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## LEGAL FRAMEWORK OF CORPORATION AND SHIRKAH AL-INAN: A COMPARISON

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### ABSTRACT

Under the civil law, the metaphor of corporate personality is used to justify the existence of the corporation as a legal person. As a creature of the statute, the existence, operation and dissolution of a company is governed by the Companies Act. Such a principle is not found to be applicable to *Shirkah al-Inan*, which has been assumed by many *Shariah* scholars to be similar to a civil corporation. With the recent vast and rapid development in *Shariah* compliance businesses such as Islamic banking and finance and halal products, it is important to study whether *Shariah* businesses could be carried out inside a civil law business structure. This paper analyses the legal framework of civil corporations and compares them with *Shirkah al-Inan* to highlight the misconception of many scholars that *Shirkah al-Inan* is similar to a civil law corporation.

Keywords: Corporation, *Shirkah 'inan*, Juristic person.

### INTRODUCTION

In Malaysia, there are four types of business entities, namely sole proprietorship, partnership, company, and limited liability partnership. All these entities were established under specific legislation. It is interesting that all *Shari'ah* compliant corporations in Malaysia, such as the Islamic Bank (BIMB), are registered under the Companies Act which was based upon the English and Australian Companies Act. BIMB is essentially an '*inan* company; a separate legal entity based on the concept of *al-musyarakah*. The issue arises is whether the concept of the body corporate is comparable with the concept of partnership or *sharikah* in Islam. This paper discusses and compares the concept of the corporation with *Shirkah al-Inan*. The main objective of this paper is to highlight the misconception of many scholars that *Shirkah al-Inan* is similar to a civil law corporation. This paper also seeks to propose a basic legal framework of *Shariah* compliant companies which adhere to the *Shariah* principles.

### CORPORATIONS IN MALAYSIA

In Malaysia, all companies must be registered under Companies Act 1965 which accords them the status and attributes of a body corporate. The legal effect is a body corporate shall be an entity separated from its incorporator. The doctrine of separate legal entity was introduced by English common law through the decision made by the court in the *Solomon's case*<sup>3</sup>. This doctrine has received its application in Malaysia via the Companies Act 1965 (Act 125). Section 16(5) laid down the effect of its incorporation, namely:

*A company shall be regarded as a body corporate, capable of exercising all the functions of an incorporated company.*

The term 'body corporate' is not defined under the Companies Act 1965. However, generally it covers both 'companies' and 'corporation'. Both of these terms are defined under Section 4 of Companies Act 1965: a corporation can be defined as anybody corporate formed or

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<sup>3</sup> *Salomon v Salomon & Co Ltd* [1897] AC 22.

incorporated or existing within Malaysia or outside Malaysia and includes any foreign company. ‘Corporation’ is one of an artificial legal person. In the case of *Tan Lai v. Mohamed Bin Mahmud*<sup>4</sup>, Salleh Abas FJ, held that it is a “body corporate” as a result of statutory acts of the Registrar of Companies for which it is capable of exercising the functions of an incorporated. In addition to that, Zakaria Yatim, J in *People’s Insurance Co (M) Sdn Bhd v. People’s Insurance Co Ltd & Ors*<sup>5</sup> [1986] held that under the ordinary rules of law, a parent company and its subsidiary company, even a wholly owned subsidiary company, are distinct legal entities.

*A company will have the right of suing and being sued.*

In the case of *Foss v. Harbottle*<sup>6</sup>, the court had established the rule which is known as the ‘proper plaintiff rule’ whereby in this case, the court held that, A member of the company cannot sue on the company’s behalf to enforce a company’s rights. If a director breaches his duty to the company, it is the company who has the right to sue him. A member cannot sue the director on the company’s behalf. Similarly, if a contracting party breaches his contract with the company, it is the company who has the right to sue the contractor. In the case of *Lee Eng Eow (as director of Lee Guat Cheow & Co Sdn Bhd) v Mary Lee (as executrix of the estate of Low Ai Lian) & Ors*<sup>7</sup>, the Court of Appeal had laid down the statutory effects of an incorporation, whereby an incorporated association has a legal personality of its own apart from the persons who comprise it; even though it is not specifically provided in the Companies Act 1965.

*A company will have perpetual succession.*

To illustrate this point, in the case of *Abdul Aziz Bin Atan v. Ladang Rengo Malay Estate Sdn. Bhd.*<sup>8</sup>, despite changes in the membership, the corporate entity continues unchanged as decided in *Re Noel Tedman Holdings Pty Ltd*<sup>9</sup>, the company may even continue to exist despite the death of all its shareholders and directors.

*A company will have the power to hold land and other property.*

Article 9 of the Third Schedule to the Companies Act 1965 provides that a company possesses the power to purchase, take on leases or exchange, hire and otherwise acquire any movable or immovable property. Besides, such rights are also conferred onto states by the National Land Code (Act 56 of 1965), where section 43(b) conferred on the State Authority with the power to dispose the land to the corporations.

Even though section 16(5) of Companies Act 1956 only mentions the right to own land, a company also possesses the right to own other sort of property (Han, 2005). The property will be treated as the company’s own and not the shareholders’ (Zuryati et al., 2009; Hassan, Abd Ghadas and Abd Rahman, 2012). Therefore, even if a person owns all the shares in the company, he does not own the company’s property, nor does he have any legal or equitable interest therein (*Macaura v. Northern Assurance Co. Ltd.*<sup>10</sup>).

*The liability on the part of the members to contribute to the assets of the company in the event of its being wound up are provided by the Companies Act 1965.*

For example, according to s. 214(1)(d) of Companies Act 1965, in the case of a company limited by shares, the liability of its members is limited to the amount unpaid on his or her shares in the company. This was noted as one of the benefits enjoyed by the members of the limited company (Rachagan et al., 2005). The above discussion clearly highlights that the

<sup>4</sup> [1982] 1 MLJ 338

<sup>5</sup> [1986] 1 MLJ 68

<sup>6</sup> (1843) 67 ER 189

<sup>7</sup> [1999] 3 MLJ 481

<sup>8</sup> (1985) 2 MLJ 165

<sup>9</sup> (1967) QdR 561

<sup>10</sup> [1925] AC 619

Companies Act 1965 adopted the English principle of corporate entity, which give rise to all the statutory attributes of a corporation.

Therefore, we may conclude that there are two types of person recognised by the law. The first one is the natural person or human beings; and the second is the artificial person (*Tan Lai v. Mohamed Bin Mahmud*<sup>11</sup>), which includes any being other than human beings which the law recognises as having duties and rights. One of the most recognised artificial persons is the corporation. Thus, we can see that the doctrine of separate legal entity is a fundamental legal principle which draws a distinction between an incorporated company and those people who have a control over it. A company will continue unchanged even if the identity of the participants in it changes.

### THE CONCEPT OF SHIRKAH IN ISLAM

*Shirkah* (or *sharikah*) refers to partnership between two or more persons. Literally, *Shirkah* means a mixing of shares (*khalat*) until it could not be distinguished from the other while according to *Syara'*, *shirkah* is a transaction between two or more people which have agreed to perform some work for the purpose of profit (Susanto, 2014). According to Ibn-e-'Abidin, *Shirkah* has also been defined as a contract between two or more people for participation in a capital and its profit (Hafeez, 2013).

### THE LEGALITY OF SHIRKAH IN ISLAM

In *surah an-Nisa*: 12, Allah swt stated:

*And for you is half of what your wives leave if they have no child. But if they have a child, for you is one fourth of what they leave, after any bequest they [may have] made or debt. And for the wives is one fourth if you leave no child. But if you leave a child, then for them is an eighth of what you leave, after any bequest you [may have] made or debt. And if a man or woman leaves neither ascendants nor descendants but has a brother or a sister, then for each one of them is a sixth. But if they are more than two, they share a third, after any bequest which was made or debt, as long as there is no detriment [caused]. [This is] an ordinance from Allah, and Allah is Knowing and Forbearing.*

In another verse, Allah said:

*[David] said, "He has certainly wronged you in demanding your ewe [in addition] to his ewes. And indeed, many associates oppress one another, except for those who believe and do righteous deeds - and few are they." And David became certain that We had tried him, and he asked forgiveness of his Lord and fell down bowing [in prostration] and turned in repentance [to Allah]. (As-shod, 24)*

### TYPES OF SHIRKAH

Muslim jurists have unanimously agreed that *shirkah* is permissible in Islam but they dispute the division of it. According to Abdurrahman Al-Jaziri in *Kitâb al-Fiqh 'alâ al-Mazâhib al-Arba'ah*, Hanafiyah, divided *shirkah* into two types i.e. *shirkah al-milk* (non-contractual partnership) and *shirkah al-uqud* (contractual partnership).

*Shirkah al-milk* (non-contractual partnership) implies co-ownership and comes into existence when two or more persons have joint-ownership of an asset without having entered into a formal partnership agreement, for example, two persons receiving an inheritance or gift of land or property which may or may not be divisible. The partners have to share the gift, or inherited property or its income, in accordance with their share in it until they decide to divide it (if it is divisible, e.g., land) or sell it (if it is indivisible, e.g., a house or a ship). The *shirkah al-milk* can be divided into *shirkah al-milk ikhtiyariyyah* for which the partners still decide to

<sup>11</sup> [1982] 1 MLJ 338

stick together even the property is divisible and, if it is indivisible it will be characterised as *shirkah al milk jabariyyah* ((involuntary). The essence of *Shirkah al-milk* is common ownership of property and it will not be considered as a partnership in a strict sense so long there is no mutual agreement with regards to sharing profits and risk.

However, according to Sayid Sabiq in *Fiqh Sunnah*, *shirkah al-milk* is not allowed because each partner has a right to deal with their portion of property without the need of authorisation from the other counterparty. While according to Wahbah Zuhaily in *Al-Fiqh al-Islâmî wa Adilatuhu*, each partner should be treated as separate entity and was not allowed to deal with the shared property without authorisation from other partners.

*Shirkat al-'Uqud* means two or more people coming together making a contract for the investment of their profit. According to Hanabilah, *shirkah* comprising of five types; *shirkah 'inân*, *mufâwadhah*, *abdân*, *wujûh* dan *mudhârabah*. While, according to Hanafiyah, *shirkah* is divided into *syirkah amwâl*, *a'mâl*, dan *wujûh* and each type was further divided into *mufâwadhah* dan *'inân*. Referring to *Mâlikiyah dan Syâfi'iyah*, *syirkah* is divided into four types; *shirkah*, *'inân*, *mufâwadhah*, and *abdân dan wujûh*. The differences in these categorisations will lead to different rulings. However, the Muslim jurists unanimously agree on the permissibility of *shirkah inan*, but they have some disagreement on other types of *shirkah*. Syâfi'iyah, Zahiriyyah dan Imamiyyah consider all types of *shirkah* as void except *'inân* and *mudhârabah*, while Hanabilah recognised all types of *shirkah* except *shirkah mufâwadhah*. Malikiyyah recognised all types of *shirkah* except *shirkah wujûh*. Hanafiyah and Zaidiyah prefer to recognise all types of *shirkah* as long as its formation is not contrary to the injunction of Islam (Susanto, 2014).

According to Chapra, *Shirkah al-'uqud* (contractual partnership) can, however, be considered a proper partnership because the parties concerned have willingly entered into a contractual agreement for the joint investment and sharing of profits and risks. The agreement can be done orally and informally. However, it would be preferable if the *shirkah al-'uqud* is formalised by a written agreement with proper witnesses, specifically stating the agreed terms and conditions in conformity with the *Qur'anic* teachings about loans and important business transactions (al-*Qur'an*, 2: 282-3). Just as in *mudarabah*, the profits can be shared in any equitably agreed proportion. Losses must, however, be shared in proportion to capital contributions. For *mazhab Shaf'i*, profits should be divided in proportion to capital contributions. This is because the contribution of labour (or skill and management) is difficult to measure and it is assumed that labour will be contributed equally. Profits, like losses, should also be in proportion to the risk shared. However, if two partners contribute to the capital and only one of them works, then even according to the *Shaf'i* school, the working partner's share in the profit should be higher.

*Shirkah al-abdan* is where the partners contribute their skills and effort to the management of the business without contributing to the capital.<sup>12</sup> In *shirkah al-wujuh* the partners use their goodwill, their credit-worthiness and their contacts for promoting their business without contributing to the capital.<sup>13</sup> Both these forms of partnership, where the partners do not contribute any capital, would tend to remain confined primarily to small-scale businesses.

<sup>12</sup>This is also called *Shirkah al-a'mal* (partnership in labour or management), *shirkah al-sana'ah* (partnership in crafts or art) and *shirkah al-taqabbul* (partnership in contracting); *Shirkah al-abdan* is not recognised by al-Shaf'i, according to whom *shirkah* arises from the pooling of only financial resources because, as indicated above, the contribution of work and skills cannot be measured precisely and it is assumed that all partners will contribute these equally to the partnership (Ibn Rushd, 1960).

<sup>13</sup>*Wujuh* is the plural of *wajh*, which means face, and refers here to the strengths associated with a person's own reputation, goodwill and credit-worthiness. *Shirkah al-wujuh* or credit partnership is not recognised by the Maliki and Shafi'i schools (Ibn Rushd, 1960).

In the case of *al-mufawadah*, the partners are adults, equal in their capital contribution, their ability to undertake responsibility and their share of profits and losses, have full authority to act on behalf of the others and are jointly and severally responsible for the liabilities of their partnership business, provided that such liabilities have been incurred in the ordinary course of business. Thus each partner can act as an agent (*wakil*) for the partnership business and stand as surety or guarantor (*kafil*) for the other partners.<sup>14</sup>

*Al-'Inan* on the other hand does not require all partners to be adults or have an equal share in the capital. They need not be equally responsible for the management of the business. Accordingly, their share in profits may be unequal, but this must be clearly specified in the partnership contract. Their share in losses would of course be in accordance with their capital contributions. Thus, in *shirkah al-'inan* the partners act as agents but not as sureties for their colleague.

Hence their liability towards third parties is several but not joint.

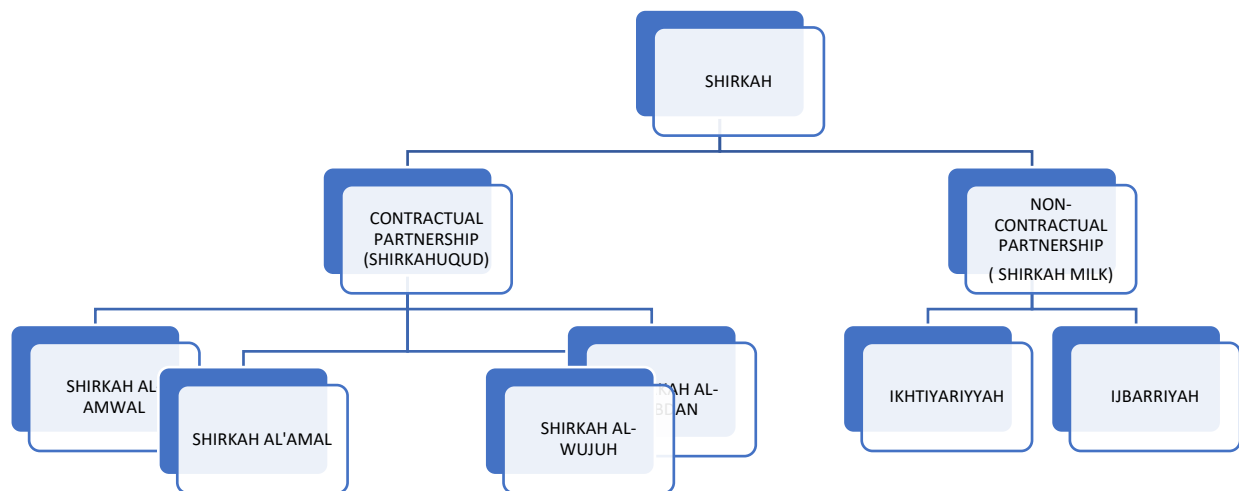
To summarise, below is the table on differences opinion of four *mazhab* regarding the types of *shirkah*.

Table 1. Differences opinion among four *Mazhab* regarding recognition of types of *Shirkah*

Mazhab	Inan	Mufawadah	Abdan	Wujuh
Malikiyah	/	/	/	
Syafiiyah	/	X	X	X
Hanabilah	/	X	/	/
Hanafiyah	/	/	/	/

Figure 1 is a diagram on the types of *shirkah* according to majority jurist and each type of them was further divided into *mufawadhah* dan *'inan*.

Figure 1. Types of *Shirkah*



Practically, the partners may contribute not only finance but also labour, management and skills, credit worthiness and goodwill, and may not necessarily provide these equally. The most popular and widely-used form of partnership is the *shirkah 'inan*, which implies unequal shares and is recognised by all schools since it is more practical. In the case of *Inan*, the profits may be divided in accordance with a contractually agreed proportion, since the *Shari'ah* admits an

<sup>14</sup>The Hanafi, the Maliki and the Hanbali schools, all recognize *mufawadah* partnership, with some differences. The Hanafis require that there be equality of the partners in net wealth and that the entire net wealth should enter the partnership business. The Malikis do not consider this to be necessary. They require only the equality of capital contributions (Ibn Rushd, 1960; Al-Sarakhsi, 1978).

entitlement to profit arising from a partner's contribution to any one of these three business assets. However, the *Shari'ah* makes it absolutely imperative that losses should be shared in proportion to the contribution made to capital. This is because losses, as already indicated, constitute an erosion in equity according to the *ijma'* (consensus) of the jurists and must be charged to the capital. If a loss has been incurred in one period, it must be offset against profits in the subsequent periods until the entire loss has been written off and the capital sum has been restored to its original level. This may be done in one stroke or in instalments depending upon circumstances and the understanding of the partners. However, until the total loss has been written off, any distribution of 'profits' will be considered as an advance to the partners. Accordingly, it would be desirable to build reserves from profits to offset automatically any losses that may be incurred in future (Chapra, 1998).

### **Contractual principles in *Shirkah***

The existence and validity of *shariah* business structure is mainly based upon contractual principles. Apart from the main contract such as *mudharabah* and *musharakah*, there are specific underlying contract as basic rules that govern relationship between partners, their various right and liabilities and even the right owed to the third parties. There are four basic contracts that can operate on a partnership. All four contracts however do not exist simultaneously in one partnership contract. These contracts are the contract of *amanah* (trust), the contract of *wakalah* (agency), the contract of *kafalah* (surety) and the contract of *ijarah* (hire).

The contract of *kafalah* does not operate in *Muzaraah*, *Mudharabah* and *Musaqah*<sup>15</sup>. While a contract for *ijarah* does not have any role in *inan* and *mufawadah* and thus, it will not be discussed further here. The underlying contracts for *shirkah inan* are the contract of *amanah* and *wakalah*.

### **OBSERVATIONS**

The concept of *shirkah 'inan* has been used to define companies in many Islamic countries and by Shariah scholars. Various types of *Shirkah* are reflected under common law such as *syarikah al-tawsiyyah al-basitah* for a company limited by guarantee, *syarikah al-musahamah*, *al-tawsiyyah bil-asham* and *zatul mas'uliyah al-mahdudah* for a company limited by share. The various names of the *sharikah*/companies limited by shares are due to the flexibility and compatibility of Islam, based on the principle of '*urf*' (custom), to suit the changing nature of modern world of trade and business. The shareholders of these companies have limited liabilities according to the portion of shares held (al-Zuhayli, 1995). However, Zuhayli does not specifically state the principle of neither separate legal entity nor juristic person (*syakhsiyah maknawiyah*) on the nature of these companies.

According to Zuhaily (1995) referring to Ibn al-Mundhir, '*inan*' is a form of partnership where the partners share the capital, as well as profits and losses, is approved by consensus (1995). These partners in a *sharikah 'inan* need not be equal in their contributions to capital, nor equal in their legal rights for using the property. Thus, one party may contribute more than another to the partnership, and one of the partners may have the exclusive right to run the affairs of the partnership. Given this potential for great variation in legal rights of dealing in the joint property, each party is only responsible for dealings that he himself performed. Thus, while they share the profits according to any rule they agreed upon in the contract, the only share losses in proportion to their contributions to the partnership's capital. The general rule is

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<sup>15</sup> *Muzaraah* is an agreement in which one party agrees to allow a portion of his land to be used by the other in return for a part of the produce of the land; while *Musaqah* is a contract in which the owner of agricultural land shares its produce with another person in return for his services in irrigating the garden; and *Mudharabah* means a type of partnership for profit which is structured so that one partner provides capital and the other provides labour and expertise. Source; [www.islamicfinancenews.com/glossary](http://www.islamicfinancenews.com/glossary) retrieved on 26th February 2017

summarized thus: “profits are shared according to the parties’ conditions, but losses are shared according to their shares in the capital” (Al-Zuhayli, 2003, p. 452).

The Joint Stock Company business is regarded as akin to the contract of *Shirkah* in Islamic legal system by the Islamic jurists. They considered that the incorporation of company having the status of distinct legal personality is permissible in *Shari’ah* (Islamic law). They argued that:

*The limited liability of the master of a slave who carries on business on behalf of his master was also cited. In such a case the initial capital for the purpose of trade was provided by his master, but the slave was free to enter into all the commercial transactions. The income would also vest in him, and whatever the slave earned would go to the master as his exclusive property. If in the course of trade, the slave incurred debts, the same would be set off against cash and the stock in the hands of the slave. But if the amount of such cash and stock would not be sufficient to set off the debts, the creditors had a right to sell the slave and settle their claims out of his bid price. However, if their claims still remained due even after selling the slave, or the slave would die in that state of indebtedness, the creditors shall not approach his master for the rest of their claims. Here, the master was actually the owner of the whole business, the slave being merely an intermediary tool to carry out the business transactions. The slave owned nothing from the business. Still, the liability of the master was limited to the capital he invested including the value of the slave. After the death of the slave, the creditors could not have a claim over the personal assets of the master. This business practice was followed in the days of Holy Prophet (P.B.U.H) (as quoted in Hafeez, 2013, p. 105).*

The above statement mirrored limited liability of shareholders in a conventional company.

Generally, Islam recognised the existence of body corporate as mentioned earlier; however, the corporate form of business organisation, with a separate legal entity, does not appear directly in the classical *fiqh* discussions. However, in Islam, *Shirkah* does not separate the entity from its partners, for they are treated as one unit. This is because, life and *dhimmah* (i.e. liability) can only be attributable to human being to which they are granted with rights and are capable of performing their responsibilities. *Dhimmah* are not something which can be transferred to a non- living entity. Islam treats human beings at the highest level. They are endowed with ‘*aql*’ and the power of disposition, to which they have the will of their own in performing their duties and obligations. (Azrae, Yusoff and Ayub, 2009)

Imran (2003) further opposed the existence of separate legal entity in *Syariah* law, and termed it as fictitious or artificial person. The concept of separate legal entity that a company is a fictitious person, which is relied upon on the instances of *waqf* and *baitul mal* and the estate of deceased, has been regarded as misplaced assertions by modern Muslim jurists. According to Imran (2003) the concept of *syarikah* will lose its significance if the concept of separate legal entity is acknowledged in *Syariah* law. In consequence, the acceptance of the principle will shatter the whole structure and violates the fundamental principles of *Syariah* law, particularly law of contract. Hence, there is a strong opposition to the concept of legal persona for a corporation (Zuryati, Yusoff and Azrae, 2009).

Another point which is of concern is the fact of absolution of debt arising from ‘limited liability’ which is designed to avoid and deny payment of debt. It is the position in Islam that the liabilities will hang on the necks of debtors even on the day of *Qiyamah*. Human beings are the only entity endowed with the life in this world and in the hereafter. Their actions in their lifetime will be carried forward to the Judgment Day. The individuals who have incurred any liability have to pay it: the claims shall remain here and will remain in the day of *Qiyamah*. A

partner's liability will not be limited to the amount they have put in. Whilst the profit distribution ratio is decided according to what is agreed, the loss is distributed relative to the amount or shares each partner invests in the business. Thus, there is no limited liability in Islam. Taqi Usmani (2006) is known as a supporter of separate legal entity, however, he himself has some reservation on its application. The concern is that the company, while the liability of the shareholders are limited, being exploited as a vehicle of fraud. This is also the basis for the adversaries that the principle is incompatible with *Syariah* law. On the other hand, on the apprehension of the company being utilised for avoidance of law or fraudulent purposes, though understandable, may be dealt with the application of exception to principle of separate legal entity that is, lifting the corporate veil. Though the exception only exposes the 'real' person behind a company, the liability is still limited to the portion of his shares without extending to his personal properties. In other words, the exception to the principle of separate legal entity does not fully solve the problem of companies being used for fraudulent purposes.

Obviously, there is a misconception about the application of *shirkah inan* in a body corporate. As mentioned by Hafeez (2013), some of the jurists argued the concept of corporate entity and limited liability does not breach the ruling of Islam by giving an example of master and slave in the trading. According to them, the master was actually the owner of the whole business, the slave being merely an intermediary tool to carry out the business transactions and therefore the liability of the master was limited to capital that he invested. This is a clear misunderstanding in the concept of *sharikah* in Islam. In Islam, the underlying contract of *shirkah* or partnership is based on *wakalah* for which the principal and agents was treated as one entity. Even, if the underlying contract is based on *amanah* and *kafalah*, still, there is no room for limited liability of the owner. Thus, according to (Alkhamees n.d.), The doctrine of limited liability is seen as a breach of the *Shariah* prohibition on *Gharar* (uncertainty or excessive risk). This is based on many prophetic Hadiths such as "The delay (in paying a debt) of a person who is able to pay is oppression", and "Whosoever takes from the wealth of a Muslim person with a transgressing hand then let him make a house as an abode in the Fire of Hell", as well as the legal maxim *Al Kharaju Bi Al-daman* ("entitlement to profit or gain depends upon the corresponding liability for loss").

## CONCLUSION

There are many differences between a company and a *Shirkah al-inan*, mainly based on the legal status of the latter which is not separated from the partners and does not exempt liability of the partners. The doctrine of corporate personality also cannot be explicitly applied in *Shirkah al-Inan*; thus reaching the conclusion that to define companies as *Shirkah al-Inan* is incorrect and misleading.

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