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AN OVERVIEW OF THE PRINCIPLE OF SEPARATE LEGAL ENTITY FROM ISLAMIC PERSPECTIVE

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Abstract

The incorporation of a company is the result of an association between a few people (shareholders) who contribute a certain sum of money with the same objective of maximising profits through a platform called “company”. Upon incorporation, there will be a separate entity of a company different from the original members who associated themselves to be the shareholders of the company. Although common law recognises the principles of separate legal entity in a company, the same is not recognised from the Islamic point of view since Islamic teaching only recognises the ‘real’ entity, a natural person contrary to common law which recognises a legally fictitious person. Research on the principle of separate legal entity from the Islamic perspective is sparse. This paper aims to explore the principle of separate legal entity from the Islamic point of view. This research found that although the principle of separate legal entity is not recognised under Islamic law, there is evidence that modern Muslim jurists have accepted the principle in Islam with careful treatment, and adherence to certain conditions to be in line with the Shariah Law. The outcome of this study adds valuable insights into legal knowledge, particularly in corporate law and Islamic Law.

Keywords: the principle of separate legal entity, Shariah law, company, legal *persona*,

1. INTRODUCTION

The incorporation of a company is the result of an association between a few people (shareholders) who contribute a certain sum of money with the same objective of maximizing profits through a platform called “company”. The company is a statutory creation, and registration of such body corporate is made at the Registrar of Companies. A company is a recognised body under the law and is able to commence business subject to the provision of the Malaysia Companies Act 2016 (CA 2016), a revamped statute from the previous Malaysia Companies Act 1965. Section 9(c) of the CA 2016 allows companies to be incorporated with a minimum of one person. The moment a company is incorporated, there will be a shield known as the ‘corporate veil’ which protects the members and officers of the company from the company’s debts and obligations (Hameed, 2012; Ng & Chang, 2021).

Upon incorporation, a company has its own legal entity. This means that once a company is formed, there will be a separate entity of a company different from the original members who associated themselves to be the shareholders of the company. The principle of separate legal entity is derived from a United Kingdom (UK) common law case *Salomon v Salomon Co. Ltd.* (1897) where the House of Lords established a principle that a company and its members are separate persons. Lord MacNaghten in the case stated:

The company is at law a different person altogether from the subscribers to the memorandum; and, though it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or trustee for them. Nor are

the subscribers as members liable, in any shape or form, except to the extent and in the manner provided by the Act (p. 51)

The aforesaid principle propounded by Lord MacNaghten was codified in section 20 of the Malaysia CA 2016 which provides that the moment a company is incorporated, the company has a distinct personality, separate from its members and continues to exist until it is removed from the register.

Lord Buckley LJ in the case of *Continental Tyre & Rubber Company (Great Britain) Limited v Daimler Company Limited* (1915) stated:

“The artificial legal person called the corporation has no physical existence. It exists only in contemplation of law. It has neither body, parts, nor passion. It cannot wear weapons nor serve in the wars. It can be neither loyal nor disloyal. It cannot compass treason. It can neither friend nor enemy. Apart from its corporators, it can have neither thoughts, wishes, nor intentions, for it has no mind other than the minds of the corporators” (p. 916).

Lord Buckley’s statement proved that although a company does not physically exist, a company has a legal *persona* in line with section 21 of the CA 2016 which amongst others the ability of the company to sue and be sued, to own and dispose of property and to be able to enter transactions with rights and obligations. The recognition of the principle of separate legal entity has continued since its inception until today. The principle of separate legal entity refers to companies or corporations which are incorporated pursuant to the legislation, i.e. CA 2016. Quite a number of companies in Malaysia have adopted Shariah Compliance principles in their business, especially Islamic banks and this raises the question of the reconciliation between the principles and the adaptation of Shariah law in the business. A lot of studies and cases have referred to the principle of separate legal entity, however, studies on the principle of separate legal entity from the Islamic perspective are sparse. Hence, this paper aims to explore the principle of separate legal entity from the Islamic point of view. The outcome of this study adds valuable insights into legal knowledge, particularly in corporate law and Islamic Law.

2. LITERATURE REVIEW

Different types of companies are provided under sections 10 and 11 of the CA 2016. Despite various types of companies, the legal concept for all remains the same, i.e. the principle of separate legal entity. The law in Malaysia recognises the principle of separate legal entity in a company based on the landmark case of *Salomon v Salomon Co. Ltd.* (1897). The same concept of company does not exist in Shariah Law. Shariah Law only recognises *Shirkah*, an arrangement between two or more people for participation in a capital and its profit (Hafeez, 2013b). The concept of *Shirkah* can be said to be similar to a partnership, i.e., the association of partners among themselves to have a business in order to make profits and such profits are distributed among the contracting parties as dividends of shares.

An author, Hafeez (2013a) opined that in Islam, the concept of a company is not against the injunctions of Islam, which means that it is not prohibited by Islam. The author contended that the principles of Islamic law of contract and partnership provide the comprehensive framework for commercial practice and the concept of liability had been adopted by the early jurist and not repugnant to any injunction of the Holy Qur’an and Sunnah. The author elaborated that *Bait-ul-Mal*, *Waqf* and *Masjid* are examples of Islamic incorporation and formation of legal persons since all three institutions have the characteristics of legal persons. Hasan (2013) stated that the concept of a corporation existed in the form of a limited partnership or *Syarikah al-Inan*, where the shareholders may sell their shares in the market and their liability is limited. Limited liability in *Syarikah al-Inan* is similar to section 192 of the CA 2016 where the statutory provision provides that the liability of a shareholder of a company limited by shares is limited to the unpaid amount of shares held by the shareholders. Another Islamic concept of *mudharabah* reflects many similarities with the corporation such as the transfer of shares by one shareholder to another person and the separation of ownership and control (Azrae et al., 2009)

Modern Muslim jurists have accepted the principles of separate legal entity based on the concept of *dhimmah*, the capacity to acquire and exercise rights and obligations (Hafeez, 2013a, Cheong, 2020). The modern jurists based their reasoning on the existence of *Bait-ul-Mal*, *Waqf* and *masjid* (mosque), wherein the *waqf* is an Islamic institution accepting properties from persons who gave it for charitable purposes. Once a property has been donated and declared as *waqf*, the donor is no longer the owner of the property but belongs to the *waqf* institution, which means that the *waqf* institution may own the property, thereby creating a separate legal entity (Cheong, 2020). Whilst *Bait-ul-Mal* is the treasury for the Muslim community which accepts and keeps all of the proceeds of donations, *zakah* is paid to the State. One of the Islamic jurists, Hanafi stated that *Bait-ul-Mal* has rights and obligations towards people in need and can act on its own, contrary to the beliefs of the Hanafiyyah who argued that institutions such as *Bait-ul-Mal*, *Waqf* and *masjid* are not eligible to rights and obligations (Busari et al., 2019).

3. METHODOLOGY

This study utilised doctrinal legal research which involves an analysis of legal propositions or legal concepts (Gawas, 2017). The objective of the doctrinal research for this study is to analyse the application of legal doctrines and the authoritativeness of relevant laws, cases, and principles before deriving the right decisions based on evidence extracted from the legal documents (Pradeep, 2019). The process of this study involves online library-based data collection from legal precedents and legislative interpretation, mostly obtained from readings of cases, statutory provisions, rules, regulations and other legal documents relevant to common law companies and also in relation to Shariah Law

4. RESULTS AND DISCUSSION

4.1 Common Law Perspective

An English jurist (Savigny, n.d, as cited in Abd Ghadas & Aziz, 2018) stated that the law recognised ‘natural persons’ and also fictitious, artificial or juristic persons such as corporations. This is contrary to the teaching of Islam, where Islamic law does not recognise corporate personality (Schacht, 1964 as cited in Busari et al., 2019), which further shows that there is no such thing as an Islamic company having a separate legal entity. Hafeez (2013a) was of the opinion that the word ‘person’ (which can also mean legal *persona*) referred to an individual human being, but in law, it has technical meaning in the sense of ‘rights’ and ‘duties’.

One of the effects of incorporation of companies is the continuous existence of companies despite the death of shareholders, and the companies will continue in existence until shareholders decide to wind up the companies or the Registrar of Companies strikes off the companies’ names from the register (*Re Noel Tedman Holding Pty Ltd.*, 1967; *Tan Lai v Mohamed bin Mahmud & Ors*, 1982). The continuous existence of a company is contrary to the Islamic point of view since Islam accept human beings, who can die and human can have *aql* (intellectual) and have the will to perform their own duties and obligations (Azrae et al., 2009). From the Islamic perspective, a corporation or company does not exist since Islamic law does not recognise fictitious persons compared to common law where the principle of separate legal entity has given recognition of individualism to companies as stated by Cave J in the case of *Re Sheffield & South Sheffield Yorkshire Permanent Building Society* (1889) where he said, “A corporation is a legal *persona* just as much as an individual” (p.476). Such recognition of legal *persona* can mean that the company can be treated as an individual and may enter a valid contract with anyone including its own members and officers. Companies incorporated under CA 2016, even with one member, have a separate legal entity or legal *persona*.

4.2 Islamic Law perspective

Companies in Malaysia can be the types of companies under section 10 of the CA 2016 (a company limited by shares, a company limited by guarantee or an unlimited company) or under section 11 of the CA 2016 (either a private company or a public company). Companies are managed and controlled by the board of

directors (the board) of which the shareholders can also be the directors. The board will have its duties and liabilities towards shareholders and stakeholders and make decisions during general meetings. The board comprises of directors appointed by the shareholders, and they are natural persons. Despite the argument that companies do not exist from the Islamic point of view due to the non-acceptance of 'fictitious' persons or due to the non-existent of natural persons, Hasan (2013) was of the view that Muslim jurists have accepted the concept of a corporation known as '*Shahsiyah I'tibariyah*' (juristic person) based on the principles of *qiyas* (analogy), *istihsan* (equity), *masalih mursalah* (public interest) and *dhimmah*. According to *Madhab* al-Syafie jurists, *al-Dhimmah* is an attribute of human beings with duties (*al-ilzam*) and obligations (*al-iltizam*) (Al-Kabashi, 1989 as cited in Abd Ghadas et al., 2017) which definition is also accepted by jurists of *Madhab* Maliki, Hanafi and Hanbali (Al-Buhuti, 1947 as cited in Abd Ghadas et al., 2017).

Previous studies also found that in the Islamic doctrine of *masalih mursalah* (public interest), the State may consider it essential to accept such principles of separate legal entity and allow the establishment of the corporation as a business organisation as long as it is for the benefit of the society, for example, an Islamic bank. Although *dhimmah* (duties and obligations) is only available through *insanniyyah* (being a natural person) (Ramli & Ghadas, 2019), modern Islamic jurists accept the corporation despite its fictitious legal *persona* since the State accepted corporations due to *masalih musalah*. The fact that corporations neither have heads nor hands but are being managed and controlled by the board of directors, it is submitted that the same concept is similar to *dhimmah*, where there are people who are clothed with duties and obligations.

In Islam, the only type of business that is recognised is the business of partnership or '*shirkah*' (or *sharikah*), which is a partnership between two or more persons (Abd Ghadas et al., 2018) who agree with another for some work for the purpose of profit (Susanto, 2014 as cited in Abd Ghadas et al., 2018). Since Shariah Law only recognises *Shirkah*, Table 1 summarised the characteristics of a company and a *Shirkah*.

Table 1. Findings

	Conventional	Islamic
Type of business organisation	Company	<i>Shirkah</i>
Incorporation	Incorporated pursuant to Malaysia CA 2016.	An agreement between partners to share capital for the purpose of business. In Malaysia, can register partnership with Registrar of Business.
Ownership	Shareholders	Partners
Separate Entity	Companies have a legally separate entity from the shareholders.	The business partnership has no separate entity from the partners.
Management and Control	Directors through the board of directors.	Partners.
Can the business organisation act on its own?	No, it must be done through the board of directors.	No, recognition is only on the partners.
Can the business organisation be Islamic?	No, but the directors can value and exercise the Shariah's practice.	No, but the partners can exercise the Shariah's practice.
Who has the duties and obligations?	Directors	Partners

From Table 1, there are similarities between company and *Shirkah* and one of the differences is the separate legal entity. In *Shirkah*, the partners actively manage the business, and each partner enjoys the contractual rights, benefits, powers and profits as provided under the mutual agreement subject to the customary practice or *'urf*. According to Maliki jurists, the partnership granted each other to do transactions while retaining the rights, which is similar to Hanbali jurists, where the latter defined *Shirkah* as the joining together in entitlement or the right of transaction (Mohiddin et al., 2021). The concept of corporation and *Shirkah* does not make much difference when it comes to practising the business. Both the company and *Shirkah* have the same duties and obligations. Thus, these findings are in line with the modern Muslim jurists who have accepted the principles of separate legal entity based on the concept of *dhimmah*, the capacity to acquire and exercise rights and obligations.

In Malaysia, the recognition of a legal person is only found in *Bait-ul-Mal*, *waqf* and *masjid* (Hafeez, 2013a). An example of a corporation carrying on the values of Islamic teachings in carrying business is the *waqf* corporation of Waqaf An-Nur Corporation established in 2004 by the Johor Corporation. Under this *waqf* corporation, the practice of *Waqf* (endowment) is structured into commercial corporations whereby it is compulsory for the companies to contribute to society and it is a must for them to spend a certain amount of their profit on the community (Abd Ghadas & Abd Aziz, 2017). However, there are certain modifications to be made to the corporation to ensure its compliance with the Shariah principles of business. Modern Muslim jurists are against total acceptance of the common law principle of separate legal entity, although they agree that corporate personality is generally viable, and a balance has to be struck between the non-human fictitious *persona* and the *dhimmah* under the Shariah law (Abd Ghadas & Abd Aziz, 2017). The management of the companies is civil in nature since it is being managed by the board, thus Islamic compliance can only be in the sense of the individual being the directors of the companies who have the *'aql* (intellectual capacity) of following the Islamic teaching. Thus, when the directors decided that the companies should give *zakah*, it showed that the company was following Islamic teachings and was similar to human beings.

Although there are strictly no proper Islamic corporations, there are corporations that will try as much as possible to comply with the Shariah practice. In Malaysia, the Shariah supervisory board has the authority to conduct a Shariah audit of Islamic Financial Institutions (Nidyanti & Siswanto, 2019) to ensure compliance with the regulations, since there are a lot of Islamic banks in Malaysia. For corporation such as banks which requires Shariah compliance, funds and operations must be “segregated” from other activities of the bank (Gheeraert, 2014). To ensure compliance, organisations must go through the Shariah compliance process which is a standard procedure of ensuring the products and services offered by Islamic Financial Institutions adhere to Shariah’s standards (Bin Ismail, 2018). It is submitted that Shariah compliance is only on the practice of running the business, but the main crux of the business is still the typical conventional common law company set up under the CA 2016 or the earlier CA 1965.

5. CONCLUSION

This paper attempts to explore the principle of separate legal entity from the perspective of Islam. The principle of separate legal entity derived from the common law case *Salomon v Salomon & Co. Ltd.* (1897) which had been adopted by the judiciary in court cases and codified in the Malaysian CA 2016. The principle of separate legal entity acknowledges the existence of the company on its own and its ability to do all acts as provided by section 21 of the CA 2016. The common law principle of separate legal entity was not found in the Shariah law, but modern Muslim jurists have accepted the concept of a corporation known as *'Shahsiyah I'tibariyah'* (juristic person) which is similar to the principle of a separate legal entity. Although the principle of separate legal entity is not recognised under Islamic law, there is evidence that modern Muslim jurists have accepted the principle in Islam with careful treatment, and adherence to certain conditions to be in line with the Shariah Law.

Islamic jurists acknowledge similarities of the characteristics of companies and *Shirkah* but the non-existence of the principle of separate legal entity in *Shirkah* makes companies differ. Nevertheless, Islamic values are incalculable through the practice of Shariah compliance in financial institutions such as Islamic

banks. Thus, Islamic banks can practice Shariah values through the Islamic doctrine of *masalih mursalah* (public interest) which establishment of an Islamic financial institution will benefit society. Although the company exists because it has its own legal *persona*, directors of the companies have the *'aql* (intellectual capacity) to follow Islamic values in their companies and also to adhere to the Shariah's standards set by the regulators regardless of the principle of separate legal entity. This study did not explore the governance of companies in detail which have adopted the Shariah Law elements in their business and only explored the principle of separate legal entity from the Shariah perspective, it is suggested to conduct quantitative research on companies that practice Islamic values in order to identify whether the players in the industry understand the principle of separate legal entity.

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