

STAKEHOLDERS MODEL OF GOVERNANCE IN ISLAMIC ECONOMIC SYSTEM

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The present paper by Zamir Iqbal and Abbas Mirakhor examines the relevance of stakeholder model of corporate governance in an Islamic economic system, which is an active area of research. The paper essentially asserts that a stakeholder oriented theory of corporate governance finds strong roots in the Islamic economic system. In what follows, I summarize the basic ideas contained in the paper and seek to elaborate on some of them that appear to hold great potential for further research and analysis.

1. A somewhat narrow and early model of corporate governance called the “shareholder model” of corporate governance focuses on the owner/investor/shareholder-manager relationship. It stresses that the objective of the firm is maximization of shareholders’ wealth. Managers as agents of shareholders have a fiduciary duty to engage in actions that help achieve this objective. A vast literature is devoted to identifying appropriate contractual mechanisms in order to resolve or mitigate the problems associated with the principal-agent relationship, commonly referred to as agency problems. It may be mentioned here that a fairly large number of studies have recently appeared that examine this issue in the context of Islamic financial contracts in general and participatory contracts in particular.
2. As pointed out by the authors, “business ethicists have generally considered this result to be ethically unacceptable because it unjustifiably neglects the rights of non-shareholder groups.” Does this imply that we may find an appropriate model of corporate governance in the domain of Islamic ethics in contrast to the Islamic law of contracts? For example, employees and consumers are important stakeholders in the firm. Islamic commercial law is quite explicit about the rights and obligations of parties in contractual mechanisms governing the employer-employee and seller-buyer relationships. Provisions seeking to protect the (informationally) weaker party are quite commonplace in the Islamic law of contracting (e.g. *khiyar-al-ayb* or option against defects that seeks to protect the interest of the buyers). However, law

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perhaps does not take into account all the externalities imposed by shareholder wealth maximization choices on non-shareholder stakeholders. To cite an example, a *mudharabah* contract may be terminated with the consent of *mudharib* (manager) and *rabb al-mal* (finance providers) after a finite period resulting in closure of business. However, this may result in local communities suffering heavily from the closure of this business. Even while law would permit the owner of business to seek closure, ethical concerns may demand its continuation. Similarly, employees are understood to invest considerable human capital in the firm. While as per the explicit *ijarah* contract, an owner may terminate the employment after the contractual period is over, ethical concerns may demand his continuation for a time period long enough for him to find an alternative employment. With respect to consumer – another important stakeholder, law would permit the seller to price a product at a level deemed unduly high by consumers while ethics would demand setting prices at a “reasonable” level that is not detrimental to consumer interests. It needs to be understood that Islamic law essentially defines the minimum level of ethics below which an act becomes impermissible. However, within the permissible domain, one may seek optimal governance structures that are ethical and that take care of interests of non-shareholder stakeholders. If we focus entirely on the “floor” level of ethics defined by Islamic law of contracts, we may lose sight of the exciting possibilities that Islamic ethics offers in terms of governance structures.

3. An interesting distinction is often made in the evolving literature dealing with stakeholders between explicit contracts and implicit contracts. Contracts between firm and financiers (*mudharib* and *rabb al-mal*), wage (*ijarah* and *ju'alah*) contracts, product warranties (*khiyar al [ayb]*) are all examples of explicit contracts. Many such contracts discussed in stakeholder theory literature are rooted firmly in Islamic law. Implicit contracts or “unwritten codes of conduct” are relatively vague and informal. Examples of implicit contracts discussed in the literature are a firm’s commitment to neighboring community, fair prices and continuing services for customers, job security to employees. Needless to say, as highlighted above, such contracts are rooted in Islamic ethics.
4. An alternative to the shareholder view is the neo-institutional view that argues that the firm’s claimants go beyond shareholders and bondholders and include others with whom the firm has any explicit and implicit contractual relationship. In this nexus-of-contracts view all stakeholders are regarded as contractors with the firm, with their rights determined through bargaining. As the authors state, there is nothing unique to corporate governance in this model, which simply becomes a more complex version of standard contractual governance. A model of governance based on Islamic contractual law would be similar to this model. Of course, this would be ethically more demanding.

Under Islamic law, mutual consent that may be an outcome of bargaining is not enough for a contractual mechanism to be acceptable. Bargaining for example, may result in unacceptable contracts if either of the parties is informationally or otherwise disadvantaged.

5. In considering an Islamic view of the role of stakeholders, the authors note that “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. The authors, it appears, base their model on the Islamic principle of “freedom from *darar* or detriment” This refers to the possibility of a third party being adversely affected by a contract between two parties. If a contract between two parties executed with their mutual consent is detrimental to the interests of a third party, then it may enjoy certain rights and options. (A case in point is the preemptive right or *al-shuffa* of a partner in joint ownership.) As they note, “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.
6. A major part of discussion in the paper focuses on property rights in Islam. As the authors rightly point out, the notion of ownership in Islam is two-tiered. The former is real and absolute and belongs to Allah SWT only. The latter is delegated to man and restricted through time-bound possession. Further, this delegated right of possession is collective and individuals can only earn a priority in use of these resources. The authors use this line of reasoning to make a general case for stakeholder theory of firm. The case is well made. One wishes however, that the authors move beyond a general recognition of supremacy of collective and societal interests over individual interests. A formal presentation of stakeholder theory of firm requires a clear delineation of rights and obligations of various stakeholders in a firm, in addition to the society or Islamic state.
7. More importantly, the authors appear to leave the task of designing of a corporate governance system to the Islamic state. As they assert, “it is the Islamic government that specifies the appropriate corporate governance structure, incorporating all stakeholders’ rights into fiduciary duties of managers of the firm on behalf of non-investors or stakeholders. So no other institutional arrangement that would allow individual non-investor stakeholders to negotiate directly with the firm is necessary. Incorporating all stakeholders’ rights into fiduciary duties of managers would be counter-productive and would lead to sub-optimal results.” This is certainly debatable. Stakeholder theory is not about legislation. While we may agree to leave the

task of legislation and regulation relating to corporate governance to an Islamic state, the basic issue is hardly addressed. The issue before researchers and scholars is to come up with alternative models of corporate governance and suggest an optimal one so that managers, directors, strategists, and management scientists can benefit from this theory. The authors seem to present this as a challenge for future researchers.