A Primer on Islamic Law of Insolvency

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Abstract:

Islamic law is a complete code of life for the believers. It enjoys the features of flexibility and rigidity. Although these features may seem to be contradictory, they are balanced by Islamic law harmoniously. Thus, we see that the general principles in Islamic law are fixed and are not subject to change. However, the minor details and practical application may change with the passage of time. Due to its flexibility, this law is capable of adapting itself according to the changes of society. A unique aspect of Islamic law is insolvency and/or bankruptcy. Although this notion is not widely discussed these days, the books of fiqh are rich with a code of insolvency for individual debtors. There is a complete theory underlying this code which balances the rights of debtors and creditors. Thus, Islamic insolvency does not violate the right of debtor or creditors. Both are given their due rights without any comprise on the rights of other party. In this article, we introduce the Islamic law of insolvency briefly. The purpose is to add to the academic debate on insolvency today. Particularly, this chapter of fiqh is important due to the wide spread growth of Islamic finance whereby instances of insolvency are observed frequently. He paper is a theoretical attempt to highlight the general theory of Islamic insolvency law.

Key Words: *Insolvency, bankruptcy, Islamic law, iflas*

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Introduction:

The question of how to treat an insolvent debtor has been addressed by all nations since centuries. There seems a gradual shift from being harsh towards a debtor and nowadays there is more or less soft corner for distressed debtors. In designing insolvency laws to deal with this issue, some principles have been developed across jurisdictions. These principles are of two types: those on which most of the nations agree and those, on the other hand, on which there is open disagreement.

Among the principles that are widely agreed upon is, firstly, the maximization of the value of debtor's assets for all the creditors. Usually, there is a rush on debtor's assets after he is known to be in distress. Every creditor tries to get hold of whatever possible. There is a kind of "feeding frenzy" or "shark attack" that the debtor is faced with. This response by creditors may destroy the value of the debtor's assets which are already insufficient. Therefore, when insolvency appears evident, the debtor's assets should be treated as a joint pool the value of which is to be maximized for the benefit of all the creditors (Wessels, Markell and Kilborn, 2009).[1] The second agreed upon principle is to put the already existing rights of the creditors into their proper order, and not to establish a new order or hierarchy. All creditors already have an established order against the debtor's assets (as per the contract agreement) and insolvency laws only distribute the inevitable losses among them. This limitation reduces the cost of insolvency proceedings by focusing on what needs to be done and how. The third and final unanimous principle is generally known as *pari passu*, i.e. equal

treatment of the creditors that fall under the same category or rank (Wessel, Markell and Kilborn, 2009).[2] Although claimed to be universal principles of insolvency systems, even these three principles are not universal in their concept and application as they may apparently seem and discrepancy does exist.

Islamic Law of Insolvency:

With the wave of Islamization across Muslim countries, attention has been paid to different aspects of Islamic law and jurisprudence in the modern context. As many of the Muslim countries had been colonized in the past century, these countries sought to introduce Islamic law into their legal systems. For this purpose, they usually adopt the method of implantation. Nevertheless, this approach is criticized by many and it has its limitations and difficulties both. Although these are parts of Islamic law, like banking and finance etc., which has received good attention in this connection, other areas like insolvency has been least investigated. The problem may be attributed to the fact that Islamic law does not talk about the notions of legal personality or limited liability whereas most of the modern insolvency legislations revolve around corporate insolvency.

However, Islam is a universal religion. It has provided a complete code of life that guides the believers in all spheres of life. Business transactions constitute an important pillar of human life whereby every human being indulges in such activities on daily basis. However, not all human being are same in their calibre to do business. Consequently, some people are faced with failure in their business adventures. This is

one area that is addressed with detail under Islamic law due to its long term consequences for the whole society. It is a matter that relates to property rights of different human beings involved jointly in transactions with a person(s). Thus, we find that the general principles to deal with a distressed debtor is revealed in Quran while some more detail of how to deal with the issue of insolvency is provided in *aÍÉdÊth*. Based on these two sources, the Muslim jurists drew a detailed guideline for the judge and/or person administering insolvency.

If we analyze the chapter related to insolvency in the books of Islamic jurisprudence, we find that this issue is discussed by the Muslim jurists either in a separate chapter, or sometimes under the chapter of interdiction. The latter approach is adopted because insolvency leads to court interdiction in most cases and this is why it is brought under this chapter. Accordingly, the jurists usually start this chapter with the definition of *iflÉs* and *Iʿsār* etc. Next, they also highlight that interdiction is usually imposed due to (1) the interest of the interdicted person himself, like an insane person *(majnËn)*, or (2) for the interest of other people like the case of an insolvent debtor. The jurists further agree that it is the right of the creditors to approach the court and request that the debtor be interdicted due to the debts that the debtor is unable to pay. In such case, the judge is required to interdict the debtor after a proper procedure which will lead to certain SharÊÑah rulings of its own. Thus, it is stated by ibn QudÉmah (Died: 630 AH) in *al-MughnÊ* (v. 4, p. 456)[3] that:

ومتى لزم الإنسان ديون حالة لا يفي ماله بها فسأل غرماؤه الحاكم الحجر عليه لزمته إجابتهم، ويستحب أن يظهر الحجر عليه لتجتنب معاملته فاذا حجر عليه ثبت بذلك أربعة أحكام (أحدها) تعلق حقوق الغرماء بعين ماله (والثاني) منع تصرفه في عين ماله (الثالث) ان من وجد عين ماله عنده فهو أحق بها من سائر الغرماء اذا وجدت الشروط (الرابع) ان للحاكم بيع ماله وايفاء

As the writer has mentioned, there are four categories of rulings that will naturally follow from the court order of interdiction. These categories further detail a series of provisions as explained in the books of *fiqh*. Although the original ruling is that it is upon the demand of the creditors based on which the insolvent is interdicted, the debtor, in certain cases, can also initiate the proceedings.

It is generally agreed by the Muslim jurists that the debts which are not due cannot be demanded from the debtor. Consequently, he cannot be declared bankrupt for these debts. Similarly, the debtor will not be asked to pay these and will not be declared bankrupt because of these since these are not yet due. In this connection, ibn QudÉmah (Died: 630 AH) further mentions that (*al-MughnÊ* v. 4, p. 456):[4]

ومن لزمه دين مؤجل لم يطالب به قبل أجله لأنه لا يلزمه أداؤه ولم يحجر عليه من أجله لأنه لا يستحق المطالبة به فلم يجز منعه من التصرف في ماله بسببه فإن كان بعض دينه مؤجلا

A similar opinion is held by many other Muslim jurists as well. However, we have discussed this issue in chapter 6 with full detail. It is argued in that section that the preferred opinion is that the deferred debts will also fall due with the insolvency declaration of the debtor.

This is the opinion of Maliki School and it is most appropriate for the current time.

Another important issue is whether a creditor can reclaim his asset from the debtor? The majority of Muslim jurists view that the creditor has the right on the condition that the asset is still intact in its original shape. This is based on a hadith of the Prophet peace be upon him. Thus, it is stated by ibn QudÉmah (Died: 630 AH) that (*al-MughnÊ*, v. 4, p. 456):[5]

(وإذا فلس الحاكم رجلا فأصاب أحد الغرماء عين ماله فهو أحق به إلا أن يشاء تركه ويكون اسوة الغرماء)

Al- BuhËtÊ (Died: 1015 AH) explains the reclamation issue in the following paragraph (*KashshÉf al-QinÉÑ*, v. 3, p. 425)[6] with further detail of the different reclamation creditors who has the right to claim their assets:

(أن من وجد عنده) أي المفلس (عيناً باعها إياه ولو) كان بائعها إياه (بعد الحجر عليه غير عالم به) أي بالحجر عليه، لعدم تقصيره. لأنه مما يخفى كثيراً (أو) وجد عنده (عين قرض، أو رأس مال سلم، أو غير ذلك) كشقص أخذه منه المفلس بشفعة (حتى عينا مؤجرة، ولو) كانت (نفسه) بأن أجر حر نفسه فحجر على المستأجر لفلس (أو غيرها) بأن أجر عبده أو دابته. فحجر على المستأجر لفلس، و (لم يمض من المدة) أي مدة الإجارة (شيء) له أجرة عادة (فهو) أي واجد عين ماله عند المفلس (أحق بها إن شاء) الرجوع فيها، روى عن علي وعمار وأبي هريرة. لحديث أبي هريرة: أن النبي صلى الله عليه وسلم قال " من أدرك متاعه عند إنسان أفلس فهو أحق به" متفق عليه.

However, it is the opinion of the ×anafÊs that the creditor does not have such right. The main logic for this opinion is that once the

contract is concluded with all its conditions fulfilled, the seller/creditor does not have the right to reclaim the asset after the buyer goes bankrupt. There is further detail in this issue that has been explained in chapter 6 of this thesis.

An important issue discussed by the Muslim jurists while discussing individuals' insolvency is whether a debtor can be imprisoned or not. The most famous opinion among the jurists is that he can be imprisoned when certain conditions are met. This is to ensure the rights of the creditors.. In this regard, al-BuhËtÊ (Died: 1015 AH) states that (*KashshÉf al-QinÉÑ*, v. 3, p. 425):[7]

(فإن أبى من) أي مدين (له مال يفي بدينه) الحال (الوفاء، حبسه الحاكم)

Based on the Quranic injunction that a debtor should be given respite, an interesting question is that whether giving time to the distressed debtor is *wÉjib* or *mustaÍab*? According to the majority of the Muslim jurists, it is *wajÉb*. Ibn QudÉmah (Died: 630 AH) accordingly opines that (*al-MughnÊ*, v. 4, p. 462):[8]

و متي ثبت إعساره عند الحاكم لم يجز مطالبته ولا ملازمته

A similar view is held by al-SharbÊnÊ (Died: 977 AH) who argues that once it is proved that a debtor has nothing left to pay his debts, it is not permissible to imprison or pursue him (*MughnÊ al-MuÍtÉj*, v. 2, p. 204):[9]

وإذا ثبت إعساره لم يجز حبسه ولا ملازمته بل يمهل حتّى يوسر

Not only have the Muslim jurists discussed the dispositions of a distressed debtor after he is insolvent, they have also elaborated his dispositions before declaration of insolvency. Accordingly, it is argued by ibnʿAbdul Barr (Died: 462 AH) that once a person's debts are more than his assets, he still has the right to pay some of his creditors instead of others. However, he cannot do some dispositions even in this situation as explained below (*al-Kāfī*, v. 2, p. 828-829):[10]

ومن كان عليه دين يحيط بماله ولم يوقف لتفليس فجائز أن يقضي بعض غرمائه دون بعض وجائز تصرفه في بيعه وشرائه، وأخذه، وعطائه، ونكاحه، وسائر معاوضاته الا أن يحابي في ذلك فإن حابى أحدا فالمحاباة عطية وهبة، ولا يجوز ذلك لمن أحاط الدين بماله قبل التفليس ولا بعده،

However, some Muslim jurists have explained that if there are dubious or doubtful transactions before insolvency, they can be rescinded after insolvency and interdiction. We have analyzed this issue in chapter 6 under the title claw-back actions.

Regarding the procedural aspects of insolvency, it is generally agreed by the jurist that the person in charge of insolvency should appoint a trustee to undertake different responsibilities related to the case proceedings. In this connection, ImÉm al-ShÉfiÑÊ (Died: 204 AH) has written in *al-Umm* (v. 4, p. 433)[11] that:

ينبغي للحاكم إذا أمر بالبيع على المفلس أن يجعل أمينا يبيع عليه، ويأمر المفلس بحضور البيع، أو التوكيل بحضوره إن شاء، ويأمر بذلك من حضر من الغرماء، فإن ترك ذلك المبيع عليه والمبيع له، أو بعضهم، باع الأمين.

Similarly, ImÉm al-ShÉfiÑÊ (Died: 204 AH) also elaborates the remuneration of the bankruptcy trustee in full detail. He states that (*al-Umm*: v. 4, p. 435):[12]

وأحب إليّ فيمن ولي هذاأن يرزق من بيت المال، فإن لم يكن، لم يجعل له شيئاً حتى يشارطوه هم. فإن لم ياتفقوا اجتهد لهم، فلم يعطه شيئاً وهو يجد ثقة يقبل أقل منه،وهكذايقول لهم فيمن يصيح على ما يباع/عليه فيمن يزيد،وفي أحد إن كال منه طعاماً أو نقله إلى موضع سوق،وكل ما فيه صلاح المبيع، إن جاء رب المال أو هم بمن يكفى ذلك لم يدخل عليهم غيرهم،وإن لم يأتوا استأجر عليه من يكفيه بأقل ما يجد.

Thus, it is visible that the purpose here is to increase the value of the debtor's assets to the maximum level.

Additionally, the jurists insist that once a person is prohibited to dispose of his property due to the rights of his creditors in his property, this should be announced widely among the people so that people do not deal with him anymore. The Muslim jurists explain what will be the provision if he still enters into transactions after interdiction Thus, al-SharbÊnÊ (Died: 977 AH) writes that (*MughnÊ al-MuÍtÉj*, v. 2, p. 193):[13]

فإذا حُجِر تعلّق حق الغرماء بماله، وأشهد على حجره لِيُحذَر. ولو باع أو وهب أو أعتق ففي قول يوقف تصرفه، فإن فضل ذلك عن الدين نفذ وإلّا لغا، والأظهر بطلانه، فلو باع ماله لغرمائه بدينهم بطل في الأصحّ.

What is explained above is only a sample of how minutely the Muslim jurists have discussed the issue of individual insolvency. What is evident from the above examples and texts is that there is a detailed theory of insolvency in Islamic jurisprudence. The modern insolvency systems have not yet reached a level of sophistication that Islamic jurisprudence achieved centuries back. However, it is now time and also a challenge to apply the individual insolvency provisions of Islamic law to corporate entities in the modern world. Indeed, most of the rulings will apply in this case. But there are provisions that are not applicable to legal entities. For instance, a legal entity cannot be imprisoned because it is not a physical being; it only

exists legally, in the papers. In any case, Islamic jurisprudence is a treasure that is capable enough to provide guideline towards a corporate model of insolvency law which is in compliance with SharÊÑah.

Conclusion:

The Muslim jurists developed a detailed theory dealing with the situation of individual insolvency. The Islamic law of insolvency is based on a combination of creditor and debtor rights. In other words, it is booth debtor friendly and creditor friendly. Since most of the insolvency provisions found in Islamic law are derived from the general principles of Islamic law, it is possible to expand these principles to corporate insolvency and derive a framework which can deal with the insolvency of legal entities. However, it is a daunting task which needs great efforts from academia, industry players, SharÊÑah experts etc. Moving forwards, further research in this area should be the starting point to arrive at a corporate model of Islamic law of insolvency.

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