PUBLIC CORPORATIONS IN PAKISTAN IN THE LIGHT OF POSNER'S THEORY OF ECONOMIC ANALYSIS OF LAW AND FROM THE PERSPECTIVE OF ISLAMIC LAW

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APPROVAL SHEET:

PUBLIC CORPORATIONS IN PAKISTAN IN THE LIGHT OF POSNER'S THEORY OF ECONOMIC ANALYSIS OF LAW AND FROM THE PERSPECTIVE OF ISLAMIC LAW

By

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DECLARATION

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

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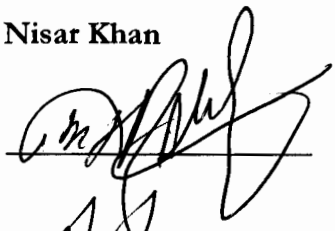
Signature: 

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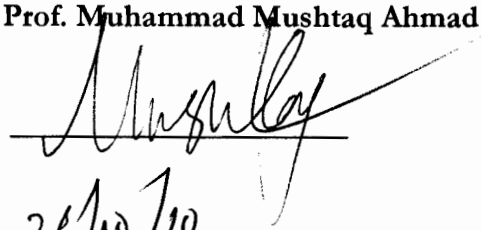
Signature: 

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ABSTRACT

The way corporations are being governed in Pakistan has many drawbacks in the light of Posner's theory of economic analysis of law as well from the perspective of Islamic law. A new form of corporation is therefore necessary which should be compliant with Islamic injunctions and which should also achieve the goal of optimum utilization of resources, maximization of utility as envisaged by Posner.

It would, however, be necessary to regulate the corporations in the light of the general principles of Islamic commercial law to ensure that justice is done to the shareholders as well as the consumers and to remove the malpractices of corporation. The separation of ownership from control in corporations leads malpractices and it would be important to introduce reforms especially in proxy rules, to safeguard the interests of shareholders. In Islamic jurisprudence, the term that matches fictitious personality is *dhimmah*, which is recognized only for human beings. However, a limited *dhimmah* could be assigned to the corporations if some form of *'aql* (intellect) is inserted in it in the form of the board of directors. As Islamic law proscribes *riba*, the underlying contract between the corporation and shareholder must not involve *riba* and must honor the rules of *al-kharaj bi al-daman*. If these conditions are fulfilled, corporations could be regarded as devices to increase the wealth of the *ummah*.

For this purpose, the Islamic model of the corporation as envisaged by Imran Ahsan Khan Nyazee relies on the Hanafi form of *wakalah* which solves the issue of limited liability because it distinguishes between the *huquq* and the *hukm* of the contract.

ACKNOWLEDGMENTS

My earnest gratitude goes to the Faculty of Shariah and Law, International Islamic University Islamabad (I.I.U.I.) and its entire staff for providing me the opportunity of qualifying to work on this topic. I am indeed grateful to the entire staff of the faculty at I.I.U.I. for the devoted assistance they provided me in their different capacities.

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DEDICATION

To *'Dada and Abai"*

LIST OF ACRONYMS

EAL	Economic Analysis of Law
SEC	Security and Exchange Commission
SECP	Security and Exchange Commission of Pakistan
CROs	Company Registered offices
GoP	Government of Pakistan

LIST OF STATUTES

- The Security and Exchange Commission Act, 1934
- The Security and Exchange Ordinance, 1969
- The Companies Ordinance, 1984
- The Partnership Act, 1932

TABLE OF CASES

INTRODUCTION

Economic analysis of law is a particular school of jurisprudence, which maintains that law is, and ought to be, concerned with economic efficiency. According to this school, economic efficiency is the main aim of law, which is achieved by reducing transaction costs. The term 'transaction costs' include the cost of identifying parties with which one has to bargain, the costs of getting them together and the costs of the bargain reached. Richard Posner in his landmark work titled *The Economic Analysis of Law* analyzed, *inter alia*, the concept of 'corporation' and successfully showed that the corporation model is preferred to the ordinary partnership model because the corporation model better achieves the goal of maximization of utility. He, however, pointed out some important defects in the corporation model, which may be deemed hurdles in maximization of utility. In this dissertation, we will analyze Posner's views regarding the corporation model and the defects pointed out by him so that we may give suggestions for improving the existing model.

The existing model of corporation also faces some very serious problems from the perspective of Islamic law. The very first problem is the fictitious personality of the corporation. Although some modern scholars have tried to justify this concept from the perspective of Islamic law, their case is not very strong, to say the least. Imran Ahsan Khan Nyazee, a renowned scholar of Islamic law and jurisprudence as well as corporate law, has shown in his monumental work titled *The Islamic Law of Business Organization: Corporations* that the thesis of these scholars is not based on sound arguments. Similarly, most of the modern scholars apply the rules of the Islamic law of partnerships (*sharikat*) for the purpose of distributing the profit of the corporation among the shareholders and the Arab scholars even call corporation *sharikat al-musahamah* (partnership by way of shares). Nyazee has conclusively

shown that from the perspective of law this position is not acceptable at all. Hence, we will also examine this issue in detail. In other words, this dissertation focuses on the views of Posner and Nyazee on the existing structure of corporation.

This dissertation has four chapters. In Chapter One, we will first briefly discuss the legal regime in Pakistan regarding corporations. This will be followed an analysis of the relationship of law and economics and then by an overview of the theory of economic analysis of law. In the end, Posner's views regarding the existing corporation model will be discussed.

In Chapters Two and Three, we will analyze the existing structure of corporation from the perspective of Islamic law. In Chapter Two, we examine the issue of fictitious personality of the corporation. In Chapter Three, we will analyze the legal relationship of the shareholders *inter se* and the legal relationship of the shareholders and the corporation. This Chapter also analyzes the bases for the entitlement to profit in Islamic law.

In Chapter Four, we will examine the new model of corporation proposed by Nyazee to see if this model answers the objections from the perspective of Islamic law and the theory of economic analysis of law.

In the end, the conclusions of the thesis have been recorded.

EXISTING RESEARCH:

For the time being no research has been undertaken about the existing structure of the corporation in the light of Posner's theory of *Economic Analysis of Law* and from the perspective of Islamic Law. However, there are studies made about Islamic Law of corporations and Posner's theory individually as separate topics. For example "*Economic Analysis of Law*" by Richard A. Posner, a relevant chapter in "*Legal Philosophy*" by J. W. Harris and a monumental

work of our modern scholar Imran Ahsan Khan Nyazee about "Islamic Law of Business Organizations: Corporation has been carried out yet. So my topic is the mixing up of these two important issues in a new combination, which is first time to be studied here.

PURPOSE OF RESEARCH

Modern research has been done on *Sharikat* and a lot of research has been carried out in the dimensions of law under Posner theory but to discuss corporation under Islamic Law and Posner's theory has not been carried out so far. Economic Analysis of individual branches of law could be found such as Economic Analysis of Tort Law, International Humanitarian law, and indecent law but my work stresses on the introduction of the Posner's theory with special focus on the defects of the modern corporations from the perspective of the said theory as well as Islamic law. To sum up, my work will not only be compliant with Islamic injunctions but also it will be a better tool for the optimum utilization of resources as envisaged by Posner. The said work will be significant for lawyers, jurists and economists.

RESEARCH METHODOLOGY:

In the compilation of these thesis, I followed the methodology given below:

The first and most reliable source of information is definitely the books. I have so far searched quiet a lot of books especially dealing with the topic. For this purpose, I visited different libraries and two present inside the new and old campuses of our university. I collected books, law journals and articles on the issue from the said libraries.

Internet, no doubt is the borrowing source of information and ocean of knowledge, searching and learning. I also conducted my research on net and collected many articles and journals

especially on insider training, limited liability, Federal Shariat Court judgments and many others, to have broad concept of the study. The finding and facts according to chapter wise structure has been carried out and lastly, I edited and amended the final version under the guidance of my supervisor until it took the final shape.

TABLE OF CONTENTS

CHAPTER ONE: PUBLIC CORPORATIONS IN PAKISTAN AND THE ECONOMIC ANALYSIS OF LAW

In this Chapter, we will first examine the significant aspects of the Pakistani legal regime regarding corporations after which we will discuss the theory of economic analysis of law and its application on corporations as governed in Pakistan.

1.1 Public Corporations in Pakistan

The word 'corporation' is used to signify the same meaning as that denoted by 'company' and the two words are used interchangeably.[1] The word company is derived from the Latin word "panis" which means bread. Hence, the word company means to eat bread together. Company is the creation of the state and possesses legal personality that enables it through its agents and representatives to do many of the things that a natural person does. It is an artificial person and its whole character and life depend on the law that brings it into being. [2]

In practice there exists two types of persons; natural and artificial. Therefore, to quote M. C. Shukla:

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[1] Imran Ahsan Nyazee, *The Company Law* (Rawalpindi: Federal Law House, 2008), 33 (hereinafter called Nyazee, *Company Law*).

[2] *Ibid.*

> Law regulates the rights and obligations of persons and divides them into two classes' i-e natural person and artificial person. Natural persons are human beings of different degrees of capacity with whom we have been dealing so far. Artificial persons are such as are created and devised by human law for the purpose of society and government which are called corporations or companies.[3]

A corporation is an artificial person, with a distinctive name, a common real and created by law for the purpose of preserving in perpetual succession right which would fail if vested in a natural person[4].

The company law is not only a valuable body of knowledge but also a key to an understanding of the word at the heart of the capitalist system, the free market economy. Richard Posner, the proponent of the theory of economic analysis of law, points out that companies raise wealth maximization to avoid huge transaction costs which is not possible through a partnership. He says:

> The theory of the firm tells us why so much activity is organized in firm, but why not most of these are corporations. A clue is that firm in which inputs are primarily labor rather than capital are frequently organized is partnership or identical proprietorships.

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[3] M.C Shukla, *Mercantile Law*, 13th revised edition. (Delhi: S. Chand and Company Limited 1991), 431. (hereinafter Shukla, *Marcantile Law*). A company is regarded in law as a person separate and distinct from its members and it makes no differences to this rule that one member own all or substantially all of the shares. In ordinary speech, we use the word, person, to refer to an individual human being, a man, a woman, or child, but the word has in law a more technical meaning:, a subject of right and duties, and it is in this sense that we speak of a corporation as a person and recognized its separate personality L.S Sealy, *Cases and Materials in Company Law* (London: Butterworths), 26.

[4] *Ibid.* Legal person other than human beings were called natural person are of the three types: a. corporation b. institution c. fund or estate and the corporation (from the word *corpus* is a group or series of persons to whom the law has assigned a personality) the institution may be a church, a hospital, university and so on. Legal personality may be assigned to a fund like the Mudaraba fund or to an estate. See Nyazee's *Jurisprudence*, 242 .A Corporation as a voluntary association for profit with capital divisible into transferable shares with limited liability, having a corporate body and common seal. See for details Janet Dine, *Company Law*, (London: Sweet and Maxwell 2001), 1. See Chatterje, Chinomy. *Guide to Private Companies* (Bombay: N.M Tripathi, 1981), 1. See also Nyazee, *Islamic Law of Business Organizations: Corporation* (Islamabad: Islamic Research Institute, 1998), 77.

> The corporation is primarily a method of solving problems encountered in raising substantial amount of capital.[5]

1.1.1 Corporation as Defined in the Companies Ordinance, 1984

Pakistan is a common law country and it inherited the bulk of its laws from the British common law system. This British heritage includes the concept of corporation.

John Marshall, the famous Chief Justice of the U.S Supreme Court, defined a corporation in the following words: "A corporation is an artificial being, invisible, intangible and existing only in the contemplation of the law".[6] The Pakistani Companies Ordinance, 1984, talks about company as a kind of legal entity or corporate body which is passed under the registration procedures. The meaning of the term as stated in the ordinance needs to be understood, however, in the light of the term "body corporate" as defined in section 2(4) of the same ordinance.

> A body corporate or corporation includes a company incorporated outside Pakistan but does not include the following legal persons: a) a corporation sole. b) a cooperative society registered under any law relating to the registration of cooperative societies. c) any other body corporate not being a company as defined in the ordinance, i-e; not formed and registered under this ordinance or an existing company.[7]

Thus it excludes universities, for example, from the meaning of the body corporate. The term "body corporate" or "corporation" is much wider than the term company as defined in the ordinance. In this sense it would include:

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[5] Richard Posner, *Economic Analysis of Law* (Boston: Little Brown and Company, 1972), 290.

[6] As quoted in Nyazee, *Company Law*, 25.

[7] Section 2 (4) of the Companies Ordinance, 1984.

- A company registered under this ordinance.
- A "company or corporation" established by any special enactment; and
- A foreign company. [8]

1.1.2 Distinctions between Company and Partnership

Here, it will not be out of place to mention a few important distinctions between corporation and partnership.

1) Corporation is a legal personality whereas partnership firm is not so.[9]
2) The minimum number of partners required for partnership is two while in a corporation the number required is seven.[10]
3) In ordinary form of partnership, the liability of partners is unlimited, while in a corporation the shareholders' liability is limited to the extent of unpaid shares.[11]
4) In ordinary form of partnership, each partner can be sued for the debts of the partnership because each of them is an agent for other partners, whereas a corporation can be sued on its own name because it is a distinct legal person.[12]

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[8] Nyazee, *Company Law*, 26-27.

[9] For further details see John Farrar, *Company Law* (London: Butterworths, 1985), 14. (hereinafter called Farrar's Company Law). However, in some states, legal personality is now assigned to what is called "limited liability partnership".

[10] *Ibid.*

[11] *Ibid.* See also M.C Shukla, *Mercantile Law*, 13th revised edition. (Delhi: S. Chand and Company Limited 1991), 172. The capital of the corporation and its assets are owned by the corporation on its name, however the assets and capital of the partnership exists in the form of coownership among the partners.see also Nyazee's Corporations, 116

[12] See Farrar's *Company Law*,14. See also Janet Dine *Company Law*, 13. Partnership should not be necessarily registered where as, corporation needs a special proceeding for its incorporation. Further, partnership is dissolved by the death of the partner where as corporation has its own existance. There seems quite alot of distinctions between the two. For details see Ibid .or a good book on Company Law.

1.1.3 Kinds of Companies

In England, two recognized forms of corporations were used i.e. corporation sole used to be held by a single individual and his office was treated as legal entity, and corporation aggregate.[13] According to the UK Companies Act 1985, there are three kinds of companies:[14]

1) Chartered companies which are granted a charter by the Crown under its special statutory powers;
2) Statutory companies are created by special acts of the Parliament;
3) Registered companies, which are further divided into public and private companies.

In Pakistan, the companies are enlisted in SECP and its shares are floated in stock exchange. Public companies can either be limited or unlimited. Public limited companies are those where the liability of its members is limited to the extent of their unpaid shares. Financial disclosure is obligatory upon such companies for the interest of the creditors and general public.[15] On the other hand, in public unlimited companies the liability of the shareholders is unlimited as is the case with general partnership.

1.1.4 The Pakistani Legal Regime about Corporations

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[13] Fledman, David, Meisel Frank, *Corporate and Commercial Law* (London: Llyod's of London Press, 1996), 10.

[14] Gower, L.C.B, *Principles of Modern Company Law.* (London: Sweet and Maxwell, 1992), 12. See also Shukla's *Marcantile Law*, 434.

[15] Chatterjee, Chinmoy. *Guide to Private Companies.* (Bombay: N.M. Tripathi, 1989), 4

The company law was introduced in India in 1850 followed by some modifications and amendments in 1857, 1866, and 1887 till the Companies Act of 1913 was passed, which was based upon the English law of 1908.[16] The Companies Act, 1913 was issued and adopted in Pakistan after independence.

In Pakistan, some of the recommendations were passed by the report of the Commission for Company Law Reform, 1961, but these were not implemented. However, some changes were made in 1972. A major revision of the law took place through the Companies Ordinance of 1984 which was promulgated on 8 October, 1984. It repealed the previous Companies Acts and some of the Islamic provisions, such as those related to Mudarabah Companies, were inserted in it.[17]

With the passage of time, it became obligatory on the companies to disclose information even if the investors did not ask them to do so. The SEC (Securities and Exchange Commission) was established in 1934 by the Securities and Exchange Act, 1934. The SEC became a governing body for the regulation of the corporations and it was granted wide powers to deal with all issues, including insider trading.

The developments in the US got influence in the laws prevalent in different countries including Pakistan. Consequently, the Corporate Law Authority was established and later on it was converted into Securities and Exchange Commission of Pakistan (SECP) on 1 January 1999 having its head office in Islamabad. SECP is a body corporate with perpetual concession and a common seal, may sue and can be sued in its own name and may enter into contracts, acquire,

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[16] For further details See, *Government of Pakistan, Report of the Company Law Commision* (Karachi: 1963) .

[17] Nazir Ahmad Shaheen, *Corporate Laws and Secretarial Practices*, (Rawalpindi: Awais Publishers, 2003), 2.

purchase, take, hold any movable property and may convey, assign, surrender, transfer any of these properties or any interest vested in it.[18]

The purpose of the establishment of SECP is to regulate the capital markets, supervise and control the corporate entities. Its main functions include; regulations of securities markets and related institutions such as Mudarabah Companies, administration of the company law, regulation of leasing companies, investment banks and insurance businesses. The important function among these is, incorporation and registration of companies which is conducted by the registration department company law division in their respective field offices known as company registration offices (CROs). SECP field offices are located in Karachi, Lahore, Peshawar, Faisalabad, Multan and Quetta.

As far as the powers and functions of the commission are concerned, these are clearly mentioned in the SECP Act. The Commission is responsible for regulating the issue of securities, business in stock exchanges, supervising and monitoring efficient and fair trade practices relating to securities markets, conduct investigations and many such other powers.[19]

The SECP Board too, has various powers. The board after the request and consultation of the commission advise the federal government on all matters relating to the securities industry, regulation of companies, corporate sector and protection of the interests of the investors. It also encourages the self regulation by the stock exchanges and other related matters.

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[18] It consists of a body of commissioners including chairman and one of the chairman is appointed by federal government. The number of the commissioners including chairman may not be less than 5 and not more than 7. The term of the office of the commissioner is 3 years. Apart from this there is a policy board consisting of 7 members. Among them 3 are from private sector and the rest of them are, the secretary finance, the secretary law, the Chairman SEC and a deputy governor of the State Bank of Pakistan. For further details, See Nazir Ahmad Shaheen, *Corporate Laws and Secretarial Practices* (Rawalpindi: Awais Publishers, 2003), 542.

[19] For further details see Nyazee's *Comnpany Law*, 223.

As far as the basic law in Pakistan is concerned, it is in the form of Companies Ordinance, 1984, which extends to whole of Pakistan.[20] The ordinance deals with all aspects of the life of a corporation, starting with the promotion of the company and the rules related to the promoters to the mandate and powers of the directors, the names and kinds of companies, prospectus, allotments and transfers of shares in the business, the meetings, the articles and

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[20] The first part (sections 1-6) of this Ordinance is a preliminary part consisting of title and definitions and its application. The second part is related to the jurisdiction of the courts, procedure and the high court having jurisdiction under this Ordinance where the registered office of the company is situated. In each high court there may be one or more than one benches called company benches. The third part (sections 11-13) is related to the SECP, its powers and functions which has already been mentioned. The fourth part (14-51) is very important deals with incorporation and registration of the companies and institutions, mode of forming the companies, Memorandum of Association, Memorandum of different types of all kinds of companies. It also deals with Articles of Association (26-28) and its forms. There are general provisions for the registration of memorandum and articles.

Part five (52-88) too, is very comprehensive part consisting the provisions relating to the prospectus of the company to know how to prepare the prospectus and what requirements are necessary for a company to issue a prospectus. Sections(67-81) of this part relating to the Allotment, certificates transfer of shares and debentures. Part six(89-120) of the ordinance deals with the classes and kinds of shares. There are some provisions regarding share capital, reduction of capital, variation of shareholders' rights and special provisions relating debentures. Part seven (121-141) is related to the registration of mortgages and charges. Some of the provisions are related to receivers and managers and their appointment. Part eight (142-282) is a long and administrative part of this Ordinance relating to the management, administration registered offices of companies. It also deals where and when a company should start commencement of business after all the formalities and legal procedure is completed. Sections 157-173 adopts the different kinds of meetings (annual general meeting, statutory meeting) and procedure, provisions regarding voting powers and procedure, proxies and all minutes of meetings. Sections (174-197) of this part is related to the directors' minimum numbers, competency of directors, retirement, procedure of the election, term of the office, removal, their liabilities and powers. The sections 198 to 282 are related to the auditors, investigation and related procedure.

Part nine (282A- 282-N) of the said ordinance is related to the non-banking Finance Companies and arbitration. Part ten is for the prevention of operation and Mismanagement. Part eleven (297-439) is very important regarding the winding up of a company, different modes of winding up(winding up by court, voluntary winding up, and winding up subject to the supervision of the court), and the rest of the parts of the ordinance i-e part eleven, twelve, thirteen and fourteen, fifteen, sixteen deals with modes of winding up of unregistered companies, foreign companies, general legal proceedings, offences and penalties, annual report of the SECP.

Apart from sections there are eight Schedules which narrate the different memorandum of associations and regulations of different companies limited by Guarantee and limited by Shares. These schedules also refer to the Annual return of a company, requirement of Balance Sheet, profit and loss account and the last schedule deals with the amendments in Ordinance XVII of 1969. For further details See; Nazir Ahmad Shaheen, *Corporate Laws and Secretarial Practices* (Rawalpindi: Awais Publishers, 2003) and Nyazee's *Company Law.*

memorandum of association of the companies, the profit and dividends and finally the winding up of companies through various mediums.

1.1.5 Advantages of the Corporations

Here, we may enumerate a few important advantages of the corporations.

- A corporation has a separate and distinct personality from its members which constitute it.
- As a corporate person the corporation is entitled to own and hold property as distinct from its members.
- As a juristic person, distinct from its members, it has perpetual succession.
- The debts and liabilities of the corporations are not attributed in law to the members. The corporation/company may become insolvent, while the members remain rich. [21]
- The corporation may have limited liability for its members and this advantage is not available to for any other form of business organization.
- The main advantage of a company as a corporation aggregate is to reduce transaction costs and the company is designed to accumulate huge funds, numerous commercial projects and activities which reduce wasteful expenditures and makes the company more efficient. [22] This is what Posner in his "economic analysis of law" pointed out that to reduce transaction costs aim of the law, that is, efficiency and

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[21] See *Nyazee's Jurisprudence*, 244.

[22] *Ibid*, 245.

promotion of wealth, can easily be gained which we will discuss in the second chapter of this study.

- The law grants others advantages to the corporation as it can claim a large number of expenses that other forms of business organizations cannot. [23]
- As the company is not a citizen and act only through natural person, it has no fundamental rights under the constitution. [24]
- the separation of ownership and management in a corporation has increased the liquidation process as the shareholders wants to let be increased the value of their shares and d management class wants to have incentives that is the reason that companies are managed by professionals and the shareholders leave their affairs to them. A characteristic of the company, therefore, is a separation between management and control such as a separation is not found in a partnership. [25]

1.2 Richard Posner's Theory of Economic Analysis of Law

Despite the fact that judges, lawyers and individuals appear to view the law in terms of rights and obligation, there is a separate school of legal thought which not only regards that law to promote economic efficiency, but also claims it a descriptive theory of law for the protection of wealth[26]. The followers of this school of thought, which has its origin in the United States in 1960's, include Ronald Coase, Guido Celebresi and Richard Posner. The influence of the

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[23] *Ibid.*

[24] See Shukla, *Marcantile Law*, .433 and see also Tata E and L.co limited Vs state of Byhar, India 1965 S.C 40, as quoted by Shukla.

[25] Nyazee, *Company law*, 26.

[26] Mc Coubrey Hilaire and Dr. White Nigel D, *Jurisprudence*, edn.2nd (London: Blackstone Press Limited, 1993), 239. (hereinafter called White's *Jurisprudence*).

Chicago School is obvious although there are many variations in the said school but we shall focus on the work of Posner, Professor of Law in the University of Chicago.[27]

Posner, in his monumental work *The Economic Analysis of Law* has analyzed in detail the problems with the traditional partnership form of business organization but he has also applies the tools of this theory to the analysis of the legal rules and institutions (corporations) and brought economic thinking to the study of law. Posner applied his theory to the analysis of legal rules and analyzed in detail the problems with the traditional partnership form of business organization and also he applied the tools of this theory to the analysis of the legal rules and institutions (corporations) and brought economic thinking to the study of law. The theory was first applied to the specific areas of law, such as anti trust legislation but later on it changed its direction towards the legal system as a whole.[28] Posner explained why many of the legal rules and institutions we have are what they are, and his theory has normative implications for how law should be improved? Therefore, we deem it necessary to briefly discuss some of the general theories of law presented by the western philosophers.

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[27] Posner in the University of Chicago, in his "economic analysis of law" has analyzed in detail the problems with the traditional partnership form of business organization but he also applies the tools of this theory to the analysis of the legal rules and institutions (corporations). See Nyazee, *Jurisprudence* (Islamabad: Advance Legal Studies Institute, 2007), 127.

[28] J.W .Harris, *Legal Philosophies* (London Butterworth's), 42.

1.2.1 Relationship of Law and Economics

Law serves as an economic "instigator" for activity in a given state or institution. A close relationship, therefore, exists between law and economics. Economics is the science of wealth and law promote social and economic affairs. Hence, law and economics help each other in developing society's welfare.

Law is a complex social institution[29]. It is because the rights and obligations which determine the role and status of member of society are expressed in the form of rules known as norms[30] and these norms are not clearly stated. Law is said to have five functions, that is, to establish order in society when disputes arises, to reaffirm social norms that may have been violated, to make the society more efficient, to act as an instrument of a social change and to enforce justice according to law[31].

Vari schools of law have defined law from different angles. [32] Some of the definitions are discussed here.

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[29] *Dias*, R.W, *Jurisprudence* (London: Sweet and Maxwell, 1976), 15. (hereinafter called Dias jurisprudence).

[30] *Norm* is a common element between all types of laws and a basic element in the atomic structure of the law. The term is derived from the Latin word *norma* which means rule and standard. Technically it means a directive which authorizes, prohibits or regulates human actions and conduct. For all these details see Nyazee, *Jurisprudence* (Islamabad: Advance Legal Studies Institute 2007), 27, 33. (Hereinafter called Nyazee's *Jurisprudence*).

[31] See Nyazee *Jurisprudence*, 39-40. Law is a tool used by individuals, groups, institutions and societies to achieve an end and that end is justice. Law comprises of rules established by societies through constitutions, statutes, administrative rules and regulations, rules of court, executive orders, court decisions discovering and applying common law principles, court decisions defining and interpreting the specific provisions of all these forms of law. For further details See Richard A. Myren, *Law and Justice: An Introduction* (Brooks/ Cole Publishing Company Pacific Grove, California American University, 1988), 3.

[32] Salmond on *Jurisprudence* (London: Sweet and Maxwell, 1966), 9-10. (Hereinafter called John Salmond Jurisprudence). One of the problems is defining law is that new developments in society create new problems and law is required to deal with those problems therefore a definition given at a particular time cannot remain valid for all times to come. See also Dr.V.D Mahajan, *Jurisprudence and Legal Theory* (Lahore: Mansoor Book House, 1995), 27.

1.2.1.1 Defining Law

John Austin[33] defines law as "the command of the sovereign backed by sanctions". [34] The three elements of his theory could be inferred from this definition;

a) Command- that is the will conceived by the sovereign

b) Sovereignty and

c) Sanction

This theory has been severely criticized by majority of the western philosophers and H.L.A Hart is one of the harsh critics of this theory.

Hart says that every command is not law and every act of the sovereign is not a command, and every command is not backed by sanction. He says a mere request is not a command[35]. Similarly, he points out that all laws cannot be expressed in terms of command. Some of the laws empower people to vote, laws relating to the sale of property and making of wills which are not commands. The concept of sanction in Austin's theory is not applicable to

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[33] John Austin (1790-1859) is an English jurist and is considered as the founder of analytical school of law. His theory of "Command", although remained almost unnoticed during his life time, however later on it gained influence on the development of English Jurisprudence. For more details See Edgar Bodenheimer, *The philosophy and Method of the Law*, (Cambridge: Harvard University Press, 1962), 94-96. (Herein after called Bodenheimer *Jurisprudence*). For a sketch of the life of Austin see Sarah Austin's preface to Austin, *Lectures on Jurisprudence*, R. Campbell, edn. 5 (London,1885). See also Dr.V.D Mahajan, *Jurisprudence and Legal Theory* (Lahore: Mansoor Book House, 1995), 27.

[34] Every book of Jurisprudence usually contains the definition of law as that of Austin. See John Salmond *Jurisprudence*, 11. John Salmond defined law in these words; "laws are interests recognized and enforced by the courts of law in the administration of justice". (*Ibid.*, 11.) Paton defines law in these words, "Law may be described in terms of a legal order tacitly or formally accepted by a community, and it consists of the body of rules which that community consider essential to its welfare and which it is willingly to enforce by the creation of a specific mechanism for securing compliance. A mature system of law normally sets up that type of legal order known as the state, but we cannot say a priori that without the state no law can exist.". See G.W Paton, *A Text Book of Jurisprudence* (London: Oxford University Press, 1972), 17.

[35] H.L.A Hart, *The Concept of Law* (Oxford: Clarendon Press 1961), 18. (hereinafter called Hart's concept of law). In modern societies where there are established states, laws may be seen in the nature of command but some laws existed prior to the state in the form of custom, religion were not the command of the state. For further details See Dr.V.D Mahajan, *Jurisprudence and Legal Theory* (Lahore: Mansoor Book House, 1995), 33.

international law, constitutional law and some ethical elements of justice.[36]Hart then gives his own concept of law as the union of primary and secondary rules. Primary rules are those which create a direct obligation, like murder rules, theft rules and secondary rules are concerned with the primary rules[37]

Ronald Dworkin, a renowned contemporary American jurist, criticizes Hart because he is of the opinion that sometimes law is not the combination of primary and secondary rules and often judges use the general principles of law, particularly in hard cases.[38] He says: "If we treat principles as law, we must reject the positivists first, that the law of the community is distinguished from other social standards"[39]

There is another school of jurisprudence known as the American Legal Realism. The American Legal Realists are of the view that law is, in fact, the practice of the courts. What the judges, police and attorney actually do in their official capacity about law cases and essentially it appears to be the law itself. [40]

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[36] *Ibid*, 38-39.

[37] See *Hart's Concept of Law*, 251.

[38] See Lloyd *Jurisprudence*, 194.

[39] Ronald Dworkin, *Taking Rights Seriously*, (London: Duckworths, 1977), 22.

[40] The realist movement in American jurisprudence is considered as an offshoot of the sociological school of law. It is not regarded as a school of law in itself because it is not composed of a group of persons with identical creed and unified program. See. Among some of the schools of legal realism Jerome frank, he said "judicial decisions depend upon emotions, tempers and other irrational factors and in such situation the legal knowledge has of no help for a judge deciding the case. No one knows the law in any case with respect to any event inasmuch there has been a specific judgment with regard to that case." The realists are of the view that law could be enforced when judges pronounce decisions, however they admitted that the statutes and the precedent serve as an important guideline for making decision For further details See Bodenheimer *Jurisprudence*, 116-17. The naturalists put forward natural law theory and natural law deals with the conceptual aspects of the legal system. The main features of the natural law are; that natural law is the body of universal laws, acceptable to all, capable of discovery through human struggle and reason. On the basis of this universality, the existing laws of all the nations in the world must be made and judged to conform with the universal laws. For further details See Nyazee's *Jurisprudence*, 64.

Lastly, we may mention Jeremy Bentham's theory of Utilitarianism.[41] According to Bentham's principle of utility, every man in a society desires and wishes pleasures and avoids pains and gives it the status of moral principle When Bentham accepts utility as a moral principle he desires it in three aspects[42] .

a) Men should approve the principle which permits them to have what they want i.e. a good standardized life.

b) After the acceptance of this principle our concern will be only with its consequences.

c) If this motivation is conducted by pain or pleasure, legislation is necessary to combat the interests of the individuals as well as of the society so that a system of rewards and punishments may be achieved, which has a sole result and that result should be the happiness of all.[43]

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[41] Utilitarianism, being a philosophical movement started in 19th century in England however it is presumed that its origin existed in the time and writing of David Hume (1711-1776) however, the general view is that it is actually emerged in Jeremy Bentham (1748-1832). The primary rule is based on a maxim that "the greatest happiness of the greatest number" used by Benthem to highlight the theory and the maxim means that the happiness of individual will increase if there is an addition to the sum total of his pleasure greater than any addition to the sum total of his pains as mentioned in the category of pleasure and pain.See Nyazee's *Jurisprudence*, 95-100. See also Bodenheimer *Jurisprudence, 82.*

[42] *Ibid.*

[43] Utilitarianism is not universal because one can identify very difficult that each individual kind of act is right or wrong and no one knows all the consequences of his acts. Principle of utility should not be the basis of our morality. The theory does not say that taking another person's life is wrong See for details Nyazee's *Jurisprudence,* 98. *Jellus* stone opined that general happiness could not be attributed to the aggregate happiness of the society. He says "even if it is accepted that each person deserves their happiness so that their happiness is good to them, how does it follow that the general happiness is good to the aggregate of all? He further says that pain and pleasure are nothing but the names for an infinitely perishing series of feelings". For further details See Lord Templeman, *Jurisprudence: the Philosophy of Law* (New York: Old Bailey Press Ltd. 1997),

1.2.1.2 Defining Economics

The word "economics" is derived from Greek words *oikosnemein*, by splitting it to two parts, *oikos* means "house", and *nemein* means "to manage"[44]. Economics is the branch of social sciences which mainly concerns to the study of wealth according to Adam Smith; the father of economics. Some of the renowned scholars defined it that "it is the study of human behavior in using resources to satisfy wants."[45]

Classical economists among them is Adam Smith, Ricardo and Mill have given it own definition as, "the science of wealth" but it is considered to be incomplete since it emphasizes on wealth and neglects man, the study of which bears prime importance. Hence the definition of Alfred Marshall was accepted unanimously that is: "economics is a study of mankind in the ordinary course of life"[46] Later Robbins offered its own definition as, "the science which studies human behavior as a relationship between ends and scarce, means which have alternative uses".[47]

Now, what do we mean by the relation of law and economics? Perhaps both of them have the common place and they overlap each other and generally a relation exists between them. It is relatively simple to say that corporation law provides us a framework for capital organization that legal relation reflects economic reality.[48]

The most important issue is to discuss the relationship of law and economics after a thorough insight into the concept of law and economics, theories of law to reach Posner's

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[44] Muhammad Muslehuddin, *Economics and Islam* (Lahore: Islamic Publications Ltd.), 3.

[45] *Ibid.*

[46] *Ibid.*

[47] *Ibid.* The definition of Robbins was criticized widely because it excludes some of the basic questions discussed by economists such as the relation between capital and labor and so on.

[48] *Ibid.*

theory of economic analysis of law which will enable the readers to the true philosophy of the theory and apply it to the concept of corporations. However it is obvious now that:

> The use of law is to regulate economic affairs depend upon a definite concept of how law and economics are two distinct domains and without this belief legal regulation would be reduced up to some extent and the fact of the relation of law and economics is quite basic to pursue economic objectives by legal means.[49]

No doubt that law and economics go side by side in the Posner's[50] theory whether it concerns with economic analysis of contract law, tort law or economic analysis of corporations. For the legal regulation of economic affairs it is clear that:

> The relation of law and economics is a necessary support and an important limitation. The point is quite easy because in order to regulate the conduct of corporations the law must have some idea of how they operate and specially how they achieve monopoly, and quite simply monopoly is a form of ownership and a way of establishing control over an industry and marketing process.[51]

The reason why law and economics overlapping each other, the relation of both of them expose the relevant economic principles into a systematic survey of the rules and institutions of the legal system and how economics may be regarded as an understanding of the legal process and how law can encourage economic efficiency.

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[49] Jones Kelvin, *Law and Economy the Legal Regulation of the Corporate Capital* (London: Academic Press, 1982), 17-18.

[50] Richard Posner was the professor of law in the University of Chicago (USA) and considered as one of the pioneering of the economic analysis of law. He has contributed a lot to the concept of economic analysis of law and brought economic thinking to the study of law. He has written the well known book on the concept known as "economic analysis of law". Now many law schools in the world have optional courses and have kept economic analysis of law as an optional subject which is not only important for the lawyer's community but also has a great significance for the economists as well.

[51] Jones Kelvin, *Law and Economy the Legal Regulation of the Corporate Capital* (London: Academic Press, 1982), 17-18.

1.2.1.2 Law as a Tool to Encourage Economic Efficiency

The aim of the law is efficiency and the practitioners of law and economics look at law as a social tool and try to evaluate its functions. To understand this, it is important to examine some of the basic concepts used in models for economic reasoning.[52]

It is important to know a set of fundamental concepts and the most important concept of economics is that:

> Human beings are rational maximzer of their individual satisfactions. It is to be noted that economics is not only restricted to analysis of monetary issues; there are non-monetary as well as monetary satisfactions but normally what is aimed at through economic reasoning, is the improvement of efficiency.[53]

The proponent's claim of the law and economic movement is, that law is best understood as a tool to promote economic efficiency and the best example is the way legal systems could be used to ensure economically efficient transactions through the enforcement of valid contracts and compliance with contractual terms[54].

However, it is interesting to note that law can be used to encourage economic efficiency but all law can be best described in economic terms, rather it can be seen by the virtue of economic analysis of law, that such disparate area of law as contract, tort, and criminal law all based on economic terms, for instance Richard Posner argues that "tort cases can be seen as

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[52] *Ibid*

[53] Coleman, Jules, *Efficiency Auction and Exchange: Philosophical Aspects of the Economic Approach to Law*, *California Law Review* 221(1980), 68.

[54] Miceli, Thomas J., *Economics of the Law: Torts, Contracts, Property, Litigation* (New York: Old Bailey Press Limited, 1997), 129.

contractual by looking for the hypothetical terms that the parties to the accident would have agreed to in advance in order to bring about the accident voluntarily."[55]

1.2.2 Economic Analysis of Law and the Role of the Chicago School

Economic analysis of law is the name for the approach of a school of law that maintains that the law has been, and ought to be concerned with economic efficiency[56]. It attempts to advance a theory of law mainly concerning with economic efficiency and the promotion of wealth and economic efficiency means the optimum utilization of resources[57] . One interesting aspect to be addressed in development studies, are the changes in legal rules and their enforcement mechanism that are needed to promote the existence of public and private organizations in which their members increase in wealth position is compatible with attaining the goals of organization and improving the overall wealth of the society.

There have been many claims as to the origins of the economic approach to law, however, the economic approach grew out of American realism which gave an explanation of law in terms of non legal factors such as economics, and indeed economics is more attractive than other social sciences for lawyers to coincide between law and non legal factors[58] .On the other hand, economic approach to the law to view it as an approved model of utilitarianism; Bentham's utilitarianism was based on the "the greatest happiness of the greatest number"[59] .

The basic idea in the Posner's theory is that man is a rational maximizer of his satisfaction and the entire theory is based on this definition. For example homo economicus i.e.

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[55] *Ibid.*

[56] *Ibid*, 126.

[57] *Ibid.*

[58] White's *Jurisprudence*, 240.

[59] *Ibid.*

economic man will achieve a thing X , if he wants to achieve and brings him the greatest benefit for his inner satisfaction and if he rejects and does not benefited him he would act irrational [60].

The underlying idea however, as mentioned by Nyazee, is that "man is rational and must act rationally. Acting rationally means maximizing his satisfaction and his wealth according to his self interest, as he acts for his interest, deriving satisfaction and thus he increases the wealth of the society".[61] In Posner's theory, maximization of wealth is based on individual self interest which leads to the optimum utilization of resources. If an individual does not act rationally he will not get benefit of satisfaction[62]. Richard Posner in explaining the meaning of wealth maximization states that, "wealth is the sum of all tangible and intangible goods and services".[63] Posner quote an example that how wealth can be maximized[64]. If A would be willing to pay up to 100$ for B's stamp collection, it is worth 100$ for A. if B would be willing to sell the stamp collection for any price above 90$,it is worth 90$ to B. so if B sells the stamp collection to A say for 100$... the wealth of the society will rise by 10$. Here the increase in wealth is not simply the measurement of the monitory gain but a derived satisfaction.

1.2.3 Different Approaches within the School

Posner's work on economic analysis of law carries significant contribution but there are distinct and various approaches within the school as well.

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[60] *Ibid*, 241, Nyazee *Jurisprudence*, 127, See also Dias *Jurisprudence* for details.

[61] Nyazee *Jurisprudence*, 128.

[62] *Ibid.*

[63] *Ibid*, 127.

[64] *Ibid* , See White's *Jurisprudence*,.241. See also Lord Templeman *Jurisprudence*, 54, See also Dias *Jurisprudence.*

1.2.3.1 The Coase Theorem

Ronald Coase, in his "The Problem of Social Costs"[65], forwarded what is now known as the "Coase Theorem". A good explanation of the theorem is based in an example which he presented[66] . He presented the problem of a factory which is emitting smoke which is damaging the laundry houses. The question is whether the residents have the right to clean air or whether the factory has the right to pollute in such situation. The natural tendency is to favor the residents because it is the factory which is causing damage. But for the economists, the issue is not the causation of damages although the factory has caused the damage, they said, the damage would not have occurred if the houses were not so close to the factory. If we are discussing the problem of damages, then both the parties cause the damages. For the Chicago School, the issue is not one of the causation but of efficiency and efficient pollution control.[67]

The efficient solution is whether there are transaction costs or not and the definition of transaction costs has been given above, if there are zero transaction costs then for an efficient solution it does not matter whether we have a legal rule saying that the polluter pays[68] or whether we have a legal rule allowing the right to pollute, i.e. whether the factory or residents pay the damages.

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[65] R.H Coase, "The Problem of Social Costs", *The Journal of Law and Economics*, 3 (1960), 1-44.

[66] A.M Polinsky, *An Introduction to Law and Economics* (Boston, Mass: Little Brown and co; 1983), 11-14.

[67] Ibid, 13.

[68] The "polluter pays principle" is one of the fundamental principles of modern environmental policies, both nationally and internationally. In simple words it means that the cost of pollution should be paid by the polluters and not by the society, or their governments. This cost is added by the polluter to production cost and is passed on to the consumer. All the economists' agreed that the polluter must pay for the pollution and its abatement, and the total production costs should be reflected in the price of the goods. This took the shape of principle and then the assigned name is assigned to it by the economists. See for details, Muhammad Munir, *The Polluter Pays Principle in International and Environmental Policy and Law: Economic and Legal Analysis* (Islamabad: Institute of Legal Studies, 2004), 1, 7 (hereinafter called Munir's Polluter Pays Principle).

The theorem has fundamental importance for decision making in the real world, where of course the markets are imperfect. In particular, the lawyers, economists focus on the imperfection of what they called transaction costs.[69]

1.2.3.2 Efficiency and Equity: Calabresi's View

There are significant views about the central theme and one of the situation is where transaction costs are not zero in the aforesaid example, then Calabresi not only addresses the narrow issue of efficiency in his analysis and also look at the nature of a right and the issue of its distribution as well and the society has to make "1st order legal decisions" for example between the right to clean air and the right to pollute and if these decisions are lacking then the decision will be on the basis of principle "Might makes right"[70] Calabresi states:

> What we choose the set of entitlements which would lead to the allocation of resources which could not be improved in the sense that a further change would not so improve the condition of those who gain by it that they could compensate who lost from it and still be better off than before.[71]

Coase's theorem is a significant idea from both the legal and economic view points;[72] from a legal view point, the thought of no nuisance cases is either greatly relieving or

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[69] Lord Temple man, *Jurisprudence and philosophy of Law* (London: Old Bailey press, 1989), 55.

[70] G.Calabresi and A.D Melamed, *Property Rules, Liability Rules and Inalienability. One view of the Cathedral*, (1972) 85 *Harvard Law Review*, 1089-1128 as quoted in Mc Coubry and D.white *Jurisprudence*, 244.

[71] *Ibid*

[72] "In the absence of transaction costs the efficiency resource allocation is independent of the placement of liability, or in the initial assignments of the rights. Coase consider a situation in which running a train beside a farmer field will destroy farmer's crops. In the view of economics, the running of a train will impose a negative externality on the farmer, however Coase consider that the farmer and the rail road will bargain and reach the optimum combination of train trips and damaged crops, regardless of which party has the initial right i-e the right to damage crops or freedom of passage, if we assume zero transaction costs."

frightening, and from the perspective of economists, it is provided a major challenge to accept economic thinking. [73] The view of Calabresi on the other hand is narrower in focus than Coase's, but it has influenced a great work in the law and economics, he argues that the principle function of accident law is to reduce the sum of the costs of accidents and the cost of avoiding the accident.[74]

1.2.4 Distinction between Bentham's Utilitarianism and Posner's Economic Analysis of Law

The distinctions are drawn by Harris between the views of Bentham and Posner as follows:[75]

i) We should not concern ourselves with the messy business of human psychology, i-e human nature base upon desire. We should simply assume a few things as is done in economics: the basic assumption is important that man is rational maximizer of his satisfaction.

ii) Benthem's goal was the greatest happiness of the greatest number, but Posner's goal is efficiency that is the optimum use of available resources.

iii) Posner believes that the theory of economic analysis of law is quite different from utilitarianism in that the former theory makes simplifying assumptions about rational actions in the world of scarce resources while the latter is based upon human psychology.

Barreto Humberto, Husted Thomas and Ann D.white The *New Law and Economics Present and Future* (Review works). Source: American Bar Foundation Research Journal, 9:1 (winter, 1984), 253-266: Blackswell publishing on behalf of the American bar foundation www.jstor.org.com (last visited 13.08.2009).

[73] *Ibid.*

[74] *Ibid.*

[75] J.W Harris, *Legal Philosophies* (London: Butterworths, nd), 37-43, 190, as quoted in Nyazee's *Jurisprudence,* 134. Richard.A.Posner presented a major view saying that, efficiency is often viewed as a major goal of legal rules and suggest that wealth maximization, not efficiency as it is usually used in the economics but it must be the goal of legal rules.

iv) The former theory looks at what people are willing to pay for in terms of money or goods and services while in the later theory we cannot find out what the people actually want, being the defective theory.

We may conclude that the aim of the law is economic efficiency and Posner applies the tools of his theory to the analysis of legal rules and institutions, including corporation, and brings economic thinking to the study of law and showed that the corporation model is the preferred form and a remarkable tool for maximization of utility.

1.2.5 Defects in Modern Corporations from the Perspective of Posner's Theory

Posner opines that economic activity could be conducted in two separate methods, *viz* the traditional domain of contract law and the master servant law in the shape of firms. He asserts that both the methods are not costless, as if the first method contains the problem of high transaction costs the second method involves the problem of loss of control.[76] Furthermore, the issue of temporary life of a firm makes the partners vulnerable to losses. Hence, as a solution to the problems mentioned above, corporations were developed which enjoy permanence of life and the advantage of "limited liability".

The concept of limited liability however has become a matter of argument between jurists and voices have been raised to replace the concept on the basis of the principle of

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[76] He believes that in the contract method "the details of the supplier's performance be spelled out at the time of the signing of the contract. This may require protracted and costly negotiations, elaborate bedding procedures etc" and if any change occurs in the circumstances, the agreed-upon performance would also required modifications. "the second method, the firm, involves incentive, information and the communication costs", he affirms further that "since performance in the firm is directed by the employer's orders, machinery for minimizing failures of communication up and down the chain f command is necessary" and then highlight the exact problem in installing this machinery "machinery both costly and imperfect. See: Richard A. Posner, *Economic Analysis of Law* (Boston: Little, Brown and Company, 1977), 290.

fairness with another principle-the proportional liability.[77] It is asserted: 'Proportional liability and the mechanisms for enforcing it are open to a variety of interpretations. At some points in history, individual creditors have been able to pursue their claims against particular shareholders up to the full amount of their claim"[78] In reply to the question of what would the so-called proportional liability offers towards the shareholders and their interests, it is claimed that:

> "[I]n the version of proportional liability...each shareholder would be liable for the excess of liabilities over the corporation's assets to the extent of the proportion of her shares to the total number of shares outstanding. In addition, such liability of shareholders would only be to the victims of tort or other so-called "involuntary" creditors".[79]

As a defect in the concept of corporation and limited liability, Posner states:

> [T]he alert reader will perceive, however, that limited liability is a means not of eliminating the risks of entrepreneurial failure but of shifting them from individual inventors to the voluntary and involuntary creditors of the corporation-it is they who bear the risk of corporate default. Creditors must be paid to bear this risk.[80]

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[77] Gordon G. Sollars, An Appraisal of Shareholder Proportional Liability, *Journal of Business Ethics*, 32:4 (Aug., 2001), 329-345. Available online at: << http://www.jstor.org/stable/25074579>> (last accessed: 30.06.2010).

[78] *Ibid.*

[79] *Ibid.*

[80] *Economic Analysis of Law*, 293.

Posner intends to highlight the fact that though the term of limited liability[81] denotes as if the risk is minimized, but in reality it is not the case, as only the pocket which would bear the loss is changed, now the creditor will bear the loss instead of the shareholder. The capital contributed by the shareholders in the form of share capital pass onto the corporation and the corporation is to repay it as the claim of any other creditor. Consequently when insolvency occurs, the creditors can claim to the assets of the corporation and the shareholders do not have any control over these assets and the creditors cannot satisfy their debts from the personal assets of the shareholders and in the same way they also stand side by side in the line with the creditors with a claim on the assets of the corporation.

For this reason, it is derived that the term limited liability is not an accurate term to be used. In such cases, probably, the corporate veil is pierced and the shareholders are regarded as the agents of the corporation which is not so under the present structure of the corporation as we see nowadays.

As we will elaborate in the next chapters, Islamic law which has no parallel in history is based on general principles of commercial law, the principle of *al-Kharaj bi Daman*, which means he who bears the risk will be entitled to profit. It is for these reasons that the liability of the investor is unlimited.[82]

It seems that Posner believes in separation of the ownership and control in the modern corporations whereby he regards the shareholders as owners of the corporation but in the usual and obvious sense of the term. He asserts: "[I]n a technical sense the shareholders "own" the

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81 For detailed appraisal of the concept of limited liability in corporations, see: Paul Halpern, Michael Trebilcock and Stuart Turnbull, An Economic Analysis of Limited Liability in Corporation Law, *The University of Toronto Law Journal,* 30:2 (Spring, 1980), 117-150. Available online at: <<http://www.jstor.org/stable/825483>> (last accessed: 29.06.2010).

82 Imran Ahsan Khan Nyazee, *Islamic Law of Business Organization: Corporations* (Islamabad: IIIT, IRI, 1998), 164.

corporation but they do not own it in the same sense in which they own their own automobiles; it would be better to speak of their owning the common stock of the corporation".[83] The separation of ownership and control in the modern business corporations has been remained the subject of a huge debate among the corporate scholars. To identify the relationship between the shareholders and corporation is a challenging issue for them. However, if analyzed, this relationship is apparently a debtor creditor relationship.[84]

Therefore Nyazee elaborates; the position of the shareholder is identical to that of the creditor with the lowest priority in claims. If anything is left, the shareholders take it as a subsidiary or gets nothing if the corporation becomes insolvent, not because of liability for the loss, but because there is nothing left to recover, and this may be the position of all the creditors too if nothing is left. He further asserts that, in-fact it is the corporation which bears all the liability but it is the shareholder too for the entitlement to the entire profit not the corporation which is a gross violation of the Islamic principles and could be considered as defect in the corporate structure in the light of Posner's theory as well.

The affairs of the corporations are governed, according to Posner, keeping in view its management by shareholders, bondholders and trust beneficiaries the direct affectees of mismanagement being the shareholders. In a corporation, this mismanagement leads to the insolvency of the corporation when they do not deal fairly with the shareholders. Its

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[83] *Economic Analysis of Law*, 300-1.

[84] Apparently such type of relationship has been admitted by Pennington in his book Company Law and says shareholder has no concern after they contributed the money and a distinction is created between the money paid and the capital. It is concluded from his this statement that their relationship is like a creditor and debtor. He states: "since the shareholder ceases to have any proprietary interest in the money he pays to the company for his shares, the relationship between him and company is that of creditor and debtor, and that one of the promises contained in the bundle which makes up a share is a promise by the company to repay the money paid by the shareholders when the company is wound up". Later on, he retracted from his statement but his arguments are not sound. For further details see Robert R. Pennington, *Company Law* (London: Butterworths, 1985), 155-6.

noteworthy, however, that mismanagement is not as dangerous as is the fact that the mangers would not deal fairly with the shareholders. As the damage to the interests of the directors is serious as compared to the later, hence, to have the corporation operative and secure the interests of the directors, they would try to keep the corporation well managed but would try to look for means of maximizing their interests for which they might ignore the principle of "fair play". The fiduciary duty that directors are awarded with prohibits one such practice i.e insider trading whereby "a manager or other insider uses information not yet disclosed to other shareholders or the outside world to make profits by trading in the firm's stock".[85]

In situations where the directors disregard the interests of shareholders, the market price of the firm's common stock will fall. When this happens, vigilant investors would realize the stock is underpriced and would exploit this information in several ways.[86]

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[85] Insider trading involves the unlawful use of material, nonpublic information; Trading rules prohibit individuals with access to privileged information about securities from trading in them or tipping others to trade in them without first disclosing to the other side of the transaction their possession of material, price-sensitive information that might affect that transaction. Prohibitions to abstain from trading are not statutorily defined.. Insider trading is known to the public as the white-collar crime of the 1980s. The vast majority of research on insider trading has been conducted by legal scholars who track the changing technical requirements of securities law and by economists who debate whether insider trading is efficient for the market. For a detailed analysis of the issue, see: Nancy Reichman, *Insider Trading* (Chicago: the University of Chicago Press, 1993), 55-96. Available online at: <<http://www.jstor.org/stable/1147654>> (last visited: 30.06.10).

[86] *Economic Analysis of Law*, 308.

1.3 Conclusion

In this chapter we went through the concepts of Corporation, Law, Economics and then the relevance of law and economics in order to highlight the vital fact that the law is a tool to encourage economic efficiency and a legal system could be utilized to ensure economic efficient transactions.

Posner's theory of economic analysis of law and the role of the Chicago school was thoroughly discussed. Apart from this, the said theory has analyzed the problems with the traditional form of business organization but this theory also applies to the corporations. Some of the defects have been asserted in the present corporate structure such as the principle of limited liability which is encrochement on the rights of the creditors in case the corporation becomes insolvent. Further, the issue of the ownership and control in modern corporations has been asserted and identified as a loophole.

CHAPTER TWO: CORPORATE PERSONALITY: A CRITICAL ANALYSIS FROM THE PERSPECTIVE OF ISLAMIC LAW

In the present structure of the corporation, shareholders authorize the corporation to act on behalf of them for the assets contributed by them, and the corporation known as legal person conducts all transactions with outsiders. Corporation takes loans form them for running the business from people who are generally called creditors. The capital of the corporation and all assets are owned by the corporation and shareholders have nothing to do with the ownership. In this case, corporation operates as a veil between the shareholders and the creditors. Thus the shareholders rights are protected because corporation is recognized by law as legal entity. The shareholders in a corporation do not have any right to buy or sell for the corporation, or to conduct any business for it, because they are not agents of the corporation. The debts of the corporation taken for running the business are attached to the *dhimmah*[87] of the corporation, therefore the demand of debts cannot be satisfied by the shareholders and they have no liability for debts in real sense.

In this Chapter, we will analyze the concept of corporate personality from the perspective of Islamic law which will be followed in the next Chapter by an analysis, from the perspective of Islamic law, of the relationship corporation with its shareholders and the relationship of the shareholders with each other and with the creditors of the corporation. "Many Orientalists including Joseph shachat, are of the view that Islamic legal system does not recognize the

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[87] The term *dhimmah* literally means covenant (*'ahd*) and its wider meaning it is an attribute by means of which a human being can acquire rights and obligations. After the creation of human beings Allah granted *aql* and *dhimmah*. For all these details see *Sadr al-Shariah, al-Tawdih*, 2:750-51 and see also Abd al-Aziz al-Bukhari, *Kashf al-Asrar*, commentary on *al-Bazdawi, kanz al-Wusul ila Marifat al-Usul*, (Beirut,1974), 4:1357.

concept of juristic person i-e corporations, universities and organizations.[88]" The argument for it is that such organization have some human features but not the human qualities, it is a presumed person but not a human being. Accordingly they can enter into contract and they have some rights and obligations[89]. Here, we will briefly mention the arguments of those scholars who uphold the validity of fictitious personality from the *Shariah* perspective.

2.1 Arguments for the Validity of Fictitious Personality from the Shariah Perspective

Those who give legality to fictitious persons, have only one thing in mind that *ahliyyah* in Islamic law is a capacity to qualify a person to become able to acquire rights, bear obligations and power to conduct transactions. They cite treasury, *waqf* and the State as perfect examples of fictitious persons.

Scholars such as Syed Abdullah Hussain inculcate the concept of fictitious personality in Islamic law and include *baitul maal*, *madaris*, *waqf* and hospitals.[90] Many scholars, such as Al-Zarqa, Awdah and Muhammad Imran Ashraf Usmani refer to these examples.[91] Muhammad Taqi Usmani and S.M hassanuzaman discussed in detail the validity of fictitious personality in Islam.

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[88] Mahmood M.Sansu,an article *"The Concept of Artificial Legal Entity and Limited Liability in Islamic Law"*, 188. .

[89] *Ibid*, 189.

[90] See for details Syed Abdullah hussain *"Almuqarana Al tashriiya"*

[91] For more details see Alzarqa, 3:258, Muhammad Ahmad Siraj, *Al Nizam ul Masrafi al Islami* (Alqahira: Darul al Thaqafa,1989).57, Awdah, *Al- tashri aljinae al Islami*, vol.1 Muassassat ul Risalah,1992, 393, Al-Rami, *Nihayat ul muhtaj*, see title of Waqf,volume.1,p.206, Dr.Muhammad Imran Ashraf Usmani, *Meezan bank guide to Islamic Banking*,p.277

Taqi Usmani is of the view that the institutions of *waqf*, *baitul maal*, joint stock companies, all are recognized by scholars as legal persons[92]. He argues that *waqf* can hold property it is therefore considered as legal person. He further says that *waqf* is not a human being but it can be treated as human being. Hassanuzaman has pointed out:

> These institutions like *baitul maal* , *waqf* can be a party to a contract, can receive gifts, donations and inheritance; can be legatees, can be sued for non discharge of other's rights; can give and take loan and can act as a guarantors.[93]

In reality, those who favor this concept in Islamic law as well as in common law have no strong arguments. Rather, there seems no logic behind their arguments and mere a repetition and reproduction of the same examples.

JUDGEMENT OF THE FEDERAL SHARIAT COURT

The Federal Shariat Court of the Islamic Republic of Pakistan took *suo moto* action, under article 203-D of the Constitution of the Islamic Republic of Pakistan, 1973 to examine whether some of the sections of the Companies Ordinance, 1984 are repugnant to the injunction of Islam as laid down in the holy *Quran* and *Sunnah* or not.

The Court amongst other sections observed and examined the concept of the fictitious personality (Company). The decision dated 24.10.2008 pronounced by the Chief Justice Haziqul

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[92] Justice Muhammad Taqi Usmani, *'The Principle of Limited Liability from the Shariah Point of View'*, new horizon,Aug/sep,1992,p.21-22. See also www.meezanbank.com,last visited 12.09.2009. See also Nyazee's corporation, 104.

[93] S.M.Hassanuzamaan, *Limited Liability of Shareholders an Islamic perspective*, Islamic Studies,IRI,28:4(1989),355.

Khairi was upheld. During the course of hearing most of the Jurisconsults, ulema and lawyers addressed that whether fictitious personality is existing in Islamic law or not.[94]

Dr. M. Aslam Khaki Advocate and Late Maulana Taseen of Karachi presented their views, that the concept of limited liability closely related to the concept of fictitious personality, is against the injunctions of Islam, so to say the liability is limited to the assets/shares of company and not to the assets of a person. Furthermore, the liability of a firm or company should not be limited as it is the source of loss to the public exchequer. They argued that the present form of Business Corporation was initially introduced in 18th century in European countries at the instance of Jewish investors which nourished under capitalism. They further elaborated that the concept of legal person and limited liability are alien to the Islamic economic system.[95]

2.2 Fictitious Personality and Limited Liability in Islamic Law: Nyazee's View

It seems that Imran Ahsan Khan Nayazee has presented an excellent analysis of the concepts of legal capacity and fictitious personality in Islamic law. He asserts that "the concept of juristic person is manifested in corporation's clashes with certain rule of Islamic law. There is a need to harmonize this concept with traditional Islamic law before a final ruling is possible".[96]

Now, there are some basic jurisprudential rules about legal personality and legal capacity that must be observed initially.

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[94] For further details see "*Selected Judgements*" Federal Shariat Court Islamabad, 35-76. Suo Moto No 73/87.

[95] Ibid.

[96] Nyazee, *Islamic Law of Business Organization: Corporation*, 73.

2.2.1 Legal Personality and *Dhimmah*

Nyazee points out that though it is widely accepted that contemporary trade cannot survive without the institution of corporation, it, nevertheless, does not mean to ignore the general principles of Islamic law and accept that concept which has no legal authenticity therein. Where there are religious duties, the concept of juristic person cannot play any role but when a duty is related to *Ibadah* [97] there seems no expectations from a fictitious person to perform. That exactly is why the *fuqaha* did not develop this concept.[98]

The term "personality" called *shakhsiyah* in Islamic law is of two types, one is real and other is fictitious i.e. *haqiqiyah* and a*itibariyah* respectively. The former is assigned to a human being while the later is assigned to a non-human person, in this case then assigning of personality, as stated earlier, makes it an artificial person.

Basically it is the *dhimmah* with the help of which a human being becomes capable of acquiring rights and obligations, which has the same meaning as discussed earlier. Interestingly however the *fuqaha* unanimously are of the view that *dhimmah* cannot be assigned to non-human beings because *shariah ahkaam* are associated with them. Nyazee, however, says that the jurists acknowledge some sort of unsound *dhimmah* for things other than human beings and a limited *dhimmah* could be assigned to non-human beings with the exemption of *khitab* (communication) of religious duties[99] .

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[97] The term used in Islamic law means, to perform religious duties, submission and worships to Allah almighty and these religious duties are required from men as the creation of man is the sole purpose to accept the norms of the Islamic law. He may be called the vicegerent of Allah. For more details see also Qamaruddin Khan, *The political thought of Ibn Taymiyah* (Islamabad: 1973),78

[98] Nyazee's *Corporation*,68.

[99] For all these details see Nyazee, *Islamic law of Business Organization: Corporation*, 92-94.

2.2.2 *Ahliyyah* or Legal Capacity

Some discussion is also necessary on another term of Islamic law, *'ahliyyah'* or 'legal capacity'. Literally it means fitness or ability and technically it is "ability or fitness to acquire rights and exercise them and to accept duties and perform them[100]."

The definition above shows two types of capacity that is *ahliyah tul wajuh* (capacity for acquisition of rights) and *ahliyah tul adah* (capacity for execution). The former indicates the ability of a human being to acquire rights and obligations, however, *dhimmah* and *ahliyah tul wajuh* are same things according to some *fuqaha*, and because *dhimmah is* also the ability to acquire rights and obligations and some of the jurists differentiate it and saying that *dhimmah* acquire both the capacities of acquisition and execution.[101]

2.2.3 Instances of Fictitious Personality Are Not Valid.

Nyazee points out that the examples cited for justifying fictitious personality are not valid. We will examine this issue here.

2.2.3.1 *Waqf* does not have fictitious personality

Waqf is a suspended property lying in the ownership of *'waqif'* i.e. the person who creates it and all its revenues goes to the beneficiaries. The *waqf* property cannot be disposed off, sold or gifted through other means. When, analyzed under Islamic law it becomes clear that it is not a legal person. The arguments are as follows.[102]

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[100] Nyazee, *Theories of Islamic Law,* chapter 6, 75 (Hereinafter called Nyazee's theories).

[101] *Ibid*

[102] *Ibid*,100.

a) There is no *ahliyah tul ada* (capacity for the execution) and *ahliyah tul wajuh* (capacity for the acquisition) because it does not have a *dhimmah*.

b) The fact that, the *waqf* property is suspended which could not be gifted, sold or inherited, on the contrary legal persons does have these rights.

c) As long as the *waqf* property is in existing, the life of *waqf* is dependent on it, if the property is destroyed, *waqf* would not exist. On the other hand legal person has its own life and is independent on the property it holds.

2.2.3.2 *Baitul Maal* does not have fictitious personality

Similarly, the institution of *Baitul maal* cannot be called as legal person and mufti Taqi Usmani regarded it as legal person by justifying after *waqf*, in these words, "another example of juridical person found in our classical literature of fiqh is that of *Baitul maal* (the exchequer of an Islamic state). Being public property, all the citizens of an Islamic state have some beneficial right in *Baitul maal*, yet nobody can claim to be its owner[103]." He further says, the *Baitul maal* consists of the state revenues and this revenue is collected by the state is stored. The wealth spent and distributed by the Islamic ruler who is the guardian of the fund and a representative of Allah.

Baitul maal is basically a co ownership between Muslim ummah and imam (ruler) of the state, who administers it and acting as an agent of the members of the *Baitul maal*. There are basically two reasons why *Baitul maal* cannot be called as fictitious personality.

1) If it was a fictitious personality it would have to deal with the property in accordance with its own will and wish, but it is not so, because the ruler being the agent of *Baitul maal* spent out the wealth among the poor and needy people of the

[103] Dr. M.Ashraf Usmani, *Meezan Bank's guide to Islamic Banking*, 277.

society. This wealth does not belong to the ruler but this property could be considered as the joint property of the state.

2) If a person commits a theft crime from *Baitul maal*, had punishment cannot be awarded to him because the thief is the co sharer in the joint property of the ummah and the thief is also be considered as a co-owner in this wealth and the had punishment is waived because of *shubha* (doubt) and there is a well-known hadith that had penalty is waived when there is *shubha*[104]. If it was a legal person in reality, then there would be no doubt regarding the awarding of had punishment[105] .

2.2.4 Conditions for Assigning Limited *Dhimmah*

Now, let us see if the concept of fictitious personality can only possible in the flexible sphere of Islamic.[106] There are two cases in Islamic law in which legal personality can be assigned[107] .

1) Personality or *dhimmah* can only be assigned to a human being who has sound mind (*Aql* or intellect), where he is incurred with religious obligations.
2) A limited *dhimmah* can be assigned to a human being or institutions and organizations if religious duties (*khitab ul ibadat*) are not expected.

Under the general principles of Islamic law legal personality could be assigned to institutions because Islamic law does not reject this concept as a whole but with some restrictions.

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104 The term literally means doubt as many people interpret it in that meaning, however, in wider meaning it is the doubt in the mind of the judge awarding punishment. See al-*Mustadraq al-Sahehain, Kitab Had al-Zina*, Dar al-Kutubul ilmia. Beruit:: Al-Tab ul oola,1990.

105 Nyazee's *Corporation*, 101-102.

106 *Ibid*, 78.

107 *Ibid*, 73.

According to Nyazee, the following conditions must be fulfilled while assigning a limited *dhimmah* to a non human being[108] .

i) That no religious duties could be expected from a legal person and this personality would not be subject to the *khitab of ibadat.*

ii) That some form of *Aql* (intellect, understanding) must be associated with this legal person e.g. this intellect or understanding may be of one individual or group of people for example the board of directors of a corporation.

iii) That the concept of dual ownership must be carried out this fictitious person that is any property held by fictitious person, it will be assumed to be held on behalf of the members of this fictitious person except its member's permission.

If these conditions and suggestions implemented in its true nature, then it will avoid many complexities and confusions and will lead to a smooth facilitation of Islamic law of business organization through corporate personality.

It is worth mentioning here that the concept of limited liability arises from the concept of legal personality; it means that corporation being an independent personality, distinct from the shareholders is dealing independently with creditors. The capital invested by the shareholders is attached to the *dhimmah* and the corporation liable to repay it like the claim of creditors, incase, the corporation become insolvent, the creditors can take the assets of the corporation and the shareholders have no relationship with these assets and the creditors cannot satisfy their debts and shareholders also stand side by side with the claim on the assets of corporation. It is for this reason Nyazee says, there is no liability for shareholders the term limited liability is not an accurate term for the legal status for shareholders and the concept of

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[108] *Ibid*, 77, 107-108.

limited liability cannot be created between legal personality and Islamic law constructs the concept of limited liability on the basis of *alkharaj bi daman*, that is a person is entitled to profit on the basis of his investment and he is liable for the corresponding loss as we have discussed before[109] .

In the light of the above discussion it is important now to know more about limited liability in Islamic law and its link with corporate personality.

2.2.5 Limited Liability in Islamic Law

Limited liability is one of the most important issues of corporate law and means that the investors in a corporation and partners in a firm are not responsible for more than the capital contributed. The definition of limited liability regarding companies means that "the liability of shareholders could not go beyond the paying in of the amount representing by their respective shareholding. It means that in case the company goes in loss or even liquidated, the shareholder's liability in any case would be limited to the extent of their shares".[110]

Under Islamic law, this concept has not been expounded by the scholars in detail however; there are two opinions of the scholars for and against this concept.

2.2.5.1 Scholars who favor the concept as valid in Islamic law

Some of the contemporary scholars such as; justice Justice Taqi Usmani, S.M Hassanuzaman and Dr. Muhammad Ahmad Siraj are of the view that the term limited liability is closely related to the concept of judicial personality and recognized in Islamic law, and when the concept of

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[109] *Ibid*, 166-168.

[110] Aiyar, P. Ramantha, *Advance Law Lexicon*, (New Delhi:Wadha and Co. Nagpur, 2007), 2751.

legal personality declared as valid, the concept of limited liability would be acknowledged as valid[111] .

Taqi Usmani says "the question of limited liability, it can be said, closely related to the concept of judicial personality of the modern corporate bodies[112]." He further says that the concept of limited liability has direct link and coincide with the concept of legal personality and once concept of legal personality could acknowledge and accepted in Islamic law, the concept of limited liability is in direct proportion to it and it will automatically be considered as proved. Interestingly he further says that the term 'fictitious person' is not a new welcome and a new concept to Islamic law, it exists since long ago in the form of various institutions, like waqf, and waqf has been acknowledged by majority of jurists as a separate legal personality.

Usmani bases his view on the analogy of an authorized slave (*Abd Madhun*) about limited liability. The master allows and authorizes his slave to do business with his wealth and enter many commercial activities. In the course of business transactions if the slave exceeds the limit which he has been ordered by his master on capital, the master will not be liable and if the creditors could not be satisfied because he crossed the prescribed limit, then the creditors would have the right to sell the slave, therefore here the liability of master is limited to that capital which he has invested.

Nyazee opposes this view and says that slave and corporation are totally different because the authorized slave is acting on behalf of the master in the capacity of agent while the corporation is not the agent of shareholders[113]. He further argues that the capital in the hands of slave is in the ownership of the master where as the shareholders have no concerns with the

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111 See for details *Al Nizam ul Masrafi al Islami* by Dr. M.Siraj.

112 Taqi Usmani, *An Introduction to Islamic Finance* (Karachi: Maktabah e Moariful Quran), 223.

113 Nyazee's *Corporation*, 171.

assets of the corporation. He says the example quoted by Taqi Usmani, the rules of qiyas have not been followed properly[114] .

Another objection is that when slave earns profit beyond that limit, master is not entitled to profit under the principle of *alkharaj bidaman*, as he is not liable for loss, he is not entitled to profit as well and this restriction is not there for corporation for excess credit purchases and the shareholders are entitled to profit[115].

S.M Hassnanuzaman has also recognized unlimited liability for partnerships and limited liability for corporations. He says "Islamic law suggests that liability of partners in an Islamic sharikah is unlimited, but modern stock public companies and corporations are registered with unlimited liability".[116]

2.2.5.2 Scholars Who Reject the Concept as Invalid in Islamic Law

Another group of scholars who oppose the above mentioned concept and some scholars rarely and partially accept and reject under *Sadd al zariyah*. [117]

Scholars such as Mufti Muhammad Ashraf declared limited liability invalid under Islamic law and he is of the view that limited liability does not comply with injunctions of Islam because there is a route to regain one's full amount of investment and is not a master slave relationship because master gives permission to his slave to enter any commercial activities on behalf of him when he gets freedom the debts could be demand from him. The slave conducts

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[114] *Ibid*

[115] *Ibid*, 172.

[116] Islamic Studies. S.M.Hassanuzaman. *Limited Liability of Shareholders, An Islamic Perspective* (IRI, 28:4, 1989),353-356.

[117] The term means "blocking the lawful means to an unlawful end. The said term is attributed to Malikis jurists. For details see Nyazee, *Outlines of Islamic Jurisprudence* (Rawalpindi: Federal Law House, 2005), 176-177.

agreements and on his falling into the debt. The slave and his wealth become like strangers to the master. He further elaborates that when a corporation is managed by the directors and they benefit from the corporation if it raises capital. They sign some memorandum and contracts on behalf of the company and the directors appear before the courts in case of any litigation on behalf of the company. On the basis of "entitlement to profit" principle, they do not entitle to profit because they are not participating in loss[118] . He further says that assigning legal personality to *Baitul maal* and *waqf* and making analogy of limited liability upon them is not possible because they are not the possession of others. He concluded that "those responsible for the company will be responsible for the debts of the company. The debts could be demanded from them, if they did not pay off the debts, they will be answerable to Allah[119] ."

S.M. Hassanuzaman goes in favor of the limited liability of shareholders in a corporation. He says in a partnership, the liability of partners in a partnership is not limited because there is a contract of agency between the partners in a partnership. That's why when partnership goes in loss, all the all the partners are severally liable and bound by the debts of the partnership. Each partner is the principal to the extent of his own share as well as acting as agent in relation to other partners. All partners are bound by each other act if they take part in business or not[120] . He then identifies different liabilities in different partnerships and says that in *sharikah tul amal* the liability of partners is unlimited because;

a) All the partners are liable equally in case of loss

b) All the partners are bound to the completion of work accepted.

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118 <<http://wwww.mahmoodiyah.org.za>>, (last visited 21.12.2009).

119 *Ibid*

120 Hassanuzaman, *Liability of Partners*; 320.

c) If the destruction of goods occur, all the partners are liable to indemnify the aggrieved party[121] .

He further says "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 partnership will be contravened and it will be a major departure from the basic conditions of *sharikah*." He further says:

> The concept of limited liability is in fact the product of the existence of the joint stock companies, which according to the existing law, enjoys the status of legal person and which due to a number of factors, is not to be treated as *sharikah* in the Islamic sense of the term. Reason also justifies the opinion that partners should have unlimited liability.[122]

Another opposed view presented by a group of ulama in South Africa, alleging that the concept of legal personality and limited liability is the corner stone of the western capitalist economic system and juridical person linked with limited liability in Islam is a none existing and imaginary concept created by western law. These concepts exist just on a paper; rather it is a fiction which has no place in Islamic law[123] . they all criticize the views of Taqi usmani in their book " the concept of limited liability untenable in *shariah*[124] ." They said that Taqi usmani treats the institution of *waqf* as fictitious person but a person dedicated his property for a religious and

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[121] *Ibid*, 324

[122] *Ibid*

[123] http/books.themajlis.net/books/print/251-120 last visited 21.10.2009, *The Concept of Limited Liability Untenable in Shariah* by the Ullema of South Africa.

[124] *Ibid*

charitable purpose declared as *waqf*, can no longer remain in the ownership of that person. Its ownership vests in Allah alone

Nyazee presented a very strong case against the limited liability. 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 partnership."[125]

According to Nyazee, there are two reasons where the liability of partners may be invoked:

a) Loans

b) Credit purchases

As far as the loans are concerned, the only form of loan in Islam allowed is *qard hasan.*[126], where no time period is fixed for it to repay it[127] . Similarly, as purchased on credit is concerned there are two possibilities:[128]

Firstly, where *wilayatul istidanah* is granted to partner i-e to purchase on credit beyond the amount of capital.

Secondly, where *wilayatul istidanah* is not granted and the partner is not allowed to purchase on credit beyond the amount of capital contributed.

In the first situation, the partner must take *wilayatul istidnah* in the form of permission from other partners[129] . All the debts of the partnership would divide according to the share of each partner in the purchased goods. For example Zaid and Aamir are partners. Zaid tells

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[125] Nyazee, *Islamic Law of Business Organization:Partnership*, 81.

[126] It is a loan which resemble to a gift or charity, and it is charity when it when a rich gives to a needy person for his daily life affairs, and the lender may demand any time he likes.

[127] Nyazee's Partnership 81.

[128] Nyazee, *Islamic law of business organization:corporation*,.57.

[129] Ibid 56, see also www.alaswaq.net, last visited 24.12.2009

Aamir: 'Go and buy on credit. I grant you *wilayatul istidnah*.' Here, both Zaid and Aamir are liable for the debts of the partnership according to their shares if the profit gained. In this example, the liability of partners is unlimited.

In the second situation where *wilayatul istidnah* is not granted and if purchases on credit allowed only to the capital contributed in the partnership and the liability of a partner arises if he purchases on credit beyond the amount of capital. But when the partners do not exceed that limit, there seems a risk of loss because the account payables will not exceed the capital of partnership. Nyazee says if all the goods of the partnership are lost in fire, all the partners will have to contribute to the partnership according to their shares and compensate the debts from their personal assets and declared their liability as unlimited[130].

In the existing structure of the corporations in which limited liability is using a better tool, Nyazee raised certain objection against it.

i) It is generally accepted principle nowadays that a corporation is a legal personality having its own rights and obligations and the shareholders are attached to it, when at the initial public offering shares are bought by the shareholders and the shareholders invest their capital, the corporation issue a note of *hawalah*(share certificate) to the shareholder and the capital of the shareholder transfer to the ownership of the corporation. The underlying contract after deeply analyzed, one can arrive to the conclusion, that it is just a debtor-creditor relationship between shareholder and corporation. It is not a contract of agency as some declared it that corporation is acting like an agent of the shareholders. The nature of the contract between them is not known in modern company law. The rules regarding the

[130] See Nyazee's Partnership, 83. See also Nyazee's Corporation, 57.

prohibition of *riba* are invoked through the contract of surf under the general principles of Islamic commercial law. The shareholders only entitled to the capital they invested and no extra privileges in the form of profits can be accepted.

ii) There is a general principle of Islamic law that entitlement to profit is dependent upon the corresponding liability for bearing loss. This maxim has been studied earlier in detail. In modern corporations the shareholders are entitled to profit by virtue of which they have invested and accept Daman (risk) under the principle of limited liability. Daman or risk works by virtue of ownership and in modern corporations, shareholders do not own the shares and the ownership passed to the corporation then how could be they entitle to the profit?

iii) Nyazee says "entitlement of the shareholders to these profits becomes difficult to justify through Islamic principles[131] ." However, the solution to this problem has been given in another chapter of this study titled "new model of corporation" but for the purpose to remind here that *Hanafi* form of *wakalah* could be the basis of the contract between shareholder and corporation.[132]

The insertion of the limited liability in modern corporations is not an easy task, however in my opinion if the basic principles of the Islamic commercial law i-e the prohibition of riba and al-kharaj bi Daman could not be violated and the relation of the agreement of the shareholder with the corporation could not be appeared as a debtor-creditor relationship, then limited liability may be accepted otherwise not.

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[131] *Ibid.*180

[132] See that chapter for detail

2.2.5.3 Limited liability and Modern Corporations

There are multifarious advantages of limited liability at company level such as it encourages investment by passive investors in risky enterprises, the company is socially beneficial in facilitating investment, partners and shareholders are no personally liable in case of suing, and encourages diversification by wealthy investors.[133]

Apart from its advantages there are disadvantages such as small creditors are almost on risky position as compared to large creditors and small creditor's debts are unsecured. In case of bankruptcy of the corporation, in the context of unlimited liability diversification tends to increase rather than decrease the risk faced by investors and an investor could loss his entire wealth. Limited liability cannot eliminate the risk of business failure and shifts the risk of business to creditors. In doing so, the risk of enterprise completely transfer to the more efficient risk-bearer i-e the creditors.[134]

However, as a corollary of the corporate form of business organization corporations would have limited liability arising merely at their advantages. Nevertheless, to introduce limited liability in corporations is not an easy task because there are a lot of difficulties which need to be observed and ratified first under the basic principles of Islamic law of business organization. The following are the basic principles which must be taken into account if limited liability is to be introduced in corporations[135] .

i) The principle of *alkharaj bi Daman* must not be violated at any cost

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[133] James Howard Candler, professor, Emory university, School of law, 1999 William J. Carney(www.vanderbiltjournal.com)last visited 12.01.2010

[134] *Ibid.* See also www. Corporationhowto.com/c-corporation last visited 12.01.2010

[135] Nyazee's Corporation, 154-155.

ii) That the *riba* based transactions must not be observed between the shareholders and the corporation. In other words the rules of the prohibition of *riba* must not be violated.

iii) The corporation will be considered a fictitious personality if there happens to be some (intellect, understanding) and the board of directors may serve it positively.

iv) It must be observed that shareholders must not bear the responsibility for the debts of the corporation if the shareholder or any party does not expect profit.

v) The relationship between the shareholders and the corporation must be clearly stated in the agreement along with the limits of the responsibilities of the shareholders.

2.3 Conclusion

To sum up, fictitious personality and limited liability in Islamic law remain a debate among the sholars of the modern age. *Dhimmah* and personality has been discussed in this issue which has the same meaning according to fuqaha. A limited *Dhimmah* could be assigned to the corporations if some form of *Aql* (intelléct) inserted in it and the board of directors can serve it this purpose, no expectations could be there relating to the khitab of *Ibadah*. As far as limited liability is concerned, it should be removed in corporations so that a fair, transparent corporate practices be observed and the creditors must not step into the shareholders shoes. Limited liability is closely related to the principle of *Al kharaj bi daman* which says loss will also be associated with profit. Shareholders invest capital but they have no liability for bearing loss in the present corporate structure. Consequently we can say limited liability cannot be applied to the corporations in islamic law. The reason is quite obvious-the peculiar relationship of

shareholders with the corporation. The new model of the corporation will solve the problem if the *Hanafi* form of *wakalah* is introduced into it. The concept is elaborated further in chapter four.

CHAPTER THREE: PRINCIPLES OF ISLAMIC LAW ABOUT ENTITLEMENT TO PROFIT AND THE EXISTING STRUCTURE OF THE CORPORATION

As it is obvious from the work of the earlier jurists, that the world 'company' does not exist in Islamic law and the only mode of trade was partnership. The modern scholars have different opinions regarding the validity of the concept and the existing structure of the corporation. Now days we see many corporations exist in the Muslim world. When analyzed under the light of Islamic commercial law, it would be crystal clear that they have many defects and a critical analysis is required to resolve some of the following issues:

1) If the corporation is contract what is the nature of this contract?
2) What is the legal status of share certificate?
3) If admitted that corporation is a contract between the shareholders and corporation what probable role would be expected from the corporate personality?
4) Under what authority the corporations sell out the undivided share certificate?
5) What is the real position of the corporation? Is corporation acting as an agent of the shareholders or *amin* holding the capital?
6) On what ratio the profit is to be distributed in a corporation among the shareholders?

In order to rectify and resolve all these issues arising from the present structure of the corporation in terms of entitlement to profit and the rules of the prohibition of *riba*, a critical analysis of the present corporate structure is necessary.

3.1 The Prohibition of *Riba*

The simplest definition is the one given by Al-Sarakhsi in these words: "*Riba* in its literal meaning is excess, and in the technical sense *riba* is the stipulated excess without a counter value in *bay'* (sale).[136]

Nyazee discuss *riba* and its rules in connection with modern corporations. He says:

> *Riba* is the most important issue of Islamic law in the modern world; it can, and does have, important consequences for the lives of each citizen. Indeed, if *riba* in its various manifestations is prohibited, it can alter the entire structure of the system of distributive justice prevalent today.[137]

Elaborating the wisdom behind the prohibition of *riba*, Nyazee says:

> Islamic law encourages the earning of wealth through all lawful means, in fact growth in wealth is an acknowledged purpose of the *shariah* and both the state and the individuals are encouraged to increase their wealth. All that Islamic law requires Muslims to do for establishing a just economic system is to avoid *riba* and to prohibit it because this will ensure the wealth may not make merely a circuit between wealthy among you.[138]

There are a number of texts of the *Quran* and *Sunnah* that are relevant to *riba*. The translation of these verses and traditions of the holy prophet (PBUH) is to be mentioned here. "Allah will deprive usury of all blessing, but will give increase for deed of charity for He loveth not creatures ungrateful and wicked".[139]

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[136] *Ibid*,28

[137] Imran Ahsan Khan Nyazee, *The Concept of Riba and Islamic Banking* (Islamabad: Advance Legal Studies Institute), 3.

[138] Imran Ahsan khan Nyazee, *Islamic Law of Business Organization: Corporation* (Islamabad: IRI,1998), 138.

[139] *Al-Quran* 2:276

Another verse of the holy *Quran* says, "Those who devour usury will not stand except as stands on whom the evil One by his touch hath driven to madness. That is because they say: "trade is like usury", but Allah hath permitted trade and prohibited *riba*".[140]

The well-known of the traditions are which have been attributed to Ibadah Ibne Samit and Abu Saeed al-Khudri that is "gold for gold, silver for silver.... And "do not sell gold for gold, except when it is like for like....".[141]

JUDGEMENT OF THE FEDERAL SHARIAT COURT REGARDING RIBA

The Federal Shariat Court of the Islamic Republic of Pakistan received numerous applications about the existing banking system pertaining to *riba* and its various manifestations. The court held that *riba* in all its forms is against the injunctions of *Quran* and *Sunnah*[142].

The Court invited *Ulama*, economists and lawyers to consider all the transactions pertaining to interest that whether the present banking and economic system and financial institutions which is giving profit and other related facilities, are repugnant to the injunctions of *Quran* and *Sunnah*.

After a detail hearing, the court accepted all the petitions and directed the government to implement the decision till June 30, 1992. The said case was challenged before the Supreme Court and the Supreme Court maintained the decision of the FSC in 2000. A review application

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[140] *Al-Quran*, 2:275

[141] Al-Sanani, Subul al-Salam Sharh Bulugh al-Maram, 3:72.

[142] Mehmood ur Rehman Vs Federation of Pakistan. PLD, 1992 FSC1. See also Selected Judgments of the FSC Pakistan,1992, p.32.

filed against this decision and extended the time for the implementation of this decision till June 30, 2002. [143]

Again another review petition filed by the United Bank against it, the Supreme Court and the Shariat Appellant Bench remanded the case back to FSC to reanalyze and reconsider further. [144]

The Arabic word 'bay' is normally treated as sale but the term 'bay' has a wider meaning Nyazee says it is a bilateral contract and an exchange of promise that affects directly on the counter values, like transfer of ownership. Hence, "any transaction that is an exchange of two counter values is Bay".[145]

A lot of discussion and research has been carried out in respect of *riba* but our study strictly relates to the rules of *riba* and to apply these rules to the modern corporations. For example, if a shareholder makes a transaction with the corporation and invest his capital, what sort of transaction it would be? Whether this transaction invokes the rules of *riba* or not? For the purpose of this analysis, Nyazee examine the rules of *riba* which may be elaborated here.

3.1.1 Rules of Riba

Nyazee says that the earlier jurists mentioned four rules of *riba* which is necessary to be found in a transaction[146].

i) *Riba* is found when there is an unequal exchange of the same kind such as such as an exchange of wheat with wheat.[147] This rule has been derived from the well known hadith of Ubadah b. al-Samit.[148]

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[143] PLD 2002.SC, 801.

[144] *Ibid*

[145] Al-Sarakhsi, al-Mabsut, 12:109

[146] Nyazee, *Islamic Law of Business Organization: Corporation,140*

ii) *Riba* is found when ownership in the exchanged item is passed to the other party.

iii) *Riba* is found when exchange takes place between the same or species of the same genus.

iv) *Riba* is found when there is excess from one side of the exchanged items.

Nyazee says that the first rule reflects 'Bay' that is the exchanged of two counter values. For example A gives 100$ to B, B returns after some days. The transaction struck the rule of *riba* involving an exchange of two counter values.

However, the second transaction covers ownership. If A gives 100$ to B for his use and B uses in his business or in some other need and then returns to A , consequently ownership in the dollars passed to B as soon as he used it.

The first part of third rule is easy to understand because the exchange of gold for gold belong to the same species but the second part of it is about genus which identify all fungibles able to be weighed or measured . If gold is exchanged for wheat it is not *riba* as evident in the well known hadith of Ubada b. al-Samit relating *riba* so there is no *riba* belonging to different genera but when wheat is exchanged for barley and delay occurs in one of the exchanged *riba* is found there.

The fourth rule of *riba* is that of excess may be through weight and measure or delay in the delivery of an item because one is taking benefit in delay period that's what Islamic law called the first excess *riba al fadl* and *riba al nasiyah* respectively. For example, 100$ are exchanged for 110$ the excess is 10 dollars. Nyazee concluded that " *nasiayah* and *fadl* do not have a separate existence from the meaning of excess, they are like the two arms or hands of *riba. Riba*

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147 Nyazee, *The Concept of Riba and Islamic Banking*, 129.

148 Muslim b. Hajjaj al-Nishapori. *Muslim al-Sahih,. Kita bul Boyu' Bab al-sarf wa Bay'* al- Zahab bil Warqi Naqdan 3:1210.

use one hand and some times the other but true *riba* exists when both hands are clasped together[149] ." he further says "thus *riba* sometimes uses *nasiyah* or *nasa*, that is delay, and at other times it uses *fadl*, but true *riba* occurs when *fadl* and *nasiyah* are working in a single transaction as counter values for each other".[150]

3.1.2 Illustrations of the Various Transactions Involving Riba

Nyazee has given different types of transactions in which *riba* is involved[151].

a) A gives to B 100 grams of gold. B gives to A in return 110 grams of gold. In this sale, A has given 10 grams in excess. This is *riba*, called *riba al fadl.*

b) A gives to B 100 grams of gold. B waits for one year, and then returns 100 grams of gold to A, obviously, B used the 100 grams in his business in delay period that's *riba* of delay or *riba al nasiyah* because the benefit arose by B from the period of delay or use.

c) A gives to B 100 grams of gold, which B is to return to A after one year with additional grams of gold, thus B will pay to A 110 grams of gold after one year for 100 grams received. Here an excess is passed to A and another excess is passed on to B. A gets 100 grams i-e fadl is there, while the excess to B is passed in the shape of the use of gold for one year which is arisen because of delay therefore it is *nasiyah.* This is the transaction where true and complete form of *riba* with two hands to be found.

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[149] Nyazee's *Corporation*, 141.

[150] *Ibid*

[151] *Ibid*, 142.

3.1.3 Applying the Rules of *Riba* on Share Certificate

After a short analysis and the rules of *riba*, we should discuss the ordinary share of a corporation in relation to the principle of the prohibition of *riba*.

Nyazee says to understand and differentiate between lawful profit and interest some of the situations be given here like *mudarabah*, *musharakah* and a loan with the condition of sharing profit and finally an important task to understand the nature of share certificate issued by the corporation to the shareholder.

3.1.3.1 *Mudarabah* Situation

Mudarabah is the form of a partnership where capital is contributed by *Rabul maal* and work is carried out by another party called *mudarib* or worker. The worker is utilizing the labor and skill while investment is from the *rabul maal*[152] . "Muslim jurists strongly emphasized on the principle of partnership , particularly *mudarabah*, as model for a non- interest based economic system, in which partners contribute only capital and the others only work, the capital owners, inactive in the business, are liable to for all losses and the workers bear no loss except in losing their labor. They are not entitled to any profit until the capital owners have recouped their investment and then only in the agreed percentage. The capital investors without involving themselves in the managing of the capital and without exposing themselves to liabilities in excess of that capital, they profit only in proportion as the venture profits and they will not be liable beyond that capital.(profit is understood to be the increase in the total value of the

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[152] Al- Marghinani, Burhanudin, *Kitab ul Hidayah* (Cairo: Darul Thaqafa, 1948), 202.

venture over the initial capital investment i-e total return, the *mudarib* receives a percentage of profit; in the event of loss, he losses his labor but has no other obligations)."[153]

The following situation of *mudarabah* will better explain the above discussion in this example quoted by Nyazee. [154]

If A (*rabul maal*) gives 1000$ to B(a *mudarib*) and B spends it for one year earning a profit of 400$ which he has to share with rabul maal in 50% ratio. The *rabul maal* dissolve the mudarabah after that stipulated time and B returns 1200$ to A. exchange of currency took place in this transaction with one year delay and 200$ passed to *rabul maal* as an additional amount. This should be prohibited like other exchange of currencies between the parties because delay plus an excess found in the transaction under the rules of *riba* but it is not.

3.1.3.2 Partnership

Partnership is a contract between two or more persons to participate in a business to share profit and loss as per agreement according to the contribution of their investment. This contribution may be in money or in labor. The example will nicely elaborate the situation and to observe whether *riba* is invoked by this transaction or not?

A and B entered into a partnership agreement and both contribute a capital of 1000$ and agreed that the profit will be distributed equally. The money is with B acting as a managing partner. After one year 400$ in the form of profit is in hand. The partnership is dissolved and they divided the profit on an agreed ratio. On the face of it A gave 1000$ to B and received 1200$ after one year. This transaction involves an exchange of currencies with a delay and

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[153] Frank E. Vogel and Samuel L. Hayes, *Islamic Law and Finance* (Kluwer Law International), 130. (hereinafter called Frank's *Islamic law and Finance*).

[154] Nyazee's *Corporation*, 149.

excess was returned after one year. This transaction should be prohibited after applying the rules of *riba* but it is not prohibited.

3.1.3.3 Loan Transaction

Islamic law does not recognize the concept of loan with interest or loan without interest and we have studied it in the last section. Let us to examine this situation by an example as well. A gives 1000$ to B on the condition that he will return it after one year along with 50% profit earned. B retuns 1200$ to A by earning 400$ as profit after one year. Here again exchange of currency occurred after a delay and excess passed to A. this transaction is prohibited under the rules of *riba*, apparently there seems no difference between this transaction and the first two transactions.

3.1.4 Investment in Corporation by Shareholder: Analysis of the Share Certificate

In all the above quoted examples and situations, an exchange of currency and an excess is found after a delay. As it is obvious that *mudarabah* and *musharakah* are lawful in *shariah* and under the rules of *riba* which cannot be invoked in these types of businesses. In the first example there was an exchange of two counter values with same species and the rule of *riba* gets satisfied there because dollars currency was used and the ownership also transferred to the other party. In the first two examples of *musharakah* and *mudarabah* ownership did not pass to the *mudarib* and the managing partner and acted as agents on behalf of the principal by retaining ownership with them. The third example of loan transaction is the true example of *riba* because ownership is transferred to the loanee and repayment of loan incurred on his shoulders.

Now, after the analysis of these three situations here, Nyazee delicately quoted an example like the third case, he says A gives 1000$ to B (a business corporation) . After one year the corporation earns 200$ on that capital. A redeems his share after one year and the corporation B returns that amount of 1200$ to investor A. an exchange of currency with excess involved there with a delay. This transaction is prohibited[155] .

So Nyazee says this example reflects the investment of the shareholder in a corporation. The shareholder invests money in the corporation and ownership is passed to the corporation. Repayment incurred a liability on corporation and the shareholder no longer remains in the ownership of this wealth. The shareholder just has a promissory note or a note of *hawalah* (a share certificate). Therefore he says the share certificate issued by the corporation to the shareholder falls under the rules of *riba* and arguing that " who are still confused , they should substitute a natural person in place of a fictitious personality and see if such a contract with a natural person would be valid or not? What is valid for a fictitious person would be valid for a natural person[156] ."

In conclusion the transaction of shareholder with a corporation issuing share certificate is a true picture of debtor-creditor relationship and is void according to the rules of *riba*.

3.2 The Principle of Entitlement to Profit on the Basis of Corresponding Liability for Loss

Man has adopted various methods to increase his wealth and participate with others to maximize his wealth. Islam addressed man on all aspects of life including economic activities.

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[155] Nyazee, *Islamic Law of Business Organization: Corporation*, 150.

[156] *Ibid*, 151.

"O you, who believe, squander not your wealth among yourselves in vanity, except it may be a trade by mutual consent."[157] In another verse, the Holy Quran says "Whereas Allah has permitted buying and selling and prohibited usury."[158] These verses clearly prohibit man from indulging in usury and illegal commercial activities.

3.2.1 Meaning of the Principle

Islam permits all modes of trades such as *mudarabah*, *musharakah* and differentiates between interest and profit and addressed us that interest is found where there is no liability for loss but when profit is there loss will be associated with it. This is our point of discussion here and could be a second objection against the modern corporations. A famous tradition of the prophet, peace be upon him says, *al kharaj bi daman*. This may be translated as follows: "entitlement to profit depends upon the corresponding liability for bearing loss". The Muslim jurists deemed it a fundamental general principle of Islamic law and became central to theory and practice of Islamic banking and finance in the modern world with special focus on profit and loss.

Abdullah Alwi haj Hassan, a contemporary Malaysian scholar translates it into "the profit belongs to him who bears responsibility". Monzer Kahf and Tariqullah Khan, two leading Islamic economists, take the view that this Shariah maxim relates entitlement of return to an asset to carrying the risk resulting from its possession. Two western scholars Frank Vogel and Samuel Hayes define the term as, "gain accompanies liabilitity for loss." Umar Mughul

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[157] Surat *al-Nisa*, verse, 29.

[158] Surat *Al-Baqarah*, verse 275.

adopts the translation of "entitlement to profit must be accompanied by a liability for loss."[159] The maxim actually means "A corollary of the principle of liability is that a person who takes liability of a thing is entitled to reap its benefit from it against that liability, because gain accompanies the liability for loss."[160]

Nyazee has come up with a better translation in these words "entitlement to profit (revenue) is based on a corresponding liability for bearing loss."[161] Nyazee says the distinction between profit and loss is not determined by the principle of the prohibition of *riba* alone but also by the principle of liability. When insolvency occurs in a business corporation and the western concept of limited liability means that the shareholders are liable, in case of insolvency of the corporation to the extent of their shares. In other words in case of the insolvency of the corporation, the creditors cannot satisfy their debts from the personal assets of the shareholders, incase the assets of the corporation are not sufficient for the satisfaction of their debts. As a result of this the creditors have no remedy but to waive their claim. Islamic law, on the other hand, constructs the concept of liability on the basis of general principle expressed in the maxim as *"Alkharaj bi al daman"*. The principle maintains that a person is entitled to profit on what he has invested to the extent that he is liable for the loss or liability arising from the business. If his liability is limited to a certain extent, then his profit should be limited proportionally. The investor will not be entitled to profit that may arise from the credit or debt for whose repayment he is not liable and it is for this reason that the liability of an investor is always unlimited for all lawful business transactions.

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159 <<www.http/humayondar.com/random.htm>> (last visited January 3, 2010).

160 Muhammad Tahir Mansoori, *Shariah Maxims on Financial Matters* (Islamabad: Shariah Academy, 2007), 172.

161 Nyazee, *Islamic law of Business Organization: Corporation*, 41.

It is, thus, an important maxim of Islamic law which needs to be elaborate in a bit detail to reach a conclusion how the business entities and corporations work under this principle. It is very much known that partnerships and corporations all have common purpose of sharing profit. So the question is on what base this profit would be shared among the members of the business entity?[162]

After defining and elaborating on this maxim we would analyze that in how many legal ways liability is created for the purpose to share profit?

3.2.2 Basis for Entitlement to Profit

According to Hanafis and some Hanbalis's school, wealth (capital contributed),work or liability for payments due for credit purchases is the base to entitlement to profit[163] . Ibn Qudamah the author of *Al-Mughni*, says:

> Liability or daman is a basis for entitlement to profit on the argument of *sharikah tul abdaan* (work partnership). The acceptance of work involves Daman for the purpose of accepting work and provides a basis for entitlement to profit. It is therefore similar to the acceptance of wealth in *mudarabah.* The worker through his work is entitled to profit; it is thus like a *mudarabah* .[164]

As far as the liability in *mudarabah* is concerned, the liability of the investor or *rabul maal* is unlimited if the *mudarib* did not act with malafide intention. The worker has no liability if he does not violate any of the terms and conditions mentioned in the contract. If the *mudarib* violates any of the condition the liability of rabul maal is limited.

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[162] Nyazee, *Islamic Law of Business Organization, Partnerships*, 69.

[163] *Ibid*, 69, opcit 42.

[164] Ibn Qudamah, *al- mughni*,.5:7

If in the contract of *mudarabah* the worker is asked to bear the liability for loss, he would be entitled to the entire profit of the *mudarabah*; It means that nothing is left for the investor (*rabul maal*); a question may be asked that the *rabul maal* has invested the capital and that wealth is the basis for entitlement to profit how then profit is denied to the *rabul maal*? The answer is that: wealth alone is not a basis for entitlement unless it is coupled with Daman or liability to bear loss.

3.2.3 Hanafi Jurists and the Entitlement to Profit

In Islamic law of business organization there are three bases for of entitlement to profit which has been assigned by the *hanafis* jurists.[165]

i) *Daman al-maal* or willingness to bear loss on the capital, with the condition to retain ownership.

ii) *Daman al- amal* or willingness to perform the contract, i-e to complete the assigned work irrespective of who has accepted the assigned task of that work.

iii) *Daman al-thaman* or the willingness to pay the price of the commodity purchased bought on credit

In Nyazee's opinon too, this principle is not only applicable to partnership but to the entire Islamic laew of contract thus, in order to the owner of the wealth to be entitled for profit, he must not only contribute wealth, but also bear the liability for bearing loss, and he must continue to retain ownership in the wealth[166] .

After all, what is the purpose of all the above discussions regarding entitlement to profit (the well known maxim of the *shariah*) and various types of liabilities? Nyazee says, Islamic law

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[165] Ibn Ibrahim, Allama Zainul Abedin, *Al-ashbah wa al-nazair* (Berut: Darul al- thaqafa,1947), 175.

[166] *Ibid*

give that concept of liability which is based on the general principle of *Alkhraj bi daman*, that limited liability means as elaborated and highly appreciated western concept that the shareholders are liable in case of insolvency of the corporation, to the extent of their shares and at last the creditors would have no remedy to satisfy their claims. Islamic principle of liability asserts that a person is entitled to profit on his investment to the extent for the loss or liability, he will be liable.

Therefore Nyazee says "the shareholders are reduced to the status of partners, who as agents for each other are made liable for the debts of the corporation[167]."

To sum up the entire discussion on the issue I would assert that Islamic business transactions purely based on the two basic principles of Islamic law, that is *riba* and the principle of *Alkharaj bi daman*. These are the two principles which are directly in contradiction with contemporary western economic system as the present modern economic system and institutions are based on interest and limited liability of the shareholders in the corporations.

If these two Islamic principles implemented in its true spirit, to modern economic system and modern institutions (corporations), it will sabotage the whole existing structure and will give a fruitful result of Islamic commercial law, because Islam has its complete system of *Uqood* and *sharikaat*, so some efforts be made and thus be implemented and not to justify western concepts through weak arguments.

3.3 Conclusion

After the discussions it seems obvious that if the objections raised against the existing structure of the corporation are identified and removed; the modern business corporations would qualify to be regarded as a remarkable tool for the maximization of wealth. In order to facilitate the

[167] Nyazee, *Islamic Law of Business Organization: Corporation*, 168.

removal of problems, three main defects has been mentioned in the modern business corporations viz the basic principles of Islamic commercial law that is rule of the prohibition of *riba*, *Alkharaj bi daman* (entitlement to profit depends upon the correspondin liability for bearing loss), and the issue of the existance of the fictitious personality in islamic law and its insertion to the modern corporations which has been a debate among the modern scholars.

There seems no exaegreaggtion in the assertion that if the underlying contract between the corporation and shareholder would not involve *riba*, the rules of *Alkharaj bi Daman* and assigning limited *Dhimmah* to the corporations, then corporations could be regarded as a device to increase the wealth of the *ummah* in accordance with these principles. The underlying contract between the shareholders and corporation explicitly invoke the rules of *riba* which is a debtor-creditor relationship between them. The rule of *Alkharaj bi daman* must not be violated and the creditors alone could not take the burden of risk on their shoulders in case the corporation becomes insolvent.

The modern scholars should strive to remove the confusion and existence of the fictitious personality in Islamic law so that the modern corporations could not violate any of the general principles of Islamic commercial law.

CHAPTER FOUR: NYAZEE'S PROPOSED NEW MODEL OF THE CORPORATION

After all, to deal all the issues like the legality of the factitious personality, the underlying contract between the corporation and the promoters, between the shareholders and the corporation and among the shareholders itself Imran Ahsan Khan Nyazee has presented a new Islamic model and discussed the above mentioned issues in a bit detail in his monumental work "Islamic law of business organization Corporation and pointed out what is wrong with the modern business corporations under Islamic law. A new model has been constructed in this work and tried to satisfy all or most of the objections raised against the existing structure and has answered all these objections within the fold of Islamic principles.

Nyazee applies the two principles of Islamic law and lead to the total destruction of the existing system and a substitute has been made by him which is purely based on Islamic economic justice.

What is this new model? How it will work? What issues and objections he has raised against the existing structure and what solution has been laid down by him to confront thes issues? The summary of his model is given below.

Nyazee is of the view that this new model cannot be based upon the concept of *Sharikah*[168], which is purely the sharing of profits; rather it is to be based on *Wakalah*[169] and should take some features of *Inan*[170] partnership.

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[168] In Islamic law the word used for partnership is *Sharikah* and literally it means "mixing or *ikhtilaat*" that is mixing of shares or capital contributed by two or more than two persons. *Ibn Humam* the author of *Fathul Qadir* says it is a partnership itself because it shows a relationship between two or more partners. Hence, there are different kinds of partnership that's why in fiqh literature a specific definition of partnership could not be found. In law partnership is a contract in which two or more than two persons agree to

4.1 Corporation As A Device for Maximization of the Wealth of the Ummah

He is of the view that the corporation should be considered as social device to raise the wealth of the *Ummah*[171] as a whole. As it is the purpose of Islamic law that the risk involved in its transactions should be shared by all who want to benefit from it whether they are the subscribers or they make any contractual relationship with it because the corporations raise their capital by hiring huge projects but it is used for passing on liability to third parties for debts or any risk underlying thereof, which is totally against the principles of *Shariah*. He says Islamic law after applying its principles strikes the heart of this system in order to provide a system that is based on equitable risk sharing which in turn leads to equitable distribution of wealth[172] .

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participate in a business and share the profit and loss as agreed upon according to their shares in the capital contributed. Section 4 of the partnership Act of Pakistan defined it in these words. "partnership is the relationship between persons who have agreed to share the profits of a business carried on by all or any of them acting for all." For all these details see *Ibn al-Humam, Fath al-Qadir*, 5:6. See Partnership Act 1932 section 4, and see also *Lindley on the Law of Partnership*

[169]The term obviously means acting on behalf of the other i-e like a *wakeel* or agent. In this type of partnership each partner becomes the agent of the other partners. Every act of the partner whether wrong or right is governed by the contract of *wakalah*.

[170] This term was used by the jurists of Kufa (Iraq) and literally it means reins. Al-Sarakhsi the author of *al-mabsoot* says " in this type of partnership each one of the partner hands over the reins(right) of conducting transaction in some wealth to the other and not in the rest and therefore it is called Inan because the animal has two reins one is longer and the other is shorter and it shows that it is allowed in this type of partnership to maintain equality in capital and profit or inequality. See for details Al-Sarakhsi, *Mabsoot* 11:14.

[171] The term *Ummah* ha described 62 times in *Quran* in the sense of religious community. Besides the *Quran*, the *Hadith* literature contains numerous injunctions on the importance of Muslim community. The prophet (peace be upon him) said: everyone in my *ummah* will enter paradise except the one who reject me. On another occasion the prophet said: my *ummah* will never agree together on an error. The said term is not transferable and must be taken in its original Islamic Arabic name. It is not synonymous with "people" "the nation" or the "state" expressions that are always determined by race, geography, language and history, or any combination of them. In short words we can say the word is used for Muslim community as a whole having no equivalent term in western languages. For details see Ijaz Akram "Muslim *Ummah* and its link with Transnational Muslim politics" Islamic studies 46:3 IRI Islamabad, 381-85. See also Al Faruqi, al-Tawhid, 105. See Abdul Rashid Moten, Political Science: An Islamic Perspective (New York: St. Martin's press,1996), 63

[172] *Ibid*, 174.

The modern corporations, as the entire transaction revealed between the subscriber and the corporation, is another route to create a debtor-creditor relationship and relatively risk free return on one's capital, and consequently with the interest based system it forms the foundation of capitalism and that's what Nyazee has pointed out that a free risk return is provided to the capitalist on his capital and the existing structure is serving a device to pass on credit risks to third parties using the tool of limited liability.[173] We May quote Richard Posner here:

> The alert reader will perceive, however the limited liability is a means not of eliminating the risk of entrepreneur failure but of shifting then from individual's investors to the voluntary and involuntary creditors of the corporation-it is they who bear the risk of corporate default. Creditors must be paid to bear the risk.[174]

Hence, Nyazee worries about the creation of limited liability. He says that the principle of leverage forces the corporations to raise as much debt financing as they can. Apart from this the payment of interest by the corporation has certain tax advantages insofar as these can be claimed as expenses of the free tax profit. Thus if the debt of the corporation is three times the size, or even twice the size of equity, there can be serious liability problems incase huge losses are made. One unit of equity will require satisfying three units of debt at the time of liquidation, which is not possible; this is why limited liability is useful.[175]

He says in our model, no debt at all will be financed in our corporation, it will be either have equity paid up by shareholders or will be based on *Inan* financing by Banks and other financial institutions. Any credit purchases the corporation wants and any accounts payable of

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[173] *Ibid.*

[174] Richard Posner, *Economic Analysis of Law* (Boston : little brown and company, 1972), 290.

[175] Nyazee *Corporation*, 182.

the corporation will never go beyond the combined equity capital provided by subscribers and financial institutions i-e banks. This so called, though not in practice, will not be permissible due to denial of *Istidannah.*

Nyazee further says that if the entire asset of a corporation lost and the credit arrears (credit outstanding) extends beyond the lost assets, then the personal assets of the share holder may be in danger. But he says such case may be dealt by a common feature of business insurances and in some specific cases, this model can prevent the need of piercing the corporate veil. In the light of the above discussions, he says there will be no problem in the creation of limited liability for the shareholders as well as the financial institutions in *Inan* financing.

As for as the creation of unlimited liability is concerned, he says under the new model, there is need to establish another relationship between this shareholders and corporation beside the contract of *Wakalah* to overcome the problems, is the additional relationship of *kafalah*[176] (surety) between the shareholders and corporation in which each shareholoder will act as a *kafil* for the corporation, jointly with other shareholders i.e. all shareholders will jointly act as a kafil.[177]

Consequently, Nyazee under the spirit of limited liability has made some assumptions and on the basis of these assumptions, he finalized the Islamic model of the corporations with the following aims.[178]

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[176] The term literally shows that the person can take surety of the acts of other person or persons. We will discuss it later in the *hukm* and the *huquq* of the contract where the principal could not be sued for the price when the agent-partner has purchased something for the partnership and also he could not be sued for the delivery of the subject matter if the agent-partner has sold something for the partnership.

[177] *Ibid*

[178] Nyazee's *Corporation*, 183.

4.2. Aims of the New Model

Nyazee says if the following goals have been owned, the new model will be a social device for the maximization of the wealth of Muslim *Ummah* without any objection. These are:

i) That the principle of entitlement to profit should not be violated at any cost.

ii) That the principle of the prohibition of *Riba* should be applied to the new model so that interest frees transactions could be conducted easily.

iii) That the to preserve the corollaries of these two principles in terms of the ownership of the assets of the business holding by the shareholders and the creation of liability through ownership and to destroy the debtor-creditor relationship in the corporation because *Riba* is found when ownership in the item exchanged is passed on to the other party.

iv) That the relationship of each and every person attached to the corporation should be clearly mentioned so that the principles of Islamic law of contract could be applied in clean and obvious manner[179] .

Now what assumptions he made on the basis of which he derived the aims of the new model?

4.3. Basic Assumptions for the Model

Nyazee says that the corporation will be a juristic person established subject to certain conditions and limitations like, lacking of liability for religious duties i-e exemption of *khitaab* of *ibadat.*

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[179] *Ibid*, 176.

1) The relationship of the shareholder and the corporation will be only the contract of *Wakalah* and not *Sharikah.*

2) Also the *hanafi form of Wakalah*[180] should be the basis to draw a distinction line between *hukum and huquq*[181] of the contract between the shareholders and the corporation.

3) The capital and the assets of the corporation will belong to the shareholders as co-ownership but will be on the name of the corporation impliedly with full right of disposal on shareholders behalf.

4) The corporation should take prior permission from shareholders, being co-owners in the assets of the corporation, to the other shareholders to sell their shares to outsiders.

5) The relationship of the corporation will be based on *wilayat-al istidanah*[182] which will consequently create limited liability.

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[180] This kind of *wakalah* inserted by Hanafis School has a unique feature as compared to the concept of agency in law because it helps to design a new model of the corporation because it distinguishes between the *hukm* and *huquq* of the contract which has been discussed elsewhere. Thus, in modern law under the concept of agency, the agent can do anything which the principal is giving permission to do. Hence ha has all the powers of the principal and the principal is bound by all his acts with regard to third parties and the principal can be sued by third parties by the act of an agent, on the other hand the hanafis form of *wakalah* is not so. Therefore the Hanafis draws a distinction between *hukm* and *huquq* of the contract see footnote 30. For further details see Hussain Hamid Hassan, *al-Madkhal li-Dirasat al- Fiqh al-Islami* (Cairo,1979), 390-91, see also al-Sarakhsi, *al-Mabsut* 11:174-75

[181] The difference between these two terms has been pointed out by Hanafis jurists is very useful in the Islamic law of business organization and relates to the acts of the agents. The *hukm* of the contract means that what is the purpose and main objective of the contract. In other words it means the effects of the contract, while huquq means rights of performance of the contract. The former means the primary effects derived from a transaction in a contract, while the later term means the means and those ways by virtue of which the main objective or the primary effects are completed. In a sale fro example the *hukm* or the objective of the contract is the transfer of ownership or legal title to the buyer and price to the seller while, on the other hand huquq involve the delivery of the price to the seller, the right to demand the delivery of the subject matter and to take the possession of it. The huquq are always associated to the agent and principal in a contract according to the hanafis jurists. See for details Nyazee's *Partnership*, 59.

6) The corporation, being the agent of the shareholder, the shareholders will be entitled to the entire profit earned by the corporation.

7) As all the effects of the contract will address to the corporation, so the corporation will be liable for all the litigation and shareholders cannot be sued by creditors of any transaction of the corporation in the hanafi form of *wakalah.*

8) At the time of liquidation it should be better to grant priority to outsiders followed by Inan claims of financial institutions, as the limited liability at the end reverts to pass outsiders and then satisfy the claims of the shareholders.

9) Nyazee says if corporations are being financed by banks, the transaction will be based on *Inan* partnership and contract of *Wakalah* will be administered between them, as it is clear from the following definition of *Inan*[183] .

Nyazee says if banks financed corporations on the basis of this contract then it will be free from debt and interest. In this type of contract the contribution of the bank and the assets of the corporation will be in the shape of dual ownership by the corporation governed by the *Sharikat -ul-milk*[184], to avoid mortgaging the assets of the corporation. This ownership of the bank will be a trust Deed and will be based on a claim through a floating charge (*Musha)*[185]. There will be

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[182] It is a special permission in which a partner intending to exceed the prescribed limit of the capital when he is involving in any purchase on credit, then he must take permission from other partners and this permission which he is taking is called wilayat al-istadanah. Hanafis jurists give this permission in some rare contracts but not in all contracts. See for details Nyazee's *Corporations* on p.56, See also Nyazee's *Partnerships*, 140.

[183] Nyazee's *Partnership*, 102.

[184] It is co ownership by more than one person in an ascertained property, or any debt which is not ascertained by weight or measure as a result of inheritance, sale (bay) or through other means. Under Islamic law this co ownership may be in ascertained property or in debt. For details see Ibn Abidin, *Hashiyah*, 4:3.

[185] When there is a joint property or the property which represents co ownership of more than one person, the undivided share in such joint property is called musha. In co ownership each co owner represents ownership in each part of the property therefore its concept is related with Sharikat al-milk and sharikat al-milk has already elaborated before by Ibn Abidin. See generally Raghi "*al-aswaq al-Maliyah.* See also Ibn Abidin *Hashiyah* 4:301

no right of *Istidanah*[186] as in the contract with the shareholder. In this type of Sharikah between the bank and the corporation, if the bank wants to enter other partners into *Inan*, subject to the permission of the corporation, the bank can issue *Inan* bonds and the bank will be acting like an agent for the investors, whatever the bank claims expenses.

Nyazee clearly mentions that in the case of any claims against the corporation, the *Inan* investors should be satisfied first after the shareholders because by virtue of these Inan investors the corporation want to increase the profitability and more money for their shareholders.

Nyazee is adding another thing to the *Inan* contracts and says that when bank finances the corporation, contracts of *Ijarah*[187], *Istinah*[188], *salam*[189], and *Murabaha*[190] may be used because these are the valid contracts under Islamic law to facilitate the partners and provide flexibility for them.

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[186] The term used in Islamic law of partnership and means "purchases on credit" beyond the capital contributed for partnership. See Nyazee's *Corporation*, 55-56.

[187] Literally it means to give something on rent. In Islamic jurisprudence it is used in two different situations. In the first place it means to employ the services of a person on wages given to him as a consideration for his hired services, while in the second place it relates to the usufructs of assets and properties and not to the services of a human beings. See *Meezan Bank to Islamic Banking* for details.

[188] This type of contract is the outcome of the Hanafis School. It is also called commissioned manufacture in which one part buys goods that the other party undertakes to manufacture according to the specification provided in the contract. The contract will be binding when goods are made and accepted by the buyer. Nowadays Islamic banks has frequently employ *istisna* to finance manufacture and construction.. for details see *Islamic Law and Finance* by Frank E.Vogel and Sameul L, 146.

[189] It is a contract of the forward purchase called advance payment. In this type of contract the buyer makes an advance payment and wait for the goods to be delivered. The said contract is an exemption to the hadith of the prophet (peace be upon him) in which He says do not sell the things which are not in existence. According to the four schools of thought, Islamic law requires that if at the time of delivery the seller can neither produce the goods nor obtain them elsewhere, the buyer has two choices; he can either take back his price, without increase, or await the goods becoming available later, with no compensation permitted for the delay.

[190] Al-Quduri has defined it in these words "it is a contract of more than one person for the participation in profit. one person contribute wealth and another is agreed on work or using skill." See for details Al-marghinani, *al-Hidayah*.5:6

After all these assumptions made by Nyazee, he also analyses the relationship of the shareholder with the corporation under the existing system of the corporation as well as under the general principles of Islamic law.

4.4. Relationship of Shareholder with Corporation

First, we will mention the relationship as it exists in the present structure. After this, we will present the relationship in the Nyazee's proposed structure.

4.4.1. Present System

Under the present system of the corporation, there seems to be no direct relationship like agency, *kafalah* etc this apparently prevents the creditors to sue the shareholders far being there is a wall of legal personality between them that is corporation. So the creditors cannot sue the shareholders directly. If there happens to be a legal relationship then the shareholders would become personally liable for all the debts and other obligations of the corporation. If contract of agency involved between them then the shareholders will be personally liable for all the liabilities but Nyazee says if we deeply analyze this relationship it is a kind of debtor-creditor relationship and invokes the rules of *riba* i-e a contract of *Surf*, because the subscriber invests money and in return the corporation gives him a certificate of *Hawalah* (share certificate) by endorsement which ultimately gives rise to objections about entitlement to profit when there is no Daman. Therefore Nyazee has proposed a relationship between shareholder and corporation.

4.4.2. New Relationship of Shareholder and Corporation: Nyazee's Model

As Nyazee stated earlier that a Hanafi form of *Wakalah* should be inserted between the shareholder and the corporation, in this type *Wakalah*, it is only the managing partner in the

business who can be sued and here is the managing partner is the corporation. It is thus, this corporation which could be sued.

Nyazee says the shareholder in fact, own the assets of the corporation because the ownership never passes to the corporation and a note of *Hawalah* will not be able to exempt the shareholder of its ownership. Although a dual type of ownership has been created which need *ijtihad*[191] from modern jurists. Nyazee says the law recognizes such dual ownership in the case of trusts[192] . He again emphasize that when shareholder retain ownership, all the objections like entitlement to profit can easily be removed. Because when ownership is there, it is a tool for the entitlement to profit and liability for bearing loss.

He says, if this arrangement comes in existence, then the corporation becomes the employee of the shareholder and the shareholder can truly own the corporation and its assets and they will also be held liable to all the acts of the corporation, under his new Islamic model.

Nyazee under this new Islamic model has mentioned some of the general advantages for it which can be discussed number wise here.

4.6 Advantages of the New Model

Finally, we may mention some important advantages of the Nyazee's proposed New Model.

1) The existing system cannot explain the why limited liability is sometimes assigned and taken away under legal principles.
2) It can not explain why it can sometimes pierce the corporate veil.

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[191] Literally it means to expend maximum effort to perform an act while technically it is an effort by a *Mujtahid* in seeking and searching rules of Islamic law through interpretation. For further details see Nyazee, outlines of Islamic jurisprudence (Rawalpindi: Federal law house, 2005), 200-203.

[192] Nyazee's *Corporations*, 181.

3) The present system cannot distinguish between debt based upon interest and equity, while the new Islamic model identified the debtor-creditor relationship and invoked the rules of *riba* on it.

4) The existing system claimed on contract theory but it could not explain certain relationship like the contract with financial institutions i-e banks etc but the proposed system did explain it being an *Inan* contract.

5) The existing system cannot explain why management is responsible to the shareholders, while in the proposed system the management is the agent of the shareholders.

4.7 Ordinary and Preferred Shares in the New Model

The shareholders in his model are linked to each other through this corporation and the corporation has mixed their wealth in the form of a co-ownership therefore in the subscription agreement should state that each shareholder permits every other shareholder to sell off his share to whoever he wants and this transaction is common nowadays in stock markets, in the case when there are ordinary shares. But when there are preferred shares problem exists.

Ordinary shares are common stock having no fixed return. For example 'A' buys OGDCL shares at Rs.10/ share and after two months its price becomes 12 and 'A' sell out it, A has the profit of Rs/ 2. May be after other two months its price will be 14, or 16 per share and so will be the profit, so it means that there is no fixed return or profit and sometimes loss can also occur if A sold it on Rs/9.

Preferred shares on the other hand are called preferred stock where there is fixed return. sometimes it is a sort of bond or you can say a debt with which corporations borrow money to launch new projects, e.g. A can buy OGDCL preferred share of Rs 100 at 7% annual fixed

return, it means that after one year A will get Rs/7 . The basic difference between the two is, ordinary shareholders have voting rights to elect corporation board of Directors and preferred stock holder's do not have such right.

Nyazee says in cumulative preferred stock, if the corporation has not made a profit in one year and cannot pay the dividend on preferred shares for that year, it is required to pay the previous dividend in the following years when does it make profit. For example if the OGDCL did not make the profit in first year and did not pay the dividend on preferred shares for that year, it is binding to pay the previous dividend in the following year.

So, Nyazee says that paying a fixed part to the investor out of a flexible actual dividend should not be considered as *riba*, if the rules of entitlement to profit are being satisfied.[193]

4.8 Conclusion

It would, however, be necessary to regulate the corporations in the light of the general principles of Islamic commercial law to ensure that justice is done to the shareholders as well as the consumers and to remove the malpractices of corporation. The separation of ownership from control in corporations leads malpractices and it would be important to introduce reforms especially in proxy rules, to safeguard the interests of shareholders. [194] For this purpose an islamic model of the corporation has been proposed as western corporations donot provide a model. The new model is based on hanafis form of wakalah and if this model could be

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[193] *Ibid*, 182.

[194] M. Umar Chapra, *Towards Just a Monetary System* (Leicester: The Islamic Foundation, 1995), 257.

implemented in letter and spirit then obviously, there will be no violation of the general principles of islamic law and it will reduce the concentration of power.

CONCLUSION

Posner's theory of economic analysis identified some important problems in the traditional form of business organization but this theory also applies to the corporations. These defects relate to the present corporate structure, such as the principle of limited liability which is an encroachment on the rights of the creditors in case the corporation becomes insolvent. Further, the issue of the ownership and control in modern corporations were identified as a loophole.

From the perspective of Islamic law, fictitious personality and limited liability remain a debatable issue. Our conclusion is that the concept of *dhimmah* in Islamic jurisprudence matches with the concept of personality in Western law. Strictly speaking, *dhimmah* is recognized only for human beings. However, a limited *dhimmah* could be assigned to the corporations if some form of *'aql* (intellect) is inserted in it. The board of directors can serve it this purpose. It is worth noting that the *khitab* of *'ibadah* is not directed towards such person.

As for the concept of limited liability, it should be removed in corporations so that a fair, transparent corporate practice is observed and the creditors must not step into the shareholders shoes. Liability is closely related to the principle of *al kharaj bi al-daman* which says loss will also be associated with profit. Shareholders invest capital but they have no liability for bearing loss in the present corporate structure. The new model of the corporation will solve the

problem if the *Hanafi* form of *wakalah* is introduced into it, which distinguishes between the *huquq* and the *hukm* of the contract.

If the underlying contract between the corporation and shareholder would not involve *riba*, the rules of *al-kharaj bi al-daman* and assigning limited *dhimmah* to the corporations, then corporations could be regarded as a device to increase the wealth of the *ummah* in accordance with these principles.

It would, however, be necessary to regulate the corporations in the light of the general principles of Islamic commercial law to ensure that justice is done to the shareholders as well as the consumers and to remove the malpractices of corporation. The separation of ownership from control in corporations leads malpractices and it would be important to introduce reforms especially in proxy rules, to safeguard the interests of shareholders. [195] For this purpose an Islamic model of the corporation has been proposed as western corporations do not provide a model. The new model of Nyazee is based on the Hanafi form of *wakalah* and if this model could be implemented in letter and spirit then obviously, there will be no violation of the general principles of Islamic law and it will reduce the concentration of power.

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[195] M. Umar Chapra, *Towards Just a Monetary System* (Leicester: The Islamic Foundation, 1995), 257.

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