

# **The Financial Distress of Corporate Personality: A Perspective from Fiqh**

**Saheed Abdullahi Busari\***

**Luqman Zakariyah\*\***

**Amanullah Muhammad\*\*\***

**Akhtarzaite bint Abdul Aziz\*\*\*\***

Abstract: Oriental scholars discuss the concept of corporate personality without any reference to Islamic law. A leading proponent of this view is Joseph Schacht; a western scholar of jurisprudence who contended that Islamic jurisprudence is limited to individual personality and devoid of corporate laws, hence, contractual agreements between corporations has no basis in Islamic law. Several scholars and researcher have responded with sufficient literature on the status of an artificial person in Islamic law, but there are still issues with the legal implication of corporate personality in the event of financial distress. This study aims to explore Islamic threshold on fundamental principles of corporate personalities and its contemporary applications in the situation of financial trouble. The study will employ the analytical approach in describing the essential characteristics of a corporation as inherent in Islamic law through interpolation from the natural person and the possibility of adapting the existing conventional bankruptcy laws. This study employs an analytical approach to

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\*PhD Candidate, Department of Fiqh and Usul Fiqh, Kulliyah of Islamic Revealed Knowledge and Human Sciences, International Islamic University Malaysia. Email: [mrbusarisheed@gmail.com](mailto:mrbusarisheed@gmail.com)

\*\*Associate Professor & Head, Department of Fiqh and Usul Fiqh, Kulliyah of Islamic Revealed Knowledge and Human Sciences, International Islamic University Malaysia. Email: [lukzaq@iium.edu.my](mailto:lukzaq@iium.edu.my)

\*\*\*Professor, Department of Fiqh and Usul Fiqh, Kulliyah of Islamic Revealed Knowledge and Human Sciences, International Islamic University Malaysia. Email: [amanullah@iium.edu.my](mailto:amanullah@iium.edu.my)

\*\*\*\*Assistant Professor, Department of Fiqh and Usul Fiqh, Kulliyah of Islamic Revealed Knowledge and Human Sciences, International Islamic University Malaysia. Email: [akhtarzaite@iium.edu.my](mailto:akhtarzaite@iium.edu.my)

Islamic literature and regular related works. The study found out that even though the concept of financial distress has basis in Islamic law, it remains complicated as it entails insolvency, bankruptcy and interdiction in a debtor-creditor relationship. Overall, further efforts need to be done to put these concepts into contemporary and applicable perspectives without violating Islamic fundamental principle of justice and fair dealings.

**Keywords:** Financial Distress, Artificial personality, Corporation, Islamic Jurisprudence

**Abstrak:** Para ulama Oriental berpendapat bahawa kepribadian korporat sebagai konsep tanpa asas dalam undang-undang Islam. Penyokong utama pandangan ini ialah Joseph Schacht; seorang sarjana barat jurisprudensi yang berpendapat bahawa perundangan Islam adalah terhad kepada keperibadian individu dan tidak mempunyai undang-undang korporat, oleh itu, perjanjian kontrak antara syarikat tidak mempunyai dasar dalam undang-undang Islam. Beberapa sarjana dan penyelidik telah menanggapi dengan sastera yang mencukupi tentang status seseorang yang tidak disengajakan dalam undang-undang Islam, tetapi masih ada isu-isu dengan implikasi undang-undang keperibadian korporat dalam keadaan kesulitan kewangan. Kajian ini bertujuan untuk meneroka ambang Islam pada prinsip asas personaliti korporat dan aplikasi kontemporarinya dalam keadaan masalah kewangan. Kajian ini akan menggunakan pendekatan analitik dalam menggambarkan ciri-ciri penting sebuah syarikat yang wujud dalam undang-undang Islam menerusi interpolasi dari orang asli dan kemungkinan menyesuaikan undang-undang muflis konvensional yang sedia ada. Kajian ini menggunakan pendekatan analitik terhadap kesusasteraan Islam dan kerja-kerja berkaitan tetap. Kajian itu mendapati bahawa walaupun konsep kesulitan kewangan mempunyai asas dalam undang-undang islam, ia tetap rumit kerana ia melibatkan ketidakmampuan bayar, muflis dan penahanan dalam hubungan penghutang penghutang. Secara keseluruhan, usaha selanjutnya perlu dilakukan untuk meletakkan konsep-konsep ini ke dalam perspektif kontemporari dan terpakai tanpa melanggar prinsip keadilan asas Islam dan urusan adil.

**Kata kunci:** Kecacatan Kewangan, Keperibadian Buatan, Perbadanan, Perundangan Islam

## Introduction

Contemporary Islamic Jurist have argued against the position of some orientalist particularly Joseph Schacht that artificial personality of the corporation lacks in classical Islamic jurisprudence is a position far from the truth. Even though most of the former scholars of the four schools

of law do not categorically mention an artificial person in their writings, its application could be analogically inferred from many of the Islamic principles relating to the establishment of Islamic treasury (*baitul Al-Māl*), Islamic Endowment (*Waqf*) (Sanusi, 2009). However, the term legal entity or limited liability of the corporation is earlier and familiar to the convention law as compared to the present-day Islamic finance industry. Nevertheless, limited liability or public or private company have certain fundamental principles inherent in the threshold of Islamic jurisprudence. That is a company having characteristics of an individual that own property, engaged in a contractual transaction, and have the ability to sue and be sued in the law court.

The ISRA compendium defines Personality in *sharī'ah* as a real or legal entity that is capable of incurring and discharging liabilities and accruing and exercising rights. There two kinds of Personalities; natural person (*tabī'iyyah*) and legal or artificial person (*'Itibariyyah or ma'nawiyah*).” Every individual is an independent personality. Every individual becomes a legal person as soon as they are born while the corporation becomes an artificial person when the law incorporates them (ISRA, 2010). Also, the legal personality of an organization or company represents the aggregate of people and wealth that has an independent financial liability, such as companies, banks, associations, and endowments. The legal personality of a limited liability company can be public or private institutions, state or public companies, or private and associations (Gabriela, 2011).

The fundamental contention of scholars is that person rights must exist as a pre-requisite to legal capacity for a person to claim, amend, transfer, or own right. That is the personality right to sue and be sued in the law court (Sanusi, n.d.). The term personality in *sharī'ah* is the eligibility to have “*dhimmah*” (trust, covenant and right) which according to the *fuqaha* (Islamic Jurist) the right of a person to claims rights and be responsible for obligations. Although all human being possess “*dhimmah*” the right and duty, the debate remains on whether a corporate enterprise can be assumed to be having an artificial personality right to make claims and be responsible for certain individual obligations particularly in the event of financial default (Fawzān, 2002). Hence, there are two scholarly opinions on the adaptation of Juridical Personality in *Sharī'ah* law.

Nevertheless, the presence of an artificial person in Islamic law which shows that there are still issues with the extent of transposition of rulings guiding a natural person to an artificial person particularly in financial distress situations. This study aims to discuss this issue as follows: (a) Literature Review, (b) The concept of corporation in Islamic jurisprudence, (c) Juristic analysis of artificial person (d) The Concept of financial distress in Islamic law (e) Juristic analysis of financial distress of corporation (f) Discussion and preference, (g) Conclusion and Recommendation.

### **Literature Review**

Joseph Schacht, (1964) was one of the main proponents of the argument that corporate personality is not recognized in Islamic law. Even though this argument has been refuted by a series of research works, there remain issues to be addressed, to be more precise the distress situation of artificial personality mainly. According to (Kuran, (2006) in his article, *The Absence of Corporation in Islamic Law: Origins and Persistence* discusses the position of the *Sharī'ah* on the formation of the corporation in Western Europe compared to the Middle-Eastern Muslim nations. The study shows that classical Islamic literature has standing and recognition for private businesses and does not recognize the corporation as a private entity. Hence, individuals can sue and be sued in the law court, but the issue of corporate business remains debatable among the scholars (Kuran, 2006). Western Europe got its corporations from the existing trusts and endowment establishments which eventually metamorphosed into corporations in the 1600s, compared to its analogous Islamic *Waqf* which had been in practice since the second era of the development of Islamic empires around 700 to 900 and yet could not transform into corporations until 1900s (Gaudiosit, 1988). This setback, according to the researcher, is a result of certain factors among which is the prevailing legal structure which does not recognize guilds and organizations of people to formulate corporations as it seems as challenging the Islamic authority. Secondly, the stagnation in Islamic law is a challenge facing the *ummah* because of "lack of innovation" (*Ijtihād*). Thus, the renewal was frozen, and the innovation and development of the corporation were discouraged within Middle-Eastern nations. The author further argues that the visit of Eastern elites to Western Europe and the influx of Western businesses into the Middle-Eastern countries motivated the rise and consideration

of corporations among the Muslim nations (Haitam Suleiman, 2016). Although there are individual businesses and *waqf* institutions providing social services in Middle-Eastern Muslim nations, yet the growth is less compared to its analogous Western corporations that have transformed into modern corporations even before the *waqf* institutions. (Shafiq ur Rahman, 2016), (Haitam Suleiman, 2016), (Usmani, 1998)(Sanusi, n.d.) have all contributed to the arguments that corporate personality is recognized in Islamic law.

### **The Concept of Corporation (Sharikah) in Islamic law**

Sharikah in literary terms means, to combine, to mix, to incorporate, to merge. The concept of Sharkah in Islamic law is defined by shāfi‘iyyah as an established common right in willful combination ownership of two or more parties for investment purpose. It also refers to a contractual agreement between two or more parties as partners in ownership of wealth either in form or labour or capital and to share arising profit or loss (Rashād Ḥasan Khalīl, 1981).

There are several portions of the Quran where the term shurakāi (partners) in shariah (partnership) is mentioned for instance thus: *“He does propound to you a similitude from your own (experience): do ye have partners among those whom your right hands possess, to share as equals in the wealth We have bestowed on you? Do ye fear them as ye fear each other? Thus do we explain the Signs in detail to a people that understand”* (Ar-Rūm: 28). Ibn Kathīr explains that Allah is expressing an analogy of how man will not allow his slave to be a partner in ownership of wealth and exact why Allah will not permit associating partners with Him in worship and lordship (Ibn Kathīr, 1997). The word shurakāi (partners), is also mentioned in the distribution of wealth: *“but if more than two, they share in a third”* (Al-Nisāi: 12).

Similarly, the Quran also mentioned in the story of Prophet Dāwūd (PBUH) when he said: (David) said: *“He has undoubtedly wronged thee in demanding thy (single) ewe to be added to his (flock of) ewes: truly many are the partners (in business) who wrong each other: Not so do those who believe and work deeds of righteousness, and how few are they?”*, Al-Qurtubī explained in his exegeses that this verse shows that khalāṭa means sharikah, (mixing, merging) this is evidence that shows that the sharikah has been in existence as far back as the time of Prophet Dāwūd (PBUH) (Al-Qurtubī, 2006).

In addition to the above evidence, the Prophet Muhammad (S.A.W) have equally said in one of his tradition, as to how Allah deals with partners in a partnership relationship thus: “*I am the third of the two partners in so far either of them does not betray the other; when they betray themselves, I automatically depart them*” (Abū-Dāwūd, n.d. vol.3 p. 256).

Islamic scholars have argued that this ḥadīth is a piece of evidence from Quran that shows the permissibility of partnership (Sharikah) in Islamic law. However, the evidence also emphasizes the importance of trust and fairness among the partners as a betrayer of partners is a condition for vitiating the blessing of Allah (Rashād Ḥasan Khalīl, 1981).

The philosophy of Islam concerning corporation in business is for the high intent of protecting the wealth and providing for the entire society. In every environment, it is a fact human cannot exist on their own, as much as you need what others possess, they are also in need of what you possess. These shreds of evidence show that Islam promotes corporation and cooperation of people to growing wealth and provide for the lack of the ecosystem. There are many types of corporation in Islamic literature, however, what is essential to this study is the juristic analysis of corporation that distinguishes between partnership by labour and wealth. The issue of limited liability of corporate partners in the event of financial distress. What should be the status of active partners and sleeping partners particularly in public joint stock company in the event of financial distress.

### **Juristic Analysis of Artificial Personality in Islamic law**

There are two opposing views among *sharī'ah* scholars on the permissibility of transposing legal personal right and law into corporate business, enterprise, and organizations. The first group of scholars opined that Islamic law had given corporate institutions the liability right of ownership and the right to obligation according to Sayyid ‘Abdullah Hussain who argued that corporate body and institutions are eligible to rights and responsibilities. For example, if *a* donor donates a waqf, then the power of ownership lies in who? The donor or beneficiary or the waqf commodity itself. It is essential to identify the issue because Islam does not accept the concept of *sā'ib* (non-ownership) as it is practised in the *Jāhiliyyah* period (Sayyid ‘Abdullah ‘Alī Ḥusain, 2001). Similarly,

in the modern time, how can we consider the income accruing to the treasury from tax, royalties, duties and fines as a property of the authority or the state, because they are not owned by the leader or president of the country. In this context, the state is an artificial personality and as such must be accorded the liability right to own the treasure, control and be responsible for its disposition (Sayyid ‘Abdullah ‘Alī Ḥusain, 2001).

In addition, ‘Alī Qaradaghi equally stressed the basis of the corporate entity as a recognized artificial personality in *shari‘ah* based on the guiding principle of *mal* in *Muḍārabah* contract. In this contract, invested capital of *rab Al-mal* is in a relationship with the *Muḍārib* (fund manager) and the *Mal* invested by the *rab Al-mal* is assumed to be having its rights from the contractual transaction. However, the long existence of the artificial personality of the corporation could also be derived from the *Muḍārabah* contract as stated by *Ḥanafiyyah* schools of law.<sup>1</sup>

On the other hand, the second group opposed the juristic adaptation of Juridical personality in Islamic law. The scholars from the first group opined that liability of obligation is only due to the human being and not to animals and non-living things around us. These groups of scholars argued that the purpose or causal effect (*‘illah*) of eligible obligation is a human being and as such animals and non-living things cannot be categorized as having the liability obligation (Zain Dīn bin Ibrāhīm, n.d.). The *Ḥanafiyyah* school of law is the primary proponent of this explicate that liability right includes the right of ownership and right to own property. The *Ḥanafiyyah* further argued that institutions such as mosques, schools, *waqf*(endowment) and treasury (*baitul mal*) are not eligible to rights and obligations. For example, a *waqf* is not eligible to own or claim debt because it does not have eligible right to request or obligation to fulfil. The *wāqif* (donor) cannot be responsible for its debt because the ownership is being transferred. Upon this logical reasoning, the first group based their argument (Al-Hanafi, n.d.).

However, the pieces of evidence of first scholastic opinion which contend that juridical personality can be found in Islamic law is based on the following; Firstly, The Juridical Personality of *Waqf* (Endowment)

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1 ‘Alī Muḥiddīn Qaradaghi: Series of the lecture at the International Islamic University Malaysia, Global Forum, Nov. 2017.



separating it from the donor. Sheikh Taqī Usmani has stated that: (Usmani, 1998) the concept of *waqf* is a legal religious body which accepts a donation in form of movable or immovable properties from persons for the purpose of charity. The *Waqf* institutions are considered a judicial person that owns the donated properties. However, neither the donor nor the beneficiaries have no right to claim the ownership because the *sharī'ah* law considered the ownership as vested in Allah SWT thus, *waqf* institutions as a separate legal entity with an artificial personality to ownership of properties and obligations. The Jurist further explicate that *waqf* an institution with artificial and juridical personality can own property by purchasing or proceeds from donations. Similarly, the Sheikh also supported his argument with the position of *Aḥmad Al-Dardīr* one of the jurists of *Mālikiyyah* school of law who validated bequest of separate legal entity for the fund of the mosque. That is, if a mosque owns a donation account, what donation accrued from contribution is owned by the administration of the mosque, that is the mosque institution is treated in this scenario as an artificial person separate from its members and administrators (Shafiq ur Rahman, 2016).

Secondly, the juridical personality of *Baitul-mal* (Treasury) as separate from the administrators. The *Baitul Mal* is the treasury of the Muslim Community, the treasury is an Institution that accepts and keeps all of the proceeds of donations, *zakāh*, taxes royalties paid to the state. Every member has the right to benefit from the treasury but cannot claim its ownership. Thus the property is vested in the institution of *Baitul- Mal*. Usmani, (1998) explicate, this position based on the verdict made by Imam Al-Sarakhsī, an *Ḥanafī* Jurist; who said that: “*The Baitul-mal has some rights and obligations which may be undetermined*” Al-Sarakhsi further validated that different departments of government institutions can borrow from one another but must be repaid because they should be considered separate legal entities with juridical personalities (Al-Sarakhsī, 1949). The Jurist opined that *kharāj* department and *zakāh* department should be treated: “If the head of an Islamic state needs money to give salaries to his army, but he finds no money in the *kharāj* department of the *Baitul-mal* (where from the salaries are generally given) he can give salaries from the *ṣadaqah* (*zakāh*) department, but the amount taken from the *sadaqah* department shall be deemed to be a debt on the *Kharāj* department. Hence, in this scenario, it seems the jurist have considered *kharāj* department as the



debtor with juridical personality and *zakāh* department as a creditor with its separate legal personality.

Thirdly, the Juridical personality of *Al-Khalṭah* (Joint Stock) As *Mudārabah*. The Concept of Joint stock company is explained in the jurisprudence of *shafi'iyah* that: in a partnership of two or more persons, that shows assets are mixed, the *zakāh* will be levied on each of them individually, but it will be payable on their joint-stock as a whole from the joint stock investment. In addition, *Al-Sarakhsī*, opined in his work; *al-Mabsūṭ*, Concerning the amount of the *nisāb* of the joint stock investment that the *zakāh* should be levied on the combined value of the total assets if it exceeds the prescribed limit of the *nisāb*. Sheikh Usmani, (1998) *zakāh* is payable on the whole joint-stock if it fulfils the *nisāb* even though the individual contribution might have been less than *nisāb* and *zakāh-able*. This jurist based his argument on the principle of *Khalṭah Al-Shuyū'* that enforce the levy of *zakāh* on livestock of joint stock investment even if the individual partner would not have been liable. The law must be respected based on the ḥadīth of Prophet (S.A.W) that said:

*“Lā Yajma' baina Mutafariq Wa lā yufarriq baina majtama' mukhāfatan Al-sadaqatan”*

*“The separate assets should not be joined together; nor the joint assets should be separated to reduce the amount of zakāh levied on them”* (Al-Hafiz Zainu ddīn Abi Al-Faraj, 1996). The *Ḥadīth* shows that the Prophet (S.A.W) forbids joint stock partners from separating their right with the intention of avoiding *zakāh*. Nor if combining individual owned properties with the intent of paying less due from *zakāh* levy. The basis of the argument here is that joint stock investment is considered the juridical person and is treated similarly as a separate legal entity that should observe its *zakāh* obligation (Usmani, 1998).

Fourthly, the inheritance under debt is assumed a separate personality from the inheritors. That is, Islamic law stipulates that in the event of liability of a debtor, the creditors cannot lay claims of debt beyond the value of property left behind by the deceased person. That is the debt of a dead person cannot be subjected to liabilities above the inheritance. This concept of limited liability is related to the inheritance under debt. According to Sheikh Taqi Usmani, (Usmani, 1998) the jurists, considered the owner of the property left behind as inheritance

is vested on neither the deceased because he is dead, nor on the heirs, because the debt on the property has preferential right and treatment on the inheritance above them. Thus, this property cannot remain as *sā'ib* (property of no one), therefore is considered as a separate legal person. Neither owned by deceased nor heirs nor the executor. Therefore, 'inheritance under debt' is offered its own entity with the right to sell, purchase, thus, becomes debtor and creditor, and has the characteristics of a juridical person.

Also, The Limited Liability of the Master-Slave is considered as separate juridical personality. In the concept of slavery in business and his master is closed to limited liability. According to Sheikh Taqi Usmani, (Usmani, 1998) the type of slave in the olden days that is permitted to trade in business is called the *Al-'abdu Al-ma'khudh* العبد المأخوذ, this slave is permitted by his master with supported capital to trade with the third party with the condition that the master owns the capital and whatever profit accrue is taken by the slave. In the event of default in debt and bankruptcy of the slave, the creditor can only make claims to the worth of the slave after it sales and its liability do not transfer beyond other possessions of the master (Shafiq ur Rahman, 2016). The right given by the master to the slave to transact in business is treated as a limited liability on behalf master and therefore the liability of the master is limited to the capital invested and the value of the slave. This analogy could be inferred from the Islamic Fiqh which is very much similar to the limited liability of the shareholders of a company.

In addition, *Al-Qādi* (the judge) is not permitted in Islamic law to judge in his own case: Hence, the law court under Islamic jurisprudence does not allow a *Qādi* (judge) to sit over his own case. According to *Zarqā*, in his work: *Al-Madkhal*, the appointed judge in the law court or a legal administrator of *waqf* institution has a separate personality from the institution. For instance, if there arises a dispute in the affair of the *waqf* institution, the judge or appointed legal administrator is not permitted to rule over the matter. The reason for debarring the judge or an administrator is that it has separate personality from the institution and he is a party to the case and cannot be counsel and a judge at the same time in his case (Al-Zarqā, 2004).

Similarly, *Shari'ah* Consideration on *Ijārah* status after Death of the Leasing Caretaker is considered juridical personality. This is one of the

theoretical issues (*fiqh Araiyyiyah*) addressed in *Ijārah* contract is to determine the status of the *Ijārah* property itself after the death of the leasing caretaker. *Aḥmad Zarqā* also explicate in his work *Al-Madkhal*; the opinion of *Ḥanafiyah* School of law which asserted that, in the event of death of either of the parties to a lease property, the contract of the lease is null and void; however, in situations where the caretaker as a party to the to the leased property dies, then the lease contract of the *waqf* property is still valid because the caretaker is not considered to have done this for himself instead on behalf of the institution or as representative of the *waqf* institution. The Fiqh adaptation here regards the *waqf* institution as a juridical personality separate from the natural personality of the caretaker (Al-Zarqā, 2004).

Likewise, the Office of State's Head (*Sulṭān*) has a specific juridical personality beside the natural personality of the leader or head of state. There are records from Islamic threshold which indicate the permission of the state head to act as *Walī* (Governor) for those without *Walī* (family representative). Very relevant evidence is recorded by *Imam Bukhārī* as recorded in the "chapter of the state head as *Walī*" a *Ḥadīth* of the Prophet (S.A.W) that: Holy Prophet arranged the marriage of a woman on behalf of her *walī*. Although this is reported only in a marriage situation, hence the possibility of transposing on other *mu'āmalat* act is logical and reasonable (Shafiq ur Rahman, 2016).

Lastly, The Juridical right of 'Āqilah in Islamic law is considered as having a juridical personality. The term 'aqala (عقل) in Arabic means to pay diyah (دية). 'Āqilah in Islamic jurisprudence means the group of family members that are responsible by law to pay the blood money of murder committed by a relative (Shafiq ur Rahman, 2016). *Imām Al-Shawkānī* commented on the *Ḥadīth* reported by six narrators except for Tirmizī that the Prophet (S.A.W) once decided in a case of a woman that the male members shall pay *Diyyah* on her behalf (Al-Shawkānī, 1993).

Some Islamic jurist considers the 'Āqilah (blood relative) as an artificial person having a juridical personality to act on individual rights and obligations. Usually, the capable male children and other family members are directly involving in contributing the blood money. The family members are expected to add to the 'Āqilah in proportionate to their inheritance from the property of the murderer (Al-Bahūtī, 1982).

Nevertheless, the opinion of the second group which opposed the existence of juridical personality in Islamic law is chiefly from the work of Schacht work in “Introduction to Islamic law”, (Schacht, 1964). However, in his work, he contended that the concept of Juridical personality is not present in the Islamic jurisprudence because the concept is not directly mentioned in any of the Islamic threshold nor practice in any of the former Islamic era. The implication of Schacht’s argument shows that the concept of artificial personality is alien to Islamic Jurisprudence; thus, the juristic adaptation of the idea seems illogical. Schacht believed the idea was introduced to the Islamic law in the first half of the 20th century (Schacht, 1964).

*Moreover, this group evident that Imām Sarakhsī also opined in his book that only human being is worth to be awarded the personality because other animals and non-living things lack (dhimma) eligibility to trust, right and responsibility. Some researchers (Shafiq ur Rahman, 2016) argued that there is no ownership relationship between the administrator and the waqf/baitul mal property, unlike the limited liability company that has ownership relationship between the shareholders and the company. Hence, some scholars hold that this transposition might seem illogical in Islamic Jurisprudence. That is Qiyās ma‘ Fāriq; an independent transposition.*

Furthermore, the debt of a deceased person overrun by inheritance is considered by some researchers as evidence not convincing enough to be precedence for awarding juridical personality to the deficit. These researchers argued that though the creditor may not be able to claim from the deceased person directly rather from the property left behind, yet the dead remain the real debtor which is the purpose the creditor can lay claims (Shafiq ur Rahman, 2016).

### **The Concept of Financial Distress (Al-‘Ajzu Al-Mālī)**

It is worth mentioning initially that the term financial distress does not have specific meaning in Islamic literature, as financial distress of firm is equally understood to be a condition when it defaulted in its financial promises to creditors. Hence, a firm that is in financial distress may lead to bankruptcy if it’s financial situation cannot be salvaged (Barbara O’Neill, et al., 2006). There are formal distinctions between four generic terms that are commonly found in the literature. They are; the failure, insolvency, default and bankruptcy. Even though these terms

are often used interchangeably, their formal usage differs because of their distinctive consequences. For instance, economic failure of a firm means that its realised rate of return on capital is significantly lower than prevailing rates on similar investments (Linden, 2015). That is; the average return on investment is significantly and continually below the firm's cost of money even though the firm can continue operation. That being said, a company may experience economic failure and yet be able to fulfil its present and immediate financial obligations (Linden, 2015). On the other hand, when the firm cannot satisfy the legal demands of its creditors, such a firm is said to be experiencing legal failure (Barbara O'Neill et al., 2006).

Insolvency is another technical term usually used to indicate the negative performance of a firm. A firm is said to be technically insolvent when it cannot meet its current obligations, most especially a result of lack of liquidity. Technical insolvency is usually measured by examining the relative relationship between net cash flow and current liability and not the working capital measurement (Mumford, et al., n.d.).

Although, technical insolvency is usually a temporary condition, yet, it may lead to an immediate cause of formal bankruptcy declaration if the situation is not resolved. However, the case of insolvency in bankruptcy is more critical and usually indicates a chronic condition of a firm performance rather than a temporary condition. That is when a firm is insolvent in bankruptcy, in other words, its total liabilities exceed the fair value of its total assets (Barbara O'Neill et al., 2006). Moreover, the deepening insolvency is the situation whereby a firm is eventually bankrupt, but the court decided to keep it alive unnecessarily at the expense of the creditors (Prawitz, Garman, Sorhaindo, Neill, & Kim, 2006).

Similarly, firms within deregulated industries sometimes cannot survive because it allows for entry and exit of new firms creating competition within the industry. Also, when the interest rate is high, many firms seem to suffer financial failure, moreover, local and international competition arising from new business formation rates. Sometimes, the failure rate in new business formation is higher because of the adaptation to the internal and external challenges which the existing firm might be in a better position to adjust. Similarly, when firms are operating with an overcapacity of human and machine labour,

it affects product quality and services which probably affect the cash flow of the industry (Edward I. & Altman Edith Hotchkiss, 2011).

Although the study has established the recognized of corporate entity in Islamic law, hence, the challenge remains how to clarify the corporate status in the event of financial failure. These failures can be described as default, insolvency or bankruptcy of a firm. The event of default is another corporate condition that is related to the distress situation of a firm. For this research, the study will emphasize the role of event of default in distress situation of a firm. Default event is not the actual default instead it is a violation of contractual agreement in the documentation. The default event is a contractual clause which can trigger real default. If a firm is experiencing technical default by violating a debt agreement to be fulfilled to the creditor at an agreed period in the contractual agreement. On the other hand, the technical default of a firm is determined by the nature of its cash flow and liquidity in the balance sheet.

### **Juristic Analysis of financial distress of corporate personality**

In economic terms, the corporate company is a contract between two or more persons to carry out joint work or a commercial enterprise where the owners participate in financial investments to share the profits resulting from the business based on the contribution of every partner. However, the corporate company from the Islamic jurisprudence means a partnership in ownership, and joint ownership with the right to act and benefit from the undertaking (ISRA, 2010). ‘Alī Jum‘ah Muḥammad *et al.* explicate the definition of *Hanaḥfiyyah* which defines the *Sharkah* (corporation) as the mixture of two or more ownerships right such that one party cannot identify its portion precisely from the other (‘Alī Jum‘ah Muḥammad, 2009). Al-Tawālī bin Al-Tawālī, of *Mālikiyyah* (Al-Tawālī bin Al-Tawālī, 2010) defines *sharikah* (Corporation) as the permission by either party to act on behalf of one another on the joint ownership of possession. Also, *Shafi‘iyyah* Defines *sharikah* as the eligibility right of ownership of two or more people of a possession (Al-Sharbīnī, 2004).

The personality of one-person business in financial distress is familiar in Islamic jurisprudence unlike in the situation of the public joint stock company and the limited liability company. According to the explanation of ibn Arabi (IbnAl-‘Arabī, 2003) on the verse: “*O you*

who have believed, do not consume one another's wealth unjustly but only [in lawful] business by mutual consent"..., [Al-Nisai:29], where he explicates that defaulting debtor is declared a procrastinator when there is no evidence to support his/her failure to fulfil financial obligation to the creditor as agreed in the contract. He further argues that since the act of procrastination on debt is forbidden in *sharī'ah* law and therefore imposing (*Shartu Jazā'*) a clause of penalty on the debtor based on the exact inconveniences caused to the creditor is allowed. Hence, the Prophet (S.A.W) is reported to have said about procrastinating debtor and the inconveniences caused to the creditor thus; "*Liya Al-Wājid dhulum Yuḥalla 'Araḍahu wa 'Uqūbatahu*" (Sunani Al-Nisāi, n.d. Ḥadīth no. 4689).

(لِي الْوَاجِدِ ظَلَمَ يُجَلُّ عَرْضَهُ وَعَقُوبَتَهُ)

The *Shartu Jazā'* is preferable to be mentioned in the contractual agreement between the parties to fulfil the statement of verse that says: "*but only [in lawful] business by mutual consent*" [Al-Nisai:29]. However, AAIOFI standard no.3 on procrastinating debtor generally forbids clauses of financial penalties on the defaulting procrastinator even a fluctuation of an exchange rate between the period the debt is due and the procrastinated time (AAIOFI, 2015). It equally prohibits the act of advocating for a financial penalty against the procrastinating debtor through the law court. However, the standard also supports the ruling that the procrastinating debtor should bear expenses incurred by the creditors during the process of realizing the debt from the debtor such as legal actions or other credit risks. This is evident from the fact that the Prophet (S.A.W) said: "*Procrastinating debtor is an injustice*" (Muslim, 1991, ḥadīth no.1563).

Furthermore, the AAIOFI, (2015) standard no. 3 on the procrastinating debtor, stipulates that the creditor has the right to request for the sale of an underlying pledged item and is permitted to include the right to sell the pledge as a clause in the contractual agreement. In the case of the *Murābahah* contract, whenever the seller can find a specific item sold to the buyer in its initial form, such creditor is entitled to its claim during procrastination rather than filing for bankruptcy. Similarly, in *Murābahah* sales resulting to debt contract, the creditor can include the clause of late penalty on the debtor with the condition that such accrual will be spent as charity or giving to endowment as



stipulated in the standard. The creditor is permitted to publicly outlaw a procrastinating debtor as a bad debtor enlisted in the company blacklist and as a warning for other businesses to be aware.

Insolvency of a natural personality in Islamic law also required contemporary conditioning for the corporate personality. Insolvency is a default in financial obligation, that is when the debt obligation of a debtor is above his/her income or money. AAIOFI, (2015) standard no. 43 provides that it is religiously required from the debtor to avoid any further expenses that will hinder or affect the debt obligation to the creditor even though it has not been declared bankrupt by the law court. Also, in the event of Insolvency, the creditors have the right to advocate and call for the appropriate bankruptcy court to declare the debtor bankrupt and to impose legal interdiction by restricting the power to act over the remaining estate of the debtor. Also, when the bankruptcy status is filed, the *AAIOFI*, (2015), standards states that; the bankruptcy court or authority should instruct the debtor to make immediate payment of debt obligations to creditors. As soon as bankruptcy is confirmed, interdiction will be imposed to restrict debtor from any charity spending, lending and any other favouritism in sales and purchases except on things that are officially permitted within the bankruptcy processing law.

Similarly, after a debtor is declared bankrupt and interdiction is imposed on him/her, it is not permissible for the debtor to make immediate payment of any long-term loan or debt. The debtor is also disallowed to make a payment due to any of the creditors either as favouritism or otherwise. The debtor with a bankrupt status is not allowed to make any financial expenses that will infringe on the creditors' rights such as travelling except as required in accordance with the bankruptcy law and with permission of the judge (*AAIOFI*, 2015).

The bankruptcy court has the right to sell the current estate of the debtor regarding bonds, shares, currency of other countries, and other properties in exchange to fulfil the financial obligation on the debtor. The *AAIOFI* (2015) standards no 43 also states exceptions to the rights of the bankruptcy court to sell the estate of debtors in situations such as manufacturing equipment, and other basic needs that serve as the debtors' surviving necessity and survival of the debtor. In addition, the standard on the insolvent debtor and its exception has put into

consideration the *ḥadīth* of the Prophet (S.A.W), “*Whoever finds the real invested asset of his fund with a bankrupt person; such is more entitled to it*”, (Al-Bukhari, 2002, ḥadīth no. 2402, p. 578).

Moreover, *Sharī‘ah* rulings of *Al-Ḥajr* (Interdiction) on bankrupt personality is also an important issue in financial distress. Firstly, *Al-Ḥajr* (interdiction) is a legal procedure that interferes with the personal rights of an individual for acting as a disposer of possessions. This judicial restraint on the rights to ownership will not be complete without fulfilling certain *sharī‘ah* conditions. *Al-Ḥajr* (Interdiction) must be a Court order upon request by the creditors: According to Sulaimān Bāji, in his work *Al-Muntaqā*, (*Sharḥ Al-Muwāṭa*) where he explains the position of the majority of schools of law that this interdiction must be a request by creditor from the court of law when the debt owed by the debtor is more than the income (Sulaimān Bāji, 1914). However, Zakariyā Al-Anṣār, (Sulaimān Bāji, 1914) also describes the position of some scholars of the *Shafi‘iyyah* school of laws that, it is permissible for a debtor to seek for a court order preventing him/her from acting on the property with the intention to protect the rights of the creditors. Also, worth mentioning that the inability of a debtor to settle his/her debt is the primary reason why the creditor is permitted to file for interdiction at the law court. However, the liability that can trigger interdiction of the debtor must be recognized by law. According to some Islamic jurists, the debt can either be an ascertained debt or a bad debt. It is also categorized as the debt due for payment and future debt (Zuwain, n.d.).

The evidence of *Ḥajr* from the Quran: “*And do not give the weak-minded your property*” [Al-Nisāi: 5]. Until where Allah says: “*And test the orphans [in their abilities] until they reach marriageable age. Then if you perceive in them sound judgement, release their property to them*” [Al-Nisai:6], these two verses indicate a justification for interdiction on the mentally disabled people or the foolish ones and also the orphans in order not to liquidate the property. These categories of people will not claim complete ownership and control of their properties until there are signs and indication that they have matured and are mentally fit to take charge (Fawzān, 2002).

*Ḥajr* (Interdiction) in *Sharī‘ah* is of two kinds, firstly, the *Ḥajr* (interdiction) on a person for protecting the rights of others such as interdiction on a bankrupt person to defend the rights of the debtors.

*Secondly, is the Ḥajr* (interdiction) on a person for his/her benefit such as an interdiction on a foolish, un-matured and mentally disabled person as Allah says: “*And do not give the weak-minded your property*” [Al-Nisāi: 5].

Shariah law permits interdiction of mentally challenged persons or unmatured person from financial obligation such as acting on the possession for protecting the interest and rights of creditors (*Al-ghuramā*). However, *Sharī‘ah* stipulates that if the bankruptcy court or the creditors realise the debtor (interdicted person) is incapable of paying unintentionally, it is strongly recommended to grant him relief either by postponing the deadline or debt reduction or debt forgiveness. This is in line with the saying of Allah SWT: “*And if someone is in hardship, then [let there be] postponement until [a time of] ease*” [Al-baqarah: 280]. in addition, the act of debt forgiveness is a praiseworthy virtue in Islam, as Allah says: “*But if you give [from your right as] charity, then it is better for you if you only knew*” [Al-baqarah: 280].

The Prophet (S.A.W) has equally encouraged the believers to give relief to their brothers in debt. *Ḥadīth* “*Whoever which that Allah placed him under His shade, should ease the affairs of an indebted person in difficulty*” (Ṣaḥīḥ Muslim, 1991, ḥadīth no. 1563). However, if a debtor is discovered to be a procrastinator or a willful defaulter, *Ḥajr* (interdiction) is not applicable to him/her because it is not necessary. Preferably, the judicial authority has the right to impose an appropriate penalty that will force him/her to settle his/her debt. Similarly, in his work “*Al-Mulakhaṣ, Al Fawzān* (Fawzān, 2002) explicates the opinion of the *Shafi‘iyyah* and *Ḥanbaliyyah* schools and even *Ibn Taymiyyah* which recommend that whoever is declared a procrastinator or a willful defaulter; a debtor who can settle his/her debt but choose not to pay, therefore such a person should be subjected to corporal punishment and jailed until he/she is ready to fulfil his/her financial obligation. The Prophet (S.A.W) says: (*Procrastinating debtor is an injustice*). (Ṣaḥīḥu Al-Bukhārī, 2002, ḥadīth no. 2287).

Similarly, Ṣāliḥ bin Fawzān further summarises four *Sharī‘ah* rulings on *Ḥajr* (Interdiction). Firstly, the right of *Al-Ghuramā*’ (creditors in bankruptcy) is attached to the estate of the debtor before and after the interdiction, and the interdicted person has no right to act on his/her estate after being prevented by the bankruptcy court order

(Fawzān, 2002). Secondly, whoever finds his/her real asset, right or trust as a borrowed item with a bankrupt person is legally permitted to reclaim it immediately. This ruling is in line with the *ḥadīth* of the Prophet (S.A.W) that says: “*Whoever finds his property with a bankrupt person, such as the first right to reclaim it*” (Ṣaḥīḥu Al-Bukhārī, 2002, ḥadīth no. 2402).

However, the application of this *Ḥadith* has six pre-requisites among which are: (1) the debtor must be alive or else the debt becomes bad debt, (2) The price or value of the property must be the same as the initial time the property was given to the bankrupt person. (3) the property of the creditor found with bankrupt person must remain but if part of it has been used or disposed, the *ḥadith* is not applicable (4) The feature of the property remains as it is without changes arising from depletion or damage, (5) The property has not gotten any attached increment or appreciation. In addition, interruption of request and claim from the interdicted person arising from the creditors and lenders. Whoever has any right to claim from an interdicted person cannot lay such an application until the interdiction is released from the bankrupt person. The bankrupt court has the right to liquidate the asset of the interdicted person and share the proceeds among the creditors whose debt are due alone (Fawzān, 2002).

### **Discussion and Preference**

The contemporary age seems to favour the recognition of corporate institution and enterprises as an artificial personality with separate liability to ownership of property, sue and be sued in the law of court. However, some scholars have cautioned the possibility of permission with certain conditions and standards. Some *sharī‘ah* scholars<sup>2</sup> have argued that even though the contemporary situation needs to be a recognized corporation as an artificial personality, its transposition must be done with the specific requirement to avoid *Qiyās ma‘ Fāriq* (unrelated transposition). In Islamic jurisprudence, *Qiyās ma‘ Al-Fāriq* is by making transposition in matters that are not likely. Meanwhile, *Qiyās* should be done on things that are close and likely in the future. Moreover, one of the characteristics of individual personality is that the

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2 Interview and consultation section with Dr Luqmān Zakariyyah, Head, Department of Fiqh and Usūl Fiqh, IIUM. On 31<sup>st</sup> Oct. 2017.

individual is bind by law to oblige by the ruling and conditions of the contractual agreement. Therefore, transposing individual personality to corporation require a person to stand as representing manager or guarantor for a private corporation who will be liable to all obligation arising on the corporation for the period of the appointment.<sup>3</sup> Moreover, this opinion is in line with the explanation of *Al-Shāṭibī* in his popular book: *Al-Muwāfaqāt*, where he explicates the effects on uncertain on *thimmah* (liability) of person, stated thus: “*when uncertainty becomes an obstacle in the way of association with the thimmah, it becomes an obstacle in the way of the obligation itself. This is that knowledge of the subject-matter of the obligation is a condition for the obligation because an obligation to undertake an uncertain act is an obligation to do the impossible.*” (*Al-Shāṭibī*, 2011).

*Sheikh Mustafā Al-Zarqā* (*Al-Zarqā*, 2004) explicates that there is a difference in the personality of a private and public company. According to him, the private company is considered in *sharī‘ah* as having unlimited liability while the public company is considered as a juridical person separate from the personality of the owners and managers. The *sharī‘ah* adaptation has offered public companies limited liability.

Sheikh Taqī Usmani (*Usmani*, 1998) also opined that the concept of limited liability should not be applied to private companies or partnership because their nature is similar to the natural person. The shareholders and partners in private companies can easily acquire adequate knowledge and information about the running of the organization or business, thus should be liable to all liabilities of the company. This statement shows that private companies are considered in *sharī‘ah* as having unlimited liability in their business. Although Sheikh Taqī Usmani equally agreed that sleeping and dormant partners might be exempted from the status of unlimited liability.

Another critical issue in transposition of individual personality is the imprisonment of procrastinating defaulter until the debt is settled. However, should the regulation be based on specificity or principle behind the imprisonment of the debtor? It is worth mentioning that the contemporary application of appropriate punishment should be based

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3 Luqmān Zakariyyah, Head, Department of Fiqh and Usūl Fiqh, IIUM, Interview and Consultation, July 2017.

on principle and wisdom behind the punishment on the distressed firm rather than on individual personality in the industry. The financially distressed organization should be viewed from two perspectives. First, if the default event is triggered by financial distress that is out of control of the corporation and its employee, then such will fall under the compensation (Al-ghārimīn) financially distressed person in the beneficial of the zakāh fund with consideration of other fundamental requirements. Secondly; if the firm is responsible for the distressed situation as a result of negligence, the firm's liability should be borne by whoever is responsible for the loss. Hence, putting pressure on owned assets of the distressed is more applicable where it is backed by collaterals or underlying assets of the contractual agreement, and there is an option of imposing fines (Gharāmah) on the responsible individuals.

Also, the death of a natural person and his debt is another crucial issue in an artificial corporation. The contemporary application favours recognizing the personality of the corporation because in the death of a partner, the debt can still be claimed as long as the firm still exists. Having said this, the regulating law of every jurisdiction is the most important at this junction. Hence, the law should explicitly state the status of investors in these companies and the multiplicity of their obligations and rights, as well as the supervision of the management processes for achieving effective bankruptcy proceedings that can protect the rights of contractual parties in the *ṣukūk* investment<sup>4</sup>

### **Conclusion and Recommendation**

The concept of the corporation in western laws have experienced rapid growth compared to it analogous Muslim nations because of bad experiences in the development of corporate law as result of stagnation in the innovation of the Ummah and freezing of the Ijtihād mainly before the 19<sup>th</sup> century. The study shows the trend and development of

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4 Muhammed Khnifer, an expert at the Islamic Development Bank in an interview with Bloomberg states that the recent Dana gas *Ṣukūk* default shows that issuing firm prefers that the existing standard should remain because it allows the company to rely on the local court injunctions which favour the debtors at the expense of other stakeholders particularly creditors. Hence, the investors are calling for an urgent need to create a comprehensive standard for treating default issues in the *ṣukūk* investment. Retrieved on 02/07/2017 from: <http://www.reuters.com/article/dana-gas-ṣukūk-idUSL8N1JB05A>.

corporate entities in western and Muslim countries. Although, financial distress of corporate personalities is a modern concept that is common to the conventional industries. However, contemporary Islamic scholars and leading Islamic financial institutions such as Accounting and Auditing Organization for Islamic Financial Institutions AAOIFI and the Council of the International Islamic Fiqh Academy (IIFA), have made a significant effort on provisions on creditors debtors' corporate relationship in a period of financial distress. The study makes several policy contributions and recommendation for further studies. The study found that the nascent Islamic finance industry required more provisions in distinguishing between the insolvency, bankruptcy, financial distress, default and interdiction. It is equally necessary to provide specific requirements for defaulting corporate entity and the appropriate Islamic regulations that should guide the contractual parties in the different situations of financial distress. When is a corporate entitled to be classified as (*Ghārimīn*) financial distressed due to natural calamity and how to measure appropriate relief from the *Zakāh* funds? The provision should also address the situation of limited liability companies that are financially distressed out of the negligence of its managers. Even though the corporate entity is recognized by law as having artificial personality, the officers and managers responsible for the loss should be held liable.

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