

USE AND ABUSE OF LIMITED LIABILITIES

Harvard - LSE Workshop Report, Feb 13, 2014, held at London School of Economics, London.

The 7th London School of Economics (LSE) Islamic Finance workshop was organized (2013) in the backdrop of the global financial crisis that had impacted all and sundry. The workshop had focused on “Insolvency and Debt Restructuring in Islamic Finance”. At the conclusion of the workshop many of the participants shared their feeling that the issue of debt and restructuring is closely linked to the concept of limited liability for corporates. Hence the majority of the participants decided to vote in favor of “Use and Abuse of Limited Liability” for the 8th LSE Workshop.

The topic of the workshop, ‘Use and Abuse of Limited Liability’ was examined from the following angles:

- Juridical person and limited liability: separate concepts or interdependent. What is the extent of justification for them under Islamic law?
- Similarities, differences and implications of a ‘juridical person’ in shari‘ah. Does the concept violate Islamic principle of *al-kharaj bi al-daman*?
- Can examples of ‘juridical person’ be emulated in and extended to other areas?
- Islamic view on one juridical person creating another juridical person.
- Benefits and costs of a Limited Liability Company to investors, shareholders, managers and the society at large.
- Various possible models under Islamic Laws.

Objectives

The main purpose of the workshop was to envisage various models or structures of organizing business that retain the beneficial aspects of limited liability while avoiding the misuse of the concept. Accordingly the objectives set for the workshop were as follows:

1. Revisiting the debate on the shari‘ah viewpoint of juridical person and limited liability;
2. Understanding advantages and benefits of limited liability to economy and business (public) in general and to promoters, shareholders, and employees in particular;
3. Discussing disadvantages and misuses: causes and extent;
4. Exploring remedies and options.

Professor Frank Vogel, the moderator of the workshop, re-emphasized the importance of gathering five key stakeholder groups at the workshop, namely: shari‘ah scholars, economists, practitioners, lawyers and industry organizations. He said that every time we pick a worthwhile and substantive issue the real purpose is to use the issue to debate how the industry itself makes decisions – how it weighs considerations that are ethical, religious, legal, economic, financial,

professional, political, reputational, and purely pragmatic to come to a conclusion on a specific issue.

Professor Vogel divided the agenda of the day-long workshop into three parts.

1. The shari‘ah issues and positions on juridical person and limited liability;
2. The economic issues and consequences of the use (*maslaha*) and abuse (*mafsada*) of the limited liability concept and how to manage the costs and benefits;
3. Shari‘ah compliant optimal organizational forms in the context of the benefits and misuses of limited liability.

Limited Liability and Legal Personality: Benefits, Costs and Concerns

The workshop began by listing several benefits of limited liability such as ability to bring together large groups of investors as one body, providing continuity for the enterprise regardless of the changing circumstances of shareholders and shielding the shareholders from unanticipated liabilities arising from the running of the business. It also provides investors an opportunity to diversify their investments across various projects rather than just in projects that they can manage themselves. Limited liability also enables small savers to invest in businesses that otherwise may be confined to wealthier investors.

These benefits, however, come with certain disadvantages. For example; it allows business managers to sometimes indulge in excessive risk taking by borrowing huge amounts of money to increase profits and hide behind the corporate veil if the venture fails, which results in the privatization of gains and socialization of losses. Many of the ills in today’s financial system, such as short-termism in the financial markets, excessive indebtedness and speculative risk-taking can be attributed to the concept of limited liability as those responsible are able to protect their personal wealth regardless of what happens to the venture for which they are responsible. The presenter also posed certain questions to the participants. For example:

- When can the corporate veil be pierced? And should it be automatic or should it be looked at on a case-by-case basis?
- What are the implications for bankruptcy and defaults within limited liability? Should we go for a regulated limited liability regime or should it be limited liability as a rule?
- Whether limited liability and legal person can be separated in shari‘ah or it has to be combined for a shari‘ah ruling.
- How to deal with different shades of limited liability company (LLC)? In different countries and at different times the limited liability concept can be applied differently.
- Can an LLC by itself create other LLCs and what are the parameters for it? Where to put a stop to this process and on what basis?
- What are the different shades of legal personality?

Scope of Limited Liability and Legal Personality in Shari‘ah

The participants agreed that interpretations of shari‘ah have allowed the concept of juridical person and limited liability and their use is widespread in Islamic finance and in Muslim

countries in general. More importantly the concept has been accepted across the world including by the Islamic standards setting bodies such as AAOIFI and *Majma Fiqh al-Islami*, etc.

One participant highlighted the concept of separation between ownership and management. Referring to the *mudaraba* contract it was pointed out that any liability incurred by the *mudarib* without the express permission of the *rabbal maal* is the responsibility of the *mudarib*. Therefore, to shift the responsibility onto the *rabbal maal* (beyond his capital), it has to be proved that all the actions of the *mudarib* were conducted keeping the *maslahah* of the *rabbal maal*. For example, if an Islamic bank fails, its creditors cannot have any recourse to the *mudaraba* fund (or investments accounts) managed by the Islamic bank as the fund does not belong to the bank. The debate on this issue concluded that overall there are many more benefits in limited liability that serve *maqasid al shari'ah* than causes for disquiet. A hadith related to Saeed ibn Mohal was also quoted in this context where the Prophet Muhammad allowed his creditors to take recourse to the garden that he had and beyond which they had no claim. Taking a cue from this ruling it was argued that creditors have no claim over the future earnings of the bankrupt, let alone having any claim in the Hereafter.

A participant then questioned what stopped classical *fuqaha* from not starting a joint partnership with limited liability? This was clarified: since the concept of juridical personality was not established at that time, any business was actually a personal company owned by its partners, who were liable for the responsibilities through their personal wealth. After the concept of juridical personality was introduced and developed, however, it was adopted under shari'ah.

A participant noted that taking a historical perspective, the idea of a limited liability corporate as a separate legal entity was developed in the time of European expansion to fund the exploration and exploitation of global resources. It provided a successful corporate structure for that purpose and has since been adapted to suit contemporary commerce. The emergence and development of the limited liability corporate structure proceeded without any serious engagement by Muslim jurists and scholars. The association of the limited liability corporate with colonial forerunners such as the East India Company led to the development of many negative connotations about this emerging structure to facilitate commerce. This is very similar to negative sentiments about capitalism due to its close association in Muslim minds with colonialism. There is, therefore, a need to separate these negative sentiments from the arguments based on the usefulness or otherwise of the underlying substance of the limited liability corporate.

It was also suggested that profit sharing is the opposite of lending money at interest or the prohibited *riba*. Profit sharing requires business partnerships and it is these business partnerships, which early on did not have limited liability, that have evolved into limited liability companies.

Managing Abuses in Limited Liability

The discussion then veered toward managing abuses. The moderator posed the question: what is required from an Islamic point of view to rectify abuses and whether it is sufficient to just rely on western legal systems, which focus more on managers and majority shareholders when it comes to managing abuses?

A participant pointed out that the real question in this regard is who controls decisions and who is responsible for abuses. In a small private company shareholders make decisions and should be liable. In a large company, however, it is managers and not shareholders who run the business. The moderator then asked, if you are in a position to control the actions of your company, does Shari'ah say you should also face the consequences even beyond limited

liability? Two of the Shari'ah scholars answered that if the shareholders are represented by a board of directors then the directors shall be responsible for any act of omission or commission as per the corporate governance code, which covers potential misuse of limited liability. If, however, the board of directors has been acting according to the articles of association and terms and conditions of their appointment then the responsibility for their actions will fall on the shareholders.

It was also highlighted that economic development requires risk-taking. If there is too onerous a burden imposed on those running limited liability corporations, putting their personal wealth and by implication the well-being of their families at risk, it may dissuade risk-taking to the detriment of economic development.

Piercing the Corporate Veil: When and How

This session began with issues related to piercing the corporate veil and under what conditions it may be pierced in the United Kingdom. It was suggested that the only possibility of piercing the veil is in a situation where the corporate form is used to avoid an existing liability. As far as future obligations are concerned it is acceptable to use the form to limit your liability, even in cases which appear unacceptable. For example, a pharmaceutical company that has a product that they think will hurt people, yet they develop it in a subsidiary, the corporate veil will not be pierced. When asked about the possibility of managers/directors being held responsible for their actions, it was clarified that, save in the situation where the company is already in insolvency, the directors have an obligation to use the powers they have to promote shareholder value. As long as the company is a going concern, those directors are not burdened with the interests of creditors.

The moderator then asked the scholars if they would be satisfied with the corporate governance rules as practiced in the United Kingdom. One shari'ah scholar suggested that rules for piercing the veil should be made clear and objective rather than left to the sole interpretation of judges. Another participant noted that limited liability companies did not grow organically in Islamic culture. The SPV (special purpose vehicle) model is also imported from the West. Instead of trying to find Islamically unique solutions to those problems, therefore, we should accept the solutions that are applicable in those countries. Another participant refuted this assertion on the ground that shari'ah allows borrowing outside the realm of rituals. He argued, 'You can use a tool you have not developed, but it must conform to the rules of shari'ah. It is important to develop necessary sensors to detect specific pitfalls and dangers to be able to protect yourself'.

The Role of SPV's and Limited Liability in Sukuk

Many participants raised the question of the growing use of SPVs in issuing *sukuk* (Islamic debt securities). Some of them were very critical of the miniscule capital base of these SPVs and called for restrictive use of these structures. One participant suggested AAOIFI should come up with a Shari'ah standard on SPVs. Another participant noted that the demand for restrictive use of SPVs is not because of its limited liability feature nor are SPVs invented on the advice of Shari'ah scholars, but lawyers need them for various reasons including tax benefits and bankruptcy remoteness. He cautioned that the concern should actually be how these SPVs are

used as a tool and whether they are used for private gains or for the benefit of society at large. If these vehicles are used to defraud people then they should be dealt with accordingly.

Another participant pointed out that the issue of transfer of ownership of assets into SPVs is not clear and therefore the ultimate responsibility still lies with the corporate (originator). It was also noted that many *sukuk* holders instead of claiming assets go for recourse to the originator.

A practitioner who has been part of many landmark *sukuk* stressed that the SPVs are created for nothing but logistic purposes. Since there are thousands of *sukuk* holders, a vehicle is needed to represent them. Since at the time of issuance the investors are not there, the documents are signed saying it is on behalf of beneficiaries who will come later. The SPV is needed to buy the assets on behalf of future investors and then to lease the same on behalf of the *sukuk*. The trust structure facilitates the transferability and allows the documents to be signed in advance of issuance itself. SPVs own the assets on behalf of the investors. From an accounting perspective also legal ownership rests with the lessee.

The SPV structure also plays an important role in acquiring high-risk assets, where the financiers want to ring fence the liability by creating an orphan SPV, where the shares are held in trust for some charity. A charity is brought into the picture because it cannot be sued. In case of something going wrong the banks have a first priority charge over the asset and if a third party claim is enforced, you say the ultimate owner is a charity which cannot be sued. It was argued that in the absence of limited liability, nobody would finance aircraft. The SPV, therefore, is a standalone entity without any ulterior motive or purpose.

Summary and Conclusion

The last session of the workshop was devoted to summarizing the day-long discussions and drawing some conclusions from it.

The moderator invited responses to the idea of imposing liability on the shareholders and managers for the misuse of limited liability. He also suggested the institution of non-legally-binding but ethical standards or industry standards under the corporate governance rules. He wanted to know if the discussion could be enlarged to include trusts and mutuals as they too are reported to have been used inappropriately. He asked participants to highlight whether there is any Shari'ah-specific suggestion and criteria or it is acceptable to work with the existing system. He further asked participants their views on whether transparency in disclosure is a sufficient requirement to justify limited liability or whether the existence of a separate legal person underlying the concept of *dhimmah* is also required as a basis and what is the logic behind the shari'ah acceptance of these notions. What is the possibility under Islamic law of imposing additional obligations of disclosure? Who will enforce them and in what context will they be enforceable?

Participants reacted to these queries in different manners. One noted that any new structure that is developed is for a purpose, but over a period it starts getting misused. The message is to remain vigilant, therefore, as the issue is more of a regulatory than statutory nature. Some others tried to cite real life examples. For instance, Malaysians have a statutory provision for piercing the veil in case of tax evasion. One participant highlighted the role of credit bureaus in providing disclosures and making available the necessary information about the creditworthiness of the borrower. On the other hand some contended that a credit history is not available for all transactions and more importantly it is not accessible to

all. One participant highlighting the shari‘ah aspect referred to a hadith describing delayed payment as an injustice punishable by exposing the delinquent.

A suggestion was made to put some sort of restrictions on limited liability. One participant tried to highlight the difference between natural factors leading to failure and fraudulent behavior. Another suggested providing incentives to those who are cautious in incurring obligations or taking too much risk. To control the misdemeanor, especially in the context of overleveraged banks it was suggested that a look should be taken at the German mutual and cooperative bank model, where shareholders could be made liable beyond their share capital. The moderator highlighted Saudi corporate practices where shareholders are required to provide guarantees if their company’s capital drops to one quarter of its total obligation. One participant drew attention to the new Malaysian Companies Act imposing higher duties on managers and increasing shareholders’ responsibility.

One participant argued that the business known as the John Lewis Partnership in the United Kingdom could be a model for Islamic enterprises. John Lewis is owned on trust for the benefit of its members. Every employee of John Lewis becomes a member on the day they join. The trustee of the settlements is the John Lewis Partnership Trust Limited. Its chairman is the partnership chairman and its other directors are the deputy chairmen. The Partnership is governed according to a written constitution, which is subordinate to and must not conflict with the settlements. Power in the partnership is shared between three governing authorities: the Partnership Council, the Partnership Board and the Chairman. Profits are used to sustain commercial vitality and distribute to the members. Each year every employee receives a percentage of their salary as a bonus. The company also provides benefits such as holiday houses that the partnership maintains. Employees who have worked at the company for 10 years or more also continue to receive benefits after they retire such as 20% off John Lewis products. The John Lewis partnership with its happy customers, employees and management may be what we would want shari‘ah businesses to consider as a model.

Looking from another perspective it was observed by participants that the current financial system has a deep influence on the capital structure used by companies. Since debt is made cheaper than equity, it is unlikely that reliance on debt will change unless equity and debt are brought to a level playing field. The systematic preference of debt over equity runs like an underlying theme behind abuse of limited liability.

(This report is published in New Horizon, Issue No. 191, 2015, pp.43-46)