



SOAS LAW WORKING PAPERS

No 3 2014

Limited Liability and Islamic Law

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Reprinted from SOAS Law of Islamic Finance Working Papers Series,
<http://www.soas.ac.uk/cimel/workingpapers/file93632.pdf>

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Centre of Islamic and Middle Eastern Law (CIMEL)

SOAS Law of Islamic Finance Working Papers Series

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ABSTRACT

This paper is concerned with some legal issues underlying limited liability and Islamic law, together with some thoughts concerning possible lessons to be learned from the development of limited liability in the United Kingdom and France.

Paper No	6
Date Accepted	28 February 2014

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‘Your Committee think the importance of removing obstructions to the secure investment of their savings, to the Middle and Working Classes, can scarcely be overstated; because this is a consideration upon which the industry, enterprise, and forethought of the classes in question greatly depend.’²

I. INTRODUCTION

In this paper, a few thoughts are provided concerning some legal issues underlying limited liability and Islamic finance, together with some thoughts concerning possible lessons to be learned from the development of limited liability in the United Kingdom and France.

The paper has been written with a view to stimulating discussion and is therefore brief.

II. SOME BASIC CONCEPTS AND TERMINOLOGY

Some Basic Concepts

Given the technical and complex nature of the subject, it is as well to ensure that the basic concepts and the terminology are clear from the outset.

First, we need to distinguish between two concepts which are all too often confused. These are the *enterprise* and the *legal entity*.³

The word *enterprise* denotes a commercial organisation. Although in a sense the enterprise is intangible, it can be said to be real because its ‘existence’ creates real-world effects. If Ali and Bilal work together, the effects they produce as an ‘enterprise’ are different from those which they could produce on their own.

The *legal entity* is completely different. It is entirely a construct of the legal system. It only ‘exists’ because the law says it does. It is like an imaginary person, say a character in a work of fiction, which is decreed to have existence by the law. The effect of the ‘existence’ of a legal entity is a change in the legal relations among the persons designated as involved in this phenomenon (persons assigned the roles of shareholders, directors, employees – internal parties) and other persons (external parties) dealing with the internal parties in the roles assigned to them in the legal entity.

So if Ali and Bilal ‘form a company’, AB Limited, what actually happens in legal terms upon incorporation is that the legal relations between Ali and Bilal change. If they are shareholders, they are bound by the provisions of the articles. If they are directors, they are subject to director’s duties and other provisions of the relevant parts of the law.

An enterprise may, or may not, be represented by a legal entity, or by several.

A legal entity does not necessarily represent an enterprise.

One of the changes in legal relations which may occur between internal and external parties is a *limitation of liability* of the shareholders of the legal entity. In the

² United Kingdom Parliament, HoC (1850) *Report from the Select Committee on Investments for the Savings of the Middle and Working Classes: Together with the Proceedings of the Committee, Minutes of Evidence and Index. Ordered by the House of Commons to be printed 5 July, 1850* London, p iii.

³ See further Foster, NHD (2006) ‘Perception, Language and ‘Reality’ in Corporate Law Theory’ (17) *King’s College Law Journal* 299.

United Kingdom, for example, the liability of the members of a company limited by shares 'is limited to the amount, if any, unpaid on the shares held by them'.⁴

Note that limited liability is only a possibility.⁵ Despite what is often said, the concepts of legal personality and limited liability are separate. If legal personality exists, it is not inevitable that limited liability follows. This can be clearly seen in present United Kingdom company law, which allows the creation of an unlimited company in which 'there is no limit on the liability of its members'.⁶ It can also be clearly seen in the history of United Kingdom company law. As noted below, the modern company was created in the United Kingdom some years before limited liability was granted. It follows that the other advantages of legal personality, which solved various problems such as the difficulty of suing large groups of people, large groups of people owning property in common and the way to regulate the relationship between investors and managers are, if one wishes, available without limited liability.

It is true, though, that limited liability is conceptually easier to formulate and deal with if one uses it in conjunction with legal personality. If one creates a person, the existence of that person can be used to argue that its shareholders should not be liable for the obligations of the legal entity. This is because there is a fundamental legal principle that one person is not normally liable for the obligations of another person.

Terminology

A general discussion of legal personality and limited liability can be problematic, as the terminology differs considerably in different legal traditions, reflecting different contexts and histories.

In England and jurisdictions which derive their law from England, the usual word used is 'company'. There is a sharp distinction between companies, governed by one body of law, and partnerships, governed by another.⁷ The word 'corporation' is also used, but mainly for public bodies. In the United States, however, the word 'corporation' is used as the equivalent of 'company'. In the civil law tradition, what a common lawyer would call companies and partnerships are categorised in one group. In French, this is the category of *sociétés*, in German the category goes under the name of *Gesellschaft*.

Another terminological problem is a general failure to distinguish properly between the enterprise and the legal entity, which are both referred to by one name, ie, depending on the legal tradition of the speaker, 'company', 'corporation', '*société*' or what have you.

In this paper, the word 'company' will be used unless an explicit distinction needs to be made between the enterprise and the legal entity. Unless the contrary is specified, the word 'company' refers to the legal entity.

⁴ Companies Act 2006 s 3(2).

⁵ Kelsen held the contrary view (Kelsen, H (2009 (1949)) *General Theory of Law and State* Vol I Transaction Publishers, p 101). He was mistaken. Although it contains some ideas of interest, the section of this book on legal personality is of generally poor quality and should not be relied upon.

⁶ Companies Act 2006 s 3(3).

⁷ The primary statutory sources of law are presently the Companies Act 2006 and the Partnership Act 1890. The word 'partnership' without qualification, when used in the context of English law, denotes a partnership governed by the Partnership Act 1890, as opposed to a limited or limited liability partnership, which are governed by separate statutes.

III. IS LIMITED LIABILITY UNIFORM?

In discussions such as this, there is a tendency to assume that limited liability is the same worldwide, that it fulfils the same functions and has the same advantages and disadvantages everywhere.

This tendency, and its limitations, are apparent in discussions of the need for limited liability. In such discussions it is often assumed that limited liability is essential, because it allows stock market financing, which in turn is essential to the operation of a developed economy.

It is indeed the case that stock markets played a pivotal role in the development of the United Kingdom and the United States. However, this is not universally true. In the development of other major economies such as France, Germany and Italy stock market financing did not play a significant role. Finance was mainly provided by banks, with some coming from the state and private sources. And even in the United Kingdom and the United States, stock markets were only one source of funding in the developmental period, and nowadays, although their role is certainly significant, it is by no means decisive. More significantly perhaps, the vast majority of smaller companies are not capitalised by means of share capital at all. They function on bank overdrafts.

These are just two examples of the wide variety of business and legal environments in which limited liability functions. As will be seen below, this is an important point to bear in mind when considering the islamicity of the concept.

IV. LIMITED LIABILITY IN EUROPEAN LEGAL HISTORY

Ideas on the distribution of liability between the investor and the trader in investment partnerships have existed for centuries. There were investment partnerships in ancient Mesopotamia, in Islamic law (*mudaraba/qirad*), Jewish law (the *'isqa*), the Byzantine Empire (the *chreokoinonia*) and medieval/early modern Europe (the *commenda*, from which spring such modern European entities as the French *société en commandite*).

However, it was not until the mid-19th century, when the modern company was born, that limited liability acquired its present significance. Large projects, notably the railways, needed equally large capital investment, and limited liability was a useful factor in attracting capital from a large number of investors.

Limited liability came to the fore in different ways in different places.

In France, for example, the *société en commandite* had the deep historical roots referred to above. As the 19th century progressed it was used in preference to the *société anonyme*, the conditions for the formation of which were highly restrictive. Article 38 Commercial Code 1807 made the *société en commandite* even more attractive by providing a variation of the *société* which had shares, the *société en commandite par actions*. It was 'the prime vehicle for corporate enterprise in the nineteenth century'.⁸ It was not until the law of 24 July 1867 that it became possible to form a *société anonyme* without government approval.

In the United Kingdom the modern company was born when the Joint Stock Companies Act 1844 was passed. However, the shareholders of companies incorporated pursuant to the act did not have limited liability, which was only

⁸ Lobban, M (1996) 'Corporate Identity and Limited Liability in France and England 1825-67' (25) *Anglo-American Law Review* 397, p 412.

introduced by means of the Limited Liability Act 1855. This act imposed numerous restrictions, most of which were removed by the Joint Stock Companies Act 1856.⁹

V. LEGAL PERSONALITY IN THE CLASSICAL PERIOD OF ISLAMIC LEGAL HISTORY

In the classical period of Islamic law a wide range of business associations existed, with various types of trading partnership (the *sharikat/shirkat*) and an investment partnership (the *mudaraba/qirad*).¹⁰ It is certain that these forms did not have legal personality. It is not certain whether legal personality existed elsewhere or not.¹¹ For example, several scholars state that the *waqf* enjoyed legal personality, while others state that it did not.¹²

This very uncertainty is indicative of fact that the concept was not particularly important. This lack of importance is unsurprising. There was no pressing need for limited liability as we now know it, any more than there was any pressing need for it in western Europe until the mid 19th century. Later on, trade empires were formed and the Industrial Revolution began, resulting in the formation of large-scale corporations, but these phenomena occurred in western Europe, not the Muslim world.¹³

By the time legal personality might have been useful, the commercial parts of Islamic law were, apart from the Ottoman Majalla, being discarded. Even more significantly, no attempt was made to adapt Islamic law for the needs of modern commerce. Western-style law (such as Parts I and III of the French Commercial Code 1850, transplanted as the Ottoman Commercial Code 1850) was introduced instead.¹⁴ Western commercial concepts such as legal personality and limited liability were accepted almost without question.¹⁵

⁹ See Muchlinski, PT (2010) 'Limited Liability and Multinational Enterprises: A Case for Reform?' (34) *Cambridge Journal of Economics* 915, pp 916-917 and sources there cited.

¹⁰ The classic work is Udovitch, AL (1970) *Partnership and Profit in Medieval Islam* Princeton University Press, an excellent successor to which is Nyazee's work: Nyazee, IAK (1998) *Islamic Law of Business Organization: Partnerships* The Islamic Research Institute Press and Nyazee, IAK (1998) *Islamic Law of Business Organization: Corporations* The Islamic Research Institute Press. See also Foster, NHD (2010) 'Islamic Perspectives on the Law of Business Organisations I: An Overview of the Classical Sharia and a Brief Comparison of the Sharia Regimes with Western-Style Law' (11) *European Business Organization Law Review* 3.

¹¹ For more details see, eg, Zahraa, M (1995) 'Legal Personality in Islamic Law' (10) *Arab Law Quarterly* 193, Zahid, A (2013) 'Corporate Personality from an Islamic Perspective' (27) *Arab Law Quarterly* 1, Foster 'Islamic Perspectives on the Law of Business Organisations I: An Overview of the Classical Sharia and a Brief Comparison of the Sharia Regimes with Western-Style Law', pp 30-31.

¹² Foster 'Islamic Perspectives on the Law of Business Organisations I: An Overview of the Classical Sharia and a Brief Comparison of the Sharia Regimes with Western-Style Law', pp 30-31.

¹³ On the reasons for the lack of larger trading enterprises in the Muslim world see Çizakça, M (2010) 'Was Shari'ah Indeed the Culprit?' *Munich Personal RePEc Archive*, pp 21-38. For another view, see Kuran, T (2005) 'The Absence of the Corporation in Islamic Law: Origins and Persistence' (53) *American Journal of Comparative Law* 785.

¹⁴ On the Ottoman Commercial Code see Foster, NHD (2011-12) 'Commerce, Inter-Polity Legal Conflict and the Transformation of Civil and Commercial Law in the Ottoman Empire' in Cotran, E and Lau, M (eds) *Yearbook of Islamic and Middle Eastern Law* Vol 17, issue 1 Brill, pp 27-36; on the Majalla, see *ibid*, pp 36-42.

¹⁵ On this 'Acceptance Mentality' see Foster, NHD (2010) 'Islamic Perspectives on the Law of Business Organisations II: The Sharia and the Western-style Law of Business Organisations' (11) *European Business Organization Law Review* 273, pp 279-282.

VI. IS LIMITED LIABILITY SHARI'A-COMPLIANT?

When faced with a question of shari'a compliance, the first, automatic reaction in Islamic finance is to look for the answer in the past. Where can one find justification, condemnation or something in between, in the details of classical *fiqh*?

If one does this for limited liability, one is faced with an immediate problem.¹⁶

One place one might start is the *mudaraba*.¹⁷ It had an investor (*rabb al-mal*), and a trading partner (the *mudarib*). So far, so good, one might think, and one might be tempted to ask whether the investor had limited liability or not. However, for a comparison of this type, one has to consider the context.

As seen above, the modern form of limited liability arose in Western law because there was a need to accumulate capital for its industrial and commercial exploitation. Limiting the liability of investors was a good way of making such accumulation possible, or at least less expensive. This is why, when we think about limited liability today, we think about the position of shareholder investors vis-à-vis the company's creditors in terms of what happens on the insolvency of the legal entity.

In the classical Muslim world, however, the structure and scope of trade, industry and finance were radically different. Classical Islamic law 'partnerships' were small in scale and entered into for specific trading purposes. In many ways they were more like joint ventures than modern enterprises.¹⁸ Conceptions of insolvency were, as elsewhere, in their infancy and, of course, in the absence of the legal entity there was no corporate insolvency law at all.

The jurists, therefore, did not think in the same terms as we do. Rather, they considered the matter from the point of view of the relationship between the partners. As Udovitch points out, in the books of *fiqh* 'the partners' transactions with third parties are [seen] exclusively from the perspective of their relations to each other.'¹⁹

It follows that it is anachronistic even to ask whether limited liability existed in the classical Muslim world, and any attempt to give Islamic law legitimacy by reference to the past is a distraction.

Which means that one has to start from scratch. However, this is far from easy, and we find ourselves once more facing the problem of the lack of a legal system in Islamic finance. It is the same issue as that encountered in the form/function-*maqasid* debate.

We know where to start, with such principles as that of *maslaha* and *al-kharaj bi al-daman*. *Maslaha* needs no introduction here.²⁰ *Al-kharaj bi-al-daman* can be

¹⁶ For a more detailed discussion, see Foster 'Islamic Perspectives on the Law of Business Organisations I: An Overview of the Classical Sharia and a Brief Comparison of the Sharia Regimes with Western-Style Law', pp 31-32.

¹⁷ Another example is the licensed slave, on which see Nyazee *Islamic Law of Business Organization: Corporations*, pp 17, 179 and §11.3.4, pp 184-186.

¹⁸ See, eg, the examples researched by Nelly Hanna: Hanna, N (1998) *Making Big Money in 1600: The Life and Times of Isma'il Abu Taqiyya, Egyptian Merchant* Syracuse University Press.

¹⁹ Udovitch *Partnership and Profit in Medieval Islam*, p 99; on the distribution of liability in the *mudaraba*, see Udovitch *Partnership and Profit in Medieval Islam*, pp 238-245. For Nyazee's views (rejecting the use of 'odd precedents') see Nyazee *Islamic Law of Business Organization: Corporations* §11.3.4., p 186.

²⁰ See, eg, Zahid 'Corporate Personality from an Islamic Perspective', pp 138-140.

translated as 'profit through risk'.²¹ Nyazee paraphrases it as: 'Revenue is based upon the corresponding liability for bearing loss.'²² It has also been explained as: 'the Islamic legal principle that means entitlement to revenue follows assumption of responsibility. Profits, therefore, are based on the ownership of, and responsibility for, capital.'²³

But how do we finish? How do we achieve an authoritative ruling in the absence of an institutional framework which has sufficient legitimacy and authority to determine the question in the eyes of all, or at least a decisive majority, of Muslims? In this situation it is natural that differences of opinion have arisen as to the Islamicity of limited liability.²⁴

There may be a lesson to be learned here from the experience of the United Kingdom. It was very difficult for the Victorians to reach a conclusion on limited liability. The issue was controversial and, even with a fairly sophisticated consultative and legislative apparatus, a decisive conclusion was only reached by government pushing the Limited Liability Act 1855 through Parliament. Since that time, however, although a small body of opinion remains opposed to it and some problems remain,²⁵ limited liability has settled into society. Business practice and legislation have accreted around it.

So, for example, limited liability is illusory in respect of the bank financing of small start up companies. This is because a small entrepreneur who chooses to use the legal entity as a vehicle for her business will nearly always be required to guarantee repayment of sums owed to the bank by the company, with the guarantee being backed up by security over assets of the entrepreneur.

Similarly, businesses dealing with a company with limited liability are well aware of limited liability and its pitfalls, and they take precautions (at least, well run businesses do). Such businesses do not rely on the creditworthiness of the shareholders, but on good credit control.

On the legal front, various aspects of the law limit the potential for unfair consequences. For instance, in the United Kingdom, shareholders are last in line for the distribution of assets on liquidation, and their ability to abuse their greater knowledge of the company's financial position than that of other creditors by granting themselves security is limited.

²¹ This and the following sentences of this paragraph are closely based on the paragraph regarding *al-kharaj bi al-daman* in Foster 'Islamic Perspectives on the Law of Business Organisations I: An Overview of the Classical Sharia and a Brief Comparison of the Sharia Regimes with Western-Style Law', p 10.

²² Nyazee *Islamic Law of Business Organization: Corporations*, § 7.1, p 86.

²³ Thomas, A; Cox, S; and Kraty, B (2005) *Structuring Islamic Finance Transactions* Euromoney Books, p 226.

²⁴ See Ali, SS (2014) *Use and Abuse of Limited Liability*, paper prepared for this workshop. See also Usmani, MT (1992) 'The Principle of Limited Liability from the Shariah Viewpoint' (Aug-Sept) *New Horizon* 22; Nyazee *Islamic Law of Business Organization: Corporations*, §12.4, pp 197-198.

²⁵ In particular as regards the shifting of the potential tortious liability of an enterprise to one member of a group of legal entities, such as those which led to the Bhopal disaster in 1984. See, eg, Muchlinski, PT (1987) 'The Bhopal Case: Controlling Ultrahazardous Industrial Activities Undertaken by Foreign Investors' (50) *Modern Law Review* 545.

VII. CONCLUSION

When confronted with a broad general question of principle framed in simple terms, such as whether limited liability is Islamic or not, one's immediate, quite natural, reaction is to try to provide a response in similar terms. Yes, it is Islamic, or No, it is not. However, it is often the case that such an answer is not satisfactory, nor even, in many cases, possible. It all depends on the way in which that principle is put into practice and its surrounding environment, which may well have evolved in such a way that many of the possible disadvantages of the phenomenon in its 'pure' form have been mitigated or eliminated.

Such is the case with the question of whether limited liability in the United Kingdom is a good or a bad thing, and such may well be the case with limited liability in Islamic law. A great deal depends on the surrounding environment and, as the environments in which Islamic finance operates vary considerably, so will the answer to the question of whether, or to what extent, limited liability is sharia-compliant.

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