

Business Organizations under Islamic Law

A Brief Overview

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ABSTRACT

The concept of partnership is uniquely dealt with in Islamic law. Under the *sharī'a*, there is no single definition that covers the different types of partnerships. The definition of each is based on the conditions and rules that govern the relationship. Understanding business partnerships is very important in today's environment. Individuals form associations, corporations, and firms that generate profit through specific businesses. There are partnerships in capital, labor, services, and work. In other cases, one partner nominates the other as his/her agent or trustee. Although Islamic law does not directly address the concept of business/commercial corporations, it does discuss in detail the different kinds of partnerships, based on factors such as responsibility, restrictions, and division of work and profit. The subject is important because it is implicated in the development of business vehicles—i.e., platforms that allow efficient development and structuring of Islamic financial products in the areas of venture capital, project finance, joint ventures, and asset-backed securities.

I. INTRODUCTION

Organizational vehicles set boundaries for designing financial products. However, conventional and Islamic financial products face different issues when developed under existing regulatory frameworks established for corporations. Islamic finance professionals are currently examining products such as tradable instruments (other than stocks), partnership structures, and others. At the same time, it is becoming equally important to review various shells or organizational structures that would support the development of such new products efficiently.

Why must we do this? Currently, when designing Islamic financial instruments, we work within a shell that caters most often to conventional finance, which caters to a different market and presents a different concept from Islamic finance. For efficient structuring of Islamic financial products, it is necessary to review the structure of companies or corporations that would form an optimum platform for designing these instruments. This would require:

1. assessing the financial needs of the beneficiaries of Islamic finance;
2. understanding the organizational structures that are approved under Islamic law;
3. in-depth review of the financial services companies existing in today's market;
4. evaluation of similarities and differences between conventional business institution(s) and those that generally classify as Islamic business organizations;
5. determining key components for structuring corporation(s) that would conform to Islamic law and would also operate within the conventional legal system; and
6. most importantly, structuring companies to meet regulatory approval.

The objective of this paper is to suggest a process of developing an optimum organizational structure that can offer completely integrated Islamic financial institutions serving both borrowers and investors. An optimum organizational structure can be determined by screening for the following criteria: legal considerations; the *sharī'a*; and tax considerations. Here we focus on the first two.

II. CONVENTIONAL LEGAL DEFINITION OF A CORPORATION

In the existing environment, the most popular business vehicle is the "corporation," an artificial person or legal entity created by or under the authority of the laws of a state. A corporation: is an association of persons created by statute as a legal entity; is treated by law as a person that can sue and be sued; is distinct from the

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individuals who comprise it (shareholders); survives death of its investors, as shares can usually be transferred; and has a personality and existence distinct from that of its several members. The purpose of a corporation is either to carry out a business for profit or to provide a service.

As an artificial person, a corporation needs some form of *‘aql* (brain) to carry out business. This brain or decision-making power can be lodged in an individual, or in a group of individuals, such as the board of directors. In either case, these groups act as agents of the company.

As a legal person, a corporation can own property in its name. It can transact business, incur liabilities, and engage in litigation to protect its interest and observe legal duties and restrictions. Also, it has all rights and privileges of an individual, subject to limitations imposed by law or constraints from its nature as an artificial person. Different forms of corporations under conventional law are identified in Table 1.

TABLE 1. MAJORITY FORMS OF CORPORATIONS EXISTING UNDER CONVENTIONAL LAW

Financial Institutions	Companies	Investment Schemes
banks	charities; unincorporated associations	real-estate investment trusts (REITs)
credit unions	firms	investment trust companies
offshore trusts	cooperatives	open-ended investment schemes
investment banks	partnerships	collective investment schemes
cooperatives	limited partnerships	various types of funds
	public limited companies	
	private limited companies	

III. APPROACH

The search for the most appropriate vehicle for developing Islamic financial products could proceed in the following manner:

7. Establish objectives.
8. Research and identify the range of corporate structures.
9. Screen each option by the above criterion.
10. Narrow the range by eliminating inappropriate structures.
11. Review results; subject the remaining corporate structures to further screening; and finally select the optimum structure (structure selected in second tier).
12. Apply the above criterion on second-tier-selected structures.
13. Identify steps to establish the vehicle.
14. Identify internal and external corporate framework.
15. Develop legal and *shari‘a* documentation.
16. Implement (set up) the corporate vehicle.

IV. CORPORATIONS UNDER ISLAMIC LAW

In Islamic law, (classical *fiqh*ⁱ discussions) the corporate form of a business organization as a separate legal entity does not appear directly. Strictly speaking, Islamic business organizations do not have legal personality; they do not exist independently of those who invest in them. The OIC Fiqh Academy accepts the concept of a legal or fictitious personality (*Shakhsyah i'tbariyah*) and so do Muslim scholars (*fuqahā*). The scholars have approved the corporate form on the basis of *fiqh* principles of *qiyas* (analogy) and *istihsan*, or *masalihā mursalah* (public interest). This, however, does not mean acceptance of any modern business corporation within the framework of Islamic law.

The closest approximation to corporate legal entities found in Islam have been *bayt al-māl* (public treasury), mosque property, *waqf* (trusts), and *Muwafada*.ⁱⁱ However, it must be noted that institutions such as *bayt al-māl* and *awqāf* are essentially non-economic organizations, and their features are somewhat distant from those of business-oriented corporations. An example from the Shafi'i schoolⁱⁱⁱ close to the concept of a legal person is a joint stock company.^{iv} According to this school, in the case where more than one person runs a business in common with others and mixes his/her property with those of others, *Zakah* is not levied on each business partner individually, and instead is payable on their joint stock.

The only type of business organization historically found in an Islamic economy and discussed in detail by Islamic law are "partnerships." We will review the different forms of business partnerships under the Hanafi school of Islamic jurisprudence and the laws applicable to these entities when conducting commercial activities.

V. COMPARISON BETWEEN ISLAMIC AND CONVENTIONAL FORMS OF BUSINESS PARTNERSHIPS

A. Partnerships under Conventional Law

According to the definition given in English law, a partnership is the relation that subsists between persons carrying on a business in common and with a view of profit. The partnership business may be owned by two or more persons who are not organized as a corporation. American law gives a similar definition: a partnership is a voluntary contract between two or more competent persons to devote some combination of their money, effects, labor, and skills in pursuit of lawful commerce or business, with the understanding that there shall be a proportional sharing of profits and losses between them. Persons who enter into a partnership to conduct business are collectively called a "firm," and the name under which they operate their business is called the "firm name."

Lawyers accept the idea of a firm. However, to analyze the underlying legal relationship between the partners, it is imperative to understand the exact nature of the partnership. A firm for the lawyer may be an association of persons, a partnership, a limited partnership, or a corporation. In law, partnership and corporation are two separate concepts, although the distinction is rapidly fading. A corporation is assigned a legal personality, whereas a partnership is not.^v

A partnership is a contractual agreement. However, no statute requires that a partnership agreement be in writing. In general, the following matters are dealt with in almost all types of partnerships:^{vi}

17. nature and place of business;
18. provision of capital;
19. ascertainment and division of profits;
20. management of the partnership business;
21. indemnity against liability in the firm's business;
22. remuneration;
23. duration of partnership;
24. death or retirement of a partner;
25. restrictions on a (retiring) partner's carrying on a competing business; and
26. reference of disputes to arbitration.

All partners are allowed (although not required) to share equally in the capital and profits of the business. They must contribute equally toward capital losses sustained by the firm. In English law, if the capital is not contributed equally, a stipulation to pay interest on capital is allowed. In this case, provision is often made for payment of interest on capital before net profits are divided.^{vii} However, a partner is entitled to the interest on capital only after the ascertainment of profits. In the absence of any agreement, express or implied, profits are divided equally because of the inference that the moneyed partner is considered equivalent in skill or knowledge to the other partner. But if the partners divide the profits equally, they must likewise divide the losses. Losses include

not only liabilities to third parties, but also losses of capital. If any partner is insolvent and unable to contribute the required share of lost capital, the solvent partners are not liable to compensate for the insolvent one's deficiency.^{viii}

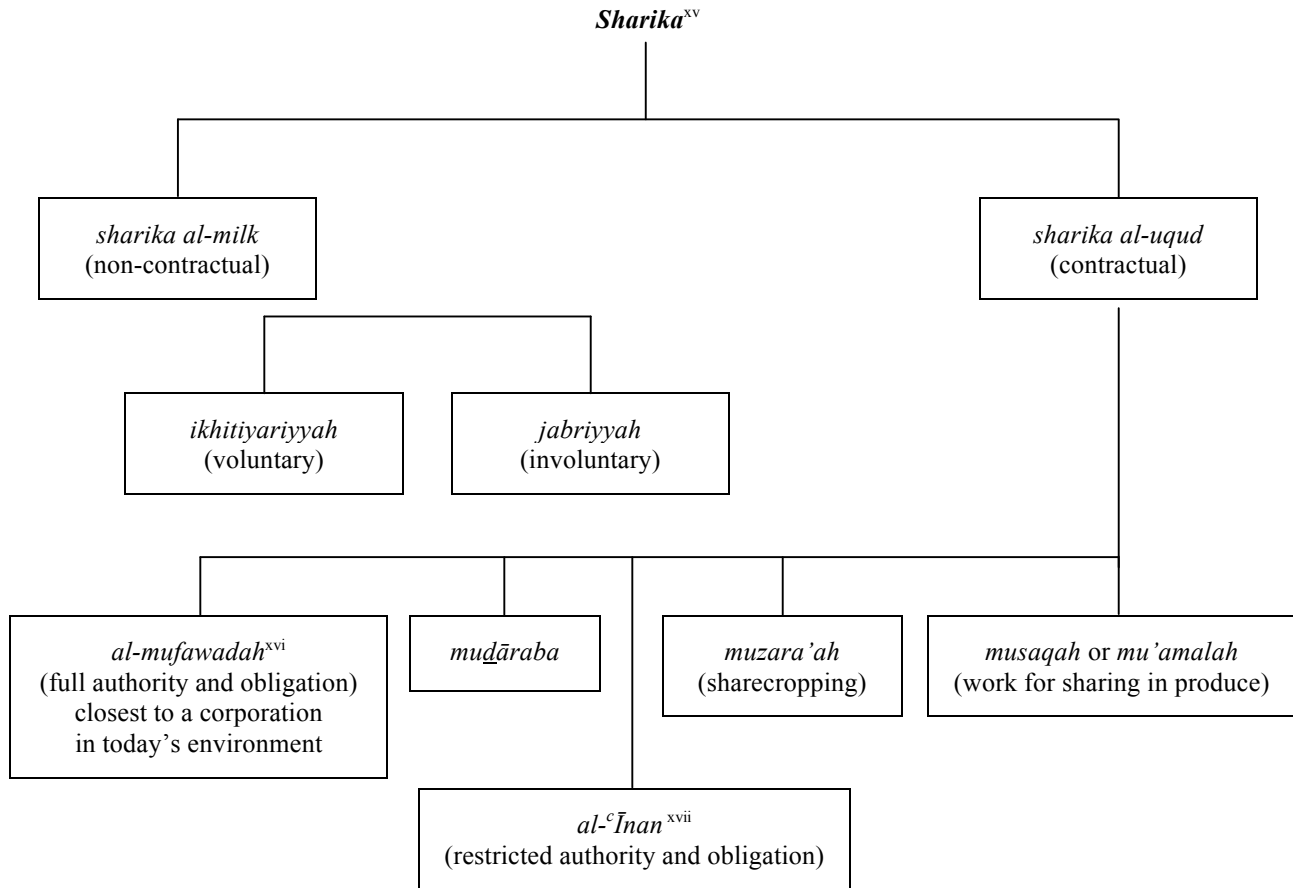
Under English law, there is no necessary connection between the proportion in which the capital is contributed and that of profit and loss. Prima facie, it may appear that the partners share profits and bear losses equally, notwithstanding that the capital contributed by each may not be equal. In other words, the profits and losses are not shared in proportion to the capital contributed by each partner. On the other hand, there is an inference that losses are to be borne in the same proportion in which profits are shared. Therefore, an agreement to share profits in certain proportions is, under English law,^{ix} prima facie evidence that it is intended that losses be borne in the same proportions and not equally.

Unless definite terms are stated, the general rule is that the partnership lasts only during the will of the partners.^x Where no fixed term for the duration of the partnership has been agreed upon, any partner may terminate the partnership at any time by giving notice of his/her intention to do so to all other partners.^{xi} Subject to any agreement between the partners, every partnership is dissolved, as regards all the partners, by the death of any partner.^{xii}

B. Partnerships under Islamic Law

The term *sharika* or *shirka*^{xiii} is used in Islamic law to define partnership.^{xiv} *Sharika* may be of two kinds: *sharikat al milk* (non-contractual), and *sharikat al uqud* or *shirka al aqd* (contractual). Figure 1 summarizes the taxonomy of *sharika*.

FIGURE 1. TAXONOMY OF SHARIKA



VI. ISLAMIC LEGAL DEFINITION OF PARTNERSHIP

The literal meaning of *sharika*, as provided by the jurists, is used in two ways:

A. Mixing or *Ikhtilat*

This implies the mixing the respective shares of capital. Some jurists describe *Ikhtilat* as the attribute of a property that is found in a mixed or mingled state; that is, the mixing of capital shares in such a way as to make individual shares indistinguishable. This means participation: when partners participate, they bring about the mingling of wealth (*khalt*), and hold the resulting wealth jointly.

B. The Contract of Partnership

The second meaning of *sharika* is the contract of partnership itself because it is the cause of *khalt*. Thus the phrase “*sharikat al aqd*” explains it further. A contract defines the type of union and its legal effects. The emphasis is on the relationship that exists between two (or more) partnerships.^{xviii} *Sharikat al Aqd* is an “agreement between two or more persons for common participation in capital and profits.”^{xix} The Hanafī school divides partnerships into two categories, as shown in Table 2.

TABLE 2. CATEGORIES OF PARTNERSHIPS UNDER HANAFI LAW

Category	Forms of Partnership	
Work from both sides	<i>sharikat al-ʿīnan</i> • <i>amwāl</i> – capital • <i>ʿamal</i> – work • <i>wujuh</i> – creditworthiness	<i>sharikat al-ʿīnan</i> • <i>amwāl</i> – capital • <i>ʿamal</i> – work • <i>wujuh</i> – creditworthiness
Work from one side only	<i>mudāraba, muzara’ah, musaqah</i>	

Under business partnerships, the primary structures that must be reviewed include: *sharikat al-ʿīnan* (*ʿīnan* partnership through wealth); Mufawadah by way of *amwāl* (Mufawadah partnership through wealth); and *mudāraba*, which is explained in several books and, as such, will not be discussed in this paper.

VII. SHARIKAT AL-ʿĪNAN

A. Contracts

Four contracts can operate on a partnership basis. However, it is not necessary that all four exist together. These contracts are *amanah* (trust); *wakala* (agency); *kafāla* (surety); and *ijāra* (hire). Every contract contains the contract of agency. The surety contract does not operate in the second category of partnership (*mudāraba*, *Muzara’ah*, and *Musaqah*). The contract of hire does not play any role in the first category.

The *ʿīnan* contract can be of two types: general or special. General *ʿīnan*, also called simply “*ʿīnan*,” is based on an agency agreement, whereas the special *ʿīnan* contract, also called *ʿīnan khāss*, is based on both agency and surety.

B. Fundamental Rules for *ʿĪnan* Partnership

ʿĪnan is a contract without complete equality: the sharing of capital on the condition of trading and dividing profits between them. The single element (*rukʿn*) of an *ʿīnan* (like all other contracts) is the form (*sighah*) of offer

(*ijab*) and acceptance (*qubul*). For *ʿīnan khāss*, the contract of *kafāla* (surety) must be mentioned, otherwise the contract is general *ʿīnan*.

For each type of *ʿīnan* (*amwāl*, *ʿamal*, and *wujuh*), the contract permits participation from all partners in wealth (capital), work, and creditworthiness in any proportion so as to share the profits in an agreed ratio.

For *sharikat al-ʿīnan* based on *amwāl*, capital should be gold or money and cannot be immovable property, merchandise, or goods.^{xx} In *sharikat al-amwāl*, the capital becomes the joint property of the partners, in equal or unequal shares. It must be declared between the shareholders as a proportion, such as a third for each; it may not be specified as a particular amount, for if a fixed amount of profit is given, the partnership is void (*batil*).

In an *ʿīnan* contract where individuals have contributed equal amounts of capital, it is lawful for profits to be divided in differing proportions, provided the person receiving the greater share of the profit is more skilled and bears more responsibility. The right of profit is according to the stipulation stated at the time of making the contract of partnership alone; it is not in accordance to the work done. The entitlement of profit is on the basis of *ḍamān* (liability for bearing loss).^{xxi} In the *ʿīnan* contract, wealth is a basis for entitlement of profit, along with the corresponding liability for bearing the loss.

Partners are *ameen* (agents) of one another in general *ʿīnan*. The partnership's property in the possession of each of them is like a thing entrusted. If this property is destroyed without fault or neglect, one partner is not responsible for the share of the other.

A partnership is dissolved by the revocation of one of the partners, but the other partners must know of its dissolution. When one wishes to dissolve a partnership, the dissolution is not effected until all partners learn of it.

A partner does not possess the authority to take loans in an *ʿīnan* contract. The bearing of loss always follows the ratio of capital contribution. However, a contract stipulation for unequal ratios of sharing in loss is valid.

In an *ʿīnan khāss* contract, which also is based on *kafāla*, one partner is a surety for the other. Thus, the liabilities created in this type of partnership are joint and several. Whatever debt or liability incurred by one partner will have recourse on the other partners as well.

VIII. FUNDAMENTAL RULES FOR MUFAWADAH PARTNERSHIP

Mufawadah is the stipulation of complete equality in wealth or capital, profit and work. This is one of the absolute conditions for the contract. The stipulation of complete equality is for working with one's own wealth or labor, or creditworthiness so that each partner is a surety to the other partner. Under Mufawadah, partners have equal interests and are sureties for one another. Also, there are contracts of *Wakala* and *kafāla* between each partner. Finally, the mufawadah contract requires that the partners meet on equal terms of profit and loss.

IX. LIABILITY OF PARTNERS UNDER ISLAMIC LAW

Under Islamic law, there is no assumption in the contract that liabilities will never exceed assets. The liability of a partner for the debts of a partnership is unlimited; Islamic law does not legitimize the concept of limited liability.^{xxii}

X. CONCLUSION

The above conceptual discussion, though brief, highlights the forms of vehicles that have historically been accepted under Islamic law. Having compared these forms with the vehicles existing under conventional law, it appears that the concept of juristic person for commercial business must first be researched in detail. The model developed must not only be *shariʿa*-compliant, but it needs to work efficiently within present regulatory frameworks. Although the concept of limited liability has been reviewed by the *shariʿa*, the issue itself is still debated among scholars, who must provide a detailed review of this issue and rulings.

ⁱ The term “*fiqh*” literally means “understanding” and “discernment.” In law, it is defined as the knowledge of legal rules pertaining to conduct, which have been derived from specific evidence. See Nyazee, Imran Ahsan Khan. Outlines of Islamic Jurisprudence. Islamabad: Advanced Legal Studies Institute, 1998. p. 29.

ⁱⁱ The Hanafi *Muwafada* partnership constitutes the single exception and is the closest approximation found in Islamic law to a corporate entity.

ⁱⁱⁱ Usmani, M. Taqi. “The Principle of Limited Liability from the *Shari‘a* Viewpoint.” Journal of Islamic Banking and Finance.

^{iv} A joint stock company is an assemblage of individuals formed to start and operate a business organization. It generally shares the same characteristics as a corporation, but does not provide limited liability. Joint stock companies are not common nowadays because it has become easier to form limited-liability corporations under state authorization.

^v In certain jurisdictions (such as Scotland), even partnerships have been assigned a legal personality. Some forms of partnerships have been assigned personality in French law, and hence in Egyptian law. The Uniform Partnership Act in the United States has preferred the entity concept and assigned legal personality even to partnerships.

^{vi} Details as per English law. However, similar details would also be necessary under American law.

^{vii} Under English law, in the absence of such a stipulation, interest on capital is not allowed for the partnership.

^{viii} The amount available after the insolvent partners have made their proper contributions is divided according to the amount of the capital standing to the credit of each partner (not including the insolvent partner who has failed to bear his share of the loss).

^{ix} Partnership Act of 1890.

^x Under English law, the partnership may be continued after the expiration of the agreed term. Where a partnership, entered for a fixed term, is continued after its term has expired, then without any express new agreement, the rights and duties of the partners remain the same as they were at the expiration of the terms, so far as is consistent with the incidents of a partnership at will.

^{xi} A provision that the partnership is to be terminated by “mutual agreement only” will prevent termination at the instance of a single partner.

^{xii} It is usual and desirable, therefore, to make provision for continuing the firm, notwithstanding the death of one or more of the partners, by stating that the business is not to be wound up, but instead the surviving partner or partners is to continue or carry it on.

^{xiii} In Urdu, the word *shirkat*, literally meaning “participation,” is used.

^{xiv} Most often, in Arab countries, the same term is used to refer to both partnerships and corporations. To distinguish between the legal forms, additional terms are used. For example, a company or corporation is called *sharikat al-musāhama*. Saudi law uses the term *nizām* (institutions) for corporations.

^{xv} This diagram shows the Hanafi and the Hanbali division of partnership. The Maliki division of partnership in inheritance, partnership in booty, and partnership in sales comes in the purview of partnership by right of property.

^{xvi} This form is only accepted by the Hanafi school. The three other major schools do not support this form.

^{xvii} This is the only form of partnership that enjoys the *Ijma* (consensus of opinion) from all schools.

^{xviii} Hanafi jurists go into great detail to emphasize the relationship and the legal effects that flow from it.

^{xix} Majallah. Note that this definition has been designed for the partnership form called *sharikat al-amwāl*.

^{xx} Labor and creditworthiness are not included here. If only they are contributed, they are discussed as a different partnership (*sharikat al-‘inan* based on labor or creditworthiness).

^{xxi} The Prophet Muhammad (peace be upon him) has said, “Revenue is based upon the corresponding liability.” Here, it means taking the risk associated with trade and business.

^{xxii} Limited liability is payment of debts of partnership from the entire assets of the partnership, including profits or from whatever is left. Creditors do not have access to the personal wealth of the partners or the wealth that has not been contributed toward the capital of partnerships. Limited liability derives from the concept of the juristic person. However, under Islamic law, the concept of juristic person is known only in cases other than those of commercial entities. For commercial dealings by Muslims in today’s environment, where the corporate world is more complex, limited liability from the *shari‘a*’s point of view is still a debated issue.