

An Analysis of Corporate Entity and Limited Liability in Islamic and Western Perspectives of Corporate Governance

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ABSTRACT

A company being a distinct and separate legal entity is quite distinct from its members wherein the company itself as a separate person conducts own business through the management. The liability of the company as a legal person might be unlimited but the liability of its members might be to the extent of their share or contributions. The company's management as corporate agent and trustee of its assets not only run its business affairs but also they are accountable to the members of the company. The principle of legal entity is evolved from common law jurisdiction in case Salomon v A Salomon & Co Ltd, but the three institutions such as Bait-ul-Mal, Waqf and Masjid provides the concept of legal person in Islamic system (Shari'ah) since ages.

Key words: legal person; corporate liability; Bait-ul-Mal; Waqf and Masjid; Shirkat-ul-Amwal; Shirkat-ul-Mal; Shirkat-ul-Wujuh

1. Introduction

A company is a species of corporation and has a dual nature as both an association of its members and legal or artificial person which is quite distinct from its members. A company being a legal and separate person can own property for its organisational benefits and interests rather than as agent or trustee of its members.

A company being a distinct and separate legal entity from its members have rights and duties. The company can sue against any person to enforce its rights and be sued for any breach like any other person. The company's business is conducted by the company as a separate person rather than for its members. Company being a person enters into contract with other parties even with its members in relation to company business and property. The liability of the company as a legal person might be unlimited but the liability of its members might be to the extent of their share or contributions. However, the natural persons being the agent of company and trustee of its assets run the affairs of company but they are accountable to the members of the company. The case Salomon v A Salomon & Co Ltd, clearly established the principle of distinct legal personality of the company in British jurisdiction. In Islamic perspective, the concept of legal personality is clear in the light of these three institutions, Bait-ul-Mal, Waqf and Masjid which were developed in Khilafah (Islamic State) through the ages.

2. Corporate Entity and Limited Liability in Islam

The concept of a company does not appear to be against the Injunctions of Islam. The formation and incorporation of a company under any legislative procedure of the state has a legal status of artificial person having legal entity rather a natural person with some rights and obligations. For instance, a company can acquire any property in any capacity (i.e. as an Owner, Lessee, Pawnee and Mortgagee etc.), alienate its property, sue and be sued on its own name, manage its property or affairs according to its constitution, incur financial liabilities and acquire financial rights. In Islamic system, examples relating to incorporation and formation of legal persons i.e. Bait-ul-Mal, Waqf and Masjid can be found which have all of the afore-mentioned characteristics of legal person

The concept of Company limited by shares prevailed in modern corporate scenario is not repugnant to the Injunctions of Islam because the status of an institution as a legal person is not prohibited by Islamic system (Shari'ah). A company limited by share is incorporated by group of natural or artificial persons. They subscribe different number of shares with equal denomination and therefore their liability is limited to the extent of their shares' subscription. However, a company as a legal personality has unlimited liabilities to its creditors which is not against the Shari'ah or Islamic injunctions, as laid down in the Holy Qur'an and Sunnah of the Holy Prophet (PBUH). The principles of Islamic law of contract and partnership provide comprehensive framework for commercial practices and concept of liability which were adopted by the early jurists. The terms of contractual arrangements are binding on the contracting parties because it is considered that these are not repugnant to any injunction of the Holy Qur'an and Sunnah. For instance, the Islamic principle of "Istihsan" and "Umoom-ul-Balwa" are modes to come out from difficulties and hardship. Similarly, the principle of "Musalahah" is exercised through taking step, action, policy- matter for the best interest of the people. Anything leading to or seeming to lead to some difficulty, hardship or injury or any offence, immorality or injustice shall be prohibited under the principle of "Saddu zari'ah" and "Fathu zari'ah". The repugnancy of any act or omission and its merits and demerits are examined on the principle of "Ibahah".

However, it is well settled principle of law and Islamic Jurisprudence that an action, deed or thing which is not specifically prohibited by Injunctions of Islam (Qur'an and Sunnah) is considered to be permitted/allowed in Islamic system. An incorporation of company or company limited by shares being an artificial and legal person can do any business that is not prohibited by Islam and nothing exists in Qur'anic injunctions or Sunnah should not be considered un-Islamic and against the Shari'ah because the company is a modern form of partnership business which is permitted by Islamic law. The partnership is a contract in which a few individuals join together for the purpose of doing business, with property, skills and goodwill. The three kinds of partnership as "Shirkat-ul-Amwal", "Shirkat-ul-Mal" and "Shirkat-ul-Wujuh" respectively have similarity with modern

form of corporate activities. Therefore, it might be argued that the incorporation of company as a legal person with limited liability of its members is not against the injunctions of Islam. The registration of an association, partnership and incorporation of company as a legal person and juristic person is allowed in Islam as in the case of State treasury, Waqf, hospital, etc. It is admitted that Mudarabah company (Profit-sharing) was an antiquarian institution of pre-Islamic times which was suitable for distant trade journeys and even this mode of corporate business is considered an ideal form of corporation in Islamic world.

On the other hand, it is argued that the International Islamic Fiqh Academy of Organization of Islamic Conference (OIC) in its seventh Session held in the month of May, 1992 adopted Resolution No.7/1/63, in relation to corporate issues in following manners:

Shares In Shirkah(a) As the original rule in Mua'malat is permissibility, The formation of Shirkah Musahamah having lawful objectives and activities, is lawful. (b) There is no disagreement about the prohibition of the shares of Shirkah whose primary objective is prohibited, like transactions in Riba or which produces and deals in prohibited products. (c) The rule of prohibition applies to the shares of Shirkah that deal at times in prohibited things like riba, even when their primary activity is permissible.

Shares with Respect to their Bearer: The share certificate is the instrument that is proof of his right in the share. There is, therefore, no legal obstacle to the issuance of shares in this way and to transactions in them.

Subject- Matter of the Contract in the Sale of the Share: The subject-matter of the contract in sale of shares is the undivided share in assets of the Shirkah. The share certificate is the instrument of the right to this share.

The Joint Stock Company business is regarded as akin to the contract of Shirkah in Islamic legal system by the Islamic jurists. They considered that the incorporation of company having the status of distinct legal personality is permissible in Shari'ah (Islamic law). They argued that:

"the Limited Liability of the master of a slave who carries on business on behalf of his master was also cited. In such a case the initial capital for the purpose of trade was provided by his master, but the slave was free to enter into all the commercial transactions. The income would also vest in him, and whatever the slave earned would go to the master as his exclusive property. If in the course of trade, the slave incurred debts, the same would be set off against cash and the stock in the hands of the slave. But if the amount of such cash and stock would not be sufficient to set off the debts, the creditors had a right to sell the slave and settle their claims out of his bid price. However, if their claims still remained due even after selling the slave, or the slave would die in that state of indebtedness, the creditors shall not approach his master for the rest of their claims. Here, the master was actually the owner of the whole business, the slave being merely an intermediary tool to carry out the business transactions. The slave owned nothing from the business. Still, the liability of the master was limited to the capital he invested including the value of the slave. After the death of the slave, the creditors could not have a claim over the personal assets of the master. This business practice was followed in the days of Holy Prophet (P.B.U.H)."

This example is very much similar to the limited liability of the shareholders of a company.

The concept of corporate entity and limited liability of the company's member is not against the injunctions of Islam. As Abdul Rahim observed that "it may be doubted whether the earlier jurists would recognize an artificial or Juristic person. The state of community is regarded by them as holding and exercising the powers of God on His behalf through the Imam. Similarly the deceased has rights and obligations on his estate. The law deals both with a man's spiritual and material rights and obligations and even the worldly rights and obligation of a person cannot be said to be altogether lost on his death. He is entitled to have his funeral expenses and his debt and other obligation discharged out of his estate. But later jurists seem inclined to recognize an artificial person. For instance, they would allow a gift to be made directly to a Mosque, while the ancient doctors would require intervention of a trustee."

However, It is also recognised that "the Islamic law has since its dawn, recognized the existence of juristic persons. The jurists have discussed the state treasury (Bait-ul-Mal) and Waqf as juristic persons. Similarly, they have considered the schools, orphanages, hospitals, etc., as juristic persons and competent to hold and exercise the rights." Further argued that:

"When we referred to the original text and sources of the Shari'ah, we found in its legal provisions which in substance propound the concept of Juristic person and its legal status. And, also, we found the legal provisions which personify the juristic person with all its 'principles and characteristics which are attributed to it by the latest western law . . . on the same pattern of the latest western legal position of the juristic person, it is found in the Shari'ah in the most perfect form in the shape of the Treasury, Waqf and the estate in which the head of the State personifies the entire Muslim Community."

On the other hand, the Muslim jurists have consensus about the Waqf being a legal and religious institution for charitable purpose wherein properties are dedicated to the Waqf that deprived the donor from ownership of the donated property. The beneficiaries of Waqf can only enjoy the benefit and proceeds from the corpus or dedicated property rather than becoming its owners because the ownership of Waqf property vests in Allah Almighty alone. The Waqf is regarded as a separate legal entity and have ascribed to it some characteristics similar to those of a natural person. The mosque is also regarded equal to the Waqf because it also has capability to own properties. Sheikh `Ali Khafif recognised the existence and assignment of legal person in the ambit of prevailing rules of Shari'ah and its functions in public interest that is not prohibited by the injunctions of Islam. The concept of legal personality is accepted that concept of limited liability should flow naturally from it. The court also holds the attribute of legal person to a Mosque; however this decision was set aside by the superior court. The Federal Shari'at Court also upholds the legal entity of the company with limited liability of its members in Islamic law relying on above-mentioned arguments.

3. Corporate Personality and Limited Liability of its Members in British System

The fundamental attribute of corporate personality is that the company is a legal entity separate from its members who constitute it. Being a legal person, company is capable of enjoying rights and subject to duties which are different from its members. In other words, company has 'legal personality' and is described as an artificial person in contrast with a natural person. Company as a distinct legal entity can own property, enter into contract, and be a party to legal proceedings. This separate entitlement of a corporate personality does not allow its members to own the company's property, carry on its business and owe its debt. However, the company as a corporate personality recognised and became an attribute of the normal joint stock company at the end of 19th century that was a last stage of its development. The House of Lords in case, *Salomon v A Salomon & Co Ltd*, clearly established the independent legal personality of a limited liability company by making every efforts on behalf of creditors of a failed company and to declare that the liability for the company's debts cannot be imposed on its controlling shareholders because of separate legal entity of the company from its members who have limited liability to the extent of their unpaid subscription of share-ownership.

This leading case not only established the principle of 'legal personality' but also laid down the concept of 'limited-liability' of company's shareholders to the extent of their unpaid subscription of share-ownership. Later on both principles, corporate personality and limited liability, which are outcome of the decisions of British courts, were incorporated in legislation not only in Common-Wealth jurisdiction but rest of the world as a whole to remove the ambiguity of corporate market. The brief facts of case are that: Salomon had a prosperous business as a leather-merchant ran it in his personal ownership as a sole proprietor. In 1892, he converted his sole proprietorship into a limited company i.e. *Salomon & Co Ltd* in which Salomon, his wife, and five of his children were the members and shareholders of the company and Salomon himself was appointed as a managing director of the company. The company (i.e. *Salomon & Co Ltd*) purchased the business from Salomon as a going concern for approximately £39000. The price was satisfied to Salomon as seller of his business by issuing secured debentures in the amount of £10000, which conferred a charge over all company's assets, 20,000 shares in fully paid £1 share were issued to him other than seven shares that were issued to all subscribers of the memorandum and rest of the approximately amount £9000 were paid to him in cash in satisfaction of the balance of the purchase price. The company almost immediately got business slump and went into liquidation for which debenture holders appointed a receiver. However, the company assets were sufficient to discharge the secured debenture but nothing was left for unsecured creditors. The company's liquidator in representation of unsecured creditors claimed that the company's business was in reality still Salomon's, the company being merely a sham design to limit Salomon's liability for debts incurred in carrying on its business, and therefore Salomon should be ordered to indemnify the company against its debts, and payment of his secured debentures debt should be postponed until the company's other creditors were satisfied.

The trial court did agree with liquidator's claim and observed that the subscribers of the memorandum other than Salomon held their shares only as nominees of Salomon, and Salomon sole purpose to form a company is to use it as an agent of running his business. The Appellate Court reached to the same conclusion of the trial court and observed that the companies Acts were intended to confer the privilege of limited liability on genuine, independent shareholders who invest their capital in company to enable it for starting its business rather than sole owner of the business who involve his family members as nominees to satisfy the formalities of incorporation of company and to carry own his business under the protection of limited liability.

The House of Lords unanimously reversed the decisions of trial and appellate courts and held that the Salomon is not liable to pay company's debts to its creditors and his debentures are secured that are validly issued and therefore, he should be given priority in payment of debentures being a secured debenture holders from company assets over non-secured creditors. The court held that:

"Either the limited company was a legal entity or it was not. If it was, the business belonged to it and not to Mr. Salomon. If it was not, there was no person and nothing to be an agent at all; and it is impossible to say at the same time that there is a company and there is not . . . The company attains maturity on its birth. There is no period of minority - no interval of incapacity. I cannot understand how a body corporate thus made "capable" by statute can lose its individuality by issuing the bulk of its capital to one person, whether he be a subscriber to the memorandum or not. The company is at law a different person altogether from the subscribers to the memorandum; and, though it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or trustee for them. Nor are the subscribers as members liable, in any shape or form, except to the extent and in the manner provided by the Act."

This principle of corporate legal personality and limited liability of its shareholders has been fully applied by the courts since decisions of the Salomon case. The decision of Salomon case recognised that a company business is conducted by company itself as a separate person from its members. The defamatory statement about company's business enables it to sue as separate legal person for libel and slander. The court explained that a company's property is the property of company as separate person from its members rather than its shareholders. The company itself is normally both the legal and beneficial owner of its property. Company as a legal person not only own its property but enter into contracts for any transaction with its members also. The company as an artificial person cannot die with the death of its members but it survives until winding up and completion of liquidation. Therefore, the company is a legal person has got a statutory status in British system and rest of the world also. However, the courts occasionally did not apply the principle of separate legal personality by lifting the corporate veil to define the proper ends of incorporation. The courts normally lift the corporate veil in circumstances of paramount public interest; evasion of obligation imposed by law; implied agency and trusteeship; fraudulent trading activities; under companies law and related legislation.

4. Conclusion

The word 'person' is normally used to individual human beings but in law it has technical meaning in the sense of 'rights and duties'. The law give the status of legal person to the inanimate entities, such as funds and companies. Although the legal person might be artificial juristic person but it can own property, run its business might be a party in any legal proceeding separately from its members like natural person. The three examples (i.e. Baitul Mal, Waqf and Masjid) of Islamic Legal system (Khilafa) provide an innovative concept of legal entities and institutions having the concept of legal personality and limited liability to the Muslims and the rest of the corporate community. However, the Western world took the concept of corporate personality and limited liability of its shareholders in the end of 19th century but these examples (Baitul Mal, Waqf and Masjid) of Islamic legal system convinced that the Islamic states have adopted the principle of legal person and limited liability since ages. I have no hesitation to conclude that both the Islamic and western legal systems have consensus about the applicability of company as juristic person and limited liability of its members and both of them has not any conflicts on the prevailed principle of corporate entity. Due to the reason, these principles are in practice in both the Islamic and Western jurisdictions.

- ¹ *Macaura v Northern Assurance Co Ltd*, [1925] AC 534 at pp. 545
- ¹ *Daimler Co Ltd v Continental Tyre and Rubber Co (Great Britain) Ltd*, [1916] 2 AC 307 at pp. 338
- ³ (a) *Badr-ud-din aini*, "Umdat-ul-Qari", Vol.11, (Beirut:Dar-ul-Ma'rifah 2011) at pp.171
- (b) This principle is derived from the following verse of the Holy Qur'an: "It is he who has created for you all things that are on earth." (Al-Qur'an:2:29)
- ⁴ *Allama Ila-ud-din ainee*, *Addur-ul-mukhtar*, V6 (Dar-ul-Ma'rifah Beirut2001) ta pp:459
- ⁵ *Ibn Nujaim* "Al-Bahr Al-Raiq" Vol. 5, (Beirut: Dar al-Ma'rifah1993) at pp. 170
- ⁶ *Abdul Qadir Audah*, "Al Tashria ul Janai" Vol. 1, (Beirut: Dar-ul-kitab arbi) at pp. 292
- ⁷ *Federal Government v Provincial Governments*, P L D 2009 FSC 1 (Federal Shari'at Court of Pakistan)
- ⁸ *Federal Government v Provincial Governments*, P L D 2009 FSC 1 (Federal Shariat Court of Pakistan)
- ⁹ *Federal Government v Provincial Governments*, P L D 2009 FSC 1 (Federal Shariat Court of Pakistan); *Mufti Taqi Usmani*, *An Introduction to Islamic finance*, 2007 (e-book) at pp.158-159 available on<http://islamicfinanceaffairs.wordpress.com/2007/05/24/islamic-finance-an-introduction-mufti-taqi-usmani-e-book-online/>
- ¹⁰ *J. A. Rahim*, "Principles of Islamic Jurisprudence and to Josef Schacht", in, *An Introduction to Islamic law*, (Oxford 1964) at pp. 125; *Federal Government v Provincial Governments*, (n. 8)
- ¹¹ *Abdul Qadir Awdah*, "Al-Tashria 'ul Jenai" Vol.1, (Beirut: Dar-ul-kitab arbi, 1992) at pp. 393; *Federal Government v Provincial Governments*, (n. 8)
- ¹² *Mustafa Zarqa*, "Al-Madkhal al Faqhi-al-Aam", Vol.3 (Damsiyq: Dar-ul-Qalam,1968) at pp. 253 & 258; *Federal Government v Provincial Governments*, (n. 8)
- ¹³ *Muhammad Bin Abi al Abbas al Ramali*, "Nihayatul Muhtaj Ila Sharh Al-Minhaj", Vol.5 (Beirut: Dar-ul-Fikr), at pp. 385
- ¹⁴ *Muhammad bin Ahmad Sarkhsi*, "Al Mabsut Lil Sarkhs"i, Vol.12, (Beirut: Dar-ul-Ma'rifah, 1406 A. H) at pp. 34
- ¹⁵ *Muhammad Bin Abi al Abbas al Ramali*, "Nihayatul Muhtaj Ila Sharh al Minhaj", Vol.2, (Beirut :Dar-ul-Fikr), at pp. 112; *Ahmad Al-Dardir*, "Al Shrhul Kabir", Vol:4 (Beirut: Dar-ul-fikr 1404 A. H.) at pp. 77
- ¹⁶ *Shaikh Muhammad Ali Al-Khafif*, "Al-Shirkat Fil-Fiqhil Islami" at pp. 25
- ¹⁷ *Justice Mohammad Taqi Usmani*, "The Principle of Limited Liability From the Shari'ah Viewpoint," *New Horizon*, Aug/Sept 1992, at pp. 21-22
- ¹⁸ *Federal Government v Provincial Governments*, (n. 8); *Masjid Shahid Ganj and others v. Shermani Gurdwara Parbandhak Committee Amritsar and others*, AIR 1940 Privy Council 116.
- ¹⁹ *Federal Government v Provincial Governments*, P L D 2009 FSC 1 (Federal Shari'at Court of Pakistan)
- ²⁰ *Paul L. Davies*, *Gower and Davies' Principles of Modern Company Law*, (Sweet & Maxwell 2003) 27
- ²¹ *Derek French*, *Stephen Mayson*, & *Christopher Ryan*, *Mayson, French & Ryan on Company Law*, 26th ed. (Oxford 2009-10) 122
- ²² *Salomon v A Salomon & Co Ltd*, [1897] A.C. 22, HL
- ²³ *LS Sealy*, *Cases and Materials in Company Law*, 7th ed. (LexisNexis Butterworths 2004) at 42-46
- ²⁴ *Salomon v A Salomon & Co Ltd*, [1895] 2 Ch 323
- ²⁵ *Salomon v A Salomon & Co Ltd*, [1895] 2 Ch 323 at pp. 341
- ²⁶ *Salomon v A Salomon & Co Ltd*, [1897] A.C. 22, HL at pp. 31 and 51
- ²⁷ *Gas Lighting Improvements Co Ltd v Commissioner of Inland Revenue*, [1923] AC 723 HL
- ²⁸ *Jameel v Wall Street journal Europe SPRL*, [2006] UKHL 44
- ²⁹ *Macaura v Northern Assurance Co Ltd*, [1925] AC 619
- ³⁰ *J J Harrison (Properties) Ltd v Harrison*, [2001] EWCA Civ. 1467
- ³¹ *Farrar v Farrar Ltd*, (1888) 40 ChD 395; *Lee v Lee's Air Framing Ltd*, [1961] AC 12
- ³² *Re Noel Tedman Holdings Pty Ltd*, [1967] QdR 561
- ³³ *The Companies Act 2006 (UK)*, s. 15 (1) and 16 (2&3)
- ³⁴ *Robert R Pennington LLD*, *Pennington's Company Law*, 7th ed. (Butterwords 1995) 46-64
- ³⁵ *Daimler Co Ltd v Continental Tyre and Rubber Co (Great Britain) Ltd*, [1916] 2 AC 307
- ³⁶ *Wallersteiner v Moir*, [1974] 3 All ER 217; *Jones v Lipman*, [1962] 1 All ER 442; *Gilford Motor Co Ltd v Horne*, [1933] Ch. 935
- ³⁷ *Smith, Stone & Knight Ltd v Birmingham Corpn*, [1939] 4 All ER 116; *DHN Food Distributors Ltd v London Borough of Tower Hamlets*, [1976] 3 All ER 462
- ³⁸ *Re Patrick and Lyon Ltd*, [1933] All ER Rep. 590; *Re Gerald Cooper Chemical Ltd*, [1978] Ch. 262; *Re William C Leitch Bros Ltd*, [1932] 2 Ch. 71
- ³⁹ *Re Building and Welby's Contact*, [1985] Ch 663