



HARVARD LAW SCHOOL
Islamic Legal Studies Program

and



LONDON SCHOOL OF ECONOMICS

Workshop on

*Use & Abuse of
Limited Liability*

Thursday, February 13, 2014

London School of Economics
Tower #3, 5th Floor (BOX)
London, United Kingdom

**Harvard Law School
Islamic Legal Studies Program
and
London School of Economics**

Workshop on

Use and Abuse of Limited Liability

**Thursday, February 13, 2014
8:30 a.m. - 5:30 p.m.**

**London School of Economics
Box Room, 5th Floor, Tower #3
London, United Kingdom WC2A 2AE**

Directions: <http://www.lse.ac.uk/resources/mapsAndDirections/findingYourWayAroundLSE.htm>

OVERVIEW

The episodes of financial crisis and the subsequent experience of various *sukuk* defaults brought to the forefront the issues of insolvency and debt restructuring in Islamic finance. Thus, last year's 7th Harvard-LSE workshop focused on the topic of "Insolvency and Debt Restructuring in Islamic Finance." At the conclusion of the workshop it was felt that a closely related matter is the concept of limited liability and its scope and limitations in Islamic finance. This has strong implications not only for the handling of insolvencies but also for business growth and economic development. Despite its importance, a concrete position on this issue exists neither among the shari'a scholars nor among Islamic economists and finance professionals. Hence, this year our participants chose to examine deeply shari'a's position on the concept of limited liability. An attempt is also needed to understand legal and economic issues surrounding this concept and to explore the optimal organizational format for Islamic financial institutions.

INTRODUCTION

The evolution of the concept of limited liability has played an important role in the economic development in general and in the growth of industrial and manufacturing at large scale in particular. The concept of a corporate body hinges on two concepts: (i) juridical person and (ii) limited liability.

There are several benefits of limited liability. It brings together a large number of investors to act as one body, shielding them from operational, financial and management risks stemming from individual actions or behavior. It also provides investors an opportunity to diversify their investments across various businesses, shielding them from the negative consequences of bad business decisions. In the absence of such, a great majority of investors would only invest in small number of businesses which they themselves can manage and give their full attention. This would limit the scale and scope of businesses. The existence of limited liability brings a large number of small savers into the economy to invest, without which only the wealthy who are able to bear such risks on a portion of their wealth would have invested. Limited liability also simplifies the valuation of shares of a firm, as valuation is based on the income stream and asset and liabilities of the company.

Notwithstanding its advantages, limited liability also has some negative impacts. It allows business managers to indulge in excessive risk, as well as borrowing to increase return on capital and to hide behind the corporate veil if the venture fails. This and many other forms of abuse of limited liability often result in privatization of gains but socialization of losses. Limited liability of financial firms can result in extraordinary risk taking. There have been many examples of abuses of limited liability both in the present and the past. The Enron debacle, the Parmalat bankruptcy, the failure of Lehman Brothers, and the closure of many financial firms during the crisis are just a few examples that reflect the deeply rooted malaise.

Corporations are predominantly financed through debt, whereas small businesses are primarily financed through internal savings, indicating that the limited liability is one of the major factors responsible for excessive debt in the economy.

OBJECTIVES

The main purpose of this workshop is to begin to envisage various models or structures of organizing business that retain the beneficial aspects of limited liability while avoiding the misuse of the concept. The discussion will begin with a focus on the concepts of juridical person and limited liability and Islam's position on them, followed by issues emanating from them and potential solutions or alternatives. This workshop aims to lead the way towards a better business organizational form that balances and aligns the interests and responsibilities of all stakeholders.

The discussions are proposed along following three subthemes:

1. Shari'a Issues and Position on Juridical Person and Limited Liability
2. Economic Issues and Consequences of Use (*Maslaha*) and Abuse (*Mafsada*) of Limited Liability Concept – How to Manage the Costs and Benefits
3. Shari'a-Compliant Optimal Organizational Forms: Keeping in View the Benefits and Avoiding the Misuses of Limited Liability

WORKSHOP AGENDA

8:30 a.m. Reception and Coffee

9:00 a.m. Opening Remarks

9:10 a.m. Workshop Chair Remarks

9:25 a.m. A Short Presentation on the Workshop theme

9:35 a.m. Part 1: Shari'a Issues

Participants' Views - Open Floor Discussion

Opportunity for participants to share their views on the following:

- To what extent the concept of Limited Liability Company (LLC) is justifiable in Islamic law?
- Are the concepts of (i) juridical person and (ii) limited liability two separate concepts or interdependent?
- Is it necessary to link the concept of limited liability with the concept of juridical person?
- Is limited liability more of an economic question rather a Shari'a/legal matter?
- Are all forms of LLCs permitted in Shari'a? Or there are specific types?
- Individual versus collective liability - where are the boundaries?
- How misuse of limited liability is (can be) addressed in Shari'a?
- Can the corporate veil be pierced? What are its limits and implications?

11:00 a.m. Tea/Coffee Break

11:15 a.m. Summary – Moderator to provide a summary of all the main points of views and frame questions.

Part 2: Economic Issues

11:30 a.m. Participants' Views – Open Floor Discussion

Opportunity for participants to share their views on the following:

- How similar or different are the implications of a 'juridical person' and 'real person' from accountability of his actions?
- What mechanisms exist to balance the incentives towards excessive risk taking by a Limited Liability Company?
- What are the benefits and costs of a Limited Liability Company to investors, shareholders, managers and the society at large?
- Limited liability is a privilege granted by society. What is expected by society in return from a Limited Liability Company?
- Is limited liability a necessary condition for growth of business firms and the economy at the aggregate level?
- How far is Islamic finance and the concept of limited liability compatible with each other? Do they help each other?

1:00 p.m.

Lunch

1:45 p.m. **Summary** - Moderator to provide a summary of all the main points of view and frame questions.

Part 3: Limited Liability Companies - Solutions & Alternative Forms

2:00 p.m. Participants' Views - Open floor Discussion

Opportunity for participants to share their views on the following:

- Should financial firms and non-financial firms be treated differently for limited liability?
- Can a juridical person have the capacity to create another juridical person?
- How to improve the use of LLC in Islamic Finance for better governance and more prudent risk management?

- Is lifting the corporate veil necessary in certain conditions? What are they?
- How to overcome the tax disadvantage for (less) non-leveraged Islamic firms?
- Alternative forms of LLC:
 - a. Pure limited liability
 - b. Preferential liabilities
 - c. Ceiling on liabilities
 - d. Mixed liabilities
- Bring out the costs and benefits of each type of model.

3:30 p.m.	Tea/Coffee Break
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3:45 p.m. **Summary** - Moderator to provide a summary of all the points of view.

3:45 p.m.	Part 4: Way Forward
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Open Floor Discussion

- If you had a blank canvas, knowing what you know now, how would you improve the current corporate structure? What would you suggest for the optimal structure of non-financial firms and for financial firms? What changes would you propose in national and international laws for improved governance?
- Participants to discuss—and, where possible, reach consensus on—issues within the areas to be raised by the moderator.

4:45 p.m.	Part 5: Summary and Next Workshop
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- Participants to assist the Moderator in drafting a workshop summary
- Participants to share ideas for the next workshop

5:30 p.m.	End of Workshop
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