (Recovery of Finance) Ordinance 2001 (FIRFO) and Specific Relief Act (SRA). The aim of discussing them was to make their comparative analysis in the light of Shari'ah which will be discussed hereunder:

We started the remedies with 'rescission' which is to bring a party to a position in which he was, before the contract. Thus, the status quo of the parties is restored and all the obligations end by it.[206] The CA entitles the party who is rightfully rescinding the contract, to compensation for any damages which has sustained because of the non-fulfillment of the contractual obligation.[207] In Islamic law, same rule is applicable that in case of any damages, compensation is to be paid following the principle of يُزال الضرر which makes it obligatory on the part of any person who causes some injury or loss to the other person, to compensate for it.

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[205] Ibid
[206] Dr. Liaqat Ali Khan Niazi, *Islamic Law of Contract*, (Lahore: Research Cell, Dyal Sing Trust Library,1991),309
[207] The Contract Act, IX of 1872, section 75

Islamic law provides for 'mandatory' or 'prohibitory' injunctions in case a person is to be compelled to perform; or if he to be restrained from an act respectively. In the early phases of Islamic law, there was no concept of delayed justice which is prevailing now-a-days. There used to be speedy trials and any aggrieved party could get the compensation quite easily by convincing the Qadi through evidences. But the situation has changed now and it takes quite a long time for the aggrieved party to get the justice. In such situations, 'Temporary" injunction is awarded in case where some person is to be prohibited from a certain act, for a specified period till the final decision of the court.[208] Thus, the meaning of the injunction and its *illat* remains same in both the Islamic law and Pakistani legislation.

As for the 'damages' in Islamic law, they are to be paid by the person who has failed to discharge his contractual obligation.[209] Islamic law only speaks of damages in case of loss to a party for non-performance of the contract by the other party. The damages should not be exorbitant and should not exceed the exact amount of loss. Interest (*riba*) in any of its form is not acceptable. But in the Pakistani law, we find some provisions of interest in different statutes. Though we noticed that the SCSAB had ordered to repeal those laws which allowed interest, but we also noticed from our research that the interest in the section 61[210] of SGA

[208] The Specific Relief Act (I of 1877), section 53

[209] Article no.215 of the Egyptian Civil Code discussed in Jamal Addin Muhammad Mahmoud's, Article " *Compensation for Damages and it's elements in the Islamic Shariah in Contractual Liability*" taken from Arab *Comparative & Commercial Law* by Graham & Trotman Publishers, 51

[210] Section 61 of the Sale of Goods Act: "Nothing in this Act shall affect the right of the seller or buyer to recover interest or special damages in any case where by law interest or special damages may be recoverable, or to recover the money paid where the consideration for the payment of it has failed.

and illustration (n)[211] of section 73 of the CA were not repealed or modified in the historic judgment.[212]

According to the CA, in case a penalty is stipulated in the contract for the breach of a contract, the party complaining for the breach is entitled to receive compensation which should not exceed the amount so named.[213] The law also provides that the aggrieved party is entitled to such compensation even if no actual loss or damage is proved to have caused thereby.[214] Thus, it is clear that the stipulated amount is not compensation for the loss, but for the breach of the contract. It is further explained in the section 74 of CA that "a stipulation for increased interest rate from the date of default may be a stipulation by way of penalty". Thus, it is permissible according to the law of contract, to stipulate any amount, or increased interest rate as a penalty for the breach of contract.

But Islamic law does not entitle any person for damages if he has sustained no loss from the breach of the contract. The stipulation of penalty is permissible only in the contract of Istisna'a and not in any loan or debt transaction. Islamic law provides for penalty in a debt transaction only where the default is without a valid reason and it has resulted as some loss to the other party. Besides, this amount as a way of penalty is not spent by the banks or IFIs, but it is spent in the charitable purposes. The compensation which is to be awarded is always for

[211] The illustration is about default in payment of money which states "A contracts to pay a sum of money to *B* on a day specified. *A* does not pay the money on that day; *B*, in consequence of not receiving the money on that day, is unable to pay his debts, and is totally ruined. *A* is not liable to make good to *B* anything except the principal sum he contracted to pay, together with interest up to the day of payment."
[212] SC Judgment on riba, 1992
[213] Section 74 of the Contract Act (IX of 1872)
[214] Ibid

direct loss and not for any indirect loss according to Islamic law and also the section 73 of the CA.

In some cases, the court awards for the specific performance of the contract and this remedy is provided in Islamic law and the Pakistani laws. All the laws are unanimous in prescribing the conditions to award this remedy. According to the Islamic law it is to be awarded where damages are inadequate remedy[215] and the same condition is there in the section 12 of the SRA and also in the rules under SG.

According to the Pakistani law, the mortgaged property can remain in the possession of the mortgagor. There are three forms of *Rehn* (الرهن) in Pakistani law.

i) Mortgage: The property documents of the mortgaged assets are handed over to the mortgagee while the property remains in the possession of the mortgagor.[216]

ii) Pledge: Mostly, in the case of movable assets, the pledged asset is handed over to the pledgee and the pledgor takes back the possession after paying his debt.[217]

iii) Hypothecation: It is collateralizing arrangement in which neither the possession nor the title but only the right to sell an asset or property passes on to the creditor or lendor.[218]

Whereas in Islamic law, according to some jurists, the true form of *Rehn* is only the one in which the property is handed over to the creditor. All other forms are just considered

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[215] Dr. Liaqat Ali Khan Niazi, *Islamic Law of Contract*, (Lahore: Research Cell, Dyal Sing Trust Library,1991),312
[216] Sayyad Sabir Hussain, *Sarmaya Kari kay Sharii Ahkaam* (Karachi: Al-Muneeb Shari'ah Academy, 2010), 196
[217] Ibid
[218] 'Definition of hypothecation' taken from <www.business dictionary.com/definition/hypothecation.html> accessed on 24th November 2012 at 8:00 p.m. PST

as securities and not *Rehn*. As discussed in chapter 3 in detail, we find that some jurists have the view that possession is the main condition for completion of the contract and without possession in the hands of the creditor; the contract of *Rehn* remains incomplete.[219] The debtor, according to this view shall be forced to hand over the pledged asset to the creditor because of Allah's saying in this regard :(فَرِهَانٌ مَّقْبُوضَةٌ) Allah has made the 'possession' (of the asset to be given as a security as *Rehn* in the hands of the pledge) a quality of *Rehn* contract, which cannot be achieved if the asset remains in the hands of the debtor.[220]

Taking the earnest money as security deposit in financial transaction is permissible both in Islamic law and Pakistani legislation. In case of earnest money, it will be forfeited in case of depositor's failure to perform, even if there was no specific forfeiture clause in the contract. The Court held in *Ahmad v. Abdul Habib Haji Muhsmmad Co.* that "if the contract goes forward the deposit is treated as part of the purchase price; if it falls through in consequence of the depositor's failure to perform, the deposit would stand forfeited to the seller, although there is no specific forfeiture clause in the contract." [221] Thus, the general rule for such deposit is that in case of breach of contract, the amount is deducted according to the loss and the remaining amount is returned to the one who has submitted it as security. But in case of *Arboun* we see that it is allowed to forfeit the whole of the amount even if it exceeds the

[219] Saad Sulaiman al-Haamidi, *At-Tauseeq wa Ahkaamuhu fil Fiqh al-Islami* , (Egypt:Daarus-Salaam littabaa`h wa al-Nashr wa at-Tauzee`, 2010) 1st edition,,219
[220] Ibid
[221] PLD 1957 (W.P) Karachi, 819

amount of loss.[222] But that is not the case with *Hamish Jiddiyah* in banking *Murabaha* which is to be deducted according to the loss.

CONCLUSION

After making the analysis of the remedies in Islamic law and Pakistani legislation, we come to conclude that any provision that is allowing interest in any of its forms e.g. the provisions mentioned in SGA and CA, are against the injunctions of Islam. The stipulation of penalty for late payment in a debt transaction is not allowed in Islam but it is provided in the CA which is against the Islamic injunctions. The other remedies are somehow or the other, similar in both the Islamic and Pakistani laws. For example even if the possession of the mortgaged or pledged property remains with the pledgor or mortgagor, still it is a valid security, though some jurists don't name it a real pledge or mortgage. In the coming chapter, we shall discuss the remedies which are availed by the modern Islamic banks for the breach of contracts, and finally we will make an analysis of them in the light of the above-mentioned remedies in Islamic law and Pakistani legislation.

[222] AAOIFI, standard no. 8, Appendix C

Chapter Five

REMEDIES FOR BREACH OF CONTRACTS IN MODERN ISLAMIC BANKS AND ISLAMIC FINANCIAL INSTITUTIONS

The remedies for the breach of FCs which are available in the Islamic law and Pakistani legislation have been discussed in detail in the previous chapter. In this chapter, First, the general remedies shall be discussed which are sought by the IBs and IFIs in case of breach of FCs. Then, the remedies shall be discussed specifically in different modern Islamic banking transactions in case of breach of financial obligations by other parties. At the end, an analysis of these remedies shall be made in the light of those which are available in Islamic law and Pakistani legislation to reach a conclusion whether they are Shariah compliant or not.

5.1 GENERAL REMEDIES FOR BREACH OF FINANCIAL CONTRACTS IN ISLAMIC BANKS AND ISLAMIC FINANCIAL INSTITUTIONS

In case of breach of FCs, generally, the modern IBs seek for the following remedies:[1]

1) Enforcement and redemption of the Pledge
2) Personal guarantor's liabilities
3) Penalty Clause (Al Shart al-Jazai)
    i) Increase in payment of debt in case of default
    ii) Bringing forward future installments in case of default
    iii) Compulsory Charity

[1] AAOIFI standard no. 5

4) Termination of sale on deferred payment in case of default

5) Freezing cash deposits

6) Earnest money, Arbun and Hamish Jiddiyah

7) Use of promissory notes and cheques

8) Non-material punishments for default in payment[2]

5.1.1 Enforcement and redemption of the Pledge

The IBs and IFIs (herein after referred to as Islamic Banking Institutions 'IBIs') have the right to stipulate in the contract of loan in which the security given by the debtor is a pledge, that they are entitled to sell the pledged asset in order to recover their debts in case of default in the payment, without recourse to the court.[3] Islamic law entitles the institutions to apply for the sale of any asset pledged as collateral for the debt, for the liquidation of the debt.[4] They are also entitled to stipulate that they must be given a mandate from the debtors to sell the pledged asset without recourse to the courts.[5]

The default in payment is established when, following a normal demand for payment, a debtor who has not proved that he is insolvent fails to settle the debt on its due date.[6] But in case, it was not stipulated in the contract, the pledgor's consent is necessary for the sale of the pledged asset. The same rule is also applied in the Pakistani legislation where the Banks or FIs

[2] Ibid
[3] AAOIFI, standard no. 5(4/4/4)
[4] Ibid, standard no. 3(2/1)
[5] ibid
[6] Ibid, standard no. 3(2/6)

are given the right to sell the pledged asset without the intervention of the courts.[7] After the sale, the pledgee is entitled to recover the amount of his debt from the sale proceeds, and he is liable to return any surplus to the debtor.[8]

As far as IBIs are concerned, they can recover their amount of debt by the sale proceed of the pledged property. In case where the proceeds fail to cover the amount of the debt, the remaining balance is treated as an ordinary unsecured debt.[9] The creditor can not obtain the ownership of the pledged asset in consideration of his debt, except with the agreement of the debtor where he agrees to sell the asset to the creditor and they enter into an agreement of set-off of the sale proceeds and the amount of the debt.[10]

The pledgor has the right to use the pledged asset with the consent of the pledgee.[11] But the pledgee can not use the asset even if the pledgor has consented to it. The pledged asset is held as a trust by the pledgee. Thus when it is destroyed, lost or damaged without the negligence or misconduct of him, he shall not be liable.[12] But in case of the destruction of the pledged asset with misconduct or negligence of the pledgee, he shall be liable for compensating

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[7] Section 15(4) of the *Financial Institutions (Recovery of Finance) Ordinance,2001*: Where a mortgagor fails to pay the amount as demanded within the period prescribed under sub-section (2), and after the due date given in the final notice has expired, the financial institution may, without the intervention of any Court, sell the mortgaged property or any part thereof by public auction and may appropriate the proceeds thereof towards total or partial satisfaction of the outstanding mortgage money.

[8] AAOIFI, standard no.5(4/4/1)

[9] Ibid, 5(4/4)

[10] Ibid 5(4/4/2)

[11] Ibid, 5(4/6)

[12] Ibid, 5(4/7)

the owner, while the debt remains outstanding.[13] In such a case, both the parties have the right of agreement for a set-off between the outstanding debt and the amount of compensation.[14]

The creditor is entitled to retain the pledged asset for the recovery of his debt but he is not entitled to retain it for any unsecured debt. Thus, if a debtor has pledged his property for the security of a specific debt that he owes to the creditor, the creditor shall retain the pledge for that specific debt only. For any other unsecured debt, there exists no contract of pledge. However, since the contract is the agreement of both the parties, after the payment, they can agree to regard the released pledged asset as security for any other debt that may be created between them within a subsequent specified time period.[15]

Thus by studying the rules of pledge as security in Islamic law, Pakistani legislation and the Islamic banks, we find that the rules are almost same in all of them regarding pledge. In every law the pledgee has been given the right of recovering the amount of debt in case of default by the pledgor by sale of the asset, and return back the sale proceeds if they exceed the amount of debt.

5.1 .2 Personal guarantor's liabilities

The IBIs are entitled to ask the debtor to secure the amount of debt by providing one or more guarantors. If the contract of a credit stipulates for providing a guarantor and the debtor fails to

[13] ibid
[14] Ibid
[15] Ibid, 5(4/5)

provide one, the institution has two options in such a case: to initiate legal action to force the debtor to provide a guarantor; or to terminate the contract.[16]

In the financial transactions, the creditor has the right to secure his debt and if he is not satisfied, he can terminate the contract if the debtor fails in providing the security that satisfies the creditor. In the contract of guarantee, it is permissible for the institution to fix the duration of the personal guarantee, to set a ceiling on the amount to be guaranteed, restrict the guarantee or make it contingent upon a condition.[17] The IBIs are not entitled to fix remuneration for providing a personal guarantee, or to pay commission for obtaining such guarantee.[18] As discussed under guarantees in Islamic law, a valid guarantee can be made for a debt, the exact amount of which is unknown, and also for a debt which will arise in the future. The effects of personal guarantee are discussed as under:

5.1.2.1 The effects of personal guarantee

A guarantor is liable for anything for which the debtor is liable whose debt is guaranteed.[19] At the time of the payment of debt, the creditor is at liberty to demand the payment of his amount from either the principal debtor or the guarantor. But the guarantor has the right to stipulate at the conclusion of the contract that the creditor shall first claim the payment from the principal debtor, and only the refusal of fulfilling the obligation by the principal debtor entitles him to claim his debt from the guarantor. In such a case, the creditor shall demand the

[16] Ibid, 5(3/3/5)
[17] Ibid, 5(3/1)
[18] ibid
[19] Ibid, standard no. 3, Appendix B (8)

payment "according to the order of liability set by the guarantor at the time of conclusion of the contract of guarantee".[20]

When the debtor is discharged from the debt, the guarantor is automatically discharged from his liability. But this is not the case where the creditor discharges the guarantor, where the principal debtor shall remain liable to the creditor. If the guarantor has secured a discount from the creditor, he has the right of recourse to the debtor for only the actual amount that he paid to the creditor and not the full amount for which he was made a guarantor.[21] So, where the debt or any amount of a credit was secured by the IBIs, they have the choice of asking the principal debtor or the guarantor for the payment.

5.1.3 Penalty clause: (الشّرط الجزاءى)

Penalty clause is "an agreement between two parties to a contract stipulating a pre-determined amount of compensation that will be due to the obligee, should the obligor delay carrying it out."[22]

According to the AAOIFI, the stipulation of penalty clauses in the contracts is permissible provided that the penalty should not be the one in contravention to the objectives and injunctions of Islam e.g. the stipulation of additional amount for non-payment of the original debt, since it is clearly against the injunctions of Islam. However, some other kinds of penalty which is intended to secure timely payment of debts can be stipulated, if it does not contravene

[20] Ibid
[21] ibid
[22] Ibid, standard no. 3, Appendix c: definition of 'penalty clause'

the basic principles of Shariah. Different kinds of penalties that can be stipulated in the FCs and their validity are discussed as under:

5.1.3.1 Increase in payment of debt in case of default

Islamic law neither allows increase in payment of debt in case of default, nor does it make it permissible to extend the date of the payment of the debt in exchange for an additional payment in case of rescheduling, irrespectively of whether the debtor is solvent or insolvent.[23] This is the main difference between Islamic and conventional banking system. The increase in the payment of debt is nothing but *Riba* (interest) which is clearly prohibited in Islam. *Riba* which is the "principal source of revenue for the classical bank" distinguishes an Islamic Bank from a conventional one.[24] Islamic Banks are to conduct their banking operations in accordance with Shariah.

The main rule in Islamic law is that if a debt is not being paid because of the poor condition of the debtor or because of any established Shariah reason, the debtor is to be given respite as is stated in the Holy Quran:

"And if the debtor is in difficulty, grant a delay until a time of ease. But if you remit it (the debt) by way of charity, that is best for you if you only knew." [25]

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[23] Ibid, standard no. 8.5(5/7)
[24] Maqbool Hussain, *Waging War Against Riba* (Karachi: Fortune Publications Pvt. Limited. 1997), 57
[25] Quran, 2:280

According to Shari'ah, if a client is committing default in the payment of debt due to poverty, he must be given extra time until he is in a better position and can pay the debt. And forgiving him altogether is very virtuous.

But the problem is that mostly the solvent debtors default in the payment of the debt, not because of being poor but because of any other reason which causes great financial loss to the creditor. Especially in the cases of IBIs, where the debtor does not have any fear of paying additional amount in case of default as he has in the conventional bank's loan case. If the debtor is defaulting without a valid excuse (which is the general case in modern Islamic commercial transactions) then the solution is not to charge an extra amount of money which is nothing but *Riba*.[26]

The question arises what to do to secure the timely payment of debts in the Islamic banking transactions. In order to solve this problem, different solutions are suggested and increase of payment in case of default is one of them. The issue of legitimacy of penalty charges has been discussed by a group of international jurists at the seminar conducted and published by the Al Baraka Investment & Development Co as follows:[27]

> In Islamic law it is permissible to hold responsible a financially capable debtor who delays payment of debt without any genuine reason, and to compensate the Financier

[26] Legal Status of Late Penalty payments in Islam by Muhammad ibn Adam al-Kawthari, UK taken from http://www.central-moaque.com/index.php/General-Figh/legal-status-of-late-penalty-payment-in-islam.html accessed on 2nd April 2014 at 4:30 p.m. PST

[27] An article on "Rulings on Penalty Charges" by Fakihah Azahari (published in Islamic Finance News Asia, dated 28the July 2006, page 9)taken from< http://nfcfakihah.wordpress.com/2010/09/20/37/> accessed on 4th April 2014 at 5:40 p.m. PST

for any loss resulting from late payment. Such a debtor is unjust as the Prophet said "A debtor who delays payment of debt is unjust." The case of such person is similar to that of an unjust decreed that besides returning the capital he should also be made to return any profit made by him on the usurped as penalty. This was the majority opinion. Some are of the view that the obligation to pay this amount is a sort of penalty clause based on the principle of public welfare provided any income obtained is spent on legitimate charitable works.

Jumhur ulama' has taken the view that a person who has the means to repay his debt but delays in doing so is actually committing an unjust act. The liability of the Customer is also subject to the proviso that he is unable to offer any genuine reasons for his delay. It may be constructed that the appropriate rate to be determined may be influenced by factors such as whether there was a willful intention on the part of the Customer to delay his payment or there are other extraneous factors beyond the control of the Customer.

If we were to stretch the element of public welfare evident in the opinion, it is also possible to look at the culpability factor that contributes to the injury committed. Culpability factor occurs where the act of delaying the payment of the debt was due directly by the actions of the person committing the act and precipitated by extraneous factors. The culpability factor may be relevant at arriving at a fair rate of penalty; depending on the circumstances of the case to be weighed by the authority imposing the penalty rate. When the element of public welfare is taken into further consideration, any penalty charges imposed may be channeled through charitable institutions, subject always to the institution overseeing and supervising the collection and distribution of the penalty charges.[28]

It is evident from the verses of the Holy Quran and the sayings of the Holy Prophet (PBUH) that it is grave injustice from the part of the solvent debtor to default in the payment of debt and he who defaults deliberately contravenes Allah's law. And the default from a solvent man is considered

[28] Ibid

wickedness (*Zulm*) in Islam. In order to ward off this evil and for the public interest, a fair penalty has to be imposed which should not be contravening the Shari'ah. The Issue whether it is permissible to stipulate a penalty clause in the case of those who delay paying their debts while they are able to pay, and the rate of penalty charges have been discussed by international jurists, and their answers are discussed as under:

> It is permissible to stipulate a penalty clause as a deterrent against those who are well off and still delay paying their debts provided the money received from these penalties is spent on works of charity and special welfare. In case there is any taxes to be paid on the amount of penalty the Bank is entitled to deduct these expenses from the penalty for late payment".

Jumhur ulama are of the opinion that it is permissible to stipulate a penalty clause in the contract between the Financier and the Customer. A valid contract is one that fulfils the conditions if a *sahih* (valid) contract namely: offer and acceptance, subject matter and the contracting parties. It is a fundamental *Shariatic* principle that consent/mutual agreement of both parties to the terms of contract are given effect to. Parties to the contract may stipulate their agreement to a penalty clause in the contract. This will effectively prevent any dispute between the parties in the future as to the rights of the Financier to impose a penalty charge on the Customer. *Jumhur ulama* nevertheless put a condition that any income received from the imposition of penalty charges should go to charitable purposes and welfare.

The rate of penalty charges:

Jumhur ulama have left the question of the appropriate rate to be imposed to the experts; the Bankers and Financiers. They have provided some guidelines for consideration namely; whether the debtor is able to offer a genuine and reasonable explanation for their delay; whether willful intention was present at the time the wrongdoing was committed and whether there was a culpability factor.

> The rate of the penalty charges to be imposed is dependent on many factors namely the Financier's cost of fund, the administrative charges, expenses, legal costs, etc. The principle in charging penalty charges is to compensate the Financier for any loss or injury suffered by the Financier. The difficulty here would be to actually quantify the actual amount of the losses or injury suffered and determine what was the losses or injury suffered.[29]

So far, we have found many legal issues in imposing any kind of monetary penalty in case of default by the customers. Though, the above arguments are quite convincing, but there should be a fixed rule which should be according to Shari'ah that provides the guidelines for dealing with such cases of defaults or delay in payments. Since, there is no codified law that governs all the IBs and IFIs in Pakistan, therefore the solution of this problem seems quite difficult.

In case of breach of the terms of the FCs, a few Islamic banks and IFIs impose two types of penalties:

i) Late payment charges (LPC)

ii) Early settlement charges[30] (ESC)

As far as LPC is concerned, it is clearly against the injunctions of Islam. But some banks take an undertaking from the customer to pay a certain amount of money as late payment charges provided that it can not be used by the bank for its own benefit, rather

[29] Ibid

[30] Muhammad Faisal Siddiqui, Manager Consumer Banking, (March 2014), Al Baraka Bank (Pakistan) Ltd, Blue area, Islamabad

it is spent for the charitable purposes. This shall be discussed under the topic of 'compulsory charity'.

As for the ESC, In case of a contract of diminishing partnership, if the party, who has to make payment in installments during a specified period of time, pays the whole of the amount before the due dates, he is charged by a few banks which is taken as a penalty for not complying with the terms of the contract. The reason behind this charge is that the bank suffers loss from the lump some payment and can not earn the estimated profit it had to earn during the term of the contract.

A few IBIs have adopted the rule of charging pecuniary compensation from the defaulting customers in case the bank has suffered from loss in case of such default. However, a few conditions are necessary for imposition of such penalty:[31]

1) Default by the debtor for no valid justification.
2) Infliction of harm or loss to the creditor.[32]
3) The causal relation between default by the debtor and loss to the creditor.[33]

According to the rules set by their Shariah Advisory Boards (SAB) of those banks who impose such penalty, they can charge the defaulter according to the amount of loss caused to them during the defaulting period. They calculate the amount of loss by making an analysis of the profit it has paid to its account holders. According to their arguments,

[31] Abdur-Razzaq al-Sinhuri, Al-Waseet fi Sharh al- Qanun al-Madni al-Jadeed (Bairut: Daarul Ahya al-Turath al-Arabi, Bairut, Labenon), 855, 856
[32] Ibid, the Egyptian Civil Code, article 224 states that a creditor does not deserve any compensation if he has not suffered any loss because of the delay of payment by the debtor.
[33] Ibid

had the customer not committed default, the bank would have earned more profit and that estimated lost profit has to be compensated by the defaulting customer.[34]

They maintain that this pecuniary compensation is different from *Riba* and thus it is a permissible form of penalty. They present different arguments to differentiate it from interest. Their first argument is that *Riba* is a liability which the debtor is bound to fulfill in case of default irrespective of the fact whether he is poor or rich; whereas pecuniary compensation is taken only from solvent debtors. [35]

The second difference is that *Riba* becomes due immediately from the time of default; whereas pecuniary compensation is not charged until the expiry of one month and after serving the defaulter four notices. Another difference is that *Riba* is the liability on the defaulting debtor whether or not it caused loss to the creditor; while the pecuniary compensation is charged only in the case the bank has incurred some loss due to the default. Finally, at the time of concluding the contract, both the parties know the rate of the *Riba* which is fixed; while in case of pecuniary compensation, no party knows its rate which is estimated and calculated according to the loss to the bank.[36]

The points of differences seem quite convincing to a layman but this is a matter related to the injunction of Islam. Only some learned jurists have the authority of accepting or rejecting them. According to the chairman of Shari'ah Board of AAOIFI, Sheikh Muhammad Taqi Usmani, who is also a permanent member of OIC Fiqh Academy

[34] Muhammad Taqi Usmani, *Fiqhi Maqalaat* (Karachi: Maiman Islamic Publishers, 1994) 123; also see *Islamic Finance* (Karachi: Maktaba Ma'arif-ul-Quran, Karachi, 2002) for detail by the same author
[35] Ibid
[36] Ibid

(OICFA), the stipulation of monetary compensation is not according to the injunctions of Islam.[37]

According to the learned jurist, the case of default by the customers is not something new for which new laws are to be made. It was prevalent at the time of the Holy Prophet (PBUH) but he never allowed the imposition of any monetary penalty on defaulters. We are not allowed to ward off evil by making anything lawful that is unlawful in Islam.

He gave his answers to all the arguments raised by those who are in favor of imposing such penalty in Islamic banking transactions. For the first argument, there is no rule of exactly determining the financial position of a customer. For IBIs, every person is not poor unless he is declared insolvent by the banks. In most of the cases, people are poor even though not declared insolvent. Thus there is no way of determining the financial position and the rule that the pecuniary compensation is charged on solvent debtors only, is not applicable as he can be a poor person.[38]

As for the argument of serving one month notice before charging the pecuniary compensation, this rule is not practically adopted by all the IBIs. In Islamic banks, mostly the financing is through banking Murabaha in which the bank and the agent know the estimated profits they will earn. Thus, the argument that the rate of profit is unknown in

[37] Ibid
[38] Ibid, 127

IB is not appropriate.[39] Thus, imposition of pecuniary compensation is against the injunctions of Islam and it amounts to an increase in the principal amount, which is nothing but a form of *Riba*.

However, the IBIs are allowed to accept a payment from a debtor who is in default that is in excess of the amount of the debt, provided there is no contractual condition whether written or verbal, or custom or mutual agreement relating to this additional amount.[40]

5.1.3.2 Bringing forward future installments in case of default

If at the time of concluding the contract, it is stipulated in the debt transaction (the payment in which has to be made by way of installments) that in case of default on the payment of one or more installments, some or all of the future installments shall fall due immediately, provided that the default was not caused by the unforeseeable intervening events or *force majeure*; it shall take effect after serving the debtor with a reminder notice and after giving him a reasonable period of time not less than two weeks.[41]

Thus, the IBIs are entitled to demand the payment of the whole of debt in case of default from the debtor in any of the installments. This is one of the many ways of securing the debt transactions by the Islamic banks. This may take place in any one of the following ways:

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[39] Ibid, 129
[40] AAOIFI, standard no.3. 2/5(b)
[41] AAOIFI, standard no.5 (5)

a) "The installments automatically become due as a result of a mere delay in a payment, no matter how short the period of delay is.

b) The installments become due after a delay in payment exceeding a specified time period.

c) The installments become due after sending of a reminder notice by the institution to the seller giving a specified time period for payment."[42]

Stipulating such condition in a contract is permissible because Holy Prophet (PBUH) said: *"Muslims are bound by the conditions they made."*

The permissibility of such a condition in a debt contract has been confirmed by the resolution no. 51 issued by the IIFA[43], the text of which reads as follows: "It is permissible for a seller on deferred credit terms sale to impose the condition that the installments become due before their original due date in case of the delay of the debtor in paying some of the installments, so long as the debtor consented to this condition when the contract was agreed."

This rule is adopted internationally as the Islamic Development bank (IDB) uses this remedy in the Installment Sale Agreements (ISA) with different countries as a penalty for not complying with the terms of the contract e.g. In ISA with Pakistan, the clause of 'Remedies' provided that:

> If the Purchaser shall commit a breach of any of its obligations hereunder, which breach shall remain uncured 30 days after the date on which the Vendor has notified the Purchaser of such breach, the Vendor may declare the outstanding unpaid balance of the Sale price to be forthwith due and payable, whereupon the Purchaser shall

[42] Ibid, standard 8; 5/1
[43] Ibid, standard 5; basis of the Shariah Rulings no.6

immediately pay to the Vendor the outstanding unpaid balance of the Installment sale Price together with any other amount payable by the Vendor hereunder.[44]

Thus, stipulation of bringing forward future installments in case of default is a valid kind of remedy which is being used by all the IBs and IFIs not only in Pakistan but also worldwide.

5.1.3.3 Compulsory charity

Regarding the IBIs, the contemporary scholars and jurists have maintained that if a client undertakes that in case he defaults in payment at the due date, he will pay a specified amount to a charitable fund maintained by the bank, it will be permissible.[45] It is as a self-imposed penalty and a sort of vow, in order to put pressure on the debtor to pay promptly.[46] Normally, such vows create only a moral obligation and are not enforceable through courts.

According to AAOIFI, It is permissible to take an undertaking from the customer to pay an amount of money or a percentage of the debt, to be donated to charitable causes, in case of a delay on his part on paying installments on their due date. [47] However, the Shariah Supervisory Board (SSB) of the institution is to supervise that such amount be used only for

[44] Installment Sale Agreement between The Government of Pakistan and the Islamic Development Bank authorizing the Government to purchase Equipment as an Agent for and on behalf of the Bank and the Sale thereof to the Government for use in the Railway development Project (Phase III) Pakistan.

[45] Legal Status of Late Penalty payments in Islam by Muhammad ibn Adam al-Kawthari, UK taken from http://www.central-moaque.com/index.php/General-Fiqh/legal-status-of-late-penalty-payment-in-islam.html accessed on 2nd April 2014 at 4:30 p.m. PST

[46] Ibid

[47] AAOIFI,standard 8, 5/6

charitable purposes, and not for the institution itself.[48] In this regard, the SBP issues instructions to the IBIs for the Charity Fund and their utilization which states as under:

> Use of Charity Fund:
>
> 1. Every IBI will create a Charity fund in which income of the IBI from non-Shariah compliant sources or penalties and late payment charges received from clients in default or overdue cases etc will be credited.
>
> The amount in this fund will be utilized for charitable and social welfare purposes in accordance with the policy vetted by Shariah Advisor and approved by the Board of Directors.
>
> 2. It shall be ensured that no amount of charity fund can be directed to or utilized by persons directly or indirectly connected with the bank, their spouses, dependents and minor children.
>
> 3. The IBIs shall maintain proper accounts and records regarding all transactions relating to Charity Fund and disclosure in their annual audited financial statements through a Statement of Sources and Uses of Charity Fund by nature of disbursement as prescribed by the SBP.[49]

Thus, any IBI can stipulate for an amount as penalty in case of default by the customer. The reason for imposing such a condition by the financial institution is nothing but to secure the timely payment of the debts. The question is whether such stipulations should be allowed or not. Taking the example of conventional banks that impose interest as a penalty for non payment, the imposition of such compulsory charity seems the best solution as it creates a pressure for timely payment on the debtor.[50]

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[48] Ibid, standard no. 8, 5/6

[49] "Instructions for Shariah Compliance in Islamic Banking Institutions" issued by State bank of Pakistan, Islamic Banking Department taken from http://www.sbp.org.pk accessed on 5th April 2014 at 2.40 p.m. PST

[50] Muhammad Taqi Usmani, *Fiqhi Maqalaat* (Karachi: Maiman Islamic Publishers, 1994) 130

In conclusion, fixing any penalty for late payment falls into the definition of *Riba*, thus unlawful, even if the intention is to give the amount in charity.[51] But the undertaking taken by IBs and IFIs is in a form of self-imposed vow which not only secures the timely payments but is also used for charitable purposes. It is the liability of the SSB of Islamic banks to ensure that this amount is not being used by the bank but only for charitable purposes. Some of the IBIs use this amount to provide *qard-e-hasanah* to the needy persons, which is recommended in Islam. And If the debtor is in very poor condition, the whole debt is remitted which is a great virtue and in great public interest. Thus, it is permissible and is used as one of the remedies for breach of contracts.

5.1.4 Termination of sale on deferred payment in case of default

In a contract of sale, the seller is entitled to stipulate that in case of default in the payment of the price by the buyer within a certain period of time, the seller is entitled to revoke the contract and repossess the sold asset without recourse to the courts.[52] This right given to the seller to repossess the sold asset has been assured by Islam. This judgment is based on the report of Abu Hurayrah (may Allah be pleased with him) that the Prophet (PBUH) said:

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[51] Legal Status of Late Penalty payments in Islam by Muhammad ibn Adam al-Kawthari, UK taken from http://www.central-moaque.com/index.php/General-Fiqh/legal-status-of-late-penalty-payment-in-islam.html accessed on 2nd April 2014 at 4:30 p.m. PST

[52] AAOIFI, standard no. 5 (6)

"If one party has sold an asset and the other party has become bankrupt, and the former party has managed to retain the asset, then he is more qualified to take possession of the asset in preference to the other creditors".[53]

5.1.5 Freezing cash deposits

For securing the future payment of debts, the institution has the right to stipulate in the contract to:

a) "Freeze the customer's investment account;

b) Revoke his right to withdraw money from such an account entirely; or

c) Block an amount in the account equivalent to the debt."[54]

Thus, the IBIs are entitled for the above stipulation in the contract in order to secure the timely payment of the debts. The basis of the permissibility of such stipulation is the permissibility of pledging funds.[55]If it appears that the pledgor of the balance is in debt to the Bank, the freezing of investment account enables to an agreed set off.[56] However, they are not permitted to freeze the customer's current account except with the free and absolute consent of the customer.[57]

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[53] This tradition was reported by Al-Bukhari (2/846) and Muslim (10/221)
[54] AAOIFI, standard no. 5 (7/5/1)
[55] Ibid, Appendix B (8/5)
[56] Ibid
[57] Ibid, 7/5/2

5.1.6 Earnest money, *Arboun* and *Hamish Jiddiyah*

Earnest money is generally known as advance payment. It is a kind of security deposited to show the seriousness of the party to fulfill his contractual obligations. The earnest-money deposit serves several purposes:

> I) It indicates the buyer's seriousness, encouraging the seller to take property off the market;
> ii) It compensates the seller for risks assumed and for opportunity costs or other losses incurred while pursuing a failed contract;
> iii) it gives the buyer an incentive to perform the contract, and gives the seller leverage to secure the performance.[58]

As discussed in the third chapter, *Arboun* is the amount of money paid by the buyer with the provision that if the sale is completed during a prescribed period, the amount will be counted as part of the price. But in case the buyer fails to execute the contract of sale, the seller would retain the whole amount.[59] *Hamish Jiddiyah* is the security deposit in *Banking Murabaha* which is returned to the customer in the case of his fulfillment of the contract. But in case of his breach of the contract, the IBIs are allowed to deduct the amount equivalent to the actual loss suffered by them and return the remaining balance to the customer.

If before entering into any financial transaction, an institute has taken any security-deposit as security, it is entitled to get the remedy by using it in case of the breach of FC by the customer. These security deposits ensure the fulfillment of the obligations but they are not the

[58] Frank E. Vogel and Samuel L. Hayes, *Islamic Law and Finance: Religion, Risk and Return* (London: Kluwer Law International, 1998) 158
[59] Ibid, standard no. 8, Appendix C

only remedy available at the time of breach. The banks and IFIs can enforce all the other securities as well e.g. pledge or personal guarantee etc. The wisdom behind all the securities is nothing but the fulfillment of FCs.

5.1.7 Use of promissory notes and cheques

In order to force the debtors to make timely payment of installments in cash, the IBIs can obtain cheques or promissory notes from them[60]. In case of default, those cheques and promissory notes can be produced for recovery. However, the debtor is allowed to take an undertaking from the bank or the institution, as the case may be, to use the cheque only for timely recovery of its due debts and not otherwise and without any addition.[61]

Such an act by the bank is allowed in Islam when taken the guarantee in its general meaning. Just like mortgage or pledge, where a debtor gives his movable or immovable property to the creditor that in case of default, the creditor can sell the item and recovers his amount of debt, the cheques and promissory notes gain the same status of pledged or mortgaged property.

5.1.8 Non-material punishments for default in payment

The Islamic banks are entitled to put the name of the defaulter debtors in their black list. After doing so, the banks and financial institutions are also entitled to send a warning admonition to

[60] AAOIFI, Standard no.5, 7/3
[61] Ibid

other companies about him so that he should not be given a chance of getting loan from other bank. This warning is considered to be an obligation as our holy prophet has said in this regard:

لَيّ الواجديحلّ عِرضه وَ عُقوبته

"Delay in payment by a solvent debtor would be a legal ground for his being publicly criticized and punished."

If all the IBIs make strict rules in this regard that a defaulter of one bank would not be given an opportunity to avail loan from any other bank, the cases of non payment of debt would lessen in no time.[62] Time plays an important factor in the modern world of trade. Default in payment causes great financial loss to the creditor which can only be minimized either when the debtor has some incentive or fear.

In the conventional banking system, the debtors are bound to make timely payments as they will have to pay interest that is an additional amount which is prohibited in Islam. If only the rule of applying non material punishment is applied in modern Islamic banks, the debtors will have a fear of not having a chance of taking loan from the banks which can ensure the timely payments. But this rule is to be applied only on the solvent debtors who delay their payments or commit default without any valid Shariah reason.

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[62] Muhammad Taqi Usmani, *Fiqhi Maqalaat* (Karachi: Maiman Islamic Publishers, 1994) 122; see also *Islamic Finance* by the same author for detail

5.2 Modes of Banking and Finance in IBs and IFIs and their Shariah Compliance

The remedies provided by AAOIFI in the Shariah Standards are discussed generally. Now, it will be discussed how the risk of the breach of FCs is minimized by the mandatory rules of SBP which govern not only the conventional but also the Islamic Banks. The Banking Policy and Regulation Department (BPRD) of the SBP frames guidelines to the nationalized commercial banks for loan default and the recovery of stuck-up loans.[63] The Islamic Banking Department (IBD) of the SBP issues instructions for the Shariah compliance in IBIs. According to its rules, every IBI is required to appoint a Shariah Advisor (SA) who shall "ensure that all products and services and related policies and agreements of IBIs are in compliance with Shariah rules and principles".[64]

As we discussed the non-material punishments for the defaulting debtors in Islamic law, the wisdom of which is to bar that client from any future transaction and warn other banks about him, the SBP has made a Credit Information Bureau (CIB) which is "an organization that collects data on borrowers from Banks and FIs."[65] The member FIs are required to submit the borrower's entire records to CIB on monthly basis which enables the organization to make the Credit Information Report (CIR) of the borrowers.[66] This financial data is then "aggregated to the system and the resulting information is made available to the FIs for the purposes of credit

[63] BPRD Circular for Loan Default and Recovery Thereof c.f. *Manual of Banking with leading Cases* by Saalim Salam Ansari (Karachi: Asia Law House, 1998) 827

[64] "Instructions for Shariah Compliance in Islamic Banking Institutions" issued by State bank of Pakistan, Islamic Banking Department taken from http://www.sbp.org.pk accessed on 5th April 2014 at 2.40 p.m. PST

[65] CIB report of SBP taken from <http://www.sbp.org.pk/ecib/faq.htm> accessed on 04-04-2014at 2:15 p.m. PST

[66] Ibid

assessment, credit scoring and credit risk management".[67] As the names of blacklisted clients or warnings from some banks about the defaulting customers enable the Banks and FIs to make prudent decisions about the clients who have a history of default, likewise the CIR is to enable the financial institutions to know the credit history of their prospective customers and make their own lending decision on the basis of their lending policies, past track record of borrower and his repayment capacity keeping in view his negative or positive CIR.

The effect of CIR is that it compels the borrowers to make timely payments, to clarify the reasons in case of their written off debts and loans. The negative CIR will decrease the chances of availing any facility from banks or FIs as they can reject their application because of his history of the negative CIR.

Most of the IBIs have made their own rules in order to minimize the risk of default from their clients. Al-Baraka Bank does not offer its services to an unmarried female unless she brings a male family member as her guarantor.[68] Likewise, people from Law Enforcing Agencies are discouraged to be made clients by the said Bank as it would be hard to pursue them in case of default.[69]

In order to minimize the risk of the breach of contracts, the banks and IFIs enter into legal documentation that is exactly according to the injunctions of Islam. Shariah commands the believers to write down all the debt transactions to avoid future disputes. Thus, banks and IFIs

[67] Ibid
[68] Information provided by Muhammad Faisal Siddiqui, Manager Consumer Banking, (March 2014), Al Baraka Bank (Pakistan) Ltd, Blue area, Islamabad
[69] ibid

follow the rule of completing the written legal documentation framed by SBP in this regard. This is to enable the IBIs to start legal action and proceedings against the defaulting clients.

In every financial transaction, every person has to give his own personal guarantee for the fulfillment of his contractual obligations.[70] He has to fill the form in which he has to provide all the necessary information about him. In case, the bank requires any security or guarantee, it will be mandatory on him to provide the same otherwise he will not be able to avail the facility from the bank.

In case of his default, the banks can take legal actions with or without the intervention of the Courts. Since it differs from case to case, we shall now discuss remedies for default specifically in different contracts with special reference to the modern Islamic Banks in Pakistan. The remedies for the breach of contractual obligations shall be discussed in the following contracts:

1) Loan and credit transactions and contracts
2) Banking Murabaha
3) Ijarah contract
4) Salam contract
5) Istsna'a contract
6) Sharikah contract
7) Mudarbah contract

[70] Ibid

5.2.1 Loan and credit transactions

Since, the Islamic banking system is not fully developed yet; *qard-e-hasanah* is a facility which is not provided by most of the banks[71]. Islam recommends *'qard-e-hasanah'* which is a special kind of loan in which "the benefits to be derived by the borrower are consciously gifted to him by the lender and the lender does not expect anything from him in return."[72]This is the kind of loan in which no time for repayment can be stipulated and the lender has the right to demand the repayment any time he wants and he can give rebate to the borrower if he is unable to pay.[73]

In case of the *qard-e-hasanah*, the banks would suffer a lot for the reason of inflation. If the debtor returns back his debt after five years, the value of money would have decreased and the creditor bank would suffer a lot. That is the main reason why Islamic banks avoid giving such loans to any needy person. However, the imposition of compulsory charity, whereby a customer undertakes to give a certain amount of money to charity in case of his default, has made the IBIs capable of providing *qard-e-hasanah* to needy people.

In Islamic Banks, short-term and long-term loans are granted with collateral guarantees.[74] No interest is charged but the borrower has to pay the services charges. In case of default, delay or fraud by the borrower, the bank has the recourse to the collateral.[75]

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[71] Information provided by Allama Irshad , The Shari'ah Co-ordinator of Burj Bank, Karachi dated 16th April 2014
[72] Imran ahsan Khan Nyazee, *The Concept of Riba and Islamic Banking* (Islamabad: Nlazi Publishing House, 1995)49
[73] Ibid
[74] Collateral is security that is used to provide a guarantee for a loan.
[75] A.L.M. Abdul Ghafoor, *Interst Free Commercial Banking* (Netherlands: apptec Publications, 1995) 7

5.2.2 Banking Murabaha

It is a contract in which a customer promises to purchase the item from the institution on Murabaha basis.[76] In the normal type of Murabaha contract, such a promise does not exist. The Banking Murabaha or as called the 'Murabaha to the purchase orderer' involves a transaction in which the institution grants the customer a Murabaha credit facility.[77]

In the Banking Murabaha, the banks and IFIs can demand a number of securities from the purchaser to fulfill his promise. These securities are used as a remedy in case of breach of the promise by the promisor. In case of Banking Murabaha banks can demand following securities and enforce them at the time of breach, to mitigate their loss:

a) In case of Banking Murabaha, the bank or the institution can demand any lawful security as a pledge e.g. the pledge of any item of real or immovable property, the pledge of the subject matter of the contract or the pledge of the investment account of the customer.[78] In case of default by the customer, the institution can get the compensation by the sale proceeds of the pledged asset; and in case of pledge of the investment account by freezing that account, revoking his right to withdraw money from such an account entirely; or blocking an amount in the account equivalent to the loss. The institution is also entitled to stipulate in the contract that the customer should

[76] AAOIFI, standard no. 8, Appendix C
[77] Ibid
[78] Ibid, Appendix A, 5/2

make an assignment to the institution to sell the pledged asset without recourse to the judiciary, in case of default.[79]

b) Every person is his own guarantor in the financial transactions with IBIs. But this does not affect the right of the banks to demand third party guarantee. In case of such demand, the customer would be bound to provide it and in case of default by him, the bank would be able to include that guarantor in litigation.

c) The institution can require the customer to provide cheques or promissory notes as a guarantee of indebtedness that will be created after the execution of the contract.[80] However, the institution is entitled to use these cheques only on the due date and not before.

d) The institution is entitled to stipulate that in case of customer's refusal to perform his obligation or delay in the payment of installment without any good reason, all the installments shall become due before their originally agreed due dates.[81]

e) In the contract of Banking Murabaha, the institution is entitled to take an undertaking from the customer to pay an amount of money or percentage of the debt, which is to be donated for a charitable cause in case of his failure to make timely payment of installments.[82]

f) If the institution has taken *Hamish Jiddiyah* from the customer as a security, in case of breach of the binding promise by the customer, the institution is entitled to retain it.[83] The institution is only entitled to deduct the amount of the actual damage incurred as a

[79] Ibid, 5/5
[80] Ibid, 5/3
[81] Ibid, 5/1
[82] Ibid, 5/6
[83] Ibid, 2/5/3

result of the breach (which is the difference between the cost of the item to the institution and its selling price to the third party).[84] This actual damage does not include the opportunity cost which is the loss of the institution's mark-up.[85]In case, there is no breach by the customer, the institution must refund the amount of Hamish Jiddiyah to him.

g) In case of *Arboun* as a security, it is preferable that the institution returns the remaining amount to the customer after deducting the actual damage incurred as a result of the breach by the customer.[86] It means that the institution has the right of forfeiting the whole of the amount deposited to it as *Arboun* by the customer.

h) "If the customer pays any security deposit in cash to the IBI, the same shall be placed in a PLS account under lien of the IBI. Customer shall be entitled to receive the profit from such PLS account against the security deposit. However, in case of default by the customer, the IBI is allowed to adjust the security deposit to the extent of customer's liability."[87]

There is no ESC in case of Banking Murabaha. The institution has the right of giving up a part of the selling price in case of early payment.[88] But there should be no such provision in the contract which would amount to *Hatt Wa Ta'ajjul*[89] which is prohibited in Islam.

[84] Ibid, 2/5/4
[85] Ibid
[86] Ibid, 2/5/6
[87] Instructions for Shariah Compliance in Islamic Banking Institutions" issued by State bank of Pakistan, Islamic Banking Department taken from http://www.sbp.org.pk accessed on 5th April 2014 at 2.40 p.m. PST
[88] Ibid, 5/9

5.2.3 Ijarah contract

Ijarah is a lease contract in which the use or the benefit of a specified asset is leased out to the lessee for a specified period in return for a specified permissible consideration. IBIs provide the facility of *Ijarah Muntahia Bittamleek* (IMB) in which the ownership of the leased asset is promised to be transferred to the lessee, either at the end of the term of Ijarah period or by stages during the term of the contract.[90]

In order to secure the rental payments Banks are allowed to take all kinds of permissible securities against misuse or negligence on the part of the lessee. Thus, in case of the damage of the leased asset caused by the negligence of the lessee, he shall be liable to replace the asset if it is replaceable; otherwise he is liable to the amount of the damage which is ascertained by valuation.[91] If the rentals are being paid in installments, the IBIs have the right of stipulating in the contract of Ijarah that all the installments shall become due in case of default in any one of them.

The IBD of the SBP issues instructions for default or late payment in case of lease contract which is as follows:

> While entering into the agreement of lease, it can be stipulated that in case of late payment of rentals by the lessee, he shall and be deemed to have irrevocably authorized the IBI to recover from him an amount calculated at a predetermined percentage per day or per annum as compulsory contribution to Charity Fund constituted by the IBI.

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[89] It is a stipulation in the contract of debt to give up a part of the debt by the creditor In case of early payment. It is prohibited in Islam as it amount to Riba. For detail see Muhhamd taqi Usmaini, *Fiqhi Maqalaat* (Karachi: Maiman Islamic Publisher, 1994), 100

[90] AAOIFI, standard no. 9, Appendix C

[91] Ibid, 7/1/4

> This contribution to Charity Fund shall not constitute income of the IBI. The IBIs can also approach competent courts for award of damages, at discretion of the courts, which shall be determined on the basis of direct and indirect costs incurred, other than opportunity cost.[92]

However, no increase in the rental due may be stipulated by the lessor in case of delay in payment by the lessee.[93] In case of IMB, an undertaking can be taken by the lessee that in case of late payment for no good reason, he shall be liable to donate a certain amount or percentage of the rentals. If he delays the payment of rentals or installments, he shall be given a notice reminding him of the payment which is due on him. If he does not make timely payment, another notice is served on him. After the final notice, the bank repossesses the leased asset and asks the lessee to either make the whole of the remaining payment or terminate the Ijarah contract.

Thus, here in the case of Ijarah contract we notice that the IBIs fully secure the contractual obligations by the clients and by taking actions against defaulters, they get compensation in case of any loss to them.

5.2.4 Salam contract

Salam is a transaction of sale of a specific commodity where the price is paid at the time of the contract while the delivery of the subject matter is deferred. Like in any other contract, the Islamic banks and IFIs can demand any guarantee for securing the delivery of the subject matter. This guarantee can be pledge, personal guarantee or any other means of security. But it

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[92] Instructions for Shariah Compliance in Islamic Banking Institutions" issued by State bank of Pakistan, Islamic Banking Department taken from http://www.sbp.org.pk accessed on 5th April 2014 at 2.40 p.m. PST

[93] Ibid, 6/3

is not permissible to stipulate any penalty clause for delay in the delivery of the subject matter.[94] In case of non fulfillment of the obligations of the seller because of his insolvency, the time of delivery should be extended.[95] If all or part of the subject matter is not available to the seller at the greed time of delivery, it is the buyer's choice to opt for any of the following remedies:

i) He can opt to wait until the subject matter is available.

ii) He can cancel the contract and recover the paid capital.

iii) He can also agree to replace the subject matter by other goods.[96]

5.2.5 Istsna'a contract

Istisna'a is a contract of sale of some specified items which are to be manufactured or constructed by the manufacturer or builder and he is under an obligation to deliver them to the customer, upon completion.[97]

The IBIs can demand *Arboun* as a guarantee in the contract of Istisna'a. In case the contract is fulfilled, the *Arboun* shall be considered as the part of price while in case the contract is rescinded, it will be forfeited.[98] The rule in the Shariah standards by AAOIFI about urboun in istisna'a contract that "it is preferable that the amount forfeited be limited to an

[94] Ibid, standard no. 10, 5/7
[95] Ibid, 5/6
[96] Ibid, 5/8
[97] Ibid, standard no. 11, Appendix C
[98] Ibid, Appendix A, 3/3/1

amount equivalent to the actual damage suffered"[99] indicates that forfeiting the entire amount of the *Arboun* is also permissible even if it exceeds the actual damage caused to the institution.

Thus, *Arboun* as a guarantee in the istisna'a contract would be enough remedy for the banks in case of loss incurred by them because of the breach of the contract. But it is not the only guarantee; it is permissible for the banks to demand any other fair and enforceable guarantee to secure the fulfillment of the contract e.g. pledge, personal guarantee, current account or consent to blocking withdrawal from an account.[100] And, in case of breach these guarantees can be enforced to compensate for the loss incurred by the institution.

It is permissible in the istisna'a contract to stipulate a fair penalty clause according to which agreed amount of money shall be paid to compensate the ultimate purchaser in case the manufacturer is late in delivering the subject matter.[101] However, this penalty is only enforceable when the delay is not because of *force majeure*.[102]

5.2.6 Sharikah contract

"Contractual partnership is an agreement between two or more parties to combine their assets or to merge their services or obligations and liabilities with the aim of making profit."[103] The assets of the partnership are maintained by all the partners on trust basis. Therefore, no one would be liable for damage or destruction of the assets caused without any negligence or misconduct of partners. But it does not deprive any institution from demanding a personal

[99] Ibid
[100] Ibid, 3/3/2
[101] Ibid, 6/7
[102] ibid
[103] Ibid, standard no. 12, Appendix C

guarantee or pledge as a security against misconduct, negligence or breach of the partnership contract from its partners.[104] A third party guarantee may be provided to make up a loss of capital of some or all of the partners.[105]

In the *Diminishing Musharkah* (DM), the banks have the right of charging ESC if the customer pays the whole amount in lump some that was to be paid through installments during a specified period of time e.g. AlBaraka and Burj Bank charge 5% ESC from the clients in case of full payment before due date, in case of DM. This charge is not considered to be interest since it is the settlement of the partnership assets at the end of the term of the contract which is allowed in Islam.[106]

Thus, the IBIs can secure their financial transactions of partnership by these guarantees, and in case of breach of the contract or damage or loss suffered by the negligence or misconduct of the partner, the bank can get its compensation by enforcing the guarantee taken by the partners.

5.2.7 Mudaraba contract

Mudaraba is the kind of partnership in which one party undertakes to contribute capital funds while the other participates with his skills and they share the profits of the joint venture in agreed proportion.[107] In case of Mudaraba partnership, the capital provider is permitted to obtain from the mudarib only those guarantees which are adequate and enforceable.[108] The

[104] Ibid, 3/1/4/2
[105] Ibid, 3/1/4/3
[106] Information provided by Allama Irshad , The Shari'ah Coordinator of Burj Bank, Karachi dated 16th April 2014
[107] Mahfooz Ali, *Interest Free Banking in Pakistan* (Karachi: Institute of Bankers in Pakistan, 1982), 120
[108] AAOIFI, standard no. 13(6)

capital provider can only enforce these securities in case of negligence, misconduct or breach of the contract by the mudarib.[109]

5.3 COMPARISON OF THE ABOVE REMEDIES WITH SHARIAH AND PAKISTANI LEGISLATION

In the previous chapter, we started our analysis of remedies for the breach of FCs in Islamic law and Pakistani legislation. After discussing those remedies which are availed by IBs and IFIs for such breach in chapter five, we shall now discuss them in the light of Shari'ah and Pakistani law.

In any FC, the demand for personal guarantee is permissible by a party to secure the contractual obligation by the other. The legitimacy of such guarantee has been proved in Islamic law[110] and it is also provided in Pakistani legislation.[111] In case of modern banking transactions, the IBs and IFIs do not enter into any contract unless and until they make every person a guarantor of himself. Thus in their contracts, every person is a personal guarantor of his own self. But this does not affect the right of IBs and IFIs to demand any other person as a guarantor e.g. in case of an unmarried female client, the IBs ask for personal guarantee from any male member from her family, in order to have a valid security.

As for the non-material punishment that is prescribed in Islamic law for the rich debtor who commits default in payment without good reason, it is applicable by the modern IBIs. They avoid making him their client in future, but this is not enough to restrain him from default as he

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[109] Ibid
[110] Quran 12:72
[111] The Contract Act, IX of 1872, section 126

gets the facility by any other IBI. If all the IBIs unanimously agree not to provide any facility to the habitual defaulters, the cases of default would lessen in no time.

In the sale contract on deferred payment basis, the IBIs have the right to terminate the contract and repossess the thing sold as a penalty for default. In Islamic law, we discussed the Restitutionary remedy where the thing is to be returned to the seller in case of failure of payment.[112] Thus, the stipulation of the termination of sale on deferred payment in case of default is also a 'Restitutionary remedy' the aim of which is to bring the parties to the position in which they were before the contract.

The IBIs take pledge as a security which is of different forms. Whatever the form is, they are permissible in Islam as it is a valid kind of security approved by Quran.[113]

In case of lump some payment of all the due installments by the customer in DM contract, the IBs charge ESC which is permissible in Islam. As stated in the case of DM contract in AlBaraka and the Burj Bank, they charge 5% as ESC.[114]

In case of stipulation of penalty clause, no IBI is allowed to increase the payment in case of default; however, they can take undertaking by the customer to pay a specific amount to charity in case of default. Though, this kind of stipulation is not allowed in Islam as it is nothing but *Riba*, but since it is not used by the IBs or IFIs, but for charitable purposes, so it is allowed. Thus, we find that it is tried by the SBP to make the laws governing Islamic Finance in Pakistan Shariah compliant, but still there are some issues to be settled.

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[112] Dr. Liaqat Ali Khan Niazi, *Islamic Law of Contract*, (Lahore: Research Cell, Dyal Sing Trust Library,1991),313

[113] Quran 2:283

[114] Information provided by Muhammad Faisal Siddiqui, Manager Consumer Banking, (March 2014), Al Baraka Bank (Pakistan) Ltd, Blue area, Islamabad

CONCLUSIONS

We started our analysis by examining the importance of contractual liability in Islamic law and Pakistani legislation. After making a thorough analysis, it was established that any law, whether it is Divine or man-made emphasizes on the fulfillment of contractual obligations. The importance of contractual liability is established according to the injunctions of the Holy Quran[115] and Sunnah.[116] The principle of *'Pacta Sunt Servanda'*[117] clearly elaborates the significance and the sanctity of contracts in positive law.

The second issue was to determine whether there is any codified law which governs the financial system of IBs and IFIs in Pakistan or not. In 2008, the SBP had developed a strategic plan for the Islamic Banking Industry in Pakistan.[118] It is stated that the SBP has not approached the Islamic banking solely as a religious or a legal issue; it considers it to more of a change management issue. In order to advise the SBP on modes, regulations, laws and procedures for Islamic banking that ensures Shari'ah compliance, a Shari'ah Board comprising two Shari'ah scholars and three experts in the areas of banking accounting and legal framework has been established in the SBP.[119]

The SBP has made plans and strategy to ensure innovation in the industry in terms of systems and products that is strictly in line with sound Shariah principles.[120] For this purpose, a roll-out plan for Shari'ah Standards framed by AAOIFI has been put in place. Though we find no

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[115] Quran 17: 34

[116] Hadith: "He who is not faithful has no faith and he, who does not keep his promises, has no religion."

[117] The principle of pacta sunt servanda taken from <http://www.wisegeek.com/what-does-pacta-sunt-servanda-mean.htm> accessed on 01-04-2012 at 09:00 p.m. PST.

[118] Islamic development bank Group (Member Country Partnership Strategy for Pakistan, 2012-1015),115

[119] Ibid,113

[120] Ibid

codified Islamic law that is governing the Islamic financial sector in Pakistan, however we see that SBP has worked on it through expansion of its Shari'ah Board, introduction of Shari'ah inspection for IBs and conventional banks' Islamic Banking Operations and building and use of multiple forums of Shari'ah experts.[121] Thus, IBs and IFIs are governed by the principles chalked out by the SBP in this regard.

The thesis analyzed the guarantees and securities taken by the IBs and IFIs to secure the contractual liabilities of their clients. The main difference between any conventional bank and Islamic bank is that the IBs can not stipulate the interest (*Riba*) as LPCs in any financial contracts. In any debt transaction, the increase in payment is *Riba* which is clearly prohibited in Islam. Thus, the IBs and IFIs have to avoid *Riba* in any of its forms. Only the valid forms of guarantees are allowed for the IBIs e.g. personal guarantees, pledge/mortgage, taking promissory notes and cheques, third party guarantees, earnest money, *Hamish Jiddiyah* etc. Stipulation of increase in the payment of debt by way of penalty is prohibited in Islam. However, it can be stipulated in a contract that the client will pay a certain amount in case of default which shall be used for charitable purposes by the SSB of the IBIs.

As a general principle of Islamic Commercial Law, any harm or injury inflicted upon a party by the breach of financial contract has to be remedied by the one who has committed the breach. The Latin maxim "*Ubi jus, ibi remidium*"[122] (where there is a right, there is a remedy), clearly explains the importance of remedies in case of the infringement of any right. The Islamic Law remedies and those provided in Pakistani legislation have been discussed in detail in

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[121] Ibid,116

[122] Bryan A. Garner, *Black's Law Dictionary*, (USA: West Group Publishing Co., 1999) 7th edition, 1695

chapter four. These remedies are similar to each other except for a few provisions in the Pakistani law which allows the increase in payment of debt by way of penalty. However, by the historic judgment of the SCSAB, we infer that anything that is repugnant to the injunctions of the Shari'ah is not applicable. Speaking specifically about the IBs and IFIs, they follow the principles of Shariah Standards and thus the laws of Contract Act are not enforceable if they are not Shari'ah compliant.

The issue of the remedies which are availed by the IBIs has established that somehow or the other, all the remedies are according to the injunctions of Islam. There are some issues which need to be reviewed but generally, the IBIs have Shariah compliant remedies. Though it seems against the reasoning to allow something prohibited to avoid the default e.g. the stipulation of compulsory charity. It is the increase in the payment which is apparently prohibited but since it is just an undertaking by the client which is a kind of vow to Almighty to pay the amount in case of default, there is a room for its permissibility. And it is not used by the IBs and IFIs themselves; rather it is used for needy persons which makes it something that is in the great public interest.

Though many efforts are being made by the SBP to improve the Islamic financial system, still there is need for making unanimous laws which govern all the IBs and IFIs throughout Pakistan. And there is a need for legislation to prevent the chances of breach, and in case of such breach the Shari'ah compliant remedies are to be framed for all the IBs and IFIs as a codified law governing all the banks in Pakistan.

RECOMMENDATIONS

Following recommendations have been drawn from the conclusions:

1- A unanimous Islamic Commercial Law should be legislated for all the IBs and IFIs which should be codified in order to be enforced in the Islamic Financial system throughout in Pakistan. The legislation should focus on giving protection to the IBs and IFIs against defaulters.

2- The SBP should strengthen its Shariah Compliance Mechanism (SCM) in order to bring conformity of the practices of IBs and IFIs according to the Shari'ah. This SCM should be comprehensive, flexible and acceptable locally and internationally.

3- There is a need for a sound regulatory framework to minimize the risks faced by IBs and IFIs and problems related to the difficulty in enforcing contracts. Such regulatory framework should make the system of early recovery efficient and effective.

4- International Islamic Infrastructure Institutions like AAOIFI and Islamic Financial Services Board (IFSB) should be consulted in providing roll out plans and strategies not only to improve the system of Islamic finance through its products, but also to decrease the cases of default by the clients and by minimizing the risks faced by the modern IBs and IFIs in financial contracts.

5- Special Review Boards (SRB) should be established in the IBs and IFIs to examine the application of the remedies for breach of modern types of financial contracts.

6- Though Supreme Court Shariat Appellate Bench repealed all the laws that were against the injunctions of Islam, in its historic judgment on interest, still there is a need of repealing or modifying all the provisions of existing Pakistani laws allowing interest in any of its form e.g.

illustration (n) of section 73 and the explanation of section 74 of the Contract Act IX of 1872; section 61 of the Sale of Goods act 1930 etc.

7-The Government should enhance the human resource development in the field of Islamic finance and economics. It should also plan a strategy for providing compulsory training to the bank staffs on Islamic banking and finance and education. Public awareness about Islamic financial system should be enhanced.

8-The SBP should focus on developing a system where the defaulters are duly punished by depriving them from enjoying a financial facility in future.

8- Finally, the government must take steps to chalk out the plan of transformation of Pakistan's financial system from interest based to Shari'ah compliant. This will improve the system that provides remedies to the IBs and IFIs for breach of contracts and ultimately will result in minimizing the cases of default.

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