THE CONCEPT OF LIMITED LIABILITY AND ISLAMIC COMMERCIAL LAW

A COMPARATIVE STUDY

Prepared by:

Fatima Saleh

REG.No:25-FSL/LLMICL/F07

Supervised by:

Dr.Abdullah Rizk Almuzaini

Assistant professor

Department of Shariah.

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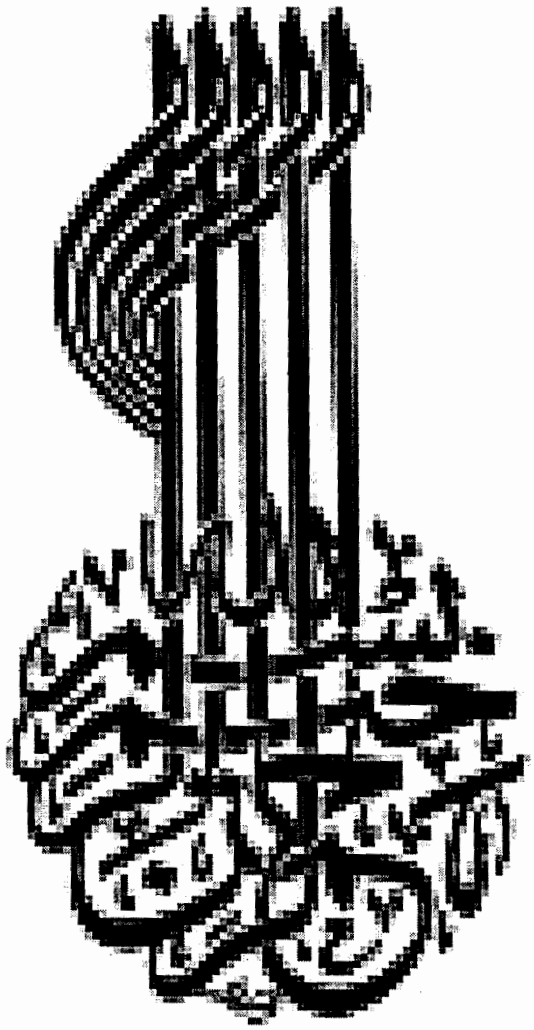


INTERNATIONAL ISLAMICUNIVERSITY
الجامعة الاسلامية العالمية
Faculty of Shariah & Law
كلية الشريعة والقانون
ISLAMABAD – PAKISTAN
اسلام آباد - باكستان
P.O. Box 1243, Islamabad Pakistan *Tel:* 0092-51-9258039, *-Fax:* 0092-51-9258021

Dated: 16-12-2009

CERTIFICATE

The thesis entitled **"The Concept of Limited Liability And Islamic Commercial Law"** submitted by **Fatima Saleh (Registration No. 25-FSL/LLICL/F07** in partial fulfillment of LLM degree with the specialization in Islamic Commercial Law has been completed under my guidance and supervision.

I am satisfied with the quality of student's research work and allow her to submit this thesis for further processes as per IIU rules and regulations.

Dr. Abdullah Rizk Almuzaini
Assistant Professor
Supervisor

DECLERATION

INTERNATIONAL ISLAMIC UNIVERSITY, ISLAMABAD

STATEMENT OF UNDERSTANDING

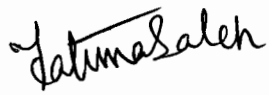
I, Fatima Saleh bearing the university registration number 25-FSL/LLMICL/F07, declare in the name of Allah that my thesis entitled,

THE CONCEPT OF LIMITED LIABILITY AND ISLAMIC COMMERCIAL LAW,

submitted to the Department of Shariah, Faculty of Shariah and Law, is a genuine work of mine originally conceived and written down by me under the supervision of Asst.Prof.Dr.Abdullah Rizk Almuzaini, by Allah's will and approbation.

I do, hereby, understand the consequences that may follow, if the above declaration be found contradicted and/or violated, both in this world and in the Hereafter.

Fatima Saleh
LLM Shariah & Law,
Reg. No.25-FSL/LLMICL/F07



(Signature)
Dated: 31.12.09

(Acceptance by Viva Voce Committee)

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Name of student:- Fatima Saleh

Accepted by the faculty of Shariah and Law, Department of Shariah (Islamic law), International Islamic University, Islamabad, in partial fulfillment of the requirements of LLM Islamic Commercial Law.

Viva Voce Committee

Supervisor/Chairman Viva Voce Committee

Dr. Abdullah Rizk Almuzaini

External Examiner

Dr. Yousaf Farooqi

Internal Examiner

Dr. Mohammad Zia ul Haq

Dated:31.12.2009

DEDICATION

Dedicated to

My parents

To whom I owe everything

رب ارحمهما كما ربياني صغيرا

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May Allah reward them all in this world and the hereafter.

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INTRODUCTION

All praise is to Allah, the undisputed Lord and the Creator of this magnificent universe and all that exists in it. May His peace and blessings shower on his chosen and final messenger, the best of His creation Muhammad (peace be upon him), his family, companions and all those who follow the path of guidance to the end of the time.

The purpose of this study is to know what the concept of limited liability in English law actually is and what is its legal status, in the Islamic perspective. To achieve this purpose it's important to discuss first the issues which are closely related to the concept of limited liability like the legal personality, the notion of company in Islam and the basic legal principles which govern the Islamic commercial law.

SIGNIFICANCE AND IMPORTANCE OF THE SUBJECT:

The topic under discussion in the research is "The concept of limited liability and Islamic commercial law". The importance of this study can be gauged by the number of different business organizations emerging in the world, of which limited liability is an integral attribute. Nowadays business organizations with the characteristic of limited liability are quite common, and are not only found in the west but also exist in the east including many Muslim countries. Therefore it's important to know whether the existing concept of limited liability is in accordance with Islamic laws or not as Muslims are always under an obligation, to abide by the Shariah norms, in all spheres of life. A study of the Islamic law of commerce shows that there are some basic principles which must be taken care of during all business activities, for example the principle of prohibition of riba, rules regarding money exchange (sarf) etc.

STATEMENT OF THE RESEARCH PROBLEM/THESIS STATEMENT:

Whether the concept of limited liability as practiced in modern corporations and limited liability partnerships is lawful according to Islamic law or not.

HYPOTHESIS OF THE RESEARCH:

Hypothesis of this research are:

1. The concept of limited liability as per the above statement is lawful according to Islamic law in case of both partnerships and corporations.
2. The concept of limited liability as per the above statement is lawful according to Islamic law for partnerships whereas it is unlawful for corporations.
3. The concept of limited liability as per the above statement is lawful for both partnerships and companies provided some changes are made in the existing structure of partnerships and companies.
4. The concept of limited liability as per the above statement is unlawful according to Islamic law for both partnerships and corporations.

AIMS OF THE RESEARCH:

This research is aimed to:

1. Explain the concept of limited liability as practiced in the companies and partnerships in English law.
2. Analyze the concept of limited liability in the light of Islamic law.
3. Find out the bases of disapproval of jurists on the subject.

Finally some suggestions are given regarding introduction of limited liability in Islamic law of partnership and companies and the ways to counter the hindrances in validating it. Towards the end there is a concluding note that summarizes the whole discussion.

RESEARCH METHADOLOGY:

It's important for the study of this concept, to first have an in-depth knowledge of companies and partnerships which avail the benefits of the concept of limited liability, followed by a study of the institutions(partnerships and companies) both in Islamic and English law. Afterwards, in order to realize the importance of the concept of limited liability for these institutions, the basis of the concept of limited liability; its advantages, disadvantages etc. have been discussed. The legislation regarding limited liability in various countries has also been brought into knowledge of the reader. Being a

comparative study, the issue of limited liability in connection with English and Islamic laws has been discussed separately. An important feature of this research is that it quotes the views of scholars regarding the concept of limited liability in Islam and also attempts to unfold the bases of their disapproval on the subject.

LITERATURE REVIEW:

According to my limited research studies, so far there is no comprehensive writing on the present topic which discusses it comparatively. Some of the important writings in this connection are introduced here:

1. Badāi' al Sanāi' by Al Kāsani is one of the important classical books in Islamic law where partnerships have been discussed in detail. Liability of partners in different types of partnerships is discussed in this book.
2. Fath al Qadeer lil Ājiz al Faqeer by kamal al din is another classical book which discusses Islamic forms of partnerships at length.

Among the contemporary books are:

1. In his book "An introduction to Islamic finance" Moulana Taqi Usmani defines the concept of limited liability, and discusses it in connection with legal person. According to him if a legal person is valid in Islam then limited liability will also be regarded as valid .Furthermore he says that limited liability should be allowed for public companies and not for private ones.
2. Imran Ahsan khan Nyazee in his book titled "Islamic Law of Business Organizations" discusses various types of partnerships in detail, gives his own view on the concept of limited liability, and shows how it does not exist in Islamic law of partnerships and companies.
3. An article by South African Ulema "The concept of limited liability untenable in the Shariah" severely criticizes the concept of limited liability. It also disapproves of the views of mufti Taqi Usmani regarding limited liability.

CHAPTER.NO:1

LIABILITY AND LIMITED LIABILITY;

AN INTRODUCTION

1.1 THE MEANING OF LIABILITY:

In the most general sense, a liability is anything that is a hindrance, a duty or something that puts an individual at a disadvantage. One of the most common meanings of liability is that it is a legal obligation to pay debts. In law[1] the term liability is commonly understood as:

1. A situation in which a person is forced by law to perform a specific act, pay specific money or correct a wrong. For example where a person is financially and legally responsible, such as in situations of torts concerning property or reputation and, therefore, must pay compensation for any damage incurred; where the liability may be either civil or criminal.
2. The liability of a company towards its creditors or the traders who deal with it.
3. Any debt which a person or a company has to pay irrespective of the nature of the debt. It can either be in terms of money or in any other form.

[1] Ghattas, Nabih, A dictionary of economics, business and finance.(Lebanon:Librarie du liban,1980),326

According to Salmond, the word liability means responsibility.[2] He says that liability or responsibility is the bond of necessity that exists between the wrongdoer and the remedy of the wrong.

While discussing liability in perspective of finance, a liability is defined as an obligation of an entity arising from past transactions or events, the settlement of which may result in the transfer or use of assets, provision of services or other yielding of economic benefits in the future. Some examples of financial liability are as follows:

- Any borrowing from a person or a financial institution such as a bank for any purpose will be regarded as the liability of the borrower. The borrower may either be a person or a financial institution. Such a liability can be settled only by paying back the money borrowed within the specified time.
- Similarly money deposited with a bank becomes a liability of the bank, because the bank has an obligation to pay the depositor the money deposited; usually on demand. The money deposited is an asset for the depositor; but this asset will not be recorded by the bank because it is not the bank's asset.
- Liability may include any responsibility or duty towards others, of providing a certain sum of money or any other economic benefit at a specified time. For example the dower promised at the time of wedding.
- Any condition in the contract made between two persons in which a promise is made of paying a certain sum of money at the time of occurrence of a specific event. At the time of occurrence of that event the promissor is left with no choice but to fulfill his liability.
- Also in case of damage caused to the body or property of a person a specific compensation needs to be paid to the victim, which is regarded as the liability of the wrongdoer or offender.

[2] Fitzgerald, P.J. Salmond on Jurisprudence. (Islamabad: National book foundation),349

According to the Accounting, Auditing and Governance standards "a liability is a present obligation to transfer assets, extend the use of an asset or provide services to another party in the future as a result of past transactions or other events".[3]

The Australian Accounting Research Foundation defines liabilities as: "future sacrifice of economic benefits that the entity is presently obliged to make to other entities as a result of past transactions and other past events".[4]

The most accepted accounting definition of liability is the one used by the International Accounting Standards Board (IASB) which defines it as: "A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits."[5]

1.2 TYPES OF LIABILITY:

According to Salmond,[6] liability can be divided into two broad categories:

1. Civil liability.
2. Criminal liability.

Civil liability is the liability which arises by the commission of a wrong towards people of the society whereas criminal liability deals with crimes. The difference between a wrong and a crime is that a crime includes both "act" and "mensrea" (bad intention or ill will) whereas a wrong is simply an act which causes damage and does not include "mensrea" or bad intention. According to another classification, liability is either remedial or penal. In case of penal liability, the sole purpose of law is to punish the wrongdoers, whereas in case of remedial liability, the purpose is enforcement of the plaintiff's right and contains no concept of punishment in it. Civil liability is sometimes penal and sometimes its remedial but criminal liability is always penal.

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[3] Accounting and auditing organization for Islamic financial institutions, Accounting, auditing and Governance standards,(Manama,2001),49
[4] http://en.wikipedia.org/wiki/Liability , last visited 12.01.09
[5] Ibid.
[6] Fitzgerald. Salmond on Jurisprudence.p.349

The different kinds of liabilities are discussed below:

1.2.1 PENAL LIABILITY:

In case of penal liability the main object of law is the protection of the society. To achieve this purpose normally three methods are used:

1. Deterrence. (this is the primary function of punishment.)
2. Prevention.
3. Reformation.

Penal liability is only inflicted in the case where it's clear beyond doubt, that the act of the wrongdoer is accompanied by the intention of causing wrong commonly known as *mensrea.* In other words the theory of penal liability says that punishment can only be granted in a case where a man is guilty of both the *act* and *bad intention* i.e. where he is responsible for wrongful acts done intentionally or willfully. But there are circumstances under criminal law where mere negligence is also punishable for example a car accident which causes death.

But where there is no wrongful intention, neither any negligence then in such a case it's called an inevitable accident and such a wrong is not punishable under criminal law. As Salmond says: "the absence both of wrongful intention or recklessness and of culpable negligence is in general a sufficient ground of exemption from penal liability."[7]

1.2.2 TORTIOUS LIABILITY:

The law of torts is basically related to damages and compensation for wrongs committed. It's a part of civil law, as it is meant for wrongs only and does not cover crimes. The difference between a wrong and a crime is that a crime contains the

[7] Ibid.p.352

element of mensrea in it whereas a wrong does not include mensrea.The tortious liability[8] in English law is divided into two main classes:

2 Strict liability

3 Vicarious liability

1.2.2.1 STRICT LIABILITY:

The term strict liability applies where guilt may exist without intention, recklessness or even negligence. These are the acts for which a man is responsible irrespective of the existence of either wrongful intent or negligence. Strict liability is basically the principle that a man acts at his peril and must therefore compensate anyone whom he injures by his acts.[9] It's an exception to the principle that a man is liable for inflicting injury only when he is at fault i.e. only when the injury is deliberate or negligent.

In civil law as opposed to criminal law strict liability should be the rule rather than the exception. As the general rule in criminal law is that no man can be punished for a wrong committed by him until the element of mensrea is found along with the act done by him. Whereas in case of civil law, mensrea has no role to play because if a person has caused any sort of damage to another whether intentionally or negligently, he has to offer compensation for it to the aggrieved party irrespective of the fact that mensrea is not present along with the act of the offender. The only exception found here is that of an inevitable accident as it cannot be avoided whatsoever is done.

1.2.2.2 VICARIOUS LIABILITY:

The general rule of punishment and compensation according to both civil and criminal laws is that the person who commits the wrong is himself responsible for it. As Salmond says: "Normally and naturally the person who is liable for a wrong is he who does it."[10] But there do lie exceptions to this general rule of punishment both in modern as well as in

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[8] Dias, R.W.M & Markesinis.B.S, Tort Law.(London: Clarendon press oxford,1989),371

[9] Posner,Richard, Tort Law cases and economic analysis,(Boston: Little brown and comp.ltd,1982),p.471

[10] Ibid.p.400

Islamic law. For example in Islamic law the master of an authorized slave can be held responsible for the debts incurred by the slave. Similarly the rab-ul-maal in the contract of mudāraba is held responsible for the debts incurred by the mudarib. Also in modern law we do see manifestation of the same rule in the form of vicarious liability under which a master is held responsible for the acts of his servants.

Vicarious liability is an important element of modern civil law and in some circumstances the doctrine is also applicable in criminal law though it is an exception in case of criminal law. Vicarious liability arises under the common law doctrine of agency, the responsibility of the superior for the acts of their subordinates.

Lord Denning M.R in a case defined vicarious liability as "vicarious liability means that one person takes the place of another so far as liability is concerned."[11] The origin of this doctrine is found in the ancient legal presumption "that all acts done by a servant in and about his master's business are done by the master's express or implied authority and are therefore in truth the acts of the master for which he may be justly held responsible."[12]

Modern civil law recognizes two types of vicarious liability:

1. An employer is held responsible for the acts done by the servant in due course of his employment.
2. That a living being is held responsible as a representative for the acts of dead men.

The first form of vicarious liability is based on the fact that master's or employers are financially more capable, whereas the servants are not capable of the burden of civil liability. Therefore logic demands that a person who is able to make compensation for the hurtful results of his activities should not be allowed to escape this responsibility of his by delegating the exercise of these activities to servants or agents from whom no redress can be obtained. Whereas the second form of vicarious liability is based on

[11] Percy,R.A, Charlesworth and Percy on Negligence, (London: Sweet and Maxwell,1983),p.94
[12] Fitzgerald. Salmond on Jurisprudence.p.401

the civil responsibility of an individual. It cannot be said that the civil responsibility of a person dies with the death of the wrongdoer though it occurs in criminal law.

1.2.3 PRODUCT'S LIABILITY:

Manufacturer's or product's liability is a legal concept in most countries that reflects the fact that producers have a responsibility not to sell a defective product. It's a form of civil liability which aims at protecting the general public or consumers against defective and dangerous products. The liability meant by this term is the owner's or manufacturer's liability for unsafe product's which is governed in English law by the Consumer Safety Act 1978.[13]

The producer's are held liable for defective goods produced by them due to their negligence or not observing the policy of duty to take care. So the principle applied here is that of strict liability, as the manufacturer has probably done no wrong, neither performed his work negligently but still is held liable for the hurt caused to the masses due to the product prepared by him. They are held liable though they don't possess the element of mensrea but since they ignored the duty to take care, they are held liable. This principle was for the first time laid down in the famous case of Donoghue v Stevenson.[14]

1.2.4 COMMERCIAL LIABILITY:

Certain types of liabilities which are specifically used in the context of commercial law include limited, unlimited, joint, and several liabilities. These liabilities are commonly used nowadays in companies, partnerships and other forms of trade. These liabilities are discussed as follows:

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[13] Percy, Charlesworth and Percy on Negligence,p.470
[14] All England Reports[1932] A.C.562

1.2.4.1 LIMITED LIABILITY:

In commercial law, limited liability is a form of investment in business, in which the investors or shareholder's are legally responsible for no more than the amount that they have contributed to a venture. If for example, a business goes bankrupt an investor with limited liability will not lose personal assets such as a personal residence, provided they have not given any personal guarantees.[15]

1.2.4.2 UNLIMITED LIABILITY:

Unlimited liability is the most general forms of liabilities where the general rule is that all partners are jointly liable for the debts and obligations of the business carried out by them, even if the amount exceeds their investment in the business. All the partners in case of general partnerships possess unlimited liability. Similarly shareholders in case of unlimited companies possess unlimited liability.[16]

1.2.4.3 JOINT LIABILITY:

While deciding the issue of liability of partners, a question may arise that are all partners jointly liable for the losses of the business or do they have individual responsibility? If we say that the creditors have the right to sue all the partners jointly then in this case the liability of partners is known as joint responsibility.[17]

1.2.4.4 SEVERAL LIABILITY:

Where the creditors have the right to recover all the debts from a single partner, this type of liability is known as several liability. In the Islamic partnerships, members of an Inān partnership possess several liability whereas in mufāwadah partnership there is joint liability.[18]

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[15] See ch.2, p.13, 24.
[16] www.usc.edu/dept/MSA/economics/islamic_banking.html
[17] ibid
[18] ibid.

1.3 FACTORS WHICH DETERMINE THE ASSIGNING OF LIABILITY:

In Islamic law liability (damān) is a basis of entitlement to profit, the ground being partnership through work (sharika abdān) and mudāraba. As in case of partnership through work the partners do not contribute in terms of money, rather they contribute in terms of work. Similarly in mudaraba the worker is a partner in the profits gained on the basis of work he does in running the business. In Islamic law there are basically three reasons for entitlement to profit namely[19]:

1. wealth
2. work
3. and the liability for bearing loss.

In the same way the English law of partnership 1860 also considers the same elements as the basis for entitlement to profit. i.e., wealth, skill and labor. As Lindley says: "agreements to enter into partnership, like all other agreements, require to be founded on some consideration in order to be binding. Any contribution in the shape of capital or labor or any act which may result in liability to third parties is a sufficient consideration to support such an agreement[20].

A bonafide contract of partnership is not invalidated by the unequal value of the contributions of its members, for they must be their own judges of the adequacy of the consideration for the agreement into which they enter".[21]

As observed by Vice-Chancellor Wigram, " if one man has skill and wants capital to make that skill available, and another has capital and wants skill, it is perfectly clear that there is good consideration for the agreement on both sides, and it is impossible for the court to measure the quantum of value. The parties must decide that for themselves." [22]

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[19]Al Kasani, Badai' al Sanai' fi tarteeeb al Sharai', (Beirut:Dar al kitab al arabi,1982),v.5,p.62
[20] Scamell Ernest, Lindley on the Law of Partnership, p.119.
[21] Ibid.
[22] Ibid.

Therefore, it can be concluded that the bases for entitlement to profit are all those factors that are found in Islamic law as well as many other.[23]

The three bases of entitlement to profit in Islam which are assigned legal names by the Hanafi jurists are:

1. Daman al māl or the willingness to bear loss on the capital, while retaining ownership of the capital.
2. Daman al a'māl or the willingness to perform the contract, that is, complete the work assigned irrespective of who has accepted the work.
3. Daman al thaman or the willingness to pay the purchase price of the commodity bought on credit.[24]

Another important principle regarding earning of profits is based on the prophet's (p.b.u.h) saying is "al kharaju bil daman"[25] that is profit of something is valid only when you bear the risk for it. Also the loss which is to be borne by each party is always in proportion to the daman provided.

1.4 THE CONCEPT OF LIMITED LIABILITY:

Limited liability is one of the unique features of corporate law. Limited liability means that investors in a corporation and partners in a firm are not responsible for more than the capital contributed by them to the respective institutions. Some definitions of the term "limited liability" are given as follows:

According to one definition "limited liability in regard to companies, means that the liability of shareholders does not extend beyond the paying in of the amount represented by their respective shareholding. It means that in case, the company runs into loss or even

[23] Nyazee, Imran Ahsan, Islamic law of Business Organisation (Partnerships), (Islamabad: Islamic research institute,1998),76
[24] ibid.
[25] Ibn ibrahim,allama zain ul abedin, Al ashbah wa alnazair,(beirut:dar al saqafa,1947),175.

if it has to be liquidated, the shareholder's liability in any case is limited to the extent of the value of the shares held by him."[26]

Another definition says: "limited liability is the satisfaction of debts of the partnership from the entire assets of the partnership including profits or from whatever is left after a loss has been made, which means that the creditor's do not have access to the personal wealth of the partners."[27]

In other words, Limited liability is a concept according to which a person's financial liability is limited to a fixed sum, which is equal to the amount invested by him at the time of commencing the business. According to the Revised Uniform Limited Partnership Act 1976 a limited partner is not liable for the debts and obligations of the partnership.[28] Generally limited liability can be achieved by two methods:

- By means of a private contract between persons.
- Or through special legislation as in case of companies and limited liability partnerships.

In case of limited companies, the liability of shareholders is limited to the extent of their investment if it is a company limited by shares, whereas in case of a company limited by guarantee the shareholder's liability is limited to the extent of amount guaranteed by them. Similarly in case of limited partnerships the liability of some partners known as the limited partners is limited to the extent of amount contributed by them.

On the other hand the liability of partners cannot be limited in case of business entities like sole proprietorship or general partnerships.

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[26] Aiyar ,P.Ramantha,Advanced Law Lexicon, (New Delhi:Wadhwa and comp.Nagpur,2007),2751
[27] Nyazee, Islamic law of Business Organization (Partnerships),81
[28] Hamilton, Robert, Statutory supplement to cases and materials on corporations,p.24

1.4.1 HISTORY AND ORIGIN OF THE CONCEPT OF LIMITED LIABILITY:

Limited liability is basically the outcome of the doctrine of legal person. When the law considers institutions as full-fledged persons and grants these institutions rights and liabilities, the liability of natural persons dealing with the institutions is shifted to the institutions instead of the living persons. As Hans Kelson says:

A legal person as defined by Salmond is: "any subject-matter other than a human being to which the law attributes personality".[29] Coke says that persons are of two types:

- Persons created by God, known as natural persons.
- Persons created by the policy of man, called "body politique" or legal person.[30]

But the question is that how can it be determined whether a specific institution is a legal person or not. Salmond says that only law has the power to recognize something as a legal person. As he says: "but legal personality is not reached until the law recognizes, over and above the associated individuals, a single entity which in a manner represents them, but is not identical with them".

The types of legal persons recognized by English law until now are:

1. The companies or corporations.
2. Limited liability partnerships.[31]
3. Institutions such as hospitals, universities, libraries, church etc.
4. Funds or estates devoted to special uses e.g. a charitable fund or a trust estate.

Corporations have long been recognized as legal persons. There has been considerable debate in most states as to whether a partnership should remain aggregate or be allowed to become a business entity with a separate legal personality. In the United States, section

[29] Fitzgerald. Salmond on Jurisprudence,305
[30] Ibid,308
[31] See chp.2,p.45

201 of the Revised Uniform Partnership Act (RUPA) of 1994 provides that "A partnership is an entity distinct from its partners." Likewise in the United Kingdom, Partnerships were assigned legal personality in 2000, under the limited liability partnership act.

Some countries like France, Luxembourg, Norway, the Czech Republic and Sweden have also granted some degree of legal personality to commercial partnerships, whereas other countries such as Belgium, Germany, Switzerland, and Poland do not allow partnerships to acquire a separate legal personality, though they permit partnerships the rights to sue and be sued, to hold property, but do not allow them the status of a legal person by way of statute or act of parliament.[32]

In December 2002, Netherlands proposed to replace their ordinary partnership, which does not have legal personality, with a public partnership which allows the partners to opt for legal personality.

Japanese law introduced Civil Code partnerships, which have no legal personality and Commercial Code partnership corporations which have full corporate personality but otherwise function similarly to partnerships.

The two main consequences of allowing separate personality are that one partnership will be able to become a partner in another partnership in the same way that a registered company can, and a partnership will not be bound by the doctrine of *ultra vires* but will have unlimited legal capacity like any other natural person.[33]

After considering corporations and partnerships as legal persons, the meaning of limited liability can be easily understood. It is clear that when companies and partnerships are considered as separate from the partners and shareholders, their separate rights and obligations also become clear. That is how the concept of limited liability came into being.

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[32] http://www.nationmaster.com/encyclopedia last visited 11.02.09
[33] Ibid.

1.4.2 ADVANTAGES OF LIMITED LIABILITY:

According to jurists and western scholars the concept of limited liability, carries along with it multifarious advantages. Some of them are briefly discussed below:

- The principal advantage of limited liability is that it encourages investment by passive investors in risky enterprises. Joint and several liabilities was a particular deterrent to investment by wealthy investors, who were likely to bear all of the costs of losses.[34] As it has been observed over the years, that a business which offers limited liability towards partners is socially beneficial in facilitating investment. If an investor had to supply unlimited amounts of capital to satisfy a corporation's obligations, he would be reluctant to make small investments. Instead of many smaller investments, people would rather make relatively fewer but larger investments. This would obviously lead towards lower economic activity. The concept of limited liability proved to be quite helpful in this regard.
- There is evidence that shares in public companies would be at a disadvantage if liability was unlimited.[35]The reason being the fear of investors to bear the risk of losses even beyond the amount they invested in buying the shares, on their own.
- Another obvious benefit of limited liability is that the shareholders are not the only ones who benefit from this concept but managers and directors of the companies will also share the benefits. Generally managers are not personally liable for the acts of their subordinates unless they actively participate in them, or sign corporate obligations in their personal capacity.
- Limited liability companies and partnerships were found more beneficial, because a business organized as a sole trader, was likely to have a hard time raising capital, whereas after the introduction of limited liability, shareholders started investing in companies and limited partnerships willfully.

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[34] James Howard Candler, Professor, Emory University, School of Law,1999 William J. Carney(www.vanderbiltjournal.com)
[35] ibid

- Another attraction, investors find regarding limited liability is that when partnerships and companies offer limited liability, than in case the business is sued, the partners are not at all personally liable.
- According to one view, in the eighteenth and nineteenth century, both limited and unlimited liability banks co-existed in Scotland. From the beginning of the nineteenth century the average size of the limited liability banks was ten times that of the unlimited liability banks, and when the unlimited liability banks were later given the choice of forms, all chose limited liability. Unlimited liability banks had lower levels of capital than limited liability banks in relation to total assets, and shareholders in unlimited liability banks earned higher returns (risk premiums) on their investments. [36]
- A study of German enterprises showed that limited liability firms tend to be larger than unlimited liability firms among start-ups.[37]
- As limited liability, is the direct outcome of legal person, a corporation is therefore considered as an entity separate from its shareholders, directors, or officers. Therefore a corporation's managers and workers are not vicariously liable for the firm's debts or other obligations.[38]
- Limited liability plays a positive role in encouraging diversification by wealthy investors because under joint and several liabilities, wealthy investors would be the first targets of firm creditors upon failure, and thus would be forced to do without the benefits of diversification in order to concentrate their investments to allow them to monitor effectively. Limited liability permits investors to decrease their exposure to risk by owning diversified portfolios of assets. If unlimited liability existed, the risk faced by an investor would turn on the wealth of other investors because creditors would be more likely to go after the wealthiest of the investors.[39]

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[36] Ibid.
[37] Ibid.
[38] As decided in the case, Salomon v Salomon (see Ch2, pg30.)

- Many of the benefits of limited liability in contracts are related to capital markets. With limited liability, investors have the ability to diversify their investments in shares of corporations. This is true to some extent, because without limited liability, for a wealthy investor, each investment would increase the risk of being held personally liable for the debts of a failed firm.[40]

- Limited liability decreases the need to monitor agents. This is found to be true as we see in partnerships where limited liability is not applicable; there has been always a need to monitor agents. Because when working together in a partnership or a company investors risk losing wealth because of the actions of their agents. Therefore, the more risk that investors are likely to bear; the more they will monitor their agents. However, in partnerships with limited liability and in limited companies as the fear of losing more than a partners contribution goes away, in the same way the need to monitor agents is reduced[41]

- The costs of monitoring other shareholders are also reduced by limited liability. As already discussed, if unlimited liability was the rule, the greater the wealth of other shareholders, the lower the probability that any one shareholder's assets would be needed to pay a judgment against the corporation. Therefore, existing shareholders would have incentives to monitor (presumably at some cost) other shareholders to ensure that they do not transfer assets to others or sell to others with less wealth.[42]

- Managers are forced to act more efficiently because limited liability promotes the free transfer of shares. The ability of investors to sell their ownership interests constrains the actions of agents. Investors respond to inefficient enterprises by not investing in such enterprises. When the buying and selling of shares is tied to getting more votes those enterprises which will install more efficient managerial

[40] ibid.
[41] ibid.
[42] ibid.

teams will be able to attract the new investors. The possibility that the agent will lose his job induces him to operate efficiently to keep share prices high.[43]

- Under an unlimited liability system, shares would not be fungible because their value would be a function of the present value of future cash flows and of the wealth of other shareholders. So under limited liability, shares being not fungible therefore, the shares of a single company would not have one market price. Under such a system, a person wishing to acquire a large number of shares would probably have to negotiate with each individual shareholder, paying different prices and perhaps a surcharge. Therefore, investors would be less likely to attempt to gain control, and managers would have less fear of losing their jobs.[44]

- Finally, limited liability helps promote market efficiency. As previously stated, if unlimited liability were the rule, shares would not be fungible, and therefore, the shares of a single company would not have one market price. Thus, investors would be forced to spend greater resources researching the prospects of the firm, in order to determine the right market price.[45]

These advantages of limited liability suggest that firms and companies would attempt to invent limited liability if it did not exist. The attainment of limited liability therefore, seems to be necessary since there are so many advantages offered by the concept. Those firms or companies who offer the privilege of limited liability will do extremely well as compared to other firms and companies where the attribute of limited liability is missing. Firms would buy insurance for them in the form of creditors, since creditors have a comparative advantage in assessing the risk involved in a given transaction and monitoring the conduct of the firm during the agreement. This arrangement is essentially what is observed with limited liability; creditors assume some risks of business failure, just as they would if they were insurers in addition to being creditors. This shows that the

[43] ibid.
[44] ibid.
[45] ibid.

legal rule of limited liability is a shortcut to this position, avoiding the costs of separate transactions.

If creditors are permitted to reach an investor's personal assets after a business failure, investors would be discouraged from investing and that is why the concept of limited liability is important. Limited liability, therefore, promotes investment. The creditors of limited liability companies accept additional risk, and therefore raise their prices to avoid the risk they have undertaken. The shift in liability from shareholders to creditors produces gains for society and does not harm the creditors that much because the creditors are more efficient in evaluating and bearing particular risks.

1.4.3 DISADVANTAGES OF LIMITED LIABILITY:

As we know that by introducing limited liability the main purpose was to achieve the trust of masses, so that they could contribute to the business organizations without taking the risk of making losses. Secondly it was noted that after the introduction of limited liability economic activity was improved. But the fact cannot be denied that in this way the risk is shifted to the creditors of the companies and partnerships. Though the concept of limited liability proved beneficial for the society at large, it also brought with it some drawbacks. Some of the disadvantages of limited liability are discussed below:

- It has been argued by some people that limited liability plays an important role in distorting the free market by allowing the entrepreneur to externalize some risk and impose it on society at large as risk is shifted from shareholders to creditors.[46]
- Because of limited liability now small creditors are at the most risky position as large creditors can avoid the risk by negotiating secured terms, whereas small creditors' debts are left unsecured.[47]

[46] ibid.
[47] ibid.

- In case of limited liability partnerships or companies the firm or company holds the position of a legal person. It's possible in certain situations that this legal person may go bankrupt or become insolvent, though it's very rare. Therefore, in such situations investors would have to bear huge losses in case the form or company claims to be bankrupt.
- In sum, limited liability does not eliminate the risk of business failure, but rather shifts some of the risk of business failure to creditors. However in doing so, the risk of an enterprise is transferred to the more efficient risk-bearer i.e. the creditors.[48]

1.5 LIMITED LIABILITY AS ADOPTED BY VARIOUS COUNTRIES:

In case of joint stock companies almost all countries have adopted the notion of limited liability for shareholders in stock corporations. This doctrine has also extended to Asian nations that have adopted western legal forms. For example, Korea is a civil code country that provides for limited liability of shareholders.[49]

1.5.1 LIMITED LIABILITY LAWS IN THE UNITED STATES:

Limited liability partnerships emerged in U.S.A in the early 1990s. Initially only two states allowed Limited Liability Partnerships in 1992, afterwards the Uniform Partnership Act was adopted in 1996, by over forty states in the form of Limited Liability Partnership statutes. According to the Revised Uniform Limited Partnership Act 1976 a limited partnership, is defined as a partnership formed by two or more persons of which one or more are general partners and one or more should be limited partners.[50]

Another type of limited liability companies also originated over the time which came to be known as the Limited liability Company denoted as LLC, in the law of many of the

[48] http://www.corporationhowto.com/c-corporation. last visited 11.02.09
[49] Ibid.
[50] Hamilton, Robert, Statutory supplement to cases and materials on corporations,p.24

United States[51] which is a legal form of Business Company, offering limited liability to its owners. It is similar in its construction to a corporation, and is often a more flexible form of ownership, which is especially suitable for smaller companies with a limited number of owners. A limited liability company, with multiple members is given the choice to choose; the options given to a business entity at the time the new entity applies for a US federal taxpayer ID number are either to be considered as a C Corporation, or as an S corporation.[52] Also the limited liability company is further divide into two types regarding its working. Its management will either be in the hands of the members known as "member managed" or it would be managed by the managers.

Also one of the forms of limited liability company is the Professional Limited Liability Company[53] (PLLC or P.L.L.C.), which is a limited liability company organized for the purpose of providing professional services. Usually, professions where the state requires a license to provide services, such as a doctor, lawyer, accountant, architect, or engineer, require the formation of a PLLC. The exact requirements for such companies differ from state to state.

Also another type of companies which exist in the United States is the Series limited liability company, which is a special form of a Limited liability company that provides extra protection for personal assets and which involves multiple business entities.[54]

Coming to the concept of limited liability in partnerships we find that the Limited Liability Partnership is the most popular form of organization among professionals, particularly lawyers, accountants and architects. In some U.S. states (including California and New York), Limited Liability Partnership's can only be formed for such professional uses.[55]

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[51] http://www.corporationhowto.com/c-corporation. last visited 11.02.09
[52] www.nuigleway.com.lastvisited 13.3.2009
[53] http://www.nationmaster.com/encyclopedia last visited 11.02.09
[54] Hamilton, Robert, Statutory supplement to cases and materials on corporations,p.27
[55] http://www.nationmaster.com/encyclopedia last visited 11.02.09

The liability of partners in case of such partnerships varies from state to state. Section 306(c) of the UPA (a standard statute adopted by many states) grants LLPs a form of limited liability similar to that of a corporation according to which the obligations of a partner of a limited liability partnership is limited to his contribution in the partnership assets. The partnership is considered liable because of its entity status in cases arising from contracts, torts etc.[56]

The general rule is that limited partners are not held accountable for the liabilities of the partnership firm, but in exceptional cases where the partners are at fault or acting negligently, they can be held personally liable for contracts and intentional tort claims brought against the partnership firm.

In the United States, Limited Partnership's are most common in the film industry or in types of businesses that focus on a single or limited-term project. These partnerships are also attractive to firms wishing to provide shares to many individuals without the additional tax liability of a corporation. Well-known limited partnerships include Carnegie Steel Company, Bloomberg Limited Partnership and CNN.[57]

1.5.2 LIMITED LIABILITY LAWS IN FRANCE:

For the purpose of French law limited partners need not have the capacity to act as traders. Registration of limited partnerships in the commercial register is necessary, and the entry in the register will specify the contributions of the limited partners.

In France there are two types of limited partnerships, which are named as the "socite en ciommandite simple" and the "societe en commandite par actions".[58] The first type is a limited partnership in which the limited partners may not take part in the management and conduct of the partnership business; otherwise they will convert to general partners. While in the second type, its working is similar to a company.

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[56] ibid.
[57] http://www.nationmaster.com/encyclopedia last visited 11.02.09
[58] Scamell, Earnest, Lindley on partnership,p. 28

1.5.3 LIMITED LIABILITY LAWS IN JAPAN:

Limited liability partnerships were introduced in Japan in 2006, during a large-scale revamp of the country's laws governing business organizations. Limited liability partnerships in Japan may be formed for any purpose, although the purpose must be clearly stated in the partnership agreement.[59] These partnerships have full limited liability and are treated as pass-through entities for tax purposes. Each partner in the Limited Liability Partnership is required by law to take an active role in the business, so the model is more suitable for joint ventures and small businesses than for companies in which investors plan to take passive roles. Japanese limited liability partnerships are not used by professionals like lawyers or accountants because in Japan professionals are required to do business through unlimited liability entities. A Japanese LLP is not a corporation, but rather exists as a contractual relationship between the partners, similarly to an American LLP. Japan also has a type of corporation with a partnership-styled internal structure, called a godo kaisha, which is closer in form to a British limited liability partnership or American limited liability company[60]

1.5.4 LIMITED LIABILITY LAWS IN CANADA:

In Canada, the provinces of Ontario, Manitoba and Alberta and the territory of Nunavut have permitted Limited Liability Partnership's for lawyers. The Partnership Amendment Act, 2004 (Bill 35) permitted Limited Liability Partnership's for lawyers and other professionals as well as to businesses.[61]

1.5.5 LIMITED LIABILITY LAWS IN CHINA:

Limited liability partnership is called Special general partnership in China. The formation of this type of partnership is restricted to knowledge-based professions and technical

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[59] http://www.nationmaster.com/encyclopedia last visited 11.02.09
[60] ibid.
[61] ibid.

service industries. This structure basically aims at shielding co-partners from liabilities due to the willful misconduct or gross negligence of one partner or a group of partners.

1.5.6 LIMITED LIABILITY LAWS IN GERMANY:

Limited liability laws have long been recognized in Germany and France. The limited partners of a German Kommanditgesellschaft do not normally take part in the running of the partnership. Though no corporate entity, it can sue and be sued, own property and act under the partnership's name. Also limited liability is an important ingredient of the joint stock companies.[62]

1.5.7 LIMITED LIABILITY LAWS IN INDIA:

In India, a concept paper on Limited Liability Partnership Law was brought out by the Ministry of Company Affairs in 2005. In the year 2006 the Limited Liability Partnership Bill was introduced in the Parliament.

The official gazette of India published the Limited Liability Partnership Act 2008 on January 9, 2009. The Act may not have come into force yet. Also, the relevant rules have not been notified yet and are in preparation. The Minister of Corporate Affairs has suggested that India will have its first Limited Liability Partnership very soon.[63]

The Lok Sabha (Lower House) granted its assent to the Bill on December 12, 2008 which was earlier passed by the Rajya Sabha (Upper House) in October 2008.

The salient features of the LLP Act, 2008 are as under:-

- The limited liability partnership introduced in India will be considered as an alternative corporate business vehicle which will provide the benefits of limited liability along with organizing their internal structure as a partnership based on agreement.

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[62] ibid.
[63] ibid.

- The limited liability partnerships would not be restricted to a particular class of professionals but would be available for use to all including enterprises.
- These partnerships will represent a separate legal entity, where the legal person would be liable to the extent of all its assets; whereas the liability of the partners would be limited to their agreed contribution in the partnership contract. Further, no partner would be liable on account of the independent or un-authorized actions of other partners, this will provide individual partners protection from joint liability created by another partner's wrongful business decisions or misconduct.[64]
- The partnership shall be a body corporate and a legal entity separate from its partners. There will be a system of perpetual succession in the partnership and these partnerships will not fall under Indian partnrship Act, 1932 for the purpose of management etc. There will be no upper limit on number of partners in an LLP unlike an ordinary partnership firm where the maximum number of partners can not exceed 20.[65]
- The taxation of LLPs shall be governed by the Income Tax Act, 1961 which regulates taxation of all form of entities.
- Provisions have been made for corporate actions like mergers, amalgamations etc. in the limited liability partnership bill.
- While enabling provisions in respect of winding up and dissolutions of limited liability partnerships have been made, detailed provisions in this regard would be provided by way of rules under the Act.
- The Act also provides for conversion of existing partnership firm, private limited company and unlisted public company into a limited liability partnership by registering the same with the Registrar of Companies (ROC).[66]
- Nothing Contained in the Partnership Act 1932 shall affect a limited liability partnership. The Registrar of Companies shall register and control LLPs too.
- The governance of LLPs shall be in electronic mode in the successful model of the present Ministry of Corporate Affairs Portal.[67]

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[64] ibid.
[65] ibid.
[66] ibid.

1.5.8 LIMITED LIABILITY LAWS IN POLAND:

A limited liability partnership in its pure form is not available here but a close equivalent to limited liability partnerships under Polish law is the *spółka partnerska*, introduced in 2001.[68]

1.5.9 LIMITED LIABILITY LAWS IN SINGAPORE:

Limited Liability Partnership's are formed under the Limited Liability Partnerships Act 2005. This legislation is drawn from both the US and UK models of Limited Liability Partnerships, and considers the partnership a body corporate as in UK. However for tax purposes it is treated like a general partnership, so that the partners rather than the partnership are subject to tax (tax transparency).[69]

1.5.10 LIMITED LIABILITY LAWS IN UNITED KINGDOM:

Britain enacted its first limited partnership statute in 1907.In the United Kingdom LLPs are governed by the Limited Liability Partnerships Act 2000. A UK Limited Liability Partnership is a corporate body which has a continuing legal existence independent of its Members, as compared to a Partnership which may have a legal existence dependent upon its membership. In the United Kingdom Limited Liability Partnership's are governed by the Limited Liability Partnership Act 2000(in England and Wales and Scotland and the Limited Liability Partnerships Act (Northern Ireland) 2002 in Northern Ireland.[70] The members in a limited liability partnership have a collective or a joint responsibility, to the extent that they may agree in an "LLP agreement", but they do not have any individual or several responsibilities for each other's actions. Therefore members in a limited liability partnership cannot lose more than they invest provided

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[67] http://www.nationmaster.com/encyclopedia last visited 11.02.09
[68] ibid.
[69] ibid.
[70] ibid.

there is no fraud or wrongful trading as the situation is with shareholders in Limited Liability Company.[71]

In relation to tax, a UK limited liability partnership is similar to a partnership in two ways:

2 It is tax transparent or pass-through, that is the partnership will pay no tax to the government.
3 Its members pay tax in relation to the income or gains they receive through the partnership business.

It is a unique entity in its synthesis of collective and individual rights and responsibilities and its infinite flexibility there is in fact no requirement for the LLP agreement even to be in writing because simple partnership-based regulations apply by way of default provisions.[72]

Until now similar partnerships have been introduced by Japan and by the financial centers of Dubai and Qatar. It is quite similar in its working to a limited liability company in the United States of America although it may be distinguished from that entity by the fact that the LLC, while having a legal existence independent of its Members is not technically a Corporate body because its legal existence is time limited and therefore not "continuing".[73]

1.5.11 LIMITED LIABILITY LAWS IN MUSLIM COUNTRIES:

The concept of limited liability has been adopted all over the world. In Muslim countries like Malaysia special legislation has been made in order to introduce limited liability in partnerships .Whereas it's a known phenomena in case of companies in all

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[71] ibid.
[72] ibid

[73] http://www.nationmaster.com/encyclopedia last visited 11.02.09

countries. Many Muslim countries acknowledge that limited liability is a good feature and have introduced it through specific legislations.

In Egypt limited partnerships (sharikāt al tawsiyah al basita) have been adopted.[74] In Pakistan limited liability partnerships have not been introduced yet. However limited liability companies are in vogue in a number of Muslim countries. In Saudi Arabia Limited liability companies are registered with the ministry of commerce and industry. These companies must possess at least two members who are not liable for more than their shares. the number of partners should not exceed fifty as per rules of the ministry. the corporate capital of the company shall not be less than five hundred thousand Riyal.[75] Limited liability partnerships introduced in Malaysia are believed to provide businessmen and investors the flexibility to select the best business entity. Both natural and legal persons can become members of a limited liability partnership in Malaysia. The partnerships offer the benefit of both limited liability and flexibility of partnership arrangement for the internal management of business. It is considered a separate legal entity with the additional feature of continuing legal existence. According to the directives of the Companies Commission of Malaysia the limited liability partnerships will be available to all classes of businessmen and would not be specified to a particular class of professionals. It is believed by the commission of companies that this new limited liability partnership vehicle would aid small and medium sized business as well as professionals in the running of their business.[76]

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[74] Muhammad Ahmad Siraj, Al nizam al Masrafi al islami,(Al Qahira:Dar al saqafa,1989),169

[75] www.commerce.gov.sa/enoci.appx(last visited 11.4.09)

[76] http://www.nationmaster.com/encyclopedia last visited 11.02.09

CHAPTER 2

LIMITED LIABILITY IN ENGLISH LAW

2.1 EVOLUTION OF THE CONCEPT OF LIMITED LIABILITY IN ENGLISH LAW:

The concept of limited liability was first introduced in English law in 1885 under the Limited Liability Act 1885.[77] Before this Act, companies were regulated by the Companies Act 1844.

Under the Company's Act 1844:

- The company's principal constitutional document known as the "deed of settlement" was required to be registered.
- After registration of the "deed of settlement" the companies could acquire the status of a corporation.

The Joint Stock Companies Act was introduced in 1844 and while this provided for the registration of companies, there was no mention of limited liability for such companies. The next step was the attainment of limited liability for the registered companies. Till that time, people invested in companies at the risk of their fortunes. There were a number of factors which made the attainment of limited liability important for companies and partnerships in Britain. Firstly, in 1852 it was recognized by the courts that multifarious benefits were achieved due to private contractual terms, providing for limited liability. Secondly, as the country became more industrialized, the importance of limited liability became obvious to the authorities; as it was necessary to raise large sums of capital from multiple investors. The greatest encouragement that could be provided was that of limited liability. As Gower suggests, "public opinion began to harden in favor of the extension of

[77] Sealy,L.s,Cases and material on company law.(London:Buttrworths,1985),1

limited liability, particularly when the slump of 1845-1848 drew attention to the consequences of its action".[78]

Despite the opposition from some factions of the society, Parliament was intent on creating a form of limited partnership. A number of committees were assigned the job of considering the alternatives, and in 1854, the Royal Mercantile Law Commission opposed the creation of the limited liability company, but it did not extend the judgment to partnerships as limited partnerships were found to be quite desirable. Later, the House of Commons passed a bill which purported to extend limited liability to Registered Companies too and while it passed through the lower House easily, it was not very favorably received in the House of Lords. Finally, the bill was passed, though with some difficulty including formal protests and amendments, and limited liability in the form, we widely know it today, was introduced.

It was under the Company's Act 1855; that companies acquired the advantages of limited liability.[79] The 1855 Act allowed limited liability to companies of more than 25 members (shareholders). This act was revised a year later and named the Joint Stock Companies Act 1856. Insurance companies were excluded from the Act. Limited liability for insurance companies was allowed by the Companies Act 1862.The minimum number of members needed for registration as a limited company was reduced to seven, by the Companies Act 1856. Limited companies in England and Wales now require only one member.[80] Some of the main attributes of this act were:

- Under this act too, the only possible way of incorporating a company was through the process of registration.
- Shareholders of the company enjoyed limited liability under this act.
- The deed of settlement was replaced by memorandum and articles of association which are still the basic constitutional documents of today's companies.

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[78] Gower,L.C.B,Principles of modern company law.(London:Sweet&Maxwell,1992),41
[79] FeldmanDavid,Meisel Frank, Corporate and commercial law.(London: Lloyd's of London press,1996),23
[80]Https www.amazines.comLimited_liability_related.html. last visited: 22-01-09

Later in 1985 the Company's Act 1985 was passed, which did not bring any major change in the institution of a company, or in the legislation regarding it. The concept of limited liability as was introduced under the Act of 1855 remained a fundamental ingredient of all the Companies Acts revised or introduced later on. Afterwards the concept of limited liability was extended to partnerships as well. The first Limited partnership act was introduced in 1907 followed by the Limited liability partnership Act in 2000.

2.1.1 THE BASIS OF THE DOCTRINE OF LIMITED LIABILITY:

The legal basis for the doctrine of limited liability is found in the case of Salomon v Salomon. In this case the courts of England for the first time laid emphasize on the fact that the company was a separate legal person from the shareholders, therefore the shareholders or members of the company could not be held liable for the debts of the creditors. The facts of the case are as follows:

CASE:

Salomon v Salomon & Co Ltd [1897] AC 22 (House of Lords)[81]

FACTS:

Salomon was a boot and shoe manufacturer and had a prosperous business. Later in 1892 he decided to form a limited company of his own. In order to fulfill the statutory requirement of seven members for the formation of a company, he distributed the shares among his family members giving his wife, one daughter and four sons each a share worth one pound. He along with his two sons formed the board of directors.

The company almost immediately ran into difficulties and a year later the debenture holders appointed a receiver and so the company was liquidized. The assets of the company were not enough to pay back the debenture holders in full whereas the unsecured creditors remained fully unpaid. The debenture holders alleged that Salomon being the sole owner of the whole business should be held responsible to pay them back.

[81]For a more detailed account see: Sealy,L.s,Cases and material on company law.p.26-35

VERDICT:

After analyzing the facts of the case, Lord Macnaughten said: "the company is at law a different person altogether from those forming the company 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 profit, 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."[82]

From the judgment of this case it can be concluded:

- That the company is a separate legal entity.
- That the creditors could not demand their debts from Solomon as he was merely a shareholder and therefore was not responsible for the debts of the company.
- That the shareholders were not liable to pay off the debts of the company as their liability is limited to the amount of their investment.

2.1.2 LIFTING THE VEIL:

Though the general rule is that the liability of members of a company is limited to the amount of their investments and they cannot be deprived of their personal property for repaying the debts of the creditors, but there are some exceptions to this rule of limited liability. In other words, limited liability is not an absolute protection.

Piercing the corporate veil, then, is one example of when the separate nature of the corporation will not be respected. The purpose of piercing the corporate veil is to decrease the encouragement created by limited liability to engage in exceedingly risky activities. The corporation will be looked upon as a legal entity as a general rule, and until sufficient reason to the contrary appears; but, when the notion of legal entity is used

[82] Farrar, John H, Company Law.(London:Butterworths,1985),55

to defeat public convenience, justify wrong, protect fraud, or defend crime, the law will regard the corporation as an association of persons.

The corporate veil may be lifted under certain circumstances which can be categorized as follows:

1. Under express statutory provisions.
2. Under judicial interpretation.

UNDER EXPRESS STATUTORY PROVISIONS:

- According to section 24 of the Companies Act 1985, if the company carries on business for more than six months, after its number of members is reduced below seven in the case of a public company and below two in the case of a private company, the person who is a member of such a company after those six months will become liable for all the debts of the company. Therefore in such a situation the privilege of limited liability attached to the corporate entity is taken away and the creditors can look beyond the corporate veil to members of the company for satisfaction of their debts.
- Another provision i.e. section 630 of the Companies Act, which is the most extreme departure from the rule in Salomon's case, states that if it appears that the business of the company has been carried on with the intent to defraud creditors of the company, then the court may hold such persons liable to contribute to the debts of the company. So if a company engages in fraudulent trading, any members who are knowingly parties to the fraud are personally liable for the debts and other liabilities of the company.
- If a public company enters into a transaction to allot shares in contravention of the provisions of the Companies Act 1980, section 117(8) which requires it to obtain a certificate from the Registrar of Companies before doing business the directors of a company are jointly and severally liable to any third party injured in consequence of such a breach.
- Under section 349(4) of the Companies Act if any officer of the company or any other person acting on its behalf: "signs or authorizes to be signed on behalf of the

company any bill of exchange, promissory note, cheque or order for money or goods in which the companies name is not mentioned he is liable to a fine and he is further personally liable to the holder of the bill of exchange, promissory note, cheque or order for money or goods for the amount of it."

UNDER JUDICIAL INTERPRETATION:

Sometimes the courts need to look behind the veil of incorporation for reasons such as public interest of people. Similarly in times of war or in cases of fraud the corporate veil has often been ignored. Below are some instances where the courts have lifted the veil of incorporation.

- In case the company is declared as having enemy character

CASE:

Daimler Co.Ltd v Continental Tyre and Rubber Co [1916] 2AC 307 (House of Lords)

FACTS:

The continental tyre company was incorporated in England but all except one of its shares were held by German nationals. Only one shareholder of the company was an English national. All other shareholders and directors of the company were resident in Germany.

The problem discussed in the case was whether the company could have a standing in a court of England for recovering a debt, at a time when England was at war with Germany. Now the general rule would have been that the company being incorporated in England and itself being a legal person could not be prevented from having a standing in a court of England for recovering the debts.

But the court went behind the veil of incorporation in this case and regarded it as a company having enemy character on the ground that majority of shareholders belonged to an enemy country.

VERDICT:

It was held that the company could not recover payment of the debts as it was a company registered in the United Kingdom but was carrying on business in an enemy country and so it was declared an enemy company.[83]

- In case the company is formed for a fraudulent purpose

CASE:

JONES v LIPMAN [1962] 1 WLR 832

In this case Mr. Lipman had contracted to sell a land to Mr. Jones but later on changed his mind. He immediately formed a company. For putting the land beyond the reach of an order of specific performance he conveyed it to the company which he had formed for this purpose. The company was owned and controlled by Mr. Lipman himself. Mr. Jones filed a complaint against Mr. Lipman, requesting the court to order specific performance of the contract.

VERDICT:

In this case the court went beyond the veil of incorporation and ignoring the fact that the land was owned by the company, ordered specific performance of the contract. The court decided so because the defendant had made the company in order to achieve a fraudulent purpose.

Russell.J made an order of specific performance against both Lipman and the company, holding that specific performance cannot be resisted by a vendor who has absolute ownership and control of the company in which the land is vested.[84]

[83] For details of case see Sealy,l.s,Cases and Material on Company law,p.48-49
[84] Gower,L.C.B,Principles of Modern Company Law,p.130

CASE:

Gilford Motor Co. v Horne [1933] Ch 935 (Court of Appeal)

FACTS:

Mr. Horne was an employee of Gilford Motor Company and was acting as its managing director. He had covenanted in a written agreement that after leaving the company's employment he will not solicit the customers of the company. Later on upon the termination of its employment he formed his own company in which he himself, his wife and an employee were sole shareholders and directors. This company started soliciting the customers of the former company. Gilford motor company filed a complaint against Mr. Horne alleging that he had broken the covenant.

It was found out that Mr. Horne himself was the sole controller of the company as the role played by his wife and the other employee was almost negligible.

VERDICT:

It was clear from the facts of the case that Mr. Horne had formed the company with the intention of avoiding penalty for breach of the covenant. Lord Hansworth said: "I cannot help feeling quite convinced that at any rate one of the reasons for the creation of the company was the fear of Mr. Horne that he may commit breach of the covenant in carrying on the business as for instance, in sending out circulars as he was doing and that he might possibly avoid that liability if he did it through the defendant company."[85] It was inevitable in this case for the court not to go beyond the corporate veil. Lord Hansworth accordingly granted an injunction, which he ruled should go against he company as well as Mr. Horne.

- In case of agency

CASE:

RE FG (Films) Ltd. [1953]

FACTS:

In this case a company filed a complaint that they had applied for registration of their film "monsoon" as a British film, which was not accepted by the board of trade.

[85] Sealy,l.s,Cases and Materials on Company law.p,55

The board of trade had rejected their application on the ground that the film was actually made by a large American company, as they had provided all finance and facilities required by the company to make the film.

In this case the court went behind the corporate veil to determine if the company had the right to register the film as a British film. It was found out that 90% of the share capital belonged to the American director of the company and only 10% of the shares were held by the British director. The participation of the British director in production of the film was almost negligible. And the work done by the British directors if any was only on behalf of the company or as agents of the company.

VERDICT:

Vassey J declared that the applicants were not the makers of the film and therefore it could not be registered as a British film.[86]

- For the purpose of taxation:

CASE:

Unit Construction Co. Ltd v Bullock [1960] A.C. 351

FACTS:

In this case a company incorporated in United Kingdom formed three other companies as its subsidiaries. All the three subsidiary companies were incorporated and registered in Kenya. Each company had a board of directors different from the parent company. Under the articles of association of the subsidiary companies no board meetings could be held in the United Kingdom. For revenue purpose the court was forced to go behind the corporate veil, in order to determine where the tax was to be paid. As a general rule tax of a company should be paid where the company is resident and the residence of a company for tax purpose is said to be the place where its real business is carried on.

[86]For details of the case see Sealy,Cases and Material on Company law,p.50-51

VERDICT:

The House of Lords held that for tax purpose the Kenya subsidiaries were resident in the United Kingdom where central management and control of the company was in fact located.

- In case of group enterprise

CASE:

DHN Food Distributors Ltd. v Tower Hamlets London Borough Council [1976] 1 WLR 852 (Court of Appeal)

FACTS:

In this case DHN a cash and carry grocery company had two wholly owned subsidiaries which carried out no business of their own. One of the companies provided vehicles to the holding company and the other was also used by it of which DHN was a licensee. The council occupied the premises but offered no compensation to DHN saying that it had no equitable interest in the property as it was a mere licensee of it. If each member of this group of companies was considered a separate company then no one could have claimed compensation in that case as the subsidiary would have had land but no business to disturb while the holding company would have had the business but no interest in the land.

VERDICT:

Looking at the peculiar circumstances of this case Lord Denning said: "this group is virtually the same as a partnership in which all the three companies are partners. They should not be treated separately so as to be defeated on a technical point. They should not be deprived of the compensation which should justly be payable for disturbance. The three companies should for the present purposes, be treated as one and the parent company DHN should be treated as that one."[87]

The court therefore allowed the appeal.

[87] Gower,,Principles of Modern Company law,p.127

- In case of trust

CASE:

Abbey Malvern Wells v Minister of Local Government and Planning [1951]

FACTS:

In this case a company named Abbey Malvern Wells owned a school which was managed by a board of trustees who were bound by the terms of the trust to use the assets of the company for educational purposes. The company applied to the Minister for town and country planning for a ruling that the land they held was exempt from development charges because it was held for charitable purposes. The Minister ruled against them but on appeal from that decision the court held that because the land was occupied by the company for the educational purpose of the school and that the property and assets of the company could only be applied to the charitable purposes of the trust deed.

VERDICT:

The court ruled in favor of the company that the interest it had in the use of the land was a charitable one and therefore it fell within the exemption provisions of the tax statute. Dnckwerts J held that where all the shares in a company were held on educational trusts and the management of the company was in the hands of trustees, the court could in this case lift the veil of incorporation so as to impress the company's property with the terms of the trust.[88]

2.2 LIMITED LIABILITY IN PARTNERSHIPS:

In order to determine the extent to which the concept of limited liability exists in English law, we will take into consideration two main types of business organizations i.e. partnerships and corporations. Before we begin to discuss the nature of liability borne by partners in partnerships and members in companies we will first give a general overview of what partnerships and companies actually are.

[88] ibid.

2.2.1 PARTNERSHIPS: (DEFINITION AND CHARACTERISTICS)

DEFINITION:

A partnership contract can be defined as:

Section 1 of the Partnership Act 1890 provides:

"Partnership is the relation which subsists between persons carrying on a business in common with a view of profit". [89]

According to s.6 of the Uniform Partnership Act 1916, a partnership is defined as: 'An association of two or more persons to carry on as co-owners a business for profit."[90]

According to the Pakistani Partnership Act 1932, "a partnership is a voluntary association of two or more persons who contribute money, property, time, care or skill to carry on as co-owners a lawful business for profit and to share the profits and losses of the business."

Other jurists quoted by Lindley define partnerships as:

According to Pollock, partnership is the relation which subsists between persons who have agreed to share the profits of a business carried on by all or any of them on behalf of all of them.

Dixon says that a partnership is a voluntary unincorporated association of individuals standing to one another in the relation of principals for carrying out a joint operation or undertaking for the purpose of joint profit.

Another jurist Kent defines partnership as a contract of two or more competent persons to place their money, effects, labor and skill or some or all of them in lawful commerce or business and to divide the profit and bear the loss in certain proportions.[91]

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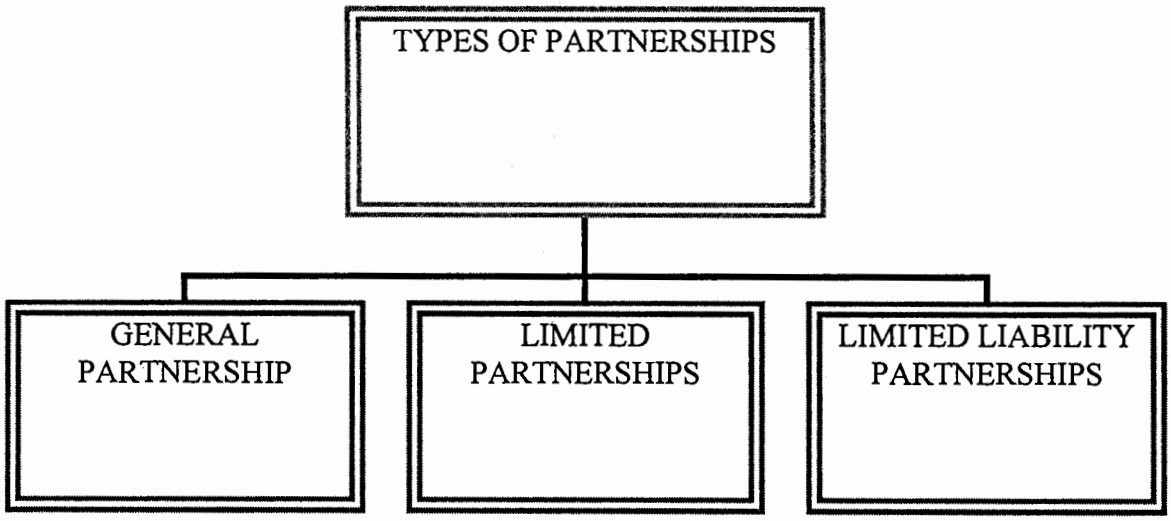
[89] Macintyre,Ewan.Commercial Law.(Shropshre:Blachstone press limited,1998),345

[90] Solomon, Lewis D & Bauman, Jeffrey D.Selected corporation and partnership statutes, rules and forms.(Minnesota: West publishing company,1992),623

[91] Scamell,Earnest . Lindley on the Law of Partnership,p.14-15

MAIN CHARACTERISTICS OF A PARTNERSHIP CONTRACT:

1. An agreement between the partners is the most important element of a partnership contract. All important details regarding the distribution of profits, contribution of each partner etc. are listed in the agreement. Preferably the agreement must be in a written form to avoid any future disputes.
2. The minimum number of partners should be two whereas the maximum number differs according to the type of business activity.
3. It's not important for a firm to get registered.
4. Every partner is an agent of the other partners and the firm as a whole.
5. A partnership firm is bound by the acts of the partners.
6. A partner cannot transfer his shares to another without the consent of the other partners.
7. The liability of the members of a partnership differs according to the type of partnership.



2.2.2 TYPES OF PARTNERSHIP:

Partnerships were not to be found in English law until the Partnership Act 1890 was introduced, though they were quite common in other European countries. According to Lindley partnerships in Europe were either civil or commercial in nature.[92] Civil partnerships were those which involved financial gain, but no trading operations e.g. a partnership between farmers. Whereas the partnerships which involved trading operations accompanied by financial gain were known as commercial partnerships.

There are mainly three types of partnerships existing today namely:

1. General partnerships
2. Limited partnerships.
3. Limited liability partnerships.

2.2.2.1 GENERAL PARTNERSHIPS:

This is one of the most common type of partnerships, which exists all over the world. Any two members who want to carry out any activity together in order to make profit can enter into a partnership agreement with each other. Before 1890, in England this type of partnership was only to be found in legal decisions and text books as there was no law framed for them by the Parliament. It was only in1890 that the Partnership Act was formally introduced and till 1907 this was the only type of partnership available to the people. The main characteristics of this type of partnership are:

1. According to Partnership Act 1890, it's not necessary to get the partnership firm registered.
2. This type of partnership may be constituted without a written agreement.[93]
3. All partners are collectively known a firm.[94]
4. A partner is considered as an agent of the firm.
5. A partner can purchase and sell goods on behalf of the firm.

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[92] Scamell,Earnest H. Lindley on the law of Partnership,p.25
[93] Ibid.,122
[94] The partnership act 1890, section 4

6. A partner can engage servants for the partnership business.
7. Every partner has the right to take part in the management of the partnership business.
8. A partner can receive payment of the firm's debts.
9. The firm is bound by the acts of all partners provided they carry out business in the usual way.[95]
10. All partners are jointly liable for the debts of the firm.[96]

2.2.2.2 LIMITED PARTNERSHIPS:

According to the definition of limited partnership "it's an unincorporated association, or firm in which one or more of the partners are, on compliance with the provisions of various state statutes regulating such partnerships, relieved from liability beyond the amount of capital contributed by them.[97]

Black's law dictionary defines it as: "limited liability partnership is a type of partnership comprised of one or more general partners who manage business and who are personally liable for partnership debts, and one or more limited partners who contribute capital and share in profits but who take no part in running business and incur no liability with respect to partnership obligations beyond contribution."[98]

The concept of limited partnerships did not exist in the British law before 1908. It was actually borrowed from the continent of Europe. The earliest limited partnerships were seen in Rome known as *societates publicanorum*. Later the concept was revived around the 10th century as the *commenda* came into existence, which became quite common in France and Germany.[99]The *commenda* was a partnership in which one of the partners supplied capital without taking part in the management of the venture. It contained all essential elements of limited liability and the modern sleeping partnership.

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[95] Ibid. section 24 (5)
[96] Ibid. section 9
[97] Nolan, Joseph, R, Black's law dictionary,(St.paul:west publishing comp,1979),836
[98] Ibid.
[99]Scamell,Earnest H. Lindley on the Law of Partnership,p.28

The main purpose of introducing limited partnerships was to enable a party to put into the stock of a firm a definite sum of money, and without indulging in the management of the affairs of the firm, share a profit which shall be in proportion to the money thus contributed, and no more. The need to adopt these partnerships aroused because the general partnerships did not serve the purpose of insulating the partners of the firm against the debts of the firm. As in a general partnership, a partner according to section 9 of the Partnership Act 1890 is liable jointly with the other partners for the whole debts of the firm.

Limited partnerships are a special kind of partnerships which were introduced for the first time in the United Kingdom under the Limited partnership Act 1907.[100] These partnerships are not legal entities like limited companies[101] or Limited Liability Partnerships. This type of partnership offers partners the extra benefit of limited liability. In the United States similar partnerships were introduced under the Revised Uniform Limited Partnership Act 1916.

An individual or a legal body such as a company may be a partner in a limited partnership, either as a general or as a limited partner. A person cannot be both a general and a limited partner at the same time.

MAIN FEATURES OF A LIMITED PARTNERSHIP:

1. A limited partnership is not a separate legal entity like a limited company, which means that legal personality is not assigned to such firms.
2. A limited partnership is basically a combination of two sets of partners namely:
    - the general partners
    - the limited partners

According to s.4 (2) of the Act,[102] there must be one or more general partners and one or more limited partners for constituting a limited partnership.

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[100] Gower,Principles of Modern Company law.,49
[101] Scamell,Earnest H. Lindley on the law of partnership,p.830
[102] Limited Partnership Act, 1907.

3. In case the partnership carries on a banking business, the number of partners must not exceed 10 whereas in case of any other business the number of partners shall not be more than 20.[103]
4. A limited partnership must be necessarily registered according to the rules provided in the Act; otherwise it would be considered a general partnership.[104]
5. At the time of entering into a limited partnership, a limited partner shall contribute a specific amount of capital to the partnership.[105]
6. A limited partner cannot draw out or receive back any part of his contributions to the partnership during the lifetime of the partnership.
7. A limited partner is not allowed to take part in control and management of the partnership business.[106]
8. A limited partner can at any time inspect the books of partnership.
9. A limited partner can advise the general partners in matters relating to the business of the partnership.
10. In contrast to general partners, the approval of a limited partner is not necessary in case a new partner is introduced to the partnership.

LIMITED PARTNERSHIPS AS CONTRASTED WITH GENERAL PARTNERSHIPS:

A limited partnership is a form of partnership similar to a general partnership. The main difference between a limited and general partnership is that in addition to one or more general partners, there are one or more limited partners in a limited partnership, whereas in a general partnership all partners are equal in all respects.

Another similarity between a limited and a general partnership is that the general partners enjoy the same legal position as partners in a conventional firm, i.e. they have management control and they share the profits of the firm in predefined proportions. Therefore the liability of general partners in Limited partnerships is also the same as of partners in a general partnership and so they are jointly and severally liable for the debts

[103] Ibid. section 4 (2).
[104] Ibid. section 5
[105] Ibid. section 4(2)
[106] Ibid. section 6(1)

of the partnership. As in a general partnership, the general partners in limited partnership too, have apparent authority as agents of the firm to bind all the other partners in contracts with third parties.

On the other hand the limited partners have limited liability like shareholders in a company i.e. they are only liable for debts incurred by the firm to the extent of their registered investment, and have no management authority. The general partners pay the Limited partners the equivalent of a dividend (as in companies) on their investment, the nature and extent of which is usually defined in the partnership agreement.

In a nutshell general partners are those partners who are responsible for the control and management of the partnership business. They are therefore responsible for the debts and obligations of the partnership. Whereas limited partners are those partners who according to the initial contract cannot be held responsible for more than the amount invested by them in the partnership business. Also these partners are not allowed to participate in the control and management of the business. In case they interfere in the management of the business, this privilege of limited liability will be taken away.

2.2.2.3 LIMITED LIABILITY PARTNERSHIPS:

A limited liability partnership is a new form of partnership which possesses the attributes of both partnerships and companies. A limited liability partnership is more suited for businesses where all investors wish to take an active role in management of the partnership business. In the United Kingdom, Limited Liability partnerships are governed by the limited liabilty partnership act 2000 in Engalnd and Wales and by the limited liability partnership act 2002 in northern Ireland[107]

MAIN FEATURES OF A LIMITED LIABILITY PARTNERSHIP:

1. A limited liability partnership is a body with legal personality (like companies) separate from its members unlike a general and limited partnership.

[107] http://en.wikipedia.org/wiki/limited_liablity_partnership_act_2000.last visited13.03.09

2. According to section 2 of the Limited Liability Partnership Act 2000 the minimum number of partners required for carrying on such business is 2.
3. Section 3 of the Act provides that a certificate of incorporation will be issued to the partnership once the formalities have been complied with.
4. Members of a Limited liability partnership are subject to income tax on their income as trading income in the same way as a normal partnership.
5. The process of winding up of a limited liability partnership is similar to that of a company.

A limited liability partnership is similar to a company in the following manner:

- Both a limited liability partnership and a company are legal entities.
- All partners of a limited liability partnership have the privilege of limited liability as members of a company.[108]

Difference between a limited liability partnership and a limited partnership:

- A limited liability partnership is considered a legal person similar to a company whereas the concept of legal personality is not found in case of a limited partnership.
- In case of Limited liability partnerships the privilege of limited liability is granted to all partners unlike Limited partnerships where it's available only to a subset of non-managing limited partners.
- Unlike the partners in a Limited partnership, the partners in a Limited liability firm do have the right to manage the business directly.
- In a Limited Liability Partnership one partner is not responsible or liable for another partner's misconduct or negligence. This is an important difference from that of a limited partnership.[109]

[108] httpswww.amazines.comLimited_liability_related
[109] httpwww.law-online.co.zasbdlegalpersonality

A Limited Liability partnership differs from general partnerships in the following manner:

- Unlike general partnerships where the liability of partners is unlimited, the liability of members of Limited Liability Partnership, on winding up is limited to the amount of capital they contributed to the business.

- Unlike a general partnership the members of a Limited Liability Partnership are not jointly and severally liable for the actions of other members. This is due to the fact that the Limited Liability Partnership itself has legal personality separate from its members.[110]

2.2.3 LEGAL PERSON IN PARTNERSHIPS:

The concept of legal person was initially enacted in the law for companies but after it proved to be successful, it was also adopted in various countries for the institutions of partnerships. Partnerships which are legal persons are called Limited Liability Partnerships and are required to be registered according to the laws of the country. The main attraction which a limited liability partnership offers is that:

- It is not affected by the bankruptcy or death of a partner.
- It enjoys perpetual succession.
- All partners have the privilege of limited liability though they are directly involved in the management of the partnership business. [111]

These partnerships were initially found only in the west but by now some Muslim countries like Malaysia have also adopted these partnerships.[112] The members of a limited liability partnership are not considered liable for debts of the partnership business because the partnership is itself a legal person and has to look after its debts and liabilities itself.

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[110] ibid
[111] ibid,also see pg.45
[112] www.islamicfinancenews.com

2.2.4 LIABILITY OF A PARTNER:

After going through the types of partnerships in English law, the liability borne by the partners in each type can easily be judged. The liability of partners as per Indian and Pakistani law is unlimited as the law says that every partner is liable for all debts and obligations incurred while he is a partner in the usual course of business by or on behalf of the partnership. Liability of partners in each type of partnership is either limited or unlimited.

1. LIABILITY IN CASE OF GENERAL PARTNERSHIPS:

Where the partnership is of a general nature and governed by the Partnership Act 1890, then in such a case section 12 of the act clearly lays down the liability of a partner saying: "every partner in a firm is liable jointly with the other partners and in Scotland severally also, for all the debts and obligations of the firm incurred while he is a partner and after his death, his estate is also severally liable in a due course of administration for such debts and obligations, so far as they remain unsatisfied ..."

This statement clearly declares the liability of a partner as *unlimited.* The reason behind it is the status which partners enjoy. All partners are agents and sureties for the firm and therefore if the assets of the firm are not enough to fully satisfy the debts of the firm, the remaining liabilities have to be discharged by the partners. Lord Lindley says that once the relation of partners is established between the partners who carry on a business and the partners who passively participate in the profits then the latter will become equally liable with the former for the debts and liabilities of the firm.

2. LIABILITY IN CASE OF LIMITED PARTNERSHIPS:

As limited partnership is the combination of General and Limited partners the liability of both types of partners is different. The liability of a general partner is *unlimited* as laid down in section 4(2) of the act which says that the general partners will be liable for all

debts and obligations of the firm as they are chiefly responsible for running the partnership business.

Whereas the liability of Limited partners is *limited* as the name indicates. They will be required to contribute a specific amount at the time of entering the partnership and therefore shall not be liable for the debts and obligations of the firm beyond the amount so contributed.[113]

However this privilege of limited liability may be taken away in following situations:

- If the limited partner is found guilty of taking part in the management of the business.[114]
- If a limited partner during the continuance of the partnership business, draws out or receives back any part of his contribution.[115]

3. LIABILTY IN CASE OF LIMITED LIABILITY PARTNERSHIPS:

The liability of the partners in a limited liability partnership is *limited* to the amount contributed by them at the time of entering the partnership, according to the Limited liability partnership Act 2000. The liability of partners in such partnerships is therefore similar to liability of members in a company. But unlike shareholders of a company, the partners here have the right to manage the business directly. Whereas in a company, the shareholders have to elect a board of directors for the management of the company's business.

However members of a limited liability partnership can lose the privilege of limited liability in case of fraud or wrongful trading, otherwise they cannot lose more than they invest. The liability of the members is limited because the partnership itself has legal personality separate from its members.

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[113] See Partnership Act 1890, section 4 (2)
[114] Ibid. section 6(1)
[115] Ibid. section 4(3)

2.3 LIMITED LIABILITY IN CORPORATE SECTOR:

In order to understand the concept of limited liability in companies, its important to know first what the word company stands for.

2.3.1 COMPANIES:

DEFINITION:

A company can be defined as: "a collection of many individuals, united into one body, under a special denomination, having perpetual succession under an artificial form, and vested by the policy of the law, with the capacity of acting in several respects as an individual."[116]

Lord Justice Lindley defines a company as "by a company is meant the association of many persons who contribute money or money's worth to a common stock and employ it for a common purpose. The common stock so contributed is denoted in money and is the capital of the company. The persons who contribute it or to whom it belongs are members. The proportion of capital to which each member is entitled is his share."[117]

According to Chief Justice Marshall:

"A corporation is an artificial being, invisible, intangible, existing only in contemplation of the law. Being a mere creation of law, it possesses only the properties which the charter of its creation confers upon it either expressly or incidental to its very existence."

Another definition given by Haney, says:

"A company is an incorporated association, which is an artificial person created by law, having separate entity, with a perpetual succession and a common seal."

MAIN FEATURES OF A COMPANY:

The main attributes of a company which are clear from the definitions given above can be stated as:

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[116] Farrar, John H, Company Law,p.5

[117] Chatterjee, Chinmoy.Guide to Private companies. (Bombay:N.M.Tripathi,1989),1

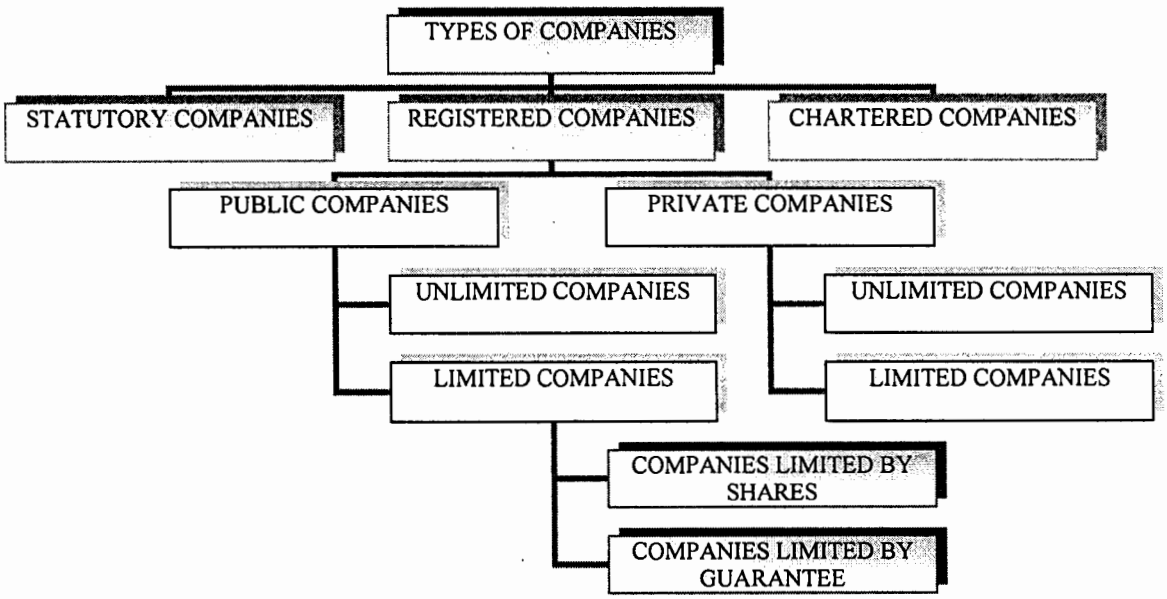
1. The most important characteristic of a company is that it is a legal entity, distinct from its members which means that it enjoys rights and is subject to duties which are not the same as those of its members. This separate legal entity of a company is also recognized by the income tax act, as the company is required to pay income tax on its profits separately whereas the shareholders pay income tax on their individual dividend income separately.
2. When it's said that a company is a legal person distinct from its members, this leads us to the concept of limited liability. So if a company bears a loss or becomes insolvent, the shareholders of the company are liable to the extent of their shares only and their personal property remains safe. They are therefore not held responsible for the debts of the company.
3. The company itself is the sole owner of its property and the shareholders have no right over it. Shareholders being members of the company have a right over their shares only.
4. The company being a separate legal person can take action to enforce its legal rights. Similarly it can be sued in its individual capacity for breach of its legal duties.[118]
5. The death, illness or incapacity of a member or director has no effect over the company. Similarly if any of the directors dies or leaves, the members will hire another director. This means that the company enjoys a long life.
6. Shareholders can transfer their shares freely and there is no restriction regarding change in membership.

DIFFERENCES BETWEEN A PARTNERSHIP AND A COMPANY:

- A partnership is not a legal entity whereas a company is considered a legal entity. Now Limited liability partnerships have also been assigned legal personality under the Limited Liability Partnership Act 2000.

[118] Farrar, John H, Company Law,p.14

- The minimum number of members required in a partnership is 2 while in a company it is 7.
- The liability of partners in an ordinary partnership is unlimited whereas the liability of members in case of companies is limited as introduced under the Companies Act 1885. (But now the liability of partners can also be limited under the recently introduced Limited partnerships and Limited liability partnerships).
- The partners in an ordinary partnership can be sued for the debts of the partnership but the shareholders cannot be sued for the debts of a company because of its separate legal personality.
- The partnership firm should not necessarily be registered whereas a company must be registered in order to acquire the status of an incorporated company.[119]



[119] ibid.

2.3.2 TYPES OF COMPANIES:

In England there were traditionally two recognized forms[120] of corporations namely:

- Corporation sole
- Corporation aggregate

Corporation sole used to be an office held by a single individual, particularly an ecclesiastical office, such as the Bishop of Birmingham or the Vicar of all souls. Such an office was treated as a legal entity independently of the person who may for the time being occupy it and even, when there is a vacancy in the office.

Whereas a corporation aggregate had long been recognized in English law, which was an incorporated group to which the law had exceptionally accorded separate legal personality. For example a company formed under the Companies Act is a form of corporation aggregate.

Gower suggests that companies can be divided into three types from a functional viewpoint.[121]According to him the first of these types are the companies which are formed for social and charitable purposes. For these companies the object is not gaining profit. These are mostly companies limited by guarantee. The second type of companies is those which are formed to enable a single trader or a small body of partners to carry n a business. The object of forming such companies is to grant them a legal personality, so that the liability of members is shifted to the company, though the members retain control and share the profits. These companies are mostly limited by shares. The third type of companies according to Gower are those which are formed to enable the general public to invest in an enterprise and share its profits without taking any part in the management of the business as do limited partners in case of limited partnerships. Majority of these companies are also limited by shares.

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[120]Feldman, David, Meisel Frank, Corporate and Commercial law,12

[121] Gower,L.C.B,Principles of Modern Company law.,10

According to the Companies Act 1985, there are three main types of companies:

1. Chartered companies.
2. Statutory companies.
3. Registered companies.

- CHARTERED COMPANIES:

Chartered companies are those companies which are granted a charter by the Crown under Royal Prerogative or special statutory powers. This method of incorporation is used only by organizations formed for charitable purposes such as schools and colleges.[122]

- STATUTORY COMPANIES:

These were bodies formed under general public acts such as the Friendly societies, the Industrial and Provident societies and the Building societies acts.[123]

- REGISTERED COMPANIES:

These are the most common type of companies. These are registered under the Companies Act through the procedure laid down in it.

Registered companies are further divided into two types[124]:

- Private companies
- Public companies.

Private companies are those in which:

1. The right to transfer shares is restricted.
2. The maximum number of members in a private company is restricted to 50.
3. The company is not allowed to subscribe its shares or debentures to the public.

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[122] Gower,,Principles of modern company law,12
[123] ibid.
[124] ibid.

Whereas a Public company does not possess the attributes mentioned above. It is openly allowed to subscribe its shares to the public. The most important reason for going public is the wish to secure additional capital by issuing shares and debentures to the public at large. The shareholders can freely transfer their shares.

A public or private company can either be limited or unlimited.

- LIMITED COMPANIES:

Limited companies are those where the liability of the members is limited to the extent of their shares, in case it's a company limited by shares or to the extent of the amount guaranteed by them, if it's a company limited by guarantee. In these companies the liability of shareholders upon liquidation does not extend beyond the amount of capital invested or guaranteed by them. Limited companies are required by law to file accounts regularly. Because the privilege of limited liability is granted to the members therefore it's obligatory upon the company to make financial disclosures in the interest of both the creditors and the general public.[125]

- UNLIMITED COMPANIES:

These are the companies where the liability of the shareholders is not limited as is the case of general partnerships and so the members can be asked to fulfill the debts of the companies upon its liquidation. Because these companies are not granted the privilege of limited liability therefore they are fully independent, they do not have to file accounts and enjoy privacy. These types of companies are limited in number.

2.3.3 THE COMPANY; A SEPARATE LEGAL PERSON:

As discussed earlier, a company is considered a separate legal entity by law. It means that a company as a person enjoys rights and liabilities like any other ordinary person. For

[125] Chatterjee, Chinmoy.Guide to Private companies,p.4

example a company can own property. It can make valid and effective contracts with its members. This can be illustrated with the help of the following cases.

CASE:

LEE V LEE'S AIR FARMING LTD [1961] AC 12[126]

FACTS:

In this case Lee had formed a company to carry on his business of spreading fertilizers from the air. He held almost all shares of the company and was appointed sole governing director of the company. Later he was also employed as a chief pilot at a salary. He was killed in an aircraft crash during his employment. The question was whether his widow was entitled to be paid compensation under the workmen's compensation legislation. The New Zealand court of appeal had held that he was not an employee, as he was not sufficiently separate from the company. But the Privy Council overruled the decision, applying strict application of the Solomon's principle.

VERDICT:

It was declared by the court that the company and the deceased were two separate legal entities. The deceased was only an agent of the company in making necessary decisions. Any profits earned would have belonged to the company and not to the deceased. There might have come a time when the deceased would remain bound contractually to serve the company as chief pilot though he had retired from the office of sole governing director.

The company and Lee were separate legal persons and it was possible for a controlling shareholder and governing director to have a contract with his company which could be the basis of a claim. If the company had appointed the deceased as its worker then in case of his death his widow was entitled to the compensation.

[126]Sealy,Cases and Material on Company law,p.35

CASE:

MACAURA v NORTHERN ASSURANCE CO[127] [1925] AC 619

(House of Lords)

FACTS:

In this case Macaura, a wealthy man sold all of his timber on his estate to a company named Irish Canadian sawmills Ltd. He in turn was allotted 42,000 fully paid shares of the company. Later on he took insurance policies in his own name, to protect the timber against fire. After two weeks almost all the timber was destroyed in afire. His claim was rejected by the insurance company saying he had no insurable interest in the timber.

VERDICT:

Lord Sumner said that the appellant had no insurable interest in the timber. Although he owned almost all the shares in the company and was a creditor of the company, but neither as creditor nor as shareholder could he insure the company's assets.[128]

CONCLUSION:

It is clear from these cases that a company is considered a separate legal person from its members. The company alone has a right over its assets, it can enter contractual relations with outsiders and that it is a separate legal person from the members and directors.

2.3.4 LIABILITY OF SHAREHOLDERS IN A COMPANY:

As discussed earlier, limited liability is one of the main characteristics of a company. This characteristic of a company was approved widely, after the decision of the House of Lords in the famous case of Salomon vs. Salomon.[129]

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[127] Sealy,Cases and Material on Company law,38
[128] ibid.,36
[129] See p.30

The relationship between the shareholders and the company can be understood by analyzing the contract of agency which exists between the following three parties:

1. Shareholders,
2. The company (in which shareholders invest)and
3. Third parties commonly known as creditors(who transact with such company)

Shareholders authorize the company to operate the assets contributed by them, and the company as a person at law (commonly known as legal person) conducts transactions with third parties. It takes loans from outsiders too for running the business, who are generally known as creditors. In the usual course of business; if a company runs into losses, third parties can only claim against the assets owned by the company to fulfill their rights without recourse to shareholders. As a result, the enterprise serves as the veil that separates the shareholders and the creditors and protects shareholders.

The reason why shareholders are protected is that a company is recognized by law as a legal person. The doctrine of corporate personality is a fundamental principle which says that, upon incorporation, a company assumes a corporate personality independent of its members. Thus a new legal person is created at law and this person like other ordinary persons, has the right to enter into contracts not only with outsiders but also with members as we saw in the case of Lee v Lee. As the company can enter into contracts, it's also bound by its contracts. It is an established principle of law that only persons who make a contract or on whose behalf a contract is made can be bound by that contract. Here we come in contact with the basic principle of contract law that only the person who has made the contract is responsible for all obligations regarding the contract. To this extent the principle of limited liability complements contract law and the process of incorporation, since the debts incurred by the company are not the debts of the individual members. Therefore logic demands that the shareholders must not be taken responsible for the debts of a company.

But as pointed out earlier there do exist some exceptions to this concept of limited liability[130]. As was seen in some cases regarding fraud and other illegal activities. A shareholder may also become liable for his own acts. For example, the directors of small companies (who are frequently also shareholders) are often required to give personal guarantees of the company's debts to those lending to the company. They will then be liable for those debts in the event that the company cannot pay, although the other shareholders will not be so liable. This processs is known as co-signing.

Limited liability, therefore distinguishes between the assets of the individuals who constitute and manage the company, and the actual assets in possession of the entity as we saw in the case: Macaura v Northern assurance. The debts of the company are not considered as the debts of the individual, and accordingly, the entrepreneur can commence business with limited risk. Their personal assets are not at risk until they specifically sign as sureties for the debts of the entity, in favor of the creditors of the entity.

2.4 ARE THE PARTNERSHIPS AND COMPANIES EXISTING IN LAW VALID ACCORDING TO ISLAMIC LAW:

After having gone through the types of partnerships and companies existing in the world today, it's important to know about their validity in Islamic law. The most common types of partnerships which exist today are discussed as follows:

- PARTNERSHIPS BASED ON WEALTH (SHARIKAT AMWAL):

These are the partnerships which are based on wealth in regard to their formation. The main types under these partnerships are sharikāt musāhama which are known as joint stock companies in which the capital is divided into equal shares and these shares are transferable in nature. Another type of partnership based on wealth is sharika al tawsiyah bil ashum which consist of two sets of partners. One category of partners possess limited

[130] See p.31

liability while the others have unlimited liability. Sharika dhat al masūliya al mahdūda also fall under this category which is commonly known as Limited Liability Company. The liability of shareholders in these companies is limited to their contributions and their shares are non-transferable.[131]

PARTNERSHIPS BASED ON PERSON (SHARIKĀT AL ASHKHĀS):

These are the partnerships where importance is given to the partners forming it, the partners know and trust each other in these partnerships. The first kind of such partnerships is the ordinary or general partnerships (sharika al tadāmun) where the partners possess unlimited liability. Another kind of partnerships is the sharikāt al tawsiyah al baseeta commonly known as limited partnerships. Here there are two types of partners, the managing and non-managing partners. The liability of the non-managing partners is limited to the amount of their shares whereas the managing partners have limited liability. The third type of partnership falling under this category is sharika al muhāssa generally known as undisclosed partnership.[132] Sharika qābida and sharika muta'adida al jinsiyyāt also exist in some countries.[133]

The decision of the Islamic fiqh academy (14th session) in this regard can be summarized as:

- The general rule regarding all these partnerships is that they are valid provided that they consist no un-islamic feature like dealing in haram, fraud, usury etc.
- Companies are not allowed to issue preference shares or debentures.
- In case of loss each partner must bear the loss according to his share.
- That the share of a shareholder will remain his sole property until it is transferred to another.[134]

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[131] www.islamonline.net
[132] ibid.
[133] ibid.
[134] ibid.

Chapter 3

LIMITED LIABILITY IN ISLAMIC LAW

INTRODUCTION:

As it's well known that trading, that is buying and selling of commodities has always been existing in our customs. From time immemorial man has endeavored to increase his wealth through various means some of which require him to jointly participate with others to achieve the objective. After the advent of Islam, Muslims were required to observe the criterion of halāl and harām in all their activities, including the economic ones. Islam proved to be a religion which guided men in all spheres of life. The very basic rules of trade mentioned in the Holy Quran are as follows:

"O you, who believe, squander not your wealth among yourselves in vanity, except it may be a trade by mutual consent".[135]

It can be understood from this Ayah that any means of trading can be adopted if it is with the mutual consent of the parties. Also the general rule for trading given in our Holy Book says:

"Whereas Allah permitted buying and selling and prohibited usury".[136] Also at another place: "O' believers take not doubled and redoubled interest and fear God so that you may prosper."[137]

These verses clearly prohibit mankind from involving in activities which include usury (riba). These two rules can be said to be the foundations of the Islamic economic system. Later on through the sayings and teachings of the Prophet (p.b.u.h) we came to know about the different modes of trade were introduced to the people which have been explained in detail in early fiqh literature.

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[135] An Nisa:29
[136] Al Baqarah:275
[137] Al Imran:130

In Islam, partnership is found to be the earliest association for trade. Initially, people started trading with the help of different types of partnerships and later on, in order to keep pace with the speedy developments all around the globe, had to inculcate some of the modern modes of financing which include different types of companies and various kinds of partnerships, like the limited partnerships and limited liability partnerships. And so with the increase in the volume of trade in the Middle Eastern and other Islamic countries, the concept of companies, gradually developed. Certain types of companies were defined in the Ottoman Commercial Code of 1860. In countries like Saudi Arabia, the new modes of trade like the concept of companies and the need to regulate by legislation such large scale activities has culminated in the Regulation for Companies 1966.[138] Similarly in Pakistan a lot of new concepts have been adopted which were deemed as necessary for boosting the economy of the country. These include the concept of legal person, the Mudaraba companies' Ordinance adopted in 1980 and some other kinds of partnerships and companies.

Before discussing the main issue of limited liability in the Islamic perspective, it's essential to have a thorough understanding of the basic modes of trade which already exist in Islamic commercial law. This will ultimately enable us to analyze the main problem concerning us. As limited liability is a concept which is closely related to the concept of companies and partnerships in law, therefore there is a need to discuss the status of companies and partnerships in Islam first.

3.1 COMPANIES AND PARTNERSHIPS IN ISLAM:

Partnership is the most common method used for trading since long. The early Islamic economic activities were mostly based on partnerships, whereas companies have evolved recently. Companies conduct business and trade at a very large scale. In order to have a good understanding of these concepts in the light of Islam it's better to have a look at the basic characteristics and attributes of partnerships and companies first.

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[138] Kay, Earnest. Legal aspects of business in Saudi Arabia,(London: Graham and trotman limited, 1979),21

3.1.1 PARTNERSHIPS IN ISLAMIC LAW:

3.1.1.1 DEFINITION:

Partnership is a contract in which two or more persons agree to participate in a business, and afterwards share in the profits and losses as per agreement or according to their shares in the contribution of partnership capital. The contribution is not necessarily in terms of money, it can even be manual or in the form of labor. A partnership of this nature is approved by the Quran, the Sunnah, and Ijma and more recently by legislation in most Middle Eastern and other Islamic countries. In Qura'n it's stated regarding partners in a sharika:

"and verily many partners oppress one another, except those who believe and do righteous deeds, and they are few."[139]

Some of the fundamental attributes of a contract of partnership in Islamic law are:

1. Offer and acceptance:

A contract without offer and acceptance, verbal or written, is not considered valid.

2. Legal status of the partners:

For example, a partner must have attained maturity of age, should have the ability to enter a contract and should be of sound mind.

3. Capital of the partnership:

The capital of a partnership can be either in form of cash or labor. The amount and type of contribution must be agreed upon in the contract so that problems do not arise later on. In principle, capital should be in cash, but legislation now supports the view that it may be in the form of circulating or fixed assets, provided these assets have a monetary value at the time the contract was entered into.

4. Object of the partnership:

It is necessary in a partnership that the object or aim of partnership is not forbidden by Islamic law. For example the buying or selling of haram items like alcoholic drinks or pork is strictly forbidden. Similarly no partnership can be entered into for an immoral or indecent purpose.

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[139] Al sād,24

5. Contribution of capital:

In this matter there is a difference of opinion among the jurists themselves, and between the jurists and the legislature as to whether the contribution should be in cash, kind, or utilizable rights. It is, however, generally recognized that contributions in cash, kind, and utilizable rights are acceptable.

6. Distribution of profit and loss:

Profit may be distributed either according to the value of shares of each partner or as agreed in the contract. In case of any loss, loss is distributed according to the share of each partner. There is controversy among jurists as to whether or not the losses can be distributed according to agreement. It is difficult on religious grounds to permit a situation where one partner does not share in the loss as it can only result in a grievance to other partners. However according to legislation, prior agreement may be reached regarding the distribution of losses.

7. Form of the partnership contract:

A partnership may be formed by agreement in writing or orally. However it's preferred that the contract be in written form. The conditions in which the contract can be revocated or nullified can also be included in the partnership agreement.

3.1.1.2 TYPES OF PARTNERSHIPS:

In Islamic law the term "sharikah" is used for both partnerships and companies. Islamic law of partnerships is divided into two main types:

- Co-ownership (sharika al milk)
- Partnership through contract or Contractual partnership[140](sharika al uqood)

Co ownership is a partnership where two or more persons jointly own a particular property whether by way of option (ikhtiyāriyah) or by compulsion (jabariya).for example when two or more persons happen to get joint ownership of something through inheritance or gift etc. Whereas, contractual partnerships can be defined as the partnerships which are entered into, for the purpose of gaining profit. So these partnerships come into existence by mutual agreement to share profits.

[140] Al Kasani, Badai' al Sanai' fi tarteeeb al sharai',p.56

We will mainly focus on contractual partnerships as the concept of limited liability can be examined, in those contracts which are entered into, in order to raise profit.

The different schools of thought of Muslim jurists slightly differ on determining the classification of partnerships. According to the Hanafi school of thought, there are three main types[141] of contractual partnerships:

- Partnership through investment (sharika amwāl)
- Partnership through work (sharika a'māl or abdān)
- Partnership through credit (sharika wujooh)

Partnership through investment (sharika amwal) is the one in which all partners contribute capital in the form of money. Partnership through work is a partnership in which the partners contribute investment in the form of labor and skill. It is also called "*sharkat*-ul-a*bdān*" because the partners perform mutual labor. In partnership through credit (sharika wujooh), the partners use their good-will their credit worthiness and their contacts for promoting their business without contributing to the capital

All these three types of partnerships can be again classified into two main classes. Either they will be "Inān" partnerships or "Mufāwadah" partnerships. So the total number of partnerships according to the Hanafi School comes to six. That is partnership through investment may be Inan or mufawadah. Similarly partnership through work will also be of two types i.e. Inan and mufawadah. The Hanbali's accept all these forms with minor differences. The Shafi's approve sharikah al Inān and mudāraba only. The Maliki's accept all these forms except sharika al wujooh.

Inān partnership means where the partners contribute according to their will and take profit according to the ratio fixed. Whereas mufawadah partnership means that all partners should contribute equal amount of capital to the partnership business and the profit shall also be divided equally between them.

The general conditions which are common for all partnerships in Islamic law are:

1. A partner must be capable of being an agent.
2. Profit must be known in advance.
3. The shares of each partner should be fixed in advance.

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[141] Ibid.

4. Profit must be in the form of a specified ratio and not a fixed sum.
5. Capital must be present and not in the form of debt.

For mufāwadah partnership;

1. All partners must be capable of being surety for the other partners.
2. The capital must be equally contributed by all partners.
3. Profit must be equally divided between the partners.
4. The term "mufāwadah" must be specifically mentioned.

➢ ACTS ALLOWED FOR PARTNERS:

- A partner is allowed to delegate the work to others if he cannot do it himself.
- All partners are agents of each other. Therefore one partner can accept work on the behalf of the others.
- A partner can sell the partnership goods on the spot and on credit.

➢ ACTS PROHIBITED FOR PARTNERS

- Buying on credit is not allowed for the partners as a general rule. In cases where prior consent wilāya al istidāna) of the other partners is acquired, the partners can buy on credit.
- The partners cannot take loans.
- Partners are not allowed to give gifts out of the partnership property.

3.1.1.2.1 SHARIKA INĀN;ITS CONDITIONS AND LIABILITY:

1. In case of sharika Inan, it must be taken care of that the capital of the partnership (Ra's ul māl) is in cash and not in the form of goods. According to majority of the schools including the Hanafi's, Shafi's, Hanabali's and Ishāq this condition must be observed while entering into a contract of sharika Inan.[142] The reason given is that goods cannot form capital of a partnership because a contract of partnership is not valid unless the profit is known. Profit is defined as the excess over

[142] Muhammad Ahmad Siraj, Al nizam al Masrafi al islami,,153

ra'sulmāl (capital) that is why the amount of capital must be known so that in the end of the transaction the profit accrued can be distinguished from the capital contributed and this is not possible in the case when goods form the capital. Except the Māliki's all hold the same opinion. The māliki school of thought holds that contributing goods to form the capital of a partnership is allowed as capital can be either in the form of goods or cash or it can be cash from one side and in the form of goods from the other side.

The Egyptian civil code Art.505[143] also allows the capital to be either in the form of goods or cash as it allows that in case of a partnership contract between two persons, one partner can contribute capital in the form of money and the other in the form of goods.

2. The capital (Ra's ul māl) of a partnership contract must be in cash which is present at the time of forming the contract and not something in the form of debt or anything which is not readily present.
3. It's a condition in case of sharika Inan that the partners agree upon dividing the losses as per their share in the capital. According to majority of jurists the same rule is applied while dividing profits. Except the Hanafi school, who claim that share of a partner in the profits can exceed his share in the capital contributed if all the partners agree.[144] The reasoning given by them is that the basis of profit is either money (māl) or work (aml), and if a partner has contributed less in terms of money but works more than the other partners, such a partner may be allowed to take more profit than his contribution in the capital.
4. Shafi's, Ahl al zāhir, Zaidiya and Imāmiya consider mixing of capitals (khalt) between the partners as a necessary condition of sharika Inān. But maliki's say that it's not a condition for validity of the contract rather it's a condition for passing on the capital into the custody of the other partners so that they bear its risk.

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[143] Ibid.
[144] Ibid.

➢ LIABILITY OF PARTNERS IN CASE OF INĀN:

Now coming to the main questions, what type of liability does the partner enjoy? In case of losses who is responsible for paying off the debts of the partnership. To explain this we will study an example. Let us suppose that A, B and C are partners by way of Inan in a partnership through investment. They are contributing 30, 20 and 50 percent of the capital. Neither of them is allowed to raise credit beyond the net capital of the partnership. The one who violates this rule will be liable for it individually. Even after acquiring permission (istidāna) a partner is allowed to buy on credit but the value should not increase the net capital of the partnership.

In normal circumstances no one of the partners is allowed to raise credit unless "wilayat al istidāna" is granted to him by the other partners. If in case a partner A violates the rule and buys on credit without permission from the other partners then in case a loss occurs, he alone would be responsible for the debts of creditors if any. This does not mean that his liability is unlimited. His liability was actually limited to the extent of his share had he not acted in this manner that is committing a wrong without the permission of other partners. The problem arose only after the partner committed a wrong himself and for that he alone will be liable.

Whereas in case where some loss is caused due to Act of god (nature) and no contributory negligence on the part of any partner is involved, in such circumstances all partners will share the loss according to their shares stipulated in the agreement. This is a situation which is very rare and inevitable and so it cannot be helped otherwise as we observed the liability of partners in Inan partnerships is limited to theirs shares.

➢ CONCLUSION:

It is concluded from the discussion on Inān partnership that:

- In normal circumstances the liability of each partner can be said to be limited to the extent of his share in the capital.
- Each partner is severally liable for the debts he incurs due to is own negligence, wrong, buying on credit without istidāna and individual contracts.

- The liability of partners is unlimited and joint in exceptional cases like the act of nature etc.

3.1.1.2.2 SHARIKA MUFAWĀDAH; ITS CONDITIONS AND LIABILITY:

1. The most important characteristic of this partnership is that there should be equality between the partners in all aspects. That is all partners must be adults, equally contributing in the capital of the partnership and equally undertaking responsibility in their shares of profits and losses.
2. One of the important features of mufawadah partnership is that every partner is not only an agent (wakeel) of the other partner but also a surety (kafil) for the other partner. The contract of surety is therefore an important element of these partnerships.
3. The word mufāwadah must be specifically mentioned in the agreement.[145]
4. Where mufāwadah partnership is through investment then there must be equality in contribution, profit and loss of partners. Where the mufawadah partnership is through work then there should be equality in the daily wages or monthly pays etc. if the mufāwadah partnership is through credit then whatever the partners buy on credit the risk of those items will be borne equally[146] by all partners. Similarly in case the partnership falls into debts the partners will be equally liable for the debts.

➢ LIABILITY OF PARTNERS IN MUFĀWADAH PARTNERSHIP:

As it is clear after going through the elements of mufāwdah partnership that the contract of surety is an important element in all cases, whether the mufāwadah partnership is through investment, work or credit. Also the element of equality between the partners in all aspects also makes it clear that no one partner can claim limited liability. Whatever

[145] Al Kāsāni, Badāi' al Sanāi' fi tarteeeb al sharāi',p.60
[146] Ibid,65

losses are incurred by the partnership all partners will be jointly liable for it. If a creditor wants back his debt from partner A, the other partners will also be equally responsible so the creditor can demand his debt from any of the partners.

➢ CONCLUSION:

- The liability of partners in a mufāwadah partnership is unlimited and joint.
- In case a partner is given limited liability under the partnership agreement the partnership will no more remain mufāwadah.

3.1.1.2.3 MUDĀRABAH:

It is a contract of partnership aimed at gaining profit, where capital is contributed by one of the parties and work is done by the other party.[147] So in this type of business money is from one side whereas labor or skill is from the other side. In Qura'n it's stated regarding mudāraba:"and other's who journey through the earth seeking the bounty".[148]

➢ ELEMENTS OF MUDĀRABAH:

- Offers and acceptance:

The contract must be entered into with the free will of both parties. The wording regarding offer and acceptance must be explicit. Acceptance of the offer should take place during the time which both parties are negotiating agreement to the contract. Also acceptance should be to the same conditions as prescribed in the offer.

- Partners must have legal capacity:

Both contracting partners, that is the investor and the worker should be eligible to act as principle and agent.

- Capital must be in absolute currency:

First of all the type and amount of capital must be known. Secondly capital must be in cash and not in the form of a debt. Hanbali jurists permit to provide non-monetary assets like planes, ships etc as mudāraba capital.

- Capital should be paid to mudārib:

[147] Al Mirghinani,Burhan al din, Kitab al Hidaya,(Cairo: dar al saqafa,1948),202
[148] Al Muzammil,20

The capital in the form of money must be paid to the worker once the contract of mudaraba is entered into. Jurists differ on the mode what constitutes payment. Some are of the view that should be made by transferring the funds from the investor to the worker, while others are of the view that payment means enabling the mudārib to have disposition of the capital. It is one of the conditions of mudāraba that the investor shall not interfere in the business.

- Profit must be known:

Profit which is the amount earned in excess of capital has some specific rules. The profit gained is meant to be for both parties; therefore one party should not have the possession without sharing it with the other party. The proportional profit share of each party should be known at the time of making the contract and it must be a percentage of the profit and not a specified amount.

➢ ACTS PERMISSIBLE FOR THE MUDĀRIB:

1. To buy and sell all types of goods as he deems fit.
2. To buy and sell on cash and credit.
3. To keep goods as deposit and pledge.
4. To hire helpers as needed.
5. To give the partnership goods as a mudāraba to a third party.
6. Partners are allowed to carry out all actions which come in the ambit of customary practice of traders.

➢ ACTS NOT PERMITTED:

- The worker is not permitted to borrow money on behalf of mudāraba unless he is specifically authorized to do so.
- The worker is not allowed to violate any of the rules mentioned in the contract.

DIFFERENCES BETWEEN SHARIKA AND MUDĀRABAH:

1. The investment in contract of sharika comes from all the partners, whereas in mudaraba investment is the sole responsibility of rab-ul-māl.
2. All partners can participate in the management of business and work jointly in sharika whereas in mudāraba the rab-ul-māl has no right to participate in the management and work.
3. In partnerships all partners share the loss to the extent of the ratio of investment while in mudaraba the rab-ul-māl alone has to suffer the losses (in case mudarib is not negligent or dishonest)
4. Liability of partners in sharikah is normally unlimited whereas in mudāraba, the liability of rab-ul-māl is limited to his investment. (unless the mudārib is permitted by him to incur debts on his behalf)

3.1.1.2.3.1 TYPES OF MUDĀRABA:

A mudaraba is divided into many types based on the specific conditions stipulated for each contract and the type of partnership it is associated with.[149] Sometimes it's associated with Inān partnership and sometimes wit partnership on credit (sharika wujooh). A brief description of the types of mudāraba is given below:

1. Pure mudāraba contract:

This type of mudaraba contract has no other type of partnership associated with it. This mudaraba is further divided into types. In one of them there is one investor (rab al māl) and one worker (mudārib) and in the second type there are be multifarious investors may be involved.

2. Mudāraba associated with Inan partnership:

In this type of mudāraba, the worker (muādrib) may also contribute money based on Inan partnership. The mudārib after working if gains profit, will be entitled to the whole profit of his share. The rest of the profit will be jointly shared by him and the investor as per rules stipulated in the contract.

3. Mudāraba associated with partnership on credit (sharika wujooh):

[149] Muhammad Ahmad Siraj, Al nizam al Masrafi al islami,p.220

In this type of mudāraba the worker has been allowed to buy and sell on credit that is he has been given wiālya al istidāna by the investor. The risk (damān) of the mudāraba in such a situation will be borne by both the worker and investor,[150] in accordance with their shares in the profit gained under the principle of "al kharāj bil damān".

- LIABILITY IN CASE OF MUDĀRABA:

After going through the contract of mudaraba the following points are concluded:

- That the liability of the investor is unlimited as far as the worker has no fault.
- That the workers has no liability (as he is considered a trustee), as long as he does not violate any of the principles mentioned in the contract.
- The liability of rab-ul-maal is limited to his investment in case the mudarib violates any of the conditions stipulated in Mudāraba contract.
- If the worker is neglectful then he will be responsible.
- After accrual of profit, the worker and investor both will be liable for debts according to their shares in profit.[151]

3.1.2 COMPANIES IN ISLAM:

Companies have not been specifically named in early Islamic law. The term sharika in Islamic law is used for both partnerships and companies. It is said that mudaraba (commenda) in English law led to the formation of joint stock companies.[152] No separate name has been used for a company in early Islamic literature.

Generally a company is an entity which is quite distinct from the partners making up that company. It has its own name, nationality and location; moreover it is itself responsible for its actions and it has legal rights. It is viewed as a separate legal person in law. The view of majority of the jurists nowadays is that there is nothing in a company which contradicts the principles of Shariah, provided the basic elements discussed earlier are taken care of. However there is slight difference of opinion upon the legal personality of

[150] Kasani, Badai' al Sanai',113 and Abdul wahid, Fathal qadeer lil ajiz al Faqeer,,446
[151] Abdul wahid, kamal al din, Fath al qadeer lil ajiz al Faqeer,447
[152] ibid,207

the company and the issues related to it.[153] Management of a company is generally carried out by partners but this function may now be delegated. A director must perform this function and will have a salary whether or not he is a partner. If a partner, he functions both as a partner and as a director. As a director, he has the right to take decisions unless it is otherwise stated in the articles of association. According to majority of Muslim scholars today the company in Islam is a separate legal person and contains no such element which is in contradiction to the Islamic Shariah. They say that according to religious principles any management organization or legal arrangement made for the company's interest, development and protection is permitted.[154]

3.1.2.1 CONFUSION REGARDING COMPANIES IN ISLAMIC LAW:

In early fiqh literature, there is no mention of the word company. The only mode of trade discussed is a partnership. The jurists of the modern age have different opinions regarding the validity of the concept of companies and the notion of legal person associated to it. Some of the main difficulties regarding the Islamic company and the opinion of scholars on how to solve them are discussed over here. As is seen today, companies seem to be an indispensable part of business organizations of a state and do exist in almost all Muslim countries. When analyzed in the light of Islamic commercial law, one notices that it has some defects which need to be resolved.

In order to rectify the problems which arise due to the present structure of a company in terms of the entitlement of shareholders to the profits and rules of prohibition of interest (riba) the suggestion which comes from one of the scholars[155] is to create a new model of the Islamic corporation. In this context following changes are suggested in the structure of a company[156]:

- Instead of the agency concept in law it would be better to apply the Hanafi concept of wakāla (agency), which will help us achieve two major objectives:

[153] Nyazee, Islamic law of Business Organizations (Corporations),p.113
[154] Kay, Earnest. Legal aspects of business in Saudi Arabia,,23
[155] Suggested by Imran Ahsan Khan Nyazee
[156] Nyaxee,, Islamic law of Business Organizations (Corporations),p.180

1. Under the present structure of corporation the relationship which exists between the shareholders and company is a debtor-creditor relationship. After we replace the agency concept in law with the Hanafi wakāla this relationship will be changed to an agent partner relationship. Here the major benefit achieved will be that only the managing party will be responsible for the acts of the company. In view of Islamic law regarding Hanafi wakāla, when debts arise the only party which can be sued is the managing party.[157] This will of course shield the shareholders of the company from being sued or demanded of the debts of the other creditors.
2. Secondly, the shareholder will continue to own the assets of the company without the problem of riba arising in view of the Islamic concept of sarf. In this way the shareholder will be entitled to any amount of profit arising through the company because now they themselves bear the risk of the company's assets.[158]

It becomes clear from the above propositions, that though the shareholder is entitled to all the profits in excess of his share but as per the rule of "al kharāj bil Dāman" he does not stand accountable for the losses occurred to the company for more than his share. The concept of limited liability seems to be not acceptable over here as it goes against the principle mentioned. Also another major problem lies in the legal personality of a company, as discussed below.

3.2 LEGAL PERSON AND ITS RELATIONSHIP WITH THE CONCEPT OF LIMITED LIABILITY:

In order to understand the concept of limited liability from an Islamic point of view, it's necessary to know the opinion of jurists about a legal person in Islam. As will be observed in the following paragraphs that majority of the jurists validate the concept of limited liability on the basis of the concept of legal person. Some of the difficulties we come across while discussing companies according to Islamic law include the legal status

[157] Al Kasani, Badai' al Sanai' fi tarteeeb al Sharai',p.68
[158] Suggested by Imran Ahsan Khan Nyazee

of bonds and shares, rules regarding riba etc. the major problem however is the concept of a legal person.

3.2.1 VIEWS ON THE LEGALITY OF JUDICIAL PERSON IN ISLAM:

We will discuss the legal person from Islamic point of view, as according to majority of jurists, it is the legal person which lays the foundation of the concept of limited liability.

The prevailing view amongst scholars of this age is that the basic principles of Islamic jurisprudence are flexible enough, to accomodate the concept of "legal person". One of the scholars of ancient times who considered this concept as valid was Syed Abdullah Hussein who mentioned in his book "Al Muqārana at al Tashri'iya" that the Shariah does recognize the concept of legal person. The examples quoted by him are those of bait ul mal, waqf, madāris, and hospitals. The ground on which he claims legal personality of these institutions is that all of these institutions are granted rights and are allowed to act.

Justice Muhammad Taqi Usmani also validates the concept of legal person in Islam. He says that the institutions of waqf, bait ul mal, joint stock and inheritance under debt are recognized by scholars as legal persons.[159]

Of the modern age scholars, Abdul Qādir Awdah is the one who mentioned the concept as valid for the first time. He says that the Shariah has from the very beginning recognized the concept of legal person and has always considered institutions like bait ul māl, waqf, hospitals and schools as legal persons, as they are capable of holding rights and can act to perform their duties.[160]

Dr. Muhammad Ahmad siraj says that he assumes that the concept of legal person is not in conflict with any of the rules and regulations of Shariah and must therefore be considered as legal in the light of Islamic principles.[161]

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[159] www.meezanbank.com (last visited 8.06.09)
[160] Muhammad Ahmad Siraj,Al nizam al Masrafi al Islami,,57
[161] ibid.

1.2.2 VIEWS OF SCHOLARS WHO OPPOSE THE CONCEPT OF LEGAL PERSON IN ISLAM:

Some scholars allege that the concept of legal person existing in the west cannot be readily accepted in its present form. It needs to be analyzed in the light of Islamic principles and some amendments need to be done in its structure before declaring it as valid according to the shariah.

Nyazee says that: "the concept of a juristic person as manifested in corporations clashes with certain basic rules of Islamic law."[162] He further says that though it is an accepted fact that corporations have enabled human beings to avoid huge transaction costs and there is no exaggeration in the assertion that modern life is not possible without the concept of corporation but this does not mean that we ignore the basic principles of Shariah and accept the concept even if it has some defects.

After knowing the views of some of the scholars, it seems that the approach of majority of Muslim scholars regarding "legal person" does not find support from the basic rules of Islamic law. It is only on the basis of necessity and maslaha that they have validated the concept.

Another scholar who opposes the judicial person is Isā Abduh. His view can be easily understood from his saying that "it is agreed upon that fictitious personality does not find support from the Islamic heritage. Despite this the texts of Arabs as well as Muslims convey the idea that it can be established. It is therefore an established fact."[163] Those who view the concept of legal person as valid, quote examples of institutions like waqf and bait ul mal as according to them, these institutions do enjoy the position of legal person from an Islamic view point. The reason why early jurists did not mention the concept of legal person is because they were dealing with a system of religious duties and assigning of religious duties cannot be handed over to institutions.

Legal personality in Islam can be assigned only in following cases[164]:

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[162] Nyazee, Imran Ahsan Khan, Islamic law of business organizations (Corporations),73
[163] Ibid, as quoted by Nyazee, 77
[164] Ibid,93

- Personality or dhimmah can be assigned only to a human being who possesses sound mind (aql), where religious duties are expected of the person.
- In case, religious duties are not expected, a limited personality (dhimmah) can be assigned to a person or human being or an organization.

The institution of waqf when viewed in the light of Islamic principles, is found to be a suspended property which lies in the ownership of the "wāqif" that is the person who creates waqf. The revenue of the property goes to the beneficiaries of the property, for whom the waqf is created. The waqf property cannot be sold, gifted or disposed off through any other method. When evaluated in the light of Islamic principles, it becomes known that it's not a legal person[165] as is claimed by most of the scholars. The reasons are listed as follows:

1. A waqf property neither has capacity for acquisition (ahliyat al wujub) nor capacity for execution (ahliyat al adā), whereas a legal person must possess both.
2. A waqf property is suspended property that is cannot be sold, inherited or gifted, whereas a legal person has every right to dispose off its property through any means.
3. The life of waqf depends upon the existence of the waqf property; if the property is destroyed the waqf no more exists whereas a legal person has a long life and is independent o the property it holds.

Similarly when the institution of bait al māl is analyzed in the light of Islamic principles, we find that it too cannot be called a legal person.[166] It is basically a co-ownership between the members of the ummah and the ruler (imām), who administers it, and is the agent of the members of bait al mal and looks after their affairs. The reason why it cannot be called a legal person is that if it were a legal person then it would have owned the right to deal with the property as it wished but it is not so, as the imam who is the agent of bait al mal can spent out of it for the well being of the poor and needy only. It is not at all something which belongs to the imam and the property is considered to be owned by the people jointly with the state. The imam is only an agent of the people. Another proof of

[165] Ibid ,100
[166] Ibid , 101

its not being a legal person is the fact that a person who commits the crime of theft against bait al mal cannot be awarded "hadd" punishment, because of the doubt (shubha) of its being owned jointly by the people and the state, so the thief is also considered as one of the co-owners. If it was a legal person in reality then, there should have been no doubt regarding the awarding of "hadd" punishment.

Some scholars claim that the estate of a deceased person can be considered as a legal person. The response to this claim in the light of Islam is that it is not a legal person because it is inherited by the heirs along with the liabilities to the extent that they can be met from the estate.

Before closing the topic, it would be beneficial to know what an Islamic legal person may look like.[167] In view of Islamic legal principles, the concept of legal person cannot be totally rejected; instead some restrictions[168] can be imposed on the form of personality which can be assigned to institutions. According to Nyazee, the following guidelines may help create an Islamic legal person:

- That no religious duties will be expected of a legal person.
- That some form of understanding (aql) must be associated with the legal person e.g. in case of a company the board of directors can serve the purpose.
- That the concept of dual ownership must be adopted for the Islamic legal person that is the property held by it must be jointly held by the source of understanding (aql), associated with it.
- The legal person will have the right to dispose off property owned by it only if the members allow.

3.3 LIMITED LIABILITY IN ISLAM:

The concept of limited liability has not been discussed in detail by the jurists, but a few scholars have given their views regarding the concept. Some favor the concept and validate it on the basis of precedents in Islamic law or on the basis of need, necessity and public benefit. While others reject the concept, calling it a concept of the west and

[167] Ibid ,107-108
[168] See p.77

something not acceptable in Islamic law. In order to have proper understanding of the issue, it would be beneficial, to first have a look into the views of those who validate it and then come to the views of the scholars who say that it's not valid in Islam.

3.3.1 VIEWS ON THE LEGALITY OF LIMITED LIABILITY:

There are divergent views of scholars regarding the concept of limited liability. The views of some scholars in favor of the concept of limited liability are discussed as follows:

- Justice Mohammad Taqi Usmani. He proves the legality of the concept of limited liability by way of the concept of legal person and says that: "the question of limited liability, it can be said, is closely related to the concept of judicial personality of the modern corporate bodies".[169]

According to Taqi Usmani the concept of limited liability is the logical consequence of the concept of legal personality. He says that once it is proved that the notion of a "legal person" is acceptable in Islam, the concept of limited liability will automatically be considered as legal.

Further, he says that the term "judicial person" is not something new to Islamic law. It existed in the form of various institutions since long. The first example quoted by him is that of institution of waqf. He says that waqf has been treated by Muslims jurists as a separate legal entity. Following are the reasons[170] on the basis of which he declares waqf as a legal entity:

- Any property after being declared as waqf can not be said to be in the ownership of the donor or the beneficiary.
- If a property is purchased with the income of waqf, it is treated by the jurist as a property owned by the waqf.
- Similarly the donations to the mosque are considered as owned by the mosque.

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[169] Usmani,Taqi, An Introduction to Islamic Finance.(Karachi:Maktaba Ma'ariful Quran,2005),223
[170] Ibid.,225

On the basis of the above reasons the scholar has tried to prove the institution of waqf as a legal person, which according to most critics is a wrong approach.[171] Another example he quotes from the classic literature of fiqh is that of bait-ul-mal. As its commonly known bait ul mal used to be an institution for the benefit of all citizens of a state, the writer says that as nobody could claim to be its owner, it was an institute having its own rights and obligations, it could borrow and advance loans therefore it can be said to be a legal person.[172]

According to Usmani if a person dies insolvent, the creditors have no claim except to the extent of the assets he left behind. Therefore he says that, after proving the legal personality of a company we can say that in case of a company becoming insolvent, the creditors have no claim except on the assets of a company and have nothing to do with the shareholders. If the creditors of a dead person can suffer, when he dies insolvent, the creditors of judicial person may suffer too, when its legal life comes to an end by its liquidation.[173]

He further says that the closest example to the limited liability of joint stock companies is that of "Abd Ma'zoon" who used to be a slave allowed by his master to enter into commercial activities. Explaining the situation he says that in this case the initial capital was given to the slave by the master. The slave was allowed to trade with it. The profits were also owned by the master. In course of trade if the slave incurred debts, they would be adjusted by what ever capital and cash the slave possessed. If that is not sufficient to clear off the debts, than the creditors have the right to sell the slave and settle their claims out of his price. But the creditors have no right to approach the master for the clearance of their debts. Here the liability of the master is limited to the capital he invested including the value of slave. This view has been rejected by Nyazee because according to him the rules of qiyas have not been followed properly in this example.[174]

- Another scholar S.M.Hasanuzaman also has similar views about the limited liability of shareholders of a company, though he rejects limited liability of

[171] for details see http/books.themajlis.net/books/print/251-120.last visited 12.06.09
[172] www.meezanbank.com (last visited 8.06.09)
[173] Usmani,Taqi, An Introduction to Islamic Finance.(Karachi:Maktaba Ma'ariful Quran,2005),224
[174] Nyaxee,, Islamic law of business organizations (Corporations),171

partners in sharikat. According to him, the institutions of bait-ul-maal and waqf enjoyed the positions of legal persons because they possessed legal rights and privileges and also had legal responsibilities. Bait-ul-maal used to collect zakat, kharaj and jizyah. It also used to borrow whenever money was needed by the state, inherited the party of the heirless, charged ransom for the enemy captives. It was the responsibility of bait-ul-maal to pay blood money of the successors of the deceased if the killer escaped. It discharged the debts of the destitute after their death and also lent money to the needy for their personal and business needs. Similarly the concept of waqf has also been discussed Hasanuzaman as a legal person. In his view there is similarity between "Abd ma'zoon" and "company".[175]

- Dr. Muhammad Ahmad Siraj also has the same views regarding legal person and says that once the concept of legal person is regarded as valid then the concept of limited liability should also be recognized as valid. He further says that the responsibility of the partners is limited to their shares and does not extend to their private property which they have not invested in the business and also cannot be extended to the profits which they personally own.

As we see there are scholars who consider the concept of limited liability as valid by drawing analogy from various ancient institutions of Islam. We have already explained the status of institutions like bait al mal and waqf in the previous section.[176] The prevailing trend is that limited liability provides a public benefit or maslaha;[177] therefore it must be made lawful. but the thing which should be taken care of is that limited liability should not be misused as sometimes companies may use it as a heela or tactic for getting rid of their debts.

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[175] Islamic Studies,S.M.Hasanuzzaman,Limited liability of Shareholders and Islamic perspective.(IRI,28:4,1989),359.

[176] See pg.77

[177] Thomas, Abdul Qadeer, Structuring Islamic Finance Transactions.(Euro money institutional investor, 2005),45-46

3.3.2 VIEWS OF SCHOLARS WHO OPPOSE THE CONCEPT OF LIMITED LIABILITY:

There are scholars who oppose the concept of limited liability totally. There are others who partly accept it but fear that it might be misused and under the concept of sadd al dharai, (سد الذرائع) invalidate it. Some views are briefly discussed as follows:

- One such view is held by a group of ulema in South Africa who allege that limited liability and legal personality are the corner-stones of the western capitalist economic system and it's wrong to adopt these concepts. According to this view the term limited liability is foreign to Islamic jurisprudence. Limited liability in Islamic law would mean the full liability for which the partner has assumed liability and not the definition which the westerners have given.

  They severely criticize the views of Justice Taqi Usmani in their book "The concept of limited liability untenable in Shariah"[178] In response to the view of Taqi Usmani where he regards the institution of waqf similar to a legal person they say that in reality waqf is something owned by Allah and there is no need of assigning it a legal personality. Where Taqi Usmani says that inheritance under debt can be considered as a situation similar to a company being insolvent they say that its wrong to assume this because a person does not die of his own will and even after his death he is not absolved of his debts whereas companies may decide to dissolve at their own will.

- Another view regarding the invalidity of limited liability held by Mufti Muhammad Ashraf[179] is that the concept of limited liability in fact suggests that there is no possible way of regaining one's full amount of money and that this does not comply to the laws of Islam . He says that those who say that it's similar to master-slave relationship are not correct because a slave given permission to conduct the business of his master is not absolved of debts and

[178] http/books.themajlis.net/books/print/251-120.last visited 12.06.09
[179] www. Mahmoodiyah.org.za

the debts can be demanded of him once he acquires freedom. The reason why the master is not demanded of the debts is because he himself did not make the agreement with the outsiders, it was the slave who made the agreement and on his falling into debt the slave and his wealth became like strangers to the master. He further says that where a company appoints a legal person to free the directors of the company from debts of the company is not correct because the whole working of the company is managed by the directors, and they are the one's who benefit from the company if it progresses, they sign the agreements on behalf of the company and they are the one's who are summoned in courts and not the company's themselves. On the basis of the principle of al kharaj bil daman, he says that the directors do not deserve any thing of the profits because they are not participating in the losses[180]. Also making qiyas of limited liability upon waqf and bait ul mal is not correct as the institutions of waqf and bait ul mal are not possessions of any one. He concludes his view in the following words: "in conclusion those responsible for the company will be responsible for the debts of the company. The debt can be demanded from them. If they did not pay off the debt, they will be answerable to Allah."[181]

- S.M.Hasanuzaman is in favor of the concept of limited liability of shareholders in a company but when it comes to the liability of partners in a firm, he argues that in the light of an Islamic form of partnership, the liability of a partner cannot be said to be "limited". The reason given by him is that the contract of agency is the most important element of a partnership. Therefore when a partnership firm suffers a loss all the partners are bound by the debts of the firm on the principle of agency. He says that the contract of Agency is in this way the foundation of a partner's liability. Each partner is a principal to the extent of his own share as well as an agent to the extent of his partner's share. "In this way all the partners are bound by each other's acts whether or

[180] ibid.
[181] ibid.

not all of them take part in business.[182]" The writer than analyzes liability of partners in different forms of partnerships in Islam. He says that liability in case of Arts partnership (sharika a'mal) is unlimited because of the following reasons:

1. The completion of work is binding on both or all partners.
2. In case of any defect in workmanship or in case of destruction of goods, all the partners are liable for indemnifying the suffering party.
3. In case of loss all partners will be liable equally.[183]

He says that partnership in reciprocity (mufawadah) and partnership in Arts (sharika a'mal) are similar in respect of liability as the liability in both forms is unlimited and is joint and several by virtue of the partners standing surety to each other.

He further elaborates his point of view by giving the example of partnership on credit (sharika wujooh) by saying that there is no capital involved in case of partnership on credit and the principle of limited liability in such a situation cannot be applied as it would mean no liability for the partners. In this case he is in favor of unlimited liability and says "it can be safely said that the liability of partners is as unlimited as that of an individual businessman".[184] To understand it clearly let us suppose two partners entered into a contract of partnership through credit, clearly mentioning in the agreement that they will share the profits in the ratio of 20:80. Now if a loss occurs they are going to bear it in the same ratio, one of the partners will be responsible for 20% of the losses only and the other will be responsible for 80% of it. We can say that his liability is limited to his share in the profit and no more. But the debts of the creditors have to be paid back at all costs. If the partner who is responsible for the debt can fulfill his obligations than in this case the other partner is not liable. But where the debts of creditors are not fulfilled the partners can resort to the private properties of each other.

Hasanuzzaman further says that "Limited liability cannot be said to be valid in Islamic law because the condition of having similar rights and obligations as laid down in the definition of sharika will be contravened and it will be a major departure from the basic

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[182] Hasanuzaman, liability of partners.p.320
[183] ibid.324
[184] Ibid.,327

conditions of sharika".[185] Also, he says "the concept of limited liability is in fact the product of the existence of joint stock companies, which according to the existing law, enjoys the status of legal person and which due to a number of factors, and is not to be treated as Sharika in the Islamic sense of the term. Reason also justifies the opinion that the partners should have unlimited liability".

- Imran Ahsan Khan Nyazee is also against the principle of limited liability in case of the liability of partners in sharika Inan and Mudaraba. He says: "the liability of a partner for the debts of a partnership is unlimited and Islamic law does not legitimate the concept of limited liability as we know it in modern law for corporations and the limited partnerships".[186]

Nyazee explains the reason due to which the liability of a partner may arise. According to him there are only two reasons:

1. loans
2. purchases on credit

First he says that business loans are simply not allowed in Islam. According to him the only type of loan allowed in Islam is Qarde hasan and for Qarde hasan no time period is fixed for the repayment of the loan. He says: "raising of loan with a fixed period of repayment is not allowed in Islam."[187]

Secondly while discussing purchases on credit; he says that there can be two situations:

1. When the partner is not allowed to purchase on credit beyond the amount of capital employed in the partnership (i.e. no wilāyat al istidāna is granted).
2. when the partner is allowed to purchase on credit beyond the amount of capital contributed.(where wilayat al istidāna is granted)

In the first situation where purchases on credit are allowed only to the extent of capital employed in the partnership, the liability of a partner would arise if he purchases on credit beyond the amount of capital employed in the partnership. When the partners do not exceed this limit for purchases on credit, there is little risk that

[185] Ibid.,327
[186] Nyaxee,Imran Ahsan Khan, Islamic law of business organizations (Partnerships),81
[187] Ibid, 83

they will run into losses because the accounts payable will not exceed the capital of the firm. I would say that here the liability of partners is limited in this case, though Nyazee does not admit it by saying that if in case all the goods of a partnership are lost in a fire, all the partners will have to contribute to the partnership according to their shares and compensate the debts from their personal property. Here Nyazee says: "this is unlimited liability loud and clear and we cannot say that imposing restriction upon those undertaking transactions is likely to yield the concept of limited liability". Here I would like to add that in normal circumstances the liability of a partner is limited to his share, it is only in exceptional cases that the liability is unlimited.

In the second situation where the partners are allowed to purchase on credit beyond the amount of capital employed in the partnership, the partner must first acquire wilayat al istidana from the other partners which is a special permission.[188] The contract of partnership is considered here to be of sharika wujooh (credit partnership). In this case the debts of the partnership would be set off according to the share of each partner in the ownership of the goods purchased. For example if A and B are partners in an Inan partnership and A allows B to buy on credit (i.e. grants wilayat al istidana to him, then in this case both A and B will be liable for the debts of the partnership according to their shares in the profit gained, even if the debts exceed their original capital input. Here too Nyazee assumes that the liability of each partner is unlimited. Moreover he also discusses the liability of partners in the contract of Mudāraba. According to him the liability of an investor (Rab ul māl) before wilāyat al istidāna has two cases:

- before the realization of profit
- after realization of profit

In the first case he quotes an example from Kāsani's Badāi' al Sanāi' where a person is given 1000 dirhams by way of mudārabah and he buys something with it but before he pays the money to the seller, the 1000 dirhams are destroyed. Here the mudarib has the right to demand the required sum again from the rab ul māl so that he can pay the seller.

[188] www.alaswaq.net/(last visited 20.11.09)

Therefore he says that it's proved through this example that the liability of rab ul māl or investor is unlimited.

In the second case that is after the realization of profits, the liability of rab ul māl will still be unlimited to the extent of his share in the capital but here the mudārib will also be responsible for his share.

LIABILITY OF RABUL MAL AFTER ISTIDĀNA:

After the authority of istidana is given to the mudarib the partnership formed between the investor and mudarib is sort of sharikah al wujooh (partnership on credit). It means that here the liability of worker also becomes unlimited.

Nyazee raises two major objections against limited liability in the present structure of companies:

1. As it's generally understood that a company is a separate legal person and has its own independent rights and liabilities apart from the shareholders. When shares are bought by the shareholders, the capital collected through this process is transferred into the ownership of the company. Now this creates a debtor-creditor relationship between the shareholders and the company and not an agency relationship. Here the rules regarding prohibition of riba manifested through the contract of "sarf" are invoked, that is the shareholders are only entitled to the money they invested and no extra benefit in the form of profits can be accepted.
2. The second objection is that shareholders are entitled to profits of only that part of capital of which they accept risk (damān) under the principle of limited liability. Because according to the rule of "al kharāj bil damān" a person can claim profit of the thing for which he takes responsibility. Damān in this case works through ownership, when shareholders in case of companies do not own the shares how can they be entitled to its profits. He says "the entitlement of the shareholders to these profits becomes difficult to justify through Islamic principles of contract."[189]

[189] Nyazee,Imran Ahsan Khan, Islamic law of business organizations (Partnerships)p.180

➢ CONCLUSION:

After going through the discussion for and against the concept of limited liability one arrives to the following result.

- The scholars who oppose the concept of limited liability reject it because it can be misused and therefore consider it as injurious to the rights of creditors in business institutions.
- Liability of partners in Islamic partnerships is found to be unlimited in case of mufawadah partnership because of the contract of surety in it.
- In case of Inan partnership liability cannot be said to be limited because there may arise a situation where in order to fulfill the obligations liability may extend to the private properties of partners. But such a situation will not arise if istidāna is not allowed and in this way limited liability can be created.
- An investor's liability in a contract of mudaraba is generally limited to the extent of his investment if he does not allow istidana to the mudarib. But if istidana is allowed then the investor will have to bear the consequences.
- I support the view of Nyazee regarding the objections on limiting the liability of shareholders in companies in the present structure and admit that the objections are rightly pointed out. These are actually the basic reasons which add up to the difficulties in the way of achieving limited liability. The solution offered to this difficulty is to change the present structure of the corporation.[190]
- According to a scholar Dr. Yousaf, the basic difference in the liability of partners in modern and Islamic law arises because of the non-existence of the concept of dhimmah (i.e. responsibility towards the rights of others) in modern law. Whereas Islamic law has always had this concept in it and that is why the idea of limiting the liability of partners never arrived in it.[191]

[190] As already discussed in s.3.1.2.1

[191] www.islamtoday.net (last visited 20.11.09)

- In order to limit the liability of partners in any case it must be kept in mind that the issues giving rise to dhimmah are not allowed e.g. .istidana by partners should not be allowed at all.[192]

1.3 SUGGESTIONS REGARDING THE CONCEPT OF LIMITED LIABILITY IN ISLAM:

After going through all details regarding the concept of limited liability, one thing is clear that the present economic structure demands the presence of limited liability in our system. And that is the basic reason why many of the jurists feel so helpless that they have validated the concept as it is in law on the basis of necessity and public benefit.

After studying the structure of partnerships and companies in Islam, the view of scholars regarding limited liability and legal person, one reaches the conclusion that introducing limited liability into the Islamic system of partnerships and companies is not something impossible. It's not wise to say that limited liability is totally against the principles of Islam and should be forbidden, when we know that it's the general trend all over the world and investors find it favorable. Rather we should look into the bright side of the concept and amend the areas where we think some changes are possible. As we know that the Islamic principles are flexible enough to accommodate innumerable new concepts provided the basic principles are not violated. The very first job in this case would be to bring out the main Islamic principles which should to be taken care of, in order to achieve a smooth application of the concept of limited liability in business organizations.

It's an admitted fact, that we do not find any express provision regarding validity of limited liability in early Islamic literature nor is the concept mentioned in it. The basic reason; however is that in early Islamic transactions the need for such a concept was not felt and because of the concept of dhimmah was present in Islam.[193] Business at that time

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[192] www.alaswaq.net/(last visited 20.11.09)

[193] as discussed earlier see p.89

did not use to be at such a large scale and so it was very seldom that such situations could arise where the personal properties of investors would have been at risk.

3.4.1 INTRODUCTION OF LIMITED LIABILITY IN ISLAMIC ECONOMIC SYSTEM:

We will discuss the issue of introducing limited liability in both companies and partnerships. There is a need to make some amendments in the present structure of companies before introducing the concept of limited liability in it. As companies carrying the feature of limited liability are working all over the Muslim world. Similarly partnerships with limited liability have been adopted in some Muslim countries. It seems that validating and adopting the concept of limited liability merely on the basis of the principle of necessity and public benefit is not enough. There is a need to chalk out a proper strategy for smooth application of the concept, relying upon some fundamental Islamic principles.

3.4.2 INTRODUCING LIMITED LIABILITY AT COMPANY LEVEL:

The greatest single advantage of adopting the corporate form is that it will usually carry with it limited liability. It is true that through a medium of a limited partnership the benefits of limited liability can be obtained with the only disadvantage that the investors will not be able to participate in the management of the business. The introduction of limited liability at company level is not easy, as there are a lot of difficulties which need to be resolved first. However if we take care of the basic principles of Islamic law of contract, limited liability can be applied to shareholders in companies. Following are the basic principles which must be ensured:

- It must be made sure that there is no element of usury (riba) in the transactions between the shareholders and the company.
- The principle of "al kharāj bil damān" must not be violated.

- The company will be considered a legal person only when some sort of understanding (aql) is associated with it. The board of directors may serve the purpose.
- The relationship between the shareholders and company, the extent to which the shareholder is accepting responsibility and the ratio of profit he will be entitled to must be clearly mentioned in an agreement between the company and the shareholder with the mutual consent of both parties.
- It must be made sure that no party is made to bear responsibility for the debts of the company if he is not getting the profit for it.

Limited liability in an Islamic company can be introduced if the following guidelines are followed:

1. The very first problem is that the company is considered to be a separate legal person and the concept of legal person is still a disputed topic amongst the jurists. This problem can be rectified by applying the concept of Islamic legal person over it.[194] This will make application of the concept of limited liability easier as the directors or managers of the company will be held responsible for the debts of the creditors and not the shareholders.
2. The second problem in the present structure of the company is that there exists a debtor creditor relationship between the shareholders and the company which makes the profit earned by the shareholder something similar to riba. It must be stipulated that the assets of the company are held by both shareholders and the company jointly. The profit earned by the shareholder will therefore become legal.
3. The shareholders shall be considered as partners in the business of the company and should not get profits of the whole assets of the company. The shares must be considered as jointly owned by the company and the shareholders so that they would not be entitled to profit of more than their investment (that is the amount of which he is accepting responsibility). In this way the principle of "al kharāj bil

[194] See p.75

damān" will not be violated. The principle of limited liability for the shareholder must be mentioned clearly in the agreement, making it clear that the shareholder will get profit only for the portion which he is ready to bear risk (damān) of.

4. The type of partnership which a shareholder enters into with the company should be Inan partnership.
5. The shareholders shall not in any case grant permission to raise credit (wilaya al istidāna) to the company. In this way their responsibility will not exceed their investment.
6. As the shareholders do not take part in the management of the companies therefore they cannot be sued by the creditors under the rules of Inan partnership.

3.4.3 INTRODUCING LIMITED LAIBILITY AT PARTNERSHIP LEVEL:

Limited partnerships introduced under the limited partnership act 1907 are not separate legal entities like companies, which means that legal personality is not assigned to such firms. This makes it clear that for introducing limited liability, legal personality is not a pre-requisite as we have already discussed in the previous chapter. Limited liability may be introduced to Islamic law of partnership[195] in the following way:

1. The type of partnership mentioned in the agreement must be Inan partnership.
2. There must be two sets of partners as exist in English law. The partners whose liability would be limited to their shares must be called limited partners. The other set of partners whose liability would be unlimited (only in exceptional cases) would be called the general partners. The presence of at least one general and one limited partner shall be compulsory.
3. The partnership business will be managed only by the general partners.
4. The general partners will not be granted permission to raise credit (wilāya al istidāna) by the limited partners. This will reduce the chance of the business's

[195] Nyazee has also given a model of Islamic limited partnerships where he suggests that the limited partnership shall be a legal person.

falling into loss. However of the general partners violate this rule they will themselves bear the consequences.

5. The limited partners would not be allowed to take part in the management of the business. In this way they shield themselves from being sued by the creditors.
6. At the time of entering into the partnership the limited partner will be required to deposit in cash his share of investment.
7. A limited partner shall not be allowed to withdraw as a partner till the business continues so that the other partners are not harmed in terms of assets.
8. A limited partner shall have the right to inspect the books of partnership, give advice regarding management of the business etc, so that he can keep a check over the activities of the business and remain satisfied that his money is not used in unlawful activities.

CONCLUSION

After a thorough study of the concept of limited liability in both English and Islamic laws, I came to the following conclusion:

- The concept of limited liability is deep rooted in English law and exists since a long time.
- That limited liability carries many advantages and benefits.
- Limited liability in English law applies both to partnerships and companies.
- The assigning of liability in law is on an arbitrary basis and there are no fixed rules for it, whereas in Islamic law there are some fixed rules for the assigning of liability.
- In case of partnerships, the rules regarding rights and obligations of partners, in both English and Islamic law are almost the same.
- In English law the concept of limited liability applies to shareholders in companies limited by shares and guarantee. Also it's a fundamental part of limited partnerships and limited liability partnerships.
- The concept of limited liability was never incorporated in Islamic law because of the theory of bearing responsibility (inshighāl al dhimmah) is present in it. On the other hand English law does not recognize it and therefore introduced limited liability since a long time.
- In Islamic law of partnerships the liability is unlimited in case of mufāwadah partnership and mudāraba (though we can say that it is limited if the investor does not allow istidāna to mudārib) however, it can be limited in case of Inān by making few amendments.
- Limited liability cannot be applied to shareholders of a company in Islamic law because of the peculiar relationship of shareholders with the company. However if the ambiguity regarding ownership of shares is removed, then it can be applied.

- Limited liability can be applied in view of Islamic commercial law by limiting the profit arising so that the partner is not entitled to both profit and liability of more than his share.
- Muslim jurists differ upon the validity of the concept of limited liability, because of the concept of legal person. Those who say that legal person is valid in Islam also validate the concept of limited liability.
- It's true that limited liability is the outcome of the concept of legal personality but it's not necessary for it. This means that limited liability can be created even without legal personality.

GLOSSARY

amin: trustee

ahliyyah: legal capacity

ahliyat al ada :legal capacity for execution

ahliyat-al-wajoob: legal capacity for the acquisition of rights and obligations

damān: compensation liability

dhimmah: legal personality

gharar: uncertainty which may lead to a dispute in a contract

inān partnership: a contract of partnership based on agency in which equality of contribution ,profit or legal capacity is not necessary

istidānah: raising credit through credit purchases

kafālah :contract of surety

al-kharāj-bi-al-damān: a principle based upon a tradition; which means that profit must be equivalent to loss borne.

milk: ownership property

mudārabah :contract of partnership where work done by one party and capital is provided by another party

mudārib: the worker in contract of a mudārabah

mutālabah: demand of a debt by the creditor of the dealing party

ra's-al-māl: capital

rabb al-māl: investor

sarf: contract for the exchange of gold, silver and currencies whether the currency or commodity exchanged is the same from the both sides or is different, that is, whether dinars are exchanged with dinars or dinars are exchanged with dirhams.

shakhsiya I'itbāriyah: juristic person; artificial personality; corporate personality

sharikah: partnership; in Egyptian law the term is used for joint stock companies and corporations as well, but is qualified with an objective to indicate its nature: thus, sharika musāhamah for a public limited company or corporation whose capital has been subscribed to the general public

sharikah musāhamah: in Egyptian law it is the name of a corporation or for a public limited company

sharikat a'māl: partnership in which participation by the partners is based on labor or skill but the partnership has to be the type of inān or mufāwadah.

sharikat al-aqd: a partnership created through contract as opposed to co-ownership that may be the result of a joint purchase or agreement or it may be result from inheritance or some other legal situation.

Sharikat al-inan: a basic contract of partnership based on agency in which participation may either be on the basis of work or labor or credit-worthiness, and in which equality of contribution or legal capacity is not necessary.

Sharikat al-abdan: another name of sharikat al a'mal.

Sharikat al amwal: a partnership in which participation is based on the contribution of wealth by all partners , but the partnership has to be of the type of inan or mufawadah:

Al-sharikat al-mas 'ulliyah al-mahdudah: the name for a private limited company in Egyptian law

Sharikat al-dhimam: a term used by malikis to indicate a situation where two or more are buying goods on credit,it is different from the Hanafi sharikat al-wujuh insofar as it requires the physical presence of all the partners at the time of purchase.

Sharikat al milk: co-ownership.

Sharikat al-mudārabah: see mudārabah.

Sharikat al-mufāwadah: see mufāwadah.

Sharikat al-wujuh: partnership based on credit-worthiness of the partnership in which the ratio of profit or loss is based on the liability borne, but the partnership has to be the type of inān or mufawadah

Waqf: charitable trust; testamentary trust.

wilāyat al istidānah :Authority granted by one partner to another to buy on credit beyond the limit of the capital of the partnership.

Table of Quranic verses

Name of Surah	Verse	Verse .no.	Page.no. in thesis
Al Nisā	يا أيها الذين آمنوا لا تأكلوا أموالكم بينكم بالباطل إلا أن تكون تجارة عن تراض منكم	29	61
Al Baqarah	و أحل الله البيع و حرم الربا	275	61
Āl Imran	يأيها الذين آمنوا لا تأ كلوا لربا أضعافا مضاعفة و اتقوا الله لعلكم تفلحون	130	61
Sād	و إن كثيرا من الخاطاء ليبغي بعضهم على بعض إلا الذين آمنوا و عملوا الصلحت	24	63
Al Muzammil	و آخرون يضربون في الأرض يبتغون من فضل الله	20	70

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