

PREFERENCE SHARES FROM SHARIAH PERSPECTIVE: ISSUES AND SOLUTIONS

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ABSTRACT

Preference shares have their own characteristics that make them different from ordinary shares. Moreover, they can be divided into various types based on unique features embedded in each type. This paper aims to scrutinise the different types of preference shares to identify related Shariah issues and subsequently propose solutions for the identified issues that would help in structuring Islamic preference shares. This paper employs a qualitative method by analysing relevant documents and literature to understand the subject-matter and Shariah-related issues. This paper finds that several features of conventional preference shares make the instrument as Shariah non-compliant. These are; (i) capital guarantee; (ii) loss sharing disproportionate to capital contribution; (iii) fixed profit; (iv) profit guarantee; and (v) waiving of right prior to realisation of profit. It is noted that there are a few articles discussed on preference shares. Nevertheless, this paper is significantly different from the others in term of in-depth analysis for each type of preference shares and the proposed Shariah-compliant solutions.

Keywords: Preference shares, *mushārahah*, Shariah issues

INTRODUCTION

Issuing preference shares is one of the well-established ways of raising capital. In the contemporary time, preference shares are attributed with different preferential and special rights. In International Financial Reporting Standards (IFRS)-based financial reporting, depending on the rights of the preference shareholders and obligations of the issuing entity, a preference share can be classified as an equity or as a liability instrument, even as a compound instrument—comprising both equity and liability components. There is no one classification that fits all. However, one common feature is that preference shareholders have prior claim than the ordinary shareholders on the issuing entity's distributable earnings and on net assets at the time of liquidation, but subordinate to the bonds and other types of debts. The preferential rights over ordinary shares raise concerns from Shariah standpoint, specifically about the classification and acceptability. Based on the rulings of *mushārahah*, pre-agreeing a dividend rate, granting one party priority over another in profit distribution and guaranteed capital repayment are not allowed.

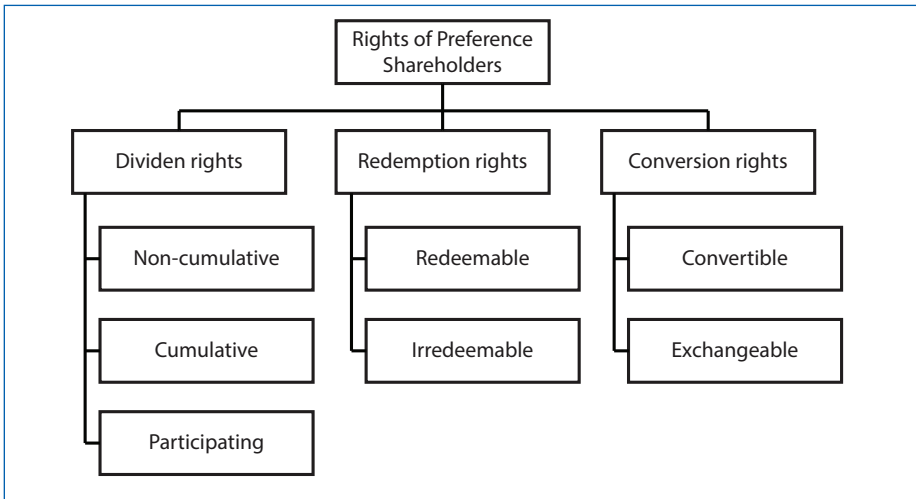
Noting the above perplexities, this paper explores the Shariah issues by taking into consideration the equity classification of preference shares. Therefore, the rulings of *mushārah* are applied by deliberating on it.

DEFINITION OF PREFERENCE SHARES AND ITS TYPES

Bursa Malaysia (n.d.) defines preference shares as shares which carry the right to dividend (normally fixed) which ranks for payment before that of ordinary shareholders. Preference shares may be preferred also as regards to distribution of assets upon dissolution of a company.

Over the history of corporate finance, preference shares went through an evolution in terms of rights that can be attached to it. **Figure 1** identifies the commonly observed rights that can be awarded in a present-day preference share issuance.

Figure 1:
Rights of preference shareholders



Source: Authors' Own

Dividend Rights

Preference shares are presumed to have cumulative dividend rights unless expressly stated as non-cumulative (Sulaiman, 2015). The non-cumulative dividend feature allows the entity to cancel dividend payments for the year(s) the predicaments exist. The cumulative dividend feature allows the preference shareholders to receive dividend irrespective of the performance of the issuing

entity. In the years of liquidity shortage or insufficient distributable profit, the issuing entity may postpone the distribution with obligation to distribute the same in the future. With the cumulative dividend feature, the preference shareholders have the right to receive unpaid dividends before the ordinary shareholders receive any dividend. The existence of cumulative dividend feature makes a preference share closer to a debt instrument.

A preference share may also offer participating dividend feature to its holder. With this feature, the preference shareholders are entitled to a fixed rate dividend as well as the right to participate in the residual earnings of the issuing entity along with the ordinary shareholders.

Redemption Rights

A preference share can be redeemable or irredeemable. The redemption feature allows a preference shareholder to surrender its shareholdings to the issuing entity on or after a predetermined time, in which case the issuing entity is obliged to pay back the original issue price or another pre-agreed amount to the shareholder.

The irredeemable preference shareholders can sell their shares in the secondary market to a willing party at a mutually agreed price. But, they do not have any contractual right to redeem their shares by surrendering it to the issuing entity. This puts them in a similar position as the ordinary shareholders.

Conversion Rights

A preference share may have the feature to convert it into ordinary share of the same issuing entity at a predetermined rate on or after a predetermined future date. The conversion can be based on fixed number of ordinary shares for fixed number of preference shares (for example, one preference share will be converted into two ordinary shares) or can be based on variable number of ordinary shares for fixed number of preference shares (for example, one preference share will be converted into a variable number of ordinary shares of RM10 market value, determined on the conversion day). The conversion to the ordinary shares can be at the sole discretion of the preference shareholders or can be automatic after lapse of a certain period, marked as the maturity of the preference share.

Similarly, a preference share may have the feature to exchange into share or other financial instrument of another entity. For example, preference shares issued by Company A may have the feature to exchange with shares or other financial instruments issued by Company B. Company A either already own the required instruments of Company B, or Company B provides guarantee to Company A to issue required instruments if the preference shareholders of Company A wish to exchange their holdings with instruments of Company B. The exchange rate can be fixed-for-fixed or fixed-for-variable as discussed in the previous paragraph.

THE CONCEPT OF MUSHĀRAKAH

The following sections discuss briefly on the meaning of *mushārah* and its important rulings which are related to profit and loss sharing.

Mushārah and its Rulings

Mushārah or *sharīkah* is categorised into two types; (i) *sharīkah al-milk* (partnership in ownership); and (ii) *sharīkah al-`aqd* (contractual partnership). The latter type is related to joint investment and sharing of profit and risks, which is the case for preference shares. Therefore, following discussion focuses on *sharīkah al-`aqd*.

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in Shariah Standard No. 12 (Item 2/1) defines *sharīkah al-`aqd* as “an agreement between two parties to combine their assets, labour or liabilities for the purpose of making profits”.

Bank Negara Malaysia (2016), in *Shariah Standards and Operational Requirements*, defines *mushārah* as “a partnership between two or more parties whereby all parties will share the profit and bear the loss from the partnership”.

Based on the above definitions, it can be concluded that a *mushārah* contract refers to an investment or trade agreement between two or more parties whereby all parties contribute a capital and share the profit and loss. Preference shareholders have the resemblance to the partners in a *mushārah*. They invest capital alongside the ordinary shareholders and take part in profit distribution of the company as well as bear the risk of capital loss. As previously discussed, like ordinary shares, the preference shares may have features similar to equity and can be classified as such in the books of the issuer.

The most important feature of *mushārah* is profit and loss sharing between the partners. Existence of any agreement or condition that contravene this feature cause the *mushārah* contract void.

The Shariah scholars opined two different opinions with regards to the distribution of profit in a *mushārah* contract as follows:

First opinion: The profit must be shared according to the capital contribution of the partners.

Zufar from the hanafis (al-Kāsānī, 1986), Mālikīs (Malik, 1994) and Shāfi`īs (al-Sharbinī, n.d.) are of view that the profit sharing must be proportionate to the capital contribution of each partner. The argument in support of this opinion is that profit in a *mushārah* venture is derived from the growth of capital.

Second opinion: The profit-sharing ratio can be agreed by contracting parties

The Hanafi (al-Kāsānī, 1986) and Hanbalī (Ibn Qudāmah, 1968) scholars are of view that the profit-sharing ratio not necessarily has to be in proportion to the capital contribution. The partners can determine a profit-sharing ratio in the premise of mutual consent. However, the Hanafi School do not allow for a sleeping partner to receive profit in proportion higher than the capital contributed if he stipulates that the work will be done by the other partner (Ibn `Ābidīn, 1992).

With regard to loss, the scholars unanimously agree that the loss sharing must be proportionate with capital contribution (al-Kāsānī, 1986; Malik, 1994; al-Sharbīnī, n.d; Ibn Qudāmah, 1968 ;).

SHARIAH ISSUES IN PREFERENCE SHARES

The International Islamic Fiqh Academy of the Organisation of Islamic Cooperation (IIFA-OIC) and AAOIFI resolved that the preference shares are not permissible due to the existence of fundamental features that are deemed to be Shariah non-compliant.

The IIFA-OIC (1992) resolved that:

“It is not permissible to issue preference shares, which have financial features that lead to a guarantee of capital and fixed return, priority [over other shareholders] in the event of liquidation or at profit distribution.”⁴

The IIFA-OIC (2003) further resolved that:

“... it is not permissible for a company to issue preferred shares or preference shares or debentures. Fourthly, in occasions when the company suffers losses, it is compulsory for every shareholder to bear his share of the loss, in proportion to his capital contribution.”⁵

AAOIFI in Shariah Standard No. 12 (Item 4/1/2/14) states that:

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

The basis of impermissibility of preference shares is that it violates the profit-sharing principle and causes injustice to the other partners (AAOIFI, 2015)

⁴ 7th session held in Kingdom Saudi of Arabia in <http://www.iifa-aifi.org/1845.html>

⁵ 14th session in Qatar Resolution no. 130 (4/14), available at: <http://www.iifa-aifi.org/2120.html>

This paper has identified five (5) Shariah issues in preference shares as follows:

- (i) Capital guarantee
- (ii) Loss sharing disproportionate to capital contribution;
- (iii) Fixed profit;
- (iv) Profit guarantee; and
- (v) Waiving of right prior to realisation of profit.

First issue: Capital guarantee

The element of capital guarantee that comes from the partners contravenes a primary principle of *mushārah* contract. In the context of preference shares, the capital guarantee is provided by the ordinary shareholders as partners in equity capital of the company.

AAOIFI Shariah Standard No. 12 (Article 3/1/4/1) states:

“All partners in a *sharikah* contract maintain the assets of the *sharikah* on a trust basis. Therefore, no one is liable except in cases of misconduct, negligence or breach of contract. It is not permitted to stipulate that a partner in a *sharikah* contract guarantees the capital of another.”

The BNM (2016) also stated the same ruling as follow:

“S 15.14: The capital invested shall not be guaranteed by any of the partners and/or the managers.”

The capital guarantee happens in the following types of preference shares:

(i) Redeemable preference shares

The shares can be redeemed at the option of the holder or the issuer or mandatorily redeemed on maturity. The redemption amount ideally is equal to the amount invested by the preference shareholders (i.e. the issue price) plus accrued but unpaid dividend (if any).

From Shariah perspective, if the redemption amount is equal to the issue price, it is considered as guaranteeing the capital. This is because, in principle, the issuer has a contractual obligation to pay the capital in full to the preference shareholders upon redemption if the redemption right is held by the preference shareholders or it is a mandatory redemption. This kind of arrangement can be considered as a contractual or constructive promise from the issuer to payback the capital to the preference shareholders once the redemption right is exercised as it is agreed upon subscribing the preference shares.

(ii) Convertible preference shares

As mentioned earlier, the conversion can be based on fixed number of preference shares to variable number of ordinary shares (fixed to variable) or fixed number of preference shares to fixed number of ordinary shares (fixed to fix).

From the Shariah perspective, the element of capital guarantee exists if the conversion is fixed to variable. This is because even though the preference shareholders will not get their capital back in form of cash, they will get equal worth of ordinary shares. They can sell those shares in the market if they wish so and retrieve their capital from the market. For example, an entity has issued 100,000 convertible preference shares for RM10 each (i.e. total issue price: $100,000 \times \text{RM}10 = \text{RM}1,000,000$). These shares can be converted into a variable number of ordinary shares, at a market price of which equals to RM1,000,000 at the time of conversion. At the time of conversion, if the market price per ordinary share is RM8, the preference shareholders will receive $(\text{RM}1,000,000 \div \text{RM}8) = 125,000$ ordinary shares. If the market price is RM5, the number of ordinary shares will be $(\text{RM}1,000,000 \div \text{RM}5) = 200,000$. In any case, the preference shareholders will receive ordinary shares worth of RM1,000,000, which is equivalent to their original invested amount.

However, there is no element of capital guarantee in the case of fixed to fixed conversion. This is due to the uncertainty in market value of the ordinary shares at the conversion date. The market value may or may not be equal to the capital originally invested by preference shareholders. For example, an entity has issued 100,000 convertible preference shares for RM10 each. The conversion ratio is two preference shares into three ordinary shares that is the preference shareholders will receive 150,000 ordinary shares on conversion. At the time of conversion, if the market price per ordinary share is RM8, the capital gain will be RM200,000 being the difference between the capital outlay ($100,000 \times \text{RM}10 = \text{RM}1,000,000$) and market value of ordinary shares at conversion ($150,000 \times \text{RM}8 = 1,200,000$). If the market price per ordinary share is RM5, the capital loss will be RM250,000 as the market value of the ordinary shares will be $150,000 \times \text{RM}5 = 750,000$ at conversion.

Second issue: Loss sharing disproportionate to capital contribution

The preference shareholders are ranked ahead of the ordinary shareholders at the time of liquidation and winding up. They can claim their capital before ordinary shareholders. This may result in no or a lesser share of capital recovery by the ordinary shareholders as it is subject to the availability of liquidation proceeds after settling all payments to the prioritised parties, i.e. creditors and preference shareholders. Thus, there is a potential for disproportionate loss sharing among the parties (i.e. ordinary and preference shareholders) that contributed capital in the business.

In *mushārah* contract, all parties must bear the risk of capital loss. Eliminating the risk violates objective of the contract (*muqtadā al-`aqd*) of *mushārah*. Furthermore, from earlier discussion on loss sharing in *mushārah*, it is evident that the loss must be based on capital contribution. This is also stated by AAOIFI Shariah Standard No. 12 (Article 3/1/5/4) and BNM (2016) in Policy Document *Musyarakah* in S 17.1.

Third issue: Fixed profit rate

The dividend rate of preference shares is fixed of the capital contribution. For example, a 6 percent RM1,000,000 preference shares will give dividend of RM60,000 per year. Whereas, in a *mushārah* contract, the profit distribution may be based on the ratio of capital contribution or any other ratio agreed between the capital contributors. This cannot be a fixed amount or a fixed rate of the capital contribution. This is because a fixed amount or a fixed rate of the capital contribution defeats the concept of profit sharing (Ibn Qudāmah 1968; AAOIFI, 2015; BNM, 2016).

Fourth issue: Profit guarantee

Pursuant to the issue of fixed profit rate, there is a guaranteed dividend pay-out to the preference shareholders. The guarantee is contractual in the case of cumulative preference shares and constructive in the case of non-cumulative preference shares. In the case of cumulative preference shares, the issuing entity holds a contractual obligation to pay-out periodical dividend, and any unpaid dividend is accrued as liability in the books of the issuer. Whereas, even though the issuing entity hold discretion to pay-out any dividend in the case of non-cumulative preference shares, there is constructive obligation for the issuing entity to pay-out dividend if the entity has sufficient distributable profit. The existence of profit guarantee element is prohibited in *musyārah* contract (AAOIFI, 2015; BNM, 2016).

Fifth issue: Waiving of right prior to realisation of profit

The partners in a *mushārah* have the right to receive profit at the same time. However, the ordinary shareholders waive their right to give priority to the preference shareholders. The consent of waiving the right is given expressly (in form of expressed words) or by default (by agreeing to issue preference shares and its features) at the general meeting where the decision to issue preference shares is taken. This means that the ordinary shareholders waive their right before realisation of the profit and before existence of cause. It triggers the Shariah issue, can a person waive his right or entitlement to monetary benefit prior to realisation of profit?

The waiver of right in this situation is related to upfront *tanāzul* (waiver of right). This paper refers to the discussion on *isqāt al-haqq* and *ibrā`*, which were used

by classical scholars while discussing waiver of rights (Al-Kāsānī, 1986; Wizārat al-Awqāf wa al-Shu`ūn al-Islāmiyyah, 1992).

Based on traditional jurists' discussion on the issue of *ibrā`* or *isqāt al-haqq* that is done before the right is effective, there is no dispute among jurists that an upfront waiver of right prior to occurrence of the cause triggering entitlement to that right is not allowable. This is because when there is no cause for the existence of the right, the right has not yet come into realm of entitlement. Thus, it is inconceivable that the waiver of right could happen on something which does not yet come into ownership of the waiving party. On top of that, it is also argued that any waiver before realisation of profit makes it a condition in the contract and such condition violates the principle of profit sharing in *mushārahah*.

STRUCTURING SHARIAH-COMPLIANT PREFERENCE SHARES

To be compliant with Shariah, any features that contradict the essential objective of the *mushārahah* contract as discussed above must be avoided in structuring the Islamic preference shares. Therefore, the authors propose the following solutions for every Shariah issues mentioned above.

(i) Issue of capital guarantee

To avoid any contradiction with Shariah principles in general and *muqtadā al-`aqq* of *mushārahah* in specific, the element of capital guarantee in preference share can be solved by the following:

a. Redemption

The redemption price must be based on market price or the agreed price upon redemption. At the inception of *mushārahah* contract, i.e. upon subscription of preference shares, the issuer may promise to redeem the preference shares or the subscribers promise to redeem their capital at market price or agreed price determined upon redemption. This kind of promise does not constitute a guarantee of capital. Dallah Al-Barakah (2001) stated that the preference shares comply with Shariah if the redemption price is based on market price as it does not constitute a guarantee of capital.

b. Conversion

The conversion must be based on fixed number of ordinary shares for fixed number of preference shares. As illustrated earlier, a fixed to fixed conversion avoids capital guarantee as the market value of ordinary shares at the date of conversion can be a different amount than the capital injected upon subscription of preference shares.

c. Issue of loss sharing disproportionate to capital contribution

The potentiality of loss sharing disproportionate to capital contribution arises from a primary feature of preference shares, which is the priority right to its holders in claiming capital in the event of liquidation or winding up of the company. This priority right is granted during subscription of the preference shares. This is before the event of liquidation or winding up when the loss is determined. This kind of pre-agreed immunity arrangement contradicts with the principle of loss sharing in *musharakah* contract. Having said that, in the event of occurrence of the loss - not before that - the ordinary shareholders may agree to waive their right of loss sharing in proportion to their capital contribution, and agree to bear additional loss by bearing full or a partial loss of the preference shareholders. This is because all jurists are of the view that the waiving of right is permissible after the right is established. Therefore, in the context of bearing additional loss, any agreement done after the realisation of loss is permissible as it does not lead to loss sharing disproportionate to capital contribution. This is considered as *tabarru`* from a partner to another partner. Furthermore, the permissibility of bearing the loss by one party at the time of the loss is mentioned clearly by AAOIFI in Shariah Standard No. 12 (Article 3/1/5/4).

A conditional waiver of right clause can ensure avoidance of pre-agreed upright immunity to the preference shareholders in bearing their share of loss. Therefore, this paper proposes that the preference share subscription documents may put a clause that the ordinary shareholders agree to give priority to the preference shareholders in claiming their capital in the event of winding up or liquidation of the company, with condition it is subject to the approval of the board of directors at the point of occurrence of the event. The board of directors as representatives of the ordinary shareholders will hold the discretion to approve or otherwise.

d. Issue of fixed profit

Based on the jurists' discussion on the impermissibility of fixed profit, it was highlighted that such practice violates the principle of profit sharing, which is the essence of the partnership contract.

However, if it is agreed that a party will get fixed profit with a condition that the entitlement of that amount is subject to availability of profit more than a certain amount or percentage, hence, this kind of arrangement does not lead to non-sharing of profit. This is because the fixed profit is given to a partner and the remainder is shared between the partners in accordance with the pre-agreed profit sharing ratio. For example, they agree that a party will be given RM100 if the realised profit exceed RM200 and if it is only RM100 or below, the profit-sharing ratio is based on their capital contribution. In this example, all parties will enjoy their profit based on their agreement and this arrangement does not violate the principle of profit sharing.

In this regard, `Ali al-Khafif views that fixed return is allowable in *mudārabah* if a partner will be getting the fixed amount of profit if the profit derived from the venture is more than certain amount of profit. This is because this kind of agreement does not lead to non-sharing of profit. Al-Khafif (2009) said:

"وعلى الجملة فكل شرط يقتضي جهالة الربح أو يفضي في بعض الأحيان إلى قطع الشركة فيه يفسد المضاربة. أما إذا لم يؤد إلى ذلك فإنه يصح متى لم يخالف مقتضاها. وعلى ذلك إذا شرط لأحدهما دراهم معدودة معلومة إن زاد الربح على مقدار كذا من الدراهم فإن ذلك الشرط صحيح لا يؤثر في صحة المضاربة."

"And in summary, any condition that leads to ignorance of profit or results, sometimes, in diluting the partnership nullifies *mudārabah*. But if it (condition) does not lead to that, then it is valid when it (condition) does not violate purpose of *mudārabah*. Consequently, if the condition is such that one party will get few determined dirhams if the profit increases over such amount of dirham, then this kind of condition is valid and it does not affect the validity of *mudārabah*."

Even though the above discussion is related to *mudārabah* contract, but the same ruling could be applied in *mushārahah* contract as well. This is because both are considered as *sharikah* (partnership) contract, thus the conditions of profit that need to be fulfilled are the same.

e. Issue of profit guarantee

A partner in *mushārahah* contract is not allowed to guarantee the profit of the other partner. In cumulative preference shares, it is common that the cumulative dividend which is accrued and unpaid due to the company is distressed in particular year(s) will be paid upon redemption. This kind of arrangement is prohibited as it is tantamount to profit guarantee and against the principle of loss sharing. Therefore, to ensure that the preference shares comply with Shariah, the payment of dividend must be subjected to the realisation of profit. Consequently, the redemption price must exclude any payment of unpaid cumulative dividend. However, in the event that the company makes a profit whereby the dividend in a year is announced and the preference shareholders agree to defer the receipt of the dividend payment, the dividend can be paid either in the following year or be included in the redemption price (if any). This is because the deferred dividend becomes a debt, in which the issuer has an obligation to pay to the preference shareholders.

Regarding the deferment of profit payment, it is allowable if the holder of the right has agreed to that. Any agreement which is based on the concept of *al-tarādī* (mutual consent) is allowable in Islam as long as it does not contradict al-Quran and al-Sunnah. Furthermore, this deferment can be supported by a consensus view in term of permissibility of setting aside a portion of realised profit in a

reserve account in order to manage any loss in the future. In the future, they can redistribute the “delayed profit” based on PSR agreed by them upon concluding the contract (AAOIFI, 2015).

f. Issue of upfront *tanāzul* before realisation of profit

The following discussion on upfront *tanāzul* will be based on the jurists’ discussion on the issue of *ibrā`* or *isqā`* that is done before the right is effective. This is because the meaning of *tanāzul* covers *ibrā`* and *isqā`*, in which both terms denote waiver (Badri & Mohamad, 2014).

Regarding exercising *ibrāt* and *isqā`* before the effectiveness of the right, there are two situations:

- i) The *ibrā`* or *isqā`* is made **before** the existence of the cause for the effectiveness of the right (*qabl wujūd sabab al-wujūb*); and
- ii) The *ibrā`* or *isqā`* is made **after** the existence of the cause for the effectiveness of the right (*ba`da wujūd sabab al-wujūb*).

For the first situation, it was mentioned earlier that the jurists are unanimously of the view that the waiver of right is not allowable.

However, for the second scenario whereby the waiver of right is made after the existence of cause, there are two views as follows:

First opinion: The waiver of right is invalid

This is the view of some jurists of Shafi`i Schools (al-Ramlī, 1984). An example for this scenario is buyer’s waiver of imposing liability (*damān*) onto seller for any defects before the defects are yet to be realised. Per this view, the waiver is invalid even though the cause which is the sale contract already exists.

Second opinion: The waiver of right is valid

This is the view of hanafis (al-Kāsānī, 1986; al-Sarakhsī, 1993), the hanbalis (al-Buhūti, 1982), a view in Mālikī School (‘Alish, n.d.) and a non-preferred view among Shafi`i School (al-Ramlī, 1984).

Al-Sarakhsī (1993, 24:92) considers *al-`afw* (an injured person forgiving the inflictor of the injury) as a waiver of right before the effectiveness of the right but it is valid and recognised by Shariah because it is done after the existence of a cause.

Preferred view

After analysing both opinions, this paper adopts the second opinion as preferred opinion which states the validity of the waiver if it is done after the existence of cause even though the right is yet to be effective. This is because there is an evidence in al-Qur`ān (Surah al-Baqarah: verse 178) where Allah SWT clearly states his recognition to *al-`afw*.

As mentioned by al-Sarakhsi, *al-`afw* is a waiver of rights before the effectiveness of the right but it is done after the existence of the cause, which is murder. Based on the above recognition from Allah SWT, it is sufficient enough to support the permissibility of waiver to be done before the effectiveness of the right as long as the cause is in existence. As a conclusion, the upfront *tanāzul* is permissible as long it is done after the existence of the cause. Therefore, the Islamic preference share may adopt the concept.

However, there are two other solutions to be considered. They are (a) promise to make a waiver of right (*al-wa`d bi al-tanāzul*) and (b) conditional *tanāzul* (*tanāzul mu`allaq*).

It is acceptable in Islam to make a promise to waive a right even though the right is yet to be effective. It is because promises are meant for future obligation and not on actions that can be offered immediately. Therefore, a promise to give a waiver in the future can be done even though the right or cause of the right is yet to exist.

Regarding the *tanāzul mu`allaq*, this paper refers to jurists' discussion on *isqāt mu`allaq* because both are having the same meaning as mentioned before.

In the discussion, they divided *isqāt* into three (3) categories: (i) pure waiver (*isqāt mahd*); e.g. *shuf`ah* (pre-emption), (ii) *isqāt* which is exchanged for a consideration (*isqāt bi iwad*) but does not imply transfer of ownership; e.g. *khulu`* (divorcing a wife with consideration) and (iii) *isqāt* which is not exchanged for a consideration but implies transfer of ownership; e.g. relinquish a debt from other's liability (*ibrā`an dayn*).

This paper focuses on the third category only because the current practice of waiver of right in preference share is without consideration but it affects a transfer of ownership. The ordinary shareholders waive their right towards the dividend by giving a priority to the preference shareholders to receive it first. As the waiver of right involves a transfer of ownership, is it permissible to make it conditional (*ta`liq*) on the occurrence of an event in the future?

According to Hanafi (al-Kāsānī, 1986), Shāfi`ī (al-Sharbīnī, n.d.) and Hanbalī (al-Buhūti, 1982) jurists, a conditional *isqāt* which implies transfer of ownership is not permitted. This is because the offer to transfer ownership must be definitive and unambiguous. Any stipulation in a contract that the ownership will be transferred upon occurrence of something in the future will make it uncertain because the future occurrence is also not certain.

However, according to Mālikī jurists (al-Hattāb, 1992; al-Dasūqī, n.d.), it is permissible to make an *isqāt* in contingent upon a future event if it is without consideration even though it involves a transfer of ownership. In other words, they allow a conditional transfer of ownership if it is without consideration. Hence, we can say that the *tanāzul mu`allaq* here connotes *hibah mu`allaqah*. Both

concepts are similar in the sense that the ownership is transferred by one party to another without expecting any consideration.

Regarding *hibah mu`allaqah*, it is allowed by Mālikīs (al-Dasūqī, n.d.), some Hanafīs (al-Kasānī, 1986) and some Hanbalīs such as Ibn Taymiyyah and Ibn al-Qayyim (Ibn al-Qayyim, 1977). Their argument is based on the following *hadīth*:

عَنْ جَابِرِ بْنِ عَبْدِ اللَّهِ رَضِيَ اللَّهُ عَنْهُمَا قَالَ: قَالَ النَّبِيُّ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ: «لَوْ قَدَّ جَاءَ مَالُ الْبَحْرَيْنِ قَدْ أُعْطَيْتُكَ هَكَذَا وَهَكَذَا وَهَكَذَا». فَلَمْ يَجِئْ مَالُ الْبَحْرَيْنِ حَتَّى قُبِضَ النَّبِيُّ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ، فَلَمَّا جَاءَ مَالُ الْبَحْرَيْنِ أَمَرَ أَبُو بَكْرٍ فَنَادَى: مَنْ كَانَ لَهُ عِنْدَ النَّبِيِّ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ عِدَّةٌ أَوْ دَيْنٌ فَلْيَأْتِنَا، فَأَتَيْتُهُ فَقُلْتُ: إِنَّ النَّبِيَّ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ قَالَ لِي كَذَا وَكَذَا، فَحَتَّى لِي حَتِيَّةٌ، فَعَدَدْتُهَا فَإِذَا هِيَ خَمْسُ مِائَةٍ، وَقَالَ: خُذْ مِثْلَهَا.

Jābir reported: The Prophet SAW said to me, "When the revenues of Bahrain arrive, I shall give you such and such and such." He passed away before the revenues were received. When they arrived during the caliphate of Abū Bakr RA, he ordered to be announced, "Anyone whom Messenger of Allah SAW promised or owed anything, should come to him." I went to him and said, "Messenger of Allah SAW told me such and such." He took a double handful out of the money and gave it to me. I counted it and found that it was five hundred dirhams. Then Abū Bakr RA said to me, "Take twice as much more of that amount" (al-Bukhārī, 1422AH, *hadīth* no. 2297, 3:96).

However, according to the Hanafīs (al-Kasānī, 1986), the Shafī'īs (al-Shirāzī, 1995), some Hanbalīs (Ibn Qudāmah, 1995) and Zahiris (Ibn Hazm, n.d.), *hibah mu`allaqah* is prohibited because the *ta`liq* makes the contract having an element of ambiguity (*gharar*) which is prohibited in Islam. The issue of *gharar* raises because the subject matter of *hibah mu`allaqah* is uncertain as it is closely dependant on future event that may happen or otherwise.

This paper prefers to adopt the first opinion which permits *hibah mu`allaqah*. Though there is an element of *gharar* in *hibah mu`allaqah*, there is a well known principle that *gharar* in a contract that is classified under category of *tabbaru`* (charitable) such as *hibah* is tolerable. On top of that, the prohibition of *gharar* in exchange contract, which is only limited to excessive *gharar* lays on the basis that it will lead to dispute among the contracting parties and cause harm to one of them. In *tabbaru`* contract, the dispute is not possible to happen because the contracting party gives something to the other party for free and without expecting any consideration in exchange. This is unlike in exchange contract whereby a party gives something to the other party who expects to receive something which is worth to what he gave. On top of that, if the party makes the *hibah* contingent with a condition, this kind of arrangement would not lead to

dispute or cause any harm to other party since the recipient of *hibah* pays nothing for what is offered by the giver.

In the application of *hibah mu`allaqah* in preference shares, the issuer (i.e. company) may state in a legal document that it will give a specific amount of dividend to the preference shareholders but it is subject to the Board of Director's ratification upon distribution of dividend. This means *tanāzul* or *hibah* is not effective until the board approve it upon realisation of profit. Since *tanāzul* or *hibah* only happens after the realisation of profit, thus the contentious issue of upfront *tanāzul* as well as profit guarantee are no longer in the picture.

CONCLUSION

This paper finds that there are different types of preference shares, which have different unique features. This paper also finds that most conventional preference shares are not compatible with the Shariah rulings of *mushārahah*. The paper identifies five (5) main Shariah issues that are commonly found in preference shares namely; (i) capital guarantee; (ii) loss sharing disproportionate to capital contribution; (iii) fixed profit; (iv) profit guarantee; and (v) waiving of right prior to realisation of profit.

To address the issue of the capital guarantee which exist in redeemable and convertible preference shares, the paper proposes that the redemption price must be based on market price or the agreed price upon redemption and the conversion must be based on fixed number of ordinary shares for fixed number of preference shares.

In term of loss sharing disproportionate to capital contribution, it can be avoided if the ordinary shareholders waive their right by agreeing to give priority to preference shareholders to receive their capital before the ordinary shareholders, if the waiver of right is only given at the point of winding up or liquidation and not at outset. Thus, in this regard, the upfront *tanāzul* is not permitted to be given as it leads to the above mentioned Shariah issue.

Regarding the issue of fixed profit, the study finds that it is permissible to give a fixed return to any partners with a condition that it does not violate the principle of profit sharing. This can be done by giving a certain profit to a partner with a condition that the realised profit exceeds certain amount. Therefore, if the condition is not fulfilled, the distribution is based on agreed profit sharing ratio.

To address the issue of profit guarantee, the paper proposes to exclude any unpaid cumulative dividend (interest in substance) from redemption price. However, if there is actual dividend announced in a year but the payment is deferred, the unpaid dividend must be included as it is considered as debt. In this case, the debt

can be paid in the following year or can be paid upon redemption by including the amount (if any) in the redemption price.

Regarding waiving of right prior to realisation of profit, the study prefers to accept a view which permits an upfront *tanāzul* to be given after the existence of the cause i.e. execution of *mushārahah*, even though a right is yet to exist i.e. the profit is not realised. However, the study also proposes other solutions which are: i) *wa`d* (promise) to make a waiver of right and; ii) conditional *tanāzul* as alternative to upfront *tanāzul* to those who of the view that upfront *tanāzul* is not permitted even though if it is given after the existence of the cause.

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