

## **STAKEHOLDERS MODEL OF GOVERNANCE IN ISLAMIC ECONOMIC SYSTEM**

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*The paper discusses the design of an efficient and optimal corporate governance structure of a firm within Islamic economic system. The objective of this paper is to identify factors, which will influence corporate governance within an Islamic economic system and to examine if corporate governance model will be 'shareholder'- or 'stakeholder'- centered? The paper argues that the governance model in Islamic economic system is a stakeholder-oriented model where governance structure and process at system and firm level protect rights of stakeholders who are exposed to any risk as a result of firm's activities. Whereas conventional system is struggling with finding convincing arguments to justify stakeholders' participation in governance, the foundation of a stakeholder model is found in Islam's principles of property rights, commitment to explicit and implicit contractual agreements and implementation of an effective incentive system. The paper also discusses the implication of a stakeholder model on depositors, Islamic financial institutions, and regulators.*

### **INTRODUCTION**

The issue of corporate governance and search for optimal governance structure has recently received considerable attention in conventional economic literature and public policy debates. This increased attention can be attributed to several factors such as (a) the growth of institutional investors, i.e. pension funds, insurance companies, mutual funds and highly leveraged institutions, and the role institutional investors play in the financial sector especially in major industrial

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<sup>1</sup> Authors are thankful to the discussants for their comments. Authors would like to remind the readers that the objective of the paper is to highlight the sound foundation and relevance of stakeholders theory in Islamic economic system and the paper is not intended to make any suggestions on the larger design of governance system in Islamic economic system. Authors hope that this paper will serve the starting point for much needed research in this area.

economies; (b) widely articulated concerns and criticism that the contemporary monitoring and control of publicly held corporations in Anglo-Saxon countries especially UK and USA are seriously defective, leading to sub-optimal economic and social development,<sup>2</sup> (c) a shift away from traditional 'shareholder value centered' view of corporate governance in favor of a corporate governance structure extended to a wide circle of stakeholders; and (d) impact of increased globalization of financial markets, global trend of deregulation of financial sectors, and liberalization of institutional investors' activities which have raised concerns over corporate governance.<sup>3</sup> Although, each of the above mentioned factors provides compelling reasons to examine current corporate governance structures, the most challenging, and the one which contains the seeds of a paradigm shift in understanding of corporate governance, is the stakeholder-oriented model of governance.

This paper examines the arguments for and against the stakeholder model presented in conventional literature and argues that a stakeholder-oriented theory of corporate governance finds strong roots in the Islamic economic system. Section I discusses the stakeholders theory in conventional system and identifies critical issues. Sections II and III examine the theoretical framework in support of stakeholders theory from Islamic economic system. Section IV discusses the governance structure in Islamic economic system. Section V concludes the discussion.

## SECTION I

### STAKEHOLDER MODEL OF CORPORATE GOVERNANCE

The concept of corporate governance is diverse and, over the period of time, definition of the term 'corporate governance' has oscillated between two extremes - from a narrow concept of a mechanism of implementing investors' interest to a broad concept advocating protection of all internal and external stakeholders' rights. This wide spectrum of concept stems out of two divergent views: (a) how the entity of a 'firm' should be perceived in an economic system, and (b) the form of the incentive system to protect rights and to preserve the obligations of economic agents in the environment in which the firm operates. Whether one views the firm as a bundle of assets and liabilities, a legal entity, an economic or social organization, a nexus of contracts, or as a combination of these elements, will influence the way in which the evolution of conceptualization of corporate governance is analyzed.<sup>4</sup>

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<sup>2</sup> Kasey, Thompson and Wright (1997).

<sup>3</sup> For a detailed discussion see, Balling, Hennessy and O'Brien (1998) and Bloomstein (1998).

<sup>4</sup> Tam (1999).

The modern theory of firm dates to Coase's (1937) fundamental insight that firms exist as a substitute for more costly modes of transacting. Transaction costs in negotiating, contracting, coordinating, enforcing and discharging rights and obligations under a set of contracts can be reduced by creating a firm that serves as an intermediary between the consumer and the supplier of inputs.<sup>5</sup> Based on Coase's idea of transaction costs as an explanation for the existence of a firm, Alchian and Demsetz (1972) further refined the idea and viewed the firm through agency-cost theory and focused on the cost of monitoring. They considered management of the firm to be a 'continuing process of negotiation of successive contracts.' Jensen and Meckling (1976), developed the notion of the firm as nexus of contracts, and argued that contractual designs emerge to minimize transaction costs between specialized factors of production. Focus of early researchers was to identify ways in which managers could be made responsive to shareholders despite the dispersed nature of share ownership.

This basic agency problem suggests a possible definition of corporate governance as that which constitutes an efficient monitoring structure solving both adverse selection and the moral hazard problems. Shleifer and Vishny's (1997) survey of corporate governance is focused on this view of corporate governance restricted to the ways in which the suppliers of finance to corporations assure themselves of getting a return on their investment. Corporate governance structure, focused on investor-manager contract and relation, is often referred to 'shareholder model' of corporate governance. It can be characterized as a model where (1) shareholders ought to have control, (2) managers have a fiduciary duty to serve shareholder interests alone, and (3) the objective of the firm ought to be the maximization of the shareholders' wealth.

Traditional definition of corporate governance among economist and legal scholars, based on agency relationship between the investor and the manager, is concerned with the protection of shareholders' or investors' interests only. Business ethicists have generally considered this result to be ethically unacceptable because it unjustifiably neglects the rights of non-shareholder groups. Opponents of shareholder-value concept point out that this profit-maximization approach to the firm is too narrow a view for an economic analysis of corporate governance because of externalities imposed by profit maximization choices on other stakeholders. These include, *inter alia*, constraints on welfare of management and workers who have invested their human capital as well as off-work related capital (housing, spouse employment, schools, social relationships, etc.) in the employment relationship and on suppliers and customers who have also sunk investments in the relationship and foregone alternative opportunities, and on

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<sup>5</sup> Cornell and Shapiro (1987).

communities who suffer from the closure of business.<sup>6</sup> The exclusion of the interests of the others involved in the firm affirms a divisiveness that could well be consequentially counter-productive.<sup>7</sup>

The neo-institutional economists<sup>8</sup> argue that the firm's claimants go beyond shareholders and bondholders to include others with whom the firm has any explicit and implicit contractual interaction. In this "*nexus-of-contracts*" view, each corporate constituency, including employees, customers, suppliers, and investors, provide some asset in return for some gain. Contracts result from bargaining by these constituencies over the terms of their compensation as well as the institutional arrangements that protect this compensation from post-contractual expropriation.<sup>9</sup> According to this view, there is nothing unique to corporate governance, which simply becomes a more complex version of standard contractual governance.<sup>10</sup> All stakeholders are regarded as contractors with the firm, with their rights determined through bargaining.

Stakeholder theorists reject the three main propositions of the shareholder system and argue for the following: (1) all stakeholders have a right to participate in corporate decisions that affect them, (2) managers have a fiduciary duty to serve the interests of all stakeholder groups, and (3) the objective of the firm ought to be the promotion of the interests of all and not only those of shareholders. This view is commonly referred to as 'stakeholders' model of corporate governance where 'stakeholders' may include customers, suppliers, providers of complementary services and products, distributors, and employees. Therefore, this theory holds that corporations ought to be managed for the benefit of all who have some stake in the firm.<sup>11</sup>

A critical review of evolving literature dealing with stakeholders reveals that the concepts of stakeholder, stakeholder model, stakeholder theory, stakeholder management, and stakeholder society are explained and used by various authors in very different ways and supported (or critiqued) with diverse and often

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<sup>6</sup> See Blair (1995), Turnbull (1997) and Tirole (1999) for a discussion of a society centered around protecting interests of all stakeholders.

<sup>7</sup> Sen (1993) points out that it is precisely the denial of distinction between shareholders and others involved in the firm and the adoption of a more integrated view of the enterprise as "a large family," that has been a major force in the cooperative efficiency that Japanese industry has tended to achieve.

<sup>8</sup> Baums, Buxbaum and Hopt (1994). The neo-institutionalists, rely on agency theory to define the firm as a "nexus of contracts" and consider agents and transactions institutionally, societally, legally, culturally as contingent (incomplete) constructs.

<sup>9</sup> Boatright (2002).

<sup>10</sup> Zingales (1997).

<sup>11</sup> Donaldson and Preston (1995), Freeman (1984), Boatright (2002).

contradictory evidence and arguments.<sup>12</sup> Trole (1999) suggests that there is little formal analysis of the economics of stakeholder model or stakeholder society. Stakeholder model is largely normative and is still evolving to find a sound theoretical foundation in conventional economic literature. In this process, a number of issues have to be addressed. First, it is argued that ‘nexus-of-contracts’ view of the firm needs to expand the concepts of contracting and agency beyond their narrow use in economics and include their legal and moral uses in order to make stakeholder theory of governance a comprehensive one.<sup>13</sup> Distinction between explicit (or formal) and implicit (or relational or self-enforcing) contracts and claims is key concept in understanding the foundation of stakeholder model.<sup>14</sup> When it is difficult to write complete state-contingent contracts—when, for example, certain variables are either ex-ante unspecifiable or ex-post unverifiable—people often rely on “unwritten codes of conduct”, that is, on *implicit contracts*.<sup>15</sup> These may be self-enforcing, in the sense that each party lives up to the other party’s (reasonable) expectations from a fear of retaliation and breakdown of cooperation.<sup>16</sup> This implies that, in addition to obligation on explicit contracts, obligations arising out of implicit contracts have to be incorporated into the “*nexus of contracts*” theory with convincing arguments, and that only can be articulated by expanding the scope of analysis to include ethics, morals and social order. Hart (2001) forcefully argues that many economic transactions are sustained by self-enforcing (“implicit”) contracts or norms of behavior, such as honesty or trust; concepts which so far have proved difficult to formalize in economic theory.

Second issue is how to draw a line of distinction between a stakeholder and a non-stakeholder. Existence of a stakeholder entity and its rights are easy to recognize, but question still remains who really qualifies as an actual stakeholder? Third issue deals with the stakeholders’ right to influence management decision-making or to participate in governance of the firm. Questions arise why stakeholders should be given such right and why managers should have a fiduciary duty to protect rights of non-investor or non-owner stakeholders if such stakeholders have protected their rights through bargaining in the terms of the

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<sup>12</sup> Donaldson and Preston (1995).

<sup>13</sup> Boatright (2002).

<sup>14</sup> Jones (1995). Contract between a firm and its bondholders, wage contracts, or product warranties are examples of explicit or formal contractual claims that firms issue to non-investor stakeholders. Concept of implicit contracts is more delicate and refined. Implicit contracts between the firm and stakeholders are relatively vague and informal, and no documents exist to describe these contracts.

<sup>15</sup> Examples of implicit contracts include a firm’s commitment to neighboring community, the promise of continuing service to customers, and job security to employees. Another example of implicit contracts is between a bank and its major customers that ensure provision of credit. Japanese and Korean (as well as other economies) top industrial firms were shown to have binding implicit contracts with the banks.

<sup>16</sup> Foss, Lando and Thomsen (1998).

contracts. Whereas there appears to be a consensus on identifying the rights of non-owner stakeholders and an implicit agreement to protect these rights, there is still a debate on why such stakeholders should participate in the control and management processes of a firm. For example, the notion that property rights are embedded in human rights and that restrictions against harmful uses are intrinsic to the property rights concept clearly highlights the interests of other non-owner stakeholders but it remains unclear which uses of property should be restricted and which persons should count as stakeholders. Simply bringing non-owner stakeholders into the conception of property rights does not, provide by itself, a justification for assigning any specific groups of stakeholders, such as employees and customers, managerial responsibilities.<sup>17</sup> So far, discussions of stakeholder model have not been able to articulate a convincing argument on either theoretical, moral, or legal grounds to recognize active role of stakeholders in management and control of a firm.

In considering an Islamic view of the role of stakeholders, it is noted that two fundamental concepts of Islamic economic system pertaining to property rights and contracts govern the economic and social behavior of individuals, society and state. These two principles also dictate objective function of economic agents, including legal entities like firms. A firm in Islamic economic system can be viewed as 'nexus-of-contracts' whose objective is to minimize transaction cost to maximize profits and returns to investors subject to constraints that these objectives do not violate property rights of any party whether it interacts with the firm directly or indirectly. In pursuit of these goals, firm honors its obligations to explicit and implicit contracts without impinging on the social order. This definition incorporates stakeholders' role in its view of the firm and supports recognition and protection of their rights. A discussion of Islam's principles of property rights and contracts in Sections II and III provide a foundation for this proposition and also clarifies issues, which the conventional stakeholder theory has yet to resolve.

## SECTION II

### PROPERTY RIGHTS AND GOVERNANCE

The design of governance system in Islam can be best understood in light of principles governing the rights of individual, society, and state, the laws governing property ownership, and the framework of contracts. Islam's recognition and protection of rights is not limited to human beings only but encompasses all forms of life as well as environment. Each element of Allah (S.W.T)'s creation has been endowed with certain rights and each is obligated to respect and honor the rights of others. These rights are bundled with the responsibilities for which humans are

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<sup>17</sup> Donaldson and Preston (1995).

held accountable.<sup>18</sup> *Shari'ah* offers a comprehensive framework to identify, recognize, respect and protect rights of every individual in creation, community, society, and the state. Islamic scholars and *fuqahā'* have defined and codified detailed principles identifying these rights.<sup>19</sup> The importance of being conscious and mindful of the rights of others (including stakeholders-- human or non-human) and the significance of discharging the responsibilities associated with such rights are reflected by the following saying of the Prophet (pbuh):<sup>20</sup>

‘So give to everyone who possesses a right his right. (*kull dhi haqin haquhu*)’

The term right (*haq*) denotes something that can be justly claimed, or the interests and claims that people may have been granted by *shari'ah*. Majority of *shari'ah* scholars and jurists hold that similar to a physical property, rights are also property (*al māl*) because, like physical property which has beneficial uses and is possessable, rights have beneficial uses and are regarded as capable of being possessed.<sup>21</sup> Rules defining the property rights in Islam deal with the rights of ownership, acquisition, usage and disposition of the property. Any violation of these rules is considered a transgression and leads to disruption in social order.

The notion of ownership in Islam is two-tiered: (i) real and absolute, and (ii) delegated and restricted through time-bound possession. The former belongs to Allah (S.W.T.) only because He is the ultimate creator while the latter is reserved for the man in order that he becomes materially able to perform his duties and obligations. Therefore, the first axiom of the property rights in Islam is that Allah (S.W.T.)-- the real owner, creator, and benefactor-- reserves the right to prescribe for man-- His vicegerent, recipient and possessor-owner-- rules governing the property while it is in the temporal possession of man.<sup>22</sup> Ownership rights in Islam originate from the concept of *Khilāfah* (stewardship) as the Qur'ān and *Sunnah* clearly and explicitly state that Allah (S.W.T) is the sole owner of property and that

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<sup>18</sup> *Shari'ah* scholars consider that the human self or soul (*nafs*) has “rights” as well as many duties and responsibilities. The basis of this is the fact that when a person violates these rights he is said to have “wronged” (*zulm*) his/her soul (see for example verses 2:231 or 37:113).

<sup>19</sup> Imam Zayn al-Abidin's treatise on the rights, *Risalat Al-Huqūq* covers a full spectrum of rights in Islam. For example, the right of one's property (*al-māl*) is that one takes it only from what is lawful and spends it only on what is proper. The right of the associate is that one neither misleads him, nor acts dishonestly toward him, nor deceives him. The right of the adversary (*Khaṣm*) who has a claim against one is that, if his claim is valid, one gives witness to it against oneself [Ali ibn al-Husayn (1990)].

<sup>20</sup> Ali Ibn al-Husayn (1990).

<sup>21</sup> Islam (1999) The term *mal* or its derivatives have been mentioned in the Qur'ān in more than 90 verses and in numerous sayings of the Prophet (pbuh).

<sup>22</sup> See Mirakhor (1989) and Ahmad (1995).

man as vicegerent of Allah (S.W.T) is merely trustee and custodian.<sup>23</sup> This relationship implies that man has the right to use and manage his ‘private property’ in a manner similar to that of a custodian and trustee. Property is not an end itself, but a means to discharge effectively man’s responsibilities as the vicegerent of Allah (S.W.T).

The second axiom of property rights in Islam is that this right of possession is a collective right and individuals can only earn a priority in the use of these resources.<sup>24</sup> While a part of these resources are reserved for the exclusive possession of the collectivity, the remaining part is allowed to become of individual’s without the collectivity losing its initial right of possession to these resources. However, when an individual applies his creative labor to these resources he gains a right of priority in the use and enjoyment of the resulting product, without the rights of others being nullified. Individuals are to use these resources with the full understanding that Allah (S.W.T)’s ultimate ownership and the collectivity’s prior right, remain intact. This notion is the result of the permanence, constant, and invariant ownership of Allah (S.W.T) of all the resources, and by implications, that of prior right to these resources by the collectivity.<sup>25</sup> This proposition becomes a legislative basis for requiring preservation of society’s well-being and interests.

<sup>23</sup> Allah (S.W.T) explicitly states that “Believe in Allah and His messenger, and spend of that whereof He made you *trustee*.” Qur’ān (57:7). By implication, the ownership of property (*al-māl*) is understood to be a trust and is considered to be a test of faith. [Bashir (1999)].

<sup>24</sup> Mirakhor (1995) makes reference to a number of verses to support this axiom. For example:

هُوَ الَّذِي خَلَقَ لَكُمْ مَّا فِي الْأَرْضِ جَمِيعًا

“He it is who has created for *you all* that is on earth” Qur’ān (2:29).

Both لَكُمْ and جَمِيعًا refer to collectivity for whom the plurality of resources have been created by Allah (S.W.T.). In another verse, Allah (S.W.T) says:

وَلَا تُؤْتُوا السُّفَهَاءَ أَمْوَالَكُمُ الَّتِي جَعَلَ اللَّهُ لَكُمْ قِيَدًا

“Do not give your *resources* that Allah has made you its preservers on to the foolish” Qur’ān (4:5).

Again, أَمْوَالَكُمْ and جَعَلَ اللَّهُ لَكُمْ قِيَدًا indicate the right of collectivity.

<sup>25</sup> Mirakhor (1989). Based on the principle of justice, and the recognition of man’s natural tendencies, rights, and obligations, individuals are allowed to appropriate to themselves the products resulting from the combination of their labor and certain of these resources—without the collectivity losing its original rights either in the resources or the products resulting from the individual’s creative labor applied to these resources in accordance with the rules, specified by the *sharī‘ah*.



Social interest and the collective dimensions of human life demands that individual freedom is kept within certain limits and a balance is created such that the individual, the society, and the state each has a claim on property rights in respect of the roles assigned to them. Property rights of these three agents should not come into conflict with one another, nor should the exercise of those rights by any one of these agents jeopardize the exercise of rights by the others.<sup>26</sup> If as a result of the growth of the society, division of labor, or increasing complexities of markets, either the obligation to share is shirked or the rights of the society and the cohesion of the community are undermined, or a harmonious social order is at stake, the justification is created for the intervention of the legitimate authority to take corrective measures.

Second axiom of the property rights implies that while individual's possession of these resources and his share in the outcome is allowed, sanctioned and protected by the *sharī'ah*, it is so as long as it does not come into conflict with society's interest and well being. Hence, private initiative and choice are recognized, but such recognition is not allowed to subvert the principle of sharing or lead to violation of the rights of the society and the state.<sup>27</sup> However, once the individuals have discharged the duties to the society and the state, in accordance with prescribed manner and amount, and are not in violation of the rules of *sharī'ah*, their right to their possessions is held inviolate and no one has a right to force appropriation (or expropriation) of that person's property to anyone else.<sup>28</sup> This is further endorsed by *hadīth* stating that "*Muslims' blood, property and dignity are protected against each other.*"<sup>29</sup>

Ibn Taimiyah views property as a right granted by *sharī'ah* to utilize an object but a right of varying kinds and degrees. Sometimes the right is an extended one so that the proprietor can sell or give away the object, lend it or make a gift of it, bequeath it or use it for productive purposes; but sometimes the right is incomplete, and therefore the proprietor's rights are limited or restricted.<sup>30</sup> Rules concerning property acquisition, possession, usage and disposal should be looked at as regulations rather than the restrictions.<sup>31</sup> Basic conditions to maintain lawful rights

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<sup>26</sup> Ibn Taimiyah was one of the earliest scholars to recognize and to advocate the rights of the society and the state along with the private ownership. Islahi (1988) claims that this distinguishing characteristic of his economic views is not found in any of scholastic scholars.

<sup>27</sup> Mirakhor (1989).

<sup>28</sup> The Prophet (pbuh), during his last sermon at Arafat declared the inviolability of property to be at par with that of life and honor: "Like this day of this month in this territory, sacred and inviolable, Allah (S.W.T) has made the life and property and honor of each of you onto the other until you meet your Lord."

<sup>29</sup> Islam, Muhammad (1999).

<sup>30</sup> Islahi (1988).

<sup>31</sup> Bashir (1999).

to property are that (1) property should not have been acquired by unlawful means (means repugnant to *sharīʿah*), (2) the acquisition and its continuity should not result in any damage or harm to others; and (3) the acquisition of property should not invalidate any valid claim nor should establish a non-valid one.<sup>32</sup> Islam places great emphasis on acquiring and maintaining rights to property through lawful means but does not impose any limits on the amount of the property owned, i.e. imposition of any cap on the amount of wealth an individual can accumulate as long as the individual is conforming to the obligations set by *sharīʿah*.<sup>33</sup>

Islam recognizes two ways in which an individual can obtain rights to property: (1) through his own creative labor and/or (2) through transfer--via exchange, contract, grants or inheritance-- of property rights from another individual who has gained title to the property or asset through his own labor. Property acquired through non-permissible and unjustifiable means like gambling (*maysir*), bribing, stealing, cheating, forgery, coercion, or illegal trading does not qualify as '*al-māl*' as defined by *sharīʿah* and therefore is proscribed and forbidden. Consequently, any property, which is considered counter-productive or non-beneficial, loses its legitimacy and its associated rights. Hoarding with the intention to creating artificial scarcity and profiteering is considered unacceptable means of building wealth and property. Similarly, property acquired through breach of trust, adulteration, non-compliance with weights and measures, or unethical means does not satisfy the definition of property (*al-māl*) and therefore it's ownership is not considered legitimate.

Concomitant with property rights, the *sharīʿah* imposes responsibilities, among which are the obligations-- severely incumbent upon the individual-- not to waste, destroy, squander, or to use the property for purposes not permitted by the *sharīʿah*.<sup>34</sup> To do so would be to transgress the limits set on one's right and an encroachment on the rights of the others. The right of the collectivity to the property is further protected by the *sharīʿah* through the limitations imposed on the right of disposition of the property by the person who has gained priority in the use and enjoyment of that property. Hence, while the right of use and enjoyment of the property is affirmed by the *sharīʿah*, the exclusive and absolute right of disposition

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<sup>32</sup> Behishti and Bahonar (1990).

<sup>33</sup> Nabhani (2000).

<sup>34</sup> These rules are supported by various verses in Qur'ān as following:

"And do not eat up your property among yourselves for vanities, not use it as bait for the judges, with intent that ye may eat up wrongfully and knowingly a little of (other) people's property." Qur'ān (2:188).

"Those who when they spend are not extravagant and not niggardly, but hold a just (balance) between those (extremes)." Qur'ān (25:67).

"Behold, the squanderers are, indeed, of the ilk of the satans..." Qur'ān (17:27).

of the property is rejected.<sup>35</sup> The prohibition of *isrāf* and *tabdhir* (wasting and squandering) in all areas applies to property as well. The individual may not make an alteration in his property that may harm even his neighbor. If the property owner proves his inability to use the property properly (within boundaries defined by *sharīʿah*), he forfeits his ownership rights. Under such conditions, the legitimate authority is fully justified in withdrawing the rights of usage of that property in order to protect it from the misuses by the owner.<sup>36</sup> This position of the *sharīʿah* is in conformity with the Islamic conception of justice (*al-ʿadl* and *al-iḥsān*) and the rights and responsibilities of the individual and the community.

Islam's concept of property rights differs in many aspects from the concept of property rights in other economic systems. On one extreme, proponents of market-based system argue in favor of individual-centered private property rights as fundamental right while on the other extreme a small minority believes that private property right is fundamentally immoral.<sup>37</sup> On the contrary, Islam promotes a balance among rights of individuals, society and the state. This concept sharply contrasts with the self-centered utility maximizer economic agent idealized in neoclassical economics in an unbounded, insatiable, quest for acquisition and accumulation.<sup>38</sup> Before the full market society came to prevail in the West, a great deal of property right in land and other assets was a right to use and enjoy the asset but not a right to dispose of it.<sup>39</sup> The development of full market society required revision of this notion of property since it was considered that the right not to be excluded from the use or enjoyment of something that is not marketable. It was deemed impossible to reconcile this particular right with a full market economy. Hence, of the two earlier kinds of property rights—the right to exclude others and the right not to be excluded by others—the second was all but abandoned and the conception of property rights was narrowed to cover only the right to exclude others. In Islam, however, this right is preserved without in any way diminishing

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<sup>35</sup> The concept that man has an unrestricted handling authority over his wealth is unacceptable. Allah (S.W.T.) has condemned the people of *Shuaʿyb* for adopting such an attitude. See Qurʾān (11:87), [Ahmad (1995)].

<sup>36</sup> Bashir (1999) argues that Islam attaches great importance on protecting people from harm caused by others. The Prophet is reported to have said “*to cause harm to others is not allowed in Islam.*”

<sup>37</sup> Some cultures and religions forbid property rights altogether. Among many of the native peoples of North America, the idea that someone could somehow “own” the land was unimaginable, while Hutterites practice Christian communism, living together in very successful farming communes in Manitoba, Saskatchewan, and North Dakota, where all material goods are held in common. Milgrom and Roberts (1992).

<sup>38</sup> Mehmet (1997) gives an overview of Ghazali's economic ideas, which are based on private property and ownership, but economic relations are subject to self-imposed (voluntary) rules of moderation, honesty, and integrity. However, this view makes Ghazali a non-Hellenic and non-rationalist in standard Western terms.

<sup>39</sup> Mirakhor (1989).

the role of the market as resource allocative and an impulse-transmitting mechanism. Islam does not endorse the notion of conventional system that a person does no harm to members of his group if as a result of his effort he is better off and others are no worse off than they would otherwise be.

Several conclusions can be drawn from the preceding discussion. First, Islam's concept of property rights is different such that the individual has a delegated right on the property whose acquisition, usage and disposal are subject to rules including the principle of sharing as dictated by *shari'ah*. Second, whereas Islam strongly recognizes individual's private property rights, these rights are governed by rules designed to protect the rights of society and the state. Third, by virtue of the first and second axiom of property rights, every individual, group, community, society and the state becomes a stakeholder whose rights are granted and preserved by *shari'ah* to promote social order and economic development. Fourth, whereas it is difficult to recognize or justify some rights of others in a formal economic theory in the conventional system without drawing any reference to ethics and morality, such problem does not exist in Islam where everyone's rights are recognized and protected by Law (*shari'ah*). Finally, inclusion (or exclusion) and recognition (or denial) of rights of stakeholders in Islamic economic system are based on foundations of rules and laws, which need no justification merely on the grounds of morality alone but are derived from principles aimed at creating a just and balance in economic and social system.

Whereas *shari'ah* guarantees some basic property rights to individuals by virtue of them being members of the society, rights of a firm or a legal entity like corporation are earned and acquired. It is not the firm, which accrues property rights but it is the property acquired in course of the firm's economic activity that has property rights and claims. Once a property is earned or acquired by the firm, it is subject to the same rules of sharing and prohibition of wasting which apply to property of individuals. Firm's property rights also come with similar claims and responsibilities as individuals. This implies that firm is expected to preserve property rights of not only local community or society but also of those who have participated in the process of acquiring or earning the firm's property. No action of the firm that violates basic set of property rights of those with whom firm interacts will be acceptable.

Principles of property rights in Islam clearly justify inclusion of stakeholders into decision-making and accountability of an economic agent's activities. This inclusion is based on the principles that (a) collectivity (community, society, state) has sharing rights with the property acquired by either individuals or firms, (b) exercise of property rights should not lead to any harm or damage to property of others (including stakeholders), (c) rights of others are considered as property and therefore are subject to rules regarding violation of property rights, and finally (d) any property leading to the denial of any valid claim or right would not qualify to

be recognized '*al mā'l*' and therefore will be considered unlawful according to *sharī'ah*.

### SECTION III

#### CONTRACTS AND GOVERNANCE

The significance of contractual obligations in economic and social relations cannot be over-emphasized. The whole fabric of Divine Law is contractual in its conceptualization, content, and application. Islam forcefully places all economic relations on the firm footing of 'contracts.'<sup>40</sup> It recognizes only one status, i.e. moral consciousness and virtue, all other status on any basis is obliterated. The very foundation of the *sharī'ah* is covenant between Allah (S.W.T) and man; this imposes on man the duty of being faithful to his word. On Allah's side, the Qur'ān often states that "*Allah will not fail in His promise.*"<sup>41</sup> On man's side, his commitment to the contractual obligations is considered the best form of honoring his acceptance of Allah (S.W.T) as his Lord.

A contract in Islam is a time-bound instrument, which stipulates the obligations that each party is expected to fulfill in order to achieve the objective(s) of the contract. Contracts are considered binding and their terms are protected by the *sharī'ah*, no less securely than the institution of property. The freedom to enter into contracts and the obligation to remain faithful to their stipulations has been so emphasized in Islam that a characteristic, which distinguishes a Muslim, is considered to be his faithfulness to the terms of his contracts. In the *sharī'ah*, the concept of justice, faithfulness (called *amānah*, whose antonym is *khiyānah* meaning betrayal, faithlessness and treachery), reward and punishment are linked with the fulfillment of obligations incurred under the stipulation of the contract.

The *sharī'ah* judges the virtue of justice in man not only for his material fulfillment of contracts but also by the essential attribute of his forthright intention (*niyyah*) with which he enters into every contract. This intention consists of sincerity, truthfulness, and insistence on rigorous and loyal fulfillment of what he/she has consented to do (or not to do). This faithfulness to one's contractual obligations is so central to Islamic belief that when the Prophet was asked "who is a believer?" He replied that "*a believer is a person in whom the people can trust their person and possessions.*"<sup>42</sup> In a very terse, direct and forceful verse, the

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<sup>40</sup> Relationship between Allah (S.W.T) and human beings initiated as a contract. A covenant was made when Allah (S.W.T) asked, "*Am I not your Lord?*" to which human beings replied, "*Yes, we testify.*" Qur'ān (7:172).

<sup>41</sup> See for example Qur'ān (30:6).

<sup>42</sup> The Prophet is also reported as having said that "*a person without trustworthiness is a person without religion.*" Mirakhor (1989).

Qur'ān exhorts “*O you who believe, fulfill contracts.*”<sup>43</sup> So basic is the notion of contracts in Islam that every public office is regarded, primarily as a contract and agreement, which defines the rights, and obligations of the parties.<sup>44</sup>

Implication of the emphasis placed on contracts in Islam is that it makes the members of the society and economic agents aware of the obligations arising from their contractual agreements-- verbal or written, explicit or implicit. In case of explicit contracts, parties to the contract clearly stipulate expected behavior and duties with respect to the terms of the contract. This contract is to be free of information asymmetry; parties intend to comply with the terms of the contract and are fully aware of rights and obligations. Importantly, the state ensures enforceability of the contract in case of violations by either party. On the other hand, implicit contracts are not formal contracts with clearly defined terms but are claims and obligations that come with the rights to be part of a society.<sup>45</sup> Principles of sharing and rights of collectivity to property rights are kind of implicit contracts to preserve and protect rights of others and thus establish a wide spectrum of implicit obligations.<sup>46</sup> Within property rights framework, one has contractual obligations to others including the community and the society according to the rules of *shari'ah*, and honoring of this obligation is considered a sacred duty. This sacred duty to preserve property rights of others is moral, social and legal foundation for recognizing and enforcing obligations to implicit contracts.

Islam's framework of contracts places equal emphasis on obligations arising from both explicit and implicit contracts. This behavior is expected from individuals as well as from public and private entities. Therefore, just as it is incumbent upon economic agents to honor explicit contracts, it is obligatory on them to preserve sanctity of implicit contracts by recognizing and protecting property rights of stakeholders, community, society and state. Whereas conventional stakeholders' theory is searching for sound arguments to incorporate implicit contracts in the theory of firm, in Islamic economic system rights of and obligations to stakeholders are taken for granted.

Islam's framework of property rights and contracts also establish guidelines regarding who can qualify as a stakeholder and if such stakeholder has right to

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<sup>43</sup> Qur'ān (5:1).

<sup>44</sup> Mirakhor (1989).

<sup>45</sup> Since, implicit claims are too nebulous and state contingent to reduce to writing at a reasonable cost and therefore they cannot be unbundled and traded independently from the goods and services the firm buys and sells. Typically, a firm can default on its implicit promises without going bankrupt or liquidation. Cornell and Shapiro (1987).

<sup>46</sup> The notion of accountability in the Hereafter is a major motive to comply with implicit contracts. Similarly, the notion of blessing in Hereafter provides a strong incentive to comply with implicit contracts.

influence the firm's decision-making and governance. In a very broad sense, any group or individuals with whom firm has any explicit or implicit contractual obligations qualify as a stakeholder even though firm may have formal contracts with them through mutual bargaining. In Islam, a stakeholder is the one whose property rights are *at stake* or *at risk* due to voluntary or involuntary actions of the firm. In case someone's rights are encroached or threatened as a result of firm's operations, that individual, group, community or society becomes a stakeholder.<sup>47</sup> This risk-based definition of stakeholder is supported by a saying of Prophet that "*a Muslim is the one from whose hand others are safe.*"<sup>48</sup>

Having established the firm's responsibility to society and stakeholders, question still remains whether stakeholders have the right of participation in decision-making. Or, if they are given right to participate, is it practical and operationally efficient? These issues are discussed in detail in the following section.

#### SECTION IV

#### CORPORATE GOVERNANCE STRUCTURE

Once the rights of stakeholders are recognized, one can focus on what determines the best institutional arrangements to protect the stakeholders' rights to its true spirit. Or what structure of governance can yield optimal results. Within the conventional stakeholder theory, there are opposing arguments with regards to stakeholders' participation in the governance. Some argue that there is greater need that a firm should internalize the externalities on the various stakeholders and this internalization should be in form of active participation in the process and structure of corporate governance.<sup>49</sup> Others argue that each stakeholder or constituency is free to bargain with a firm and to choose the most effective means for protecting its interests. Some stakeholders may derive little benefit from the set of rights negotiated by shareholders and therefore would prefer other safeguards for their interests. Consumers, for example, instead of seeking a seat on the board of directors, or the benefit of fiduciary duties may settle for manufacturers'

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<sup>47</sup> Classical definition of stakeholders is given by Freeman (1984) as any group or individual who may affect or be affected by the attainment of the firm's goals. Donaldson (1995) argues that this definition lacks any normative rationale or criteria for identifying who the stakeholders are or for allocating the rights corresponding to each one. Clarkson's (1995) offers a refined view of a stakeholder based on the stakeholder's exposure to the risk (a hazard, a danger, or the possibility of suffering harm or loss) as result of firm's activities.

<sup>48</sup> Sahih Bukhari, Volume 1, Book 2, Number 10.

<sup>49</sup> Tirole (1999).

warranties, consumer and product safety laws, and tort liability system because these protections better serve their interests.<sup>50</sup>

Islamic economic system is a rule-based incentive system; based on the rules of *sharī'ah* with the ultimate goal of maintaining a just and harmonious social order. Rules are restrictions on what the members may do without upsetting the social order on whose existence all members count in deciding on their individual choices and actions. Therefore, attachment to and observance of rules will guide the members of the society in their actions. The rules themselves are composed of those which deal with the individual's body and his state of consciousness, those which govern his relationships with other members of the society, those which guide his relationship with the collectivity and finally those which constitute the code of conduct necessary for the community as a whole. Rules serve to prevent conflicts, reconcile the different purposes of many individuals and facilitate cooperation among them. If as a result of growth of the society, division of labor, or increasing complexities of markets, either the obligation to contracts or property rights are shirked or the rights of the society and the cohesion of the community are undermined, justification is created for intervention of the legitimate authority to take corrective measures.<sup>51</sup> Compliance with them promotes social integration and unity and preserves the intended social order.

In Islam, expected behavior of a firm would not be any different from the expected behavior of any other member of the society. Since firm itself does not have a conscious, behavior of its managers becomes the behavior of the firm and their actions are subject to the same high standards of moral and ethical commitment expected from a Muslim. In other words, firm's economic and moral behavior is shaped by its managers acting on behalf of the owners and it becomes their fiduciary duty to manage the firm as a trust for all the stakeholders and not for the owners alone. Consequently, it will be incumbent upon managers to ensure that behavior of the firm conforms to the principles and the rules of *sharī'ah*. If there is any deviation, institutional arrangement discourages such deviation. In an ideal situation where all agents are *Mo'meneen*, those among Muslims whose behavior correspond fully to the requirement of the *sharī'ah*, the faithfulness to the terms of contracts and accountability to respect others' property rights will lead to elimination of problems due to asymmetric information, moral hazard and adverse selection and thus would guarantee optimal governance. In a less perfect world where commitment to contracts may be influenced by personal interests at the cost of interests of collectivity to induce deviation from the terms of contract, design of a governance structure will be required to ensure faithfulness to agent's contractual agreements and protections of everyone's rights.

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<sup>50</sup> Boatright (2002).

<sup>51</sup> Mirakhor (1989).



The design of a corporate governance system in Islamic economic system entails implementation of a rule-based incentive system such that the compliance with the rules ensures an efficient governance system to preserve social justice and order among all members of society.<sup>52</sup> This would imply the design of institutions and rules that induce or, if needed, compel managers to internalize the welfare of all stakeholders. The rights that are claimed for stakeholders are not ends in themselves-- which ought to be recognized in any form of economic organization-- but means for protecting constituency rights.<sup>53</sup> In an Islamic system the observance of rules of behavior guarantees internationalization of stakeholder rights (including those of the society at large). No other institutional structure would be needed if there were complete adherence to Islamic rules. However, to ensure compliance to the Islamic rules, there is need for institutional arrangements. Therefore, it would be the Islamic government that should specify appropriate corporate governance structure, “incorporating all stakeholders’ rights into fiduciary duties of managers” of the firm on behalf of none-- investors or stakeholders. So no other institutional arrangement that would allow individual non-investor stakeholders to negotiate directly with the firm would be necessary. Incorporating all stakeholders’ right into fiduciary duties of managers would be counter-productive and would lead to sub-optimal results. The important point is that each stakeholder is given freedom of bargaining to protect its rights and there are systematic institutional arrangements in place to provide protection and to mediate where disputes and disagreements arise.

Institutional arrangements can be part of system-wide infrastructure surrounding the governance structure of the firm. For example, because contracts are invariably incomplete, judicial interpretations can fill in the gaps. It is permissible to regard employment law, consumer law, tort law, as well as judicial rulings and administrative regulations, as part of the contracts that various stakeholders have with the firm.<sup>54</sup> Similarly, the concept of *sharī‘ah* boards is very unique to Islamic financial system. A *sharī‘ah* board, consisting of *fuqahā’* (scholars in *sharī‘ah* matters) has been used to oversee the operation of a financial institution to ensure that the operations and code of conduct of Islamic bank is according to the rules of *sharī‘ah*. A *sharī‘ah* board for every firm, which is seen in present architecture of Islamic banking, is not efficient whereas only one set of rules is needed for appropriate corporate governance based on the *sharī‘ah* for all firms. The same idea of *sharī‘ah* board can be extended to a system-level board consisting of scholars from different disciplines including *sharī‘ah*, economics, finance, and commercial law, to ensure that rules are defined and enforced so that economic agents fully comply with contractual obligations to all the stakeholders.

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<sup>52</sup> Iqbal and Mirakhor (2001). It is assumed that the social, legal and political environment surrounding the economic system is also in compliance with the Islamic rules.

<sup>53</sup> Boatright (2002).

<sup>54</sup> Boatright (2002).

## V. CONCLUSION

This paper examines the conventional stakeholder theory of corporate governance, which views a firm as a 'nexus-of-contracts' with different stakeholders and argues that firm's objective should be to maximize welfare of all stakeholders. This theory has yet to offer strong arguments with regards to who is a stakeholder and why firm has any obligation to non-owner stakeholders because of absence of theoretical foundation to incorporate morals, ethics and trust in the economic theory. This paper argues that the principles of property rights and contracts in Islam offer theoretical foundations to acknowledge the rights of all stakeholders.

Islam's principles of property rights, contracts, and just social order define the business environment where economic agents are morally conscious of protecting property rights and contractual obligations to each other whether acting as managers, employees, suppliers, customers, or in any other capacity. All participants in economic activities, whether individuals, firms, corporations, non-profit organization or public institutions, are subject to the same degree of commitment. Notion of sanctity of contractual obligations is not limited to explicit contracts, which are well defined, stipulated and documented, but is equally applicable to implicit contracts, which are incomplete in nature. Property rights of all contractual parties, i.e. individuals, or local communities, or intangible legal entities, or the society are preserved and protected. Keeping in mind that voluntary behavior of all economic agents may deviate from the expected behavior, implementation of an incentive system according to the guidelines of *sharī'ah* will ensure that all economic activities adhere to *sharī'ah*'s principles of property rights and contracts so that an optimal social order is achieved. It is not necessary for each stakeholder to be a participant in the decision-making as long as their rights are protected through sound institutional arrangements.

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