Corporatisation under Islamic Law

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Abstract

This article examines the possibility of corporatisation of Islamic form of business organisations and their functioning under Islamic Law. It analyses, in comparative perspective, the Islamic form of business organisations with western form of business organisations. It further analyses the possibility of functioning of Islamic business organisations under the capitalist financial system. This article concludes that the Islamic form of business organisations, with some exceptions, can be equated with western form of business organisation in its contents and functioning to fulfil the needs of modern financial system for the world in general and Muslim world in particular.

Keywords: Corporatisation, Islamic Law, Islamic Finance, Company, Pakistan

Introduction:

The triumph of capitalism over its rival communism in the last part of previous century highlights the importance of capitalist financial system. The western world with its capitalist financial system has been ruling in the world since then. The western form of corporatisation is not an old phenomenon. This phenomenon started only in 19th century. The concept of modern form of company known to western financial system was alien to classical Muslim jurists. However, the Islamic finance and business organisation was very much in vogue in early period of Islam. Recent industrialisation and globalisation has increased the utility of modern form of company. The Islamic form of business organisations can be equated with western form of business enterprises in order to justify the corporatisation in order to fulfil the needs of modern financial system prevalent in the world. It is concluded that with some exceptions, the western form of corporatisation is very much similar to Islamic form of business organisations.

The concept of a company under Islamic law:

Musharakah and *mudarabah* under Islamic law resembles a partnership in conventional finance. The word *musharakah* is derived from the Arabic word *shirkah* which means 'sharing'[1] or 'becoming partners'[2]. This may be used as an ideal alternative to interest-bearing debt financing.[3] However, there is disagreement between classical jurists regarding the correct definition of the term *musharakah*. In simple terms, *musharakah* is like a kind of partnership in the western system of finance.[4] It may also be termed a company subject to the condition that Islamic law recognizes its fictitious legal personality and limited liability, which are main features of the modern form of a company.

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[1] Mufti Muhammad Taqi Usmani, *An Introduction to Islamic Finance* (Karachi: *Maktaba Ma'Ariful Qur'an*, 2004), 33.

[2] Muhammad Imran Ashraf Usmani, *Meezan Bank's Guide to Islamic Banking* (Karachi: *Darul-Ishaat*, 2002), 81.

[3] Ibid.

[4] Muhammad Tahir Mansuri, *Islamic Law of Contracts and Business Transactions* (Islamabad: 3rd edn, *Shariah* Academy IIUI, 2005), 241-2.

The *musharakah* comes into existence by mutual contract between all parties involved. The objective is to conduct business where the parties have certain rights and liabilities.[5] As far as the rights and liabilities of the parties are concerned, there is disagreement between classical jurists. The Maliki and Shafi schools consider the distribution of profit strictly according to the ratio of investment made by the parties. The Hanbali School prefers contractual agreement between parties for the distribution of profit. The Hanafi School has an intermediate view that relies on the role of the partners in the business.[6] The Maliki and Shafi view does not seem appropriate as this practice may discourage entrepreneurs in business activities who are more active and contribute more in the business by way of their skills, efforts, knowledge and experience. This contractual agreement may be a useful methodology as it may encourage partners with expertise and skills to run the business. Partners who are more active and contribute more in the form of skills, efforts, experience and knowledge may be allocated a higher percentage of the profits compared to those who are not active and skillful.

However, there is no disagreement with regard to sharing in business losses. According to them, every partner will share in a loss strictly according to his or her investment.[7] This view needs some consideration by modern jurists. A point to be considered is that if profit can be contractual, then why not the loss? If some partners get more shares from profit because they are more active and take business decisions, they should also take more responsibility for losses. The sharing of profit and loss on equal footing may be more helpful for business development.

As far as the nature of capital is concerned, again there is disagreement between classical Muslim jurists. Some favour money and exclude commodities as capital. However, others favour any kind of capital, including exclusively money or commodities or a mixture of both.[8] In modern business forms there seems no reason to exclude commodities as an alternative to capital because it is much easier now to evaluate the market price of any commodity.

As far as the management in *musharakah* is concerned, a general rule of Islamic finance developed by the jurists is that the management in *musharakah* will be shared by all the partners. However, one or more partners may be sleeping partners, in which case their share in profit will not exceed the ratio of their investment.[9]

The termination of *musharakah* may be in the same way in which the modern form of partnership is terminated. As far as the question of the continuity of *musharakah* is concerned, there is no guideline in classical Islamic jurisprudence on excluding those partners who are not willing to carry on the business and want to withdraw their investment. However, modern scholars are of the view that since huge business investment normally calls for continuity of business, this can be done on the basis of the nature of the business conducted in modern times. Therefore, if any partner is not willing to carry on the business, then his or her

[5] Frank E. Vogel and Samuel L. Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (Kluwar Law International, The Hague 1998), 195.
[6] Mufti Muhammad Taqi Usmani, *An Introduction to Islamic Finance* (Karachi: *Maktaba Ma'Ariful Qur'an*, 2004), 35-7.
[7] Ibid., 37.
[8] Ibid., 38.
[9] Muhammad Imran Ashraf Usmani, *Meezan Bank's Guide to Islamic Banking* (Karachi: *Darul-Ishaat*, 2002), 86.

investment and share of profit, if any, accrued until his disinvestment may be returned.[10] This supports the idea of establishing a modern form of a company that can handle huge investment with multiple forms of investments and frequent transfer of investment without liquidating the company.

Mudarabah ('Partnership'):

Mudarabah is another form of doing business in Islamic finance. In *mudarabah* the capital is invested by one party while the business is conducted by another party. The first party only contributes capital and does not participate in the management, whereas the second party does not invest in, but carries on, the business. The first party is called *rabb al-mal* ('investor'), whereas the second party is called *mudarib* ('the manager').[11] The ratio of profit is determined in advance by the mutual consent of the parties. Islamic law does not prescribe any fixed profit.[12] If both parties invest money, this will not be a *mudarabah* business it will amount to a *musharakah* business. In a *mudarabah* business, loss of the investor is monitory, whereas the manager loses potential benefits that he or she might have obtained had the business earned profit. The loss of the manager is, therefore, in terms of his or her loss in efforts and skills. The liability of the investor is limited to the extent of his or her share in the business.[13] Therefore, a *mudarabah* business is like a modern form of partnership with limited liability where an investor is a sleeping partner. The only difference between *mudarabah* and a modern form of partnership is that the manager is not an investor in *mudarabah*. Even in modern forms of partnership, the law of partnership does not prohibit some of the partners from investing without taking part in the management. Similarly, some partners taking part in the management without investment.[14] Such partners may contribute their skills, expertise and knowledge, and thereby share in the profit. The only problem will be in sharing in losses. However, this can be resolved through contractual arrangement. Mansoori writes that *mudarabah* may also be equated with the western form of a company as under Islamic law there is no difference between a partnership and a company.[15] However, again, the question is acceptance of the separate legal personality and limited liability in Islamic law which are the main ingredients of the company under the western form of a company.

As a general rule, the liability of the investor is limited to the extent of his or her share in the business but if he or she had allowed the manager to incur debts on his or her behalf, then his or her liability will be unlimited. The manager is also supposed to work with the due care and diligence that is normally required for that kind of business. If, however, he or she fails to exercise due care and diligence, then he or she is accountable for his or her misconduct.[16]

It is possible to combine both *mudarabah* and *musharakah* business in one contract. In this scheme, some parties only invest money without the right to take part in management, and some investors and non-investors are involved in the management. In this case a business

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[10] Mufti Muhammad Taqi Usmani, *An Introduction to Islamic Finance* (Karachi: *Maktaba Ma'Ariful Qur'an*, 2004), 35-44.
[11] Muhammad Imran Ashraf Usmani, *Meezan Bank's Guide to Islamic Banking*, 98.
[12] Mufti Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, 50.
[13] Muhammad Imran Ashraf Usmani, *Meezan Bank's Guide to Islamic Banking*, 100.
[14] The Partnership Act 1932 applicable in Pakistan.
[15] Muhammad Tahir Mansuri, *Islamic Law of Contracts and Business Transactions* (Islamabad: 3rd edn, *Shariah* Academy IIUI, 2005), 278.
[16] Mufti Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, 43-5.

will be run as a combination of both *mudarabah* and *musharakah*.[17] This is like a modern, complex form of a company where some investors and some non-investors run the company, whereas others are only investors without taking active part in the management.

Both *Musharakah* and *Mudarabah* can be equated with the western form of a company, provided all basic characteristics of a company are also acceptable under Islamic law. The acceptance of the concept of a company under Islamic law is significant because it may resolve many problems involving finance under Islamic law.

Kraakman *et al*. describe five basic characteristics of a company: (1) legal personality, (2) limited liability, (3) transferable shares, (4) centralized management under a board structure and (5) investor ownership.[18] These features can be tested with Islamic forms of business organizations.

Legal personality:

Legal personality means the existence of an entity that is separate from its members. It can sue and be sued in a court of law. It can own and transfer property in its own name. It can delegate powers to agents and can also enter into contracts in its own name. Though all these functions are performed by the directors on behalf of the company, the company is liable for these acts unless directors' act beyond their powers. This legal personality concept is, in fact, entity shielding, which means that it protects the assets of the company from the creditors of the owners.[19] According to classical jurists of Islamic law, there is no concept of a fictitious legal entity. Under Islamic law, the objective of any legal person is to perform duties as well as to worship. Since a fictitious legal entity cannot worship, these jurists did not recognize this entity under Islamic law.[20] Usmani believes that the concept of a fictitious legal personality, as is understood in the west, was not known to classical jurists. Though they did not discuss it, they were aware of the concept. He writes that the classical jurists considered and treated *waqf* ('trust'), *bait-al-mall* ('exchequer of the Islamic state) and the joint stock of different investors as separate entities.[21] Therefore, a fictitious personality concept in the form of a company is not against Islamic law. This can also be rationalized under the Islamic principle of *ibahah* ('presumption of continuity'). Under this principle, as the concept of creating a legal entity is not against the *Shariah*, it may be allowed under Islamic law.[22] Nyazee considers that the only reason for creating a corporation under the Islamic concept may be to provide a social device for the growth of the wealth of the Muslim community as a whole.[23] This may be one ground for creating a company but this is a very restricted approach. There may be more appropriate grounds to create a company under Islamic law, other than the growth of the Muslim community's wealth. The principle of *darrurah* ('necessity'), such as modern business requirements, the welfare of society, the continuity of big business enterprises, economic growth and the principle of *ibahah* ('presumption of continuity') are more appropriate grounds for creating a company under Islamic law.

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[17] Mufti Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, 53.
[18] R. Kraakman *et al*., *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford: 2nd edn, Oxford University Press, 2009) 5.
[19] Ibid., 9-10.
[20] Imran Ahsan Khan Nyazee, *Outlines of Islamic Jurisprudence* (Islamabad: Advance Legal Studies Institute, 2000), 102.
[21] Mufti Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, 223-8.
[22] Habib Ahmed, 'Islamic Law, Investors' Rights and Corporate Finance' 12 (2) *Journal of Corporate Law Studies* (2012), 392.
[23] Imran Ahsan Khan Nyazee, *Corporations in Islam* (Rawalpindi: Federal Law House, 2007), 226.

Limited liability:

Limited liability is an important characteristic of the modern form of a company. Under this concept, the liability of the equity holders is limited to their investment in the company or guarantee given by them to contribute towards the assets of the company at the time of winding up. This is, in fact, owner shielding which protects the assets of the shareholders from the creditors of the company.[24] Acceptance of the limited liability of a fictitious legal personality is important under Islamic law. Usmani writes that the classical jurists were aware of the limited liability but this concept was not associated with a fictitious person. As far as limited liability of a natural person is concerned, Usmani gives the example of a deceased natural person who dies indebted. In this case the creditors of the deceased cannot claim from the family of the deceased more than what was left by the deceased. The creditor can claim only what is left by the deceased. This shows acceptance of the concept of personal liability of a natural person by Islamic law. On the same grounds, this concept can be extended to an artificial legal person.[25]

Modern jurists consider limited liability according to the *Shariah* using the same reasoning as for accepting the concept of a corporation. Therefore, it may be allowed keeping in mind the needs of modern financing. The separation of ownership and management necessitates limited liability of the investors. The liability created by the management, more than what has been invested, may restrict the public from making an equity investment in corporations. Furthermore, the involvement of the general public and freely transferable shares are other reasons for the introduction of limited liability. If Islamic law does not allow limited liability, then big projects that require large-scale public investment may not be feasible. However, as far as creditors' rights are concerned, Usmani writes that this concept needs more *ijtihad* in view of the potential dangers for the creditors.[26] This concern about creditors' interest may not be as strong as it appears. Modern finance, as well as Islamic finance, provides more security to the creditors than the shareholders. Islamic law will give the creditors priority over the owners in cases of liquidation of companies. This premise is based on the priority rights of the creditors of the deceased natural person over the heirs in the inheritance at the death of the debtor. Another important point in this regard is that Islamic law allows creditors to take collateral from debtors. Therefore, limited liability cannot be a potential threat to the creditors as far as their security is concerned. Vogel acknowledges this concept of limited liability under Islamic law by providing a solution to the problem. He writes that Islamic finance may limit the ratio of debts to the equity of the company and may also allow vigorous piercing of the corporate veil in cases of excess loans taken by the managers.[27]

There is also disagreement on the extent of the application of limited liability of companies under Islamic finance. Usmani considers that as limited liability is injurious to creditors, it should be allowed only in public companies. He asserts that the public cannot be held responsible for the day-to-day affairs conducted by the management. He further suggests that this should not be allowed in private companies and partnerships. According to him, an exception can be extended to those shareholders or partners who are not involved

[24] R. Kraakman *et al*., *The Anatomy of Corporate Law: A Comparative and Functional Approach*, 9-10.
[25] Mufti Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, 221-4.
[26] Ibid., 22.
[27] Frank E. Vogel and Samuel L. Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (Kluwer Law International, The Hague 1998), 169.

in the management of companies or partnerships respectively. The rest of the members will be responsible for unlimited liability. He further explains that the objective to restrict limited liability to public companies and sleeping partners is to avoid the cheating of investors and creditors.[28] There does not seem to be any cheating if all the stakeholders, including the creditors, are aware of the fact that the liability of the company is limited. They should also be vigilant about the financial position of the company while advancing loans or credit to a company. Similarly, allowing limited liability only to large public companies vis-à-vis the interests of the creditors is not justifiable as this interest may be more exposed in big public companies than in small companies. Large companies have huge capital investments, and large numbers of shareholders and creditors. This situation may be more dangerous than in small companies where assets and liabilities can be determined more easily than in large public companies. So, public interest and welfare necessitate extending limited liability to small companies and partnerships as well. This concept may not be against the principles of the *Shariah* and may be allowed keeping in mind the welfare of the nation and the principle of *ibahah*. Nyazee also favours extending the concept of limited liability to all forms of business enterprises.[29] He writes that if the concept is beneficial to large-scale investors, then it should be beneficial to sole proprietors, partnerships and companies, including both private and public companies. This will allow small investors an opportunity to do business that includes the benefit of limited liability.

Transferable shares:

A transferable share is also a basic characteristic of the modern form of business corporation that distinguishes a company from partnerships and other forms of enterprises. It means an interest in a company is fully transferable without interruption in the business. However, some restrictions may be imposed in private companies, where the transfer of interest remains within the limited group of persons or subject to approval of the board of directors.[30] This concept can also function in Islamic finance if interests in enterprises are securitized. Islamic finance does not prohibit converting interests in business organizations such as *musharakah* and *mudarabah* into small units that represent the ratio of investment in the business.[31] As *musharakah* is a kind of investment where investors may have limited liability and the right of participation in the management, shares in *musharakah* will represent shares with voting rights. Voting rights provide the right to participate in the affairs of the company which is a basic requirement for a *musharakah* form of business. However, securitization in *mudarabah* would be like the shares of a company with limited liability without voting rights. As the nature of *mudarabah* business is such that investors do not have the right to participate in the management, therefore, shares in *mudarabah* will be without voting rights. The rights of management remain with the manager who does not invest. A combination of *musharakah* and *mudarabah* is allowed under Islamic law; a company may issue some shares with voting rights and some shares without voting rights. Therefore, according to Islamic law, there is no harm in securitizing investments in *musharakah* and *mudarabah* or a combination of both into shares that are tradable in the secondary market. The general public can invest through the purchase of shares on the stock market and may get profit and can take part in the decision-making by the right of vote attached to these shares.

[28] Mufti Muhammad Taqi Usmani, 'The Principle of Limited Liability from Shariah Viewpoint' (1992) online, published by New Horizon available at <http://www.newhorizon-islamicbanking.com/ index.cfm?section=features&action=view&id=11312>

[29] Imran Ahsan Khan Nyazee, *Corporations in Islam* (Rawalpindi: Federal Law House, 2007), 226.

[30] R. Kraakman *et al*., *The Anatomy of Corporate Law: A Comparative and Functional Approach* ,11.

[31] Mufti Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, 58-61.

They can also sell their shares once they want to disinvest from the company. The seller may incur a capital gain or capital loss depending upon the performance of the company. In an ideal market the price of a share is directly connected to the real value that represents the assets of the company. If the company is earning profit, then this may increase the assets of the company and the share price. However, if it is not performing, then the value of assets and, consequently, the price of the shares may decrease. Investors may get profit either in the form of a dividend or capital gain and may also share loss in the form of capital decrease. This will fulfil the *Shariah* requirement of sharing in profits and losses. The market and good governance mechanism will play a major role in this process.

The issuance of preference shares under Islamic law is debatable. Nyazee asserts that the issuance of preference shares is not against Islamic law. He explains that if the preference shareholders are contracted to a 12% dividend and the board decides on a 15% dividend for ordinary shareholders, then the extra 3% can be retained to provide a cushion for payment of dividends to preference shareholders for the next years.[32] This interpretation clearly shows a misunderstanding of the nature of preference shares in the modern form of a company. This presumption does not seem to fulfil the requirements of Islamic law due to the nature of preference shares. Preference shares are normally of four categories. The first category is preference in the profit of the company over ordinary shareholders by inserting a condition in the contract that the preference shareholders will be paid a dividend at a fixed rate. The second category is where preference shareholders may have enhanced voting rights over ordinary shares. The third category is where preference shareholders enjoy preference in the capital return at the time of winding up or reduction of share capital.[33] In the fourth category the nature of some preference shares may also contain a condition that if the profit is not paid out in one particular year, but that the same amount will be accumulated for the next year and so on unless fully paid. These are called *accumulative preference shares*. The question here is whether Islamic law allows fixed return. As far as the fixing of the ratio of profit of any business is concerned, there seems to be no prohibition, for example, suppose A and B start a business with £10,000 and £20,000 respectively and agree on 30:70 profit ratios. A may be a sleeping partner and B an active partner to carry on the business. This may not be problematic for Islamic law as profit ratio is quite legal in Islamic law. However, if the parties stipulate that A will get 30% of his investment, A's investment will amount to a debt to B at 30% interest. In preference shares the stipulation of a condition that the parties will get a fixed rate of return that is directly related to the ratio of their investment and not to the ratio of profit, amounts to a kind of debt. However, if a condition in the contract stipulates that the preference shareholder will get 30% of the profit of the business; this may be a valid condition. No doubt, a declaration of a dividend is related to the realization of profit but fixing of a profit ratio to the parties' investment is like a debt to the company with interest. Sometimes a company may yield such an amount of profit that could only satisfy the claims of the preference shareholders and the ordinary shareholders get nothing. If a dividend paid to preference shareholders is fixed to some ratio to profit earned by the company, it may be an Islamic mode of financing. As regards the second type of preference shares, namely of giving enhanced voting rights, as discussed earlier, there seems to be no problem under Islamic law. The third kind of preference share, namely of giving preference over capital return vis-à-vis ordinary

[32] Imran Ahsan Khan Nyazee, *Islamic Law of Business Organisation: Corporations (Islamic Law and Jurisprudence 2* (Islamabad: The International Institute of Islamic Thoughts and Islamic Research Institute, 1998), 181-2.

[33] Murray A. Pickering, 'The Problems of the Preference Share' 26 (5) *The Modern Law Review* (1963), 499.

shareholders at the time of the reduction of capital or winding up resembles preference shares with debt security. This kind of investment through preference shares is a kind of debt to the company. The fourth category of preference shares, namely accumulating profit for subsequent years in cases where company fails to pay dividend resembles preference shares with debt security. Therefore, the issuance of preference shares may not be in accordance with the Islamic mode of financing.

The problem with preference shares is the nature of preference shares themselves. The rights attached to preference shares are based on the contract, regulations of the company and court decisions in common law jurisdictions. Most of the problems of preference shares stem from the absence of clear provisions as regards the rights attached to these shares. No doubt, preference shareholders have certain advantages over ordinary shareholders but it is quite possible that they are at a disadvantage in certain cases. For instance, preference shareholders may be at a disadvantage as compared to ordinary shareholders in cases of surplus profit at the time of winding up or the declaration of more profit to ordinary shareholders than fixed profit paid to preference shareholders. Preference shareholders are also normally at a disadvantage in relation to other debt security holders in the absence of express provisions to the contrary. Debenture holders, for instance, normally have charge over the assets of the company and also priority of capital return at the time of winding up. Therefore, debenture holders have an advantage over preference shareholders. These abnormalities can be resolved only by equating preference shareholders with debenture holders or fixed income securities. The other option may be to clearly define the rights attached to these shares as preferred in respect of dividends or participating shares in respect of voting rights.[34] These problems may limit external finance through preference shares. However, this may be resolved by constructing preference shares in a way that can attract external finance.

Preference shares can also be constructed in Islamic finance within the limits prescribed by the *Shariah.* The *Shariah* does not prohibit variation in the percentage of a share in profit. This could be any proportion of profit, irrespective of the share in the investment, as long as the contract is drafted in accordance with requirements of *Shariah*. One option may be that the preference shareholders are given a higher rate of profit than the ordinary shareholders, for instance, this could be provided in the terms of the preference shares, namely that the holders of these shares will be given 10% more profit than ordinary shareholders. Furthermore, for instance, whenever ordinary shareholders are paid a profit at a rate of 20%, the preference shareholders will get 30% shares in dividends. Another option may be that the terms of the preference shares may be constructed in this way that if preference shareholders and ordinary shareholders have 10: 90 ratios in equity, then the share in profit may be fixed at 20% for preference shareholders and 80% for ordinary shareholders. This will not violate the conditions of the *Shariah.*

However, as the condition of giving preference shareholders priority in liquidation violates a *Shariah* requirement, the preference shareholders must share in the loss of the company according to their investment or contractual rights and duties (if allowed under Islamic law). Preferences shares may, therefore, be issued under Islamic finance provided the above conditions are met. Vogel acknowledges that preference shares that are issued in terms of conventional finance are against Islamic norms. He suggests that preference shareholders may be given more dividend rights as compared to ordinary shareholders subject to their sacrificing rights in the management. According to him, the preference shares can be issued

[34] Ibid., 515-9.

with enhanced dividend rights but without voting rights attached to them.[35] However, there seems no reason to object to the issuance of preference shares that have voting rights with enhanced dividend rights.

As to trading in shares under Islamic finance, there does not seem to be a prohibition under Islamic law. However, this is permissible under certain conditions. Some jurists put a condition on the trading of shares of a company to the general public.[36] They argue that the shares of a public company can be traded among the general public. However, it is necessary that the company owns some non-liquid assets before starting to trade the shares in the market. The OIC Academy has also approved the trading of shares for those companies in which the value of real assets is greater than cash and debts. The reason is that if all the assets of the company are in liquid form, then shares will represent money and, according to Islamic law, money cannot be traded for money except when it is exchanged in equal amount and on the spot.[37] This condition may not be a problem under Islamic law as provision may be made in company law for the shares of the company to be transferable when some of its assets are in non-liquid form.

Delegated management with board structure:

In the modern form of corporations, as it is not feasible to invite all the members to make day-to-day business decisions, the power of making decisions is delegated to the board of directors, who are elected periodically, exclusively or primarily by the shareholders.[38] There appears to be no reason why this cannot be done under Islamic finance. Islamic law allows the delegation of management to certain persons nominated by the owners; for example, *mudarabah* allows managers to carry on with the business excluding the investors. Similarly, under *musharakah* business, there may be sleeping partners who are not involved in the business affairs. So, a board structure with delegated management is very much Islamic.

Investor ownership:

Investor ownership under conventional finance has two aspects: (1) the right to participate in the management and (2) the right to participate in the net earnings of the corporation. The right to participate in the management means the right to contest the election of a director, the right to exercise voting powers to elect the board of directors and the right to participate in major decisions of the company. The right to participate in the net earnings in the corporation means to share in the profit and claim residual earnings.[39] Both these rights have exceptions as well, for instance, the right to participate in the management may be restricted when the company issues shares without voting rights. Similarly, the right to participate in the profit may be restricted when the company is formed to carry on a charity or co-operative objects. As discussed earlier, investor ownership is a basic characteristic of business corporations under Islamic law. Therefore, Islamic law does not prohibit the investor ownership requirement of the modern form of a company. Therefore, the formation of the

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[35] Frank E. Vogel and Samuel L. Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (Kluwar Law International, The Hague 1998), 196-7.
[36] Muhammad Imran Ashraf Usmani, *Meezan Bank's Guide to Islamic Banking*, 189-190.
[37] Decision 5 (d4/08/88), Fourth Session (1988), *Fiqh Academy Journal* 3:2161, 2163 referred to by Frank E. Vogel and Samuel L. Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (Kluwar Law International, The Hague 1998) 173; Brian Kettell, *Introduction to Islamic Banking & Finance* (London: Brian Kettell, Islamic Banking Training, 2008), 183.
[38] R. Kraakman *et al*., *The Anatomy of Corporate Law: A Comparative and Functional Approach* ,13.
[39] Ibid., 14-5.

modern form of a company is not prohibited under Islamic law. However, there may be some restrictions on the activities of the company under Islamic law.

Functioning of a company under Islamic law

As discussed earlier, the modern form of a company can conduct business with the Islamic mode of financing and its shares can be traded in the market. However, a major difference between the conventional form of a company and Islamic finance is the restriction of the activities under Islamic law. Islamic law does not allow certain kinds of activities that are otherwise allowed under the western model. These activities include, but are not limited to, businesses involving the production of alcohol, opium and pork; gambling; pornography; and other immoral businesses. Some other business activities, such as interests, uncertainty and future trading in shares, are also not allowed under Islamic finance.

In a system that is not pure Islamic or where two parallel systems are operating, it will hardly be possible for a company, operating under Islamic finance, to keep out of interest-bearing transactions because the company has to deal with financial institutions, banks and other companies involved in interests-bearing transactions. Therefore, companies that operate under Islamic finance may involve some kind of activities based on interest-bearing transactions. Therefore, a part of the profit of the company may also represent interest-baring profit which, under the strict prohibition on interest under Islamic finance, is not allowed. Usmani has proposed a way out to avoid such interest-bearing profit.[40] He writes that suppose a company has declared a dividend but the company has accrued most of its profit through *Shariah*-compliant businesses but some of its profit is earned through interest-bearing transaction. The shareholders must segregate such proportion of the dividend that is earned by the company through the interest-bearing transaction. To avoid interest, the amount of profit that represents interest must be given to a charity. This will purify the profit from the interest. However, as regards purification of the capital gain, there is divergence of opinion. Some jurists consider that a portion of the capital gain should also be given to charity as a portion of the company's assets may represent assets obtained through interest-bearing transaction. However, other jurists are of the view that there is no need to purify capital gain as the majority of the assets of the company are composed of legitimate business and only a negligible portion is composed of interest-bearing profit.[41] If this plea is good for the capital gain, then the same may also be applied to the dividend. However, implementing pure faith requires avoiding such kinds of earnings. Therefore, corporate governance requires from the firms operating under Islamic finance to disclose separately the amount and percentage of profit earned through interest-bearing transactions.

Islamic financial institutions use *musharakah* and *mudarabah* as modes of financing which are alternatives to interest-based financing. Islamic financial institutions establish *Shariah* boards to guide them to check whether a particular mode of financing is according to the *Shariah*. The *Sharaih* boards consist of Muslim scholars who synchronized western forms of financing and the Islamic mode of financing. However, the problem is that there are differences of opinion in their own ranks regarding compliance with these modern modes of financing according to the *Shariah*. The reason is that they belong to different schools of interpretation, which results in the differences of opinion. Members of *Shariah* boards never

[40] Mufti Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, 208.
[41] Mufti Muhammad Taqi Usmani, 'Principles of *Shariah* Governing Islamic Investment Fund' an online article available at < http://www.albalagh.net/Islamic_economics/finance.shtml>

make uniform or absolute decisions as they sometimes take back their earlier decisions.[42] This causes divergence in Islamic finance within the Muslim world.

As the creation of a company is a relatively new concept in Islamic finance, there is a scarcity of investor protection mechanisms. However, there are many instances in the primary sources of Islam which provides protection to the investors especially the minority stakeholders.[43] Here only few are narrated to explain the objective of the Shariah to explain the investor protection. Qur'ān says:

'And do not swallow up your property among yourselves by false means, neither seek to gain access thereby to the judges, so that you may swallow up a part of the property of men wrongfully while you know'[44]

This verse clearly provides protection to the property rights of the others. Similarly, the Sunnah also provides protection to the property of the others:

'…A Muslim …does not oppress his brother nor abandon or humiliate…every Muslim is protected; his blood, his wealth, and honour'[45].

Holy Prophet (peace be upon him) has also been quoted as saying that God says:

'I am a third partner of those who form partnership; unless one of them betrays the other, I leave them alone'[46]

This Sunnah indicates that one, who betrays the other partner, will lose blessings of God. It is also part of religious duty to be faithful to other partners in business. These references clearly provide that protection to the property is given high importance in the religion of Islam. In entrepreneurship, the weaker party is mostly at risk of being dealt unfairly, exploited and expropriated by the stronger party. Therefore, the focus of the Shariah is to provide protection to the weaker party in commercial dealings.[47]

As the modern techniques of investor protections have developed recently, therefore, there is less investor protection mechanism developed under Islamic financial system. The kind of protection available to investors that is commensurate with western forms of rights and protection can encourage an Islamic mode of financing. The Islamic method of interpretation of *ijtihad* can help to provide investors with such protection.[48] The reason for the absence of such investor protection is that Islamic finance has shown its presence quite recently. Most of the Islamic law developed in the early periods of Islam when the modern techniques of financing were not developed. Therefore, classical jurists were not aware of the contemporary techniques of financing which developed during the previous century. The other reason is that Muslim countries remained under the influence of western powers due to colonization. These countries adopted the western model of legal, regulatory, financial and governance mechanisms after

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[42] Frank E. Vogel and Samuel L. Hayes, *Islamic Law and Finance: Religion, Risk, and Return* ,9-10.
[43] Mahmoud Almadani, ' The Role of Sharia Law in Protecting Minority Shareholders in Private Companies' (2010) 21 (12) *International Company and Commercial Law Review* 397.
[44] *Al-Qur'ān, Al-Baqarah,2:*188.
[45] Narrated by Imam Muslim (May Allah be pleased with him) (A well-known Muslim scholar and collector of Sunnahs).
[46] Narrated by Abu Dawood (May Allah be pleased with him) (A well-known Muslim scholar and collector of Sunnahs).
[47] Dr Lu'ayy Minwer Al-Rimawi. 'Relevance of Sharia in Arab Securities Regulation with Particular Emphasis on Jordan as an Arab Regulatory Model' 27 (8) Company Lawyer (2006) 228.
[48] Habib Ahmed, 'Islamic Law, Investors' Rights and Corporate Finance' 12 (2) *Journal of Corporate Law Studies* (2012), 391-2.

independence. This might be the main reason for the stagnancy of Islamic finance in the Muslim world in general and Pakistan in particular. However, during the past century the situation was changing. The financial crisis all over the world during the last part of the previous century stimulated the introduction of an alternative model of financing. Islamic finance, which was not practised in modern times, is considered to have the potential to show its presence and to solve problems. Research has also been carried out in the west regarding the scope and potential of Islamic finance. In recent times modern jurists have been giving due attention to Islamic modes of financing. The Islamic financing can solve the problems of modern financial system under the corporatisation of Islamic mode of business organisations.

Conclusion:

Corporatisation is not an old phenomenon even in the western world. This was started developing in 19th century. This has now almost become uniform in its structure and functioning in capitalist countries with the passage of time. However, the concept of modern form of company, known to western financial system, was alien to classical Muslim jurists. No doubt, there is less literature on contemporary financial system in Islamic financial system developed by the classical jurists. However, the Islamic finance and business organisation was very much in vogue in early period of Islam. The recent industrialisation and globalisation has increased the utility of modern form of company which is not developed under Islamic financial system as has developed in the western world. Most of the Islamic law developed in the early periods of Islam when the modern techniques of financing were not developed. Therefore, classical jurists were not aware of the contemporary techniques of financing which developed during the previous century. Later on there was stagnancy in development of Islamic financial system. The reason is that Muslim countries remained under the influence of western powers due to colonization. These countries adopted the western model of legal, regulatory, financial and governance mechanisms after independence. The situation started changing during the last part of previous century after the financial crisis all over the world. This stimulated the introduction of an alternative model of financing. Islamic finance, which was not practiced in modern times, is considered to have the potential to show its presence and to solve problems. In recent times modern jurists have been giving due attention to Islamic modes of financing.

As discussed earlier, the Islamic injunctions do not prohibit the forming of company as understood in the capitalist countries. Therefore, the Islamic business organisations can be corporatized in the form of western form of business organisations. The functioning of these organisations, with some exceptions, can be in the same manner as the western form of companies. Therefore, the Islamic financing can solve the problems of modern financial system in the Muslim world under the corporatisation of Islamic mode of business organisations.