



UNIVERSITY OF  
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**Law School**

**The Liability of Groups of Companies in Islamic Law  
(A Comparative Study with Common Law)**

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**for the Degree of PhD**

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# Dedication

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*This work is dedicated to the memory of my parents who taught me to walk in the path of truth and righteousness*

# Statutory Declaration

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I declare that the thesis has been composed by myself and that it embodies the results of my own research or advanced studies. Where appropriate, I have acknowledged the nature and extent of work carried out in collaboration with others included in the thesis.

# Keywords

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- Parent and subsidiary companies
- Groups of companies
- Law on groups of companies
- Separate personality
- Shareholders' Limited liability
- Piercing the corporate veil
- Islamic law

# Abstract

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Groups of companies offer considerable economic and practical advantages over other forms of business organizations. However, the phenomenon creates a long list of problems in terms of antitrust law, tax law, labour law, corporate law, and in the case of international companies, conflict of laws. National laws do not provide a complete solution to these problems because groups of companies are still governed by traditional corporate law, which is designed to govern single independent companies. On the other hand, harmonization of the law of corporate groups across Common legal systems is neither feasible nor advisable.

The most important problem which has not yet been completely solved by Common law systems is the liability of groups of companies for the debts of their subsidiaries. This has been described as "one of the great unsolved problems of modern company law". The present study aims to analyse the solutions provided by Common law systems to this problem and evaluate if they provide a solid settlement or whether further safeguards are needed for those dealing with corporate groups, namely minority shareholders and outsiders including creditors.

By using a comparative approach with the Islamic law system, the study evaluates if the Common law solutions are also applicable in such a religious system or whether, due to its unique character Islamic law needs to create its own solution. This comparative approach assesses the possibilities of harmonization between Common law and Islamic law systems and promotes the Islamisation of modern laws in Islamic countries.

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# Introduction to the Study

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From time immemorial man has endeavored to increase his wealth through various means, some of which require him to jointly participate with others to achieve his objective. More often than not, the personal capacity of an individual is not enough for him to pursue his dream of amassing assets. He may need to invite others to his side so that they can work together in a partnership where everyone understands his rights and obligations. Partnerships are thus formed in a number of ways with the common objective of pursuing certain activities jointly to generate profits, which will be shared according to an agreement reached beforehand.<sup>1</sup>

## **1. The Emergence of Companies**

However, the partnership form came to prove inadequate for large scale undertakings. As long-distance trade continued to grow, corporations began to emerge. They have been around for some centuries. Originally a corporation was a social invention of the state which granted a corporate charter, permitting private financial resources to be used for public purposes. This initial creation of private finance and merchants aided the colonial expansion of states such as Britain and served to expand colonial and imperial interests, sometimes supporting military adventures. Corporations had therefore the potential, from the outset, to become very powerful. Abraham Lincoln recognized this:

*“I see in the near future a crisis approaching that unnerves me and causes me to tremble for the safety of my country. ... corporations*

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<sup>1</sup> Zainal Azam B. Abd Rahman, *Islam in the Corporate World*, published at [www.thestar.com](http://www.thestar.com) dated 31<sup>st</sup> August 2004.

*have been enthroned and an era of corruption in high places will follow, and the money power of the country will endeavor to prolong its reign by working upon the prejudices of the people until all wealth is aggregated in a few hands and the Republic is destroyed”.*<sup>2</sup>

According to Donaldson,<sup>3</sup> the evolution of the corporation occurred in four stages. The first stage encompassed the medieval period and gave the Church, guilds and boroughs corporate status, but failed to do so for purely profit making associations. The second stage witnessed the rise of corporations whose members shared nothing besides the desire to make money. This occurred in the early sixteenth century, when European entrepreneurs organized to launch trading voyages to the East. Such corporations, however, were a far cry from modern ones. Instead of pooling their capital, members financed their voyages individually and used the corporation only to act as a bearer for special trading rights.

The third stage of corporate evolution ushered in the prototypes of modern corporations. Beginning in 1612 with the reconstitution of the East India trading company, this saw capital being pooled, power placed in the hands of a governor and his committees, and liability being distributed among the stockholders. These changes produced the great trading companies.

The final stage is characterized by the gradual shedding of government restrictions upon corporate chartering procedures. From the seventeenth century through the first half of the nineteenth, prospective English corporations were required to apply to the Crown for charters. In the United States following the Revolutionary War they were scrutinized, accepted or rejected, and when

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<sup>2</sup> Abraham Lincoln's letter to Col. William F. Elkins, Nov. 21, 1864, published at [http://www.notable-quotes.com/lincoln\\_abraham.html](http://www.notable-quotes.com/lincoln_abraham.html).

<sup>3</sup> Thomas Donaldson, *Corporations and Morality*, New Jersey: Prentice Hall, (1982), p. 4-5.

accepted, sometimes burdened with special conditions. This system was the target of vigorous criticism. Those unable to receive charters, or to receive them under favorable conditions, charged that winners in the system were granted monopoly power by corrupt state officials. For a time, especially in the United States, losers adopted the strategy of circumventing the chartering process through clever legal maneuvers. Finally, as so often happened in the past, the law was forced to acknowledge the realities of existing practice. The old system of special incorporation with its uncertain review process was junked in favor of a general system which assured corporate status to any organization able to fill out forms and pay fees.

The Bubble Companies Act 1825 was the beginning of gradual lifting of restrictions that acknowledged for the first time the possibility of the transfer of shares in companies from one person to another. Then in 1843, William Gladstone took chairmanship of a Parliamentary Committee on Joint Stock Companies, leading to the Joint Stock Companies Act 1844, which allowed ordinary people to incorporate through a simple registration procedure without a royal charter or Act of Parliament. At that time the advantage of establishing a company as a separate legal person was mainly administrative, creating a unified entity under which the rights and duties of all investors and managers could be channeled. The most important development was thus the Limited Liability Act 1855, which allowed investors to limit their liability in the event of business failure to the amount they invested in the company. These two features - a simple registration procedure and limited liability - were subsequently codified in the first modern company law Act, the Joint Stock Companies Act 1856. This was subsequently consolidated with a number of

other statutes in the Companies Act 1862, which remained in force until the end of the century. A series of Companies Acts up to the present Companies Act 2006 have essentially retained the same fundamental features.

## **2. The Emergence of Groups of Companies**

Although the corporation was first developed in Britain, it was soon outstripped by the USA. In 1889, New Jersey permitted corporations to own equity in one another, perhaps as an attempt to attract more business. In 1896 it then passed the revolutionary “General Revision Act,” permitting unlimited size and market share, removing all time limits on corporate charters, reducing shareholder powers, and allowing all kinds of mergers, acquisitions, and purchases. Not to be outdone, Delaware passed its “General Incorporation Law” in 1899, which set the standard by essentially allowing corporations to write all their own rules of governance.<sup>4</sup>

The company thus entered a new evolutionary stage of its structural organisation. The earlier model of the single corporate entity started to be superseded by the more complex model of group of companies, which now represents what is, by and large, the dominant form of company organisation in the largest world-wide markets.<sup>5</sup>

After the Second World War, there was a major move toward the development of conglomerates, in which large corporations purchased smaller corporations to expand their industrial base. Moreover, electronic commerce makes it easier for corporations to contemplate venturing into new markets. As a result of

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<sup>4</sup> Lee Drutman, *The History of Corporation*, Citizen Works Corporate Power Discussion Groups, Published at <http://www.citizenworks.org/corp/dg/s2r1.pdf>.

<sup>5</sup> Jose Engracia Antunes, *The Liability of Parent Corporations and their Directors*, Paper Presented at the Univeridade Autonoma de Madrid, (2004), p.10.

globalization, corporations no longer limit their activities to national economies. They are increasingly moving from a local or regional base to a global base, becoming multinational corporations operating at the interface between production, international trade and foreign investment. The scale of multinational corporations makes them very powerful and able to influence the national policy of many states.<sup>6</sup>

However, the power of the multinational corporation is often associated with abuse and corruption, especially in the third world.<sup>7</sup> This has led scholars to question if the current structure of corporate law protects the economy, minority shareholders and the creditors of these corporations, especially when they operate through groups of companies, since each company is still largely regarded as being legally independent and pursuing its own economic interests.

For these reasons the law on groups of companies has long been the subject of numerous reports, studies and analyses especially among scholars of company law and insolvency, and especially as regards the liability of groups of

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<sup>6</sup> Some statistics indicate the scale of multinational corporations' influence:

- a. UNCTAD considers that there are about 63,000 multinational corporations, with 700,000 branches in other countries, accounting for 25% of world economic output, and employing 86 million people.
- b. Practically 2/3 of world exports of goods and services are accounted for by multinational corporations,<sup>6</sup> with 33% of exports and 40% of imports being attributable to multinational corporations based in the U.S.A.
- c. The foreign direct investments of multinational corporations grew from \$180 billion in 1980 to \$1000 billion in 2000.
- d. In 2002, the stock of foreign direct investments was about \$7100 billion, as opposed to \$802 billion in 1982.

See U.N.C.T.A.D, World Investment Report (2003). See also J Dunning, *Re-evaluating the Benefits of Foreign Direct Investment*, International Thomson Business Press, London, (2003); N Grimwade, *International Trade: New Patterns of Trade, Production and Investment*, Routledge, London, 2000.

<sup>7</sup> For example, in March 2003, James Giffen of the Mercator Corporation was indicted, accused of bribing President Nursultan Nazarbayev of Kazakhstan with \$78 million to help ExxonMobil win a 25% share of the Tengiz oilfield, the third largest in the world. In June 2001 a lawsuit against ExxonMobil was filed in the District of Columbia alleging that ExxonMobil knowingly assisted human rights violations, including torture, murder and rape, by employing and providing material support to the Indonesian military forces, who committed the alleged offences during civil unrest in Aceh. Yet the most dramatic example of Multinational corporate fraud might be the Enron scandal of 2001, eventually which led to the bankruptcy of the Enron Corporation, an enormous American energy company, and the dissolution of Arthur Andersen, one of the

companies, the nature of corporate status, and the protection of the various interests involved in insolvent liquidations.<sup>8</sup> Yet perhaps the most astonishing thing about groups of companies is the lack of a serious debate concerning their governance. The topic is absent from or briefly touched on by most company law textbooks and treatises on corporate governance, while discussion of the problems posed by groups of companies often focuses narrowly on insolvency issues rather than governance.<sup>9</sup> This may be because economic analysis concentrates on the role played by the individual entrepreneur in organising production. Classical economists assumed that entrepreneurs headed firms which they personally owned; and they could see no obvious reason to modify this view when analysing the behavior of the modern, large scale business corporation.<sup>10</sup>

Groups of companies are regulated by various national laws and also by the European Community. Equally, case law, especially in common law countries, has gradually sought to address certain issues arising from group relationships. However, there is no single legal system governing group of companies either nationally or internationally, so that many legal questions related to them remain unsolved. One such question is their liability toward subsidiaries and their creditors. Although debates regarding the liability of groups of companies have increased in recent decades, no theory is sufficiently developed to offer a satisfactory solution to this problem.

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five largest accountancy partnerships in the world. In addition to being the largest bankruptcy reorganization in American history at that time, Enron was regarded as the biggest audit failure.

<sup>8</sup> Harry Rajak, *Corporate Groups and Cross-Border Bankruptcy*, 44 *Texas International Law Journal*, 521 at 545.

<sup>9</sup> Janet Dine, *The Governance of Corporate Groups*, Cambridge Studies in Corporate Law, (CUP, 2000), p. 37.

<sup>10</sup> J. Scott, *Corporate Groups and Network Structure* in J. Mechaery, S. Picciotto and C. Docott (eds), *Corporate Control and Accountability*, Clarendon, Oxford, (1993), p.292.

### 3. This Study

The liability of groups of companies has been described as "one of the great unsolved problems of modern company law".<sup>11</sup> This may be due the lack of understanding of the concept of group of companies in interdisciplinary studies. There is a conflict between the understanding of basic features of group of companies in legal studies and the socio-economic realities.<sup>12</sup>

Given that it has not yet been completely solved by common law systems, could one find a solution in other legal systems such as Islamic legal systems? It may be asked why the researcher has selected Islamic legal systems in particular? There are two reasons. First, the researcher aims to use this study to participate in the process of the Islamisation of laws in Muslim countries known as the 'Islamic revival'.<sup>13</sup> Secondly, it is a response to the increase of interest in solutions provided by Islamic law both in the Islamic world and outside; especially after the Islamic Banking system survived the financial crisis.<sup>14</sup>

The aim of this study is to investigate the approaches taken by the Common law in respect of liability of groups of companies for the debts of subsidiaries with a view to determining whether they might also be applied in Islamic legal

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<sup>11</sup> C Schmitthoff, *Banco Ambrosiano and Modern Company Law*, 363, quoted by Jose Engracia Antunes, *Enterprise Forms and Enterprise Liability: Is there a Paradox in Modern Corporation Law*, Paper presented at School of Law of Iniversidade Autonoma de Madrid, February 27<sup>th</sup> (2004), p.198

<sup>12</sup> Muzaffer Eroglu, *Modern Organisation of Multinational Enterprises and Liability: Critical Analysis of Control Theory*, 23<sup>rd</sup> December 2008, published at SRRN.com.

<sup>13</sup> Since the 1970s the Muslim world has experienced an Islamic revival which has slowed and even reversed the rush towards uncritical westernization. Many Muslim countries have embarked upon a programme of part or complete Islamisation of their societies, economies and legal systems. It is obvious that most Muslims want the entire law to be Islamized so that they can feel its impact on their lives. There would be very few Muslims who would agree to confine Islamic law to personal matters of inheritance, marriage, and divorce, or to a few penalties laid down as deterrents by the Lawgiver, which are meant to be applied rarely. They would deem it imperative that Islamic law deal with matters covered by the law of torts, contract, taxation, and above all constitutional law and fundamental rights. They would like to see Islamic law taking into its fold the laws of business organization and commerce.

<sup>14</sup> Based on this interest, a considerable number of studies have appeared on Islamic law and jurisprudence. These studies have mostly been addressed to understanding substantive Islamic laws – the family law, penal law, civil law,



system. I am not aiming to provide a comprehensive solution to the issue, but rather look to use the study to galvanise Muslim Scholars and Institutions of Islamic Studies to start seriously studying the possibility of initiating a comprehensive regime regulating groups of companies. Such a scheme would preserve the economic benefits of corporate groups, while mitigating the negative impact of misusing the device to the disadvantage of creditors.

Such a comparative study will not be an easy task because:

- a. There is a great natural difference between Islamic law and common law systems. Whereas common law is largely secular, Islamic law is firmly based on religion. The sources of Islamic law not only represent the foundations of the law, but embody the religion of Islam as well. A separation between law and religion is therefore impossible in Islam. The religious basis and nature of Islamic law contrasts sharply with the ideals of secularism, both in the political and in the legal sphere, that have formed the basis of the English legal system in the modern age. There can be no doubt that many principles of English law are informed by Christian ethics and values, but unlike Islamic law, these origins remain unacknowledged. In contrast, Islamic law cannot be understood, and cannot be studied, without an appreciation of the religious nature of its sources. The study of Islamic law is therefore as much a study of religion as it is of law.
- b. The primary sources of English law (i.e. reported case law and legislation) are normally supported by a wide range of secondary sources, including textbooks on individual subjects, collections of cases and materials and academic writing. The primary sources of Islamic law, however, namely the Qur'an and the *Sunnah*, cannot be compared to case law or legislation, and it is therefore necessary to go beyond these primary sources and to consult other sources in order to understand how

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etc., of Islam. Compared to these, works dealing with Islamic law of corporation are scarce and this study will help and might encourage the scholars to respond to the need of more studies in the field of Islamic law of corporations.

Islamic law emerged as a complete legal system from these religious origins.

- c. The basic principles of Islamic law are not contained in case law but were developed by Muslim jurists. For the same reason legislation has no role to play in the emergence of these basic principles, and one will find that in many modern legal systems Islamic law has not been codified.
- d. The study of English law is concerned with law applied by the courts. In contrast, the study of Islamic law is not based on the legal systems of individual countries but on basic principles of law developed by different schools of jurists over a long period of time. Some of these principles do form the basis of law in contemporary legal systems.
- e. The common law has developed continuously, creating new concepts to allow it to respond to the social and economic issues created by groups of companies, while Islamic law was unable to develop for a considerable period, for many specific reasons which will be elaborated later in this study.

Some justification should be given for adopting a comparative approach. There are two reasons. First, In order to judge a legal system on its merits one has to look at the solutions provided by other legal systems. Secondly, and more specifically, a comparative study enables the researcher to assess the possibilities of harmonization of the rules concerning the subject matter of the study.

#### **4. Plan of the Study**

The Study is divided into 4 Chapters. The First Chapter will seek to explain the phenomenon of group of companies in Common law System by explaining: the key legal definitions of the concept; the reasons why corporations form groups of companies; the role of groups of companies in the economy; and the

relationship between a parent and a subsidiary. Thereafter I will review the risks and problems of groups of companies, ending by explaining the problems they create for corporate governance. I will proceed to explain how common law countries regulate groups of companies, in particular whether a group is treated as an unitary economic enterprise, so that the parent company is automatically liable for the debts of the companies within the group, or whether each company in the group is a separate legal entity with its own rights and liabilities even when controlled or wholly owned by another company and collectively engaged in the business of the group..

The Second Chapter addresses groups of companies in Islamic law. Because of the unique nature of Islamic law I must first explain some of its broad aspects, such as Islamic commercial law, Islamic law of business enterprises, and Islamic understanding of the concepts of corporate personality, limited liability, credit and liability. Without this explanation, it would be difficult to understand the relevant background. Therefore, I have divided the Second Chapter into two parts. The First part provides a brief explanation of the aspects, nature, sources and origins of Islamic Law. This is essential to understand Islamic Law's sophisticated methods of interpretation and law finding, and how it devises concrete rules capable of solving legal problems. Part one will also explain briefly how 'Islamic jurisprudence' emerged and how it currently works. Part II will deal with the main principles of Islamic commercial law to explain which principles will apply to Islamic corporate law. It will explain the meaning of corporations in Islamic law, describing the various types and considering the possibility of establishing modern forms of corporation in

Islamic law including groups of companies. Part II will end with a suggestion for the creation of a new model of Islamic corporation.

The Third Chapter is the heart of the study and divided into two parts. Part I aims to investigate how Common law systems allocate the liability of groups of Company and the sort of protections given to the creditors dealing with a subsidiary. Part II will investigate whether such protections can also be accommodated under the principles of Islamic law. It will thus begin with an examination of the rationale of debts as developed from the basic principles of Islamic Law, then seek to determine whether Islamic law acknowledges the concept of limited liability, and whether it offers the possibility of a practical solution for the problem of the liability of groups of companies for the debts of subsidiaries different from that provided by the Common law.

In the last Chapter four, I will summarise my findings regarding the Common law position, and based on these findings will provide my recommendations as to how to allocate liability within corporate groups in Islamic law in a way which matches Islamic law unique character.

I should add that I faced two main obstacles when conducting this study. The first is the lack of Islamic legal resources in English, necessitating reliance on Arabic resources which are difficult to translate into legal English. Secondly, legal opinion in Islamic law is not unified, as there are four main Islamic legal schools, who interpret the law differently, sometimes providing different solutions. As a general rule, I cannot review such differences in detail, as that would make this work over-voluminous and cumbersome. Therefore, I shall explain any differences in a very limited way in order to focus on the main subject of the study.

# Chapter One

## The Phenomenon of Groups of Companies in Common Law

A company is one of the many forms of business organizations. However, it has become the most important form due to the large-scale of activities that it allows. The company represents a major economic, social, political, and even cultural institution. However, it may incur huge losses or even totally collapse, bringing down with it the hopes of those who invested their wealth in it, those who extended it credit, those who worked for it, and perhaps even of those who bought its products and services.

A company constitutes a legally independent entity, with its own rights and duties, its own assets and liabilities. It enjoys its own legal personality, akin to that of a human being. The attribution of legal personality to companies leads in turn to a clear cut separation between the legal sphere of their owners or investors (shareholders) and the legal sphere of the company itself. This separation, *inter alia*, entailed that only the company would be made accountable for consequences stemming from its activities.

A revolutionary rule dealing specifically with the allocation of enterprise risks has been consecrated in order to encourage the widespread investment and capital accumulation required for the growth of enterprises (i.e. the rule of limited liability of the shareholders for their corporate debts). According to this rule, the responsibility of corporate investors is limited to the amount of their capital investment. This classical statutory model of company, and its attached liability regime, has operated satisfactorily as long as the business enterprise has indeed been organised and conducted through a single independent company. However, companies have increasingly chosen to organise and conduct their business operations in the form of a cluster of various separate corporations (group of companies) rather than as a single corporate entity.

That one company might be a shareholder in another company was well understood by the nineteenth century, but was initially viewed with some suspicion. In the United States, it was not until New Jersey enacted its first general incorporation statutes in 1888-1893 that corporations were permitted to own shares in other corporations.<sup>15</sup> Since then the company has entered a new evolutionary age of its structural organisation. The earlier model of the individual company has been superseded by the more complex model of the group of companies, which represents the dominant form of company organisation in the largest world-wide markets.<sup>16</sup>

To understand the character of this complex form of corporation, it will be necessary to appreciate some basic economic and legal facts concerning groups of companies: why businessmen elect to conduct their business in this form; what its commercial and economic role might be; what sort of control a parent exercises over a subsidiary; how groups of companies emerge and why parent companies are keen to grant limited liability to its subsidiaries; and finally, what would be the proper model of corporate governance for this business form.

## **1. Reasons for Corporate Groups**

The reasons why a company expands its business must be distinguished from the reasons why it establishes one or more subsidiaries – although the two may, in some circumstances, be related. There are several reasons for company expansion - the possibility of economies of scale in production or distribution, or a reduction in transaction costs. Expansion might also result from the need to obtain access to new markets or suppliers, or to eliminate competition. It may even occur so that managers can increase their personal status and power.<sup>17</sup>

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<sup>15</sup> Harry Rajak, *op. cit.* p. 522

<sup>16</sup> Jose Antunes, *op.cit.* p.10.

<sup>17</sup> Ian Ramsay and Geoff Stapleton, *Corporate Groups in Australia*, Research Report provided to Centre for Corporate Law and Securities Regulation, the University of Melbourne, (1998) p.14

On another hand, a company may establish one or more subsidiaries, so that its business is conducted through a corporate group rather than through a single company, in order to benefits from the following economic realities:<sup>18</sup>

- a. Reducing commercial risk, or maximising potential financial return, by diversifying an enterprise's activities into various types of businesses, each operated by a separate company.
- b. Attracting capital without forfeiting overall control. A parent may want outside investment in only part of its overall business. This can be achieved by incorporating that part of the business as a separate subsidiary and allowing outside investors to acquire a minority shareholding.
- c. A company may want to acquire a business in partnership with another party. A convenient way of structuring the acquisition is for the respective interests in new business to be represented by shares.
- d. Preserving intangible commercial property of existing companies by acquiring the companies themselves to expand an enterprise or increase market power.
- e. From an accounting perspective, establishing a subsidiary makes sense because in most jurisdictions there are considerable tax advantages. The main tax benefit is the ability to offset profits and losses of one part of a business against another in tax returns. Some states allow subsidiaries to file tax returns only on the profits generated within the state's borders as opposed to those generated

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<sup>18</sup> D.D. Prentice, A Survey of the Law Relating to Corporate Groups in the United Kingdom, in Eddy Wymeersch (ed) *Groups of Companies in the EEC*, a *Survey Report* to the European Commission on the Law Relating to Corporate Groups in Various Member States, (de Gruyter, 1992), p. 281.



by operations in other locations. The same is true for many companies that set up shop internationally. Typically, the profits and losses of those subsidiaries will be taxed in the country where the subsidiary is incorporated and might not be subject to income tax where the parent is incorporated. Also, it is frequently preferable, for taxation reasons, to acquire companies as a going concern, rather than merely their assets.<sup>19</sup>

- f. A corporate group may wish to continue operating an acquired company as a separate entity so as to utilise its corporate name, goodwill and public image.
- g. The establishment of subsidiary may allow greater flexibility in debt financing,<sup>20</sup> For instance, a lender may require that the borrower shift specific assets into a separate company incorporated for that purpose, thereby ensuring that the lender has a first charge over the whole or most of the new company's property.<sup>21</sup> Likewise, a separate group company may be formed to undertake a particular project and obtain additional finance by means of substantial charges over its own assets and undertaking.<sup>22</sup>

Eisenberg<sup>23</sup> observes that it is very difficult to find economic reasons for the formation of wholly owned subsidiary, since any economic goal that can be achieved by the creation of a wholly owned subsidiary could equally well be

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<sup>19</sup>H Ford, R Austin & I Ramsay, *Ford's Principles of Corporation Law*, Butterworths, 6<sup>th</sup> Ed., (1992), at 23,020.

<sup>20</sup> D Leebron, *Limited Liability, Tort Victims, and Creditors*, (1991), Columbia Law Review, p. 1614.

<sup>21</sup> P Crutchfield, *Corporate Voluntary Administration Law*, 2<sup>nd</sup> ed, Law Book Company Limited,(1997),p. 27.

<sup>22</sup> K Lightman, *Voluntary Administration: The New Wave or the New Waif in Insolvency Law*, (1994) 2 Insolvency Law Journal 59 at 84.

<sup>23</sup> M Eisenberg, *Corporate Groups* in M Gillooly, *The Law Relating to Corporate Groups*, Federation Press, (1993), p.3.

achieved by the formation of a division within a single corporate entity. Consequently, he argues that the reasons for formation tend to be organisational or historical. Organisational reasons may include the fact that where a company wishes to concede managerial autonomy to a particular business, running it through a subsidiary may be a useful way to emphasise its separation and autonomy. Secondly, in the case of a multinational group, the law of a country in which the group wishes to do business may demand that local business be conducted by a separate subsidiary. Thirdly in some cases, there may be a tax advantage to derive from operating through a separate subsidiary; while in others it may be possible to limit the influence of regulators (e.g. in areas like such as banking or insurance) by vesting that business in a subsidiary and leaving the holding company outside the regulatory umbrella. The legal motivation includes confining high liability risks, including environmental and consumer liability, to particular companies in a group, with a view to isolating the remaining group assets from this potential liability.

## **2. How Do Groups come about?**

A group will obviously exist where there is a relation of parent and subsidiary between two or more companies. Under s.1159 of the Companies Act 2006 a parent/ subsidiary relation will be taken to exist if a company:

- a. holds a majority of the voting rights in another,
- b. is a member of the other and has a right to appoint or remove a majority of the board of the other, or
- c. is a member of it and controls alone or with the agreement of others the majority of the voting rights in the company.

Where a company acquires control of another company by share acquisition, the relationship of parent and subsidiary will be created between the acquiring

company and the target company. If the entire share capital of the target changes hands, it becomes a wholly owned subsidiary of the acquiring company. Where the target company itself has subsidiaries, the acquisition brings into existence a group with three levels (and so on). A group which expands by making acquisitions rather than by achieving 'organic' growth of its core business may end up with an array of diverse activities under its wing.

The promoters of a business venture may decide from the start to incorporate a parent company and several subsidiaries to carry on different aspects of the enterprise. In addition, a company may decide to transfer certain sectors of its business to subsidiaries specifically formed for this purpose. Similarly, where a number of different businesses are being run under the umbrella of a single company, these may be separated out and hived down to subsidiaries.<sup>24</sup> At the furthest extreme, a holding company may acquire shares solely as investment and may not intend to integrate the subsidiary into the group at all, instead may leave it as a separate economic entity, exercising little control over its policy.<sup>25</sup>

### **3. The Structure of Corporate Groups**

A Corporate group may have many subsidiaries spread round the world, each operating under the law of its country of incorporation, but in practical terms they operate in accordance with the economic and managerial policies of the group. Therefore, there is a compound structure under which, in law, companies are independent, while in economic reality they are entirely interrelated. From an economic perspective, two or more companies can be associated through corporate mechanisms in several ways. The simplest model is where company A owns shares in company B. This model is described sometimes as a vertical association between corporations. This association

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<sup>24</sup> Denis Heshon, *International Mergers and Acquisitions*, the College of Law of England and Wales, Issue 6 – 2006 p. 211.

<sup>25</sup> A Hicks & S Goo, *Cases and Materials on Company law*, 6<sup>th</sup> ed, (2008) Oxford University Press, p 492.

might be extended where, for example, B owns shares in C and so on. A horizontal association may exist where corporations A and B each own shares in the other. This too might be extended where A and/or B own shares in C, which in turn owns shares in A and/or B. In addition to share ownership, an association of companies might be established through the mechanism of corporate director appointment. Corporation A might be given powers by the constitution of corporation B to appoint one or more directors to the board of B and vice versa. Also, groups may be formed as, or develop into, “conglomerates”, whereby group of companies conduct a diverse range of businesses in unrelated fields. Associations of companies may also be established by non-corporate mechanisms. The most obvious is by contract when company A and B have the same or largely the same shareholders and directors; they are likely to create a close association.<sup>26</sup>

Some corporate groups may have a primarily hierarchical structure, with succeeding layers of parent and controlled companies. Other groups may maintain a more lateral structure, with many sibling group companies, often with a high level of cross-ownership between them. Of importance in examining the structure of groups, is the level within the group at which a subsidiary operates, that is, the distance at which sub-subsidiaries are removed from the ultimate holding company. This becomes an issue of some importance if the question arises as to the liability of a parent company for the obligations of its subsidiary. Some company in the chain of companies has to be identified as the parent and

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<sup>26</sup> Harry Rajak, *op.cit.* 522.

it could be the ultimate holding company, or be an intermediate holding company.<sup>27</sup>

The degree of financial and decision-making autonomy within groups of companies can vary considerably. Some companies may be active trading entities, with primary responsibility for their own business goals, activities and finances. For instance, conglomerate groups may operate under a highly decentralised structure, given their involvement in a range of industries. In other groups, strategic and budgetary decisions may be centralised. With this structure, each company effectively operates as a division of a larger business, exercising little independent discretion within this cohesive economic unit. A parent company may exercise close control by allocating equity and loan capital to its subsidiaries through a central group treasury mechanism, prescribing their operational and financial policies, setting their performance targets, choosing their directors and other key personnel, and continuously monitoring their performance and staffing.<sup>28</sup>

The “power centre” of some corporate groups may be the ultimate holding company. More commonly, companies in the next step down of the group chain may effectively direct a group’s operation, with the ultimate holding company owning the key shares, but not having any direct productive or managerial role. The degree of economic and organisational integration of different corporate groups can be compared according to various organisational, market and public image criteria.

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<sup>27</sup> Report of the Review Committee on Insolvency Law and Practice (1982) Cmnd 8558, p.2. Also known as the Cork Committee Report, this was an investigation and set of recommendations on the modernisation and reform of UK insolvency law. It was followed by a White Paper A Revised Framework for Insolvency Law (1984) Cmnd 9175, which led to the Insolvency Act 1986.

<sup>28</sup> See *Corporate Groups Report, Final Report*, May 2000, p.2. This is a systematic and comprehensive review of the application of Australian corporate law to corporate groups.

#### 4. Management of Corporate Groups

A group of companies may often be managed under a unified management policy as a single economic entity. As groups get larger, the directors of individual companies may be different, and the unity of management may become looser. The organizational structure of corporate groups depends on the size of the group as a whole and the geographical location and variety of its businesses. Business specialization implies, where the group conducts more than one business, that there is a degree of decentralization of management. However, the synergies produced by combination are unlikely to be optimized unless management is centralized. An analogy has been drawn between the central management team and the external controlling shareholder of traditional legal theory, which intervenes to replace directors and officers who are not meeting the shareholders' targets for growth and profitability.<sup>29</sup>

The organizational structure for financial management of the corporate group is typically more complicated than the business management structure. Banking and corporate finance functions are likely to be centralized through the parent company's treasury operations. Budgets and budget projections will probably be set on a business divisional basis. Financial reporting must take into account the separate corporate entities through which the business is conducted, in order to satisfy statutory reporting and income tax requirements. This means that some important decisions, including the funding of divisional businesses and transfer pricing within the group, are executed at a corporate entity level even if arranged at the central management or divisional level. The need to satisfy corporate entity requirements as well as business divisional requirements in financial management of the corporate group creates a special level of complexity and, if the group is not properly managed, can produce a

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<sup>29</sup> Robert P Austin, *Corporate Groups*, in *Corporate Personality in the 20th Century*, Hart Publishing, Oxford, UK, (1998) p. 75.

chaotic picture of intermingling of the assets of separate entities and insufficient financial trails.<sup>30</sup>

## **5. Risks Related to Corporate Groups**

Hadden<sup>31</sup> identifies some techniques which may be used to avoid possible hazards facing groups of companies.

- a. The techniques of group control, notably those involving interlocking shareholdings and directorships, may be used to entrench the positions of incumbent managers against any possible threat from external shareholders.
- b. The techniques of integrated financing, notably the freedom to pass assets and liabilities from company to company within the group, and the creation of complex group structures may be used to conceal the true financial position of individual companies or of the group as a whole from shareholders or creditors. Both techniques may be used to ensure that the interests of shareholders and directors of the group are preferred to those of minority shareholders in subsidiaries and to conceal that this has been done. The technique of integrated financing may be used to avoid taxation by ensuring that maximum profit is generated in forms or in jurisdictions which attract low levels of tax.
- c. The creation of separate companies for particular operations, supplemented by the techniques of integrated financing, may be used to avoid liability to external creditors by relying on the limited liability of each constituent company within the group.
- d. More or less complex group structures may be used to avoid the impact of regulatory measures on a wide range of matters, such as monopolies and mergers legislation, health and safety provisions, employee participation and planning requirements.

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<sup>30</sup> Ibid.

<sup>31</sup> T Hadden, *The Regulation of Corporate Groups in Australia*, (1992) 15 University of New South Wales Law Journal 65.

In additions to these problems, it is widely recognised that corporate groups may present specific risks for minority shareholders and creditors at various levels.<sup>32</sup> In this regard, one must distinguish between vertical and horizontal groups. In vertical groups there is an important distinction between wholly owned and partly owned groups. In the latter case, the existence of the minority shareholding interests creates important issues of shareholder protection, whereas in the case of the wholly owned group the focus tends to be on creditor protection.<sup>33</sup>

### **5.1 Minority Shareholder Risks**

The form of groups of companies exposes minority shareholders of subsidiaries to certain risks, e.g.<sup>34</sup>

- a. A parent company may operate the affairs of its subsidiary to maximize the overall welfare of the group to the prejudice of minority shareholders in a particular subsidiary. For example, a subsidiary might be forced to sell goods to another group member at less than the fair market price. Alternatively, and more subtly, the parent in allocating economic opportunities may prefer a wholly owned subsidiary at the expense of one that is partly owned.
- b. The group's interest could override the interests of the subsidiary, and this in turn could amount to the majority shareholders' abuse of the minority shareholders' interests in the subsidiary.

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<sup>32</sup> *Report of the High Level Group of Company Law Experts on a Modern Regulation Framework for Company Law in Europe*, 4<sup>th</sup> November 2002, p.94.

<sup>33</sup> Robert P Austin, *op.cit.* p. 73.

<sup>34</sup> Vassya Prokopieva, *Parent Company Liability in Case of Subsidiary Insolvency*, Thesis presented for the Degree of Master of European Studies, College of Europe, Law Department, Academic Year (2003-2001) pp.10-11.



- c. Transactions between companies in the group can be, and often are, conducted on a basis which is not arms length. Assets may be transferred between group companies at lower than market value. Loans may be made without interest or at less than market rates. One company may guarantee another's obligations for no charge and without reference to the interests of the guaranteeing company. Dividends may be paid from a subsidiary to the parent without regard to the cash requirements of the subsidiary.<sup>35</sup>
- d. A subsidiary's assets may be used to cure the financial difficulties of the parent corporation.
- e. There may be spillover effects in the event of the insolvency of a parent or sister company.
- f. There may be jurisdictional and substantive law problems in case of cross-border group insolvency.

On the other hand, in certain jurisdictions minority shareholders of a subsidiary can complain that the conduct of the holding company has been unfairly prejudicial to their interests and hence they may petition the court for a remedy.<sup>36</sup>

## **5.2 Creditors' Risks**

One attraction of corporate groups is that the combination of legal personality and limited liability enables the controller to separate out an area of activity or particular assets, and to control a subsidiary's legal relationship with the wider organisation. There may be an effective shifting of risk from the controllers and owners to the creditors of a subsidiary as a result of its separate legal

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<sup>35</sup> Cork Committee Report, para.1926.

<sup>36</sup> E.g. in the UK under s.994 of the Companies Act 2006.

personality.<sup>37</sup> The control of shares by another company also brings subsidiaries under common management. Here problems may arise, as unlike individual majority shareholders, the common management may have a reason to direct the subsidiary to act contrary to its own interest, and may even put its existence in danger. Therefore, being controlled and managed by a company shareholder and especially being open to be interference from other companies under a group structure could put the subsidiary's creditors at risk.<sup>38</sup>

Creditors when dealing with corporate groups face three risks. First, such a structure might reduce transparency by blurring the lines between the assets of group members, commingling assets, and suggesting, often falsely, that the entire group or at least the controlling parent company stands behind each member's debt. Secondly, the holding company might assign risky activities to a particular company in the group, while not providing it with an adequate equity cushion to pay off any potential liabilities, choosing instead to capitalise it with loans. Third, the holding company might assign and reassign value within the group.<sup>39</sup>

Additional risks may arise when a company in a group goes into liquidation. There will be a delay while the liquidator sorts out the assets which are available for distribution to that company's creditors. In all probability, several, and possibly all, companies in the group will be in liquidation, and a substantial part of the assets which would otherwise have been available to the group's creditors will need to be expended in ascertaining the facts and the applicable

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<sup>37</sup> A. Griffiths, *Corporate Governance and the Uses of Companies*, University of Manchester, Faculty of Law Working Paper no.18 (1993), p.32.

<sup>38</sup> Muzaffer Eroglu, op cit. p.3.

<sup>39</sup> Eike Thomas Bicker, *Creditor Protection in the Corporate Group*, University of Freiburg - Faculty of Law, Published in SSRN.com, (July 2006) p.3.

law which determines which group creditors may obtain a distribution and which may not. The level of complexity which a corporate group's affairs can present for the liquidator, necessarily unfamiliar with the group's operations before the commencement of the winding-up, can hardly be overstated.<sup>40</sup>

The risks for creditors may increase where an individual (or a small group of individuals) control two or more companies. The cases indicate that there is a high level of abuse of the corporate form in this type of situation (normally involving private companies), with a common controller misusing the assets of one company he controls to benefit another company which he also controls.<sup>41</sup>

Finally, it is important to mention that creditors may be at risk if they cannot differentiate between companies in the group. However, it is not always practical to do so. For example, in *Qintex Australia Finance Ltd v. Schroders Australia Ltd*<sup>42</sup>, one of the witnesses who dealt with Qintex stated:

'It was not my practice to ask which of the Qintex companies was responsible for the deal. I always treated the client as Qintex and did not differentiate between companies in the group'.

The court commented,

Regularly, liquidators of subsidiaries, or of the holding company, come to court to argue as to which of their charges bears the liability. As well, creditors of failed companies encounter difficulty when they have to select from among the moving targets of the company with which they consider they concluded the contract. The result has been unproductive expenditure on legal costs, a reduction in the amount available to creditors a windfall for some, and an unfair loss to others. Fairness or equity seems to have little role to play.<sup>43</sup>

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<sup>40</sup> Robert P Austin, *op.cit.* p.82.

<sup>41</sup> D.D. Prentice, *op cit.* p. 285.

<sup>42</sup> (1990) 3 .A.C.S.R 267.

<sup>43</sup> *Ibid.*, at 268-69.

## 6. The Terminology of Corporate Groups

The expressions 'group', 'corporate group' and 'group of companies' are commercial and economic expressions adopted through common usage to describe 'a collection of companies associated with each other usually through a common ownership or control'.<sup>44</sup> It can also be defined as 'a union of companies, which operate under an aim to ensure the profitability of the association as a whole'.<sup>45</sup>

Eisenberg<sup>46</sup> defines a corporate group as 'two or more corporations that are affiliated in a manner that depends in significant part on stock ownership'. At its simplest, a corporate group is 'the operation of two or more companies as a single economic unit, despite each having its own legal personality and limited liability'.<sup>47</sup>

Some scholars<sup>48</sup> prefer to use the term 'enterprise group' as a wider term encompassing incorporated and unincorporated organizations. This term enjoys some legal recognition. For example, it been used in the European Union by the Ninth Draft Company Law Harmonization Directive (the so-called "Groups of Companies Directive"). It was also used by a working group of the United Nations Commission on International Trade Law which is trying to achieve harmony among member states in handling the problems that arise when one, some, or all of the members of an enterprise group suffers bankruptcy. Finally,

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<sup>44</sup> Damien Murphy, *Holding Company Liability for Debts of its Subsidiaries: Corporate Governance Implications* (1998) 10 Bond Law Review, p. 241.

<sup>45</sup> Muzaffer Eroglu, op cit. p.85

<sup>46</sup> M Eisenberg, op cit. p. 2.

<sup>47</sup> L Gower and P Davies, *Principles of Modern Company Law*, 7th Edition, Sweet Maxwell, London, (2003), p. 103.

<sup>48</sup> Harry Rajak, op.cit. p. 523.

UNCITRAL itself used the term 'enterprise group', defining it as "two or more enterprises that are interconnected by ownership or control".<sup>49</sup>

Other commercial terms are used to reflect a relation between two companies. For example, "Associated companies" means companies in which one company holds an equity interest in another of at least 10% but less than 50% of the other company's shares.<sup>50</sup> The terms "cross-holding" and "circular-holding" are also used to explain the connection between companies.<sup>51</sup> A 'cross-holding' occurs where, for example, three companies 'with a common board of directors or with boards which agree to act in concert' each have a holding of 36% of the votes of each of the other companies. This assures *de iure* control of each company. Thus, the 'cross-holding' enables the companies to be operated as a group as long as there is agreement between the directors of the three companies. Circular-holdings produce roughly the same effect, although in this situation, there is no *de iure* control. A 'circular-holding' occurs where company A holds 40 per cent of the ordinary voting shares of company B, which holds 40 per cent of the ordinary voting shares of company C, which in turn holds 40 per cent of the ordinary voting shares of the company A. The effect of this is that, although there is not *de iure* control of the various companies, provided the directors of each company act in unison by which they can effectively control the various companies in which the circular holdings are held.

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<sup>49</sup> Working Group on Insolvency Law, *Supra* Note 11, para 2.

<sup>50</sup> S.J.Gray, *International Group Accounting Issues in European Harmonization*, 2<sup>nd</sup> Ed., Routledge, London (1993), p.149.

<sup>51</sup> D.D. Prentice, *op cit*, pp. 283-284.

In addition to definitions provided by jurists, and although there is no single set of definitions in national laws,<sup>52</sup> a number of laws offer definitions of groups of companies and parents/subsidiaries. Not only do all States apply different definitions, but within a State one frequently finds several different definitions, which adapt the ambit of the rule to the specific needs of the area in question. Examples are set out below.

In this study, the terms “company groups” and “group of companies” are used interchangeably.

### **6.1 The United Kingdom**

The Companies Act 2006 (CA 2006) provides definitions of groups of companies for very specific purposes such as a company’s obligations relating to accounts. Particular words or expressions sometimes have a single meaning within the Act as a whole, but may have that meaning only within a specific part of Act. For example, the term ‘quoted company’ has no fewer than three separate definitions for the purposes of different parts of the Act.<sup>53</sup>

The terms ‘holding company’, ‘subsidiary’ and ‘wholly-owned subsidiary’ are defined by s.1159, together with a further two pages of verbiage in Schedule 6 to the Act. According to this section a company is a “subsidiary” of another company, its “holding company”, if that other company:<sup>54</sup>

- a. holds a majority of the voting rights in it, or
- b. is a member of it and has the right to appoint or remove a majority of its board of directors, or

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<sup>52</sup> Erik Werlauff, *EU Company Law*, 2nd edition, DJØF Publishing, Copenhagen, (2003), p. 456.

<sup>53</sup> A Hicks & S Goo, *op.cit.* p 491.

<sup>54</sup> In s.1159 and Schedule 6 “company” includes anybody corporate.

- c. is a member of it and controls alone, pursuant to an agreement with other members, a majority of the voting rights in it, or if it is a subsidiary of a company that is itself a subsidiary of that other company.

A company is a “wholly-owned subsidiary” of another company if it has no members except that other and that other’s wholly-owned subsidiaries or persons acting on behalf of that other or its wholly-owned subsidiaries.

Under s.1160, the Secretary of State may amend the provisions of s.1159 and Schedule 6 so as to alter the meaning of the expressions “subsidiary”, “holding company” or “wholly-owned subsidiary”.

For the purpose of Part 15 (Accounts and Reports), ‘group’ means ‘a parent undertaking and its subsidiary undertaking’, while s. 1162 contains an elaborate definition of what constitutes a parent /subsidiary undertaking relationship, and s.1173 (1) defines a parent company as ‘a company that is a parent undertaking’.

The Act defines a parent or a holding company in relation to a subsidiary undertaking by using the concepts of formal voting control. For accounting purposes it adopts the concept of effective control (as set out in the Seventh Company Law Directive) by indicating that a company is the parent of another if it:

- a. has the right to exercise dominant influence over the subsidiary by virtue of its memorandum or articles or by virtue of a control contract (legal control); or if it
- b. has a participating interest in the undertaking and actually exercises a dominant influence over it, or it and the other company are managed on a unified basis (factual control).

For non-accounting purposes, such as where subsidiaries are barred from holding shares in their parents or from giving their parents financial assistance,

a corporate group is defined more narrowly in terms of formal control. It is therefore identical to the first part of the test used for the accounting definition. However, the definition does not encompass natural persons who hold shares in several companies even if they may control those companies. Prentice, considers the CA 2006 definition of what constitutes a “group” for the purpose of consolidated accounts to be the first time that the English legislature has tried to define the phenomenon in terms of substance, or economic reality rather than legal form. He believes that there is no good reason, should the need arise, why the definition cannot be extended to other areas of the law.<sup>55</sup>

## **6.2 Australia**

Under s. 46 of the Corporations Act a company A is a holding company of company B (and company B is a subsidiary of company A) if company A:

- a. controls the composition of the board of company B (including by exercise of any power to appoint or remove all, or a majority of, the directors of company B)
- b. is in a position to cast, or control the casting of, more than 50% of the total voting shares of company B,
- c. holds more than half of the issued share capital of company B, or
- d. is the holding company of any holding company of company B (this also applies where there are any number of intermediate holding and subsidiary companies between company A and company B).

Section 47 deems the composition of A’s board to be controlled by B if B can appoint of, remove all, or the majority, of A’s directors. Section 50 defines related companies and this is generally regarded as the legal definition of groups of companies.

It provides that two companies are related if:

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<sup>55</sup> D.D. Prentice, op. cit. p. 298.



- a. one is the holding company of the other; or
- b. each is a subsidiary of the same holding company

Section 9 defines the term "holding company" in this way: in relation to a particular company A, a holding company is another company of which A is a subsidiary. This definition relies on the definition of subsidiary in ss.46 and 47.<sup>56</sup>

Mason J has stated that the word 'group' is generally applied to a number of companies which are associated by common or interlocking shareholdings, allied to unified control or capacity to control.<sup>57</sup> Murray J has commented that close and common management links, as well as an interlocking web of complex mutual shareholdings are features sufficient in *de facto* terms to constitute the various companies in question within the group as being properly described as such, being responsive to the needs and interests of each other as corporate entities through their management.<sup>58</sup>

### **6.3 New Zealand**

New Zealand legislation defines companies as related where "the businesses of the companies have been so carried on that the separate business of each company, or a substantial part of it, is not readily identifiable".<sup>59</sup>

### **6.4 European Law**

The European Company Statute recognizes but unfortunately does not define groups of companies. It provides that the national law of the state in which the European Company is registered will be the applicable law for this purpose.<sup>60</sup>

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<sup>56</sup> Ian Ramsay and Geoff Stapleton, *Corporate Groups in Australia*, p.18..

<sup>57</sup> *Walker v Wimborne* (1976) 3 ACLR 529 at 532.

<sup>58</sup> *Re Enterprise Gold Mines NL* (1991) 3 ACSR 531 at 540.

<sup>59</sup> New Zealand Companies Act 1955 s.2(5)(d), New Zealand Companies Act 1993 s.2(3).

<sup>60</sup> Vassya Prokopieva, *op.cit.* p.15.

With respect to applicable law, the statute points to the national law of the state in which the European company ("SE") is registered.<sup>61</sup>

## **7. Parent /subsidiary tests**

From the group of companies' definitions mentioned above it is clear that control is the underlining feature of a parent/subsidiary couple,<sup>62</sup> as in most of the legislation a parent company exercises control over its subsidiary.<sup>63</sup> In determining the existence of a control in the case of parent/subsidiary relationship, accounting standards and company law apply the following tests.

### **7.1 The Accounting Standard Test**

According to standard 27 of the International Accounting Standard (IAS), "Consolidated and Separate Financial Statements" control is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than half of the voting power of an entity unless, in exceptional circumstances, it can be clearly demonstrated that such ownership does not constitute control. Control also exists when the parent owns 50% or less of the voting power of an entity when there is:

- a. power over more than half of the voting rights by virtue of an agreement with other investors;
- b. power to govern the financial and operating policies of the entity under a statute or an agreement;
- c. power to appoint or remove the majority of the members of the board of directors or equivalent governing body and control of the entity is by that board or body; or

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<sup>61</sup> Council Regulation (EC) No 2157/2001 of 8 October 2001 on the Statute for a European company (SE), art.3 and art.51 and Council Directive 2001/86/EC of 8 October 2001 supplementing the Statute for a European company with regard to the involvement of employees, both published in OJ L 294 of 10.11.2001

<sup>62</sup> L Gower and P Davies, op. cit. p.209.

<sup>63</sup> Vassya Prokopieva, parent Company Liability in Case of Subsidiary Insolvency, p.15.

- d. power to cast the majority of votes at meetings of the board of directors or equivalent governing body and control of the entity is by that board or body.

In the United Kingdom, the group accounts of certain parent companies are required to be prepared in accordance with International Accounting Standards (IAS) while the group accounts of other companies may be prepared in accordance with s.404 of the Companies Act 2006, or in accordance with international accounting standards "IAS group accounts" (S. 4.3). After the first financial year in which the directors of a parent company prepare IAS group accounts 'the first IAS year', all subsequent group accounts of the company must be prepared in accordance with international accounting standards unless there is a relevant change of circumstance. A parent company must prepare group accounts on a consolidated basis with respect to its activities as a 'parent undertaking' with respect to its subsidiary undertaking. An undertaking can be either a body corporate, partnership, or an unincorporated association. The accounts must give a true and fair view of the state of affairs as at the end of the financial year, and the profit or loss for the financial year, of the undertakings included in the consolidation as a whole, so far as concerns members of the company.

In Australia the Approved Accountant Standard AASB 1024 defines control as "the capacity of an entity to dominate decision-making, directly or indirectly, in relation to the financial and operating policies of another entity to enable that other entity to operate with it in pursuing the objectives of the controlled entity". Capacity is defined as "ability or power, whether direct or indirect, and includes ability or power that is presently exercisable as a result of, by means of, in

breach of, or by revocation of, any of or any combination of the following: (a) trusts; (b) relevant agreements; and (c) practices; whether or not enforceable”.

## 7.2 Company Law Tests

A comparable control test is set out in number of company laws, for example the Australian Corporation Act states that:<sup>64</sup>

- a. For the purposes of this Law, an entity controls a second entity if the first entity has the capacity to determine the outcome of decisions about the second entity’s financial and operating policies.
- b. In determining whether the first entity has this capacity:
  - i. the practical influence the first entity can exert (rather than the rights it can enforce) is the issue to be considered; and
  - ii. any practice or pattern of behaviour affecting the second entity’s financial or operating policies is to be taken into account (even if it involves a breach of an agreement or a breach of trust).

Under US law, the tests focus on the capacity of one company to determine, or in some cases influence, the decision-making of another company, and therefore achieve a coordinated central direction for the activities of the corporate group. For instance, the US Securities Code defines control, *inter alia*, as “... the power, directly or indirectly, to exercise a controlling influence over the management and policies of a company ... (either alone or pursuant to an arrangement or understanding with one or more other persons), whether through the ownership of voting securities, through one or more intermediary persons, by contract, or otherwise”.<sup>65</sup>

There can be difficulties in applying the parent/subsidiary and related company tests to corporate groups. For instance, whether one company controls the

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<sup>64</sup> Corporate Groups, Final Report, May 2000, p. 8.

<sup>65</sup> US Securities Code (1980) s 202(29).

board of directors of another company turns on a legal, rather than *de facto*, power. Also, the potential liability of an ultimate controlling company for the insolvent trading of a group company far removed down the corporate chain may turn on whether all intermediate group companies satisfy the holding/subsidiary company definition. Therefore, the accounting and Corporations Law control tests may better identify *de facto* control than the parent/subsidiary company test. For instance, there is no requirement that control depend on shareholding or control of the composition of the board of directors. The control tests could be applied to corporate group structures employing a series of interlocking shareholdings, each less than the holding/subsidiary company threshold, or vertical corporate groups that do not have holding/ subsidiary company continuity.<sup>66</sup>

## **8. How Do Jurisdictions govern Corporate Groups?**

While groups of companies are mainly governed by company law, other branches of law, e.g. labour law, tax law, anti-trust law, market regulation, bankruptcy law regulating groups of companies. Jurisdictions tend to adopt one of two broad approaches, either relying on traditional company law (including insolvency law) or developing a specialized body of law.<sup>67</sup> This is considered in detail below.

### **8.1 UK Law**

There has not been a strong demand in the United Kingdom for the introduction of law that would deal in a comprehensive way with the issues and problems arising from group activity. This may be attributable to legal culture. UK statutes

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<sup>66</sup> Corporate Groups, Final Report, Companies & Securities Advisory Committee, p.6

<sup>67</sup> Eike Thomas Bicker, op cit. p.3.

are extremely pragmatic. Instead of laying down board principles to deal with all contingencies, issues are dealt with on an individual and an ad hoc basis. It has been observed, rightly it is submitted, that most UK legislation is drafted in the form of specific rules, individual solutions to particular problems.<sup>68</sup> This emphasis on the particular and specific in the drafting of legislation is motivated by a desire to obtain a high degree of certainty as regards the scope of legislation. It will also be seen that many of the problems associated with the group form are not unique to the group form of trading but arise from the use of the limited liability company to carry out trading. Accordingly, these problems have been dealt with by principles, which apply to all aspects of company law and this has accordingly reduced the need for a special law to deal with groups.<sup>69</sup>

Although UK law does not possess a specific law of corporate groups, that phenomenon undoubtedly exists in the UK. The carrying on of business through groups is a salient feature of UK commercial life, and some evidence suggests that use of group form may be more widespread in the UK than in other comparable economies.<sup>70</sup>

UK law facilitates the creation of groups. It is permissible for one company to hold shares in another. The statutory requirement that all companies must possess at least two shareholders does not preclude the creation of a 'wholly owned subsidiary', as one of the shareholders can act as nominee for the other. And while a subsidiary is forbidden from being a member of its holding

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<sup>68</sup> P.S. Atiyah, *Pragmatism and Theory in English Law*, London, Stevens & Sons, (1987), p. 31.

<sup>69</sup> D.D. Prentice, *op. cit.* p. 287.

<sup>70</sup> There is no exhaustive survey of the group phenomenon in the United Kingdom, but a survey has been carried out of the group structure of companies within The Times 1000 UK top industrial, quoted companies concentrating on the companies lying in the 1-100 and 401- 500 size bands. It can be seen from this survey that the top fifty companies had over 10,000 subsidiaries and that the arithmetical average for each company is 230.

company, this prohibition does not apply where the subsidiary holds the shares as a personal representative or a trustee. The prohibition is justified in that (i) it precludes a parent company from trafficking in its own shares, (ii) it prevents the dilution of a parent company's capital and (iii) where the shares carry votes, it prevents the directors of a parent company from using these votes to keep them in control.<sup>71</sup>

The Companies Act 2006 contains a range of provisions regulating or prohibiting certain transactions between a company and its directors. The general purpose of these provisions is to prevent abuses. Thus s.197 prevents a company from making a loan to a director of its holding company. This prohibition extends in the case of a "relevant company" (broadly speaking a public company) to the making of loans to persons "connected" with a director. The Act contains elaborate provisions as to what constitutes a "connection", which embraces, *inter alia*, a company with which a director is "associated". For this purpose, a director will be treated as being "associated" with a company if, *inter alia*, he is interested in shares of that company which "carry more than one-fifth of the voting power at any general meeting of that body". The significance of this definition is that it defines the relationship of association in terms of less than control of half of the company's voting share capital.<sup>72</sup>

There is also a high degree of transparency with respect to the affairs of groups. The CA 2006 contains mandatory disclosure rules to protect creditors and minority shareholders. For example:

- a. A group's directors under s.399 have a duty to prepare a consolidated group accounts containing the financial statements and the auditors' and

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<sup>71</sup> D.D. Prentice, *op. cit.* p. 288.

<sup>72</sup> *Ibid.*, p. 298.

directors report. The consolidated accounts give the creditors and minority shareholders an accurate impression of the overall financial position of the group.

- b. A parent company must under s.409 provide details of the shares it holds in the subsidiaries and the subsidiaries' name and country of activity.
- c. A subsidiary has to name its ultimate parent. Furthermore, the directors have to prepare a report containing a fair review of the development of the business of the company and its subsidiary undertaking.
- d. Where a person acquires an interest in 3% or more of the 'relevant share capital' (defined as capital carrying rights to vote in all circumstances) of a public company, or ceases to be interested then he must make disclosure of such interest, and any alternations to it, within two days of the obligation arising. This obligation is extended to cover the interests in shares of a person's spouse, infant child, or a company which a person controls. Also, where persons acting in concert acquire shares in a public company, disclosure must be made of the shares acquired pursuant to the arrangement between them.<sup>73</sup>
- e. A public company under s.793 has wide powers to serve notice on any person whom it has reasonable cause to belief is interested in its shares, or was interested in its shares in the three year period prior to the service of the notice, to disclose the nature of the interest and to indicate if any other person was interested in its shares. If the company does not receive satisfactory answer to its enquiries, it can petition the court to place a freezing order on the shares which prevents the shares being voted, transferred, or any dividend being receivable with respect to them, until the relevant information has been received by the company or the order discharged. In addition, shareholders holding one tenth of the voting capital of the company can under s.803 require the company to exercise its power to determine the nature of the interest held by a person in its shares.

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<sup>73</sup> A Hicks & S Goo op.cit. p.64.



The effect of ss.793 and 803 coupled with the disclosure requirements mentioned above results in there being a high level of transparency with respect to the identity of the beneficial ownership of shares in an English public company. Moreover all group members, even wholly owned subsidiaries, are obliged to comply with the Act's provisions regulating how the affairs of a company are to be conducted (e.g. holding of meetings, preparation of accounts etc.). Some scholars argue that often there is no sensible reason for insisting that these procedures should apply to companies that are part of a group, and that, for example, it does not make any sense for a wholly owned subsidiary (which will more often than not be a private company) to hold an annual general meeting.<sup>74</sup>

The CA 2006 recognizes group relations in a number of other ways. For example, where inspectors are appointed to investigate the affairs of a company, they can also, to the extent that they consider necessary, investigate the affairs of other companies that are related to the company under investigation either as a parent company or as a subsidiary.<sup>75</sup> Another example is that a liquidator who has obtained information pursuant to his power of investigation would appear to be able to release it to other companies within a group.<sup>76</sup>

Outside of company law, special legislation has been introduced in a number of areas to deal with the phenomenon of groups, (such as tax, accounting law, labour law, criminal law and competition law).<sup>77</sup>

## **8.2 European Law**

The European Union has legislative capacity, in terms of which it may enact instruments whose provisions are binding throughout the territory of the EU, as

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<sup>74</sup> D.D. Prentice, *op. cit.* p. 295.

<sup>75</sup> Companies Act, 1985, s.433.

<sup>76</sup> Insolvency Act 1986, ss.235-237.

<sup>77</sup> In a wide range of situations, the tax regime lays down special rules for the taxation of the profits of companies that are part of a group. The underlying policy of these rules is to treat the group as a single economic entity for tax purposes. For example where there is, a transfer of assets among the members of a group (defined in terms of a 75% subsidiary), there will be no charge on any profit made by the disposing company nor will there be any allowable loss. Capital gains tax will only be payable on the disposition of the assets outside the group. See D.D. Prentice, *op. cit.* p. 297.

well as instruments that are binding on the governments of the member-states, principally so that the latter should take municipal legislative steps to bring their own laws into harmony with declared EU ends. Legislation of the former kind is usually enacted in a form of legislation known as a Regulation, and the latter type of legislation is usually in the form of a Directive.<sup>78</sup>

Two initiatives have been taken by the EU in matters of corporate law and corporate groups, the first fell within a longstanding EU programme of Corporate Law harmonization. Under this programme, the EU issued Directives so as to effect harmonization of Corporate Law principles throughout the EU. Fifteen Directives have been enacted and implemented by the member-states on various Corporate Law issues, such as the regulation of takeovers, insider trading, corporate accounts, protection of third party creditors, levels of capitalizations, and so on. In 1980, the EC issued a draft of what was proposed as the Ninth Draft Company Law Harmonization Directive (the so-called “Groups of Companies Directive”) <sup>79</sup>. It was intended that this Draft should mature into a permanent Directive setting out agreement among all the member-states as to the conditions under which an enterprise group would be determined as such and the basis on which the group might be treated as a single entity. This Directive never got beyond the preliminary draft stage. After the failure of this proposal, harmonization of the law relating to corporate groups was abandoned.

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<sup>78</sup> Harry Rajak, *op.cit.* p. 536.

<sup>79</sup> First version of 1974/75, Doc. No. XI/328/74, Doc. No. XI/593/75, later Doc. No. XI/215/77: amended version of 1984/85, Doc. No. III/1629/84; the text (without the comments) can also be found in (1985) ZGR 446-465.

In 1998, principles and proposals for European corporate group law were elaborated by the Forum Europaeum Konzernrecht.<sup>80</sup> The Forum made proposals to the EU and national legislatures for addressing the common problem of corporate groups in Europe. Its starting point was that the existence of such groups has long been an economic reality everywhere. To cope with this, framework rules by both European and national legislators are necessary. The Forum produced various recommendations for European corporate group law including disclosure requirements; the legal recognition of group management subject to certain safeguard conditions; buy-out and withdrawal rights; and, ultimately, liability for wrongful trading. The Forum rejected complete harmonisation and encouraged instead differentiated regulations grounded in part at the European level but more so at a member-state level. The recommendations were conceived on a building block basis, so that they need not necessarily be adopted *en bloc* by the EU and/or the Member States. On September 2001, the European Commission set up the High Level Group of Company Law Experts to make recommendations on a modern regulatory framework for company law in the EU. In its First Report of January 2002, the group dealt with issues related to the Takeover Bids Directive, which was

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<sup>80</sup> The Forum Europaeum Konzernrecht (Forum Europaeum Corporate Group Law) is a group of European legal scholars under the leadership of Hommelhoff, Hopt and Lutter working in close cooperation with Doralt (Vienna), Druet (St. Gallen), and Wymeersch (Gent). Supported by the Thyssen Foundation since 1992. The Forum in 1998 devised theses and recommendations for a European corporate group law. The Forum rejected complete harmonisation and encouraged instead differentiated regulations grounded in part at a European level, but more so at a member-state and business firm level. The recommendations have been conceived along a building block principle so that they need not necessarily be adopted *en bloc* by the European Commission and/or the Member States. The theses are in the meantime being discussed in Europe and beyond. Initially appearing in German (ZGR 1998, 672-772), the publication of the recommendations and their explanatory statements in various languages has contributed to their accessibility. In 2000 a version was published in English: *Corporate Group Law for Europe*, Forum Europaeum Konzernrecht, Stockholm (Corporate Governance Forum) 2000 and also in the *European Business Organization Law Review (EBOR)* 1 (2000) 165-264. In the latter publication, Windbichler comprehensively addresses the recommendations of the Forum Europaeum Konzernrecht, and Klüber shows how the proposals of the Forum and Australian corporate law reform recommendations relate to one another. This contribution likely represents the first instance of an extensive dialogue between continental Europe and Australia in the field of corporate law.

rejected by the European Parliament in July 2001. The group original mandate was further extend in April 2002 by the Commission following the ECOFIN Council meeting in Oviedo to deal specifically with number of corporate governance issues.<sup>81</sup>

On 4<sup>th</sup> November 2002, the group issued its final report. It took the view that the enactment of an autonomous body of law, specifically dealing with groups, was not to be recommended at EU level. It rejected a new attempt to bring about the Ninth Company Law Directive on group relations. Rather, it recommended that the Commission considered provisions within the existing range of corporate law to address particular problems. The areas where intervention could be needed were (i) the transparency of group structure and relations, (ii) the tensions between the interests of the group and of its parts, and (iii) the special problems of pyramid structures.<sup>82</sup>

The European Commission, following the High Level Group recommendation, now seeks to tackle the issue within the range of existing company and insolvency law measures, and takes the view that there is no need to revive the draft Ninth Directive. The Commission's proposal obviously bears resemblance to the British approach and similarly to the French '*dirigeant de fait*'-concept. First, it aims to enhance financial and non-financial disclosure with regard to the group's structure. This reflects the British approach to facilitate creditor self-help through mandatory disclosure rules. Second, it proposes a framework rule for corporate groups that will allow groups to adopt and implement a co-ordinated group policy, and on the other hand protects creditors adequately. By that the

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<sup>81</sup> Report of The High Level Group of Company Law Experts on a Modern Regulation Framework for Company law in Europe, p.1.

<sup>82</sup> Ibid. p.94.

Commission has taken up the French Rozenblum doctrine and shares the view of the High Level Group that some Member States, foremost the U.K., do not recognise the interest of the group as such, which impedes business efficiency and competitiveness.<sup>83</sup>

### **8.3 International initiatives**

In 1966, The UN established the United Nations Commission on International Trade Law (UNCITRAL) in express recognition of the disparities between national laws governing international trade and the extent to which these disparities create obstacles to the flow of trade. UNCITRAL was thus established as a vehicle for exploring and, where appropriate, recommending changes in order to create greater harmony within the legal systems of the member-states in matters of international trade law.

It has made a huge contribution to the current attempts to harmonize bankruptcy procedures where the debtor's business stretched across international boundaries. In 1997, UNCITRAL completed and published the Model Law on Cross-Border Insolvency and Guide to Enactment.<sup>84</sup> The nature of a Model Law is that, while not binding on any state, individual states will implement it as far as possible in the form in which it was drafted, and thereby bring wide international legislative uniformity.

Some sixteen countries have implemented the Model Law on Cross Border Insolvency, including the United States, U.K., Australia, New Zealand, South Africa, and Japan.<sup>85</sup> It was followed by the adoption by UNCITRAL and the UN General Assembly in 2004 and the publication in 2005, of the Legislative Guide

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<sup>83</sup> Eike Thomas Bicker, op cit. p.7

<sup>84</sup> [http://www.uncitral.org/uncitral/en/uncitral\\_texts/insolvency/1997Model.html](http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model.html).

<sup>85</sup> [http://www.uncitral.org/uncitral/en/uncitral\\_texts/insolvency/1997Model\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model_status.html).

on Insolvency Law,<sup>86</sup> which was designed to encourage member-states of the UN to adopt effective business insolvency regimes. Both these initiatives are essentially concerned with traditional single debtor insolvency, but the Legislative Guide references the issue of group insolvency. Moreover, the topic of Corporate Groups in Insolvency was referred to UNCITRAL's Insolvency Working Group (Working Group V), and the Working Group is nearing the end of its discussions, following which it will publish its list of recommendations.

It is thus too early to say anything substantive about this initiative in the matter of the insolvency in enterprise groups. Nevertheless, it may be helpful to recite the initial approach of the Working Group—in effect, the mandate that the Working Group saw itself inheriting<sup>87</sup>:

- a. It was indicated that the structure of corporate groups could vary greatly and be especially intricate, in particular, in the case of transnational corporate groups. Recent developments added further elements of complexity, for instance, in case of special forms of intra-group control, such as special purpose entities and joint ventures, as well as in the case of agreements for the temporary control of one company over another. It was added that economic activities, which were traditionally subject to a separate discipline, such as banking and insurance, were also increasingly performed in the context of corporate groups, thus adding an additional layer of complexity to their discipline.
- b. It was confirmed that, while most jurisdictions refrained from offering a general definition of corporate groups, such definitions often existed for special purposes, such as tax and accounting rules. In the insolvency field, the “separate entities approach” was prevalent, but certain instruments were available, under given conditions, to trigger the cross-liability of the companies belonging to the same corporate group.

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<sup>86</sup> [http://www.uncitral.org/uncitral/en/uncitral\\_texts/insolvency/2004Guide.html](http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/2004Guide.html).

<sup>87</sup> [http://www.uncitral.org/uncitral/en/commission/working\\_groups/5Insolvency.html](http://www.uncitral.org/uncitral/en/commission/working_groups/5Insolvency.html).

- c. In some jurisdictions that had recently reformed or attempted to reform their insolvency law to recognize the notion of corporate groups, it was observed that difficulties were encountered in the definition of that notion because of the need to achieve a balance between ensuring predictability and transparency and reflecting economic reality. It was suggested that reference to the notion of ownership, typically in terms of percentage of shares owned by the parent company, would provide a more certain basis for the definition of corporate groups. On the other hand, reference to the notion of control, while based on less objective parameters, would give more flexibility in addressing the diverse economic realities expressed by the operations of corporate groups.
- d. The view was expressed that corporations served many important social, commercial and legal purposes. The provision of limited liability, in particular, facilitated the raising capital for business purposes, enabled creditors to rely on the assets and liabilities of the corporate entity with which they dealt, and provided certainty in commercial relations. It was noted that those purposes were baseline commercial and legal principles in many nations, and that to interrupt reliance and the expectations that arose from those principles would require some extraordinary rationale. It was further suggested that the circumstances for disregarding those principles rarely occurred.

The Working Group changed the title of the concept from Corporate Groups to Enterprise Groups. Although it has divided its deliberations between Domestic and International issues, there is a substantial overlap between these two categories. Some of the issues in which this overlap occurs include the COMI of the group, post-commencement financing, procedural coordination, substantive consolidation, the appointment of a single insolvency representative, the reorganization of two or more group members, the approval of a single reorganization plan, avoidance proceedings, and equitable subordination.<sup>88</sup>

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<sup>88</sup> Harry Rajak, *op.cit.* pp. 543-545.

## **9. How are Corporate Groups regulated?**

Regulation of corporate groups in common law countries is generally based on one of two approaches, or a combination of them: the separate entity approach and the single enterprise approach. According to the former approach, each company in a corporate group is a separate legal entity with its own rights and duties, even when controlled or wholly or partly owned by another company and collectively engaged in the business of the group. This approach achieves the most important advantage of the group structure that it enables the parent company to create bulkheads, which prevent the whole group from sinking if one member is flooded. Under this approach, debts incurred by a company are debts of that company, not of the controllers of that company or of the corporate group collectively and the assets of the group cannot be pooled to pay for these debts.

By contrast, the single enterprise approach treats the corporate group as a unitary economic enterprise and hence the parent company is liable for all the debts of its insolvent controlled companies, whether or not wholly owned. These approaches are elaborated below.

### **9.1 The Separate Entity Approach**

Corporate law in common law countries has developed from the separate entity approach. In essence, this involves three inter-related principles, originally developed for single companies, but subsequently applied to corporate groups, namely:

- a. separate legal personality (corporate autonomy),
- b. limited liability of the shareholders of each company in a group, and



- c. the directors of a company in a corporate group owe fiduciary duties to that company and not to other entities in that corporate group.

### **A. Separate Legal Personality**

One distinct feature of a company is that it exists as a legal entity separate from its members. From this it follows that a company can sue and be sued in its own name; has its own right and duties; can enter into contractual relations of its own accord; and own property itself distinct from its shareholders. The landmark case that affirmed separate legal personality principle is *Salomon v. Salomon and Co. Ltd.*<sup>89</sup> Mr. Aron Salomon had for years carried on business as leather merchant and boot manufacturer. He decided to convert his business into a company with limited liability. In order to maintain complete control over the company he restricted the membership of the company to himself and to six other members of his family. All seven thus subscribed to the memorandum for one share each, and he appointed two of his sons as directors. The company entered into a contract with Mr. Salomon in order to purchase Mr. Salomon's business. The purchase price was fixed at £38,782, which was apportioned amongst the various assets that made up the business. It was to be paid in cash, except for £16,000, which was to be satisfied by issuing debentures. The company had £40,000 in £1 pound shares as its nominal capital, with 20,000 of these shares allotted to Mr. Salomon. £10,000 of debentures was also issued to him. The company floated by Mr. Salomon did not make a profit in the market, and had to be wound up within a year. At this point, the company had outstanding debts to the extent of about £7,733. It was the contention of the official liquidator that the company was simply a sham designed by Mr.

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<sup>89</sup> *Salomon v Salomon & Co* [1897] AC 22.

Salomon in order to be able to limit his own liability; and that this should not be allowed as the creditors would be adversely affected while Mr. Salomon would have little to lose. The liquidator thus proposed that Mr. Salomon be made personally liable for the debts of the company as the company was nothing more than Mr. Salomon himself wearing a mask; and that the debenture debt to him by fulfilled only after all the other creditors of the company were satisfied.

The trial court agreed with the liquidator on the basis that the sole purpose of Mr. Salomon in forming the company was to use it as his agent in running the business, and therefore by the principles of agency, Mr. Salomon should be held personally liable. The Court of Appeal reached the same conclusion though on the different ground that though the incorporation of the company itself was not invalid, the purpose for which Mr. Salomon had formed the company was unlawful. However, the House of Lords unanimously reversed the decision of the two lower courts. The Lords pointed out the motive for becoming a shareholder cannot be a field of enquiry, and neither can any assumption be made on the basis of who the shareholders are or the number of shares each holds. According to their Lordships, as long as the company was formed in accordance with the legal requirements it would have to be treated as separate legal entity, distinct from its individual shareholders.

Thus the issue of limited liability and separate corporate personality were finally settled by the highest judicial body in the United Kingdom. *Salomon* established the separate legal personality of a company. The case along with such cases as *Asbbury Railway Carriage and Iron Co. v. Riche*<sup>90</sup> and *Trevor v.*

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<sup>90</sup> [1875] LR 7 HL 653.

*Withitworth*,<sup>91</sup> made clear that incorporators of a company could structure its capital so as to minimise their risk of the company's failure by taking some form of secured debenture.

The separate legal personality doctrine meant that a corporation's members are not liable for its debts, and that when a company acts, it does so in its own right and not just as an alias for its controllers. Similarly, shareholders are not liable for the company's debts beyond their initial capital investment, and have no proprietary interest in the property of the company.

As applied in Salomon's case, the consequence was that while the creditors of his business had claims against the company which conducted the business, neither they nor the company had any direct claim against Mr. Salomon, who was entitled to rely on the security granted by the company to him for the debt which it owed him.

Applied to a corporate group context, this reasoning entails that creditors who contract with a subsidiary have no claim against other companies within the group, or against the parent company.<sup>92</sup> The extension of the separate corporate personality doctrine to group of companies has often been supported by courts in common law countries. For example, in the Australian case of *Briggs v James Hardie & Co Pty Ltd*<sup>93</sup> the court stated:

“The proposition that a company has a separate legal personality from its members survived the coming into existence of the large numbers of fully-owned subsidiaries of

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<sup>91</sup> [1887] 12 App. Cas. 409.

<sup>92</sup> Robert P Austin, op.cit. p.71.

<sup>93</sup> [1989] 7 ACLC 481 at 861.

companies and their complete domination by their holding company ...”

Likewise, in *Adams v. Cape Industries plc*<sup>94</sup>, the English Court of Appeal stated that:

“Our law, for better or worse, recognises the creation of subsidiary companies, which though in one sense the creatures of their parent companies, will nevertheless under the general law fall to be treated as separate legal entities with all the rights and liabilities which would normally attach to separate legal entities”.

Equally, the High Court of Australia in *Hobart Bridge Co. Ltd. v. Federal Commissioner of Taxation*<sup>95</sup>, rejected an invitation to disregard the corporate entity lying between the investor and the business, stating that,

“It is said that this was ‘machinery’, but that is true of all participations in limited liability companies. They and their operations are simply the machinery, in an economic sense, by which natural persons, who desire to limit their liability, participate in undertakings which they cannot manage to carry on themselves, either alone or in partnership, but, legally speaking, this machinery is not impersonal though it is inanimate. Between the investor, who participates as a shareholder, and the undertaking carried on, the law interposes another person, real though artificial, the company itself, and the business carried on is the business of that company, and the capital

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<sup>94</sup> [1991] 1 ALL ER 929 at 1019.

<sup>95</sup> [1951] 82 CLR 372 (HCA).

employed is its capital and not in either case the business or the capital of the shareholders. Assuming, of course, that the company is duly formed and is not a sham (of which there is no suggestion here), the idea that it is mere machinery for affecting the purposes of the shareholders is a layman's fallacy. It is a figure of speech, which cannot alter the legal aspect of the facts."

The application of the corporate autonomy doctrine to corporate groups has various consequences, including:

- a. The debts incurred by each company are exclusively its debts, not of its controllers or of the corporate group collectively. The assets of the group cannot be pooled to pay for these debts.<sup>96</sup>
- b. Parent companies are not automatically parties to contracts entered into by other group companies with external persons.<sup>97</sup>
- c. A parent company cannot take into account the undistributed profits of other group companies in determining its own profits. However, there is no restriction on the right of a subsidiary company to pass on profits to its holding company via a distribution to shareholders.<sup>98</sup>
- d. A group company may breach its obligations to an external party if it passes confidential information about that party to its parent company.<sup>99</sup>

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<sup>96</sup> *Walker v Wimborne*, [1976] 137 CLR 1 at 6-7.

<sup>97</sup> *Pioneer Concrete Services Ltd v Yelnah Pty Ltd*, [1986] 11 ACLR 108.

<sup>98</sup> The New Zealand Court of Appeal said that 'there is no principle of company law precluding a wholly-owned subsidiary from paying over its profit reserves to the parent company by some act which it has capacity to perform, provided that this does not improperly prejudice the interests of its creditors.' *Corporate Groups Report, Final Report*, May 2000, p.16.

<sup>99</sup> *Bank of Tokyo v Karoon* [1986] 3 All E.R. 468 at 476.

## **B. Limited Liability**

Limited Liability means that shareholders of a company are not personally liable, as shareholders, for the debts incurred or wrongs committed by the firm. If the firm fails, a shareholder's losses thus are limited to the amount the shareholder initially paid to purchase his or her stock. In other words: unless otherwise provided in the article of incorporation, a shareholder of a corporation is not personally liable for the acts or debts of the corporation unless that he becomes liable by reason of his own acts or conduct.<sup>100</sup>

The principle of limited liability was originally introduced by the UK's Limited Liability Act 1855. The invention of limited liability has greatly influenced the economy and the legal environment, to the extent that President Nicholas Murray Butler of Columbia pronounced in 1911: "I weigh my words when I say that in my judgment the limited liability corporation is the greatest single discovery of modern times... Even steam and electricity are far less important than the limited liability corporation, and they would be reduced to comparative impotence without it".<sup>101</sup>

Hicks<sup>102</sup> describes the benefit of limited liability, stating that 'to be a sleeping partner without limited liability would be exceedingly dangerous'. Accordingly persons will invest in a firm with unlimited liability only where they can control the riskiness of the firm's activities and also monitor the wealth of their co-adventures. Indeed, if there were no limited liability, such investments would have hardly be made at all, except in the public sector. Thus, it is not surprising

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<sup>100</sup> Section 6.22(b) of the US Model Business Corporation Act.

<sup>101</sup> Quoted in Bernard F. Cataldo, *Limited Liability in One-Man Companies and Subsidiary Corporations*, (1953) 18 Law & Contemporary Problems 473.

<sup>102</sup> Hicks, *Limited Liability :Pros and Cons*, in T Orhnia (ed.), *Limited Liability and the Corporation*, London, Croom Helm, (1982), p.179

that the building of railways was historically connected with the coming of limited liability.

Limited liability achieves various economic goals based upon principles of economic efficiency:<sup>103</sup>

- a. It decreases the need for shareholders to monitor the managers of companies in which they invest because the financial consequences of company failure are limited. Shareholders may have neither the incentive nor the expertise to monitor the actions of managers.
- b. It provides incentives for managers to act efficiently and in the interest of shareholders.
- c. It assists the efficient operation of the securities markets because the prices at which shares trade does not depend upon an evaluation of the wealth of individual shareholders.
- d. It permits efficient diversification by shareholders which in turn allows shareholders to reduce their individual risk. If a principle of unlimited liability applies so that a shareholder could lose his or her entire wealth by reason of the failure of one company, shareholders would have an incentive to minimise the number of shares held in different companies and insist on a higher return from their investment because of the higher risk they face. Consequently, limited liability not only allows diversification but permits companies to raise capital at lower costs because of the reduced risk faced by shareholders.
- e. It facilitates optimal investment decisions by managers and provides incentives for shareholders to hold diversified portfolios. Under such circumstances, managers should invest in project with positive net values and can do so without exposing each shareholder to the loss of his or her personal wealth.

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<sup>103</sup> F Easterbrook and D Fischel, *The Economic Structure of Corporate Law*, Harvard University Press, (1991), p. 414.

- f. It facilitates the transferability of shares, and greatly cuts down the cost of carrying on business in a collective form, in that shareholders will not need to monitor the wealth of the fellow shareholders which they otherwise would be in a regime of unlimited liability.<sup>104</sup>

In terms of groups of companies, Blumberg<sup>105</sup> argues that number of justifications for limited liability have either limited application or no application to holding companies and their wholly-owned subsidiaries for the following reasons:

- a. In the context of corporate groups, the reduction of monitoring argument is valid mainly where shareholding in a particular group company is widely dispersed. It would be impractical, as well as unduly costly, to impose any monitoring obligation on shareholders in those circumstances. However, this argument is less convincing where a group company is effectively controlled by its parent company. The parent can use its shareholding to control the decisions of any wholly-owned subsidiary or otherwise monitor the activities or financial performance of other controlled companies. Limited liability can operate in this context as a disincentive for a parent company to closely monitor its group companies.
- b. The market efficiency argument is relevant to listed group companies whose shares are publicly traded. It has no application to closely or wholly-owned subsidiaries whose shares are not tradable. Nor is the equity diversity argument relevant where shares in a group company are

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<sup>104</sup> Dan Prentice, *Corporate Personality, Limited Liability and the Protection of Creditors*, in *Corporate Personality in the 20<sup>th</sup> Century*, Hart Publishing, (1998), p.101.

<sup>105</sup> P Blumberg, *Limited Liability and Corporate Groups*, (1986), *Journal of Corporation law* 573, at 623-26.



issued primarily to control that company, rather than to invest equity capital in it.

- c. Possibly the strongest argument for limited liability in the corporate group context is its role in facilitating enterprise. Without limited liability, controlling shareholders of wholly- or even partly-owned subsidiaries may risk all or much of their wealth through the activities of these subsidiaries. Nevertheless, permitting parent companies, as controlling shareholders, to rely on limited liability can increase the risk of “moral hazard”, or displacement of business risks to outsiders, in some circumstances.
- d. If limited liability is absolute, a parent can form a subsidiary with minimum capitalization for the purposes of engaging in risky activities. If things go well, the parent captures the benefits. If things go poorly, the subsidiary declares bankruptcy [to the detriment of its outstanding unsecured creditors], and the parent creates another [subsidiary] with the same managers to engage in the same activities. This asymmetry between benefits and costs, if limited liability is absolute, would create incentives to engage in a socially excessive amount of risk activities.

The above argument provides general support for rethinking some aspects of limited liability in the context of corporate groups. The full effects of application of limited liability were not clear at the time of its emergence, since limited liability was not an essential characteristic of corporate law. Theories supporting limited liability ignore contemporary economic realities because parent companies and their subsidiaries are collectively conducting a common enterprise. Thus limited liability, being designed to protect shareholders not

enterprises themselves, does not aid economic efficiency in the case of corporate groups. Moreover, there is a significant tension between the legal principle that a company is a separate legal entity and therefore desiring of limited liability, and the fact that many corporate groups operate as a single entity because of the economic benefits that result from the integration of activities.<sup>106</sup>

### **C. Directors' Duties**

Since the separate legal entity approach treats a company as a separate and distinct entity, so that its interests cannot be submerged with those of the parent or with other members of the group, a director of a particular company is not entitled to sacrifice its interests. The interests of other group companies may be taken into account only to the extent that this furthers the interests of that company. A director would breach his fiduciary duties if he sought to put the interest of the corporate group above that of the company. Thus the orthodox common law is that a director of a company in a corporate group owes fiduciary duties to that company and not to other entities in that group, even though he is appointed by the parent company or may even be a director of the parent company. Likewise, the directors of a parent company will owe no fiduciary duties to the subsidiary.<sup>107</sup> The Cork Committee assumed this principle in stating that 'the present law (and however much it may be ignored in practice, it remains the law and enforceable as such) is that the directors of each separate

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<sup>106</sup> Ian M Ramsay, *Holding Company Liability for the Debts of an Insolvent Subsidiary*, (1994) U.N.S.W.LR 500 at 537.

<sup>107</sup> It also follows from this that it would not be possible for a parent company and its subsidiary to enter into a legally binding control agreement. This would constitute an abdication by the directors of the subsidiary of their responsibilities and would be a breach of duty. D.D. Prentice, *op.cit.* p. 291.

group company owe duties to that separate company and must consider that separate company's interests'.<sup>108</sup>

This principle was confirmed by the courts. For example, Mason J in *Walker v. Wimborne*,<sup>109</sup> stated that:

“the director of a company which is a part of large group must adhere to the fundamental principle that each of the companies is a separate and independent legal entity, and that it is the duty of the directors to consult its interests and its interests alone in deciding whether payment should be made to other companies”.

Thus there is a breach of duty where the directors of a company which is a part of a group act on the instruction of the parent company, failing to consider the interests of the subsidiary. There will be also situations where it will not be possible to equate the interests of an individual company in a group with those of the group, and it will be improper for the directors of such a company to act to further the group's interests if this is not also in the interests of the that company.

Although each company in a corporate group must be treated as having its own interests, different tests have been expressed by courts regarding the extent to which directors, when performing their duties, are able to consider the interests of other companies within the corporate group. In *Charterbridge Corporation Ltd. v. Lloyds Bank Ltd*<sup>110</sup>, Pennycuik J had to consider whether directors of a company (C) has acted in its interests when they had it guarantee payments of a debt owed to a bank by an associated company. The judge found that the

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<sup>108</sup> Cork Committee Report, Para. 1951.

<sup>109</sup> [1976] 3 ACLR 529 at 532, per Mason J.

<sup>110</sup> [1970] 1 Ch 62 at 74.

directors looked to the benefit of the corporate group as a whole and did not give separate consideration to the benefit of C. In this situation, the judge proposed the following test for whether directors have breached their duties:

“The proper test, I think, in the absence of actual separate consideration, must be whether an intelligent and honest man in the position of a director of the company concerned, could, in the whole of the existing circumstances, have reasonably believed that the transactions were for the benefit of the company”.

However in *Equiticorp Finance Ltd v. Bank of New Zealand*,<sup>111</sup> the Australian Court of Appeals stated that the preferable test is that where directors have failed to consider the interests of the company and instead have consider the interests of the corporate group they should be found to have committed a breach of duty. If, however, upon an objective assessment, the transaction could be said to be in the interests of the company, then no consequence would result from the breach of duty.

A director’s duty to look to the interests of his company rises a difficult question what those interests may be, particularly when one is dealing with a wholly owned subsidiary. The answer to this question will vary with the context.<sup>112</sup>

Where a company is insolvent, the interest of the company normally taken as those of its shareholders. Thus in *Brady v Brady*<sup>113</sup> it was stated that:

“The interests of the company, an artificial person, cannot be distinguished from the interests of the persons who are interested in it. Who are those persons? Where a company is both going and solvent,

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<sup>111</sup> [1993] 32 N.S.W.L.R. 50.

<sup>112</sup> D.D. Prentice, op. cit. p. 295.

<sup>113</sup> B CLC 20 [1988].

first and foremost come the shareholders, present and no doubt future as well. How material are the interests of the creditors in such a case? Admittedly, existing creditors are interested in the assets of the company as the only source for the satisfaction of their debts. But in a case where the assets are enormous and the debts minimal it is reasonable to suppose that the interests of the creditors ought not to count for very little. Conversely, where the company is insolvent, or even doubtfully solvent, the interests of the company are in reality the interests of existing creditors alone”.

So where a company has substantial creditors, then they will have prior claims and the interests of the company will not be those of the shareholders. In fact, if the company is insolvent, the shareholders will cease to have any continued interest in the company.

The rule against fiduciaries placing themselves in a position where their own interests conflict with those of the person to whom their fiduciary obligations are owed is very strict. However in certain situations, courts and legislatures have found ways of relaxing this rule to accommodate the realities of modern commerce in relation to companies within corporate groups. An example of parliamentary intervention in this regard is s.131(2) of the New Zealand Companies Act 1993, which provides that directors of a company that is a wholly owned subsidiary may, if expressly permitted to do so by the constitution of the company, act in a manner which they believe to be in the best interests of the holding company even though it may not be in the best interests of the subsidiary. Where the subsidiary is not wholly owned, s.131(2) further requires

that the directors must obtain the prior agreement of the shareholders (other than the holding company) of the subsidiary.<sup>114</sup>

Another example is s.187 of the Australian Corporations Act. According to this a director of a corporation that is a wholly-owned subsidiary of a body corporate is taken to act in good faith in the best interest of the subsidiary if (a) the constitution of the subsidiary expressly authorises the director to act in the best interests of the holding company; and (b) the director acts in good faith of the best interests of the holding company; and (c) the subsidiary is not insolvent at the time the director acts and does not become insolvent because of the director's act. Obviously, s.187's operation is confined to directors of wholly owned subsidiary companies and does not extend to the directors of companies that are members of a group in any other way. Prior to the introduction of s.187, the Australian courts developed a concept of 'derivative benefits' in relation to companies within a corporate group.

Mason J in *Walker v Wimborne*<sup>115</sup> acknowledged that a company's best interests may sometimes be bound up inextricably with what is best for the group of which it is a member. The example he cited was that of an intra-group loan: in such a case the payment of money by company A to company B to enable company B to carry on its business may have derivative benefits for company A as a shareholder in company B, if that company is enabled to trade profitably or realize its assets to advantage. Mason J observes that directors might properly act in the interests of a subsidiary company of their own company where 'derivative benefits' will flow to their own company from so

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<sup>114</sup> Ian M. Ramsay, Allocating Liability in Corporate Group: an Australian Perspective, Connecticut Journal of International Law, Vol 13, 329 at 350.

<sup>115</sup> 137C.L.R.1 (High Court of Australia) (1976).

acting. This statement draws attention to the fact that such “derivative benefits” will flow due to the position of the directors’ own company as a shareholder of the subsidiary. The statement can also be interpreted to permit the making of decisions by directors of a subsidiary that are for the primary benefit of their holding company, again due to the shareholding that links the companies together.

How can the directors of a company A conclude that A will gain “derivative benefits” from an action that is ostensibly in the best interests of companies A and B as a whole, or simply in the best interests of company B, where companies A and B belong to the same corporate group? The answer to this question was laid down in *Charterbridge Corporation Ltd v Lloyds Bank Ltd*.<sup>116</sup>

When considering whether directors of a company have acted in the best interests of that company in a situation where it appears that they have in fact acted in the best interests of a group of companies or in the best interests of another company within the group of which their own company is a member, the court might consider whether an intelligent and honest man in the position of a director of the company concerned could, in the whole of the existing circumstances, have reasonably believed that the transactions in question were for the benefit of the company.

From the above, the obvious conclusion is that office holders of the subsidiary company, who will have been appointed by the parent company with the aim, whether explicit or implicit, to serve its interests, face the challenge of dealing with conflicting fiduciary and statutory duties to the parent company and the

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<sup>116</sup> (1970) Ch.62.

subsidiary and they need to be aware of both risks and responsibilities of such situation.

## **9.2 Evaluation of the Separate Legal Entity Approach**

The separate legal entity approach for groups of companies has been strongly criticised as not compatible with commercial practice especially in the case that the affairs of companies within a group are conducted in the overall interests of the group. Thus the Cork Committee Report states (at Para. 1926):

“In practice, however, the affairs of companies in a group are often conducted by management by reference to the interests of the group as a whole. The control, which the parent company has over the composition of the board of each of the subsidiaries and the series of common directorships which this often entails mean that, transaction between companies in the group can be, and often are, conducted on a basis which is not arms length. Assets may be transferred between group companies at lower than market value. Loans may be made without interest or at less than market rates. Guarantees may be given by one group company of another group company's obligations for no charge and without reference to the interests of the guaranteeing company. Dividends may be paid from a subsidiary to the parent without regard to the cash requirements of the subsidiary.”

The major weakness of the approach is that it takes no account of intra group liability problems. This is because it considers matters from the standpoint that the separateness of the constituent corporations in a group is the normal rule, with cases where the courts deemed justifiable the disregard of such separateness as exceptions. However, there is no consistent basis for



determining when such exceptions should exist. Thus cases which are virtually identical on their facts see the courts reaching completely contrary results.<sup>117</sup> Blumberg suggests that "this is a jurisprudence of epithet and metaphor". The formalism of this approach is also inconsistent with the implementation of the legal policies underlying the concrete liability issue at stake. Its undifferentiated character often prevents the achievement of the objectives pursued by the law.<sup>118</sup> It is likely to be the source of important economic inefficiency with regard to the management and organisation of polycorporate enterprises themselves. While the limited liability rule is often praised as supporting higher economic and social efficiency regarding all corporate actors involved (shareholders, managers, creditors), its automatic extension to the field of polycorporate groups seriously increases the risk of moral hazard, which notoriously generates inefficient allocation of business risks and inevitably jeopardises the interests of both creditors and minority shareholders.<sup>119</sup>

### **9.3 The Single Enterprise Approach**

Despite the policy reasons for protecting limited liability, some commentators have noted an "alarming trend to disregarding the corporation in situations for which no predictable basis can be ascertained".<sup>120</sup> One doctrine that has been heavily criticized as an improper and unwise criticism of this doctrine, but has become more prominent as courts have increasingly recognized it as an acceptable basis for "piercing the corporate veil" is the single business

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<sup>117</sup> See for example, *D.H.N Food Distributors Ltd. V. Tower Hamlets London Borough Council* [1976] W.L.R. 852; and *Woolfson v. Strathclyde Regional Council* [1978] S.C. (H.L.) 90.

<sup>118</sup> Blumberg, *The Increasing Recognition of Enterprise Principles in Determining Parent and Subsidiary Corporation Liabilities*, (1996), 28 Connecticut Law Review 295 at.299.

<sup>119</sup> Jose Antunes, op.cit. p.19.

<sup>120</sup> For more justification of the approach see G West & B Bodamer, *Corporations*, 59 SMU L. REV. 1143, (2006).

enterprise theory. This approach treats the corporate group as a unitary economic enterprise, functioning to further the interests of the group as a whole, or those of its dominant corporate body. It may more closely reflect the economic functioning and organisational structure of those corporate groups that operate under a highly centralised governance system. It may also better reflect the expectation of creditors dealing with a corporate group, who have been led to believe that they are doing business with the group as a whole and can rely on the creditworthiness of the overall group rather than that of an individual group company.

In contrast to the separate entity approach, a single enterprise approach adopts the following governing principles:

- a. the dominant company in a group is entitled to operate the group companies it controls for the benefit of the corporate group collectively, even if this is contrary to the interests of particular controlled companies or their minority shareholders.
- b. directors of group companies owe their fiduciary loyalty primarily to the parent company or to the corporate group collectively, not to their individual group company.
- c. the parent is liable for all the debts of its insolvent controlled companies, whether or not wholly-owned.

This doctrine allows courts to impose joint liability on two corporations when they are not operated as separate entities and their resources are used for a common purpose. In particular, courts have frequently been asked to determine whether a corporate parent should meet the liabilities of its subsidiary if the

parent exercised considerable control or dominion over the subsidiary. Faced with this issue, in *Berkey v. Third Avenue Railway Co*<sup>121</sup> a US court stated:

‘The whole problem of the relation between parent and subsidiary corporations is one that is still enveloped in the mist of metaphor. Metaphors in law are to be narrowly watched, for starting as devices to liberate thought; they end often by enslaving it. We say at times that the corporate entity will be ignored when the parent corporation operates a business through a subsidiary which is characterized as an ‘alias’ or a ‘dummy’. All this is well enough if the pictures queness of the epithets does not lead us to forget that the essential term to be defined is the act of operation. Dominion may be so complete, interference so obtrusive that by the general rules of agency the parent will be a principal and the subsidiary an agent. Where control is less than this, we are remitted to the test of honesty and justice....’

The single enterprise approach has important economic shortcomings. By exposing parent corporations to potential liability for the defaults of each subsidiary and thus to a permanent threat of a group insolvency, such a system is likely to force group networks to adopt inefficient, hierarchically and centralised-oriented organisational structures as to avoid risk exposure. Moreover, it is also likely to fall short from the viewpoint of the protection of shareholders and creditors of affiliate corporations. Operating virtually as a sort of liability insurance against subsidiary default risk, it provides minority shareholders with a sort of windfall for which they have not paid. In addition, it gives extra protection against the defaults of corporate debtors originating from

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<sup>121</sup> N.Y. 84, 155 N.E. 58, 61 (N.Y. 1926).

purely fortuitous market or casual circumstances, from which creditors of independent corporations under similar circumstances do not benefit at all.<sup>122</sup>

According to the supporters of this approach, because shareholders or parents will always control, or at least have the potential to control, their corporations, to hold a shareholder liable merely because it controlled a corporation's affairs would eviscerate the notion of limited liability, and thus piercing the corporate veil under such circumstances, without more, would be inappropriate.

Contrary to the above, some Scholars find single enterprise approach uncertain and overly rigid for the following reasons:<sup>123</sup>

- a. The vagueness of the central concept of a "group of companies" is likely to create an uncertain legal environment for the operation of polycorporate enterprises. This is particularly serious for parent corporations, exposing them to a permanent threat of unexpected liability is hazardous for the entire group's financial and economic stability, whose fate would ultimately depend on the idiosyncrasies of jurisprudential construction.
- b. As a result of the various presumptions which support the concept of the group, in the overwhelming majority of cases it should be enough for creditors of a subsidiary to prove the existence of the legal or factual instrument from which stems the possibility of the parent exercising a dominant influence over the subsidiary, in order to set in motion a system of unlimited liability for the parent.

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<sup>122</sup> Jose Antunes, op. cit. p. 22.

<sup>123</sup> Ibid, p. 21.

- c. By imposing indiscriminately a uniform solution to all types of corporate groups, it fails to provide a flexible and differentiated regime able to accommodate the diversity of organizational and governance structures.

However, the implementation of separate entity approach raises main critical question, better to be addressed here, do creditors require protection or should they be expected to contract to protect themselves?

Most creditors of most companies are eventually paid, and commercial life goes on as usual. In addition, most creditors who are not paid sums due will eventually take some form of legal action, other than winding up, to obtain judgment and, if need be, execution.<sup>124</sup> However, the existence of corporate groups may exacerbate problems for creditors. The creation of complex group structures may be used to conceal the true financial position of individual companies from creditors. It has been noted that, where a company in a corporate group is in financial difficulties, managers may move assets from that company to other companies in the group that have a better chance of survival.<sup>125</sup> This will be at the expense of the creditors of the company in financial difficulty.

The creditors' risk increases upon corporate insolvency, where shareholders have an even more powerful incentive to engage in risky investments. In addition to such risks, the uncertainty of the law and the discrepancies between the law and commercial reality threaten the

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<sup>124</sup> Dan Prentice, *op. cit.* p.99.

<sup>125</sup> W Forst, *Organizational Form, Misappropriation Risk, and the Substantive Consolidation of Corporate Groups*, (1993), 44 *Hastings L.J.* p. 485.

creditors' interests. Rogers C.J highlighted these discrepancies in *Qintex Australia Finance Ltd. V. Schroders Australia Ltd*,<sup>126</sup>:

“As I see it, there is today a tension between the realities of commercial life and the applicable law in circumstances such as those of the present case. In the everyday rush and bustle of commercial life in the last decade it was seldom that participants to transactions involving conglomerates with a large number of subsidiaries paused to consider which of the subsidiaries should become the contracting party . . . it may be desirable for Parliament to consider whether this distinction between the law and commercial practice should be maintained. This is especially the case today when many collapses of conglomerates occasion many disputes. Regularly, liquidators of subsidiaries, or of the holding company, come to court to argue as to which of their charges bears the liability . . . [C]reditors of failed companies encounter difficulty when they have to select from among the moving targets the company with which they consider they concluded a contract.”

The above-mentioned risks and the natural conflicts of interest between a company's shareholders and creditors have led some commentators to call for protection for creditors, as it is unfair that they should suffer loss because a holding company operated a subsidiary to which they loaned money without realising that it was insolvent<sup>127</sup>.

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<sup>126</sup> [1990] 3 .A.C.S.R 267.

<sup>127</sup> Smith and Warner identify four major sources of conflict: (a) the payment of excessive dividends; (b) claim dilution; (c) asset substitution; and (d) excessive risk taking. C W Smith and J B Warner, *On Financial Contracting: An Analysis of Bond Covenants*, (1979), 7 J of Fin Econ, p. 177.

Other commentators argue that the creditors are not entitled to special protection because:

- a. Creditors when dealing with companies are fully aware that the principle of limited liability will preclude recovery from members of the company, and therefore they should set the terms of the bargain with the company so as to ensure compensation for this risk.
- b. Creditors should contract so as to protect themselves against the prospect of not being paid. For example, the interest rate on any loan negotiated between the creditor and the company can be expected to reflect the risks that the creditor faces. Moreover, the contract may contain restrictions on the activities of the company. For example, it may restrict the amount that the company can pay out in dividends. There may also be restrictions on the company incurring debt of a similar or higher priority. These types of restrictions are common in debenture trust deeds.
- c. There are enough constraints upon companies which operate to protect the interests of creditors. There is the maintenance of share capital doctrine.<sup>128</sup> Creditors accept the risk that a company whose members enjoy limited liability may lose money in the ordinary course of its business. But they are entitled to protection against reduction of the company's net assets in other ways such as return of paid-up capital to shareholders either by way of purported but improper dividend, by unregulated buying-back of shares before a winding up, or by giving its assets away in a manner not incidental to its business.
- d. An additional constraint that operates to protect creditors' interests is the reputations of the shareholders and the managers of the company with which the creditors are contracting. Shareholders and managers will be reluctant to undertake actions which harm their reputations and which may make it difficult to raise capital in the future.<sup>129</sup>

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<sup>128</sup> H Ford, R Austin & I Ramsay, *op.cit.*p. 829.

<sup>129</sup> Ian M Ramsay,  *Holding Company Liability for the Debts of an Insolvent Subsidiary*, (1994) 17 U.N.S.W.L.R. 500 at 524.

In the context of corporate groups, creditors have to take special precautions. The onus should lie with the creditor to ascertain which company in the group he is dealing with, and to ensure that the contract documentation reflects that understanding.<sup>130</sup> If creditors expect to be able to select the most wealthy corporate group entity as the entity to be made accountable for their debt, they have an unrealistic expectation which the law should not be required to satisfy'.<sup>131</sup> On this view, the key issue will be whether a creditor has sufficient information about companies and their creditworthiness to negotiate effectively with the correct entity.

Although the theory that creditors should be obliged to protect themselves is interesting, it has two main weaknesses:<sup>132</sup>

- a. The theory that creditors charge different interest rates for different levels of risk does not work where the costs of the creditor acquiring adequate information about the level of risk are disproportionate to the value of the transaction. The theory also does not work in the case of involuntary creditors (such as tort claimants). Moreover, dispersed creditors face a collective action problem and may therefore lack appropriate incentives to undertake joint action to prevent opportunistic behavior by the company that threatens payment to them. Finally, even sophisticated creditors cannot foresee all contingencies and contract for protection against them. Significant corporate restructuring, such as leveraged buyouts, have seen transfers of wealth from sophisticated creditors (namely some bondholders) to shareholders. The result has been a vigorous debate concerning whether directors should owe fiduciary duties to bondholders as a means of protection.

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<sup>130</sup> Robert P Austin, *op.cit.* p. 81.

<sup>131</sup> S Firdman, *Removal of the Corporate Veil: Suggestions for Law Reform in Qintex*, Published at *Corporate Personality in the 29th Century*, Hart Publishing, (1998).

<sup>132</sup> Ian M Ramsay,  *Holding Company Liability for the Debts of an Insolvent Subsidiary*, (1994) 17 U.N.S.W.L.R. 500 at 522-524.



- b. The effectiveness of the legal rules underpinning the maintenance of share capital doctrine applies only when the present value of maintaining the company as a going concern exceeds the value of the benefits derived from taking action that adversely affects creditors (for example, the payment of excessive dividends). A final constraint is that, although shareholders may want to take actions which adversely affect creditors, the shareholders may lack effective control over the management of the company because of a separation of ownership and control.' However, whether the separation of ownership and control adequately protects creditors is open to question. First, as managers increase the percentage of shares that they own in the company, their incentive to act in the interests of shareholders increases. Second, there is evidence that the ownership concentration of companies is increasing.

#### **9.4 Position in Common Law Countries**

In most common law countries corporate law has traditionally applied the separate entity approach to corporate groups. It does not permit the controllers of a corporate group to treat the group as a single enterprise for the purpose of their entrepreneurial activities. Instead, the separate legal personality of each company must be maintained. Limited liability in corporate groups is a common characteristic of common law countries and is usually supported by the courts. For example in *Radaszewski V. Telecom Corp*<sup>133</sup> the US Court of Appeals stated that:

“The doctrine of limited liability is intended precisely to protect a parent corporation whose subsidiary goes broke. That is the whole purpose of the doctrine, and those who have the right to decide such questions, that is, legislatures, believe that the doctrine, overall, is socially reasonable and useful. We think that the doctrine would

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<sup>133</sup> [1981] F.2d 305, U.S. Eighth Circuit Court (1992).

largely be destroyed if a parent corporation could be held liable simply on the basis of errors in business judgment.”

Nevertheless, sometimes the single enterprise approach is seen in common law countries. Examples are discussed below.<sup>134</sup>

#### **A. Australia:**

The separate entity doctrine was overridden in the following cases:

- a. Consolidation of corporate group accounts: A company must prepare consolidated accounts for itself and any controlled entity. That company must also list in its annual report the entities that it controls.<sup>135</sup> These requirements seek to enhance the ability of users of financial reports to assess the overall performance and financial position of corporate groups, rather than having to rely on the accounts of individual group companies. They also seek to ensure that the true financial position of various group companies cannot be concealed by intra-group transactions designed to artificially create profits or conceal losses in particular group companies, or otherwise manipulate the balance-sheet of individual group companies. However, each group company must, in addition, maintain its own accounts concerning its assets and liabilities.<sup>136</sup> For instance, one group company cannot lawfully declare a dividend based on profits generated, and held, by another group company.
- b. Related party transactions: A public company is prohibited from giving a financial benefit (including any intra-group loan, guarantee, indemnity, and release of debt or asset transfer) to a related party unless that transaction has been approved by the fully-informed disinterested shareholders of the public company or is otherwise exempt.<sup>137</sup> These

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<sup>134</sup> Corporate Groups Final Report, May 2000, p.16-28.

<sup>135</sup> Part 2M Div 6 (Special provisions about consolidated financial statements); Australian Accounting Standards Board (AASB) 1024.

<sup>136</sup> Australian Corporations Act, s 286

<sup>137</sup> Australian Corporations Act 2001, Chapter 2E.

provisions are designed to protect shareholders of public companies from the possibility of their company's assets being eroded, or its financial position otherwise undermined, through undisclosed intra-group dealings.

- c. Cross-shareholding: Companies are generally prohibited from acquiring, or taking a security over, the shares of any controlling company or issuing or transferring their shares to any controlled company.<sup>138</sup> Also, there are controls over a group company providing financial assistance for the acquisition of shares in its holding company.<sup>139</sup> Some of these provisions are designed to prevent entrenchment of control in a holding company through indirect self-acquisitions (by a controlled company holding shares in a controlling company) or group controllers using group assets to influence the market price of shares in particular group companies.
- d. Insolvent trading: The Corporations Law has sought to reduce the “moral hazard” problem of corporate group structures being used to displace entrepreneurial risks to outside creditors. It provides that a holding company which ought to suspect the insolvency of its subsidiary can be made liable for the debts of that subsidiary incurred when it was insolvent.<sup>140</sup> The rationale for this rule is that the ability of a holding company to control the affairs of its subsidiary should give rise to some positive duty of the holding company to prevent harm to the subsidiary's creditors.

## **B. The USA**

US laws affecting corporate groups increasingly employ single enterprise principles. Blumberg<sup>141</sup> points out that “American statutes of specific application to corporate groups that use enterprise principles substantially now include the

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<sup>138</sup> Australian Corporations Act 2001, ss 259B, 259C.

<sup>139</sup> Australian Corporations Act 2001, ss 260A-260D.

<sup>140</sup> Australian Corporations Act 2001, ss 588V-588X.

<sup>141</sup> PI Blumberg, *The Increasing Recognition of Enterprise Principles in Determining Parent and Subsidiary Corporation Liabilities* (1996) 28 Connecticut Law Review 295.

great federal statutes regulating the banking industry, the savings and loan industry, securities, investment companies, employer sponsored pensions, export controls and foreign trade. Enterprise concepts also play an important, though less pervasive, role in federal labour relations, employment, and anti-discrimination legislation ... Through reliance on the concept of 'control' or the 'integrated enterprise' doctrine, numerous federal and state statutes of specific application regulate major industries in American society by extending the statutory program to include the corporate group as a whole rather than restricting the statutes' scope to the component corporation of the group that actually conducts the regulated activity".

US courts have also selectively introduced single enterprise principles into US corporate law. This evolution has been possible primarily because these courts have held that controlling shareholders owe duties of fairness to minority shareholders. The rationale for these duties is that, just as directors of a company are bound to act in the interests of the company and its shareholders collectively, any shareholder who, in effect, can control the board's actions should be subject to equitable duties. Thus, for instance, in the corporate group context, a parent company which is a controlling shareholder has a "fair dealing" obligation in any transactions with its controlled company or the use of its controlled company's information.<sup>142</sup>

### **C. The United Kingdom**

In the Companies Act 2006 provisions that define the parent/subsidiary company relationship for various purposes generally form an exception to the principle of separate personality, since they recognise that a separate company should be treated as having a connection with another body or person, which itself is usually a company. Other example is the publication of accounts. S.405

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<sup>142</sup> Corporate Groups, Final Report, May 2000, p. 33.

requires holding and subsidiary companies to publish consolidated financial statements. If at the end of a financial year the company is a parent company, the directors, as well as preparing individual accounts for the year, must prepare group accounts for the year unless the company is exempt from that requirement. Section 404 (1) defines Group accounts as:

- a. a consolidated balance sheet dealing with the state of affairs of the parent company and its subsidiary undertakings, and
- b. a consolidated profit and loss account dealing with the profit or loss of the parent company and its subsidiary undertakings.

This provision treats all the members of the group as a single enterprise.<sup>143</sup>

#### **D. New Zealand**

New Zealand has introduced some single enterprise principles into its corporate legislation. In some instances, directors of wholly or partly-owned subsidiaries may act in the interests of the holding company rather than their subsidiary company,<sup>144</sup> while nominee directors appointed to group companies may pass on otherwise confidential information to their nominators.<sup>145</sup> In addition, New Zealand legislation provides for streamlined corporate group mergers,<sup>146</sup> and permits courts to make contribution orders (whereby a solvent group company can be directed to contribute towards the debts of a related insolvent group company in liquidation), or pooling orders (whereby the assets and liabilities of

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<sup>143</sup> Harry Rajak, *op.cit.* p.531.

<sup>144</sup> New Zealand Companies Act 1993 s.131.

<sup>145</sup> New Zealand Companies Act 1993 s.145(2).

<sup>146</sup> New Zealand Companies Act 1993 Parts XIII, XV.

corporate group companies in liquidation can be pooled for the general benefit of their unsecured creditors)<sup>147</sup>

**In conclusion** the tensions between the separate entity and the single enterprise approaches to groups of companies have given rise to a number of legal questions. The most important is the circumstances under which a parent company may be held liable for the debts of its subsidiary. The question still inspires debate among scholars and lawyers all over the world.

## **10. Corporate Groups and Corporate Governance**

With the collapse of Worldcom, Enron (with a network consisting of over 3000 entities) and a number of scandals in the EU, it was clear how companies could use their subsidiaries and special purpose vehicles to manipulate balance sheets and hide losses. Such scandals have strongly affected public confidence in the operation and governance of large entities trading their shares in organized capital markets.

### **10.1 The Situation of Groups of Companies**

Despite the concerns mentioned above, there is a lack of debate concerning the corporate governance of groups of companies. The topic is absent from or briefly touched on in most company law textbooks and treatises on corporate governance. Discussion of the problems posed by groups of companies often focuses narrowly on insolvency rather than governance issues.<sup>148</sup>

The European Commission reacted by issuing an Action Plan on Modernizing Company Law and Enhancing Corporate Governance in the EU on 21 May 2003. The Action Plan contained a number of measures, which the Commission wanted to implement over the period up to (until 2010). The key issues in the

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<sup>147</sup> New Zealand Companies Act 1993 ss. 271, 272.

<sup>148</sup> Janet Dine, op. cit. p.37.

Action Plan concern corporate governance, capital maintenance, recapitalization as well as decreasing capital, groups of companies, international corporate restructuring and the introduction of a new legal form of incorporation. The fact that the big rating agencies have begun to rate the corporate governance performances of major companies, can well be seen as a further indicator that good corporate governance has an important concern for managers, shareholders and for policy makers.<sup>149</sup>

In terms of the governance of group of companies, some questions are looking for answers. Which powers should be devolved by the board of the parent company to the boards of the subsidiaries? Should subsidiary boards have autonomous boards with independent, non-executive directors? Do traditional control techniques still work? And how can a parent board delegate decision rights in a system of networked, mutual independent subsidiaries?<sup>150</sup> The challenge is to extend sound corporate governance practices and policies downstream to the subsidiaries.

A parent company can use the following tools in order to guarantee proper implementation of corporate governance in its subsidiary:

- a. Subsidiary board composition should be given similar care and scrutiny that of the parent board. There is a need for a uniform guideline on board composition and better guidance for directors.
- b. Depending on the size and nature of the business, it is important that directors bring the right skills to the table to offer effective oversight. For

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<sup>149</sup> A Koulouridas and J von Lackum, *Recent Developments of Corporate Governance in the European Union and their Impact on the German Legal System*, (2004) 10 German Law Journal 1.

<sup>150</sup> J Strikwerda, *An Entrepreneurial Model of Corporate Governance: Devolving powers to Subsidiary Boards*, 4th International Conference on Corporate Governance and Direction, 2001, Henley Management College, UK,

increased objectivity, it may be advisable to have a director from outside the business unit. Improved corporate governance now means that the majority of every board should consist of outside directors. Moreover, the company should have a number of directors who are connected neither with corporation or any significant shareholder, fairly reflecting the investment in the corporation by other shareholders.

- c. The parent board is responsible for the stewardship of the subsidiary and owes a duty to act in its best interest with due regard for the interests of the parent, the ultimate shareholder.
- d. An internal support structure, including a director's guide should be provided to support internal directorships. Not only will this serve as a reference tool for them, but it should also spell out their obligations, risks and corporate indemnification policy.

On the other hand, with higher public and institutional expectations regarding parent/subsidiary governance, and the resulting complexity of the relationships among corporate directors, companies have an immediate practical need for accurate and readily available information on their directors and the directors of their subsidiaries. One compelling reason for such information is that interlocking directorships may give rise to a conflict of interest. For example, in Canada, a director of one corporation who is also a director of another corporation engaged in a similar business must ensure that he acts in the best interests of both corporations. The decision in *Abbey Glen Property v. Stumborg*<sup>151</sup> suggests that a director may breach his or her fiduciary obligation to the corporation merely by acting as a director of the second corporation. The

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<sup>151</sup> (1976) 65 DLR (3d) 235.



case implies that no actual conflict is necessary but that the potential for conflict is enough to create a breach of fiduciary duty. Therefore, laws currently require corporate directors to disclose all of their corporate directorships.

In addition, the 2008 financial crisis represents a political as well as substantive challenge to policy makers that can be compared with the challenges that followed the collapse of Enron/Worldcom and the Asian financial crisis of 1997. The national and international response to the 2008 financial crisis has been characterized by widespread calls for further regulation and re-regulation of not only the financial services sectors but also for other sectors.

The financial crisis can be to an important extent attributed to failures and weaknesses in corporate governance arrangements. When they were put to a test, corporate governance routines did not serve the purpose of safeguarding against excessive risk in many financial services companies. A number of weaknesses have been apparent. The risk management systems have failed in many cases due to corporate governance procedures rather than the inadequacy of computer models alone. Information about exposures often did not reach the board or even senior levels of management, while risk management was often activity rather than enterprise-based. These are board responsibilities. In other cases, boards had approved strategy but then did not establish suitable metrics to monitor its implementation. Company disclosures about foreseeable risk factors and about the systems in place for monitoring and managing risk have also left a lot to be desired, even though this is a key element of the Corporate Governance Principles. Accounting standards and regulatory requirements have also proved insufficient in some areas leading the relevant standard setters to undertake a review. Last but not least,

remuneration systems have in a number of cases not been closely related to the strategy and risk appetite of the company and its longer term interests.<sup>152</sup>

The 2008 financial crisis revealed severe shortcomings in corporate governance. When most needed, existing standards failed to provide the checks and balances that companies need in order to cultivate sound business practices. Therefore, in 2008, the OECD<sup>153</sup> launched an ambitious action plan to develop a set of recommendations for the improvements of its Corporate Governance Principles. On June 2009, the OECD Steering Group on Corporate Governance issued a report explains the finding and lessons from the financial crisis.<sup>154</sup> The report addresses four areas of corporate governance that considered closely linked to the financial crisis and that also formed the basis of a global consultation. These areas are: remuneration/incentive systems; risk management practices; the performance of boards; and the exercise of shareholder rights.

Nevertheless, the Group found that the OECD Principles of Corporate Governance provided a good basis to adequately address the key concerns that have been raised and that there was no urgent need for them to be revised. Rather, a more urgent challenge for the Steering Group was to encourage and support the implementation of already agreed international and national standards, including the OECD Principles of Corporate Governance.

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<sup>152</sup> Grant Kirkpartick, The Corporate Governance Lessons from the Financial Crisis, 2009 Financial Market Trends, p.1

<sup>153</sup> The OECD is a unique forum where the governments of 30 democracies work together to address the economic, social and environmental challenges of globalisation. OECD provides a setting where governments can compare policy experiences, seek answers to common problems, identify good practice and work to co-ordinate domestic and international policies.

<sup>154</sup> The report is published at:

<http://www.oecd.org/corporate/ca/corporategovernanceprinciples/corporategovernanceandthefinancialcrisis.htm>.

To this end, the Steering Group decided to issue a set of conclusions and emerging good practices that together seek to assist companies and policy makers to implement the OECD Principles more effectively. The conclusions and emerging good practices was published on 24<sup>th</sup> February 2010 as a complementary to OECD Principles and as recommendations to help companies and governments to overcome corporate governance weaknesses and support a more effective implementation of the OECD Principles. In some instances, the complementary develops the implications of individual principles that are important in the current situation and in others develop further the existing annotations in the light of the financial crisis and emerging good practices.<sup>155</sup>

## **10.2 The Response to Calls for Proper Corporate Governance:**

A response to the calls for proper corporate governance for group of companies is presented by the UK Corporate Governance Code (formerly the Combined Code)<sup>156</sup>. The Code sets out standards of good practice in relation to board leadership and effectiveness, remuneration, accountability and relations with shareholders. For example:

- a. The Code requires all companies with a Premium Listing of equity shares in the UK under the Listing Rules to report on how they have applied the Code in their annual report and accounts.
- b. Listed companies are required to report on how they have applied the main principles of the Code, and either to confirm that they have complied with the Code's provisions or - where they have not - to provide

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<sup>155</sup> The Recommendations were published in OECD paper titled Corporate Governance and the Financial Crisis, Conclusions and emerging good practices to enhance implementation of the Principles, 24<sup>th</sup> February 2010, published at: <http://www.oecd.org/corporate/ca/corporategovernanceprinciples/corporategovernanceandthefinancialcrisis.htm>

<sup>156</sup> The Code was prepared by the Financial Reporting Council - the UK's independent regulator responsible for promoting high quality corporate governance and reporting. It promotes high standards of corporate governance through the UK Corporate Governance Code.

an explanation. Some of the provisions of the Code require disclosures to be made in order to comply with them.

- c. Companies have to provide clear and meaningful explanations when they choose not to apply one of the provisions of the Code, so that their shareholders can understand the reasons for doing so and judge whether they are content with the approach the company has taken.

The new edition of the Code was published in September 2012 and applies to reporting periods beginning on or 1 October 2012. Companies reporting on reporting periods beginning before 1 October 2012 should continue to report against the June 2010 edition of the Code, although they are encouraged to consider whether it would be beneficial to adopt some or all of the new provisions in the revised code earlier than formally expected.

## **11. Conclusion of Chapter I**

There can be no doubt concerning the benefits resulting from the formation of groups of companies. Hence, the law on groups of companies has since long been the subject of numerous reports, studies and analyses especially among scholars of company and insolvency laws. However, the problems of group of companies do not related to formation or freedom of incorporation. The problem is that there is no unified law dealing with the legal problems such as the liability for the holding company to the debts of its subsidiary. More importantly, there is a lack of a serious debate concerning the governance of groups of companies. The topic is absent from or briefly touched on by most company law textbooks and treatises on corporate governance. Therefore, and in order to prevent the repetition of the financial crisis, I would call for greater use of regulation over what are considered to be self regulating “codes and standards”. In addition, jurisdictions have to review regularly the capacity of their supervisory,

regulatory and enforcement authorities and to promote forward looking capacities.

# Chapter 2

## Groups of Companies in Islamic Law

Islamic Law (*Shari'ah*), writes Joseph Schacht, is 'the epitome of Islamic thought, the most typical manifestation of the Islamic way of life, the core and kernel of Islam itself. This description might have an element of exaggeration; nevertheless, there can be no denying that law occupies a distinctively important position in Islam. This position drives some scholars to state that If Islam is submission to the will of ALLAH (God), then Islamic Law is the path by which submission is enacted, and hence, for many Muslims, Islam is the *Shari'ah* and *Shari'ah* is Islam.

Islamic law is a complex and rich system, which is much wider than the normal understanding of 'law', encompassing aspects of belief and religious practice which would not be considered 'law' elsewhere. It includes rules relating to belief, prayer, fasting, making *Hajj* (Pilgrimage), giving *Zakat* (the compulsory charity tax) and other religious matters. In addition, it governs the Muslim way of life from political government to the sale of real property, from hunting to the etiquette of dining, from sexual relations to worship and prayer. It also regulates commercial transactions, and regulates the governing of the Islamic state and its relationship with non-Muslims within the state as well as with foreign states.<sup>157</sup> It follows that the Islamic conceptual framework is quite unlike that of the Common law. It developed in a very different context, and its solutions are sometimes very different because Islamic law is based on religion, while both Common law and Civil law are secular in origin.<sup>158</sup> Therefore, although it would

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<sup>157</sup> For more information about fields of Islamic law visit the Institute of the Study of Islam and Christianity (ISCI) [www.isic-centre.org](http://www.isic-centre.org).

<sup>158</sup> In Common law countries, speakers sometimes refer to the "Judeo-Christian ethic" as being the basis of the legal system. Generally, this means that the Common law legal system is based on Christian principles. However, this does not mean that the Common law has been adopted from the Bible, or from a legal system established by the church, but recognises the influence of Christian thinking in these countries on acceptable and unacceptable behaviour. Today, the Common law system is secular and insists upon separation of church and state - see Jamila Hussain, *Islam, its law and society*, Second Edition, The Federation Press, (2003) p.6.

make no sense to refer, for example, to 'Christian commercial law', it is meaningful to speak of 'Islamic Commercial Law'.<sup>159</sup>

Because of the unique nature of Islamic law, it will be difficult to investigate Islamic law's position on groups of companies without firstly appreciating the unique nature of Islamic law, its aspects sources, origins and, most importantly how "Islamic jurisprudence" provides interpretation, law finding and the mechanism for providing concrete rules capable of solving legal problems. Such appreciation is presented briefly in Part I of this Chapter.

After understanding the nature of Islamic law, Part II examines the main principles governing corporations in Islamic law to find if it allows the formation of modern corporations including group of companies. Part II will end with a justification for the creation of a new model of Islamic corporation.

At the outset, it is important to dispel confusion regarding certain Islamic law terms which can be found in some English sources. Many writers use the term 'Islamic law' to translate both '*Fiqh*' and '*Shari'ah*', although these terms are not synonymous in Arabic.<sup>160</sup>

### **A. *Shari'ah* and *Fiqh***

The literal meaning of *Shari'ah* is the path or road to water; i.e. the path which directs mankind to the right way as regards to their faith in ALLAH (God). *Shari'ah* is the whole divine law and values as given by God. It refers to the sum total of Islamic commands as recorded in the Qur'an as well as deducible

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<sup>159</sup> Nicholas HD Foster, *Islamic Commercial Law, an Overview*, School of Law and School of Oriental and African Studies University of London, (October 2006), p.3.

<sup>160</sup> For detailed meaning of Islamic legal terms, see Yousef Ahmad Badawi, *the History of Islamic Fiqh*, تاريخ الفقه الاسلامي (2004), pp. 17-35.



from the Prophet's divinely guided life (the *Sunnah*).<sup>161</sup> *Shari'ah* is the constant, unchanging, basic dimension of Islam. It defines not just the relationship of man to man, but also the relationship of man to God and of man to the cosmos. As such, it is all embracing and its dimensions are infinite.<sup>162</sup>

The term *fiqh* literally means "understanding". It implies an understanding of Islam in a general way or what a prudent person is likely to conclude from obvious evidence. It is the knowledge of the legal rules pertaining to conduct that have been derived from their specific contexts. It is the study and science of the *Shari'ah*, but includes also jurists' interpretation of the two sources of the *Shari'ah* (the *Qur'an* and the *Sunn'ah*).

A jurist or scholar who specialises in law is called "*Faqih*". He understands and is skilled in interpreting the *Qur'an* and the *Sunnah*. The goal of the *Faqih* is to determine reliably, given a set of circumstances—including time, place, identity of the legal agent, and so on—the legal status of particular possible acts. The *Faqih* also explains or decides points of law in the absence of the binding text of the *Qur'an* and the *Sunnah*.<sup>163</sup> Muslim jurists devote themselves to seeking to determine God's intentions concerning the specific obligations of believers on

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<sup>161</sup> The objectives of *Shari'ah* are of three kinds according to the degree of their importance: essentials, needs and embellishments. (i) Essentials: include five major interests, namely religion, life, human intellect, family lineage and material wealth. (ii) Needs: include concessions granted to the law in exceptional times and situations so that the essentials remain in existence. For example, obligatory prayer five times a day is an essential part of the religion of Islam. Yet when a believer is travelling, he/she is required to shorten the prayers so that they do not become a burden on him or her, but at the same time the "essential" (prayer in the present instance) remains in practice. (iii) Embellishments: entails optional and supererogatory duties. For example, optional prayers, optional charity, good manners, etc. The aim of this category is to encourage believers to do things which are not obligatory, so that it becomes easy and comfortable for them to practise the essentials. God and His Messenger encourage believers to do supererogatory things. For example, the Prophet encouraged Muslims to give charity voluntarily. The purpose is to make them habituated to making charity so that it will be easy for them to give *Zakat* (obligatory charity). Giving *Zakat* plus optional charity together will bring economic justice in society- the gap between the rich and the poor will be narrowed- and a fraternal community will develop thereby over time See Md Anowar Zahid, *Considering Corporate Personality from Islamic Perspective*, 2nd International Conference on Business and Economic Research, (October 2011), pp. 23-24.

<sup>162</sup> Nazeer Ahmed, the Development of *Fiqh*, the Encyclopaedia of Islamic History, published at [www.historyofislam.com](http://www.historyofislam.com).

<sup>163</sup> Michael J.T. McMillen, *Islamic Shari'ah Compliant Project Financing: Collateral Security and Financing Case Studies*, (2004) 48 *Fordham International Law Journal* 4.

the basis of available evidence. It should be kept in mind that the opinions and verdicts of a *Faqih* are not infallible. The *Faqih* is human and is prone to make mistakes, even when he has given his utmost to find out the truth.

While many writers use the two terms interchangeably<sup>164</sup>, the concepts of *Shari'ah* and *fiqh* are clearly different. The term *Shariah* has a wider meaning, including both *fiqh* and knowledge of the tenets of faith. The real distinction is that *Shariah* is the law itself while *fiqh* is knowledge of that law-its jurisprudence.<sup>165</sup>

## **B. Fiqh and Usul al fiqh**

Another confusion needing to be cleared up is that between *fiqh* and *usul al-fiqh* (the roots of law). The two are separate disciplines. The main difference between them is that *fiqh* is concerned with the knowledge of the detailed rules of the law in its various branches, where *usul al-fiqh* is concerned with the **methods** that are applied in the deduction of such rules from their sources. In other words, *usul al-fiqh* is the methodology of the law or the indications and methods by which the rules of *fiqh* are deduced from their sources. *Usul al-fiqh* has been called Islamic legal theory by analogy with modern law. Like legal theory, it answers questions such as "what is law?" and "how do judges discover and apply the law in hard cases? Yet the analogy ends here. While legal theory analyzes what judges do, *Usul al-fiqh* lays down the methodology that must be used for discovering and applying the law. Legal theory attempts to understand and record the nature of the judicial process, *Usul al-fiqh* governs it. Thus, there is a difference in function and approach. The role of *Usul al-fiqh* is much wider than that of legal theory. *Usul al-fiqh* has been assigned different

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<sup>164</sup> Bilal Philips, *The Evolution of Fiqh*, International Islamic Publishing House, (2006), p.2.

<sup>165</sup> Imran Ahsan Khan Nyazee, *Theories of Islamic Law*, Islamic Research Institute, Islamabad, 3<sup>rd</sup> printed 2009, p 26.

titles by different writers, to attempt to understand what it really stands for. It has been called 'Islamic Jurisprudence', 'Islamic legal theory', and 'the methodology of Islamic law', besides other things. There is nothing wrong with this, though, and all these titles are essentially correct.<sup>166</sup>

In this study, the term 'Islamic Law' will be used to mean the laws of *Shari'ah* and the laws of *Fiqh* combined. The term *fiqh* and *Shari'ah* will be used where a distinction seems necessary.

Finally, it is important to highlight that in this study I cannot hope to do complete justice to the richness and complexity of Islamic Law. Rather, I would like to provide a basis from which to explore it further by concentrating on the principles at the core of this study.

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<sup>166</sup> Nyazee argues that *Usul al-fiqh* and Western jurisprudence study the same subjects. Western jurisprudence has come to be divided into two major areas: general jurisprudence and particular jurisprudence. Institutions of legal learning in countries like Pakistan are still occupied solely with particular jurisprudence, while the Western world has moved away from it toward general jurisprudence. Particular jurisprudence deals with legal concepts that cut across different branches of law, that is, concepts like right, property, and duty. This is the area of jurisprudence examined by writers like Salmond a long time ago. General jurisprudence, as the title implies, deals with broader questions - the nature and concept of law itself: what is law? Why do we obey it? What is the nature of obligation? How do judges discover and apply the law? how are laws validated? What constitutes a legal system? What role has morality to play in a legal system? These and other questions of legal philosophy underlie this field that continues to dominate the work of Western legal philosophers. A study of the works of legal philosophers like Hart, Fuller, Raz and Dworkin reveals that general jurisprudence is the same thing as *usul al-fiqh*, though the legal materials it operates on are secular in nature, while the materials for the latter are divine in origin. Nevertheless, both are legal materials. What is surprising is that the issues faced by Western legal philosophers today were approached by Muslim jurists more than a thousand years ago. It is true that the language used by Muslim jurists was different, while some of the sophistication found in modern legal systems was lacking in those days, but the basic questions answered are the same. See *ibid* p.1.

## Part I

### Introduction to Islamic Law

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Before Islam, Arabs inhabited tribal communities who followed animistic religions. That community was the focal point for the individual, and survival outside the community was difficult if not impossible. The tribes themselves developed their own sets of customary laws that were binding on all members. Besides the tribal communities, there were trading communities in *Makah* and *Medina* who enjoyed commercial relations with areas outside the Arab region. The merchants and traders developed their own set of mercantile laws.<sup>167</sup>

This situation had been changed after the Prophet Muhammad (PBUH) received his message (in approximately 610 AD). He acted not only as the messenger from God, but claimed the leadership of the Islamic society. During his life legislation derived from two sources - the 'Holly Quran' and his own words, deeds and practice (the '*Sunnah*'). These are not only the basic textual sources of the *Shari'ah* but the principal religious texts of Islam. After the death of the Prophet (PBUH) and in the early phase of Islamic expansion and unified political control under the Caliphs '*Alrashidun*' (the rightly guided ones) it had been possible to achieve a consensus about the contents of Islamic law. However, during the rule of the *Umayyad* and *Abbasid* dynasties, the true nature of Islamic law had been clarified and schools of Islamic law began to develop. During these years, Islamic Law developed sophisticated methods of interpretation and law finding, offering solutions in cases where the main sources of *Shariah* was silent.

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<sup>167</sup> Tribal communities largely converted to Islam and gradually Islamic codes of conduct and law modified or replaced tribal customary law. In many instances, Islamic law did not completely replace tribal customary law but merely modified it. This can be seen most clearly in the law of homicide and the law of marriage, both of which have retained substantial elements of pre-Islamic tribal law.

The following chapters offer a brief appreciation of the aspects, nature and sources of Islamic Law as a necessary introduction before addressing the main topic of the study.<sup>168</sup>

## **1. Sources of Islamic law**

The sources of Islamic Law mean the types of evidence that the Lawgiver sets down as valid proof of the relevantly rules. Jurists have classified these as primary and secondary sources. This classification is of the utmost importance because it determines how the commands of God are discovered, and the sources to which the *Shari'ah* gives weight.

### **1.1 The Primary Sources**

The first stage in the development of Islamic law covers the era of the Prophet Muhammad (BPUH) during which the only source of Islamic law was divine revelation in the form of either the Qur'an or the *Sunnah*. The Qur'an represented the blueprint for the Islamic way of life, and the *Sunnah* provided detailed explanation of the general principles outlined in the Qur'an, as well as a practical demonstration of their application. The Holy Qur'an and the *Sunnah* are the primary sources of Islamic Law.

The Holy Qur'an contains a considerable number of verses with legal significance, but is far from being a comprehensive code. It is supplemented by the '*Sunnah*'. Yet even this combination does not provide enough detail to deal with all commonly occurring problems. Therefore jurists treat *Ijma'* (consensus) and *Qiyas* (analogy) as among the primary sources of Islamic Law mainly are.

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<sup>168</sup> For detailed information and studies concerning the sources and origin of the Islamic law, see Martin Lau and Doreen Hinchcliffe, *Introduction to Islamic law*, External Programme: University of London 2005; Kamali, M.H. *Principles of Islamic Jurisprudence*, Islamic Texts Society, 1991 2nd edition; Zafar Ishaq Ansari, *The Contribution of the Qur'an and the Prophet to the Development of Islamic Fiqh'*, (1992) 3 *Journal of Islamic Studies*141; Bilal Philips, op. cit..

No scholars have challenged the authority of these four sources over other subordinate sources.

### **A. The Holly Qur'an**

In the Islamic legal system where the hierarchy and order of priority of sources are carefully maintained, the Holly Qur'an enjoys the highest position as the most primary source in the *Shari'ah* from which Islamic legal rules are derived, and through which the purposes of *Shari'ah* are to be achieved. The Holly Qur'an, being the words of God, serves as a source of divine commands, knowledge and fundamental guidance for humankind. It is the duty of every Muslim to submit him or herself to these commands. The Holy Qur'an was not delivered to the Holy Prophet as a complete book, but was revealed to him piece by piece through the Archangel *Jibrail* (peace be with him) during the last 23 years for the Prophet's life. The authoritative text of the Qur'an is the Arabic text.<sup>169</sup>

After the death of the Prophet (PBUH), many '*suras*' were reduced to writing, on materials ranging from leather to pieces of board. The Qur'an was collected in a unified hard copy during the reign of the third Caliph, Othman, in about 650 AD.<sup>170</sup> All copies of the Holy Qur'an which exist in the world today are true

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<sup>169</sup> Over the years, the Qur'an has been translated into many languages, but translations must be used with caution, since the meaning conveyed by a particular word or phrase in Arabic may convey a considerably different meaning in another language, and thus lead to misinterpretation of the text.

<sup>170</sup> The Arabs being a race of illiterates, there were very few in Mecca who could read or write. There was no paper, and pens and inkpots were scarce. It was a most difficult task to get the revelations written down as they came. But the arrangement was made. A few of those who knew the art of writing embraced Islam. The verses of the Holy Quraan were inscribed on palm-leaves and leather sheets. Some of the Companions were specially charged with the duty of learning portions of the Quraan as they were revealed. Persons were specially selected from among the Companions who would take lessons from the Holy Prophet (peace be with him!). Each lesson consisting of ten verses of the Holy Quraan. They would learn by heart those verses, their meanings and interpretations as taught by the Holy Prophet, and teach the same to others. Then came the time of the Migration to Medina. The Muslim group had been growing gradually. At Medina it was knit into a functioning community. Among other things, the Holy Prophet made the arrangements whereby a larger number of Companions could learn to read and write. The work of writing down the revelations of the Quraan continued with the fullest exertion. Its compilation in the form of a scripture was entrusted to Zaid bin Thabit, a freed slave who was one of those Companions assigned

copies of that manuscript. It exists not only as a written text, but also in the brains of hundreds of thousands of Muslims, which makes it impossible for anyone to change even a comma.<sup>171</sup>

The Qur'an contains 6,219 verses, collected in 114 chapters called 'suras'. A number of Quranic verses are direct answers to the questions raised by both Muslims and non-Muslims during the era of prophethood. Many of these verses actually begin with the phrase "They ask you about," For example,

(They ask you about wine and gambling. Say, there is great evil in them as well as benefits to man. But the evil is greater than the benefit.. ) (Qur'an 2:219).

Much Islamic legislation found in the *Sunnah* also results from answers to questions, or consists of pronouncements made at the time that particular incidents took place. The reason for this method of legislation was to achieve gradation in the enactment of laws, as this approach was easily accepted by

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the task of writing down the Quraan. The revelations continued to come, and they were not only preserved in writing, but the Holy Prophet, under Divine guidance, would fix up the chapters and would instruct the scribes to insert a certain revelation at a certain place in a certain chapter. Gradually, the delivery of the Word of God reached completion and, at the Farewell Pilgrimage, in the plain of Arafat, came the revelation: "***This day I have perfected your religion for you and completed my favour upon you and have chosen for you Islam as your religion.***" (V:4) Not only was the arrangement of the verses and the arranging of chapters done by the Holy Prophet, but he also fixed the serial arrangement of the chapters, and all that he did under Divine instructions. To carry the work to its logical finish, Abu Bakr the Truthful, Islam's first Caliph, rendered the service of giving the separately written chapters the form of a consolidated compilation.

Different portions of the Quraan written by different people continued to remain, however, in their possession. The people of different places also continued to follow their local pronunciations of Quraanic verses. Then came the period of the third Caliph, Osman (God be pleased with him!). Islam was no more confined to Mecca and Medina, but had crossed the boundaries of the Arabian Peninsula and had entered Egypt, Palestine, Syria, Iraq and Iran. People were entering the fold of Islam in ever-growing numbers. The interest in Quraanic recitation was becoming universal. Large numbers of people had only portions of the Quraan in their possession. Misunderstandings could arise that only such and such a portion formed the whole Quraan, and that the other portions were not part of it. Hence, Caliph Osman got several copies made of the manuscript compiled during Caliph Abu Bakr's regime and sent those copies to the different centres of the Islamic empire. The copy which Caliph Osman himself used for study and on which, it is said, the drops of his blood fell at the time of his martyrdom, remained preserved first at Medina and was later transferred from there to the Imperial Library at Istanbul by the Turkish Sultans.

<sup>171</sup> Muhammaad Abdul Aleem Siddiqui Al Qadri, *The History of the Codification of Islamic law cultivation of Science by Muslims*, زراعة القانون الإسلامى للعلوم والمسلمين، تاريخ التدوين، (1935), p 13.

Arabs who were used to complete freedom. It also made it easier for them to learn and understand the laws.

Within the Qur'an verses, no more than 600 verses deal with specifically legal rules and injunctions<sup>172</sup>, which can be classified under four headings:<sup>173</sup>

- a. **Concise injunctions**: these are precise commandments but the Qur'an does not give detailed rules about how they are to be carried out. Examples include prayer, fasting, payment of zakat.
- b. **Concise and detailed injunctions**: these are commandments given in the Qur'an but about which further details may be discovered from the *Sunah* and other recognised sources, e.g. rules about relations with non-Muslims.
- c. **Detailed injunctions**: the Quran gives complete details about those commandments and nothing further is required or may be sought, e.g. punishment limits.
- d. **Fundamental principles of guidance**: these principles do not have clear cut definitions and the way to put them into effect must be determined through *ijtihad* (use of personal reasoning), e.g. principles such as freedom, equality, the public interest and justice.

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<sup>172</sup> Martin Lau & Doreen Hinchcliffe, op. cit. p.18. Various commentators suggest that there are anywhere from 80 to 600 verses of the Qur'an which have content that can be called legal. For instance, while Kamali states that the Qur'an contains 350 legal verses, some scholars consider 500 or 600 of the over 6,000 verses in the Qur'an to be legally oriented. However, most of those verses deal with worship rituals, leaving about 80 verses that deal with legal matters in a strict sense. Other scholars point to 350 verses with legal content, 140 dealing with devotional issues; 70 dealing family matters - marriage, divorce, the waiting period, revocation, mahar, maintenance, custody, fosterage, paternity, inheritance and bequest, 70 dealing with commercial transactions, 30 dealing with crimes and penalties, 30 dealing with the rights and obligations of citizens, and 10 dealing with economic matters. See : Mohammad Hashim Kamali, Principles of Islamic Jurisprudence, 3rd ed, Cambridge, Islamic Texts Society, 2003; Abdullahi Ahmad An-Na'im, *Towards an Islamic Reformation: Civil Liberties, Human Rights, and International Law*, Syracuse University Press, (1990).

<sup>173</sup> Jamila Hussain, op. cit. p.31.



The verses in the Qur'an which are of a more general nature, eschewing evil and seeking good, however, have also proved to be foundations for principles of the *Shari'ah*. For example the verse which says '**Muslims abide by their stipulations**' may be considered as the basis of the Islamic law of contract, while the verse which says '**There is no harm in Islam**' as the basis of the Islamic law of tortious liability.

Another way of classifying Islamic legislation in the Qur'an is in terms of the variety of acts which have been enjoined by divine decree on mankind. These acts form basic categories with regard to the parties involved in the acts:<sup>174</sup>

- A. **Dealings between God and man:** These are the religious rites which are not valid without correct intention. Some of them are purely religious forms of worship, like prayer and fasting; while others are socio-economic forms of worship, like Zakah (compulsory charity) and yet others socio-physical forms of worship, like Haj (pilgrimage to Makah). These forms of acts of worship are considered the foundation of Islam after faith.
- B. **Dealings among men:** The laws governing these dealings may themselves be divided into four sub-sections relative to the subject matter of dealing:
  - i. Laws ensuring and defending the propagation of Islam. These are embodied in the codes of armed or unarmed struggle.
  - ii. Family laws for the development and protection of the family structure. These include laws concerning marriage, divorce and inheritance.
  - iii. Trade laws governing business transactions, leases ... etc.
  - iv. Criminal laws governing business transactions, leases and various crimes.

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<sup>174</sup> Strzyzewska, Bozena Gajane, *The History of Islamic Law*, (1980), pp. 34-35.

Since the Qur'an has no secular, earthly source, none of it can be altered by any human agency or institution.

## **B. The Sunnah**

The word '*Sunnah*' literally means a beaten track, and thus an accepted course of conduct. Among the Arabs before Islam, it meant the traditional practices of the community. Gradually, in Islamic thought, it came to mean all the acts and sayings of the Prophet as well as everything he approved. The *Sunnah* is considered the second source of revelation based on God's statements in the Qur'an. It is, next to the science of the Qur'an, the most important source for the development of Islamic law.

The authority of *Sunnah* comes from many Qur'an verses, including the following verse whereby God clarifies that whatever originated from the Prophet (PBUH) does not come from his own desire, but it is an inspiration from God.

*' Nor does he say (ought) of his own desire. It is no less than inspiration sent down to him'. (Qur'an 53: 3-4)*

This directly indicates the role of *Sunnah* as the type of revelation from God to his prophet (PBUH). It is important to mention that within the *Sunnah* the only thing of a legal nature held to form part of the *Shari'ah*, the personal practices of the Prophet (PBUH) are not considered to form part of the law.

As the time-line from the Prophet increased, it became necessary to collect, sort out and pass on his traditions. This was the beginning of the science of "*ahadith sing.-hadith*" (oral communication traced back to the Prophet). Although, collections of *ahadith* came into existence a few centuries later, the tradition of passing on *ahadith* was continuous and active throughout the interim period. Each '*hadith*' consists of two parts. The first part describes the

chain of communication of the sayings of the prophet from the first to the last informant. The status and the credibility of a *hadith* depend therefore to some extent on the status and the credibility of the informants.<sup>175</sup> The second chart concerns the formal content of the practice or the saying of the Prophet itself.

The Prophet (PBUH) used several techniques to declare Islamic law. Sometimes he would explain the intent of the Qur'anic text by making a statement, sometimes he would do so by an act, and sometimes he would do both. He also encouraged his Companions to make legal rulings in order to prepare them to carry on the application of the *Shariah* after he left them.

The *Sunnah* is used by the jurists for the following purposes in ascertaining the law:<sup>176</sup>

- a. to confirm the law which has already been mentioned in the Qur'an;
- b. to give an adequate explanation of matters mentioned in general terms only in the Qur'an;
- c. to clarify verses in the Qur'an where this proves necessary;
- d. to introduce new rules not mentioned in the Qur'an.

Thus the *Sunnah* was an exposition of the Qur'an by which its generalities were clarified and its intended meaning specified. Consequently, everything in the *Sunnah* is addressed in the Qur'an, either by inference or by direct reference.

The address may be so general as to include the whole as in the case of the verse:

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<sup>175</sup> Islamic jurisprudence developed a sophisticated science of tradition to verify whether or not a *hadith* can indeed be traced back to the Prophet (PBUH) or one of his companions. *Hadiths* are accordingly classified by *hadith* scholars depending on the reliability with which this chain of communication could be established. The highest grade of transmitted material is 'sound'; next comes 'good'; with the lowest grade of credibility being termed 'weak'.

<sup>176</sup> Jamila Hussain, op. cit. p. 32.

(... Whatever the messenger gives you take it; and whatever he forbids you, leave it...) (Qur'an 59:7).

Alternatively, the address may indicate generally defined laws, the details of which are left to the *Sunnah*. Hence, the *Sunnah* may explain the methodology, reasons, requirements and location, or it may explain the inclusion which could not be logically deduced. The Qur'an takes priority over the *Sunnah* as a source of law, and jurists should resort to the *Sunnah* for legal guidance only when no clear guidance can be obtained from the Qur'an. It is a fundamental principle that the Qur'an and the *Sunnah* can never contradict each other.

### **C. Ijma (consensus)**

*Ijma* or the consensus of scholars has been technically defined as the consensus of jurists over a certain period on a religious matter. *Ijma* should be based on consultation between jurists and the use of juristic reasoning, taking into account what guidance is given by the Qur'an and the *Sunnah*. *Ijma* cannot violate the Quran or the *Sunnah*. The authority of *Ijma* is based on the prophet's statement that 'My people will never agree on an error'. As such, the agreement of the scholars of Islam on any religious matter is a source of law.

The scope for *Ijma* is wider than just providing binding interpretations of the Qur'an and the *Sunnah*. Questions not covered by the Qur'an and the *Sunnah* may also be answered by *Ijma*. Nevertheless, the principle of *Ijma* does not mean that the masses could somehow collectively agree on a certain course of action. Only those interpretations, forms of worship and legal practice are approved by consensus are authoritative and binding on the *ummah* (the community of believers) and once a certain legal principle or a certain interpretation has been established by the consensus of the jurists, it cannot be

repealed or deviated from. The reason for this is simple *Ijma* represents the truth, since God would not allow His followers to err collectively. There can be no reason why the right principle, once established, should become wrong at a later stage.

A good illustration for the principle of *Ijma* occurred right after the death of the Prophet. The election of Abu Bakr to the post of Caliph by the votes of the people was the first manifestation of *Ijma*. During the development of Islamic law certain qualifications became to be regarded as essential for deciding who would be allowed to participate in the process of arriving at a rule of law on the basis of *Ijma*. Minors and lunatics were excluded, as were non-Muslims, and eventually the power to participate in *Ijma* was confined to those learned in the law (i.e. Islamic jurist-theologians of a given period). Only their consensus was capable of establishing a binding rule of Islamic law. The practical value of *Ijma* became in the course of time very limited since it was impossible to obtain a consensus on a given problem by just asking all those jurists. There was no organisation that represented all jurists and as a result *Ijma* has come to be determined by looking into the past; for instance if there is doubt about a certain interpretation of the Qur'an it is possible to look into the past and to find that a certain interpretation has become accepted through *Ijma*, because all jurists had agreed on that particular interpretation and it had been followed for a long time.

#### **D. Qiyas (Analogy)**

Unlike the other main sources, which are based more or less directly on the divine commandments, *qiyas* depends on the judgment of man. *Qiyas* means a comparison between two things with the view of evaluating one in the light of

the other. It is the extension of a *Shariah* value from an original case to a new case, because the latter has the same effective cause as the former. *Quiyas* may be resorted to discover the law on a certain matter only if no solution can be found in Qur'an or *Sunnah*, or in cases covered by *Ijma*. Qiyas also means that the search for an analogy to the case in point is not restricted to any particular legal provision contained in the Qur'an or the *Sunnah* but can include the examination of the totality of law in order to find a solution which is most closely aligned to the general spirit of Islamic law. An example of a legal ruling developed through *qiyas* is the case of drugs. The Qur'an and *Sunnah* prohibit drinking alcohol (the original case) because it intoxicates. Now narcotic drugs (the new case) are prohibited because they also intoxicate. So the law prohibiting alcohol is extendable to narcotic drugs. The Agreement of Jurists upon this conclusion leads to an *Ijma*.

## **1.2 Secondary Sources**

In medieval times jurists developed various interpretive methodologies that balanced the need for authority, legitimacy and discretion in a way that ensured a just outcome under the circumstances. They extended scriptural rules through analogy, balanced competing precedents in light of larger questions of justice (*istihsan*), and legislated pursuant to public policy interests where scripture was otherwise silent (*maslaha mursala*), they also observed the public interest (*istislah*), the presumption of continuity (*istishab*) and blocking means to evil (*sad al-dhara*).

There are a few other secondary sources of Islamic law that depend upon transmission and not on methods of reasoning, for example, a companion's opinion (Qawl al-Sahabi). A companion is someone who saw the Prophet

(PBUH) and associated with him for some time so that he could understand something of the ways of the Shariah from him. Another secondary source of the same kind is Urf (the custom of a particular locale). Jurists recognize that urf may serve as the basis of law as long as it does not contradict other legal principles. Custom has played a particularly important role in commercial arrangements, which varied widely from one area of the Muslim world to another. In the following chapters, I will provide a short explanation of the secondary sources in order of their importance.<sup>177</sup>

#### **A. Istihsan (Legal Preference):**

On a particular matter there may be two *qiyases*. One may be harsh and inconvenient, while the other may be good and useful to the society. The former is called open *qiyas* and the latter is hidden *qiyas*. Jurists accept the latter and reject the former in order to achieve the public interest. They base their action on the verse of the Qur'an:

‘Allaah wants ease and comfort and not hardship’ (Al-Bakara 185)

For example, *Waqf* (religious endowment) may be compared with sale or lease to transfer of property. In *fiqh*, one of the conditions of a valid sale is that the object of the sale must be clearly stated in the contract. For lease this is not the case. If *Waqf* is compared with sale anything related to the object not clearly mentioned in the *Waqf* deed cannot be a part of the *Waqf*. This *qiyas* is against the public interest and will defeat the purpose of *Waqf*, which is to serve the public benefits. On the other hand, the purpose is upheld if it is analogised with lease.<sup>178</sup> Another example is the acceptance of modern forensic evidence as proof in criminal cases. Under classical Islamic law, oral evidence was considered the best and most reliable type of proof and was given precedence over all other types of proof. However, with the development of modern

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<sup>177</sup> For more explanation of the secondary sources, see Bilal Philips, op. cit. pp.82-119.

<sup>178</sup> Md Anwar Zahid, op. cit. p.23.

accurate methods of proof through forensic science, *istihsan* allows a departure from the established rule in the interest of discovering the truth by the best method possible.<sup>179</sup>

### **B. Istislah (Welfare):**

*Istislah* simply means seeking that which is more suitable. It deals with things which are for human welfare but have not been specifically considered by the *Shari'ah*. An example of *Istislah* is found in Caliph Ali's ruling that a whole group of people who took part in a murder were guilty even though only one of the groups had actually committed the act of murder. The legal texts of *Shari'ah* covered only the actual murderer. Another example is the right of a Muslim leader to collect taxes from the rich other than *Zakah* if the interest of the state demands it, whereas in *Shariah* only *Zakah* is specified.

### **C. Uruf (Customs):**

Local customs were accepted as a source of law in a given region. Any long standing practice of the people may be accepted as a source of Islamic law subject to certain specific conditions, the most important being that it shall not conflict with the letter or spirit of *Shari'ah*. Examples of accepted customs by *Shariah* are found in *Diyah*, and Dowry and rental custom. *Diyah* (blood money as compensation in case of unintentional killing), was practised in Arab society from long before the Prophet. As this was good, it was therefore accepted by Islamic law. A dowry must be agreed upon as part of a marriage contract but there is no set time for payment. It is the custom of Egyptians as well as others that a portion of it must be paid before the marriage ceremony, while the remainder is only required to be paid in the case of divorce. These arrangements are acceptable to the *Shariah* as a valid custom. *'Urf* can be seen

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<sup>179</sup> Jamila Hussain, op. cit. p. 39.



also in rental customs. Islamic law does not require the payment of a price until the thing leased has been delivered completely, however, it is an accepted custom that rent is paid before the rented place or object has been used for the agreed time period.

#### **D. Istis-hab - (Linking)**

*Istis-hab* literally means seeking a link, but legally it refers to the process of deducing laws by linking a later set of circumstances with an earlier set. It is based on the assumption that the laws applicable to certain conditions remain valid so long as these conditions have not altered. If, for example, on account of the long absence of someone, it is doubtful whether he is alive or dead, then by *Istis-hab* all rules must remain in force which would hold if one knew for certain that he was still alive.

#### **E. Pre-Islamic Shari'ahs:**

Islamic is a monotheistic religion. It is the last in the chain of preceding religions that propagated the faith of one God such as Judaism and Christianity. There are some pre-Islamic rules which the Qur'an and *Sunnah* clearly ordain for the followers of Islam. With regard to fasting the Qur'an says, 'O who believe! Fasting has been ordained upon you as it was ordained on the people before you.' This is an explicit acceptance of pre-Islamic law by the Qur'an. There are some commands which are implicitly approved. For example, law of retaliatory punishment ordained in Judaism is mentioned in the Qur'an without abrogation or condemnation.

#### **F. Opinions of Sahaba (the Companions):**

Muslim jurists accept, in general, the opinions of the Companions of Prophet Muhammad as a source of law. Since they were with the Prophet, they had

direct knowledge from him. Therefore, their opinions carry special value in Islamic jurisprudence. The opinion of the *Sahaba* either as a group or individually is thus an important source of law. If the *Sahaba* opinion unified it will be converted to *Ijma*, where if they had a different opinions on a single issue, each opinion was referred to as personal opinion of the relevant *Sahabi*. All the above mentioned secondary sources of Islamic law allow the law to remain socially responsive without undermining its traditional authority.<sup>180</sup>

## 2. How is Islamic Law Made?

In the Islamic legal system, a rule of law in order to be valid has to be derived from the sources of Islamic law. Therefore jurists looking for Islamic law position on a certain case will seek the solutions from the sources of *Shari'ah*. They will seek first in the Qur'an and *Sunnah* because the lawgiver has omitted nothing for which a rule has not been laid down. The basis of this principle is in number of verses in the Qur'an:

“We have neglected nothing in the Book (of our decrees)”. (*Qur'an* :38)

“And we have sent down to the Book explaining all things, a Guide, a Mercy, and glad tidings to Muslims”. (*Surah al Nahl* 89)

Nevertheless, there are many things in the modern world for which explicit rules cannot be found in the Qur'an or the *Sunnah*, and for which it is difficult to derive a rule on the basis of strict analogy. In such cases jurists believe that the principle that nothing has been left out means that, even when the rule has not been expressly stated, it still exists implicitly and has to be discovered in the sources. How the jurists do this and what methodology do they use?

If the two main sources of the *Shariah* have not mentioned the matter at all, or if they have pronounced but still need further interpretation, Jurists have to strive to discover the law form the texts through all possible means of valid

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<sup>180</sup> Anver M. Emon, *Conceiving Islamic Law in a Pluralist Society: History, Politics and Multicultural Jurisprudence*, (2006) *Singapore Journal of Legal Studies* 335.

interpretation. This is called "*Ijtihad*" (effort). It is a struggle, to discover the law from the texts and to apply it to the set of facts awaiting decision.

When Jurists need to make law on any particular issue, they turn first to the Qur'an and *Sunnah*. If the law in this respect is clear and is free from ambiguity, they follow it and avoid *ijtihad*. There is no *ijtihad* within an explicit rule in the texts. This implies that when the rule stated in the texts is so clear that only one meaning can be derived from it, jurists are prohibited from undertaking *ijtihad* in it.<sup>181</sup> On another words, if a meaning is given in these texts, it becomes the legal meaning and is to be followed, irrespective of its conformity with the literal meaning of the word. When no explanation is available, a jurist looks for literal meanings and uses his own reasoning and judgment to arrive at the appropriate answer. In this case the literal and technical meanings would be the same.<sup>182</sup>

When the set of facts awaiting decision is not covered by literal meanings and implications, jurists will proceed by analogy. The form of analogy used here is very strict and goes by the name of analogy of cause (*qiyas al-illah*). This entails the extension of the meaning to a new case from a single text of the Qur'an or the *Sunnah* with a specific meaning on the basis of a common underlying cause. Should this method fail to solve the problem, jurist undertakes the extension by considering the texts collectively, that is, by looking at the spirit of the laws. Jurists use the general principles of the law by

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<sup>181</sup> Examples of these include the words "hundred stripes" and "cut off their hands." Here the word hundred has a single meaning, but the word stripes may be subject to interpretation. What kinds of stripes are intended here with respect to the instrument used, the intensity of the stroke and so on? In cutting of hands to punish a thief, the rule is clear that hands are to be cut, but what is the exact meaning of the term hand, as it may extend from the elbow to the fingers. And is the left hand is to be cut or the right? Again, there may be questions about the thief and about the value of the property stolen. These questions are first answered on the basis of the texts themselves, that is, through the Quran and Sunnah.

<sup>182</sup> Imran Ahsan Khan Nyazee, *Theories of Islamic Law*, p.8.

referring them to the purposes of the *Shariah* (*maqasid al-shari'ah*) and checking them against these purposes.<sup>183</sup>

Jurists may end with different interpretations and even solutions because there are several schools of Islamic law. The theories of the jurists can only be understood by appreciating the detailed principles preferred by each school. This diversity does not confuse Muslims, as they have the freedom to follow the opinion or interpretation which they believe is right. Lawyers, judges and scholars are free to base their interpretation on the opinion of any jurist, whatever his affiliation. They may even follow rules of interpretation adopted by a particular school in one context, and those adopted by a different school in another rule. Questions of internal analytical consistency are ignored by the proponents of such a view. A multiplicity of theories of interpretation in no way indicates discord or tension within the Muslim community. On the other hand, it indicates an unparalleled richness and variety in a system of law that accommodates a large number of distinct races, cultures, and geographical regions.<sup>184</sup>

It is worth mentioning that from the earliest days of Islamic law the roles of jurists and rulers were clearly defined. Jurists focused on that part of the law that was derivable directly from the text, whereas rulers generally dealt with new situations using the general principles of the *Shariah* available in the Quran and *Sunnah*. This separation between the activity of the state and the writings of jurists was intentional, because of the structure of Islamic law and the design of the Islamic legal system, and it was carried out under the principle of separation of functions in a spirit of cooperation.

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<sup>183</sup> Ibid., p 279.

<sup>184</sup> Ibid., p10.

The aforementioned primary sources of Islamic law namely the Qur'an, *Sunnah*, *Ijma'* and *Qiyas* are the main fountains of *Shari'ah*. Jurists either find ready law there in the first two or extend that law by analogy to new cases. This part of Islamic law is small and relatively fixed. It includes the laws of worship, inheritance, marriage, dower, divorce and fixed punishment. Beyond this remains a vast area of law which is flexible. It is an Islamic State's responsibility to legislate, with the aid of Jurists, in this area given the needs of the time. Jurists, engaged by the State, may make law in this sphere resorting to any of the abovementioned subsidiary sources.<sup>185</sup> Nevertheless, the jurists derive general principles to be used by the rulers in creating Islamic law for certain matters. More elaboration of these principles follows.

### **3. The Principles of Islamic Law:**

A principle is an authoritative starting point for legal reasoning from which we seek grounds of decision by deduction. In modern law, principles are said to come into operation in "hard cases." These are cases where the text of the statute fails to provide a direct answer. A judge in such a case would search for a general principle that would cover the particular set of facts. Eisenberg suggests that principles are explanations for rules, in the sense that we commonly invoke general propositions to explain those that are more specific. However, the force of principles is not merely explanatory. Principles, like rules, are binding legal standards, and often determine results without the mediation of rules.

In English common law, principles are laid down by court decisions. These principles have usually been refined over the years by later judgments.

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<sup>185</sup> Md Anowar Zahid, op. cit. pp. 23-26.

Whenever a judge needs a principle he looks for it in such judgments. In Islamic law both general principles and rules are laid down in the Qur'an and the *Sunnah* or could be constructed from the general words. Islamic law principles according to the great jurist "Al-Ghazali", who converts the discovery of the general principle into a theory, are of three kinds, and each of these is discovered in a defined way.

#### **A. Principles stated explicitly in the texts:**

The first category of principles are those stated explicitly in the texts of the Qur'an and the *Sunnah*, e.g. the prohibition of *riba* (interest) emerging from the Qur'an and its supplementary principles stated in the *Sunnah*. The principle stated in the text of the Qur'an is read by the jurists as implying: "All sales are permitted, except those bearing *riba*" Another example is that "eligibility for profit is based on a corresponding liability for bearing loss." Principles stated explicitly in these texts must be followed even when they do not conform to the purposes of the law. Such principles are nevertheless limited.

#### **B. Principles Derived from the Underlying Wisdom of the Texts**

This category includes principles not explicitly stated in the texts, but which that have been derived directly therefrom, as being derived from the wisdom related to an underlying cause. An example is the "minority" concept which was generalized to yield the concept of "incapacity". Through this the rule of guardianship was extended from minors to all persons who were unable to look after their own affairs, e.g. insane persons. This was further generalized to yield the principle of "necessity", so that guardianship could be extended to cases of financial mismanagement.

### **C. Principle Introduced by Jurists**

These principles are not derived from the texts by generalization, but seek authenticity through conforming to the purposes of the law and consistency with the rest of the law. These principles have to meet the following conditions:

- a. They should not be alien to the law, but conform analytically to other propositions and principles of the law,
- b. They should not clash with the text, and
- c. They should not attempt to alter the implications of the texts, i.e. the general propositions and principles of the law.

We will use some of these principles in supporting our argument when proposing a solution to the liability of the shareholders to the debts of their subsidiaries.

### **4. The Development of Islamic Law**

Islamic law has a history whose normative foundations and development stretch from the 7th century to the present, which illustrates that legal rules were often the product of Muslim jurists utilizing their analytical discretion in light of cultures, institutions of education, precedent, principles, and doctrines. Therefore, the development of Islamic law cannot be appreciated without studying the history of *fiqh*, as it is the foundation of Islamic civilization and was the cement for its stability through the turmoil of centuries. As long as the process of *fiqh* was dynamic, creativity and ideas flowed from Islam to other civilizations. When this process became static and stagnant, historical Islam increasingly turned inwards and became marginalized in the global struggle of humankind.

Islamic law passed through six major stages of development:

- a) **The Foundation:** the era of the Prophet (PBUH) (609-632CE).
- b) **The Establishment:** the era of the Righteous Caliphs, from the death of the Prophet (PBUH) to the middle of the seventh century CE (632-661).
- c) **The Building:** from the founding of the Umayyad dynasty until its decline in the middle of the 8<sup>th</sup> century CE.
- d) **The Flowering:** from the rise of the Abbasid dynasty in the middle of the 8<sup>th</sup> century CE to the beginning of its decline around the middle of the 10<sup>th</sup> century CE.
- e) **The decline of the Abbasid dynasty** from about 960 CE to the murder of the last Abbasid Caliph at the hands of the Mongols in the middle of the 13<sup>th</sup> century CE.
- f) **Stagnation and Decline:** from the sacking of Baghdad in 1258 CE to the present.

While the details of the history and development of Islamic law lie out with the scope of this study, I can only highlight its most important features.<sup>186</sup> During the life of the Prophet (PBUH), he was the only source for Muslims to know and understand the *Shari`ah*. His example was necessary and sufficient for the guidance of the community. The Qur'an presents the doctrinal principles and ethical underpinnings of the *Shariah* and the Prophet (PBUH) clarified, substantiated and implemented these principles. However, he did not leave this world until after the edifice of the *Shari`ah* was completed and its basis and general principles were fully outlined. Yet he did not leave a fully codified Law,

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<sup>186</sup> For a detailed explanation of the history of Islamic Law, see Bilal Philips, op. cit.; Jamila Hussain, op. cit.; Yousef Ahmad Badawi, op. cit.



but a collection of principles and general rules along with a number of specific injunctions and judicial verdicts.

Therefore, his death presented a challenge to his Companions to continue the process of realizing God's orders in the matrix of human affairs. The first generation of Muslims rose to this challenge. Where God's orders were explicit or where the Prophet had given clear direction, they followed that direction. Where the Qur'an and the *Sunnah* provided general principles but no directive for explicit implementation, they used the process of consultation and reasoning to find solutions to the pressing problems of the day. Over time this methodology developed into a broad tradition practised by the first four Caliphs - the *ijma* (consensus) of the Companions. Such consensus was sometimes universal. At other times, it was the consensus of only some of the Companions. The Companions created history with their deeds, leaving others to follow in its trail. It was left to later generations to study, understand and argue about what they had done.

Further challenges emerged with time. As the Companions passed away, intellectual leadership of the community passed on to the *Tabeyeen* (those who had followed or learned from the Companions). This was the second generation of Muslims. Eventually this generation too passed away presenting a great challenge, especially as the Islamic empire extended worldwide<sup>187</sup> to include Arabs, Persians, Egyptians, Africans, Spaniards, Afghans, Turks and Indians. The people of the empire needed answers to the issues that faced the vast and diverse world of Islam. Arab and non-Arab jurists fed these needs, presenting

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<sup>187</sup> The year 740 witnessed the zenith of the Islamic Empire. Muslim armies had crossed into France and were on the borders of Switzerland. Constantinople (Istanbul), the seat of the Byzantine Empire, had undergone multiple assaults. Muslim merchants had encountered the Chinese in Sinkiang on the ancient Silk Road and were actively trading in the Indonesian islands and eastern China. The centre of Vedic culture in Sindh (in today's Pakistan) was under Muslim rule.

fruitful values and new choices to Islamic law. These choices were modulated and transformed by Islamic history. Muslim society was in a state of flux, and the pent up tensions brought by new peoples and ideas were soon to erupt like a volcano, giving birth to great Muslims scholars who systematized the science of *fiqh*.

In the early years of Islam, the cities of *Madina* and *Kufa* were two of the prime centers of learning. *Madina* was the city of the Prophet and its people had close access to Prophetic traditions. However, *Madina* as the heart of the Islamic Empire was insulated from the challenges of ideas from neighboring civilizations. The *Madinite* School was much more orthodox in its approach to *fiqh*. *Kufa*, on the other hand, located at the confluence of Arabia and Persia, was a melting pot and more susceptible to foreign ideas. It was from *Kufa* that the *Umayyad*<sup>188</sup> ruled Iraq, Pars (central and southern Persia), Khorasan and western India (today's Pakistan). The *Kufans* had somewhat less access to the traditions of the Prophet, but were at the forefront of the challenge of ideas from the neighboring Greek, Persian, Indian and Chinese civilizations.

It was only natural that *Madina* and *Kufa* would become the earliest centers of schools of jurisprudence, and the earliest developments in *fiqh* centered on these two cities, creating had two schools of *fiqh*, the *Madinite* and the *Kufic*. The first and foremost scholar of the Kufic School was Imam *Abu Haneefa* (d.768) whereas the first and foremost scholar of the *Madinite* School was Imam *Malik bin Anas* (d. 795).

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<sup>188</sup> The Umayyad name derives from Umayya bn Abd Shams, the great-grandfather of the first Umayyad caliph. Their capital was Damascus. At its greatest extent their empire covered more than five million square miles, making it one of the largest the world had seen, and the fifth largest contiguous empire ever. After they were overthrown by the Abbasid, they fled across North Africa to Al-Andalus, where they established the Caliphate of Cordoba, which lasted until 1031.

The period of the Abbasid dynasty<sup>189</sup> saw great support for Islamic scholarship. *Fiqh* developed as an independent Islamic science, compilations of *hadith* and *fiqh* were made, and great scholars debated theological matters and disseminated their ideas throughout the Empire. The process of commentary and analysis of *Shariah* provided by the Imams and their jurist followers stretched over a period of three hundred years, throwing up at least nineteen schools of jurisprudential thought (called in Arabic *madhahib*, literally way of going). Over time, the number of *madhahib* diminished, to the extent that there are now only four remaining Sunni schools and three Shia schools.<sup>190</sup>

The four Sunni schools are:

- a. the Hanafi madhhab, named after Abu Hanifah (d. 768)<sup>191</sup>;
- b. the Maliki madhhab, named after Malik b. Anas (d. 795)<sup>192</sup>;

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<sup>189</sup> The Abbasids were the dynasty of caliphs who ruled the Islamic Empire from 750 until the Mongol conquest of the Middle East. The dynasty takes its name from its ancestor al-Abbas, the uncle of the Prophet Muhammad. In 750 the Abbasids defeated the Umayyads and transferred the capital of the Caliphate from Damascus to Baghdād, thereby shifting the empire's center from Syria to Iraq. The regime reasserted the theocratic concept of the caliphate and continuity with orthodox Islam as the basis of unity and authority in the empire. The Abbasid "revolution" also made Islam and the fruits of power accessible to non-Arabs. A strong Persian influence persisted in the government and culture of the Abbasid period, and Hellenistic ideas led to the rapid growth of intellectual life. The Abbasid period may be divided into two parts. In the period from 750 to 945 the authority of the caliphs gradually declined, with Turkish military leaders gaining increasing influence. The dynasty's power peaked in the reign (786-809) of Harun Al-Rashid. In the later period, from 945 to 1258, the caliphs generally held no more than nominal suzerainty. Real power, even in Baghdād, passed to dynasties of secular sovereigns.

<sup>190</sup> The Shia sect differs in many respects from the Sunni schools. The Shia school of law emerged as a result of a political division of the Islamic community after the death of the Prophet (bpuh). The term shi'a itself means faction and denotes that party, which after the death of the Prophet (bpuh), attached itself to Ali, the son-in-law of the Prophet, considering him the successor of the Prophet (bpuh) both in temporal and religious matters. Central to Shia jurisprudence is the role of the Imam, a descendant of Ali, who is regarded as the leader by divine right. The Shias themselves can be divided into three schools: the *Ithna'asharis*, the *Ismailis* and the *Zaydis*. The *Zaydis* represent a very small minority within the *Shia* sect. The distinctive hallmark of the *Zaydis* is that they regard the Imam as an ordinary human being who has no closer link to God than any other member of the community. Both the *Ismailis* and the *Ithna'asharis*, the latter being the most numerous *Shia* sect, believe that the Imam has a close link to God, having been appointed by him. However, the *Ithna'asharis* believe that there were no further Imams after the twelfth Imam 'retired from the world' in 874 AD. In contrast, the *Ismailis* have maintained an unbroken chain of Imams from the time of Ali down to the present. Shias are nowadays found mainly in Iran, but also form sizeable minorities in other countries, for instance Iraq and Pakistan.

<sup>191</sup> The Turks loved the egalitarian disposition of Imam *Abu Haneefa*, as well as the creative aspects of the *Hanafi Fiqh*. When they embraced Islam, they became *Hanafis* and its arch defenders. The Seljuk Turkish dynasties in the 11<sup>th</sup> and 12<sup>th</sup> centuries as well as the Ottomans endorsed the *Hanafi Fiqh*. The Timurids, Turkomans as well as the Great Moghuls of India were its champions as well. For these historical reasons, the Hanafi School is the most widely accepted of the various schools of *Fiqh* in the Muslim world today. Most of the Muslims of Pakistan, India, Afghanistan, Central Asian Republics, Persia (until the 16<sup>th</sup> century), Turkey, northern Iraq, Bosnia, Albania, Skopje, Russia and Chechnya follow the *Hanafi Fiqh*. A large number of Egyptians, Sudanese, Eritreans and Syrians are also Hanafis, although as we shall elaborate later, for reasons rooted in geography, the Maliki and Shafi'i Schools are also well established there.

<sup>192</sup> The Maliki School spread through Egypt, Libya, Algeria and Morocco through the Hajj. The North Africans visited Mecca and Madina and learned their *fiqh* from the Madinites. They had little reason to visit Kufa and Iraq and therefore had only occasional contact with the *Hanafi* School. The cultural affinity between the unsettled Berbers of North Africa and the Bedouins of Arabia also contributed to the acceptance of the *Maliki* School in Libya and the Maghreb. From

- c. the Shafi'i madhhab, named after Muhammad b. Idris al-Shafi'i (d. 820)<sup>193</sup>; and
- d. the *Hanbali madhhab*, named after Ahmad b. Hanbal (d. 855).<sup>194</sup>

The schools were formed, it has been claimed, in an attempt to maintain autonomy from the Caliph, and exclude dogmatic theologians and sectarian groups from religious authority. The Schools had no charters, patents, or membership lists; their organization was informal. Nevertheless, by the mid-tenth century, it became impossible to study or teaches Islamic law without belonging to one of the established schools.<sup>195</sup>

The four Sunni schools are not sects. Each is organized around a theory for the derivation of law that it upheld and practised. Each has an individual and independent system of interpretation, which is internally consistent and thus must be followed as a whole or not at all. An attempt to merge or combine two systems of interpretation would lead to a new theory of interpretation. This would be permissible only if the new theory is developed as a whole and is also internally consistent. Such attempts have indeed been made, though the jurists advancing their theories have rarely claimed that they were proposing new theories outside their schools. There is no restriction, however, and there has never been one, on the formulation of new theories by competent jurists. Today qualified jurists may advance fresh theories, if such theories are needed.

The schools played a crucial role in shaping legal interpretation and the transmission of legal knowledge, while providing a strong element of continuity and homogeneity in Islamic society over space and time. The schools differ in various respects, including the way they arrive at a legal decision, but accept

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North Africa, the *Maliki* School spread to Spain and was the only official School sanctioned by the *Umayyad* dynasty in Cordoba. As Islam spread from the Maghreb into sub-Saharan Africa through trade routes, the *Maliki* School also spread to Mauritania, Chad, Nigeria and other countries of West Africa. Most Africans today follow the *Maliki* School.

<sup>193</sup> The *Shafi'i* School spread to Egypt, the Sudan, Eritrea, East Africa, Malaya and the Indonesian Islands. Like the *Hanafi* School, the *Shafi'i* School produced many brilliant scholars. One of them, the great *Abu Hamid al Gazzali* (d. 1111), not only influenced the development of *fiqh*, but also changed the course of Islamic history through his brilliant dialectic.

<sup>194</sup> The *Hanbali* School flourished in Arabia and western Iraq until the *Wahhabi* movement in the 18<sup>th</sup> and 19<sup>th</sup> centuries supplanted it. Because it was considered disruptive of accepted practices, it came into conflict with the Ottomans in the 18<sup>th</sup> century. After the Wahhabis captured the Hijaz from the Ottomans in 1917, the *Hanbali fiqh* became the official jurisprudence in the Arabia (later known as Saudi Arabia).

<sup>195</sup> For the curriculum often taught at these legal schools, see George Makdisi, *The Rise of Colleges: Institutions of Learning in Islam and the West*, Edinburgh University Press, (1981).

each other as orthodox. The schools recognize each other's traditions as legitimate and their opinions on disputed legal questions as equally valid. It is important to know that all schools have contributed in different degrees to the development of *fiqh*, and that no single school can properly be claimed to represent Islam or Islamic law in its totality. In other words, *fiqh* is not determined by any one school of thought acting alone. All schools have been important instruments for the clarifications and applications of the *Shari'ah*.<sup>196</sup>

The work of a school founder was continued by his disciples, and over the centuries several widely used handbooks of law were composed by famous scholars, which supposedly laid down all what was needed to be known about the law for all generations. These books come to be regarded as authoritative legal texts in their particular schools. The writings in Law for every school passed through different styles, from commentaries on original texts, to summaries and abridged works, and then to the legal encyclopedias. Thereafter, writings began to define general axioms of Islamic Law, including comparing and grouping injunctions according to evident patterns. The fields of comparative law and legal theory also developed, as well as the codification of definitions, and the formulation of formal legal codes.

The oldest extant legal compendia show that the study of the law was already quite sophisticated. There are indications that its systematic formulation dates back to the first half of the eighth century in Iraq. By 900 CE, all the main genres of legal literature had been established, including extensive legal compendia, epitomes of the points of law, collections of model legal documents,

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<sup>196</sup> Bilal Philips, op. cit. p.8.

collections of model court records, manuals for judges, collections of response, and manuals of jurisprudence, legal method and interpretation.

By the late eighth and early ninth centuries C.E., from which date the earliest extant compendia of the points of law, such as the Book 'al-umm' of *Muhammad b. Idris al-Shafi'i* (d. 820), Islamic law was already a sophisticated science with a substantial tradition behind it. In such works, the law was organized into chapters in a more or less standard order, falling into three main sections:

- a. (*ibadat*) devotions, including ritual purity, prayer, almsgiving, fasting, the pilgrimage, and related topics;
- b. (*mu'amalat*) transactions, contracts, including sales, debt, rental, pawning and mortgage, partnership, loans, inheritance, marriage, divorce, slavery, gifts, endowments, etc.; and
- c. (*ahkam*) verdicts, including payment of indemnity for injuries, criminal punishments, and court procedure.

Obviously, the law includes not only topics directly related to religious devotions and rituals but also general topics of family, commercial, and criminal law.

Closely related to the *madhahib* was the institution of the *madrasa*, or college of law, which began in the eleventh century in Baghdad in 1067 and subsequently spread throughout the Muslim world. The *madrasa* was usually a building that provided space for teaching large classes as well as lodging for students, often on an upper story.

The colleges of law were supported by a perpetual endowment (*Waqf*) that generated income from the produce of agricultural land or the rent from a row of shops, for example. These funds paid the salaries of the overseer of the endowment, the professor of law, and other staff, as well as student stipends, repairs, and other expenses. Generally, the *madrasa* was devoted in the endowment deed to the law of one of the *madahhib* and had one professor who

taught the law of that *madhhab*. Stipends were also provided for students who studied the law of that particular *madhhab*.

*Madrasas* soon became the most important institutions of learning in the Muslim world. They tended to exclude the teaching of the Greek sciences, including philosophy, medicine, astronomy, and so on, relegating their teaching to private settings, but to accept the teaching of other religious sciences, such as Arabic grammar, rhetoric, *hadith*, scriptural commentary, and so on, but as ancillary to the study of the law.<sup>197</sup> Certainly by the thirteenth century, but possibly earlier, the completion of legal study was recognized by the conferral of a diploma granting the status of law teaches to its carrier. A diploma was granted by a master jurist to his student.

In the early years, a considerable amount of flexibility in opinion was accepted, but towards the end of the Abbasid period the schools became more formalised and inflexible, until gradually the rule was made that Muslims had to follow a one school only and there could be no interchange between them. They became *Sunni*, *Shi'a*, *Hanafi*, *Maliki*, *Shafi'i*, *Hanbali*, ... etc. With time, stagnation set in and what was once a bridge to the future became a bridge only to the past. The schools became ossified. Heredity, official sanction, political events, tribal and national loyalties all played their historical part in this process.

By the 11<sup>th</sup> century, Islam had become a city-based civilization. People longed for a break from controversies. A broad consensus developed that the existing

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<sup>197</sup> The system of legal education that developed in conjunction with the *madhhab* and the *madrasa* involved three main levels: ancillary studies in Arabic grammar, rhetoric, and related fields; intermediate study of the legal tradition of the *madhhab*; and advanced study on the disputed questions of the law. Disputation and dialectic were major foci of the advanced law student's training; they played an important role in the elaboration of the law.

schools of *fiqh* were sufficient to meet the challenges of the day. Islam had successfully withstood the onslaught of Greek thought and had successfully accommodated the spiritual challenge from eastern religions. It appeared that the interfaces between Islam and its sister civilizations of the day had been well defined. It was now time to rest the case. The door to *ijtihad* was therefore closed and people were required to copy or follow the work of previous jurists (*taqlid*). Faced with the possibility of extinction, Islamic civilization increasingly turned inwards to its own inner soul. The close of *ijtihad* made the *fiqh* fixed and inflexible and prevented it adapting to modern times.<sup>198</sup>

After the fall of the Ottoman Empire and during the period of Western expansion between the 16<sup>th</sup> and 20<sup>th</sup> centuries, most Muslim countries came at some time under the commercial and political domination of one of the major European colonizing powers.<sup>199</sup> In such countries the *Shari'ah* was replaced with European-style legal systems, except for areas of law such as family law and inheritance, which were of little significance to the colonial power. Even in countries which were not directly colonized by European power, such as the Ottoman Empire, there was a tendency to “modernize” by adopting Western legal systems. New court systems were accompanied by legal education programmes that focused on European principles. *Shari'ah* courts were amalgamated with European concepts in unified court systems. The fusion of the two systems diluted *Shari'ah*, creating confusion and fostering limited

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<sup>198</sup> The Crusader invasions (11<sup>th</sup>, 12<sup>th</sup> and 13<sup>th</sup> centuries) and Mongol destructions (13<sup>th</sup> century) led to the death of *ijtihad* and helped to consolidate the status quo.

<sup>199</sup> The British ruled India and Malaya and at various time exercised political mandates in the Middle East. The Dutch controlled the East Indies (Indonesia), while and the French ruled North Africa.



knowledge of Islamic law among Muslim lawmakers, jurists and lawyers in affected countries.<sup>200</sup>

By the middle of the 20<sup>th</sup> century at one extreme certain Muslim countries had a mixed legal system, while at the other extreme Saudi Arabia, Iran, Afghanistan and Sudan retained an almost complete and traditional *Shariah* legal system.

## **5. How Islamic Law Is Now Made**

The idea of closure of the gate of *ijtihad* was not accepted by many influential earlier Scholars<sup>201</sup> who maintained that despite the decline in the fortunes of Islamic civilizations under Western colonialism, *ijtihad* was still possible and should continue to be exercised. Modern scholars argue that the four great Islamic schools and their founders never claimed infallibility or finality for their interpretations of the *Shariah*. Moreover, it is a false and unhistorical view to assume that the compilations of the great jurists of the past are a fixed and categorical body of law which must be accepted as divine. The decisions of these jurists were the product of human reasoning and the reasoning of men in a patriarchal era. Therefore some principles can and must be changed with changing circumstances, so that it is a necessity and a duty for qualified Muslims to re-exercise *ijtihad* in the present time.<sup>202</sup>

The call to re-open the gate of *ijtihad* is supported by the fact that recent substantial political, economic and technological change has made urgent the need to find solutions in Islamic law to new problems and to reassess some old rulings in the light of new knowledge. This will not be achieved unless scholars

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<sup>200</sup> Irsbad Abdal Haqq, *Islamic law: an overview of its Origin and Elements*, in *Understanding Islamic law*, Altamira Press, 2006, p 46.

<sup>201</sup> Such as *Ibn Taymiyah* in the 14<sup>th</sup> century, *Mohammad Iqbal* in Pakistan, and *Al-afghani* and *Mohamad Abdu* in Egypt.

<sup>202</sup> Jamila Hussain, *op. cit.* p 18.

are free from the doctrine of *taqlid*, exercising *ijtihad* in order to formulate new legal rules from a new interpretation of the *Shariah*. This means going back to the original sources to consider whether interpretations other than the traditional are ones possible.

Since there are specialized areas where a religious scholar alone would not have sufficient technical knowledge to be in a position to give a proper opinion, there is a necessity for what has recently been called “collective *ijtihad*”, which may be obtained through the formation of councils of religious and secular scholars who are specialists in their chosen fields (such as finance, insurance ... etc). Such councils have already been formed in many Muslim countries even in Europe.<sup>203</sup>

In addition to the efforts to revive *ijtihad*, various Muslim countries have attempted to modernize and “westernize” their legal systems by re-interpreting the *Shariah* text. Such modernization is done by different tools such as *Takhayyur and Talfiq*. *Takhayyur* means making a choice from the variety of legal opinions offered by the eminent jurists of the past. If a satisfactory solution to a problem cannot be found within the opinions of the school predominant in a certain area, a solution may be adopted from the opinion of another school. Similar to this is the doctrine of *Talfiq*, which means combining part of the juristic opinion of one school with part of the opinion of another school or jurist in such a way as establish new legal rules.

Another aspect of *Shariah* modernization is codification of *Shariah*. Modernists argue that it is in the public interest that the government should promulgate comprehensive codes of law so that modern interpretations of law could be put

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<sup>203</sup> For example, the European Council for Islamic Rulings and Research has its headquarters in London.

into effect clearly and comprehensively. Such a method is more certain and convenient than searching through juristic treatises of the appropriate opinion in each case.

## 6. Implementation of Islamic Law in Muslim Countries

The wide spread of Islam has meant that many legal systems have either incorporated some elements of Islamic law, which govern Muslim citizens of these countries, as in South Africa and Nigeria,<sup>204</sup> or are to a large extent completely based on classical Islamic law, as in Saudi Arabia.

Countries with majority Muslim populations are officially Islamic states, and their constitutions contain provisions to the effect that Islam is the state religion and that all laws should be in conformity with Islamic *Shariah*. This applies for instance to both Iran and Pakistan. However, Islamic law is not only relevant in countries with majority Muslim populations. The legal systems of many non-Muslim countries allow Muslims to be governed in the area of family law by Islamic law, e.g. India.<sup>205</sup>

In many Arab countries, Islamic Law still forms the basis of the legal system, though in many instances it has been reformed and codified. The constitutions of some Arab countries provide that the *Shariah* is [a] or [the] principal source of law and some have enacted statutes based on the *Shariah*.<sup>206</sup> However, this is different from the *Shariah* being the law. In the first case, it is no more than

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<sup>204</sup> In recent years, some of the states in Northern Nigeria not only apply Islamic law in matters of personal status such as marriage, divorce, custody of children and succession on death, but also to criminal offences. The aim in these Muslim states of Northern Nigeria is to apply the *Sharia* in its entirety.

<sup>205</sup> Malaysia, which has a Muslim majority, is another example of a mixed legal system. Islam is the religion of the Federation but the majority of laws in force in Malaysia today were introduced during British colonial rule. However, Islamic law is nevertheless an important source of law especially in the area of family law where it is applied by special Islamic courts, the *Syariah* courts, as they are called in Malaysia. These courts have also a very limited jurisdiction to deal with minor offences against Islamic law. However, the jurisdiction of Islamic courts is limited to Muslim citizens.

<sup>206</sup> See, for example, Article 2 of the Egyptian Constitution states that *Shari'a* principles are the main source of law; Article 2 of Kuwaiti Constitution, stated that the *Shari'a* is a main source of law.

a/the source; in the second, one of its essential attributes, its ultimate authority, has been altered, from Allah to the state. In Saudi Arabia, the *Shariah* is the law, but even there it is supplemented by numerous regulations enacted by the government.

In terms of adherence to *Shariah* for commercial transactions, Islamic countries can be grouped into four categories:<sup>207</sup>

- a) countries that are highly observant of the *Shariah* (like Saudi Arabia, Iran, Pakistan, and Afghanistan);
- b) those who have made serious attempts to revive traditional Islamic jurisprudence (like Jordan and the United Arab Emirates);
- c) those whose legal systems have been influenced by that of France (like Lebanon, Syria, Iraq, Kuwait, and Egypt); and
- d) Those which have completely abandoned traditional Islamic law and adopted instead western-style codes (like Turkey).<sup>208</sup>

Adherence to the *Shariah* also varies depending upon the area of law. The rules of marriage, divorce, child custody, and inheritance are still strictly followed in the Muslim world. On the other hand, Islamic rules of crime and punishment are not always followed. In most Muslim countries imprisonment has replaced cutting off the hand of a thief, while the death penalty for apostasy has been abolished.<sup>209</sup>

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<sup>207</sup> H.S. Shaaban, *Commercial Transactions in the Middle East, Law and Policy in International Business*, (October 1999), p.4.

<sup>208</sup> Mohamed Mattar, *The relevance of Islamic Law in Contemporary Commercial Transactions*, in *Islamic Finance: A guide for International Business and Investment*. London: Gmb Publishing, (2008) pp.2-3

<sup>209</sup> *Ibid.*, p.3.

## **7. Conclusion: Islamic Law is a Growing Tree:**

Nyazee describes Islamic law as an ever-growing tree. Its seed was sown in the hearts and minds of men fourteen hundred years ago by the Prophet Muhammad (*PBUH*). Since then it has taken root, grown, and spread its branches on all sides. With each passing century, it grows in size, its evolution and growth never ceasing. Its spreading branches cast their shade on all sides covering different cultures, peoples, and races. Like the trunk of this tree, Islamic law has a part that is fixed, and like its branches and leaves, the law has a part which changes shape and color every season. The fixed part of this tree is closer to the roots and cutting this part is likely to damage the tree itself. Like the trunk of this tree, the fixed part of Islamic law has grown directly from its roots or sources. Changing this fixed part will affect the nature of the legal system. Like the branches of the tree, the flexible part of the law has been changing with the times, sometimes yielding abundant fruit, sometimes less.

When the branches of this tree are cut off, its cool shade is missing, but its strong trunk continues to guide and protect those who cling to it in storms and times of crisis. Thus, when the state does not let the branches of Islamic law provide their shade, it is the fixed part that continues to keep the Muslims on the right track. For those Muslims living in secular states, the fixed part of the tree is the only guide, and this is all they are obliged to follow, except for certain parts that are beyond their power to implement. Tending the trunk of the tree, the fixed part, has always been the task of Muslim jurists. They have looked after it with loving care for fourteen centuries. Their labour has made the trunk so strong that ceaseless attacks against it have failed to budge it. Not only this, many attacks on its roots have also failed. When the tree was young, its stem

was tended jointly by the state and the jurists, as then there was no distinction between the fixed and the flexible part. It was later, when the tree reached a mature stage of development, that the fixed part could be distinguished from the changing part with ease. At this stage the jurists left the care of the flexible part in the hands of the *imam* or the state, while they devoted themselves to the strengthening and refinement of the fixed part of the law. The only condition that the jurists imposed upon the *imam* for developing the flexible part of the law was that he is a qualified jurist, that is, he should employ a valid methodology, either directly or through delegation, for developing this part of the law.

Rulers in some ages did care for the branches of this tree, while in others they did not. On occasion some rulers cut off the branches that had grown in earlier ages and started all over again. This discouraged the development of firm offshoots from the tree, that is, the development of legal institutions and practices that could be developed further in later ages. After some centuries, when the Muslim empire split up, the branches of the tree were divided into different segments on different sides, with each ruler looking after the branches on his own side of the tree, as it suited his wisdom. Some took interest in this law while others did not. Thus, for example, the Ottoman rulers tended these branches in their own way in the Ottoman Empire, while Awrangzeb Alamgir developed the law in his own fashion in India.

The period of these rulers was followed by violent storms around this tree, and alien winds struck it destroying the branches on all sides. On some sides the Muslims pulled down the branches themselves. The age of colonization left nothing but the solid trunk of the tree, which could not be uprooted with ease, thanks to centuries of dedicated work by Muslim jurists. When the storms were

over and the Muslims were left alone to take care of the tree, all they could see was the trunk of the tree with no branches or leaves. In their confusion they started blaming the jurists for not having looked after the branches, and having fallen prey to *taqiid*. They failed to distinguish between the fixed part and the flexible part. They did not realize that it was certain rulers and not the jurists who were to blame for not having established lasting institutions. Some even tried to bring branches from other alien trees to hang on their own tree, least realizing that these would rot one day. Today, some Muslim states are trying to look after the tree in their own way and on their own side, while others are busy trying to cut down the tree and even dig at its very roots. Nevertheless, branches have begun to sprout and it will not be too long before they start to bear fruit. Indeed, they must bear fruit, because the culture, history, life, and the very identity of Muslims are associated with this tree.

A question may be asked here as to what we mean by the "fixed" part of the law. Very simply, the law that is stated explicitly in the texts, the Qur'an and *Sunnah*, or is derived through strict analogy (*qiyas*), is more or less fixed. The rules relating to *ibadat* are fixed; the rules relating to inheritance are fixed; the rules relating to marriage and divorce are fixed; and the rules relating to the *hudud* penalties are fixed. These laws are not likely to change over time. In comparison, if we make laws about income-tax, traffic, new forms of crimes, and other areas in accordance with the *shari'ah*, we might change them through fresh *ijtihad* in a later age, because these rules are not stated explicitly in the texts.

Nyazee<sup>210</sup> stated that Islamic law is not only a stable tree patiently waiting for its fruit to be picked. It may also be compared to a giant river that has moved very rapidly in some stages, while in others it has slowed down, spreading out into the plains consolidating, depositing its fertile silt, and then moving on, sometimes bursting out again through the dams that have been constructed to block its path, threatening to wash away all that stands in its way.

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<sup>210</sup> Imran Ahsan Khan Nyazee, *Theories of Islamic Law*, pp.52-55



## Part II

### Groups of Companies in Islamic law

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Islamic Jurisprudence (*fiqh*) has certainly addressed commercial transactions. When jurists classify *fiqh* into *akhlaq* (morals), *ibada* (religious observance) and *mu'amalat* (transactions) they paid special attention to commercial transactions due to their importance and complexity. *Fiqh* books contain special sections for sales, leasing, partnership, transfers, mortgage and other topics related to commercial and business transactions. Moreover, Islamic commercial law has often been singled out as the most important area of contemporary research in relevant Islamic studies, and has been given an even higher rating than research in applied sciences and medicine. This is due to the critical importance of commercial transactions in the generation of wealth and the prospects of productivity in contemporary Muslim countries.<sup>211</sup>

The concept of commercial law has special features in Islamic law compared to Western systems. These features give rise to two main differences between the two regimes<sup>212</sup>:

- a. Commercial law in Western regimes works on the assumption that different attitudes are needed for commercial as opposed to non-commercial transactions, since business people need less protection

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<sup>211</sup> Mohammad Hashim Kamali, *Islamic Commercial Law, an Analysis of Futures and Options*, Islamic Texts Society, 2<sup>nd</sup> Ed., (2002), p.262.

<sup>212</sup> For a detailed description of the Islamic commercial law, see W Ballantyne and H Stovall, *Arab Commercial Law: Principles and Perspectives*, Chicago, American Bar Association Publishing, 2002; Mallat, C, *Commercial law in the Middle East: Between Classical Transactions and Modern Business*, (2002), 48 *American Journal of Comparative Law* 81; A Udovitch, *The Law Merchant of the Medieval Islamic World* in G von Grunbaum (ed), *Logic in Classical Islamic Culture*, Otto Harrassowitz 1970; Hashim Kamali, *Islamic Commercial Law* London: Islamic Texts Society, 2000; Hegazy, Walid S, *Contemporary Islamic finance: From socioeconomic idealism to pure legalism*, (2007) *Chicago Journal of International Law* 2; Saleh, Samir A, *Commercial law in the Gulf states*, (1986) *International & Comparative Law Quarterly* 35; H.S. Shaaban, op. cit.; David J. Karl, (1992) 25 *Geo. Wash. J. of International Law & Economics* 1; W. M. Ballantyne, *Commercial Law in the Arab Middle East: The Gulf States* (1986); Mohamed Mattar, op. cit.

than ordinary individuals and different moral standards apply. Islamic law applies the same principles of morality to all situations. A Muslim should not behave in one way at home and another way in his business. Therefore, consistently with its overarching values in other areas, Islamic law emphasizes a moral approach to commercial and business transactions, based on values of justice, equality, and fairness, and any definition of Islamic commercial law must be read in the light of this consideration.

- b. Within Western systems, Commercial law' in the Common law tends to cover transactions, rather than institutions such as partnerships and companies, whereas Civilian law encompasses both.<sup>213</sup> These considerations do not apply to Islamic law where the distinction between transactions and institutions is not relevant.<sup>214</sup>

Islamic commercial law provides a framework for commercial transactions based on two main general principles, firstly freedom of trade and contract so far as the limits of *Shari'ah* allow, secondly in Islam everything is '*Halal*' (allowed) unless it has been declared '*Haram*' (forbidden).<sup>215</sup> A transaction will be considered '*Haram*' if it includes one or more of the following forbidden actions; '*Riba*' (usury), '*Gharar*' (uncertainty), '*Qimar*' (gambling), or if it involves

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<sup>213</sup> Another striking difference, which cannot be categorised according to the common law/civilian law divide, is that between systems which have a formal distinction between commercial and non-commercial law and those which do not. Italy, for example does not have a formal distinction. United States jurisdictions do not fit into this categorisation, as they have statutes based on the Uniform Commercial Code, but do not make a formal distinction in the same way as, say, French law.

<sup>214</sup> Nicholas HD Foster, op. cit. p.5.

<sup>215</sup> For detailed description of what are illegal actions and transactions under the *Shari'ah*, see *Yusuf al-Qaradawi, The Lawful and Prohibited in Islam, published at [http://www.witness-pioneer.org/vil/Books/Q\\_LP/index.htm](http://www.witness-pioneer.org/vil/Books/Q_LP/index.htm).*

prohibited products or services such as alcohol, pork-derived foods, or pornography.<sup>216</sup>

What follows from these two general doctrines is that the forces of the market should be protected from unfair manipulation such as inflating the price of commodities by creating artificial shortages or concealment of vital information in a transaction from the other party. Speculative activity of any kind is also banned. In general, exploitation of any kind is expressly forbidden, including any attempt to capitalize on the other party's poor negotiating position.<sup>217</sup>

The structures of commerce and business for trading, investment, and profit-making have always been of great interest in the *Shari'ah* especially the structure of partnership. This was based on the Prophet Muhammad's (PBUH) statement (*Hadith*) that:

“God will become a partner in a business between two partners, so long as they do not indulge in cheating or breach of trust”

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<sup>216</sup> Prohibition of Riba requires that any reward or return should be accompanied by undertaking a level of risk and liability. Thus, there can be no reward for time preference alone. Islam expressly forbids any usage of money to make money. Instead, Islamic commercial law supports a partnership-based approach to business with, for example, finance providers treated as stakeholders with an interest in the success of a business, rather than external lenders charging interest for the use of their money. The *Shari'ah* dictates that charging interest is unjust and even damaging to the economy. Instead of paying interest on deposits and charging it on loans, Islamic banks enter into profit-and-loss agreements with depositors and borrowers. Under the 'Mudarabah' system, for example, a bank gives money to a borrower under the agreement that it will share in the profits in an agreed proportion. The bank's depositors receive a share of profits based on the agreed formula instead of interest. Islamic banks are also forbidden to deal with businesses involving alcohol, pork products, gambling or arms dealing.

Prohibition of Gharar forbids contracting under conditions of excessive uncertainty and unacceptable levels of risk. Prohibition of Qimar forbids gambling and any game of chance which may result in accumulating Maysir (unearned income). Thus, uninformed speculation not based on a proper analysis of available information is not allowed. Prohibition of Gharar means that existence of any avoidable uncertainty in a commercial dealing would invalidate it as it may lead to deceit or unjust enrichment. In practice however, as no commercial dealing can ever be completely free of risk and uncertainty, it has always been assumed to mean an unacceptable level of uncertainty, where the level of acceptability is largely defined by the facts of each individual case. Classically the question was mostly raised with regard to two sales in one contract, sale of an object which did not yet exist, sale of an object which was not yet in the control of the seller, or when the consideration furnished by one party in a contractual agreement was undeterminable. It is agreed by a majority of scholars that Jahl (ignorance) of price or subject matter, characteristics of price or subject matter, quantum of the price or quantity of the subject matter and finally date of performance or delivery would render a contract void for existence of Gharar.

<sup>217</sup> Nima Mersadi Tabari, *Islamic Finance and the Modern World, the Legal Principles Governing Islamic Finance in International Trade*, The University of East Anglia Law School Working Paper 10, (2010), p.3.

This also reflects the practice of the Prophet (PBUH), who was a great trader. When he started his prophethood in Mecca, he found that people practised a form of partnership, whereby an individual with surplus capital would entrust a person who had business talent with money to do business with, on the basis that any profits gained would be shared according to an agreed percentage. This is the origin of what is known today as *mudarabah* in Islamic finance. The Prophet sanctioned this practice, and it thus became Islamic by virtue because of his approval.<sup>218</sup> With this beginning, *mudarabah* has become one of the widely used methods of investment carried out in the Muslim world. Muslim scholars and jurists of the past discussed detailed rules governing this type of investment mode, especially those relating to the rights and obligations of the parties in a *mudarabah* contract and the ways the profits are to be divided.

Another form of partnership known in Islam is the *Sharikah* (a partnership in modern law) which literally means a joint venture by agreement. *Sharikah* is formed when two or more individuals agree to carry out a business venture, sharing income or profits from the business in accordance with an agreed ratio or percentage. *Sharikah* has been the subject of scrutiny by Muslim jurists.<sup>219</sup> Although earlier juristic books provided clear law governing all aspects of *Sharikah*, there is a disagreement between modern jurists concerning the existence of the concept of a corporation in Islamic law. In this Part I will focus

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<sup>218</sup> Some reports also suggested that even the Prophet, before his prophethood, used to receive *mudarabah* funds from Khadijah who later became his wife and that he excelled in managing the funds which generated good returns. It was reported that he (PBUH) travelled to Syria to do business. Also several instances of business partnerships among the companions of the Prophet have been cited in history texts. With this beginning, *mudarabah* has become one of the widely used methods of investment carried out in the Muslim world for more than a thousand years. Muslim scholars and jurists of the past had discussed detailed rules governing this type of investment mode, especially those relating to the rights and obligations of the parties in a *mudarabah* contract and the ways the profits are to be divided.

<sup>219</sup> See A Udovitch, *Partnership and Profit in Medieval Islam*, Princeton University Press, Princeton, New Jersey, (1970); Imran Ahsan Khan Nyazee, *Islamic Law of Business organization, Partnership*, Islamic Research Institute, and International Institute of Islamic Thought; 1999; Roshash, Mustafa, *Islamic Company Law : A Comparative Juristic Analysis*, (2009). Imran Ahsan Khan Nyazee, *Islamic Law of Business organization, Corporations*, Islamic Research Institute, and International Institute of Islamic Thought, (1999); Muhamas Nejatullah Siddiqi, *Partnership and Profit-Sharing in Islamic Law*, The Islamic Foundation, London, (1985).

on finding a settlement of this disagreement. I will also look to determine whether Islamic law acknowledges corporations, and if so in what form. Is the concept the same as recognised by the modern laws? Does a corporation in Islamic law have its own legal personality independent from its partners? Do the partners enjoying limited liability? The answer of these questions is very important to the study, since that if the answer is no, there will be no basis to proceed further to ask whether partners who are themselves company might be liable in Islamic law for the debts of their companies.

The starting point must be to understand the concept of *Sharikah* by answering three questions:

- a. Is it possible to extend the concept of *Sharikah* to include corporations?
- b. What is the nature of partners' liability in the *Shaikah*?
- c. Is the *Sharikah* regime fit also for modern form of corporation or there is a need to establish special model for Islamic corporations?
- d. Is it possible to have an Islamic corporation matching or at least accommodating the modern form of corporations including groups of companies?

## **1. The Concept of Sharikah (Partnership) in Islamic Law**

*Sharikah* in Islamic law is a generic term meaning participation of any type, and jurists consider every form of business organization as a *Sharikah*, the concept being thereafter subdivided into different forms of organization.<sup>220</sup> It is a flexible concept covering many different situations, including not only partnership but

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<sup>220</sup> Ali al-Khafif, *Al-Sharikat in Islamic Fiqh*, ابحاث مقارنة، الفقه الإسلامى، Dar El Fiker Al-Arabi, (2009) p.92.

any other structure involving capital contributions and subsequent profit and loss sharing.<sup>221</sup>

In literal sense *Sharikah* has two meanings:

- a. Mixing: the mixing of the shares contributed; the shares may be money, labour or anything else. Alternatively, it means mixing of shares so that one cannot be distinguished from another. Thus when two partners participate, they bring about the mingling of wealth, which is held jointly by them.
- b. The contract of partnership itself, because it is the cause of the mixing.

The legal meaning assigned to *Sharikah* by jurists does not go beyond its literal meaning, because partnership arises either through a contract or through the mixing of wealth. Nevertheless, there are a variety of legal meanings given to the term. *Hanafi* scholars define *Sharikah* as "a contract between partners on both capital and profit". *Shafi'i* scholars define it as "a contract giving two or more people rights in common to something ". The *Hanbali* School, defines it as "the coming together of two or more people in disposal or acting."<sup>222</sup>

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<sup>221</sup> There is another term more commonly used between jurists which is *Musharakah* (sharing). Both words are from the same derivative and are used interchangeably. However, the concept of *Musharakah* is slightly limited in relation to the concept of *Sharikah*, which is used in a wider sense. *Musharakah* is a partnership that may assume numerous forms. It is a highly flexible concept and may cover various situations. In its broader sense *Musharakah* means a joint enterprise formed for conducting some business in which all partners share the profit according to a specific ratio while the loss is shared according to the ratio of the contribution. The connotation of this term is limited in comparison to the term *Shirkah*, which is more commonly used in classical Islamic law.

<sup>222</sup> The *Hanfis* definition incorporates the essence of *Sharikah* as it being a contract, whilst the other definitions focus more on the *Sharikah* objectives and its legal implications. See Al Zuhaili, Wahbah, *Islamic Fiqh and its Evidences*, الفقه الإسلامى وادلته, 3rd Ed. (1989) vol.5, p.792; and Sabiq, Sayyid, *Fiqh al Sunnah*, فقه السنة, (1987), 3 Dar al Kitab al 'Arabiyy 287.

Modern Scholars define *Sharikah* as “participation of two or more persons in a certain business with a defined amount of capital, under a contract to jointly carry out a business and share profits and losses in specified proportions.”<sup>223</sup>

*Sharikah* has the following characteristics:

- a. It is a joint venture agreement, involving two or more parties for a specific business activity for the sake of profit.
- b. It is an agreement to fulfillment a certain objective within a given time.
- c. Both parties will contribute capital and be involved in the management of that business activity. Capital can take any form.
- d. Profit sharing is based on a specified agreed ratio.
- e. Parties shoulder any loss in proportion to their share of the finance.

The coming sections aim to elaborate the concept of *Sharikah* in Islamic law in order to understand if this concept can also govern the concept of corporation as presented by modern laws. This will include explaining *Sharikah*'s types and classification in old *fiqh* books and in the modern laws of Islamic countries.

### 1.1 Sharikah Classification

Jurists categorize *Sharikah* in many ways. When the term is applied to mean **co-ownership**, it is changed to *Sharikah al-milk*, which emphasizes that the participation has arisen out of mere joint ownership. When jurists want to indicate that the basis of participation is a **contract** between two or more persons, they change the term to *Sharikah al-aqd* (contract partnership) as understood in the modern law.<sup>224</sup>

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<sup>223</sup> Muhammad Neigatullah Siddiqui, *Partnership and Profit-Sharing in Islamic law*, The Islamic Foundation, London, UK, (1985), p.15.

<sup>224</sup> Some scholars add to the *Sharikah* types *Sharikat al-ibahah*. It is defined as the “common right of the people in ownership by acquisition or gathering of things that are permissible for such acquisition and are not originally owned by anyone.” This type of partnership, then, is the participation of the people in the common right to own things that are not owned by anyone. In other words, all things not owned by any individual or group of individuals exist as a kind of partnership of the people generally, and this partnership grants the right to all the members of the community to convert

## A. Sharikah al milk (Co-ownership)

*Sharikaht al-milk* is defined as “the existence of a thing in the exclusive joint-ownership of two or more persons, or the joint claim of two or more persons for a debt that is due from another individual arising from a single cause.” It is also defined as “the joint ownership of a number of persons in an ascertained thing or debt”. There is no difference in these definitions, except that the second definition does not elaborate that the debt arises from a single cause.<sup>225</sup>

The origin of *sharikah al milk* is the joint ownership of property. This is the only qualification, no joint exploitation of property is necessary. It exists simply where two or more persons become joint owners of a property without entering into a partnership contract and hence any increase in the property shall be shared by the co-owners in proportion with the extent of their ownership. This type of *sharikah* may not be known in the Common law. Mere joint-ownership is generally insufficient to constitute a partnership under the Common law.<sup>226</sup>

*Sharikah al milk* could be a voluntary or involuntary partnership. A voluntary partnership refers to a situation where two or more persons jointly buy a property or receive a certain property. Involuntary partnership refers to a situation where two or more persons acquire the ownership over something without any action on their part. This may happen, for example, when two or more persons jointly inherit a certain property. The partners have to share the property or its income based on their shares until they decide to divide it or to

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a thing to personal ownership. These things can pass into the ownership of individuals through two ways: actual gathering or acquisition, like gathering firewood or the revival of barren lands, and by bringing about the cause of acquisition, like placing a pan for gathering rain water or throwing a net in the water for fish. It is obvious that today such a partnership would be difficult to form. All things not owned by the citizens are owned by the state, except for things that are free like air or rain water. Today, forests, land, lakes and all other things are owned by the state, which is an individual in the eyes of the law—a corporation. Thus, an individual may not be permitted to throw his net into water for fish if the state has chosen to grant licenses for such an economic activity.

<sup>225</sup> Imran Ahsan Khan Nyazee, *Islamic Law of Business organization, Partnership*, p35.

<sup>226</sup> *Ibid.*, p38.



sell it. Each of the owners is in the category of a stranger in regard to any action on the part owned by his colleague. In other words, it is not lawful for either partner to perform any act with respect to the other's share except with the latter's express permission. Thus, in terms of liability of the partners, they are quite independent of each other, except for actions based on express authorization by any of the partners. Their partnership relates only to ownership and potential sharing of any profit or increase in value of the co-owned property, not in term of sharing the liabilities arising from the partners' actions.<sup>227</sup>

## **B. Sharikah al aqd (contract partnership)**

*Sharikat al-'aqd* is the most important type of *Sharikah* in Islamic law. Jurists consider it as the only type properly considered as a commercial partnership and hence it is necessary to elaborate its concept as follows:

### **1.2 Definition of the Sharikah al aqd**

*Hanafis* define *Sharikah al'aqd* as “an agreement between two or more persons for common participation in capital and profits”. *Malikis* define it as “permission from each of the participants to the others for transactions in his wealth and on their own behalf, while retaining the right to transact personally (in such wealth)”.<sup>228</sup> The *Shafi* school defines it as “an established undivided right in a

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<sup>227</sup> Ariff Abd Ghadas & Engku Rabiah Adawiyah Engku Ali, *The Development of Partnership Based Structure in Comparison to the Concept of Musharakah (Sharikah) with Special Reference to Malaysia*, International Islamic University Malaysia Journal of Islam in Asia, Spl. Issue, No.2 (June 2011) .

<sup>228</sup> There is another definition given by this school as it is “the permission by each partner to his companion for transacting for the partner and for himself in wealth”, see Abdul Aziz Al-khayyat, *al-Sharikat in Islamic Shariah*, الشركة في الشريعة الإسلامية, 4th edition, (1994) p.43.

single thing or a contract implying this”. Finally the *Hanbalis* define it simply as “participation of two or more persons in transactions.”<sup>229</sup>

A wider definition of *Sharikah al'aqd* is proposed by Modern Scholars – it is a contract between two or more people for participation in capital and its profits or for participation in profits without participation in capital”.<sup>230</sup> Nyazee<sup>231</sup> expands this definition; he defines *Sharikah al'aqd* as “a contract between two or more people for participation in capital and its profits, or participation in transactions in someone else’s capital and its profits, or participation in profit without participation in capital or transactions.”<sup>232</sup> It can be seen from this definition that the structure of *Sharikah al aqd* may have more similarities with a normal partnership at Common law, where joint ownership is not an element necessary for the establishment of the partnership. The emphasis is rather on the joint exploitation of capital and the joint participation in profits and losses, based on the terms of the partnership contract. In other words: joint ownership is one possible consequence, and not a prerequisite for the formation of *Sharikah al aqd*.<sup>233</sup>

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<sup>229</sup> Since the relation between the partners in *Sharikah al a al'aqd* is based on a contract, then all general conditions regulate contract in Islamic law has to apply to the contract between the partners in *Sharikah al a al'aqd* . For example the three essential elements for the contract namely: (i) offer and acceptance, (ii) the parties full legal capacity to contract, and (iii) the legality of the subject matter of the contract has to be also available in the contract between the partners is *Sharikah al a al'aqd*.

In addition to the validation of the condition of contracts there are two main general conditions have to be in place in order for the *Sharikah al a al'aqd* to exist. Firstly, each partner should meet all the requirements of both *muwakkil* (appointer) and *wakil* (agent). This is because each partner acts both on his own behalf and on behalf of other partners. This is why he should meet the requirements of both appointer and agent, so that his action is legal and correct. However, if the contract includes a special stipulation or limitation, this has to be implemented. Secondly, partners should obtain their shares of the profit as stated in the contract according to the agreed rate or percentage. If the rate is not specified, the contract of the company is considered corrupt, as not specifying the rate in this case is a form of deceit, which is likely to lead to dispute; and this is against the teachings of Islam.

<sup>230</sup> Ali al –Khafif, op.cit. p.18.

<sup>231</sup> Imran Ahsan Khan Nyazee, Islamic Law of Business organization, Partnership, p. 20.

<sup>232</sup> This expanded definition is not true for all the four schools. It applies to the views of the *Hanafi* school alone, and with slight modification to the *Hanbali* school as well.

<sup>233</sup> Zuhairah Ariff Abd Ghadas & Engku Rabiah Adawiyah Engku Ali, op. cit..

### 1.3 Classifications of Sharikah al aqd

There is great disagreement between jurists in classifying *Sharikah al `aqd*. The most sophisticated classification is provided by the Hanifi School because it is the only school that has a developed law of partnership. According to this school, the subdivisions of *Sharikah al aqd* depend on a number of factors. If the underlying factor is the subject matter of capital contribution, *Sharikah al aqd* can be sub-divided into three main categories:

- a. When the subject matter of the capital is money, it becomes *sharikah al amwal* (monetary partnership).
- b. If the capital is in the form of labour, it becomes *sharikah al a`mal* also called *Sharikat al-abdan* (labour partnership), a type of partnership where two or more partners agree to work together and share their earnings. The partners contribute their skills and efforts without contributing to capital. All partners jointly undertake to render services to their customers, and the fees are distributed among the partners according to the agreed ratio. Thus two tailors may agree to undertake joint services for their customers on the condition that the wages earned will distributed between equally, irrespective of the volume of the work each partner has actually done.
- c. If the capital is in the form of reputation or creditworthiness, it becomes *sharikah al wujuh* (reputation or creditworthiness partnership). Partnership upon credit arises where two persons who do not contribute any property become partners by agreeing to purchase goods jointly upon their personal credit without immediately paying the price, and to sell them on their joint account. Neither partner contributes any capital.

They purchase commodities at a deferred price, sell them for cash and share the profit. It is possible that one of the partners may own a greater share of the goods than the others. The profits might then be distributed based on their respective shares, or they may distribute profit and losses on an agreed ratio.

The *Hanafi* school further sub-divides *Sharikah al aqd* based on the terms of the contract between the parties, i.e. whether the partners are required to contribute equally to the capital and enjoy full equality in exploiting the capital and sharing the profits. Based on this consideration, *Sharikah al aqd* can be divided into two types:<sup>234</sup>

- a. *Sharikah al mufawadah*, which means an unlimited investment partnership, whereby each partner must contribute equally to the capital, and enjoys full and equal authority to transact with the partnership capital and property. Each partner in this company is an agent for the partnership business and stands as surety for the other partners. Thus, the partners can be made jointly and severally liable for the debts of the business, provided they have been incurred in the ordinary course of business.
- b. *Shaikah al inan*, which can be defined as a limited investment partnership whereby each partner may only transact with the partnership capital according to the terms of the partnership agreement and to the extent of the joint capital. Hence, their liability towards third parties is

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<sup>234</sup> In English law we find the approach of classifying business organizations into partnerships and companies to be similar to the *Hanafi* approach of giving more emphasis to the relationship established. See E Scamell and R. l'Anson Banks, Lindley on the Law of Partnership, 14<sup>th</sup> Ed., (1979) Sweet & Maxwell, London, pp.14-16.

several but not joint. This liability resembles that of the modern limited liability partnership.<sup>235</sup>

Both *mufawadah* and *inan* can occur in all three types of *Sharikah al-aqd* mentioned above. This means that the *Hanafi* School has a six fold classification of *Sharikah al-aqd*:

- a. *Sharikat al-amwal* by way of *mufawadah*.
- b. *Sharikat al-amwal* by way of *inan*.
- c. *Sharikat al-abdan* by way of *mufawadah*.
- d. *Sharikat al-abdan* by way of *inan*.
- e. *Sharikat al-wujuh* by way of *mufawadah*.
- f. *Sharikat al-wujuh* by way of *inan*.

We shall shortly explore both *mufawadah* and *inan* further. Yet before do that, we need to understand that *Sharikah al aqd* as a partnership contract only explain how the profit is shared between the parties. All actual partnership found in another contract between the parties, the “underlying contracts”. Underlying contracts along with the rules of partnership regulate the entire law of partnership in Islamic Law.

There are four basic contracts that can regulate partnership relationships, although all four never exist together in a single partnership contract. These contracts are:

- a. The contract of *amanah* (trust),
- b. The contract of *wakalah* (agency),
- c. The contract of *kafalah* (surety), and
- d. The contract of *ijarah* (hire).

These contracts do not and cannot provide for the sharing profits on their own.

This can be seen by examining a contract of *wakalah* (agency), which is the

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<sup>235</sup> Some of the majority schools use these terms too but emphasize the type of capital employed rather than the relationships established.

basic underlying contract in a partnership. A mere agent, who is not a partner, is not entitled to a share in the profits through the contract of agency alone. He can only share profits with the principal when their relationship is further strengthened by a contract of *sharikah*.<sup>236</sup>

It is only the *Hanafi* School that gives priority to the underlying contracts in determining the types of partnerships permitted in Islamic law and in classifying these partnerships. This does not mean that the types of capital or skills through which the partnership forms are ignored.

#### **A. Sharikah al mufawadah**

Basically, *sharikah al mufawadah*<sup>237</sup> means an unlimited investment partnership, whereby each partner must contribute equally to the capital, and enjoys full and equal authority to transact with the partnership capital or property. According to the *Hanafis* School, each partner in *sharikah al mufawadah* is considered an *wakil* (an agent) for the partnership business and stands as *kafil* (surety) for the other partners. Thus, partners are jointly and severally liable for the debts of their partnership, provided they have been incurred in the ordinary course of the *Sharikah* business. This type of *Sharikah* clearly implies unlimited liability on the part of partners since they are both agents and guarantors of each other.<sup>238</sup>

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<sup>236</sup> Imran Ahsan Khan Nyazee, Islamic Law of Business organization, *Corporations*, p.21.

<sup>237</sup> The name *mufawadah* is taken from the Arabic word *tafawud* which means equality. It may be derived from the word *tafwid* (power of attorney) since each one of the partners gives his colleague(s) the freedom to act in any affair.

<sup>238</sup> The implementation of *mufawadah* occurs if two persons conclude a contract and record an explicit deed between them to the effect that they have participated in each minor and major thing by way of *mufawadah*, that the capitals contributed is equal, and that each one of them will act according to his considered opinion. If the *mufawadah* contain a surety, each partner shall be both the surety and agent of his partner. According to the *Hanafis*, the *mufawadah* is "a contract of partnership between two or more persons, with the stipulation of **complete equality** with respect to capital, profit and status, for working with their own wealth, or with their labour in another's wealth, or in the basis of their credit-worthiness." This definition signifies that all partners in this kind of company are equal in terms of shares in capital, profits and freedom of disposing of the company's affairs, and each partner is an agent as well a helper of the other partners.

A company will be a *mufawada* if two conditions are met. First there must be equality in capital, profit, work, contractual capacity and religion. One partner should not be inferior to the other in any way. The second condition is that each partner operates on his own initiative. This form of partnership preserves and applies a basic business practice; namely, that none of the partners is permitted to carry on a similar business outside the partnership on their own account. All the partner's skills in the given trade should be devoted to the benefit of the partnership. This explains the condition of equality mentioned above. When parties are not allowed to carry on the business outside of the partnership, this commitment requires total equality. Such commitment cannot be demanded of people who are not equal in every way, as it would lead to injustice. If one partner has some edge over the other he may feel that his superior status or other merits are being exploited in the name of the partnership. *Mufawadah* require equality in assets. This makes it a highly cumbersome form of partnership, because any inequality in wealth would lead to the vitiation of the partnership and its conversion to the *sharika al 'inan*.

#### **B. Sharikah al inan:**

The *inan* partnership is the type mainly used in contemporary Islamic banking and finance. *Sharikah al mufawadah* is rarely chosen, due to the high degree of responsibility and the practical difficulty of achieving full equality between the partners in all aspects of the partnership. Nyazee defines *inan* partnership as “a participation of two or more persons, with the permissibility of stipulating equality, through their work or their wealth, or through their work on the wealth

of another, or through their credit-worthiness without wealth, so that the profit can be shared by them as agreed.”<sup>239</sup>

In order to highlight the underlying contracts of *inan* partnerships he adds that, “*inan* is a contract, based either on *wakalah* (agency) or on *wakalah* as well as *kafalah* (surety), that permits participation from both sides with wealth, or credit-worthiness and the sharing of profits in an agreed upon ratio”. From this definition, the simple *inan* contract implies the following characteristics:

- a. In this type of partnership, equality of capital, management, or the distribution of profit is not a condition and hence one of the partners may contribute more to the capital than the others.
- b. It is allowed that one or more of the partners may manage the partnership, while the rest do not participate.
- c. Partners are considered agents for each other, whereby an action done by one in the ordinary course of business binds the other partners. When a partner becomes the agent of another, he possesses all the rights of an agent, including the right to buy and sell for the partnership.
- d. A partner is not a surety for other partners. He, therefore, does not possess the right to raise or build up credit through purchases, because this arises through express permission under a contract of surety. Nevertheless, there is no objection to the parties including a contract of surety (*kafalah*) in an *inan* contract if they so wish.
- e. An undivided share of a partner is like a deposit in the possession of the other partner, and is governed by the rules of trust. This means that what

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<sup>239</sup> Imran Ahsan Khan Nyazee, Islamic Law of Business organization, Partnership, p.102.



is lost or destroyed is a loss that is borne by the partners and falls within their liability.

f. The partners' liabilities towards third parties are several and not joint.

Each partner is liable to the extent of his contribution to the capital.

The *Hanafi* School suggests that the partner who deals with a customer is the only person whom the customer can approach in relation to the transaction. The reason is that he is the agent of the other partners and only the agent can be approached and not the principal. If the relationship of *kafalah* (guarantee) is also established between the partners, customers have the right to approach and, if need be, sue the other partners as well. Liability therefore, becomes joint and several. Such partnerships still operate in certain Muslim countries, for example, Saudi Arabia and Egypt.

## **2. Partnership under the Laws of Islamic Countries:**

Modern business organizations basically take two legal forms: partnership and companies. The distinction between them is based upon the concept of legal personality. Partnership is based upon the aggregate concept, while companies rest on the entity concept. In other words, partnerships do not have legal personality, but companies do.

Partnerships are divided into two broad types: ordinary partnership and limited liability partnership. Ordinary partnerships are further divided into two types, depending upon whether they are based on general or special agency. Limited liability partnerships, on the other hand, have general partners who have unlimited liability, and limited partners whose liability is limited to the extent of their shares, and who do not interfere in the management of the firms. Companies are first divided into those that work for profit and non-profit

companies. They are further divided into limited liability companies and those with unlimited liability. The liability of the shareholders in those with limited liability may be limited by shares or by guarantee to the extent of the guarantee. Companies working for profit are divided into public and private companies depending upon whether the general public has been asked to subscribe to the shares. Companies where the liability of the members is limited to the extent of their shares are called corporations in the United States.

The situation is different in some Islamic countries, for example, the laws of both Saudi Arabia and Egypt use the term *Sharikah* to include partnerships and corporations. The categorization of the companies is also different. More elaboration follows.

## **2.1 Saudi Law:**<sup>240</sup>

*Sharikah* under Saudi law is defined as “a contract under which two or more persons undertake to participate in an enterprise for profit, with each contributing a share in the form of money or services, with a view to dividing any profits (realized) or losses (incurred) as a result of such enterprise”.<sup>241</sup>

A partner's contribution may consist of a sum of money or a capital asset or even services, except where the provisions of the Companies Act imply otherwise, but may not consist solely of the partner's reputation or influence.<sup>242</sup>

Saudi law allows shareholders to agree that the profits of a shareholder need not reflect his ownership of the capital of the company.<sup>243</sup>

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<sup>240</sup> In Saudi Arabia, formation and operation of business firms and companies is regulated by the Companies Act which was promulgated by Royal Decree No. M/6 dated 22 Rabi I 1385 H., (1965) amended by Royal Decree No. M/5 dated 12 Safar 1387 H (1967) and Royal Decree No. M/23 dated 28 Jumada II 1402 H. (1982).

<sup>241</sup> Companies Act, Article 1.

<sup>242</sup> Companies Act, Article 3.

<sup>243</sup> Companies Act, Article 9.

Companies under Saudi Law are divided into eight types:

**A. General Partnerships:** Called *sharikat al-tadamun* in Arabic and *société en nom collectif* in French, this corresponds to partnerships in common law jurisdictions. It is defined as an association of two or more persons who assume joint liability, to the extent of their entire fortune, for the partnership's debts.<sup>244</sup>

**B. Limited partnerships:** Called *sharikat al-tawsiya, al basita* in Arabic and *société en commandite simple* in French, this consists of at least one general partner, who is responsible to the extent of his entire fortune for the partnership's debts, and at least one limited and unnamed partner who is responsible for the partnership's debts to the extent of his interest in the partnership's capital.<sup>245</sup> The law considers a general partner to be a trader. He has the right to manage and run the partnership, which may take his name as its commercial name. A limited partner is not regarded as a trader. He cannot run the partnership nor add his name to its commercial name. His right is limited to sharing the partnership profits in accordance to the partnership contract, while his liability is limited to his share in the partnership capital.

**C. Joint Adventure:** Called *sharikat al mahasa* in Arabic and *société en participations* in French, it is a company without legal personality. It may be formed without that formation being publicised. It is an association of which third parties are not aware and which neither enjoys a juristic personality nor is subject to the publication formalities.<sup>246</sup>

**D. Joint stock:** Called *sharikat al musahama* in Arabic and *société anonyme* in French, this is the equivalent of the Common Law public limited company. It is

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<sup>244</sup> Companies Act, Article 16.

<sup>245</sup> Companies Act, Articles 36 to 39.

<sup>246</sup> Companies Act, Article 40.

defined as a company capital divided into negotiable shares of equal value. Its members (whose number shall not be less than five) are responsible only to the extent of the value of their shares.<sup>247</sup>

**E. Partnerships limited by shares:** Called *sharikat al-tawsiya bi'l ashum* in Arabic and *société en commandite par actions* in French, this company consists of at least one general shareholder who is responsible to the extent of his entire fortune for the company's debts, and at least four limited shareholders who are responsible for the company's debts to the extent of their interest in the company's capital.<sup>248</sup>

**F. Limited liability companies:** Called *al-sharika dhat mas'uliyya al mahdudah* in Arabic and *société à responsabilité limitée* in French this is the equivalent of Common Law limited liability companies. The law defines this as a partnership consisting of two or more (but fewer than 50) partners who are responsible for the debts of the partnership to the extent of their respective interests in the capital.<sup>249</sup>

**G. Variable capital company:** Called *al-sharika dhat ras al mal al qabil li tarir* in Arabic and *société au capital variable* in French, this is a company, which provide in its articles of association or bylaws that its capital may be increased by additional payments made by the shareholders or by the admission of new shareholders, or that its capital may be reduced by withdrawal of shareholders' shares from the capital.<sup>250</sup>

**H. Co-operative company :** Called *al-sharika ta'awuniyya* in Arabic, this company is formed in accordance with cooperative principles and aims at the

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<sup>247</sup> Companies Act, Article 48.

<sup>248</sup> Companies Act, Article 149.

<sup>249</sup> Companies Act, Article 158.

<sup>250</sup> Companies Act, Article 181.

attainment of the following objects for the benefit and through the joint efforts of the members (i) reduction of the cost, purchase, or sale price of certain products or services, by engaging in the business of producer or broker, (ii) improvement of the quality of products or the standard of services provided by the company to its members, or by the latter to consumers. A co-operative company can take the shape of a Joint Stock Company or a limited liability partnership<sup>251</sup>

In addition to these eight legal forms, Saudi law allows the formation of any other form of company known to Islamic jurisprudence<sup>252</sup> with the exception of a company where a partner's contribution consists solely of his reputation or influence.<sup>253</sup> Any company not having any of the eight legal forms or otherwise unknown to Islamic law shall be null and void, and persons who have made contracts in its name shall be personally and jointly liable for the obligations arising therefrom.<sup>254</sup>

Some scholars have tried to connect each *Sharikah* type stipulated by Saudi law to one and more category of *Sharikah* as introduced by Muslim Jurists. This results in these eight types matching the *Sharikah* as defined in Islamic law and hence being accepted by Islamic jurisprudence.<sup>255</sup>

## 2.2 Egyptian Law

While Saudi law derived its classification from Egyptian law, the latter offers a broader classification. It divides *Sharikah* into civil and commercial, reflecting the corresponding division of the courts. The *Sharikah* are then divided into *Sharikst al-ashkas* (companies based on the personality of partners) and *Shariksh al-amwal* (company based on finance). *Sharikat al-ashkas* is a

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<sup>251</sup> Companies Act, Article 18.

<sup>252</sup> Companies Act, Article 2.

<sup>253</sup> Companies Act, Article 3.

<sup>254</sup> Companies Act, Article 2.

<sup>255</sup> For example of this argument, see Yousef Ahmad Al-Kasem, *Liberality in Sharikah in Islam and the Sharikah in Saudi Law* Al-Eqtesadiy newspaper on 14<sup>th</sup> May, 2009.

company based on the personality and mutual trust of the partners. Such a company will end if one of the partners dies or goes bankrupt. *Shaikat al-amwal* does not rely on the parties' personality, but the company capital. A partner can assign his shares to third parties without the other parties' approval and the company will continue if any partner dies or goes bankrupt.

*Sharikat al-ashkas* are of several types:

- a. General Partnerships *sharikat al-tadamun*,
- b. Limited partnerships: *sharikat al-tawsiya, al basita*,
- c. Joint Adventure *sharikat al mahasa*,

*Sharikat al-amwal* includes

- a. Joint stock: *sharikat al musahama*,
- b. Partnerships limited by shares: *sharikat al-tawsiya bi'l ashum*,
- c. Limited liability companies: *al-sharika dhat mas'uliyya al mahdudah*,

### **3. Concept of Liability in Sharikah**

The relationship between the right to enjoy benefit from a property and the liability to incur loss due to proprietorship is governed by a number of rules that carry great significance in transactions of commercial nature. In cases, where commercial considerations are involved, the rule provides that: "*Damage and benefit go together*". That is to say that a person who obtains the benefit of a thing, takes upon himself also the loss from it". This general rule is based on the Prophet's (PBUH) saying: "*Al-kharaj bi'd-daman*" ("*Revenue goes with liability*").

Another legal maxim that also has the same bearing is: "*The blessings of a thing are in proportion to the evils thereof and vice versa*". Thus when the thing used is destroyed while in the possession of the user compensation for use will be included in relation to its value; for example, if the buyer of an animal returns it because of a defect, after using it for a period, he is not liable to pay for the

use of the animal, since if it had died before being returned, it would have died as his property. These rules imply that if the merchandise not yet possessed by the buyer is lost, it is the seller but not the buyer who would have to bear the loss because the former enjoys possession or, in case the price of purchased goods still in possession of the seller increases, the increase will benefit the one who is deemed to be liable to suffer from an adverse fluctuation in price of the goods.

Contrarily, in a contract of *Shirkah* a condition under which one party is entitled to a share in profit only while the other party is made liable to the entire loss along with his share in profit would contradict the above rule. Similarly, renting out one's house on the condition that the tenant would be liable to the value of the house if the same is damaged due to flood or earthquake is also a contravention of the rule because the owner who is earning its rent should also bear the loss. These rules are to be made applicable to all situations where an owner earns benefit from the property which he has transferred or intends to transfer fully or partially to others under a contract of sale, hire, lease, tenancy, agency, etc; or joins with another person with a view to earning through partnership (*Shirkah* or *Mudaraba*) or sharecropping (*Muzaraa*).<sup>256</sup> In all forms of business organization in Islamic law, the liability of an investor is unlimited. This applies to all types of *'inan* and *mufawadah* partnership. The only distinction is whether the liability is jointly and several or merely joint. Joint liability means that all partners are jointly liable to pay the debts of the partnership. Several liabilities mean that each one of the partners may be sued separately for the entire debt and be liable for it individually. After making

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<sup>256</sup> SM.Hasanuzzaman, *The Economic Relevance of the Shariah Maxims*, Islamic Economics Research Centre, (2007), pp.41-45.

payment he will have recourse against the other partners, that is, he may sue them if necessary for the recovery of their shares of the debt. To understand the topic more clearly, liability in Islamic law will be divided into liability for lawful transactions and liability for unlawful transactions.

### **3.1 Liability for Lawful Acts**

*Hanafi* law in the case of contracts based on *wakalah* (agency), like the ordinary *inan* as well as *mudarabah* (contract of partnership and sharing of profits in which the investor provides all the capital and is liable for the loss), has a unique way of permitting dealing with liability. Liability is neither several nor joint. It is only the person managing the business who is liable. This happens where the partners leave the business to one person. As he deals with all third parties, only he can be sued. This does not mean, however, that the other partners have limited liability. The managing partner has recourse against the other partners for the recovery of payments to the extent of their individual liability. In a *mudarabah*, the investor (*rab al-mal*) will be fully liable for all the lawful debts of the partnership, even though it is the worker (the worker) who is being sued by the creditors. Likewise, in an *inan*, the sleeping partner will be liable to the extent of his share even if it is the managing partner who is being sued for the debt.

When the contract of *kafalah* (surety) is introduced into a contract, each partner becomes a surety for the others. This contract enables the creditors to sue all partners jointly or severally. Each partner, being a surety of the others, is liable for the entire debt with a right of recourse against the others to the extent of their liability. Such liability is, therefore, both joint and several.



In the above cases, it has been assumed that all the partners are acting lawfully, i.e. within the authority granted to them by the contract of partnership. In such cases the liability of the partners for the debts of the business is unlimited. But, what if the managing partner involves the partnership in a transaction that he had no authority to conclude? This can take place when there is no *wilayat al-istididanh* (authority for buying on credit) available to the managing partner.

### **3.2 Liability for Unauthorized Acts of the Managing Partner**

In contracts that are based on agency alone, like *mudarabah* and the ordinary *'inan*, the managing partner, according to *Hanafi* law, has the authority to buy on credit for the partnership. This authority, however, is not unlimited. The managing partner can buy on credit only to the extent of the capital of the firm. Thus, if the investor has given £1,000 to the worker, the worker can buy on credit only to the extent of £1,000. As long as he does this, the liability of the investor will remain unlimited, and their sharing of profits will remain lawful. But what if the worker buys goods worth £3,000 on credit? The investor may ratify the transaction, in which case a new partnership is created between the two to the extent of the excess £2,000. This will be *sharikah al-wujuh* (partnership based on credit worthiness) whose profits will be shared according to different rules.

If the investor chooses not to ratify the transaction, the act of the worker or the managing partner, to the extent of the excess purchase, will become unlawful. He alone will be liable for the excess payment of £2,000, and he alone will reap the profits of this excess purchase. What about the liability of the investor? To understand this, a distinction has to be maintained between the lawful part of the business and the unlawful part. The liability of the investor with respect to the unlawful part of the business is limited to the extent of his capital. With respect to the lawful part of this business, the liability of the investor is still unlimited. Let us suppose that the capital of the business, the £1,000, is somehow lost after the worker has made a credit purchase of £3,000. The investor will have to pay £1,000 bound again. If the capital is lost once again,

the investor will have to pay once again, and must continue doing so till the liability for payment of £1,000 arising from the lawful part of the transaction is met. Thus, there are three types of liability here: two lawful cases and one unlawful.

- a. Unlimited liability of the investor when he grants authority for buying on credit to the worker.
- b. Unlimited liability for the lawful part of the business when he does not grant authority for buying on credit.
- c. No liability for the unlawful or unauthorized act of the worker in the absence of authority for buying on credit;

#### **4 Does the Sharikah regime equate to the modern concept of a corporation?**

A corporation in English law is an artificial person with its own legal personality. It can carry on business, acquire rights, incur obligations, hold property, and sue and be sued in its own name. It has perpetual existence, something that is not available to partnerships under most laws. Such characteristics show there are clear differences between the features of partnerships and corporations, inviting the conclusion that corporations require a special legal regime distinct from that governing partnership.<sup>257</sup> More specifically,

- a. A corporation has a legal personality whereas a partnership does not.<sup>258</sup>

Thus corporations may enjoy all types of rights and incur all manner of obligations, except those specific to natural persons. A Partnership does not have these attributes. While a corporation has the right to sue and to be sued in its own name, this is also true of partnerships if they are registered. A Corporation also has a permanent domicile and nationality.

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<sup>257</sup> Imran Ahsan Khan Nyazee, *Islamic Law of Business organization, Corporations*, pp.114-117.

<sup>258</sup> Except under Scottish law the Uniform Partnership Act in the USA.

- b. A corporation's capital and other assets are owned by the corporation in its own name. Its shareholders do not own its assets. The capital and assets of a partnership are co-owned by the partners. This is one of the basic reasons preventing partnerships having a perpetual life.
- c. Corporate debts are those of the corporation and have nothing to do with the shareholders personally. They are never sued for corporate debts.
- d. The shareholders of a corporation do not have contract for the corporation because they are not its agents. Nor is the corporation their agent.
- e. The liability of the shareholders of a corporation is usually limited, whereas the liability of the partners is always unlimited except in the special case of a limited partnership.
- f. In a corporation, a shareholder can sell his shares without the consent, or even knowledge, of the other shareholders. A partner has no such right.

From the above, it is clear that corporations under common law require a specific legal regime distinct from that of partnership. Yet, is this also true of Islamic law? In order to answer this question we have to answer another, related question. – Does Islamic law considers corporation to be based on a contract between its shareholders? The reason for asking is that the legal regime governing partnership liability flows from the fact that partnership is always a contract between its partners and according to this contract the partners' liability is unlimited as explained above. Yet if the corporation is not formed as a result of contract, then the basis of liability under *sharikah* in Islamic law will not apply to corporation and hence it will be necessary to find another basis for shareholder liability.

#### 4.1 Are Corporations Based on Contract?

Two different analyses of the nature of corporations in Common law systems have been advanced. The first stated that all corporations are creatures of the state, created by a public act and not merely by agreement. Because a corporation is an artificial person created by the state, its whole character and existence depends upon the state. Accordingly a corporation is not a contract, nor is it a result of a contract, but the result of an act of state. This is the view upheld by English law. The second doctrine is that business organizations have existed from the earliest times, so that their formation is related to the habits of people and the exercise of their right of “freedom of association”. Accordingly, corporations are the natural product of the exercise of the right of association.<sup>259</sup>

Most Arab Countries apply the second doctrine. They consider a corporation to be a contract, and do not distinguish between partnership and corporation on the basis of legal personality. Any distinction between them operates on other bases. Some Arab laws use the term ‘institution’ for corporations, but most use the term *Sharikah* to include both partnerships and corporations as explained in Saudi and Egyptian law.

Some modern Islamic scholars oppose the idea that corporation is a contract and deny its contractual basis for the following reasons:

- a. a corporation from the first moment of its existence does not fulfill the conditions of a contract of partnership. If it is a contract then, what sort of contract? Who are the parties to the Contract? What is the nature of the offer and acceptance? What kind of legal relation is established between the shareholders - agency, surety or some other contract?

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<sup>259</sup> Thomas Donaldson, op. cit. p 5.

- b. corporations do not come into being simply by the will of individuals, but are dependent on the official sanction that permits their establishment. The mere agreement of the parties is not enough.<sup>260</sup> In other words corporations come into being through an act of state, and are not associated with the contract between the shareholders or the promoters. A legal person born by an act of state has full legal capacity and personality, but does not have wealth of its own. The need for wealth and assets leads corporation to contract with those who are willing to subscribe to its capital. This contract is between two people alone: the corporation on the one side and the single subscriber on the other. The terms of this contract are listed in the subscription agreement. The subscriber gives money to the corporation as an investment and in return for this the corporation issues it as share certificate.<sup>261</sup>
- c. In a corporation, a shareholder has the right to sell his shares and thus move out of the group of shareholders without their knowledge. This is not possible in partnership contract.
- d. Calling a corporation an Institution rather than *Sharikah* has no real benefit. While precision in the use of terminology is good for clarifying concepts, the issue of the nature of corporations in Islamic law does not disappear simply by the use of different terms.
- e. The word *Sharikah* as is used in *fiqh* in the sense of a contract cannot be applied to the corporation that enjoys a legal personality of its own, just as the word “partnership” used in English law cannot be applied to corporation. Neither meaning of the word *Sharikah* in *fiqh* (mixing of shares, and the contract between the partners) applies to a corporation.<sup>262</sup>

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<sup>260</sup> Abdul Aziz Al-khayyat, op. cit. p. 45.

<sup>261</sup> The contract concluded between corporation and the investors, on the face of it, is a *mudarah* contract. Subscribers may be considered to stand in the shoes of the investor (*rabb al-mal*), while the corporation apparently resembles the worker (*mudarib*), who has now wealth of his own and is working with capital contributed by investors. The corporation will enter into contracts with the owners, each of which is indetical, yet an independent contract which has nothing to do with the contract of another investor. See Imran Ahsan Khan Nyazee, Islamic Law of Business organization, *Corporations*, p.131.

<sup>262</sup> Ibid p.121.

It may thus be concluded that the regime applicable to partnerships in Islamic law cannot be applied to corporations, which should have their own regime. But what would be its characteristics?

## 5. The Formation of Groups of Companies in Islamic Law

Modern scholars<sup>263</sup> argue that modern corporations including groups of companies can be established under Islamic law based on the general principle of permissibility - that all things are permissible and nothing can be declared illegal except on the basis of a prohibition in the Qur'an and the *Sunnah*.<sup>264</sup> However, modern corporations must meet two main conditions in order to be allowed under Islamic law.<sup>265</sup>

- a. The objective of the corporation should be "*Halal*" (legal or permitted in the *Shari'ah*). A company will be considered forbidden "*Haram*" if it is based on one or more of the forbidden actions such as "*Riba*" (usury), "*Gharar*" (uncertainty), "*Qimar*" (gambling), or if it engages in transactions or investments involving prohibited products or services such as alcohol, pork-derived foods, or pornography.
- b. The corporation should be free of any reason of nullity in accordance with the *Shari'ah*.

The corporation needs also to comply with the following four main basic principles of Islamic Contract law:<sup>266</sup>

- a. ***The requirements of liability (al-kharaj bi-al-daman) must be satisfied:*** This principle states that profit can only be earned if the investor is also ready to accept the entire loss resulting from his investment. Jurists have applied this principle consistently throughout the

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<sup>263</sup> For example, Ali Al-khafif, op. cit. pp.122-127; Muhammad Ibraheem Almusa, Personal Companies between Law and *Shariah*, الشركات الخاصة بين الشريعة والقانون, Dar Alasema, (1998), pp. 279-305.

<sup>264</sup> Ali Al-khafif, op. cit. p.127.

<sup>265</sup> International Fiqh Academy Resolution # 130 (14/4) of the Islamic Fiqh Academy in its meeting # (14) dated 16 January 2003 in Doha, Qatar.

<sup>266</sup> Imran Ahsan Khan Nyazee, Islamic Law of Business organization, *Corporations*, pp.154-156.

Islamic laws of contract and business organization. This principle governs the question of entitlement to profit, the issue of limited liability, the retention of ownership of capital by the investor, as well as the ratios in which the profit is shared. In short, almost every issue is directly or indirectly traced back to this principle.

- b. **Prohibition of *riba***: This principle must be implemented in the corporation, and all its transactions, whether they pertain to financing, issuing of securities or any other matter, must conform with the requirements of this principle to be deemed valid.
- c. **Ownership must subsist with liability**: Islamic law constructs the concept of liability on the basis of general principles. The principle that operates here is *al-kharj bi-al-daman* (revenue goes with liability). This principle, as explained previously, maintains that a person is entitled to a profit on his investment to the extent that he is liable for the loss or liability arising from the business venture. If his liability is limited to a certain extent, then, his profits should be limited proportionately. An investor will not be entitled to the profits that may arise from the credit or debt for whose repayment he is not liable. It is for this reason that the liability of an investor is always unlimited in all lawful business transactions.
- d. **Using Recognised Contracts**: This rule requires that legal relations between persons, whether natural or artificial, participating in a business venture must be reduced to recognised forms of contract. The four contracts used by Muslim jurists for the law of business organization are *amanah* (trust), *wakalah* (agency), *kafalah* (surety) and *ijarah* (hire). If no such contract is identified, the legal relations between the parties involved and the nature of the underlying transactions are difficult to analyse.

If a corporation complies with the Islamic principles mentioned above, it can have share characteristics with modern corporations. For example:

- a. The concept of shares is valid because they represent ownership of the corporation.
- b. The return of shares is also valid as long as such return is not agreed in advance and the corporation does not have unlawful purposes.
- c. A shareholder has a common share of the corporate assets to the extent of the shares he owns.
- d. A shareholder remains the owner of his shares unless he transfers them to another.
- e. The corporation may borrow money, although it would be preferable if its financing needs are entirely met by equity financing.<sup>267</sup>
- f. A corporation is prohibited from issuing privileged shares or debentures.
- g. In the event of loss of the corporation capital, partners shall bear any losses in accordance with their contribution to that capital.

The attempts of modern scholars to argue in favour of the possibility of forming corporations under Islamic law have been supported by the Islamic *fiqh* Academy<sup>268</sup> which by its resolution No. 130 (4/14) issued in meeting No. 14 during the period 11-16 January 2003 acknowledged the formation of modern types of corporations under Islamic law as follows.<sup>269</sup>

**First:** *Shariksh al-amwal* (companies based on finance): The creation of such a company depends on the capital contributed by the partners, regardless of their

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<sup>267</sup> Hasanuzzman, Limited Liability of Shareholders: An Islamic Perspective, (1989) 28 Islamic Studies 145.

<sup>268</sup> The International Islamic Fiqh Academy was established by the resolution issued by the Third Islamic Summit Conference dated 25 to 28 January 1981. The Academy consists of scholars, scientists and thinkers in various fields of knowledge - doctrinal, cultural, scientific and economic - across the Muslim world, and the main aim of the Academy is to study the problems of contemporary life and work hard in diligent integral prayer in order to provide solutions emanating from the Islamic heritage and open to the evolution of Islamic thought. At the Academy, Muslim jurists meet in order to provide answers to questions posed by developments in contemporary life. The Academy headquarters is located in Jeddah (Saudi Arabia) and its selected members and experts are among the best scholars and thinkers in all branches of knowledge (Islamic jurisprudence, science, medicine, economy, culture ... etc.) in the Islamic world, including Muslim minorities in non-Muslim countries. The founding conference of the Academy was held in Makah on 7-9 June 1983. Forty-three of fifty-seven States were represented by one or more of the finest scholars of Islamic jurisprudence, and the Academy is assisted by several distinguished experts in the fields of Islamic knowledge and other fields of knowledge and science.

<sup>269</sup> The Academy used the term "*Sharikah*" for all types of modern corporations.



personality. Its shares are tradable. These companies are divided into three types:

- a. *Sharikat al musahama* (Joint stock): a company with capital divided into negotiable shares of equal value. The shares are tradable and the members of the company are liable only to the extent of the value of their shares.
- b. *Sharikat al-tawsiya bi'l ashum* (Partnerships limited by shares): a company whose capital consists of tradable shares, its partners being of two types: partners jointly and severally liable for company debts and partners who are liable only to the extent of the value of their shares.
- c. *Al-sharika dhat mas'uliyya al mahdudah* (Limited liability companies): A company whose capital is owned by a limited number of partners (the maximum number varies from law to law), the liability of each partners being determined by his share of the capital. The shares of such companies are not tradable.

**Second:** *Sharikst al-ashkas* (companies which are extensions of the partners' personalities): This is a company based on the personality and mutual trust of the partners. There are three different types.

- a. *Sharikat al tadamon* (Partnership): a company created by two or more individuals for the purpose of trading. Partners shall share the capital between them, and are jointly liable, to the extent of their entire fortune, for the company's debts. This type of company is based primarily on the personal relationship of the partners.
- b. *Sharikat al-tawsiya, al basita* (Limited partnerships): This consists of one or more general partners responsible to the extent of their entire fortune for the Sharikah debts, and one or more limited partners who do not participate in the Sharikah management and are responsible for the Sharikah's debts to the extent of their interest in the partnership's capital.
- c. *Sharikat al musahama* (Joint stock): This is a disguised sharikah with no legal personality. This is created by two or more persons, each of whom

has a share in the capital, and who agree to share profits and losses arising from business done in the name of one partner or them all.

**Third:** *AlShirikah al kabadah* (Holding Company): This is a company that owns shares or stakes in the capital of another company or companies. Such ownership shall be by a percentage enabling the holding company legally to control the other companies' management, and decide their general plans.

**Fourth:** *Alsharikat muadedat al gensyat* (Multinational company): is a company consists of a group of subsidiary companies. The mother company is located in a country whereas its subsidiaries and related companies are located in other countries and often acquire these countries' nationality. The mother company is linked with its subsidiaries and working through an integrated economic strategy aims to achieve the group overall investment and financial objectives.

The Academy had issued an earlier resolution acknowledged the possibility of forming Joint Stock Companies under Islamic law and the permissibility of dealing in shares. The resolution stipulated that:<sup>270</sup>

- a. As the original rule in *mu'amalat* (Transactions/Agreements) is permissibility, the formation of Joint Stock Companies having lawful objectives and activities is valid.
- b. The shares of a company whose primary objective is prohibited, like transactions in *riba*, or which produces and deals in prohibited products, cannot be sold.
- c. The same rule applies to the shares of companies that sometimes deal in prohibited things, even when their primary activity is permissible.
- d. The purchaser of a share acquires an undivided share in the capital of the company, the share certificate being the instrument that is proof of

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<sup>270</sup> International *fiqh* Academy Resolution # 7/1/65, meeting # (7) dated May 1992.

his right to the share. There is no *Shariah* obstacle to the issuance of shares or transactions in them.

- e. The subject-matter of the contract in the sale of shares is an undivided share in the assets of the company. The share certificate is the instrument of the right to this share.

Although the efforts of the International *fiqh* Academy represent a revolution in the field of the Islamic law of business organisations, Nyazee, while accepting the principle of the possibility of forming corporations under Islamic law, does not accept the basis used by the Academy to accept modern forms of corporation. He argues that the Academy's resolution and other views put forward by certain modern scholars are not based upon a thorough examination of the principles of Islamic law. They have not related their notion to true principles found in the traditional law of business enterprise. They rely on the general principle of permissibility, which itself has not been understood thoroughly. A better approach would be to analyse the entire structure of the modern business corporation in the light of the general principles of Islamic law and then come up with a new Islamic model of corporations. Therefore, he provides a proposal for modern Islamic corporation, based on the general principles of Islamic law, especially the Islamic law of contracts.

## **6. Proposal for a Modern Islamic Corporation**

Nyazee,<sup>271</sup> spent the first 174 pages of his book "*Islamic Law of Business Organization, Corporation*" explaining the principles of Islamic law related to corporations and the defects of modern corporate structures, concluding that neither the common law regime nor that offered by Arab and Muslim laws provide a proper regime for Islamic corporations. Therefore, he calls for the formation of a modern Islamic Corporation having the following characteristics:

- a. The corporation will be a juristic person established in accordance with certain conditions and hence will have no liability for religious duties.
- b. The relationship of the shareholder and the corporation will be based on an agency contract alone and not on partnership, i.e. the sharing of profits. The

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<sup>271</sup> Imran Ahsan Khan Nyazee, *Islamic Law of Business organization, Corporations*, pp.175-184.

contract of agency will be based on the *Hanifi* school view, which presents different concept of agency than under modern laws. The latter concept of agency is based upon the principle *qui facit alium facit per se* (he who does a thing through another does it himself). Thus, the agent can do almost anything that the principal would be permitted to do himself. He is a mere servant of the principal. A partner as an agent has all the powers, unless expressly restricted, of the principal. Further, the principal is bound by all these acts, and thus can be sued by a third party for an act performed by the agent on his behalf. By contrast, under the *Hanifi* concept of agency<sup>272</sup> the corporation will be the managing party and the shareholders as principals will continue to stay in the background.

- c. The capital and assets of the corporation will belong to the shareholders as co-owners, but will be held in the name of the corporation, with the corporation having full rights of disposal on their behalf. The same dual ownership relationship will be established when financing is undertaken by banks and financial institutions.

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<sup>272</sup> The *Hanifi* School, with regard to the acts of the agent, distinguishes between *hukm* (effects) of the contract and *huquq* (rights of performance) of the contract. The effect of the contract is its main objective or purpose. The right of performance of a contract is the means adopted to complete the main objective. In a transaction of sale, for example, the *hukm* is the transfer of ownership of the goods to the buyer and transfer of the price to the seller. When a sale has been made by an agent, title passes at once to the principal. The *huquq*, however, stays with the agent. The *huquq* in a sale involves the delivery of the price to the seller, and the right to demand delivery and take possession of the goods. The agent also has the right to stipulate conditions, to reject the goods on the basis of defects and to terminate various types of option *what does that last phrase mean?* In other words, the performance of the contract belongs to the agent. As the *huquq* always inheres in the agent, the principal, according to the *Hanafis*, cannot be sued for performance. It is important to note here that the other schools of Islamic law do not have this complication, which is introduced by the *Hanafi* School alone. This should not mean that we should summarily reject the *Hanafi* opinion and follow the majority. The utility of this distinction must be appreciated through its operation within the law. Further, the majority schools may offer us a highly limited form of agency in their own way. When the contract of *Wakalah* operates within the contract of *Sharikah*, each partner becomes the agent of other partner or partners. Each act undertaken by a partner on behalf of the partnership, whether right or wrong is governed by the contract of *Wakalah*. Within the partnership the distinction drawn by the *Hanafis* affects the joint and several liabilities of the partners. For instance, if a partner buys something for the partnership; his other partners are his principals to the extent of their shares in the partnership. The title to the goods purchased will pass to the other partners in proportion to their shares in the partnership. Parties dealing with the partnership can only demand payment for the goods from the partner who made the transaction. It is this partner who is liable for making payment. The managing partner has the right to collect the appropriate share of payment from each partner. The seller of the goods, therefore, cannot sue the other partners for price, nor can the other partners sue the seller for the delivery of the goods, this right belongs to the partner who made the transaction. This applies even to the return of property to the seller on account of defects. In short, the title in the goods passes to all the partners, but the rights and obligations pertaining to performance stay with the partner making the transaction. There are ways, applied to partnerships, through which the distinction drawn by the *Hanafis* with respect to the separation between the *hukm* and *huquq* can be done away with. Thus, these rules affect the contract of *Sharikah* that is based upon the contract of *Wakalah* alone and is not supported by other contracts of partnership that include *Kafalah* as well.

- d. The shareholders will grant prior permission (in the subscription agreement), as co-owners, to the other shareholders to sell their shares to outsiders without further authority.
- e. The relationship between the shareholder and the corporation will be based upon a strict denial of *wilayat al-istidanaḥ* - the entitlement to raise or build up credit through credit purchases; (other than cash loans). The determination of the limit for *istidanaḥ* will be tied to the net assets of the corporation at any one time and not to the capital contributed.
- f. As the corporation will be an agent of the shareholders, they will be entitled to the entire profit earned by the corporation.
- g. As the *ḥuquq* (rights of performance) of each contract will revert to the agent, on the basis of the *Hanifi* form of *wakalah* (agency), it will not be possible for creditors to sue the shareholders in respect of transactions undertaken by the corporation.
- h. If the corporation wishes to raise money from banks, it must form an *inan* partnership with the bank based on *wakalah* (agency) alone. This will provide the same features that arise from debt financing, like floating charges, but will be free of debt and interest. The *inan* will be based upon the *Hainfi* school form, especially the distinction in *wakalah* (agency) between the *ḥukm* (effects) and the *ḥuquq* (rights of performance) of a transaction undertaken by the corporation.
- i. As limited liability is in the end a device to pass on or shift liability to outsiders dealing with the corporation, it may be appropriate to grant priority to outsiders at the time of liquidation, followed by *inan* claims of banks and then the claims of the principals.
- j. Under the proposed Modern Islamic Corporation, ordinary shares and preference shares are allowed. A co-owner of property can sell his property to an outsider, but in a partnership this is possible only if the other co-owners agree. The shareholders in Nyazee's proposed model are linked to each other through the corporation, which has mixed their wealth in the form of co-ownership. On the basis of technical reasoning, this view can be refuted, but it is simpler to insist that the subscription or allotment agreement

should state that each shareholder permits every other to sell his share to whoever he pleases. This will enable transactions in shares in the stock market. No difficulty can arise as far as ordinary shares are concerned, but difficulty may arise in the case of preference shares and cumulative preference shares. In preference shares the profit is usually paid to such shareholders prior to other types of shares and the rate of profit may be fixed. In cumulative preference shares if the corporation has not made a profit in a given year and thus cannot pay a dividend on preference shares for that year, it is required to pay that dividend in following years when it does make a profit. Technically, there appears to be no reason why this cannot be done under Islamic law. It should be remembered that paying a fixed part to the investor out of a flexible actual dividend should not be considered as *riba* as long as the rules of *al-kharaju bial-daman* (Liability) are being satisfied.

- k. In terms of creation of limited liability, Nyazee argues that the principle of leverage forces corporations to raise as much debt financing as they can. In addition to this, the payment of interest by the corporation has certain tax advantages insofar as these can be claimed as expenses out of the pre-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 where huge losses are made. One unit of equity will be required to satisfy three units of debt at the time of liquidation, which is not possible. This is why limited liability is useful. In his model, the corporation will not be financed on the basis of debt at all. It will either have equity paid up by the shareholders or equity based on *inan* financing by banks or financial Institutions. The only form of credit that the corporation can raise is through credit purchases. The accounts payable of a corporation may never go beyond the combined equity capital provided by the shareholders and banks. The reason is that so much market credit may not be required in practice. Even if it is required and a corporation is tempted to do so, it will not be permissible due to a denial of *istidhanah*.
- l. The only way that the personal assets of the shareholders may be threatened is when the entire assets of a corporation are lost and the credit

outstanding extends beyond the value of the ruined assets. Such extreme cases may be covered by business insurance, which is a very common feature today. Each corporation may be asked to take up mandatory insurance, at least in the case of public corporations. This depends, of course, on what the ruling is about insurance from the Islamic point of view. It is assumed that some form of insurance will be possible. In certain cases, however, this model may prevent the need for piercing the corporate veil. There is, therefore, no problem in the creating limited liability for shareholders as well as financial institutions participating in *inan* financing.

- m. For the creation of unlimited liability Nyazee argues that the law arbitrarily denies limited liability in certain cases without determining the relationship between the shareholder and the corporation. In his proposed system, the creation of unlimited liability will be very simple. All that needs to be done is to establish another relationship between the shareholders and the corporation, besides the contract of *wakalah* (agency). The additional relationship is created through a contract of *kafalah* (guarantee) between the corporation and the shareholder, by virtue of which each shareholder becomes a *kafil* (guarantor) for the corporation, jointly with the other shareholders.

## **7. Conclusion**

A comparison of the characteristics of *Sharikah* with that of partnership in the common law shows some similarities.

- a. The English law definition of partnership as “a relation which subsists between persons carrying on business in common with a view of profit” has some similar characteristics with *Sharikah* under Islamic law in terms of contractual relations between the parties; carrying on business in common, implying authorization to transact with common property; and in profit-sharing.
- b. An important legal effect of a contract of *Sharikah* is the fiduciary position that the partners hold in relation to the partnership property and capital, whereby the exercise of necessary prudence and avoidance of harm is

the overriding principle. This may be analogous to the common law concept of good faith and the fiduciary duties of partners to each other.

- c. In terms of the legal effects of the contract of *Sharikah*, the majority of the Muslim jurists agree that it is not a binding contract, meaning that the partners can terminate the contract at any time they wish to. This may be quite similar to the concept of partnership at will under English law.

On another hand, there are many noticeable differences in focus between the two regimes in term of corporation and partnership.<sup>273</sup>

Modern Islamic scholars have found a base to accept the formation of modern corporations under Islamic law, including group of companies, on the condition that all types of investment entities should comply with *Shariah* principles. Nevertheless, all such efforts were based on individual opinions. Moreover, the efforts presented by academic entities were not based on a deep analysis of Islamic business law.<sup>274</sup> Most notions presented are essentially based on the principle of permissibility in *Shariah* and on necessity without testing other *Shariah* principles.

I believe that the best way to devise an Islamic corporation law is, as highlighted by Nyazee, to first analyse the entire structure of the modern business corporation including groups of companies in the light of the general principles of Islamic law, and then come up with a new Islamic model of the corporation. Failing to do this will mean many questions remain without clear answers such as the relation between a company and its subsidiaries. However, his proposal for Modern Corporation although it integrates Islamic law principles does not clearly explain how this proposal will work in reality.

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<sup>273</sup> For detailed explanation to these differences see Zainal Azam B. Abd. Rahman, op. cit..

<sup>274</sup> For example, the Accounting Standards Board justifies the legal personality of corporations in saying "There is no objection in the *Shariah* to setting up a company whose liability is limed to its capital, for that is known to the company clientele and such awareness on their part precludes deception". Accounting Standards Board, Objectives and Concepts and Information about the Organization Jeddah 1994.



Moreover, it provides a complex relation between the shareholders and the corporation and its management especially in term of the requirement of contracts shaping such relation. The response to the requirements of modern economy requires simplicity rather than the complexity evident in his proposal. His proposal still cannot explain in terms of Islamic legal principles why limited liability is sometimes assigned and at other times it can be taken away arbitrarily.

# Chapter III

## Allocating Liability in Corporate Groups

The origin of the problem of liability in corporate groups' context lies in basic concepts of company law- namely limited liability and separate legal personality. Under limited liability, shareholders have no obligations to the company or its creditors beyond the obligations on the par value of their shares, or under their guarantees in the case of a company limited by guarantee. Under this tradition, a corporation's liability is also limited to the amount of its investment, and a parent or any other company in a group cannot be held liable for a subsidiary's non-performed obligations.<sup>275</sup>

This approach collides with the principle of fair allocation of risks between creditors and debtors and exposes creditors to risks arising from the power of shareholders to manipulate limited liability and to use the group structure for abusive, self-serving, fraudulent, and even criminal conduct. The scale of the problem is now firmly entrenched in the realms of international law, triggering the negotiation of a number of significant multilateral treaties and involving domestic courts in international legal challenges that only a generation or two ago would have been inconceivable.<sup>276</sup>

The unfair effects of limited liability in a corporate group context have forced courts and litigators in common law countries to search for techniques to reduce these unjust effects and protect corporate groups' creditors.

The position in Islamic law cannot be simply comparable with the Common law because there is still ongoing debate between Muslim scholars concerning some basic principles of the corporation in Islamic law, most importantly, the concepts of separate legal personality and limited liability. This situation forces

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<sup>275</sup> See Muzaffer Eroglu, *op cit*.

<sup>276</sup> Some concern has been expressed on occasion at the potential abuse of the group form. For example, the Cork Committee devoted chapter 51 to the discussion of the problem. Yet, it declined to make any significant proposals to deal with the issue of groups as it considered it raised issues which were outside its terms of reference which were confined to insolvency law. The committee felt that it was outside its terms of reference to propose any change as this would require fundamental changes to company law and not merely the law on insolvency.

us to first settle the debate about these fundamental principles before addressing the liability of groups of companies in Islamic law.

Therefore, in Part I of this Chapter I will examine the sufficiency of the techniques presented by Common law systems to allocate liability within group of companies and assess if these techniques provide a sufficient solution. Part II will investigate the concept of the corporation in Islamic law, the possibility of creating modern forms of corporation including groups of companies, and finally the Islamic law position on the liability of groups of companies.

## Part I

### Groups of Companies' Liability in Common Law

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The economic forms of company organization have evolved in the direction of group structures, benefiting from the principle of limited liability which not only assists small businesses, but encourages entrepreneurial activity in corporate groups. Without it, corporate group managers might be reluctant to expose the funds of the parent to risky new business activity.<sup>277</sup> However, legal separation and accompanying limited liability of company members, coupled with integrated control and management of group members, accentuate agency conflicts within the group, may lead to misrepresentation of the limited risk of the group's member, and/ or greater levels of debtor opportunism.<sup>278</sup>

In order to reduce the risk of debtor opportunism, Courts and legislators have used various techniques to allow creditors to recover debts from entities within a corporate group other than the entity with which they have contracted.

Examples of these techniques are as follows:

- a. Looking behind the separate corporate personality of a company - "lifting the corporate veil".
- b. Techniques empower courts to order a subsidiary's directors (who might be the parent company), to contribute to the assets of a company which has gone into insolvent liquidation.
- c. Trading while insolvent
- d. Pooling of assets.
- e. Substantive Consolidation
- f. Directors' Duties to creditors
- g. The Single Economic Unit Theory.

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<sup>277</sup> Robert P Austin, *op.cit.* p. 89.

<sup>278</sup> Jennifer Dickfos, Enterprise Liability for Corporate Group, a safeguard for Creditors, CLTA conference, 2011, p.7.

In this Part, I will explain the above mentioned techniques and assess if they are sufficient to provide a comprehensive solution to issue of the liability of corporate groups.

## **1. Lifting the Corporate Veil**

### **1.1 The General Principle**

Although the *Salomon* case had firmly established the principle of the separate legal personality of a company, the court in that case did however recognise that there could be "occasions" where the courts would have to deviate from this principle. On these occasions the court would be ready to disregard the separateness of the corporation and hold a shareholder liable for the actions of the company. In other words, the court would strip away the corporate mask, and ascribe directly to those in the corporation who have caused it to act in a particular way the legal consequences of such actions. This situation is generally described or known as 'lifting the veil' or 'piercing the veil'. Staughton L.J separated the meaning of the two phrases in *Atlas Maritime Co SA v Avalon Maritime Ltd*<sup>279</sup>:

“To pierce the corporate veil is an expression that I would reserve for treating the rights and liabilities or activities of a company as the rights or liabilities or activities of its shareholders. To lift the corporate veil or look behind it, on the other hand, should mean to have regard to the shareholding in a company for some legal purpose.”

A court may refer to lifting or looking beyond the corporate veil at any time it want to examine the operating mechanism behind a company. For example, in

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<sup>279</sup> *Atlas Maritime Co SA v Avalon Maritime Ltd (No 1) (The Coral Rose)* [1991] 4 All ER 769, at 779.

*Dennis Willcox Pty Ltd v Federal Commissioner of Taxation*<sup>280</sup>, Jenkinson J stated that:

“The separate legal personality of a company is to be disregarded only if the court can see that there is, in fact or in law, a partnership between companies in a group, or that there is a mere sham or facade in which that company is playing a role, or that the creation or use of the company was designed to enable a legal or fiduciary obligation to be evaded or a fraud to be perpetrated”.

Other Factors that may lead to a piercing of the corporate veil can be grouped as follows:<sup>281</sup>

- a. To prevent the use of a company for fraudulent purposes or to evade a legal obligation or liability,<sup>282</sup>
- b. If a company is in effect the agent of a shareholder, regardless of whether that shareholder is a natural or corporate person,<sup>283</sup>
- c. Where the veil is lifted in compliance with a court order,<sup>284</sup>

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<sup>280</sup> *Dennis Willcox Pty Ltd v Federal Commissioner of Taxation* (1988) 79 ALR 267 at 272.

<sup>281</sup> For more clarification about these areas see Ian M Ramsay, *Piercing the Corporate Veil in Australia*, (2001) 19 Company and Securities Law Journal 250; and Simon Goulding, *Company Law*, 2<sup>nd</sup> ed, Cavendish Publishing, (1999), pp.66-88.

<sup>282</sup> For example, In *Gilford Motor Co Ltd v Horne* [1933] Ch.935; H worked for G, but then left. His contract stated that he was not allowed to sell to G's customers for a period after leaving. H set up a company which then approached his former customers. He argued that his company was approaching the customers, not him; and if there was wrongdoing, his company was liable and not him. The Court of Appeal held that the company was a sham, and granted an injunction against both H and the company. Similarly, in *Catamaran Cruises Ltd v Williams* (1994) W was employed by C. W then set up a company which C then contracted with, paying it W's wages gross of tax. W worked and had the same benefits as all other employees of C. C ended their contract with W's company, but the courts held that this was the same as dismissing W directly, and W was able to sue for unfair dismissal.

<sup>283</sup> In *Smith, Stone & Knight Ltd v Birmingham Corporation* [1939] 4 All E.R. 116; SSK owned some land, on which a subsidiary company operated. BC purchased the land compulsorily. BC was obliged to compensate the owner for the business they ran on the land. Since the subsidiary company did not own the land, BC claimed they were entitled to no compensation. It was held that the subsidiary company was the agent of SSK, so that BC must pay compensation.

<sup>284</sup> The courts have the power to order enforcement of their judgments or orders against any party whom they think will ensure compliance with the order should they be named therein. In exceptional cases the courts have lifted the corporate veil in exercising this power and have issued an order against the directors or controllers of a company in addition to the company itself. An example is found in *Dublin County Council v Elton Homes Limited* [1984] ILRM 297; where the court issued a planning injunction against the directors of a company in addition to the company itself.

- d. In the case of a 'sham' or 'facade', when the corporate form was used as a 'mask' to hide the real purpose of the corporate controller,<sup>285</sup>
- e. When piercing of the corporate veil will bring about a fair result,<sup>286</sup>

Some scholars argue that in spite of the importance of the principle, it is not possible to distil any single principle from the decided cases as to when the courts will lift the veil, and that no two commentators categorise the case law in precisely the same way. Thus Farrar<sup>287</sup> describes Commonwealth authority on piercing the corporate veil as 'incoherent and unprincipled'. Similarly Rogers AJA stated in *Briggs v James Hardie & Co Pty*,<sup>288</sup> that:

"There is no common, unifying principle, which underlies the occasional decision of the courts to pierce the corporate veil. Although an ad hoc explanation may be offered by a court which so decides, there is no principled approach to be derived from the authorities".

One should not expect to find such a principle or coherent categorisation, as the cases are extremely diverse and, although they may all be termed lifting the

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<sup>285</sup> Suggesting that a company is a sham or a façade is one of the strongest arguments that would prompt a common law court to lift the veil of incorporation. The argument is that the corporate form was merely used as a mask to hide the real purpose of the corporate controller. In the Australian case of *Sharrment Pty Ltd v Official Trustee in Bankruptcy* (1988) 82 ALR 530 at 539, Lockhart J stated that: "A 'sham' is...something that is intended to be mistaken for something else or is not really what it purports to be. It is a spurious imitation, a counterfeit, a disguise or a false front. It is not genuine or true, but something made in imitation of something else or made to appear to be something which it is not. It is something which is false or deceptive". Any argument based on fraud usually depends upon a sham being present, and common law jurisdictions have indicated over the years that no fraud can be perpetrated where the corporate form is real and not a façade.

<sup>286</sup> See, for example, the Australian case of *RMS Glazing Pty Ltd v The Proprietors of Strata Plan*, where R argued that the veil be pierced because S's Managing Director, L had played a very active role in the court proceedings because the company was in effect a man of straw. Cole J. rejected this argument on the basis of the company's record of profitable trading, adding "apart from that I am not satisfied that justice would require the making of such an order. The Body Corporate dealt with RMS over a period of more than a decade. It was prepared to deal with the company rather than L personally and to enter into contractual relationships with the company resulting in the payment of many millions of dollars. I do not think that the interest of justice requires that it now be permitted to simply disregard the corporate veil".

<sup>287</sup> J Farrar, *Fraud, Fairness and Piercing the Corporate Veil* (1990) 16 Canadian Business Law Journal 474 at 478.

<sup>288</sup> (1989) 16 NSWLR 549 at 861.



veil cases, the courts are being requested to undertake a variety of different processes.<sup>289</sup>

To conclude, the application of the veil piercing principles by the courts differs from one jurisdiction to another. Sometimes courts ignore the rigid principles of company law; but most of the cases simply repeat the *Salomon* principles. The courts have never taken an evolutionary step in creating alternatives, as they did when establishing the principle of separate corporate personality in *Salomon*. This rigid commitment to the *Salomon* principles has prevented the courts from creating sound reasons for intervention where the corporate structure was ignored.<sup>290</sup>

## **1.2 Parent/Subsidiary**

Courts have attempted to develop a basis for lifting the veil of incorporation so as to ignore the separate identities of companies within a group.<sup>291</sup> Some scholars believe the veil of incorporation may be lifted between a parent company and a subsidiary in the same way as it can between an individual and a company.<sup>292</sup> Other scholars argue that courts should be more willing to pierce the corporate veil in the parent/subsidiary context than with respect to individual shareholders on the basis that the application of the *Salomon* principle to corporate groups offers greater potential for harm, because of the greater economic impact it may have.<sup>293</sup>

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<sup>289</sup> Simon Goulding, *op.cit.*p.66.

<sup>290</sup> J Dobson, *Lifting the Veil in Four Countries: the Law of Argentina, England, France and the US* (1986) 35 I.C.L.Q, 839.

<sup>291</sup> Harry Rajak, *op.cit.* p.525.

<sup>292</sup> Simon Goulding, *op.cit.* p.75.

<sup>293</sup> See, e.g. Easterbrook and Fischel *supra* note 95, p. 56.

Bainbridge<sup>294</sup> distinguishes between the liability of individual shareholders and corporate group liability. While the liability of individual shareholders may demand veil piercing, corporate group liability issues should be dealt with as a species of enterprise liability, because veil piercing is a vertical form of liability, providing a mechanism for holding a shareholder personally liable for the corporation's obligations, while enterprise liability provides a horizontal form of liability, offering a vehicle for holding the entire business enterprise liable. The single business enterprise theory will not allow one to reach a shareholder's personal assets, whereas enterprise liability can be a useful remedy in some settings. If correctly (and successfully) invoked, enterprise liability does permit a creditor to reach the collective assets of all of the corporations making up the enterprise. According to this view, the law of fraudulent misrepresentation and fraudulent conveyance are adequate to the task of policing abuse of limited liability and therefore obviate the need for veil piercing.

Practically, courts in common law countries have devised a number of mechanisms to pierce the corporate veil between a parent company and its subsidiary. There are a number of cases in which the courts have been willing to pierce the corporate veil and hold a parent liable for the debts of its subsidiary. However, it is exceptional for the courts to do so; as a rule, they adhere strictly to the corporate entity principle.<sup>295</sup> On another hand there are numerous statutory provisions that, one way or another, have the effect of lifting the veil. These provisions operate to negate the effect of corporate personality and limited liability.

In the main, the courts have been unprepared to lift the corporate veil merely because a group has conducted some of its business through subsidiaries or has arranged the group structure to ensure that any legal liability in respect of particular activities will fall only on one group member. *Adams v Cape Industry*

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<sup>294</sup> Stephen M. Bainbridge, Abolishing Veil Piercing, Harvard Law School, August 2, 2000, p.58. Bainbridge sees veil piercing as rare, unprincipled, and arbitrary, calling for it to be abolished.

<sup>295</sup> D.D. Prentice, op. cit. p.308.

*plc*<sup>296</sup> is a very good illustration of this position. A class of plaintiffs sought compensation for personal injury caused by the defendant. The injury was caused by asbestos mined in South Africa and distributed in the United States by corporations in which C had a controlling shareholding, although latterly it had taken steps to eliminate its connection with the American subsidiary by disposing of its shares. C refused to appear before the court in Texas where the personal injury suit was successfully brought. Thus an action raised in England, where C was registered, to have the judgment of the Texas court enforced against it. The Court of Appeal refused to find C liable, holding that it was an independent legal entity, and therefore not responsible for the debts of other entities, even entities with which it had enjoyed a close association. The court rejected all three arguments by which it was sought to make C liable. First, it was not willing to treat the group as a single economic unit. Secondly, it refused to treat a subsidiary as its parent company's agent in the absence of an agreement to this effect.<sup>297</sup> Thirdly, it did not regard the subsidiary as a mere facade. The court declined to attempt a comprehensive definition of what a company a façade, other than to say that a company was a facade when it was 'no more than a corporate name'. It continued,

“We do not accept as a matter of law that the court is entitled to lift the corporate veil as against a defendant company which is the member of a corporate group merely because the corporate group structure has been used so as to ensure that the legal liability (if any)

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<sup>296</sup> [1990] BCLC Ch 433 at 544.

<sup>297</sup> If it can be shown that the subsidiary acted as an agent for its parent company, then under general agency principles liability will attach to the principal. But the principal-agent relationship only exists if consent between the two can be established. Under English law, there is no presumption that a subsidiary acts as the agent of its parent.

in respect of particular future activities of the group (and correspondingly the risk of enforcement of that liability) will fall on another member of the group rather than the defendant company. Whether or not this is desirable, the right to use a corporate structure in this manner is inherent in our corporate law.”

In *Yukong Line Ltd of Korea v Rendsburg Investments Corporation of Liberia*<sup>298</sup> the court refused to lift the corporate veil in the context of a corporate group, notwithstanding its finding that the purpose of an asset transfer within the group was to put those assets beyond the reach of an external plaintiff in the event of litigation. The court took a narrow approach to lifting the corporate veil:

“In the main the concept that a duly incorporated limited liability company, if not a real thing, is at least not to be identified with its shareholders has been faithfully followed by British and other Commonwealth courts ever since *Salomon’s* case. But there has been some gnawing away at the edges of the doctrine, a process commonly described as piercing or lifting the corporate veil. I believe that there is only one broad class of cases where this is truly consistent with the *Salomon* reasoning. They are all cases where, under the enactments such as those against fraudulent or wrongful trading, or on the permissible interpretation of an enactment or contract, or for the purposes of common law or equitable principles against fraud or oppression or relating to agency it is necessary to look at what has happened in fact rather than in form”

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<sup>298</sup> [1997] 1 WLR 294 at 306.

Additionally, English courts have been unwilling to accept that under-capitalisation of particular group companies "alone" justifies lifting the corporate veil. They refuse to lift the veil between a parent and subsidiary merely because the latter has a small paid-up capital and has a board of directors all or most of whom are also directors or senior executives of its holding company.<sup>299</sup>

However, this rule has been departed from on a number of occasions. The English courts have indicated that where the justice of the case so requires, the separate legal personality of companies within a group may be disregarded and the companies may be treated as being a single economic entity. This approach is not considered to be a departure from the principle as laid down in the *Salomon* case as much as an application of that principle.<sup>300</sup> Courts limit the remedy of piercing the corporate veil to situations where parents so control and dominate their subsidiaries that corporate independence is lacking and the parent and its subsidiary are effectively alter egos. Even then, veil piercing is only appropriate where the subsidiary is improperly used, causing damage or harm – such as preventing the subsidiary's creditors from being repaid.<sup>301</sup>

A major indication that the courts might be willing to disregard the separate legal personality of companies within a group came in the judgment of Lord Denning MR in *Littewoods Mail Order Stores Ltd v Inland Revenue Commissioners*<sup>302</sup>, where he lifted the veil between parent and subsidiary in an

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<sup>299</sup> *Re Polly Peck International plc* [1996] BCC 486 at 496. In this case, a Cayman Island company that had no assets, but which raised bank borrowings of £400 million on the strength of the guarantees of its parent company, was held to be a separate entity from that parent company.

<sup>300</sup> Marguerite Gallagher, *Separate Legal Personality, Lifting the Corporate Veil*, (2005) 23 Irish Law Times 11.

<sup>301</sup> Steven L. Schwarcz, *Collapsing Corporate Structures: Resolving the Tension between Form and Substance*, (2004) 60 Business Lawyer 109.

<sup>302</sup> [1969] 1 WLR 1214 at 1241.

income tax case. In declining to treat a subsidiary company as a separate and independent entity from the parent, he stated:

The doctrine lay down in *Salomon* ... has to be watched very carefully. It has often been supposed to cast a veil over the personality of a limited company through which the courts cannot see. But that is not true. The courts can and often do draw aside the veil. They can, and often do, pull off the mask. They look to see what really lies behind. The legislature has shown the way with group accounts and the rest. And the courts should follow suit. I think we should look at the [subsidiary] and see it as it really is – the wholly-owned subsidiary of Littlewoods. It is the creature, the puppet of Littlewoods in point of fact: it should be so regarded in point of law.

In *DHN Food Distributors Limited v Tower Hamlets London Borough Council*<sup>303</sup> D was a holding company, which operated a business from land that was owned by its wholly owned subsidiary. When the local authority compulsorily acquired the land, D was only offered nominal compensation on the basis that it only occupied the land on licence and its subsidiary was not losing business as a result of the acquisition of the land. The Court of Appeal held that D was entitled to proper compensation for the disturbance, as it held an equitable interest in the land. The court therefore did not require disregarding the separate legal personality of the companies. However, Lord Denning M.R. observed,

“These subsidiaries are bound hand and foot to the parent company and must do just what the parent company says. ... This

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<sup>303</sup> [1976] 3 All ER 462 at 861.

group is virtually the same as a partnership in which all the three companies are partners. They should not be treated separately so as to be defeated on a technical point. ... The three companies should, for present purposes, be treated as one, and the parent company DHN should be treated as that one.

DHN, although not holding an appropriate interest in the property acquired, could therefore claim compensation for disturbance. This is probably the strongest English case, regarding the creation of group liability, because it was arguable that the court there did not base itself on the particular statutory provisions but on a more general approach founded on the idea of single economic entity.<sup>304</sup> The parent and subsidiary were treated as a single economic unit when there was evidence indicating that the parent could make any arrangements it pleased in regard to the management of the business of the subsidiary, that every step taken by the subsidiary was determined by the policy of the parent, that the subsidiary had to do just what parent said, and that the parent controlled the purse strings, on an item-by-item basis.<sup>305</sup>

Lord Denning's view was adopted by Costello J in the Irish case of *Power Supermarkets Limited v Crumlin Investments Limited and Dunnes Stores (Crumlin) Limited*.<sup>306</sup> P was a tenant which operated a large supermarket in a

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<sup>304</sup> L. Gower and P Davies, *op.cit.* p.185.

<sup>305</sup> D.K. Avgitidis, *Group of Companies; The Liability of Parent Company for the Debts of Its Subsidiary*, Sakkoulas, Athens-Komotini 1996, p.182.

<sup>306</sup> 22 June 1981, Unreported, High Court (Costello J). The authority of Lord Denning's findings were doubted by Lord Keith in the Scottish House of Lords case, *Woolfson v Strathclyde Regional Council*, 1978 S.L.T. 159; and further doubted and restricted in *Adams v Cape Industries plc* [1990] Ch 433 to the extent that *DHN* might have been construed as authority for the proposition that the courts can generally treat closely connected companies in a group as one economic entity, ignoring their separate personalities, it must be conceded that the decision is no longer good law. More representative of this position is the statements of Roskill LJ quoted in *Adams v Cape Industries* [1975] 3 W.L.R. 491, 521, that: "... each company in a group of companies (a relatively modern concept) is a separate legal entity possessed of separate legal rights and liabilities so that the rights of one company in a group cannot be exercised by another company in that group even though the ultimate benefit of the exercise of those

shopping centre of which C was the landlord. The lease contained a covenant that the landlord would not permit the sale of grocery or food produce by any party from a unit exceeding 3000 square feet within the shopping centre for the duration of the lease. When the shopping centre failed to be a financial success, C disposed of its interest to Cornels Court Shopping Centre Limited, a member of the Dunnes Stores group of companies, by way of a transfer of all of its shares to that company. The Dunnes Stores group wished to establish its own outlet in the centre. A separate company – D - was set up and Cornels as controlling shareholder caused C to convey the freehold of a large unit in the centre to D, which then set up in competition with P. P succeeded in obtaining an injunction restraining D from trading in the shopping centre. Costello J found that D was bound by the terms of the lease even though they had not formally been a party to it, on the basis all the companies involved were part of a single economic entity. In the course of his judgment, Costello J. stated:

"It seems to me to be well established that a court may, if the justice of the case so requires, treat two or more related companies as a single entity so that the business notionally carried on by one will be regarded as the business of the group or another member of the group if this conforms to the economic and commercial realities of the situation".

He went on to describe D as a 'mere technical device.....a company with a £2 issued capital which had no real independent life of its own'.

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rights would ensure beneficially to the same person or corporate body irrespective of the person or body in whom those rights were vested in law. It is perhaps permissible under modern commercial conditions to regret the existence of these principles. But it is impossible to deny, ignore or disobey them".



The two decisions mentioned above and the comments of Lord Denning M.R. in *DHN* were cited with approval by the Irish Supreme Court in *Re Bray Travel and Bray Travel (Holdings) Limited*.<sup>307</sup>

Yet, and in contrast to the above, in *Allied Irish Coal Supplies Limited v Powell Duffryn International Fuels Limited* both the Irish High Court and Supreme Court reaffirmed the significance of the *Salomon* principle, and firmly rejected arguments that the separate legal personality of companies within a group should be disregarded merely because there was a close relationship between the companies. In refusing the application to join the parent as a co-defendant in the proceedings, the High Court held that to allow such an application would be in contravention of the principle of separate personality. Laffoy J stated that:

'it cannot be used to render the assets of a parent company available to meet the liabilities of a trading subsidiary, to a party with whom it has not traded. The proposition advanced by the plaintiff seems to me to be so fundamentally at variance with the principle of separate corporate legal personality laid down in *Salomon v Salomon & Co.*, and the concept of limited liability, that it is wholly un-satiable.<sup>308</sup>

The Supreme Court upheld his decision, Murphy J. noting:

"While it would be impossible to say that there are no circumstances in which the members of a company, whether corporate or individual, could not conduct, or purport to conduct the business of a company in such a way as to render their assets liable to meet claims in respect of the business normally carried out by the company, I believe that this would be an altogether exceptional state of affairs

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<sup>307</sup> 13 July 1981, unreported, Supreme Court.

<sup>308</sup> [1998] 2 ILRM 519 at 61 (High Court), [1998] 2 IR 529 (Supreme Court).

and difficult to reconcile with the seminal judgment in *Salomon v Salomon & Co...*"

Moreover, in *The State (McInerney & Co Limited) v Dublin County Council*<sup>309</sup> the Irish High Court held that the justice of the case did not necessitate the lifting of the corporate veil where two subsidiaries of the same holding company sought to be regarded as a single economic entity so that one of them could, when it was refused planning permission, require the defendant to purchase lands owned by the other company. Carroll J stated:

"...the corporate veil is not a device to be raised and lowered at the option of the parent or group. The arm which lifts the corporate veil must always be that of justice.....it appears to me that here is a group of companies operated so as to maximise the benefits to be gained from the individual corporate identity of each subsidiary..... It is not for the corporate group to claim that the veil should be lifted to illuminate one aspect of its business while it should be left in situ to isolate the individual actions of its subsidiaries in other respects"

### **1.3 Evaluation of Court Position**

Some scholars criticize the approach of courts to lifting the corporate veil between a parent company and its subsidiary. Prentice<sup>310</sup> argues that the cases fail to articulate any clear principles from which it is possible to predict when the court will or will not pierce the corporate veil. Judges seem to decide whether to pierce the corporate veil based on their own personal notions of fairness and equity, or the extent of impropriety. He does not expect any significant judicial creativity in lifting the corporate veil on the part of the English courts. He feels this is due to (a) the extent to which the corporate entity

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<sup>309</sup> 12 December 1984, unreported

<sup>310</sup> D.D. Prentice, op. cit. p.310-311.

doctrine is entrenched in English company law (pre-dates the evolution of the group form), (b) judicial conservatism, (c) and policy considerations which are considered to make this an area which is more suitable for legislative than judicial intervention.

Austin<sup>311</sup> argues the corporate veil is generally only disregarded where this confers some benefit on the companies (as in *DHN*) rather exposing them to liability. This subjective focus leads to inconsistencies in the manner in which the veil is pierced.<sup>312</sup>

The English and Irish courts are keen to reaffirm the importance of the *Salomon* principle and will not easily disregard the separate legal personality of a company. They are reluctant to treat a group as a single legal entity, but may lift the veil if the interests of justice required them to do so.

## **2. Imposing Liability on the Directors of Subsidiaries**

One way of minimising any incentive which a company may have to continue trading where it is in financial difficulties is to impose liability on the shareholders and/or directors with respect to losses incurred by creditors in such circumstances. When a company is insolvent, the value of the shareholders' interest is zero. The value of continued trading to directors will, of course, not be zero since they will have a continued interest in receiving remuneration.<sup>313</sup> Thus the legislative response to directors continuing to trade when the company is insolvent or on the verge of insolvency has been to impose liability on directors for fraudulent or wrongful trading.

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<sup>311</sup> Robert P Austin, *op.cit.* p. 80.

<sup>312</sup> Steven L. Schwarcz, *op. cit.* p.28.

<sup>313</sup> Dan Prentice, *op. cit.* p.110.

## 2.1 Fraudulent Trading

Statutes in Australia, New Zealand and the United Kingdom have long provided that directors responsible for reckless or fraudulent trading can be ordered without limit of liability to contribute to the asset pool should the company go into insolvent liquidation. Broadly, these provisions apply where directors, or others who participated in the management of a company, did do in a reckless manner or so as to defraud the members or creditors.<sup>314</sup> Thus s.213 of the UK Insolvency Act 1986, known as the 'fraudulent trading' provision, provides that, if, in the course of the winding up of a company, it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, then the liquidator can apply to the court for a declaration that any persons who were knowingly parties to the carrying on of the business in this way be liable to make such contributions to the company's assets as the court thinks proper.

Section 213 sets out three elements that must be established before liability will attach. First, the company must be in the course of winding up. Second, the company's business must have been carried on with the intent of defrauding creditors. Third, to be liable, the persons must have knowingly been parties to the carrying on of the business. Section 213 raises three main questions. The first is what is the meaning of 'fraud' in this context? On *Re Patrick & Lyon Ltd*,<sup>315</sup> the court suggests that the words 'defraud' and 'fraudulent purpose' connote actual dishonesty involving real moral blame. Thus in that case the test was satisfied when the company had never made a trading profit and the

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<sup>314</sup> Ibid., p.111.

<sup>315</sup> [1933] Ch 786, p 790.

directors' secured money owed to them by the company by causing the company to issue debentures to them. In *Re Gerald Cooper Chemicals Ltd*,<sup>316</sup> it was held that an insolvent company could be carrying on a business fraudulently where it accepted an advance payment for the supply of goods in circumstances where the directors knew that there was no prospect of the goods being supplied or the payment being repaid. Similarly, in *Re William C Leitch Brothers Ltd*,<sup>317</sup> the court held that, if a company continues to carry on business and to incur debts at a time when there is, to the knowledge of the directors, no reasonable prospect of the creditors ever receiving payment of those debts, it was, in general, proper to infer that the company had been carrying on a business with intent to defraud.

The second question is who might be defrauded? It has been held that the provisions apply not only where all the creditors of the company have been defrauded but where only one has been so affected. Also, it is no defense to argue that a person supplying goods on credit to a company is not a creditor but, at that time, only a supplier with a possible future claim against the company. The courts will construe the wording so that creditors include potential creditors.<sup>318</sup>

The third question is who is carrying on the business of the company? It has been held that to be a party to the carrying on of the business' of the company, a person must be involved in taking positive steps towards that end or exercising a controlling or managerial function and not just 'advising on' or 'concurring in' or even 'participating in' the business. Nevertheless, in *Re*

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<sup>316</sup> [1978] 2 Ch 262.

<sup>317</sup> [1932] 2 Ch 71.

<sup>318</sup> Simon Goulding, op.cit. p.82.

*Gerald Cooper Chemicals Ltd*,<sup>319</sup> it was held that it was possible for an outsider to be a party to the carrying on of the company's business for the purpose of s.213.

There is also the possibility that criminal liability could follow, with a term of imprisonment as the ultimate penalty. While the criminal penalty was intended to act as a strong deterrent to fraudulent behavior, it proved to have the unfortunate effect of neutralising the effectiveness of s.213 as the courts set a very high standard of proof for 'intent to defraud' because of the possibility of a criminal charge also arising.

### **2.1.1 Parent/Subsidiary Case**

The implementation of fraudulent trading principle in the context of parent/subsidiary is rare. The decision in *Re Augustus Barnett & Son Ltd*<sup>320</sup> is a good example. A was a subsidiary of R. A had operated at loss, and its auditors had only agreed to certify its accounts because R had provided a letter of comfort. Furthermore, R transferred money to A and assured A's suppliers that it would continue to support it. Later, R withdrew support and A went into insolvent liquidation. The liquidator sought to make R liable for fraudulent trading under s. 332 of the Companies Act 1948. It was alleged that, although the directors of A had carried on the business, R had induced A's directors to do so with the intent of defrauding A's creditors and thereby had been a party to the fraud. The argument failed because the directors of A honestly believed in the continuing support of R, so that there was no fraud to which R could be a party. The court also considered if R itself could have been carrying on the business with fraudulent intent. It found it is possible that a parent company might be considered as carrying on its subsidiary's business. However, the evidence did not support any contention of intent to defraud creditors.

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<sup>319</sup> [1978] Ch 262

<sup>320</sup> [1986] BCLC 170, at 172.

The difficulties and inadequacies of the law relating to fraudulent trading were examined by the Cork Committee Report in 1982. It thought that the main problems with the interpretation and application of the fraudulent trading provisions, which prevent them from operating as an effective compensatory remedy, are the reluctance of the courts to declare civil liability except in cases where there has been dishonesty, and the courts' insistence upon a strict standard of proof. Both of these problems were seen as stemming from the fact that fraudulent trading has both criminal and civil aspects, with the courts maintaining the same requirements in relation to each. The Committee was of the view that concept of fraudulent trading should be abolished, and that a new provision be enacted which did not require dishonesty to be proven and which would apply in cases of not only fraudulent but also unreasonable trading. This new concept was to be known as 'wrongful trading'. The legislature adopted this proposal and enacted the wrongful trading provision in s.214 of the Insolvency Act 1986.<sup>321</sup>

## **2.2 Wrongful Trading**

Section 214 provides that the court, on the application of the liquidator, may declare that a person who is or has been a director of the company is to be liable to make such contribution (if any) to the company's assets as the court thinks proper if (a) the company has gone into insolvent liquidation, (b) at some time before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, and (c) that person was a director of the company at that time.

Section 214 operates on the basis that at some time before the company entered insolvent liquidation there will have been a point where the directors knew it was hopeless and the company could not trade out of the situation. In deciding whether a director ought to have concluded that a company could not

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<sup>321</sup> Simon Goulding, *op.cit.* p.83.

avoid insolvent liquidation, a director is deemed to have the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions that director carries out for the company.

To avoid liability under this section, a director must:

- a. exercise the knowledge, skill and experience that he possesses.
- b. prove there was no reasonable prospect that the company would avoid going into liquidation, and
- c. prove he took every step he should have taken to minimise the potential loss to the company's creditors.<sup>322</sup>

Where a person has been found liable to make a contribution under s.214, this can constitute grounds for disqualifying him from acting as a director of a company for up to a period of fifteen years.<sup>323</sup> The prospect of personal liability for the debts of the company, coupled with the threat of disqualification is a strong incentive for directors to bring the affairs of a company to an end where the company can no longer trade at a profit.<sup>324</sup>

### **2.2.1 Parent/Subsidiary case**

The most important contribution of s.214 to the liability of corporate group is when the parent company is a "shadow directors". S.251 of Companies Act 2006 defines shadow director as "a person in accordance with whose instructions the directors of the company are accustomed to act". This obviously has important implications for parent company liability, as in many situations a parent company will instruct its subsidiary as to how to carry on its affairs. Where this is the case, the parent company will be potentially liable under s.214 as a shadow director. Therefore, wrongful trading may well be able to provide a remedy in situations similar to that in *Re Augustus Barnett Ltd.*<sup>325</sup> However, The

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<sup>322</sup> Ibid p.85.

<sup>323</sup> Company Directors Disqualification Act 1986 s.10.

<sup>324</sup> D.D. Prentice, op. cit. p.314.

<sup>325</sup> L Gower and P Davies, op.cit. p.195.



Cork Committees' proposal that a parent should be presumed to be a shadow director if it is responsible for the appointment of the directors of the subsidiary has not been implemented.

Morris LJ in *State for Trade and Industry v Deverell*<sup>326</sup> suggested taking a more inclusive view of who might be a shadow director. He held that a shareholder may be treated as a shadow director if he exercises "real influence" over the board of the company's management; total dictatorial control over every aspect of management does not have to be established. However, the latest authority on the subject, namely *Secretary of State for Trade and Industry v Becker*<sup>327</sup> offers a more conservative view. The court emphasized that there must be a consistent pattern of board compliance with instructions. Therefore, it is not sufficient if the directors followed such instructions in an isolated event at the end of the company's life.

Liability can also be extended to a 'de facto director', a person who presumes to act as a director. He is held out as a director by the company, claims and purports to be a director, although never actually or validly appointed as such'.<sup>328</sup> To establish that a person was a *de facto* director of a company, it is necessary to prove that he undertook functions in relation to the company which could properly be discharged only by a director. Where a parent company is alleged to be the director of the subsidiary, whether de facto or as a shadow director, it will not necessarily follow that the directors of the parent company will, *ipso facto*, be the de facto or shadow directors of the subsidiary. Evidence will need to be adduced on this point.<sup>329</sup>

The concept of a parent company being held liable because it is a shadow or de facto director of a subsidiary is also found in a number of European countries.

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<sup>326</sup> [2001] UKHL 45, CH 430.

<sup>327</sup> [2002] EWHC 2200 (CH), [2003] 1 BCLC 555.

<sup>328</sup> Millett J in *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180 at 161.

<sup>329</sup> *Ibid.*

Three main features need to be appreciated when using the concept of Shadow director under s. 214:<sup>330</sup>

- a. being a shadow director is a matter of evidence and is not automatically assumed where one company has majority control of another company, or even where the other company is its wholly owned subsidiary. However, in many situations it will be difficult for a parent to deny that it does not control its subsidiary's affairs. As companies are legally required to maintain extensive records of their affairs (minutes of meeting, accounts, etc), it will be difficult for a parent company to conceal the reality of control if it is at all being exercised. In the case of a wholly owned subsidiary, or where the directors of the parent company also act as the subsidiary directors, the inference of control will be virtually irrefutable.
- b. liability under s.214 is not absolute. A parent company considered to be a shadow director can yet show that it took every step to minimise the potential loss to the company's creditors. There are no decisions spelling out what this defence entails, but it is reasonably clear that the standard imposed is a demanding one. However, the possibility of this defense means that a parent which has acted as a shadow director of its subsidiary is not made automatically liable for the debts of its subsidiary.
- c. Section 214 designed primarily to protect creditors and not shareholders. Thus it does not deal with the situation where a parent company causes damages to its subsidiary to the prejudice of minority shareholders in the subsidiary but which does not ultimately result in the insolvent liquidation of the subsidiary.

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<sup>330</sup> A Hicks & S Goo, op.cit. p 358.

### 2.3 Evaluation of the Wrongful Trading Provisions

The application of the provisions on fraudulent and wrongful trading in the context of groups of companies relies upon evidence demonstrating that the parent company exercises some degree of managerial control over its subsidiary. The limited liability of the parent is lifted either where the parent was knowingly party to the carrying on of its subsidiary's business with intent to defraud creditors (fraudulent trading) or where the parent was a shadow director of its insolvent subsidiary (wrongful trading). Although s.214 does not directly make a parent company liable for the debts of its subsidiary, the extension of s.214 to shadow directors entails that parent companies will, in many situation, have to come to rescue of their failing subsidiaries.<sup>331</sup>

Some scholars believe that the introduction of the fraudulent and wrongful trading provision can be seen as the most important statutory exception to the separate legal entity doctrine.<sup>332</sup> The major advance brought about by the introduction of the notion of wrongful trading is that considerable personal liability can be imposed on those persons who have run a company which has gone into insolvent liquidation, even where they have not acted dishonestly.<sup>333</sup> Yet others argue that the provisions do not properly apply in cases of parent/subsidiary, and that they are subject to very strict conditions similar to those required for veil piercing.<sup>334</sup> Moreover, several problems attend the 'shadow directors' doctrine in some countries. First, under some of the laws

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<sup>331</sup> D. Prentice, op cit. p.314.

<sup>332</sup> L Gower and P Davies, op.cit.p. 195.

<sup>333</sup> Some scholars praised s.214 as "one of the most important developments in company law in this century", equipping creditors with a "welcome additional weapon in the fight against abuse of the privilege of limited liability" -see Oditah, Wrongful Trading, Loyd's Maritime and Commercial Law Quarterly, (1990), 205 at 222.

<sup>334</sup> L Gower and P Davies, op.cit. p.196.

there is a need to show that the interests of the subsidiary were undermined for the purpose of ensuring that the interests of the holding company prevailed. However, it is often difficult to show that the subsidiary has a separate interest when the affairs of the holding company and the subsidiary have been merged for a significant period. Second, in some jurisdictions liability depends upon a breach of fiduciary duty by the shadow or de facto director. The definition of fiduciary duty requires reference to an independent interest of the subsidiary. Because of this holding company liability will only be established in the most egregious cases of holding company misconduct. Finally, some jurisdictions require breach of fiduciary duty by the de facto director to be enforced derivatively. Derivative litigation presents significant problems because of the lack of incentives to commence litigation.<sup>335</sup>

Finally, the requirements for successfully establishing the liability of parent corporations indicate that the Insolvency Act is only an enacted equivalent of the veil piercing principles laid down in case law. Therefore, it cannot be claimed to have removed the negative effects of limited liability principles in the groups of companies' context.<sup>336</sup>

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<sup>335</sup> Hofstetter, *supra* note 72, p. 588. Several of these enforcement problems are less relevant under English law.

<sup>336</sup> S. Griffin, *Limited Liability: A Necessary Revolution* (2004) 25 *Company Lawyer* 99.

### 3. Trading while Insolvent

In Australia, the Corporate Law Reform Act 1992 amended the Corporations Act to expose parent entities to liability for insolvent trading of their subsidiaries. A subsidiary's liquidator may raise recovery proceedings against its holding company if the specific provisions of ss.588V and 588W of the Corporation Act are met. A holding company contravenes s.588V if a subsidiary is insolvent when it incurs a debt, or becomes insolvent by incurring the debt, and at that time there are reasonable grounds for suspecting that the subsidiary is insolvent, or would so become insolvent, and,

- a. the holding company, or one or more of its directors, is or are aware at that time that there are grounds for so suspecting; or
- b. having regard to the nature and extent of the holding company's control over the affairs of the subsidiary and to any other relevant circumstances, it is reasonable to expect that either a holding company in the company's circumstances would be so aware or one or more of such a holding company's directors would be so aware.<sup>337</sup>

Section 588W provides that where a holding company contravenes s.588V in relation to the incurring of a debt by a subsidiary, and the person to whom the debt is owed has suffered loss or damage in relation to the debt because of the subsidiary's insolvency, and the debt was wholly or partly unsecured when the loss or damage was suffered, the subsidiary's liquidator may seek to recover from the holding company an amount equal to the amount of the loss or damage. Yet where the court is satisfied that, at the time when the subsidiary

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<sup>337</sup> The provisions outlined have their origin in a report of the Australian Law Reform Commission. The recommendations of the Commission were broader than section 588V, and would have applied not just to a holding company but to any related company. The Commission proposed that a court should be able to order a company to be liable for the debts of a related company if the court determined this to be just. Three criteria to which the court should have regard were proposed: (a) the extent to which the related company took part in the management of the insolvent company; (b) the conduct of the related company towards the creditors of the insolvent company; and (c) the extent to which the circumstances that gave rise to the winding up of the company were attributable to the actions of the related company. Australian Law Reform Commission, *General Insolvency Inquiry*, (Canberra, 1988).

incurred the debt, the creditor who suffered the loss or damage knew that the subsidiary was insolvent or would become insolvent by incurring the debt, s.588Y provides that the court may order that the compensation paid by the holding company is not available to pay the debt unless all the subsidiary's other unsecured debts have been paid in full.

The approach of s.588V is commendable. It is reasonable to expect a holding company and its directors to be aware that the subsidiary is facing the risk of insolvency of a subsidiary's insolvency, at least where the holding company exercises control over the affairs of the subsidiary. In other words, there are grounds for imputing an awareness of the subsidiary's plight to the holding company or its directors if it is reasonable to do so having regard to the control relationship.<sup>338</sup>

Section 588X gives a holding company a defense if it can establish that:

- a. At the time when the debt was incurred, it and each relevant director (if any), had reasonable grounds to expect, and did expect, that the subsidiary was solvent at that time and would remain solvent even if it incurred the debt.
- b. At the time when the debt was incurred, it and each relevant director (if any):
  - i. had reasonable grounds to believe, and did believe that a competent and reliable person was responsible for providing to the holding company adequate information about whether the subsidiary was solvent and that the person was fulfilling that responsibility; and
  - ii. expected, on the basis of the information provided to the holding company by the person, that the subsidiary was solvent at that time and would remain solvent even if it incurred that debt.

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<sup>338</sup> Robert P Austin, *op.cit.* p. 88.

- c. Because of illness or for some other good reason, a particular relevant director did not take part in the management of the holding company at the time when the subsidiary incurred the debt.
- d. It took all reasonable steps to prevent the subsidiary from incurring the debt.

### **3.1 Evaluation of the Trading while Insolvent Provisions**

Section 588V seems to focusing cases where parents and subsidiaries are managed separately, as in the case of a local subsidiary of a foreign parent. The provisions are apt to deal with a local wholly owned group where assets of group entities are intermingled and the affairs of the entities are intricately intertwined. In such a case, it may be possible to prove the ingredients of holding company liability under s.588V. However, the very complexity which creates problems in the liquidation of group entities will also generate problems in the proof of the ingredients of liability. The establishment of a judicial power to order that one entity should contribute to the debts of the other and that liquidation should proceed together would be a much easier way of solving the problem.<sup>339</sup>

### **4. Pooling of Assets**

Section 271 of New Zealand Companies Act 1993<sup>340</sup> entitles the court on the application of the liquidator, a creditor or shareholder, and if the court satisfied that it is just and equitable to do so, to order that:

- a. a company that is, or has been, related to the company in liquidation must pay to the liquidator the whole or part of any or all of the claims made in the liquidation. This is a 'Contribution Order'.
- b. Where two or more related companies are in liquidation, the liquidations in respect of each company must proceed together as if they were one

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<sup>339</sup> Ibid, p. 89.

<sup>340</sup> A similar approach to contribution and pooling of assets has been adopted in Ireland and Australia, and there are also parallels in the German Stock Corporation Act 1965.

company to the extent that the court so orders and subject to such terms and conditions as the court may impose.

Section 272 (1) sets out the guidelines for making such order. In deciding whether it is just and equitable to make such order, the Court must have regard to the following matters:

- a. the extent to which the related company took part in the management of the company in liquidation;
- b. the conduct of the related company towards the creditors of the company in liquidation;
- c. the extent to which the circumstances that gave rise to the liquidation of the company are attributable to the actions of the related company;
- d. such other matters as the Court thinks fit.

In deciding whether it is just and equitable to make such order under s. 271(1)(b), the court must have regard to the following matters as stipulated in s 272(2),

- a. the extent to which any of the companies took part in the management of any of the other companies;
- b. the conduct of any of the companies towards the creditors of any of the other companies;
- c. the extent to which the circumstances that gave rise to the liquidation of any of the companies are attributable to the actions of any of the other companies;
- d. the extent to which the business of the companies have been combined;
- e. such other matters as the Court thinks fit.

Section 272 (3) stated that the fact that creditors of a company in liquidation relied on the fact that another company is, or was, related to it is not a ground for making an order under s.271 of the Act.



The circumstances under which the court will grant such a pooling order were set out in the case of *Mountfort v Tasman Pacific Airlines of NZ Ltd.*<sup>341</sup> In July 1999, Tasman Pacific Airlines Limited (Pacific), an Ansett Australia subsidiary set up to compete with Air New Zealand, acquired Tasman Pacific Regional Airlines Limited (Regional). Regional provided regional “feeder” flights for Pacific’s main domestics’ routes under an agreement which ensured that Regional produced profits irrespective of the number of passengers carried. Pacific however had made multimillion dollar losses over several years and had been supported by injections of funds from its Australian holding company in the hope of achieving a turnaround. The holding company had also provided Pacific’s bank with a substantial guarantee which ensured that Pacific remained solvent. In March 2000, Zazu Limited (Zazu), owned by several New Zealand investment companies, acquired Pacific and the previous owner’s withdrew their guarantee. Zazu lacked sufficient assets to continue to fund Pacific’s losses and looked to Qantas to secure an injection of additional equity. In the interim, Pacific procured Regional to transfer \$650,000 from Regional’s bank account to Pacific. This transfer would have been legitimate if both companies had been solvent as the resulting debt would simply have replaced a debt of the same amount owed by Regional’s bank. A heavily undercapitalised Pacific continued to make substantial losses and in July 2000 the value of Pacific’s debt to Regional was discounted to nil. The removal of the \$650,000 from Regional effectively rendered that company insolvent. Qantas ultimately decided not to support Pacific and unable to secure additional finance both Pacific and Regional were placed into liquidation.

The liquidator for Regional applied for a pooling order under ss.271 and 272 of the Companies Act 1993 on the basis that Pacific had wrongfully caused Regional’s losses and should be required to disgorge the benefits received at the expense of Regional’s creditors. The Court affirmed that a subsidiary company is a separate legal entity from its parent and must be treated as such. The Court also indicated that solvency is the premise on which distinct corporate identity is accorded to the parent and subsidiary. Once the previous owner’s had withdrawn their guarantee, Pacific had become insolvent. Pacific’s

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<sup>341</sup> [2005] 9 NZCLC 263,864.

insolvency was more than a mere paper position; Pacific had no prospect of generating sufficient income from reasonably minor expenditure which might justify continued trading. Pacific had adopted a policy of trading while insolvent and had caused Regional to trade while insolvent by knowingly providing it with bad debt. The Court found that Regional had been a slave of Pacific and that Pacific had abused the potential creditors of Regional by sweeping money from its subsidiary in circumstances where there was a real risk of inability to repay the debt it owed. The Court was cognizant that a pooling order would increase the assets available to Regional's creditors while diminishing the assets available to Pacific. The Court held that this consideration was relevant as to whether an order would be equitable and to what its terms ought to be but was not be a bar to exercise of the statutory power. The Court affirmed the equitable principal that a party will not be permitted to take advantage of its own wrong.

An example of the operation of s 271(1)(b) is presented in *Re Pacific Syndicated (NZ) Ltd.*<sup>342</sup> Two related companies had solicited funds for contributory mortgages and had set up schemes, but had not set up the nominee companies which were to act as trustees for the scheme investors. Consequently, the funds received under each scheme had been mingled in the same bank account. Additionally, a mortgage was granted to a director of one of the companies to secure an advance from that company's bank account; that director stated that he held the mortgage on behalf of scheme investors. The companies had brought an action to recover monies allegedly misappropriated from them, and their claim was settled by payment of a global sum. The liquidator of the companies obtained an order permitting the proceeds of the settlement to be pooled, on the basis that it was not feasible to apportion the fund between the two companies. This was clearly a much more satisfactory outcome than having to apportion on some more or less arbitrary basis and treat the claims of investors in the two companies separately.<sup>343</sup>

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<sup>342</sup> [1989] 4 NZCLC 64,757.

<sup>343</sup> Robert P Austin, op.cit. p.86.

#### 4.1 Evaluation of the Pooling of Assets Provisions

Sections 271 and 272 potentially create a charter for the New Zealand courts to discard the *Salomon* principle in relation to groups of companies where some or all of the members of the group have been placed in liquidation. This model also enables the courts to overcome some of the difficulties of corporate group liquidation, saving time and expense and ultimately improving returns for creditors.<sup>344</sup> However, these provisions and their predecessors appear to have been little used, and the extent to which they will be used in the future courts is unclear.

Goddard,<sup>345</sup> believes that contribution to an insolvent company's debts by a solvent related company is still more problematic. Where a parent company is called on to contribute to the debts of a subsidiary, in particular, the Salomon principle is clearly challenged. If the creditors of the insolvent company knew who they were dealing with, what is the case for contribution? How can it be relevant that the solvent company "took part in the management of the company in liquidation", if it did not commit any breach of duty to the company in so doing and is not liable for losses suffered as a result? If an individual shareholder who took part in the company's management would not be liable, why impose liability on corporate shareholders? Goddard is convinced that an economically rational case for contribution by a related company is made out only if, and to the extent that:

- a. creditors were led to believe they were giving credit to the surviving company, or that some assets of the surviving company were in fact

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<sup>344</sup> Ibid, p.89.

<sup>345</sup> David Goddard, *Corporate Personality – Limited Recourse and its Limits*, in *Corporate Personality in the 20th Century*, Hart Publishing Oxford (1998), p.57.

assets of the insolvent company, and such representations were material to those creditors; or

- b. a parent company is a deemed director under s.126 of the Companies Act 1993, due to the control it exercises over a subsidiary's affairs, and is liable for losses caused by insolvent trading on the basis applicable to directors generally.

He finally mention that ss.271 and 272 go far beyond these bounds and require careful review if Salomon is to survive in the corporate group context.

On another hand, it is suggested that there is a clear conceptual distinction between pooling and contribution. A pooling order is an example of disregarding separate legal personality in order to divide an existing pool of assets among the creditors, while a contribution order is an example of disregarding separate personality by imposing liability upon a related company and so swelling the pool of assets available for the creditors of the company in liquidation. Yet this distinction is curiously submerged in the guidelines to which a court must have regard in deciding whether it is just and equitable to make a pooling or a contribution order.<sup>346</sup>

## **5. Substantive Consolidation**

Substantive consolidation is similar to the concept of pooling of assets although it goes further than the New Zealand legislation in that consolidation is available to merge the assets and liabilities of individual debtors with affiliate companies as well as merging the assets and liabilities of related companies<sup>347</sup> Its effect is that intercompany debts and liabilities under guarantees are eliminated, the

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<sup>346</sup> Austin, op. cit. p.94.

<sup>347</sup> T Cashel, *Groups of Companies: Some US Aspects*, in CM Schmitthoff and F Woolrige, (eds.), *Groups of Companies*, Sweet & Maxwell, London, (1991), pp.37-38.

assets of the debtor companies are treated as common assets, and they are applied to the claims of creditors against any or all of the companies. The concept of substantive consolidation was developed by the US courts in exercising their general equitable powers. A court commonly orders consolidation where the affairs of the companies in question are inextricably entangled, or at least so entangled that the cost of unraveling them is likely to absorb the assets in the liquidation. Less commonly, consolidation may also be ordered on the basis that the creditors have dealt with the debtor companies as a single economic unit and did not rely upon the credit of a particular company within the group. In such cases, difficulty in separating the affairs of the companies may be only one factor in determining whether consolidation should be ordered. In an appropriate case, consolidation may be ordered even where the affairs of the debtor companies are readily separated, as in *Re Flora Mir Candy v R.S Dickson&Co.*<sup>348</sup>

The American courts have cautioned that consolidation should be used sparingly because of possible prejudice to creditors of a debtor company who have dealt solely with that company in isolation from others in the group. This occurs where the likely distribution by company A within a group of companies would substantially exceed a distribution following consolidation of all companies in the group. The solution is to order consolidation of the debtor companies excluding company A. Here the courts rely upon the doctrine of separate corporate personality, not for the usual purpose of shielding corporate participants (directors and shareholders) from liability, but to protect creditors. For this reason, Landers argues that the reliance by a creditor upon the credit

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<sup>348</sup> US Court of Appeal, No. 59, Docket 34713, 432 F 2d 1060 (2d Cir 1970).

of a particular entity should not be emphasised in considering whether consolidation should be ordered: the doctrine of separate incomparability was not designed as a protection for creditors. Consolidation is available in the United States between a solvent and an insolvent company. The non-debtor company is said to be 'collapsed' into the debtor company. It appears to be only rarely ordered, and has the effect that all the assets and liabilities of the collapsed company are brought into the liquidation of the debtor company.<sup>349</sup>

## **6. Directors' Duties to Creditors**

Directors are appointed by shareholders to manage the company ultimately for the benefit of the latter. Although directors must act only in the interests of the company rather than the shareholders, the interests of shareholders must be taken into consideration, as it is ultimately for their benefit that the business of the company is being conducted. However, the concept of the interests of the company has undergone significant development.

In *Teck Coproration Ltd v Millar*,<sup>350</sup> Berger J suggested expanding it to include the interests of employees and the community, while the Australian High Court decided in *Walker v Wimborne*<sup>351</sup> to oblige directors to have regard to creditors' interests.<sup>352</sup>

The common law traditionally did not recognise that a director owed any duties to a company's creditors. The Jenkins Committee Report stated that a director owed fiduciary duties only to the company itself rather than individual members

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<sup>349</sup> Austin, op. cit. p.92.

<sup>350</sup> [1973] 33 DLR (3d), 288.

<sup>351</sup> [1976] 137 CLR 1.

<sup>352</sup> Mohammad Razal Salim, *Corporate Insolvency: Separate Legal Personality and Directors' Duties to Creditors* New Horizon. (June, 1996), p.6.

of the company, and *a fortiori* owed no duties to a person who is not a member.<sup>353</sup>

More recently, however, courts have been willing to find ways to impose fiduciary duties towards a company's creditors on directors where the company continues to trade at a time when it is insolvent. The conceptual apparatus for achieving this is relatively straightforward. Once a company goes into insolvent liquidation, the shareholders cease to have any interest in the assets of the company. In insolvency, the shareholders 'come last' and drop out of the picture. In this situation, the courts have held that the interests of the company are the interests of the creditors and the directors must act so as to maximise creditor welfare.<sup>354</sup>

Accordingly, in *Winkworth v Edward Baron Development Ltd*<sup>355</sup>, Lord Templeman stated that:

“a company is not bound to pay off every debt as soon as it is incurred, and the company is not obliged to avoid all ventures which involve an element of risk but the company owes a duty to its creditors to keep its property inviolate and available for the repayment of its debts. The conscience of the company, as well as its management, is confided to directors. A duty is owed by its directors to the company and to the directors of the company to ensure that the affairs of the company are properly administered and

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<sup>353</sup> Report on the Committee of Company Law Reform Cmnd 1749 (1962), Para 89. Although directors owe no direct fiduciary duties to shareholders, the UK Companies Act 2006 provides remedies for shareholders for oppression or unfair conduct.

<sup>354</sup> Dan Prentice, op. cit. p.107.

<sup>355</sup> [1987] 1 W.L.R. 1512, at 1517.

that its property is not dissipated or exploited for the benefit of the directors themselves to the prejudice of the creditors. ”

The clearest recognition of this doctrine is found in the decision of Court of Appeal in *West Mercia Safetywear Ltd v Dodd*.<sup>356</sup> The court held that a director of a company which was insolvent had to repay moneys which he had used to pay the debts owed by the company to its parent, but which he should not have so used, as this breached the duty which he owed to the company’s creditors as a class. In *Kinsella v Russell Kinsella Pty*,<sup>357</sup> Dillon L.J. stated that:

“In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise. If, as a general body, they authorise or ratify a particular action of the directors, there can be no challenge to the validity of what the directors have done. But where a company is insolvent the interests of the creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company’s assets. It is in a practical sense their assets and not the shareholders’ assets that, through the medium of the company, are under the management of the directors pending entire liquidation, return to insolvency, or the imposition of some alternative administration.”

A company’s obligations towards creditors are primarily contractual. However, even while the company is a going concern, directors must consider the

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<sup>356</sup> [1988] BCLC, 250.

<sup>357</sup> (1986) 4NSWLR 722 at 730.



interests of the creditors, as a failure to do so will result in certain repercussions, of which the most obvious will be a legal action being taken against the company, and the harm inflicted to the company's reputation and credit rating. Yet while the interests of creditors are relevant, directors will be under no obligation to actively advance those interests. Nevertheless, where the company is insolvent or nearly so, the creditors replace the shareholders as the primary corporate constituent. This is because the shareholders can no longer benefit from the company and it is the creditors who will stand to lose or gain the most, depending on how the business of the company is conducted and its assets utilised.<sup>358</sup>

Although this doctrine is in an embryonic stage, the following points can be tentatively made about its possible operation:<sup>359</sup>

- a. It only applies when the company is insolvent and thus its principal purpose is to protect creditors and not shareholders.
- b. the duty, although expressed to be owed to the creditors, will be mediated through the company. There are a number of reasons for this. First, it avoids the difficulties of double recovery which could arise were a director to be held to owe his duty to the creditors directly. Secondly, it is an important principle of insolvency law that all creditors of the same class should be treated equally. If a creditor could sue a director directly for an alleged breach of duty, this principle could be subverted. Also, if a direct action against director were to be permitted, difficult problems could arise

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<sup>358</sup> Mohammad Razal Salim, op. cit. p.14.

<sup>359</sup> D. Prentice, op. cit. p.316.

as to 'how any recovery obtained by a creditor from a director should be treated in a winding up.

- c. the effect of channeling claims through the company means that if the company has ceased to exist, then the creditor will in all probability have no enforceable claim with respect to any breach a of duty owed to him by the director through the company.

Some commentators argue that having regard to creditors' interests does not necessarily mean that the directors owe a duty to creditors. This is because the notion of directors' duties to creditors is inconsistent with the doctrine of separate legal personality. Furthermore, as the relationship between a company and its creditors is purely contractual, there is no basis for finding that directors owe any duties, fiduciary or otherwise, towards the creditors. In addition, even if a duty can be said to exist, there are no remedies that the creditors may obtain and a supposed duty which is not matched by a remedy is nonsensical.<sup>360</sup>

The effect of this common law development in the parent/subsidiary context is that where a parent company is the director of its subsidiary and as a director, it breaches the duty that it owes to its subsidiary's creditors, this will give the creditors a claim against the parent. This rule should as a matter of principle applies where the parent is a *de jure* or *de facto* director. In addition, it will operate to prevent a parent company in breach of this duty from making certain claims in the insolvency of its subsidiary in competition with the subsidiary's creditors.<sup>361</sup>

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<sup>360</sup> LS Sealy, *Directors' Wider Responsibilities – Problems Conceptual, Practical and Procedural*, (1987), 13 MULR 164 at 177.

<sup>361</sup> D. Prentice, op. cit. p.318.

## 7. The Single Economic Unit

Although the EU failed to agree a unified notion for group of companies, especially in relation to the liability problem, the European Court of Justice (ECJ) has used the single economic unit theory to impose liability on a parent company in the context of competition practice. The ECJ decided that where a company and its subsidiaries form as a single economic unit, the subsidiaries cannot enjoy any real autonomy in determining their operations.<sup>362</sup> Consequently, the most established basis in EC competition law for asserting jurisdiction over foreign companies is the doctrine of the group as a 'single economic unit'. This doctrine features the foreign parents' responsibility for the anti-competitive activities of a subsidiary that is active in Europe, and over which they supposedly exert control. Owing to that supposed control, the parent and other relevant members of the group may be brought within the jurisdiction of European Law.<sup>363</sup> The court has emphasised the corporate structural relationship between the parent and the subsidiary, and merely considered the parent's ability to control the latter, rather than asking whether that control was actually exercised. The court has stated that:

'the fact that a subsidiary has separate legal personality is not sufficient to exclude the possibility of imputing its conduct to the parent company... in the circumstances, the formal separation between these companies, resulting from their separate legal

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<sup>362</sup> *Centrafarm BV v. Sterling Drug Inc* 15/1974 ECR 1147; and *Viho Europe BV v. Commission* [1996] ECR I-5457.

<sup>363</sup> Case 48/69 *ICI v. Commission* [1972] ECR 619; *Viho Europe BV v. Commission* [1996] ECR I-5457. See D Goyder, *EC Competition Law* (Oxford University Press, Oxford 2003) p.499.

personality, cannot outweigh the unity of their conduct on the market for the purposes of applying the rules on competition’.<sup>364</sup>

Accordingly, the ECJ has held that where a subsidiary does not enjoy real autonomy in determining its course of action in the market, the prohibitions set out in article 81(1) of EU Treaty might be considered inapplicable in the relationship between it and the parent company with which it forms one economic unit.<sup>365</sup>

The application of single economic unit theory in EC competition judgment requires certain conditions. First of all, the parent and subsidiaries should form an economic unit as explained in the *Viho* case<sup>366</sup>:

‘an economic unit with in which the subsidiary has no real freedom to determine its course of action in the market because the parent company permanently supervises the making of decisions by, and the administration of, its subsidiary...’

Second, the parent company should exercises “decisive influence” over the conduct of the subsidiary. Decisive influence may be establish where the subsidiary, despite having a separate legal personality, does not decide independently its own market conduct but rather is considered to operate in accordance with the will of its parent company.<sup>367</sup>

Examination of the principles established by ECJ case law indicates that the requirements can only be met by vertically organised corporate groups because

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<sup>364</sup> *Centrafarm BV v. Sterling Drug Inc.*

<sup>365</sup> *Case of Istituto Chemioterapico Italiano and commercial Solvent Corporations v. Commission* cases 6-7/73 [1974] ECR 223.

<sup>366</sup> *Viho Europe BV V. Commission*, [1996] ECR I-5457.

<sup>367</sup> Such as the case of *El DuPont de Nemours and Oters v Commission*, T-76/08, 2<sup>nd</sup> February 2012. The General Court concluded that the European Commission did not err in finding both El DuPoint and Dow jointly and severally liable for decisive influence. The court looked closely at the fact of the case and

clear control established by a parent over its subsidiaries is apparent only in such groups. Thus in the *Viho* case found that Parker Pen Ltd controlled its subsidiaries in Belgium, Germany, the Netherlands, France and Spain, taking all key decisions. Examination of other cases where the ECJ has found that a corporate group constitutes a single economic unit demonstrates similar characteristics of control or supposed control by a parent over its subsidiaries. Thus, the analysis of competition case law demonstrates that the single economic entity theory applied in anti-trust cases by ECJ has some similarities to the veil piercing doctrine.<sup>368</sup> In the cases the separate legal personality of a subsidiary is ignored in order to reach its corporate shareholders. However, the single economic unit argument in the EU competition law is more advanced than the veil piercing theory, because the required nature of control in groups of companies is less strict than that required in veil piercing cases, as the Court looks for supposed rather than actual control by the parent. However, a liability regime designed according to a theory of vertical control in corporate groups cannot be applied to complex structures of multinational corporate group under which there is a horizontal organisational structure and cultural control.<sup>369</sup>

## **8. Conclusion to Part I**

1. There are difficulties associated with the imposition of liability because of the fact that a group exists. It is important that the law when providing solutions to these difficulties should at the same time provide a necessary degree of

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concluded that decisive influence was exercised over DDE's conduct on the relevant market and that the parents and DDE formed a single undertaking for these purposes.

<sup>368</sup> W.D. Schenck, *Jurisdiction over the Foreign Multinational in the EEC: Lifting the Veil on the Economic Entity Theory* (1989-1990) 11 U. Pa. J. Int'l Bus. L. 495.

<sup>369</sup> Muzaffer Eroglu, op cit. p.39-40.

flexibility in the organization of the affairs of the group of companies. In this regard, Prentice<sup>370</sup> proposes the following:

- i. While the privilege of limited liability can be abused by the parent company, the mere fact that risk is 'hived off' is not in itself considered evidence of abuse. Company law should be sufficiently flexible to enable a company to arrange its activities to limit its risk by the use of subsidiary companies without using this device to impose unreasonable risks on others.
- ii. Difficult problems concerning the treatment of various classes of creditors arise if a parent is to be answerable for the liabilities of its subsidiary. Such liability would entail that the whole assets of the group would, in the last resort, be made available to meet the liabilities of any individual member of the group. If a creditor deals with a group member on the basis that the member's assets are to be made exclusively available to meet its own debts, any form of group liability could result in such a creditor finding that the creditors of other group members possessed a potential claim on those assets.
- iii. Imposing liability on a parent company for the debts of a subsidiary gives rise to some special problems in the case of a subsidiary which is not wholly owned. If such liability is imposed, this could provide the minority shareholders in the subsidiary with a windfall. The potential liability of the parent company could be seen as operating virtually as a guarantee for which the subsidiary would not have to pay, and this would benefit the minority shareholders in the subsidiary. It would in effect result, by operation of law, in a wealth transfer from the shareholders in the parent to the minority shareholders in the subsidiary for which the former were not compensated.
- iv. If a parent company is to be made answerable for the debts of its subsidiary, difficult questions arise in determining the extent of

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<sup>370</sup> D.D. Prentice, op. cit. p.305-308

such liability where a new member joins or an existing member leaves the group. For example, where a member leaves a group, does the liability of the parent cease at this point or does it in some way continue?

Finally, it is important to mention that the techniques used by the courts and jurisdictions to protect group's creditors have two main important features. First, there is no presumption of liability on the part of a parent company following from the mere existence of the group form. Status does not determine liability or obligation unless the parent company shown to have 'abuse' its position. The second feature of these principles is that they normally only operate in the context of insolvency.<sup>371</sup> However, efforts to reach a sound level of liability have been wiped out by judges' rigid devotion to the restrictive characteristics of the doctrine of veil piercing. Basic liability principles are still attached to a traditional piercing the corporate veil doctrine, which requires a situation of parent company's control over the subsidiary together with some form of unlawful action.<sup>372</sup>

From the above, I believe the solutions presented by the Common law are not sufficient to protect creditors, especially as they operate after loss has already occurred, and the possibility of compensating the creditors for that loss is minor. Therefore, it is important to think about a proactive approach to protect creditors and, while keeping the privilege of the form of groups of companies. Such approach will be elaborated at the final chapter of this work.

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<sup>371</sup> D.D. Prentice, op. cit. p. 305.

<sup>372</sup> Muzaffer Eroglu, op cit. p.44.

## Part II

### The Liability of Groups of Companies in Islamic law

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The main conclusion of Part II of Chapter II was that modern Islamic scholars had found a basis in Islamic law allowing the formation of modern corporations including holding companies and group of companies, subject to certain conditions. Nevertheless, they had not yet found comprehensive solutions for problems related to modern forms of corporations, such as the liability of shareholders for the debts of their companies.

In my opinion, the starting point to discover this solution is to appreciate the principle of “juridical person” and corporate personality under Islamic law. Although it is a fundamental principle in modern company law that a corporation is a “juridical person” enjoying a distinct legal personality separate from its shareholders, the opinions of modern scholars concerning the existence of this concept in Islamic law are divided. On one view there is no reliable evidence in Islamic law to support the validity of this concept. Another view suggests that Islamic law does acknowledge the concept and quotes examples of various institutions in support. Settling this argument is vital to my study because the scholars who affirm the existence of the concept of juridical person in Islamic law argue that all applications of this concept will automatically become valid, especially the concept of limited liability. Taking this view will not solve the problem, because even if it is proven that the concept of limited liability has an Islamic basis; it does not mean that its implementation will correspond to that in common law system.



The presentation of this dilemma cannot start without first understanding the concept of debt in Islam and why paying debts is a highly important obligation in Islam.

Therefore, the structure of Part III will be as follows:

1. The Concept of debts in Islam,
2. The concept of juridical person in Islamic law,
3. The concept of limited liability in Islamic law, and
4. Liability of Groups of Companies in Islamic Law.

### **1. The Concept of Debts in Islam:**

There are different ways in which funds may be raised to meet the needs and funding requirements of individuals and organisations. Raising a loan is one such various way. In Islamic terminology "*qard*" (loan) and "*dayn*" (Debt) relate to the giving or taking of loans. However, the word "*dayn*" has a broader connotation, depicting anything payable by a person either to another person or to God, based on a commitment towards that person or God. By contrast, "*qard*" could be defined as an interest-free loan for needy borrowers extended on a goodwill basis.

Islam encourages Muslims to help each other including grating *dayn* or *qard*.

The Prophet (PBUH) stated:

‘A Muslim is the brother of another Muslim. He should not oppress his brother or hand him over to the enemy. The individual who fulfils the need of his Muslim brother, Allah will fulfill his need. That individual who removes a difficulty from his Muslim brother, Allah will remove his difficulty on the Day of Judgment.’

In Islam to give a loan is better than to give charity. Thus one who takes and repays a loan is better and respected than those who receive charity. However, Islam has commanded Muslims to give and take debt that is interest free, "*Qardh Hasan*".

Debt in Islam should be written down properly as God says,

"O ye who believe! When ye deal with each other, in transactions involving future obligation in a fixed period of time, reduce them into writing, let a scribe write down faithfully as between the parties; let not the scribe refuse to write: as God has thought him..." (Qur'an 2:282).

It is the order of the Holy Qur'an, when money is borrowed in whatever amount, that this should be the subject of a written contract. Also, if possible this transaction should take place in front of two witnesses, so that there is no dispute at a later stage. If for any reason, in the future there is a dispute; the written document can be produced as proof. The Prophet (PBUH) warned debtors to pay their debts. As a result, Muslims should be careful to write down their debts, so that if they fail to repay, their heirs or next of kin will settle the debits on their behalf.

The fulfillment of one's contractual obligations is a religious duty in Islam. Therefore, the *Shari'ah* defines specific rights and responsibilities of debtors and creditors. The most important duty of the debtor is to repay the loan in fulfillment of the promise or contract made with the creditor. God's punishment of borrowers who do not intend to repay will be severe. The main duty of the creditor is not charge interest on the principal amount of the loan, because

those who do are compared in the Quran to those controlled by the devil's influence. More elaboration will follow.<sup>373</sup>

### 1.1 Creditors' Rights and Duties

Authentic traditions have greatly emphasised the rewards promised for the one who lends to his Muslim brothers. Sometimes it is obligatory to lend and sometimes not prohibited. Sometimes it is recommended to lend and sometimes detestable not to lend. Indeed under certain circumstances it is obligatory to borrow, e.g to save one's life or honor. A Muslim's motivation to lend to his brothers is based on the *Sunnah* where the Prophet (PBUH) said:

“One who lends to his believing brother and gives him respite till he is capable of repaying it, the amount that he has lent is considered as Zakat and the Angels pray for him and seek Divine mercy for him till this (amount) is returned.”

He also remarked:

“If one lends to his Muslim brother, it is for his own (good). Every Dirham that he lends will qualify him for a reward equivalent to Mount Ohud (a mountain in Mecca) and Mount Sinai. And if he is lenient in collecting his debt he shall cross the bridge of *Sirat* like a stroke of lightning. And if a Muslim brother relates his woes before a person and this person does not lend him any money, the Heaven shall be denied to him on the Day of recompensing good doers”.

Although a debtor may sell off his unnecessary belongings to repay his debts, a creditor is under divine obligation not to cause undue trouble to the debtor. He

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<sup>373</sup> For details about debts in Islam see Ajaz Ahmed Khan and Helen Mould, *Islam and Debt*, Islamic Relief Worldwide, (2008).

should give respite so that the debtor can easily repay. Thus if the creditor condones his loan altogether, it will be considered a *Sadaqah* (alms) for which he will continue to benefit from forever. God says in the Holy Qur'an:

“And if (the debtor) is in stringency, then let there be postponement until (he is in) ease, and that you remit (it) as alms is better for you, if you knew.” (*Surah al-Baqarah* 2:280).

Two important points can be derived from this *Surah*. One, it is obligatory to give respite to a debtor who is incapable of repaying the loan. Secondly, it is more meritorious for the creditor to condone the loan completely.

If a person dies before he has repaid his debt, and the creditor has not been compensated from deceased's estate nor forgiven the debt, provided the debtor has not been negligent about repaying, nor was the loan taken for an illegal purpose, and also debtor had every intention of repaying but was unable to do so, God by His Grace will compensate the creditor on the Day of Judgment.

In the case of a debt with a settlement date, the creditor is not entitled to ask for earlier repayment, so long as the debtor does not transgress the debt's terms and conditions. But, if a creditor is not disposed to give more time for repayment, he cannot be compelled to do so, and the debtor would then be liable to repay the debt at the due date from whatever assets he has beyond his basic needs.

*Shari'ah* allows creditors to ask for collateral to ensure recovery of the amount loaned should debtors fail to repay. Pledge is permissible in the *Shari'ah* even between a Muslim and a non-Muslim. The ownership of the pledged goods remains with the pledgor, who takes on the risk of losing the pledged commodity, while the pledgee holds the goods on trust. Hence, if the pledged

goods are lost without any fault of the pledgee, the loss is that of the debtor. If the due debt is not paid, the pledgee can apply to the court to have the pledged good sold and the debt recovered out of the proceeds of sale.

## **1.2 Debtor Obligations**

If a person knows that he will not be able to repay a loan, then he should refrain from borrowing, unless he is in dire need. Yet a person who is not in a position to repay his debt must necessarily have the intention to repay it as soon as he is capable of doing so. This intention should have the first priority with him. In fact the intention to repay should be there right at the outset. In this regard the Prophet (PBUH) stated:

‘The person who takes wealth from people with the intention of repaying it, Allah will assist him in the repayment of that loan. The person who takes wealth from people with the intention of squandering it, Allah will cause him destruction.’

The Companions of the Prophet (PBUH) being aware of the warnings issued by the Prophet were thus very concerned to repay loans as soon as possible. If for some reason, they were unable to pay back a loan in their lifetime, they would request their relatives to repay any specific loan immediately after their passing. Persons, who do not repay a loan in full, having the means to do so, are guilty of a Major sin; The money obtained will be accursed and a means of destruction in the debtor’s temporary life in this world as well as the Hereafter.

The Prophet (PBUH) stated:

‘The individual who has the means to repay a loan but does not do so, this is oppression.’

and also stated that :

‘Jibrail informed me (the Prophet) to not pray the funeral prayer of that person who has outstanding debts.’ The Prophet then stated:

'The debtor remains imprisoned in his grave until his debts are settled.'

This means that if a person dies before paying his debts he will not achieve salvation till they are repaid or condoned. His good deeds are given to the creditor, or if there are no good deeds, the sins of the creditor are transferred to the debtor. Therefore, his heirs, after paying for funeral expenses, should try to pay his debts. In this regard God says:

"In what your wives leave, your share is a half, if they leave no child; but if they leave a child, ye get a fourth; after payment of legacies and debts..." (Qur'an 4:12).

Islam prescribes that debts to individuals are more important than that debts to God. God will not forgive debts to individuals if they are paid or condoned by the creditor. The Prophet (PBUH) says:

"Nothing is more serious after the Greater sins than the fact that a person dies while he is in debt to people and there is nothing to (sell to) repay his debt."

The Prophet also stated that:

'All the wrongs of a martyr are forgiven, except his debts.'

The Prophet told his companions after prayers one day:

"Such and such person who was martyred is still waiting outside Paradise. He cannot enter it because he still owes Three Dirhams to a Jew."

Debtors should not only pay debts on time, but express gratitude to the creditor while repaying and repay the loan in a beautiful manner. The Prophet (PBUH) took a camel from an individual by way of a loan. The Prophet stated:

'The best person is he who repays his loan in a beautiful manner.'

In Islam the person who delays payment without valid cause could be admonished, disgraced or even jailed. If necessary his assets could be disposed of to pay the debt. A monetary fine, on the other hand, would not be a lawful option, since this would amount to a monetary penalty for delayed payment, which is *Riba* (interest).

### **1.3 Conclusion on the Concept of Debt in Islam**

It is clear that a Muslim's obligation to pay his debts is a mandatory obligation. Liability for debt can last beyond this world into the hereafter. However, Islam makes a distinction between debtors who default by procrastination and those who default by necessity. The latter deserve compassion and must be given respite until able to pay. The mandatory obligation to pay debts should be appreciated as a main feature of Islamic law, where there is no distinction between an individual's personal and business behavior. He should act well in both. This principle should always be kept in mind when studying the liability of shareholders for their company's debts.

## **2. Juridical Persons in Islamic Law**

Salmond,<sup>374</sup> defines a juridical person as "any being whom the law regards as capable of rights or duties." Such a being may be a natural person (human being) or a legal person (an artificial being like a corporation). God is the creator of the former while man is the creator of the latter by the instrumentality of law. Blackstone,<sup>375</sup> says, "Persons also are divided by the law into either

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<sup>374</sup> John W. Salmond, *Jurisprudence*, 4<sup>th</sup> Ed., London Stevens and Haynes, (1913), p. 329.

<sup>375</sup> Sir William Blackstone, *Commentaries on the Laws of England* (1765-1769), University of Chicago Press, (1979). According to Salmond, the first example of a fictitious personality in the world was deities and idols. This type of institution was found in many cultures, especially the Hindu culture. The idols owned what was presented to them, irrespective of the property being real estate or sacrificial meat. This means that there is some kind of legal personality for idols. What is significant here is that an idol, insofar as it had legal personality, was by necessity in need of a corpus, a body. This body could be constructed

natural persons, or artificial person. Natural persons are such as God of nature formed us. Legal or artificial persons are created and devised by human laws for the purposes of society and government.”

A living human being, from birth to death, is a natural person. Such a person will considered a legal person if he/she can hold rights or duties. Thus neither a slave nor a dead man is a legal person. Artificial persons may also hold rights and duties.<sup>376</sup> The law personifies something and attributes rights and duties thereto. The law can create as many legal persons as it wishes. The first and most popular category of legal person was a corporation, a personification of a number of individuals who constitute the corpus. The second category of legal person includes institutions such as churches, hospitals, universities... etc. The institutions form the corpus of such personalities. The third type of legal person takes as its corpus a fund or estate dedicated to a particular purpose such as a trust or charitable fund.

A corporation, as a legal person, is born through a legal process such as registration or creation by royal charter or statute. It is an entity separate from its shareholders. Like other legal persons it has capacity to hold property, to sue and to be sued. Its property is not legally the property of the shareholders. Nor are its liabilities attributed to them. Shareholders, being distinct and separate from the corporation, can enter into contractual relations with it. Any change in the life of its corpus (the shareholders) shall not affect its life. Thus the insolvency or death of any particular member shall not impact on its life, even if it is a single member company. Shareholders may come and go, but the

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out of stone or wood or some other material. When this body was destroyed another one could be created to house the legal personality.

<sup>376</sup> Gray J C, *The Nature and Sources of Law*, 2<sup>nd</sup> Ed., (Peter Smith, 1972), p.154.



corporation goes on until law puts an end to its life by dissolution. The essence of a body corporate consists of its legal personality, not the corpus of its members.<sup>377</sup>

As a corollary of corporate personality, the liability of shareholders in a limited liability company is limited to the amount of their shares. They are not liable for all of the debts of the company. It is liable for its own debts. Thus if a company fails to pay its debts and is declared insolvent, that will not affect the shareholders. The company may be insolvent while the shareholders are rich and vice versa. This is so because shareholders are distinct and separate from the company. This is the principal advantage of corporate personality, which encourages business and commerce in any given society.

While concepts such as juridical persons, corporate personality and limited liability have long been recognised in western jurisprudence, and are now common phenomena, there is no unanimity regarding these concepts in Islamic Jurisprudence. Opinion is divided among Islamic scholars concerning the existence of the concept of a juridical person in Islamic law. Some contend that Islamic law does acknowledge this concept and quote examples of various institutions in support. Others cannot find reliable evidence in Islamic law for the validity of this concept. An investigation of this concept in Islamic law would not be complete without a brief appreciation of the legal capacity of natural persons in Islamic Law and if such capacity can extend to artificial persons.

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<sup>377</sup> Salmond op. cit. p.351.

## 2.1 Natural Persons in Islamic Law.

Natural persons from birth to death have legal personality (*ahliyyah*).<sup>378</sup> It is defined as “a description presumed in a person rendering such a person a possible candidate to receive a legislative injunction”,<sup>379</sup> and as “the ability of a person to oblige, be obliged and conduct his affairs”.<sup>380</sup> Thus legal personality is capacity to acquire rights and bear obligations, and power to take actions and engage in transactions that have legal effects.<sup>381</sup> Such basic capacity is inherent in every natural person until death.

Legal personality in Islamic Law consists of two aspects, *ahliyyat al-wujup* (capacity to acquire rights) and *ahliyyat al-ada'* (capacity to execute) The first aspect - the ability of a person to acquire rights and bear obligations exists in every living human being regardless of sex, colour, race, age, creed, mental, and physical ability or disability. The second aspect is defined as “the ability of a person to initiate actions, the consideration of which depends on a sound intellect” or “the ability to effect actions that are recognized by Law”. The presence of a sound intellect, comprehension and discernment are, therefore the main attributes of *ahliyyat al-ada'*. Once these conditions exist the person attains the level of full legal capacity and becomes able to receive the *Shari'ah* injunctions and be accountable for actions involving obligations and use of rights. Full *ahliyyat al-ada'* can be attributed to every human being upon attaining the age of maturity and satisfying its requirements, namely, attaining a sufficient level of mental and physical maturity, a sound mind, comprehension and discernment. Any person who lacks one of these qualities is presumed to have restricted *ahliyyat al-ada'*.

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<sup>378</sup> Mahmood. M. Sanusi, *The Concept of Artificial Legal Entity and Limited Liability in Islamic Law*, (2009) 3 *Malayan Law Journal* 58.

<sup>379</sup> Al-Zarqa, Ahmed, *The fiqh*, General Introduction, شرح القواعد الفقهية, Damascus, 6<sup>th</sup> Ed., 1959, vol.2, p.733.

<sup>380</sup> Al-Sabouni, A, *Introduction for Studying the Islamic Fiqh*, مقدمة لدراسة الفقه الإسلامى, 4<sup>th</sup> Ed., (1978), vol. 2, p.24.

<sup>381</sup> Saleh, Nabil, *Definition and Formation of Contract under Islamic Laws*, (1990) 5 *Arab Law Quarterly* 101.

Earlier jurists are very clear in their view that legal personality cannot be assigned to a non-human for the simple reason that only humans have the intellect which is the primary condition for legal capacity. Without this intellect, a person cannot perform his Islamic duties to God and other people. In other words, personality cannot be granted to non-humans because it is required for the performance of duties expected of a Muslim, which duties can only be understood and performed by human beings, because they partly pertain to the hereafter. Accordingly, we cannot find any mention of the term juridical person in early writings. Does this mean that early jurists did not recognise this concept? If so, how can legal personality be assigned to a corporation under Islamic law? Modern scholars are divided in their opinions concerning the existence of the concept of juridical person in Islamic law as follows:

### **2.1. First Opinion: The Concept of Juridical Persons Exists in Islamic Law**

Proponents of this opinion argue that the concept of a juristic person had been acknowledged in the *Shariah* from the beginning. For example, the Holy Qur'an explains that pre-Islamic idols had a sort of legal personality, by saying that infidels, while distributing the products of agriculture and cattle, treated their idols as co-sharers beside Almighty Allah (*Surah al Annaam: 136*). If some kind of legal personality is imputed to idols in this verse, then Islamic jurists should obviously be aware of the concept of juridical person.

The concept was recognized by the early jurists such as "al *Ramli*" and "al *Mawardi*" who stated that:<sup>382</sup>

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<sup>382</sup> Al-Ramli, Shamsuddin Muhammed, *Nihayat al-Muhtaj, نهاية المحتاج إلى شرح المنهاج*, Dar Al-fiker, Beirut, (1984), vol. 3, p. 116.

“the will in favour of a Mosque is lawful although the intention is to make it owner of the property. Mosque is like a free natural person and can hold property”.

“*Baitul Mal* (the exchequer of an Islamic state) is a head of states assets and not mere a place of storage it can be noted that all kinds of state assets, immovable property, animal herds, ammunition depots and water reservoirs are property of *Baitul Mal*”.

Scholars relying on these statements thus assume that the *Sharia'h* from the outset has acknowledged juristic persons. These jurists considered both the *Baitul Mal* and the *waqf* as institutions, that is, juristic persons. Likewise, schools and hospitals were considered institutions and juristic persons, with the capacity to own and dispose of property.<sup>383</sup>

The strongest argument presented in favour to the acceptance of the juridical person concept in Islamic law was presented by Justice Usmani, who supports his view by citing four examples of institutions considered by jurists to be juridical persons.<sup>384</sup>

#### **A. Waqf**

*Waqf* is a legal and religious institution wherein a person dedicates property to a religious or a charitable purpose. Property, after being declared as *Waqf*, is no longer owned by the donor. The beneficiaries of a *Waqf* can benefit from the corpus or the proceeds of the dedicated property, but are not its owners. Its ownership vests in Allah Almighty alone. Muslim jurists have treated the *Waqf* as a separate legal entity and ascribed to it some characteristics similar to those of a natural person. This can be understood from two rulings of early Muslim jurists. First, if a property is purchased with the income of a *Waqf*, the purchased property cannot become a part of the *Waqf* automatically. Rather,

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<sup>383</sup> Abdal Qader Awad, *Criminal legislation in Islam*, vol1, Beirut, (1992), p.393.

<sup>384</sup> Mufti Muhammad Taqi Usmani, *Limited Financial Liability and the Islamic Viewpoint*, New Horizon. Sept (1992).

the jurists say, property so purchased shall be treated as a property owned by the *Waqf*. This clearly means that *Waqf*, like a natural person, can own property.

Secondly, jurists have clearly mentioned that ownership of money given to a *Masjid* (Mosque) as a part of *Waqf* does not form part of the *Waqf*, but passes to the Mosque. Here again the mosque is accepted as capable of being the owner of money. The capacity of the Mosque is constructive, while the capacity enjoyed by a human being is physical. Equally bequests can be made in favour of mosques, because mosques can own properties. The principle may also extend to an inn or a bridge, provided that they are *Waqf*. In addition, jurists explain that *waqf* may incur debts with the permission of a judge. The *Mutawali* (the *Waqf* Administrator) can ask a judge to allow him to borrow money on behalf of the *waqf* in order, for example, to provide the necessary maintenance for the *waqf* properties. A loan may be proved against the *waqf* without the intervention of the administrator. It is therefore clear that early jurists accepted that a *Waqf* can own property. Obviously, a *Waqf* is not a human being, yet they treated it as such in the matter of ownership. Once capacity for ownership is established, it logically follows that it can sell and purchase, become a debtor or creditor, and sue and be sued. In short all the characteristics of a juridical person can be attributed to it.

## **B. Baitul-Mal**

*Baitul-mal* (the exchequer of an Islamic state) enjoys financial independence and has a special system for the distribution of *Zakat* resources, taxes, booty, tribute ...etc. *Bait al-mal* enjoys legal rights and has financial legal capacity. It is independent, subordinate neither to the head of state or to any administrator. Being public property, all the citizens of an Islamic state have some beneficial right over *Baitul-mal*, yet nobody can claim to be its owner.

*Hanafi* jurists explain that if the head of an Islamic state needs money to pay his army, but finds no money in the *Kharaj* department of the *Baitul-mal*, he can draw on the *Sadaqah* (Zakah) department, with amount so taken being deemed

to be a debt owed by the *Kharaj* department. It follows from this that not only *Baitul-mal* but the different departments therein can borrow money from each other, with liability resting on the concerned department. This means that each department is a separate entity, with the same capacity to be a debtor or creditor, and thus sue and be sued in the same manner, as a juridical person.

### **C. Joint Stock**

The *fiqh* of the *Shafi'i* School maintains that if persons run their business in partnership, whereby their assets are mixed with each other, the *Zakah* will be levied on each of them individually, and will be payable on their joint-stock as a whole. Thus even if one of them does not own the amount of the *Nisab* (the minimum amount on which *Zakah* is due), but the combined value of the total assets exceeds the prescribed limit of the *Nisab*, then *Zakah* will be payable on the whole joint-stock including the share of that person. Accordingly, he must contribute to the levy in proportion to his ownership in the total assets, whereas he would not be subject to the levy of *Zakah*, had it been levied him in his individual capacity. This means that the joint-stock has been treated as a separate entity, and the obligation of *Zakah* has been diverted towards the joint-stock as an entity.

### **D. Inheritance under Debt**

Property left by a deceased person whose liabilities exceed the value of that property is known as 'inheritance under debt'. According to jurists, this property cannot be owned by the deceased, because he is dead nor it is owned by his heirs, as the creditors of the deceased have a preferential right over the property. It is not even owned by the creditors, because the settlement has not yet taken place. They have their claims over it, but it is not their property unless

it is actually divided between them. Being the property of nobody, it has its own existence and can be termed a legal entity. The heirs of the deceased or his nominated executor will look after the deceased's properties as managers, but do not own them. If the process of the settlement of debt requires expenditure, this will be met by the properties. Looked at from this angle, this inheritance under debt is an entity which may sell and purchase, become a debtor or creditor, and has characteristics very much similar to those of a juridical person. Not only this, the liability of this juridical person is certainly limited to its existing assets. If the assets do not suffice to settle all the debts, there is no remedy left with its creditors to sue anybody, including the heirs of the deceased, for the rest of their claims.

#### **F. Additional Examples**

Scholars add to *Usmani's* examples other minor examples from *fiqh* to support the existence of the concept of a juridical person in Islamic law. For example, the Head of State case. Under Islamic Law, a Head of State has a specific personality besides his natural being. The Prophet (BPUH) affirms that a Head of State would be *wali* (responsible) for those who have no other *wali*. For example, the Prophet (BPUH) arranged the marriage of a woman on behalf of her *wali*. Although these traditions are specifically applied to marriage, a Head of State also has a financial responsibility towards his subjects. During the Prophet's (BPUH) life if someone died in a state of indebtedness he (the Prophet), as Head of State, would pay his debts. This proves that a Head of State in Islamic law has a personality other than his own, which allows him to stand in the shoes of a *wali* not only for conducting marriages but for repayment of loans for those who died in indebtedness.

The examples mentioned above show that the concept of juridical person is not totally foreign to Islamic jurisprudence. The essential characteristics of juristic persons: (i) perpetuate existence; (ii) capacity to own property; (iii) responsibility for its legal obligations; and (iv) the power to borrow, are exhibited in the mechanisms of *Bait al-mal* and *waqf*.<sup>385</sup> If the juridical existence of a company is accepted on the basis of these precedents, no serious objection is likely to be raised against it.<sup>386</sup>

### **2.11.2 Second Opinion: Islamic Law Does not Recognize Juridical Persons**

The proponents of this opinion doubt whether early jurists did recognize this concept and argue that fictitious personality does not find support in the Islamic heritage. They do not find any convincing evidence in *fiqh* that the concept of a juridical person was acknowledged.<sup>387</sup> Early jurists<sup>388</sup> insist that only human beings are capable of incurring liabilities. Therefore, no artificial person can be held liable, and a corporation has no capacity to engage in any commercial transaction.<sup>389</sup> Moreover, scholars who take this view criticize the examples cited to prove that the early jurists acknowledge the concept of juridical person. They argue that even if these examples may help in proving the existence of the concept of a juridical person in Islamic law, they are not applicable to corporations, because all of them relate to entities for which it is difficult to trace

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<sup>385</sup> Syed Riazul Hassan *The Reconstruction of Legal Thought in Islam*, (a comparative study of the Islamic and the Western systems of law, with particular reference to the Islamic laws suspended by the British rule in the sub-continent, Lahore: Law Pub. Co., (1974) pp.389–398.

<sup>386</sup> Mufti Muhammad Taqi Usmani, *op. cit.*.

<sup>387</sup> Sir Abdul Rahim, *Principles of Islamic Jurisprudence According to four Schools*, Madras, (1908), p. 318.

<sup>388</sup> such as Imām Sarakhsī.

<sup>389</sup> Zuryati, Yousoff and Azare, *Separate legal entity under Shariah law and its application in Islamic banking in Malaysia*, 6 *International Journal of Banking and Finance* 140.



human owners. These institutions also exist for the public benefit and not for individual profit as in a corporation. There are difficulties, therefore, in fully translating existing Islamic doctrines of independent entities to the corporate arena.

In addition to the above condemnation, such scholars criticize each example provided by Justice Usmani as follows:

- a. Waqf & Baitul Māl cannot become precedents for a corporation for the following reasons:
  - i. In *Waqf* and *Baitul Māl* the administrators do not own the assets, whereas in a company shareholders own the assets.
  - ii. In case of bankruptcy, a company's assets are returned to the shareholders pro rata, whereas in *Waqf & Baitul Māl* there is no particular share for anyone, so assets are not returned to anyone.
  - iii. A trustee of *Waqf* and director of *Baitul Māl* are basically voluntary posts, whereas directors of company are salaried employees of the company and have an intrinsic interest in its affairs.
  - iv. *Waqf* and *Baitul Māl* are created and work for the welfare of people, whereas the company, under the shadow of a juristic person, only protects the interests of a few people and is usually based on dishonoring human values.
- b. The example of inheritance under debt cannot be a precedent for a juristic person because it is the deceased and not the debt itself which is liable. The reason why creditors are directed to the deceased's property is because first debt is a monetary liability of the deceased which should attach to his property, and secondly because no claim can be preferred against the deceased as a person after his death. This does not mean that the deceased has ceased to be the debtor.

- c. The Joint Stock example also cannot be a precedent because contrary to *Zakāt* in joint stock, the tax on a company is levied on individuals and not on the company. This makes it clear that there is a difference between joint stock and a company. The reason why *Zakāt* is payable on joint stock is that according to the Jurists (other than *hanafī* school) *Zakāt* is payable as a monetary liability and has nothing to do with the capabilities of the individual shareholders. Moreover, levying *Zakāt* on the joint stock, and not on the shareholders, is more beneficial for needy people.

To conclude, the juridical personality of corporations cannot be established by clutching at odd examples of institutions that may or may not appear similar to fictitious legal persons. Thus it is important to find solid basis for the concept in Islamic law.

### **2.11.3 Assessment of Juridical Persons in Islamic law**

It is clear from the above that there are wide differences of opinion regarding whether juridical persons other than real persons are recognised, although such bodies had been so recognised by early Muslim jurists. The arguments on either side have their strengths. However, I favour accepting the concept of juridical persons in Islamic law, even if it lacks a sound historical basis, for the following reasons:

- a. Although the term juristic person is not mentioned specifically by the classical texts of Islamic jurisprudence, it is untrue that Islamic legal system does not recognize the concept. Early jurists recognized the concept based on Islamic practice rather than specific definitions and explicit terms. It could be implied from the cases that are cited in their writing. Personalization of institutions including companies would not have been necessary in most cases.<sup>390</sup>

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<sup>390</sup> Mahmood M. Sanusi, op. cit. p.188.

- b. The non-existence of nomenclature does not negate the existence of the concept. Early jurists were fully aware of the idea of assigning legal personality to a non-human, but were not ready to do so, as it did not fit into the system of law they had developed. They never intended to exclude it entirely from Islamic law. The jurists were dealing with a system that combined religious duties with worldly affairs. They were responsible for developing the system that emerged directly from the texts or could be extended from such texts by methods such as strict analogy. This system was intended to be stable over the ages, and to be practised by Muslims wherever they were, and whether or not they were subjects of an Islamic state. There were certain areas of the law that the jurists did not touch, leaving these for the Islamic state and the *ijtihad* of the ruler. Most of the topics they did not touch would require further development and reform over the ages. The state was expected to develop these areas of the law in accordance with *ijtihad* based upon general principles of Islamic law.<sup>391</sup>
- c. The concept of juridical person falls purely within the *muamalat* (transactions/ agreement) area and Islamic states are entitled to employ it to achieve benefits for the state and people. Should a better concept be discovered tomorrow, Islamic states would be free to adopt that too, if it conformed to the general principles of Islamic law.
- d. The acceptance of the concept of corporate personality can be accommodated in *Shariah* simply on the basis of needs and necessity. The modern economy and trading cannot work without this concept and hence the Muslim benefits could not be achieved without accommodating this concept in *Shariah*. Moreover, there is no need to decide whether the concept of juridical person exists under Islamic law or not simply because there is nothing in the main sources of the *Shariah* that denies the assignment of legal personality to a non-human.<sup>392</sup>

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<sup>391</sup> Nyazee, Islamic law of Business Organization, p. 86.

<sup>392</sup> Ali Al-khafif, op. cit. p.35. Similarly Hohfeld maintained that legal personality is merely a matter of rules. See R Dias, Jurisprudence, London: Butterworths, (1985), p. 254.

- e. Finding dissimilarities between *Waqf* and *Baitul Māl* on the one hand and corporations on the other is of no consequence, because according to the classical *fiqh* precedents are not necessarily required to be the same in all respects. In addition, the institutions have different purposes and aims and hence are governed by different sets of laws, rules and regulations. If the minute details of the two do not match, it does not bar the former becoming precedent for the latter.
- f. It cannot be denied that only humans are capable of holding responsibility. That is why when corporate liability is apportioned only human beings i.e. directors, are held responsible. Moreover, when a juristic person is made party to court proceedings, it is cited in the name of its head. This means that as long as purely religious duties are not expected from an organization, limited legal personality may be assigned it as long as human intelligence is present to direct its acts.<sup>393</sup>

Having said that, the question of whether the concept of legal personality is acceptable to Islamic law is not the real issue. The main problem is the way this concept manifests itself in its modern applications, especially the modern business corporation. Some of these applications, if accepted, may require drastic changes in the Islamic law of contract to the extent that some of its basic principles may have to be abandoned.<sup>394</sup> On another words, the focus and intension should paid to the consequences of accepting the concept of a juridical person in Islamic Law. The most important consequence is that the shareholders will not be liable for the debts of their company because the concept of limited liability is the natural result of corporate personality. Or does the special character of Islamic law suggest a different logic? This will be considered in the next chapter.

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<sup>393</sup> Md Anowar Zahid, op. cit. p.24.

<sup>394</sup> Nyazee, *Islamic law of Business Organization*, p.180.

### **3. Limited Liability in Islamic Law**

Limited liability denotes the situation where a shareholder of a business is protected from bearing a loss greater than the amount he has invested. If the business incurs a loss, the worst a shareholder can suffer is the loss of his entire original investment. The loss cannot extend to his personal assets, and if the assets of the company are not sufficient to discharge all its liabilities, the creditors have no claim on the personal assets of shareholders. While the concept of limited liability is beneficial to the shareholders of a company, it may be injurious to the creditors. If a company becomes insolvent and is consequently liquidated, the creditors may lose a considerable amount, because they can only receive the liquidated value of the assets of the company, and have no recourse to its shareholders for the rest of their claims. Even the directors of the company who may be responsible for such an unfortunate situation cannot be held responsible for satisfying the creditors' claims.<sup>395</sup>

There is no elaborate discussion of the liabilities of shareholders for corporate debts in Islamic law literature. All that is mentioned is the general principle that liabilities follow the amount of capital contribution. This lack of detailed discussion is understandable because the way Islamic economics and business works (ensuring a built in mechanism against excessive mismatch of asset and liability ratio). In addition, the traditional concept of partnership liability under Islamic law, as described part II, applies to corporations because of a simple reason. While Islamic law does not treat a partnership as a separate entity independent from its partners, corporations under modern laws enjoys a separate personality from its partners. Therefore, due to the absence of rules

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<sup>395</sup> Nyazee sees the shareholders themselves standing at the end of the line of creditors with a claim on the assets of the corporation. It is for this reason that we say that there is no liability for shareholders, and the term limited liability is not an accurate description of their legal status of. Shareholders have no liability;

governing shareholder liability in classical Islamic law literature, modern scholars disagree on accepting the concept of limited liability in Islamic law. One strand of opinion totally refutes the concept, because it has no basis in Islamic law, and because its economic disadvantages outweigh its benefits. Another insists that limited liability should be acceptable to Islamic law, as it is the natural result of the acceptance of the concept of corporate personality. Its principles do not contravene any injunction of Islam.<sup>396</sup> Moreover, limited liability can be regarded as approved by analogy in certain Islamic cases.

In the following sections, I will examine these arguments and then offer my conclusion and recommendation.

### **3.1 In Support of the Existence of Limited Liability in Islamic law**

Scholars arguing that Islamic law accepts the concept of limited liability base their argument in the fact that Islamic law recognizes the concept of juridical persons. Since this concept cannot be isolated from that of limited liability, Islamic law should therefore accommodate the latter concept. Thus Justice *Usmani* states,

“Once the concept of juridical person is accepted and it is admitted that, despite its fictive nature, a juridical person can be treated as a natural person in respect of the legal consequences of the transactions made in its name, we will have to accept the concept of limited liability which will follow as a logical result of the former concept. The reason is obvious. If a real person i.e. a human being dies insolvent, his creditors have no claim except to the extent of the assets he has left behind. If his liabilities exceed his assets, the creditors will certainly suffer, no remedy being left for them after the death of the indebted person. If we accept that a company, in its capacity of a juridical person, has the rights and obligations similar to those of a natural person, the same principle will apply to an insolvent company. A company, after becoming

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they are merely creditors sharing profits on the basis of the money they have advanced. Islamic law of Business Organization, *Corporations*, p.166.

<sup>396</sup> Mufti Muhammad Taqi Usmani, op. cit.

insolvent, is bound to be liquidated, and the liquidation of a company corresponds to the death of a person, because a company after its liquidation cannot exist anymore. If the creditors of a real person can suffer, when he dies insolvent, the creditors of a juridical person may suffer too, when its legal life comes to an end by its liquidation”.

Kelsen<sup>397</sup> similarly argues that the concept of limited liability arises from that of legal personality. A corporation as a legal person distinct from its shareholders deals independently with creditors. It is not the shareholders' agent, nor do they act as sureties for its debts. The money the shareholders have paid to it in the form of share capital is attached to the personality of the corporation. It has to be repaid like the claim of any other creditor. When a corporation becomes insolvent, as with a natural person all that the creditors can lay claim to its assets? As the shareholders have no relationship to these assets and are not sureties for the corporation, the creditors cannot satisfy their debts from the personal assets of the shareholders.

The issue of limited liability of members of corporations is very important for Islamic economies, as modern corporations cannot conceivably function on the basis of unlimited liability.<sup>398</sup> In addition, the concepts of a juridical person and limited liability do not contravene any injunction of Islam, and should not harm the creditors of a corporation, who are aware that their claims are limited to its assets and capital and thus deal with it on this basis. Therefore, there is no possibility of the shareholders or the corporation committing fraud or deception in such cases.<sup>399</sup>

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<sup>397</sup> Hans Kelsen, *General Theory of law and State*, LawBook Exchange, (2007) p.92.

<sup>398</sup> Panel of Economists and Bankers, Report on the Elimination of Interest from the Economy submitted to the Council of Islamic Ideology, (1980), Para. 1.25,12.

<sup>399</sup> This was the same argument used by the Islamic *Fiqh* Academy.

Finally, and most importantly, Scholars arguing for limited liability quote cases from the old *fiqh* literature which seems to support limited liability, and then use analogy to grant limited liability to corporations. The most important example is the “authorized slave case” (*al abd al mazoon*). This relates to a period of Muslim history when slavery was in vogue. Slaves were treated as the property of their masters and were freely traded. Slaves were of two kinds, those allowed by their masters to trade and those who were not. The initial capital for the purpose of trade was given to the former kind of slave by his master, but he was then free to enter into all commercial transactions. The capital invested by him totally belonged to his master, and whatever the slave earned would go to the master as his exclusive property. If in the course of trade, the slave incurred debts, the same would be set off by the cash and the stock present in the hands of the slave. But if the amount of such cash and stock was insufficient to set off the debts, creditors had a right to sell the slave and settle their claims out of his price. However, if their claims were not satisfied even after selling the slave, the creditors could not approach his master for the rest of their claims. In this example, the master is actually the owner of the whole business, the slave being merely a tool to carry out business transactions and owning nothing from the business. Still, the liability of the master was limited to the capital he invested including the value of the slave. After the death of the slave, creditors could not have a claim over the personal assets of the master. The case of the authorized slave is the clearest evidence found in the Islamic *fiqh* approving the possibility of accommodating the concept of limited liability in Islamic law. By



analogy, the limited liability of the shareholders of a company can be justified in Islamic law.<sup>400</sup>

### **3.2 Against the Notion of the Existence of Limited Liability in Islamic Law**

Modern scholars who reject the concept of limited liability in Islamic law attack it from two main angles, first, the connection between corporate personality and limited liability and secondly the social harm caused by limited liability. We can summarize the arguments as follows:

- a. Corporate personality and limited liability are two different things. Even in common law systems they do not necessarily go together. Unlimited companies formed under the Companies Act 2006 s.3(4), Scottish partnerships under the Partnership Act 1890 s.4(2), and French partnerships (*societe en nom collectif*)<sup>401</sup> are examples of separate legal entities which do not involve limited liability. The law may or may not combine corporate personality and limited liability.
- b. The *Shariah* can accommodate an artificial entity for the purpose of commercial convenience, but Islamic standards of accountability will not permit shareholders limited liability.<sup>402</sup>
- c. Ownership in Islam is a trust owed to God and every individual is accountable in the after-life for how his/her resources are used and that trust met. One of the most serious obligations owed by any Muslim during their lifetime is debt. Even if the debt is incurred through a company, the owners are the ones responsible to God. With the strong Islamic admonition against being in debt and in adherence to the Islamic spirit of not separating spiritual from daily affairs, it is correct that

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<sup>400</sup> Mufti Muhammad Taqi Usmani, op. cit.

<sup>401</sup> A Hicks & S Goo, op.cit. p.95.

<sup>402</sup> Anaf Masood and Mohammad Iqbap Tahir, Towards a Theory of Islamic Financial Reporting, Accounting and Finance Association of Australia and New Zealand, (2008), p.21.

company shareholders are made practically, as well as morally, accountable for corporate debts.<sup>403</sup>

- d. The limited liability concept is not required in Islamic economies since all financial participation in business is essentially in the form of equity, the only exceptions being suppliers' credits and *qurud hasanah* (beneficial loans). Thus the liability of partners is practically limited to their capital contributions. All other participants in the business (whether by way of loan or equity) would be treated as equity holders and would share in the risks of business. Since interest bearing loans are not allowed, the total obligations of the business could not be out-of-step with the total assets, and any erosion in their value may not exceed the total equity. Hence, in the ultimate analysis liability would essentially be limited to the extent of the total capital (including ploughed-back profits) invested in the partnership business.<sup>404</sup>
- e. Under limited liability if a company is declared insolvent, creditors have only rights over the assets of the company itself. If the assets are insufficient to settle the amount, the debt is simply written off and cannot be claimed from anyone. This goes against Islamic principles, which protect peoples' rights and avoid any action which infringes such rights.<sup>405</sup>
- f. The situation of authorized slaves is not a good analogy for implementing the limited liability in Islamic law, because limited liability should be decided as a matter of principle rather than on odd

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<sup>403</sup> Ibid. p.23.

<sup>404</sup> All loans in Islam are to be interest free. A lender receives no returns above the sum advanced (Al-Quran 2:278-279). Any debt transaction, however, always involves some chance that the borrower is unable to repay. By not making the loan in the first place, this risk is avoided and the desired result at the end of a loan period is replicated - there is no loss of capital. As a result, there is little incentive in Islam to engage in debt financing. In practice, the only type of loan Islamic financial institutions provides are "Qard Hasanah". This is a 'benevolent' facility made available to those in serious financial difficulty, with the lender prepared to delay or waive repayments altogether. To obtain any return, Muslim financiers have to use participatory financing, becoming partners or shareholders who share in the business income (There is a risk that some of the capital advanced may be lost in the event of the firm failing. That risk, though, will be no different to a situation in Western finance where proceeds from charged assets are insufficient to meet loan repayments. This is because in the absence of debt, shareholders' claims over the business assets will not lose priority). This means that a company's capital will consist solely of equity. At liquidation, this will significantly reduce the outstanding debts that shareholders are liable for.

<sup>405</sup> Zuryati, Yousoff and Azare, op.cit. p.140.

precedents. Moreover the cases of authorised slaves and corporations are totally different for the following reasons:<sup>406</sup>

- i. An authorised slave is an agent of the master, whereas a corporation is not an agent of its shareholders.
- ii. The capital and assets the slave possesses are owned by the master, whereas shareholders have nothing to do with the assets of the corporation.
- iii. When slaves earn profits from excess credit purchases, the master is not entitled to them; on the principle *al-kharaju bi d-aman* (revenue goes with liability). As the master is not liable for the loss resulting from excess purchases, he is not entitled to the profits either. By contrast there is no restriction on corporations regarding excess credit purchases or in raising capital, while shareholders are entitled to the entire profit resulting from them as a residuary.
- iv. It cannot be said that the liability of the master is limited for all transactions of the slave. As explained in the concept of liability in Islamic *sharikah*, the liability of the investor falls into three categories, depending on whether he has authorized the worker to make excess purchases. Two of these types arise from lawful acts and one from the unlawful act of the worker. Applying this to the case of an authorized slave, the liability of the master for the debts of the business will be unlimited when the transactions of the slave involving credit purchases are lawful, and his liability will be limited only in the case of an unlawful act of the slave. In fact, the master has no liability for unlawful acts. This conclusion does not apply to corporations where the liability of the shareholder is limited even in the case of debts arising from lawful transactions.

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<sup>406</sup> Nyazee, *The Islamic law of Business Organization, Corporations*, pp.171-172.

### 3.3. My Assessment of Limited Liability in Islamic law

I am with the opinion of that Islamic law can accommodate the concept of limited liability, for the reasons presented by the supporters of this opinion and because of three main reasons:

- a. Since *Shariah* will continue to govern Muslims in their personal and business life, and since economic developments proceed so fast, the Islamic *fiqh* has to work quickly in order to address these developments. I believe that the flexibility of Islamic law can accommodate such developments and any new concepts as long as they do not contradict with *Shariah* principles.
- b. Accommodating the concept of limited liability is necessary because it meets the needs and requirements of Muslim economies. The concept meets the needs of Muslim economies because it encourages people to invest their money to the overall benefit of the economy. It is also necessary because economies around the world including Muslim economies trade with each other on the basis of limited liability, so that foreign investors expect limited liability when investing in Muslim economies.
- c. The concept of limited liability has a basis in the *fiqh* heritage. It was clearly acknowledged by early jurists on their work concerning authorized slaves. This case is closely related to that of shareholder liability, and it is now the role of modern scholars to complete the task and provide a detailed analogy in order to provide a comprehensive Islamic concept for limited liability. The objection that the Authorised Slave case does not match that of a corporation is not relevant, because according to the classical *fiqh*, precedents are not necessarily required to be the same in all respects. In addition, the cases have different purposes and aims, and hence are governed by different sets of rules and regulations. If the minute details of the two do not match, it does not bar the former becoming precedent for the latter.

Nevertheless, and despite of any argument presented by modern scholars, my concern is not to find evidence in Islamic law acknowledging the concept of limited liability rather to understand the consequences of this concept for Islamic law principles. I am confident that the concept of limited liability can be implemented and supported by Islamic law. However, the concept's consequences should be well understood and mitigated in accordance with Islamic law principles.

#### **44. The Liability of Groups of Companies in Islamic Law**

The main conclusion of the previous sections was that there are no obstacles in Islamic law to the creation of modern forms of corporations including the corporate groups as long as they comply with the main principles of Islamic law. This leads to the conclusion that shareholders will enjoy the advantage of limited liability as long as they do not misuse its merit. In other words, the concept of limited liability should not be used by shareholders to break the law or escape from liabilities and should not be exploited for fraudulent purposes.

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This argument has the same logic as that of lifting the corporate veil under the common law. However, due to the natural differences between the Common law and Islamic law, the justification of the concept of lifting the corporate veil has a different basis in the two systems. These bases are found in *Shariah*

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<sup>407</sup> Mufti Usmani argues that the concept of limited liability has to be restricted to companies who issue their shares to the general public and whose shareholders numbers are so large that shareholders cannot be held responsible for the day-to-day affairs of the business and for debts exceeding assets. He insists that the concept of limited liability should not be applied to private companies or partnerships, because each shareholder and partner can easily acquire knowledge of the day-to-day affairs of the business and should be held responsible for all its liabilities. There may be an exception for sleeping partners or shareholders of a private company who do not take part in the business. Their liability may be limited by agreement between the partners. If sleeping partners have such limited liability, it means in terms of Islamic jurisprudence that they have not allowed the working partners to incur debts exceeding the value of the assets of the business. In this case, if those debts are allowed to exceed the limit, it will be the sole responsibility of the working partners.

Maxims - the set of principles and their subordinate legal maxims which Muslim jurists have derived from the Quran and the *Sunnah* to determine the Islamicity of any act, institution or policy. They are the systematic exposition of the spirit of the text, which has guided man in different social situations throughout the ages. *Shariah* Maxims enjoy an important place in Islamic jurisprudence, encapsulating concepts and precepts that can help one understand the details of law. More importantly, they are capable of helping in arriving at the appropriate ruling where no explicit law exists.

The following maxims support the implementation of the concept of lifting the corporate veil in Islamic law:<sup>408</sup>

#### **A. Prohibition against Taking another's Property and Prohibition of Oppression**

One of the main principles in Islamic law is the prohibition against taking another's properties in vain. It is ordered by God and the Prophet (BPUH). God says in the Quran,

[And eat not up your property among yourselves in vanity, nor seek by it to gain the hearing of the judges that ye may knowingly devour a portion of the property of others wrongfully]. (Al Baqara 2:188)

The Prophet said that:

"Verily your blood [i.e. lives] and your property and your honour are all Sacred/ Prohibited".

and:

"All Muslim to the Muslim is forbidden, his blood, properties and his honour.

The Prophet also said that God says:

"My servants! I have forbidden oppression for Myself, and I have made it forbidden amongst you, so do not oppress one another".

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<sup>408</sup> For detailed explanation of *Shariah* Maxims, see SM.Hasanuzzaman, *The Economic Relevance of the Shariah Maxims*, (Al Qawaid Al Fiqhiyah),.

It is therefore clear that Muslims should not take another Muslim's (or a non-Muslim's) money or property without legal reason (e.g. legal trade). When shareholders cheat creditors by intentionally not paying their debts, or use their company for fraudulent means or to break the law, they take another's property in vain and by oppression, which is strictly forbidden in Islam. Therefore, in such a case shareholders should not enjoy the protection of limited liability. The corporate veil can be lifted.

### **B. No wrong, no Wrong-doing**

This is one of the most important rules of the *Shariah*. It is based on a *Hadith* of the Prophet (BPUH) with similar wording. This guiding rule, read with its sub-rule, "wrong is to be undone", provides a guideline to regulate the entire economic and financial system in such a way that prohibits the imposition of harm and discourages retaliation. This rule is treated as a pillar of Islamic law, forming the basis of the laws of option, inhibition, return of defective merchandise, pre-emption, requital, compensation and indemnity, etc. The rule also allows individuals to act unilaterally to protect themselves or others from harm. It is, therefore, necessary that an Islamic state should legislate in such a way as to prevent the causes of harm or damage. It is on this basis that the government has a right to blacklist traders who indulge in illegal and antisocial activities such as smuggling and adulteration. It can also take action against influential persons who provide support or give protection to unlawful practices or to miscreants. It is similarly on this basis that a landlord is not allowed to eject a tenant from cropped land on the expiry of the period of the lease, so that a cultivator is protected against the loss of his crop. The landlord is bound to extend the period of tenancy against the payment of standard rent till the crop

sown by the tenant is harvested. Also, if a buyer of perishable goods absents himself without taking possession of them, the seller, in order to protect himself and the buyer from loss, has a right to unilaterally revoke the contract of sale and sell the goods to some other party lest the commodity should perish.

Based on this important rule, shareholders are bound not to abuse the privilege of limited liability to harm creditors or the overall community by using the corporation for fraud or wrongful trading. Moreover, the state, in order to prevent harm or damage by shareholders to creditors, is entitled to pierce the corporate veil and extend liability to the corporation's shareholders.

### **C. Unlawful Things are to be prevented Irrespective of Benefit**

There may be situations in which an act might have certain benefits while producing corruption and inequity. In such a case the *Shariah* would ban that act despite any benefits it might apparently yield. For example, trading in unlawful items and earning in unlawful ways might provide employment to a large number of persons and bring substantial revenues to the government. Gambling might be an effective source of collecting funds for philanthropic objectives. Nonetheless, this behaviour must be eliminated since the removal of corruption has priority over the acquisition of benefits to economic, social or otherwise.

Accordingly, while the concept of limited liability benefits the economy by encouraging people to invest their money and form corporations, if shareholders abuse limited liability protection by, for example, using the corporation to cheat creditors or in fraudulent or wrongful trading, this protection should be removed despite the benefits to the economy, because preventing unlawful action has the utmost priority.



#### **D. a Greater Injury May be Avoided by Enduring a Lesser Injury**

A minor harm may have to be endured to avoid a major harm. For example, if a customer loses his coin in a slot-machine, his coin may be allowed to go waste rather than dismantling the machine which is worth much more than the coin. But if a very expensive piece of jewellery is lost in a washing machine in a laundry, its recovery justifies damage to the machine. This maxim means that in cases where the choice is between two harmful alternatives the one fraught with less harm may be chosen. If shareholders abuse the protection of limited liability, the law will be entitled to withdraw such protection where the resultant harm to shareholders is less than the harm to creditors and the general economy.

#### **E. to Avoid Public Injury, Private Injury May be Suffered**

This rule operates in the case of conflict between a particular and a general harm. The *Shariah* is inclined to allow free market operation and, under normal conditions, is disinclined to price-regulation. But if traders manipulate the market and reap exorbitant profits so that the interest of the consumers, i.e. the general public, is seriously jeopardised, government action regulating prices or profits to protect the interests of consumers is justified. This is so because protecting the public interest is more important than securing traders' interests. The government will be preventing general harm by tolerating a particular harm. It is this rule which justifies nationalization, price control, and a large number of similar policies.

Thus the state can withdraw the protection of shareholders resulting from limited liability, when they abuse this protection. The action of the state is allowed, because although it causes a private injury to the shareholders, it

avoids injury to the public and the economy, as if creditors stop giving credit to limited liability corporations, the viability of corporations which drive the economy will be under serious risk.

#### **F. The Extent of Necessity Limits Action Thereunder.**

This maxim aims at restricting the scope of relaxation only to the extent necessary. One is not allowed to extend this relaxation to cover situations that are not really necessary. A person may be allowed to save his life by eating unclean or *haram* stuff, but this permission is restricted to the extent of eating a quantity that may save him from death. Everybody has a right to dispose of his property in any lawful manner he chooses. As a general principle he cannot be deprived of this right. But under the rule of necessity governments may freeze or seize the property of a defaulter who fails to discharge government claims or personal or institutional debts, in order to adjust the claims with the defaulter's frozen accounts or seized properties. Yet, the maxim that the extent of necessity limits action thereunder binds a government to attach only as much property as is sufficient to adjust the claims and no more. It would be offensive to deprive the defaulter of all his property or to stop him from exercising his normal business operations that exceed the extent of claims.

As shareholders' limited liability is justified by necessity (it achieves economic needs and encouraging people to invest their money, while the concept is necessary because economies around the world trade with each other and with Muslim economies on the basis of limited liability), therefore it applies only to the extent necessary, so that shareholders should be liable for any abuse the concept of limited liability.

**From the above**, I argue that the concept of the liability of groups of companies in Islamic law has the following features:

- a. Islamic law accepts the concept of corporate personality and limited liability and approves the establishment of modern forms of companies including groups of companies.
- b. According to the Islamic law of contract, the acceptance of the limited liability concept is subject to one main condition - that the subsidiary's creditors did not face any sort of *gharar* (uncertainty) when dealing with the subsidiary i.e. in dealing with the subsidiary they fully understood its legal nature whereby shareholders are not liable for the subsidiary's debts except to the extent of their shares in the subsidiary's capital.<sup>409</sup> Avoiding *gharar* in the treatment of creditors can be achieved by two tools. Firstly, creditors before dealing with an entity should conduct simple due diligence in order to understand whether its shareholders enjoy limited liability or not. Secondly, the law must oblige corporations to disclose their legal type when dealing with public. For example, Saudi regulations oblige corporations to publish their constitutional documents in the official Gazette and in local newspapers and to explain their legal type and capital amount in their company's letterheads.
- c. The liability of groups of companies cannot be solved by making a parent automatically liable for the debts of its subsidiary. This would go too far by completely negating the use of subsidiaries as risk-shifting devices. The use of subsidiaries to provide a measure of protection for a group should not be, as a matter of policy, proscribed. In addition, automatic liability would make it difficult for creditors to assess the degree of risk when extending credit to the parent or any subsidiary which the parent is supporting by, for example, a guarantee.<sup>410</sup> Yet, shareholders shall lose

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<sup>409</sup> According to the Islamic law of contract, in the interests of fair and transparent dealing in the contracts between the parties, any unjustified enrichment arising out of uncertainty in or lack of definition of the essential elements of a contract is prohibited. This principle is called "Avoiding of *gharar*" (dubiousness in Contract). *Gharar* originates from deception through ignorance by one or more parties to a contract. Gambling is a form of *gharar* because the gambler is ignorant of the result of the gamble. In order to avoid *gharar*, the contracting parties should clearly understand and define the characteristics of their contract before signature. signature

<sup>410</sup> Dan Prentice, op. cit. p.118.

the protection of limited liability if they misuse its merits by using their corporation to defeat creditors or minority shareholders or to break the law.

- d. Any techniques aiming to protect creditors and minority shareholders have to retain the facility to create and exploit enterprise groups, while preventing its use for fraudulent, abusive, and criminal purposes.<sup>411</sup>

The above features are not far from the Common law approach. However, and since Islamic law is a religious law emphasizing a moral approach to commercial and business transactions based on the values of justice, equality and fairness, the liability of groups of companies must be read in light of this consideration. Therefore, in the final chapter, I will provide a proposal to align the liability of groups of companies with the special character of Islamic law.

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<sup>411</sup> Harry Rajak, *op.cit.* p. 525

# Chapter IV

## Findings and Proposal

Before elaborate my proposal regarding the liability of groups of companies in Islamic law, I would summarize my findings on the position under Common law as follows:

1. The law on groups of companies has since long been the subject of numerous reports, studies and analyses especially among scholars of company and insolvency laws.<sup>412</sup> Yet, there is a lack of a serious debate concerning their governance. The topic is absent from or briefly touched on by most company law textbooks and treatises on corporate governance.<sup>413</sup>
2. The problem posed by corporate groups are so varied that, unless a common nomenclature is established, it is easy for commentators to talk past each other and even to confuse the real issue.<sup>414</sup>
3. In most common law countries corporate law has traditionally applied the separate entity approach to corporate groups. It does not permit the controllers of a corporate group to treat the group as a single enterprise for the purpose of their entrepreneurial activities. This shows a lack of understanding of the nature of groups of companies and prevents scholars, practitioners, courts and parliaments from developing satisfactory regulations.<sup>415</sup>
4. Limited liability in corporate groups is a common characteristic of common law countries and is usually supported by the courts.<sup>416</sup>
5. The fact that corporate groups have not yet been regulated in a way that is comparable (as regards its scope and depth) to that of other organizational forms (e.g. joint stock companies and limited liability companies) does not diminish their importance as a legal institution and the concomitant need to

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<sup>412</sup> Harry Rajak, op.cit. p.545

<sup>413</sup> Janet Dine, op. cit. p.37.

<sup>414</sup> Melvin Aron Eisenberg, op.cit., p.1.

<sup>415</sup> Muzaffer Eroglu, op cit. p.12

<sup>416</sup> For example in *Radaszewski v. Telecom Corp* [1981] F.2d 305, the US Court of Appeals stated that: "The doctrine of limited liability is intended precisely to protect a parent corporation whose subsidiary goes broke. That is the whole purpose of the doctrine, and those who have the right to decide such questions, that is, legislatures, believe that the doctrine, overall, is socially reasonable and useful. We think that the doctrine would largely be destroyed if a parent corporation could be held liable simply on the basis of errors in business judgment".

provide legal answers to the questions they throw up.<sup>417</sup> However, mean that the system of regulation is fragmented and highly complex.<sup>418</sup>

6. There is no uniform comprehensive modern law or principles that can provide solutions to the liability problems of corporate groups.<sup>419</sup>
7. The European Union has not managed to produce a comprehensive regime for group of Companies.<sup>420</sup> Full harmonization of the law of corporate groups within the EU is neither feasible nor advisable. Regulation in this field is fragmentary and sector specific remaining controversial and problematic in some areas.<sup>421</sup> The European Forum's extensive study on corporate groups failed to produce a regime for the liability of group of companies, rather copying the existing ineffective regimes. Moreover, the European Commission pursued the High Level Group's recommendations that the existence of a group of companies should not itself a reason to abandon the limited liability principle, except perhaps in the most patent cases of abuse on the part of the group or the parent company, leading to insolvency of subsidiary.<sup>422</sup>
8. The structure of company law and insolvency law are not apt to regulate corporate group because the principles of company law and insolvency law were developed in the 19<sup>th</sup> Century, so that it is not surprising that some of their basic principles fit uneasily with the modern commercial realities of group of companies.<sup>423</sup> For example, while modern economic reality is characterized by the massive emergence of large-scale enterprise networks, where parts of a whole business are allocated to and insulated in several

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<sup>417</sup> J. Embid Irujo, *Trends and realities in the Law of Corporate Groups*, (2005) 6 European Organization Law Review 65 at 67.

<sup>418</sup> D.D. Prentice, op. cit. p. 279.

<sup>419</sup> D. Prentice, *Some Aspects of the Law Relating to Corporate Groups in the United Kingdom*, (1998-1999), 13 Connecticut Journal of International Law 305.

<sup>420</sup> J Embid Irujo, *Introduction to the Law of Corporate Groups*, Granada, Comares 2003, p. 207.

<sup>421</sup> Klaus J. Hopt , *Modern Company Law Problems: A European Perspective - Keynote Speech, Company Law Reform in OECD Countries, A Comparative Outlook of Current Trends*, Stockholm, Sweden, 7-8 December 2000.

<sup>422</sup> This means that the wrongful trading concept will be the only device to limit group opportunism and enhance creditor protection, and liability is based on requiring the proof of some violation of duties to the subsidiary, meanwhile giving the parent company a chance to avoid liability by proving non-existence of excessive control over subsidiaries. See Muzaffer Eroglu, op cit. p.45.

<sup>423</sup> Cork Committee Report, Para. 1922.

legally independent companies submitted to a unified economic direction, the company law still treats groups of companies as independent enterprises.<sup>424</sup>

9. In order to establish liability on a group basis for certain behavior, one needs to prove the existence of control of parent over the subsidiary and the intention to abuse the relationship between the subsidiary and other companies in the group.<sup>425</sup> There have been some judicial efforts to ease the requirement of control in favor of broader liability for parent companies. Such efforts have been undermined because of strong resistance to fundamental changes in principles of company law, particularly limited liability principles.<sup>426</sup> However, the domination of control theory makes proposals to regulate groups of companies inefficient.
10. Courts and legislators used various techniques to allow creditors to recover debts from entities within a corporate group other than the entity with which they have contracted. These techniques, when piercing the corporate veil, have two main important features. First, there is no presumption of liability on the part of a parent company following from the mere existence of the group form. Status does not determine liability or obligation unless the parent company shown to have 'abuse' its position. The second feature of these principles is that they normally only operate in the context of insolvency.<sup>427</sup> However, efforts to reach a sound level of liability have been wiped out by judges' rigid devotion to the restrictive characteristics of the doctrine of veil piercing. Basic liability principles are still attached to a traditional piercing the corporate veil doctrine, which requires a situation of parent company's control over the subsidiary together with some form of

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<sup>424</sup> In this regards Hadden observes that "[c]ompany lawyers still write and talk as if the single independent company, with its shareholders, directors and employees, was the norm. In reality, the individual company ceased to be the most significant form of organization in the 1920s and 1930s. The commercial world is now dominated both nationally and internationally by complex groups of companies. Tom Hadden, *Inside Corporate Groups*, (1984) *International Journal of the Sociology of Law* 271. Bill Webberburn *Multinationals and the Antiquities of Company Law*, (1983) *Modern Law Review* 320 adds that "we speak, teach, and litigate about company law. But the predominant reality is not today the company: it is the group of companies".

<sup>425</sup> Muzaffer Eroglu, *op cit.* p.10. He believes that there are similarities in treatments of liability of corporate groups and Multinational Enterprises in case law and statutory law.

<sup>426</sup> S. Griffin, *op. cit.*.

<sup>427</sup> D.D. Prentice, *op. cit.* p. 305.



unlawful action.<sup>428</sup> At the same time, however, there is no evidence that veil piercing has been rigorously applied to effect socially beneficial policy outcomes. Judges typically seem to be concerned more with the facts and equities of the specific case at bar than with the implications of personal shareholder liability for society at large. Veil piercing thus has costs, but no social pay-off.<sup>429</sup>

### **My Proposal, the Concept of Pro-active Protection**

Modern scholars when investigating the Islamic law position on a new concept or legal matter are keen to prove that such concept has or does not have a basis in Shariah. I rather suggest paying more attention to the consequences of concepts for Islamic law principles. It is important to understand the way a concept manifests itself in its modern applications, because some of these applications may require changes to the principles of Islamic law. In addition, efforts should be made to mitigate any negative impact of modern concepts on Muslim business and economy in general.

Applying this approach to the subject matter of this study lead one to focus on avoiding harm which may result from shareholders misusing the protection provided to them by the concept of limited liability. A proposal for such avoidance will work for not only the normal form of corporation but also to groups of companies. It is logical that if a proposal works where the shareholders are natural persons, there should be no difference if one or all of the shareholders is a juridical person. However, the parent/subsidiary context is more important because a corporate group presents greater potential for harm because of its greater economic impact.

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<sup>428</sup> Muzaffer Eroglu, op cit. p.44.

<sup>429</sup> Stephen M. Bainbridge, op.cit. p.1.

Although the solutions provided by the Common law systems can be also implemented in line with Islamic law principles, yet they remain inadequate and insufficient. They are inadequate because they are working under the umbrella of company law and insolvency law. This causes discrepancies between the law and commercial reality threatens the creditors' interests. For example:

1. corporate law generally requires directors to act in the best interests of the company to which they have been appointed. However, in practice, this duty may conflict with a director's actions within a corporate group which is managed and controlled as a single enterprise. Directors or controlling shareholders of the corporate group may act to maximise the wealth of the group as a whole and this may be at the expense of creditors. The Parent's lack of any duty (as a shareholder) in dealing with the subsidiary means that creditors are unable to make an accurate assessment of the investment risk because the possible range of the parent's conduct is very wide.<sup>430</sup>
2. The gap between the law and the commercial life is shown by the fact that creditors look to a company's net assets for repayment of their debt. Recourse against the company is generally limited to the value of such net assets. The use of corporate group branding and intra-group financing by the corporate group may mislead creditors, so that they cannot distinguish between each corporate group member's ownership of assets or liabilities. Where creditors cannot accurately determine the net assets of the corporate group member they contract with, they may

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<sup>430</sup> Richard Schulte, *Corporate Groups and the Equitable Subordination of Claims on Insolvency*, (1997), 18 Company Lawyer 2,.

assume greater apparent ownership of net assets than actually exists. Such misconception may lead creditors to inaccurately assess the level of limited recourse risk.

The existing protections provided by common law for creditors are deficient because in real terms these protections impose few restraints on the owners or directors of corporate groups, at either the organizational or operational stage of the group's existence. Rather the protections arise only when a group members' existence is threatened, which invariably is too late to provide adequate protection. The existing protections work only in the case of insolvency. Until insolvency arises there is little if any protection for creditors against the dissipation of the subsidiary's resources. Such protections are thus offered too late. There is no protection even when there are early indications that a company is nearly insolvent or of doubtful solvency. The current protections are confined to minor remedial action after the damage has been done. They do not stop misuse of subsidiaries.<sup>431</sup>

**From the above**, the solutions provided by the Common law are not in line with the main feature of Islamic law which relies on the justice, equality and fairness. Therefore, my proposal focuses on avoiding the negative consequences of implementing the concept of limited liability by providing prior protection to the creditors and minority shareholders in case a parent company or any of its related companies misuses the merit of limited liability, rather than waiting until the subsidiary is in the position of insolvency.

Explaining the bases of this proposal requires me to answer some fundamental questions. Who is to prove that a parent company or a related company is

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<sup>431</sup> Jennifer Dickfos, op. cit. p.260260.

misusing the limited liability doctrine so that creditors and/or minority shareholders deserve proactive protection? Is it the role of the State, or should it be left to the judgment of the courts on a case by case basis?

I say it is the state's obligation to provide proactive solutions and develop an alarm system to indicate that there is a threat to creditors and/or other stakeholders. The duty to consider creditors' interests should arise where a company's situation is such that there are indications by which a director can reasonably expect that the action, upon which the company is going to embark, could lead the company to be unable to perform its obligations towards its creditors. This might be triggered, for example, if a subsidiary's losses reached 50% per cent of its working capital. In such a case it is clear that the parent company is not properly managing the subsidiary's business, and that creditors and other stakeholders face a real risk. The parent company would then be obliged to support the subsidiary in order to keep it running and serve the interests of creditors and other stakeholders.

An example of proactive protection is provided by the Saudi Arabia Companies Act.<sup>432</sup> Pursuant to Article 180 of that Act, the manager of a limited liability company that has losses of **fifty per cent** of the company's capital must, within thirty days, convene a meeting of the shareholders to consider whether the company should continue to exist or be dissolved prior to the expiration of the

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<sup>432</sup> The Basic System of the Kingdom of Saudi Arabia states that the Qur'an and the *Sunnah* of the Prophet Muhammad (PBUH) are the Kingdom's constitution. Article 7 of the Basic System reaffirms Islamic *Shari'ah* as the foundation of the Kingdom, stating that the government draws its authority from the Qur'an and the *Sunnah*, and that these two sources govern all administrative regulations of the state. It emphasizes that the state's role and objective is to protect the principles of Islam and to enforce its *Shari'ah*. According to the Basic System it is expected that all the Kingdom's laws should comply with *Shari'ah*. Therefore, for example, the Companies Act 1965, after explaining the types of companies allowed to be established in the kingdom, stipulate that this does not prevent the establishment of companies known in Islamic jurisprudence.

term specified in the company articles of association. A shareholders' resolution must be unanimous in order to validly continue with company operations. In the case of a resolution to dissolve the company, the resolution must be adopted by a majority of shareholders that represents at least three quarters of the company's capital. If the shareholders have resolved to continue with the company, then they are deemed to be providing an undertaking to be jointly liable to pay all company debts on a pro-rata basis, based on their shareholding percentage. Importantly it should be noted that if the company manager fails to convene the required shareholders meeting in accordance with Article 180, then each shareholder may be **jointly and severally liable** for all the company's debts. In addition, if the shareholders are unable to reach a resolution on whether the company should continue to exist, then any interested party may request the dissolution of the company.

This example is one of many solutions which could be devised in order to protect creditors and prevent the misuse of subsidiaries.

In my proposal, imposing liability on a parent or related company outside of cases of insolvency would be only available where a parent or related company exercised "**decisive influence**" over its subsidiary. Decisive influence may be established where the subsidiary, despite having separate legal personality, does not act independently but rather in accordance with the will of its parent company. The availability of decisive influence alone would not be enough to make the parent liable. It must actually exercise such influence.

In determining the existence and practice of decisive influence I propose that the courts apply the same criteria articulated by the European Court in

establishing the decisive influence test in *El DuPont de Nemours and Others V Commission*.<sup>433</sup>

- a. The conduct of a subsidiary may be imputed to the parent company where the former does not decide independently upon its own conduct, but "carries out, in all material respects, the instructions given to it by the parent company, regard being had in particular to the economic, organisational and legal links between the two undertakings".
- b. The court cannot merely find that the parent company is in a position to exercise decisive influence over the conduct of its subsidiary, but must also check whether the influence was actually exercised. It is for the court to demonstrate such decisive influence on the basis of factual evidence.
- c. A parent company may exercise decisive influence over its subsidiaries "even when it does not make use of any actual rights of co-determination and refrains from giving any specific instructions or guidelines on individual elements of commercial policy". A single commercial policy within a group may be inferred "indirectly from the totality of the economic and legal links between the parent company and its subsidiaries. For example, the parent company's influence over its subsidiaries as regards corporate strategy, operational policy, business plans, investment, capacity, provision of finance, human resources and legal matters may have indirect effects on the market conduct of the subsidiaries and of the whole group".
- d. Parent companies have a specific responsibility to ensure that all subsidiaries over which they hold decisive influence comply with applicable laws.

I would also extend court power to award protective measures to situations where "it is satisfied that it is just" to do so.

The proposed court power has two important features. First, interference or involvement in management could trigger liability rather than the more stringent

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<sup>433</sup> T-76/08, 2nd February 2012.

test for shadow directors where the complete domination of the subsidiary's board is required. The reality of the corporate groups is that a parent company can leave a measure of autonomy to the boards of its subsidiaries yet, have a significant influence on the management policy of the group. Secondly, liability can arise where the parent creates a false impression of credit worthiness. To the extent that third parties are so misled in extending credit a parent should be held liable when the court is satisfied that it is just.

The proposal might appear to provide a very wide base for holding parent companies liable for the debts of subsidiaries compared with common law systems. This could be true. Yet, the proposal should be understood on the basis that Islamic law is a religious and moral system, and that liability for debt can last beyond this world into the hereafter, while the main principle governing Muslims in their commercial life is that a Muslim should act as well in his commercial life as in his personal life.

## Final Conclusion

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Groups of companies offer economic and practical advantages over other forms of business organizations. It is the only form permitting organisational control when companies are incorporated in different states. However, groups of companies may create problems in terms of antitrust law, tax law, labour law, corporate law, and in the case of international companies, conflict of laws. National laws do not provide a complete solution to these problems because groups of companies are still governed by traditional corporate law, which is designed to govern single independent companies. On the other hand, harmonization of the law of corporate groups across legal systems is neither feasible nor advisable.

Protections offered by corporate law to the minority shareholders and creditors of a corporation are based primarily on the concept of corporate self-interest, which flows from the existence of the corporation as a separate legal entity. These protections are adequate only so long as corporations are truly independent and free from external control. In company groups, however, different notions of protection and management are needed. The centralized management of a group's dominating corporation frequently gives instructions to one of the corporations it controls in order to benefit the group as a whole, and these instructions may be contrary to the interests of a dependent corporation. While the dependent corporations' interests are legally recognized and the dependent corporations' shareholders' and creditors' rights are thereby protected, there is no recognition of company groups themselves. There is thus



a disparity between the legal protection provided and the reality of corporate group structures.<sup>434</sup>

The conflict between the interests of the group and those of the corporations' shareholders' and creditors is not sufficiently managed by common law system. The techniques invented by statutes and courts aim to allow creditors to recover debts from entities within a group other than the entity with which they have contracts. However, these techniques are attached to the doctrine of veil piercing which requires a situation of a parent company's control over the subsidiary together with some form of unlawful action. In other words, liability will not be determined unless the parent company is shown to have 'abused' its position. In addition, these techniques normally only operate in the context of insolvency. Moreover, courts tend towards a rigid adherence to these principles.

When studying the position in the Islamic law, the study proves that Islamic law accepts the limited liability doctrine in terms of group of companies and stresses the important of avoiding harms which may result from parent companies misusing the protection granted by the concept of limited liability. In particular it argues that parent companies shall lose such protection if it proven that they have employed the device to defeat creditors or break the law. This is exactly the same notion provided by the common law under the concept of piercing the corporate veil. Yet, Islamic law as a religious legal system (where liability for debt can last beyond this world into the hereafter) adds to the concept a proactive feature i.e. the provision of prior protection to creditors rather waiting until the subsidiary is in an insolvency situation.

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<sup>434</sup> Patrick Derom, *The EEC Approach to Groups of Companies*, (1976) 16 Virginia Journal of International Law 566.

According to this proactive approach, legislatures, with the assistance of economists, accountants, scholars ... etc, have the duty to invent criteria which indicate when a parent company is misusing the merits of the limited liability doctrine and exerts decisive influence over its subsidiary. As a result, if a subsidiary is not able to perform its obligations towards its creditors, its parent company shall be obliged to support the subsidiary, otherwise it shall be liable for its debts. When applying the law, courts should have the full power to protect creditors when satisfied that it is "just" to do so.

This proactive approach presented in this study might also be considered for adoption in common law systems (albeit on a different basis than a moral one) because current common law solutions to problems of liability within groups of companies' provide inefficient protection to the creditors against the unlimited power of the controlling company to dictate the actions of its subsidiaries.

It only remains to mention that when I started this study, I was aiming to use its outcome as a contribution towards the process of the Islamisation of Muslim countries. Now additionally, I will use this outcome to call on Islamic *Fiqh* institutions and modern scholars to conduct greater efforts (*ijtihad*) **at a collective level**, in order to devise a comprehensive solution not only for issues of liability within groups of companies but for the whole question of groups of companies generally, in order to produce an Islamic model of corporate groups which can respond to economic needs while complying with *Shariah* principles.

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# Glossary<sup>435</sup>

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- *'abd*: slave; servant; *'abd ma'dhun* is a slave who has been authorized by his master to handle business on his behalf. Some scholars have compared the authorized slave with the corporation, because the slave can be sold to meet claims if he exceeded his authority.
- *'ahd*: covenant; here it is used in the context of *dhimmah* (personality), which is considered by the jurists a covenant with the Creator. *Dhimmah* or personality is the result of this covenant.
- *ahkam*: Plural of *hukm* (rule); the *ahkam* of a contract (legal effects) as distinguished from its *huquq* (rights of performance of the contract )-the Hanafis make a distinction between the two.
- *ahliyah*: Legal capacity.
- *Ahliyat al-ada'*: Legal capacity for execution or the legal ability to perform rights and duties.
- *Ahliyat al-wujub*: Legal capacity for the acquisition of rights and obligations.
- *a'mal*: plural of *amal* (work) that is required in a partnership or on the basis of which a partnership is formed.
- *amanah*: trust; the contract of *amanah* gives rise to fiduciary relationships and duties.
- *amin*: trustee.
- *amwal*: plural of *mal* (wealth); wealth that is contributed as capital in a partnership.
- *'aqd*: agreement; contract.
- *'aql*: reason; fourth interest secured by the *Shariah* and recognized as a purpose of the law; the existence of *'aql* is an essential condition for *ahliyat al-ada'*.
- *arkan*: The elements or essential ingredients of an act, without which the act is not legally valid.
- *batil*: Nullity; void.
- *daman*: compensation; liability.
- *daman al- 'amal*: liability underlying a partnership formed on the basis of labour, where the partner is liable for performing the contract or completing the work accepted by either partner.
- *daman al-mal*: liability for the debts of the partnership; the usual form of liability underlying all partnerships, especially one formed on the basis of wealth.

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<sup>435</sup> This Glossary is published at the end of Imran Ahsan Khan Nyazee's book, *Islamic Law of Business organization, Corporations*, Islamic Research Institute, and International Institute of Islamic Thought, (1999).



- *daman al-talaf*: liability for damaging or destroying property accepted by the partnership for value-added work.
- *daman al-thaman*: liability underlying a partnership formed on the basis of credit-worthiness where each partner is liable, jointly and severally, for paying the price of goods bought on credit.
- *darurah*: Necessity. A principle used for permitting forbidden things in case of duress or extreme hardship.
- *dayn*: receivables; the term does not apply to cash loans for which the word *qard* is used.
- *dhimmah*: equivalent of legal personality in positive law; receptacle for the capacity for acquisition; see *ahd*.
- *fasid*: vitiated; irregular; unenforceable; used in the sense of voidable in the positive law, but a contract is voidable at the option of the parties, while the *fosisd* contract can become valid only if the offending condition is removed.
- *gharar*: uncertainty; hazard that is likely to lead to a dispute in a contract; does not mean speculation in goods or currencies or the acquisition of huge profits.
- *ghasb*: usurpation; abduction.
- *hamil*: surety; the term is used by Hanbali jurists for *kafil*.
- *hukm*: rule; command; prescription; the *hukm* of a contract is a term for the legal effects of the contract.
- *Huquq*: rights; the rights of performance of a contract that belong to the agent according to the Hanafis.
- *ibahah*: permissibility.
- *ijab*: obligation as distinguished from *wujub* (duty); offer in a contract.
- *Ijma*: consensus of opinion of jurists on a rule of law.
- *ijma sukuti*: consensus where some jurists give tacit approval to the rule pronounced by others.
- *ijtihad*: effort of the jurist to derive the law on an issue by expending all the available means of interpretation at his disposal and by taking into account all the legal proofs related to the issue.
- *ikhtilat*: mixing of shares so that they can no longer be separated.
- *inan*: rein of an animal; type of partnership; the *inan* partnership that is formed for a particular project or for trading in a particular commodity or in which the agency granted to the partners is restricted.
- *istidhanah*: raising or building up credit through credit purchases; does not apply to the raising of cash loans; see *istiqrif*.
- *istihsan*: principle according to which the law is based upon a general principle of the law in preference to a strict analogy pertaining to the issue, the principle is used by the Hanafis as well as the Malikis,

- *istiqrad*: the raising of cash loans for business purposes, declared *batil* by al-Sarakhsi as it is against the principle of prohibition of *riba*.
- *jaiz*: permissible; permissible contract.
- *jahalah*: uncertainty; uncertainty in a contract that may lead to a later dispute; see *gharar*.
- *kafalah*: contract of surety; guarantee; bail; posting a bond.
- *kafil*: surety; person providing the surety; guarantor.
- *al-kharaj bi al-daman*: a principle based upon a tradition; it is, perhaps, the most influential principle in Islamic law, applies to contracts, damages and even crimes.
- *khalt*: mixing of shares.
- *lazim*: binding; binding contract.
- *mal*: wealth.
- *milk*: ownership; property.
- *mu'amalaht*: transactions; agreement.
- *mubah*: permissible.
- *mudarabah*: contract of partnership and sharing of profits in which the investor provides all the capital and is liable for the loss.
- *mudarib*: the worker in a contract of *mudairabah*:
- *mufawadah*: a basic contract of partnership based on *wakalah* and *kafalah* that requires full commitment from the partners and to achieve this purpose tries to maintain equality in the capital, labour, liability and legal capacity and also declares each partner to be a surety for the other-it is converted into the *'inan* partnership if such equality is disturbed.
- *murabahah*: sale at stated cost price and mark-up.
- *mutalabah*: demand; demand by a creditor for the satisfaction of debts from the dealing partner or from the other partners.
- *muzara 'ah*: contract for the cultivation of land between the owner of the land and the worker with the condition of sharing the produce.
- *muzari'*: tenant.
- *nizam*: institution; term used in Saudi law for the corporation, in place of the usual term *sharikah*, in Arab law.
- *qabul*: acceptance.
- *qard*: loan, especially an interest-free loan in which the period of repayment is not fixed; a loan in which the period is fixed is permitted by Islamic law, even if it is without interest, because it is hit by the stipulations of the contract of *sarf*.
- *qard hasan*: gracious loan without interest in which the benefit to be derived is gifted by the owner to the beneficiary-without this charitable act, the use

of the money for a period would be considered an unjustified excess transferred to the beneficiary also called *riba al-naei'ah*:

- *qiyas*: analogy; syllogism.
- *rabb al-mal*: investor; owner of capital.
- *rahn*: pledge; mortgage.
- *riba*: interest; unlawful excess in the exchange of two counter-values where the excess is measurable through weight or measure (called *riba ai-fal*) or is measurable through time (called *riba al-nasi'ah*).
- *rukhn*: element; part of an act without which the act is not complete or valid; essential ingredient or element of a contract.
- *sadaqah*: charity; also used for *zakat*.
- *salam*: contract in which an advance payment is made for a delayed delivery of goods.
- *Sarf*: contract for the exchange of gold, silver, and currencies whether the currency or commodity exchanged is the same from both sides or is different, that is, whether dinars are exchanged with dinars or dinars are exchanged with dirhams.
- *shakhsiyah i'tbaryah*: juristic person; artificial personality; corporate personality.
- *sharik*: partner.
- *sharikah*: partnership; in Egyptian law the term is used for joint stock companies and corporations as well, but is qualified with an adjective to indicate its nature: thus, *sharikah musahamah* for a public limited company or a corporation whose capital has been subscribed to by the general public.
- *sharikah 'ammah*: general partnership; a partnership in which each partner is a general attorney for the other partners; a partnership that permits trading in all types of goods.
- *sharikah khasah*: special partnership; partnership for a single venture or for trading in a particular item; partnership in which each partner is a special attorney of the other partners.
- *sharikah musahama*: in Egyptian law it is the name for a corporation or for a public limited company.
- *sharikat a'mal*: partnership in which participation by the partners is based on labour or skill, but the partnership has to be of the type *'inan* or *mufawadah*.
- *sharikat al-'aqd*: a partnership created through contract as opposed to co-ownership that may be the result of a joint purchase or agreement or it may result from inheritance or from some other legal situation.
- *sharikat al-'inan*: a basic contract of partnership based on agency in which participation may either be on the basis of wealth or labour or credit-worthiness, and in which equality of contribution or legal capacity is not necessary.

- *sharikat al-abdan*: another name for *sharikat al-a 'mal*.
- *sharikat al-amwal*: a partnership in which participation is based on the contribution of wealth by all partners, but the partnership has to be of the type *'inan* or *mufawadah*.
- *al-sharikah dhat al-mas 'uliyah al-mahdudah*: the name for a private limited company in Egyptian law.
- *sharikat al-dhimam*: a term used by the Malikis to indicate a situation where two or more persons are buying goods on credit-it is different from the Hanafi *sharikat al-wujuh* insofar as it requires the physical presence of all the partners at the time of purchase.
- *sharikat al-ibahah*: a common right of individuals to gather, possess and own free commodities.
- *sharikat al-jabr*: mandatory co-ownership created by an act of law, like inheritance.
- *sharikat al-milk*: co-ownership.
- *sharikat al-taqabbul*: partnership for the acceptance of work, which is the same thing as a partnership based on labour or skill.
- *sharikat al-wujuh*: partnership based on credit-worthiness of the partners in which the ratio of profit and loss is based on the liability borne, but the partnership has to be of the type *'in an* or *mufawadah*.
- *shurut*: conditions; the name given to the art of conveyancing in Islamic law.
- *'urf*: usage; custom.
- *urud*: property that includes goods, slaves and even real estate.
- *wakiilah*: agency.
- *wakalah 'ammah*: general agency.
- *wakalah khasah*: special agency.
- *wakil*: agent.
- *wali*: guardian.
- *waqf*: charitable trust; testamentary trust.
- *wasiyah*: bequest.
- *wilayat al-istidanah*: authority granted by one partner to another to buy on credit beyond the limit of the capital of the partnership.
- *zakat*: obligatory religious dues on wealth.