Title A functional derivative action framework for Pakistan

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ABSTRACT

Company law in Pakistan does not recognise shareholders' right of derivative action. This situation raises the question as to what extent derivative action, if recognised under the company law in Pakistan, can promote good corporate governance and contribute to reinforce enforcement powers of shareholders as to safeguarding their rights? The purpose of this thesis is twofold. First, this thesis argues that an effective derivative action system could act as a means of disciplining corporate management in Pakistan. Second, it presents it argumentations that other legal and extra-legal managerial disciplinary mechanisms have limitations of their own that support the introduction of a statutory derivative action system in Pakistan.

The methodologies used in this thesis are doctrinal, historical, case study, comparative and semi-structured interviews. Doctrinal analysis has been employed when analysing statutes and case law. Case study methodology has been used to exemplify problems of directorial misconduct and providing empirical evidence for carrying out further analysis. A comparative approach has been utilized for which the UK has been chosen for comparative purposes to identify lessons that Pakistan can learn from the UK derivative action system while finding ways for effective use of derivative action system in Pakistan. Semi-structured interviews are aimed at providing an evaluation of the reform proposals.

This study contributes to the subject of derivative action in three key ways. First, it provides an in-depth examination of the regulatory framework pertaining to shareholder protection in Pakistan in order to highlight the inherent challenges presented by un-updated legal framework. Second, based on the findings from this thesis, reform proposals are made as to codifying derivative actions, clarifying the procedural route

for derivative proceedings and providing a funding mechanism to attract shareholders to bring derivative actions to enforce corporate rights. Third, suggestions proposed in this thesis are supported by both the opinions of the interviewees and original research on judicial experience of other jurisdictions, particularly the UK. The findings made in this study and proposals have implications for law reforms and are expected to inform practitioners, academics, legislators and policy makers on the way forward in reforming shareholder protection in Pakistan. Thus, this thesis would inform reforms in the company law in order to strengthen the enforcement power of shareholders and ensure corporate accountability in Pakistan.

AUTHOR'S DECLARATION

I, Aamir Abbas declare that this thesis and the work presented in it are my own and have been generated by me as the result of my own original research.

Title: A functional derivative action framework for Pakistan

I confirm that this work was done wholly or mainly while in candidature for a research degree at this University;

Where any part of this thesis has previously been submitted for a degree or any other qualification at this University or any other institution, this has been clearly stated;

Where I have cited the published work of others, this is always clearly attributed; Where I have quoted from the work of others, the source is always given. With the exception of such quotations, this thesis is entirely my own work;

I have acknowledged all main sources of help;

Where the thesis is based on work done by myself jointly with others, I have made clear exactly what was done by others and what I have contributed myself;

Either none of this work has been published before submission

Signature:_____

Date: 12 January 2017

ARTICLE AND CONFERENCE PAPER

1. Article: “Supremacy of the Constitution versus Supremacy of the Parliament: Finding the Basic Structure of Constitution of Pakistan” Pakistan Law Journal, Feb, 2016.
2. Conference Paper: Derivative Litigation in Pakistan, Lessons to be learned from the US, presented at 7th International Business Conference, Las Vegas, USA, December, 2014.

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LIST OF ABBREVIATIONS

All ER: All England Report

BMM: Berle-Means Model

CEO: Chief Executive Officer

CPR: Civil Procedure Rules

CH: Law Reports, Chancery Division

CLA: Corporative Law Authority

CLD: Corporative Law Division

CLRC: Corporate Law Review Committee

CVS: Cumulative Voting System

FCA: Financial Conduct Authority

FSC: Federal Sharia Court

HL: House of Lords

IMF: international monetary fund

KSE: Karachi Stock Exchange

LHC: Lahore High Court

LLSV: R.LaPorta, FLopez-ed-silanes, A. Shleifer and R. W. Vishny

LC: Law Commission

NJP: National Judicial Policy

NAB: National Accountability Bureau

OECD: Organisation for Economic Co-operation and Development

PICG: Pakistan Institute of Corporate Governance

PLD: Pakistan Legal Decision

SC: Supreme Court of Pakistan

SCR: Supreme Court Reports

SECP: Securities and Exchange Commission of Pakistan

SHC: Sindh High Court

SOE: State-Owned Enterprises

WB: World Bank

WLR: Weekly Law Reports

KEY TERMS

The Ordinance: the Companies Ordinance 1984

The Code: the Code of Corporate Governance of Pakistan.

The SECP Act: the Securities and Exchange Commission of Pakistan Act 1997.

Pyramiding: In pyramid ownership arrangements, a family based company may control a publicly traded company A, and then the company A controls another publicly traded company B and then the company B controls yet another company C and in doing so, the company at the top of the pyramid controls the company that is at the lowest tier of the pyramid often with very low shareholding.

Cross share-holding: Cross share-holding structures help shareholders maintain control over different firms by occupying shares therein. For example, if majority shareholders, due to their majority shareholdings, have the control of a company A and if company A occupies majority shares of company B, this phenomenon helps the majority shareholders of company A to control company B alongside though they are not occupying majority shares in the company B.

Derivative action: a legal action initiated by a shareholder in the name of a company defrauded by its directors or managers, is called a 'Derivative Action'.

Direct action: a legal action initiated by a shareholder in his own name for the enforcement of the violation of his personal right is called, a 'Direct Action'.

The following table explains the difference between direct actions and derivative actions.

Shareholder Litigation	**Direct Action**	**Derivative Action**
Who brings action?	The individual shareholder whose private rights are infringed by the management can take a direct action against the management.	Any shareholder of the company can take a derivative action against management alleged to have violated the rights of the company.
Who pays the legal costs ?	The individual aggrieved shareholder himself pays the legal costs.	The company pays the costs.
Who is entitled to compensation?	The aggrieved shareholder receives the compensation as a result of the successful direct action.	The concerned company receives the compensation as a result of the successful derivative action and it is to be shared by all shareholders in proportion to their shares in the company.

Difference between Public Enforcement and Private sector Enforcement:

The public enforcement is related to government initiated proceeding while private sector enforcement is related to shareholders' actions for the enforcement of their rights.

Difference between Common Law and codified law:

Common law is judge-made law (judicial precedents) while a law passed by the legislature of a country is called, a statutory law.

RESEARCH BACKGROUND

An effective corporate governance framework ensures smooth functioning of a company, promises shareholder protection and guarantees that the directors perform their duties in accordance with the companies' interests.[1]The framework ensures that financial reports and information are consistent, and that all shareholders are treated impartially and equitably. Attempts have been made to improve corporate governance within companies in different countries by promulgating corporate governance codes of best practices and improving their legal framework to ensure shareholder protection. Reliable remedial measures have been devised, such as derivative actions, which the shareholders can resort to when things happen to go wrong and thus, to have the wrongdoers held accountable.[2]

A central feature of derivative litigation is to provide shareholders, particularly minority shareholders with an armoury to safeguard their interests.[3] Minority protection is an important corporate governance objective. It wields greater significance especially in the context of Pakistan where equities are held in blocks of shares enabling the

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[1] Stijn Claessensa and Joseph P.H. Fanb, 'Corporate Governance in Asia: A Survey' (2002)3(2) *International Review of finance* 71-103,72

[2] Harald Baum and Dan W. Puchniak, 'The Derivative action: an economic, historical and practice-oriented approach in Dan W. Puchniak, Herald Baum and Michael Ewing-Chow (eds), The Derivative action in Asia :a comparative and Functional Approach (Cambridge University Press 2012) 1; Coffee and Schwartz, 'The Survival of the Derivative Suit : An Evaluation and a Proposal for Legislative Reform' (1981) 81 *Columbia Law Review* 261, 302–309; William Kaplan and Bruce Elwood, 'The Derivative Action: A Shareholder's "Bleak House?"'(2003) *University of British Columbia Law Review* 443, 451, 455

[3] James D. Cox, Randall S. Thomas, ' Common Challenges facing shareholder suits in Europe and the United States' (2009) 6(2)*European Company and Financial Law Review* 348-57; Robert Clark, Corporate Law (Little, Brown US (01 July 1986) 622

block-holders to control and manage not only family firms but also other related companies through the use of stock pyramids and cross-ownership structures.[4]

Based on the recommendations of agency, legal and communitarian theories, law is needed to protect minority interests against majority abuses in block-holding ownership structures and to avoid conflict of interest problem between the owners and the managers in instances where the ownership structures are diffused.[5] In Pakistan, the primary agency problem does not lie between owners and the managers as viewed in different studies; rather conflict of interests between major and minor shareholders is of a prime concern.[6] This form of conflict of interest is further deepened by inadequate minority protection and weak corporate governance mechanisms[7].

The majority shareholders, by virtue of their dominant role and voting power, may misuse their authority by taking major corporate decisions such as investments the companies make, appointments and removal of directors, directors' excessive pay and perks, related party transactions and exploitation of business prospects for their private benefits.[8]These controlling shareholders treat the companies as a mere projection of

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[4] Farooq Sobhan and Wendy Werner (eds), A Comparative Analysis of Corporate Governance in South Asia: Charting a Roadmap for Bangladesh 2003' p 117 < bei-bd.org/wp content/uploads/2015/03/whc4f4bb192762221.pdf> accessed 02 January 2016 ; Atif Ikram, Syed Ali Asjad Naqvi, Family Business Groups and Tunneling Framework: Application and Evidence from Pakistan' Centre for Management and Economic Research Working Paper No.5-41, 2005 p 1 <saber.eaber.org/sites/default/files/documents/LUMS_Ikram_2005.pdf> accessed 12 January 2016.

[5] Michael C. Jensen and William H. Meckling,"Theory of the Firm: Managerial Behaviour: Agency Costs and Ownership Structure" (1976) 3 (4)*Journal of Financial Economics* 305,308; Million David, New Direction in Corporate Law; Communitarians, Contractarians and the Crisis in Corporate law'(1993) 50(4) *Washington and Lee Law Review* 1373-1393; Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, 'Legal Determinants of External Finance' (1997)52(3) *The Journal of Finance* 1131-1150,1149

[6] Fahad Abdullah, Attaullah Shah, Safi Ullah Khan, 'Firm Performance and the Nature of Agency Problems in Insiders-Controlled Firms: Evidence from Pakistan'(2012) 51(4)*The Pakistan Development Review* 161-183, 167

[7] Ibid (n4), 178

[8] Ibid (n4), 176-180

their interests and may influence the internal management and exploit the financial resources of the company to suit their individual advantages.[9]

For instance, they can dictate the policies of the company and the way it is managed and controlled, decline to pay dividends, approve abusive-related party transactions and pressurise minority shareholders to sell their shares below the market value. Since minority shareholders lack sufficient resources to counterbalance the manoeuvres of majority shareholders; they are incapable of countering these unscrupulous practices.[10]

An effective legal framework ensures that all shareholders are treated fairly and equitably, irrespective of their shareholding. Shareholders must be assured that in case of a grievance, they are entitled to resort to court and seek an appropriate remedy, or that they may have the choice to sell their shares at fair market value if they wish to leave the company. Thus, systems must be in place for shareholders to enforce their legal rights and prevent expropriation of corporate assets by the majorities; failing which, minority shareholders will continue to be helpless victims of managerial or directorial wrongdoings.[11]

Derivative litigation provides minority shareholders with a safety valve that protects them against managerial/directorial wrongdoings.[12] Abuse of minority interests by majority shareholders is a common phenomenon in Pakistan and unfortunately the protection that exists is too weak to afford adequate redressal to minority

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[9] Khurram Raja, 'Corporate governance and minority shareholders' rights and interests in Pakistan: a case for reform' (2012) 23(10)*International Company and Commercial Law Review* 347-362, 347

[10] Ibid 347.

[11] Anthony Boyle and John Birds, *Boyle & Birds Company Law* (6th edn, Jordans 2007) 381

[12] Chrispas Nyombi, Alexender Kibandama, *Principles of Company Law in Uganda* (Law Africa Publishing (k) Ltd,2014)117

shareholders.[13] Derivative actions are inaccessible to shareholders in Pakistan. This is because the company law of Pakistan does not provide for derivative action system. Pakistan is a unique jurisdiction amongst the common law countries that does not have a statutory derivative action system.

On the other hand, the subject of derivative proceedings received world-wide acceptance being an effective enforcement mechanism as to safeguarding corporate rights. For example, the United Kingdom,[14] the US,[15] New Zealand[16] and Australia[17] have codified derivative action systems. Many developing countries like Hong Kong[18], Japan[19], Taiwan[20], South Korea[21], Singapore[22] and China[23] have also introduced derivative actions system in their company laws which provides for robust weaponry for minority shareholders to safeguard their interests. The recognition of statutory framework for derivative actions in both developed and developing countries vividly highlights the important role that derivative litigation has to play in preserving corporate assets and fostering corporate accountability in Pakistan.

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[13] Ali Cheema,'Corporate governance in Pakistan: issues and concerns'(2003)8(2)*The Journal*7-19; Lubna Hasan, 'Rule of Law, Legal Development and Economic Growth: Perspectives for Pakistan; Pakistan Institute of Development Economics September 2010 < https://mpra.ub.uni-muenchen.de/25565/> accessed on 05 April 2016 ; Haroon H Hamid and Valeria Kozhich, 'Corporate Governance in an Emerging Market; A perspective on Pakistan (2007) 1 (1)*Journal of Legal Technology Risk Management* 22-33, 26.

[14] Corporate Law Review Commission Report 2005 <www.secp.gov.pk/pdf/Concept.pdf> accessed 14 February 2016 p 17, S. 260-264 UK Companies Act 2006.

[15] See section .327 Delaware General Corporation Law

[16] See Sections 165-168, New Zealand Companies Act, 1993

[17] See section . 237-242 Australian Corporations Act 2001

[18] Part *IVAA* of the Companies Law (Amended by the Companies Amendment Bill 2003)

[19] Article 847 , Company Act

[20] Article 214 Company Act

[21] OECD Report , Corporate Governance in Asia, 2011 <www.oecd.org/daf/ca/48806174.pdf > accessed 15.02.2016 p 18 ; Article 403-406 Korean Commercial Code

[22] See 216 A, 216 B , Singapore Companies Act 1994

[23] See Article 152 of Company Act

Table 1 Availability of derivative suits (minimum 0; Maximum 1) They are available in all jurisdictions surveyed with the Exception of Pakistan, Netherland, Slovenia and Mexico.

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Canada	1	1	1	1	1	1	1	1	1	1	1
France	1	1	1	1	1	1	1	1	1	1	1
Malaysia	1	1	1	1	1	1	1	1	1	1	1
S. Africa	1	1	1	1	1	1	1	1	1	1	1
Switzerland	1	1	1	1	1	1	1	1	1	1	1
Japan	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.5	0.5	0.5	0.5
US	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.75	0.75	0.75
Argentina	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Brazil	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
India	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Spain	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
U.K	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Germany	0.25	0.25	0.25	0.25	0.5	0.5	0.5	0.5	0.5	0.5	0.75
China	0.25	0.25	0.25	0.25	0.25	0.25	0.5	0.5	0.5	0.5	0.5
Czech Rep.	0.25	0.25	0.25	0.25	0.25	0.25	0.5	0.5	0.5	0.5	0.5
Sweden	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Turkey	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Russia	0	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75
Italy	0	0	0	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Chile	0	0	0	0	0	0.5	0.5	0.5	0.5	0.5	0.5
Latvia	0	0	0	0	0	0	0.5	0.5	0.5	0.5	0.5
Mexico	0	0	0	0	0	0	0	0	0	0	0
Netherland	0	0	0	0	0	0	0	0	0	0	0
Pakistan	0	0	0	0	0	0	0	0	0	0	0
Slovenia	0										

Source: CBR Shareholder Protection Index-25 countries.[24]

The table shows the absence of derivative claims in Pakistan that are available in other jurisdictions. The absence of derivative claims continued following the year of 2005 and to date, shareholders' right to derivative litigation is not recognised in Pakistan.[25]

The introduction of statutory framework for derivative action is expected to play a crucial role in improving corporate governance and protecting the interests of minority shareholders in Pakistan. In fact, shareholders stand deprived of important measure of

[24] Mathias Siems, Priya Lele, Pablo Iglesias-Rodriguez, Viviana Mollica, Theis Klauberg, Stephan Heidenhain, Nina Cankar, John Hamilton, Gerhard Schnyder, and Pinar Akman, ' CBR Shareholder Protection Index-25 countries' (2009) <www.cbr.cam.ac.uk/research/programme2/project2-20output.htm.> accessed 03 October.2016.

[25] This is based on searching from Pakistan law site and Pakistan law journal =, leading databases of reported judgments in Pakistan by using the expression, derivative suit' and derivative claims'. However it does not count unreported judgments in Pakistan. Till date means date 10 January 2017.

evoking managerial accountability as the right to engage in derivative actions is not available to shareholders in Pakistan. This makes the prospective role of derivative litigation to discipline errant managers and directors in Pakistan worth exploring. The essence of this thesis is to address issues; (1) should derivative litigation play its role in protecting shareholders' interests in Pakistan?(2) If the answer is in affirmative, how such a system can effectively be implemented in order to discipline corporate management in Pakistan.

Second, this thesis presents its argument by demonstrating the shortcomings of internal and external managerial disciplinary mechanisms. As a consequence, the codified derivative action system ought to be introduced and should play a pivotal role in regulating the misbehavioral hierarchy of controlling shareholders, corporate officers and directors. After demonstrating the need to introduce and effectively implement derivative action system in Pakistan, this thesis takes to explore the scope of derivative litigation in Pakistan.

It examines the prevalent minority protection mechanism under the company law in Pakistan. Despite the presence of some provisions regarding minority protection, judicial treatment of managerial oppressions has been very discouraging and circumstances in which relief may be obtained have not been given. Absence of statutory derivative actions in the company law constitutes a barrier for shareholders intending to exercise this right of action against directorial misconducts.

After discussing why derivative action system should play a significant role in monitoring management, this thesis aims at articulating the structure of derivative action system and how it can be implemented so that it could address issues of widespread managerial opportunism and minority protection in Pakistan.

This thesis argues that shareholders are willing to go for the derivative actions to protect their interests because of the establishment of commercial and by virtue of litigious society, if strategies are developed and embraced to provide incentives to them. The courts are also capable of dealing with derivative action cases because of the increasing recruitment of more qualified people to the judiciary[26] and establishment of special commercial courts in Pakistan.[27] It is expected that setting flexible, modern and accessible criteria for derivative actions can contribute to foster good corporate governance and can ensure protection of corporate as well as small investors' assets in Pakistan.

This study is particularly important at the time when the government of Pakistan plans to introduce new company law that would replace the Companies Ordinance,[28] currently the main company law that sets out the structure of corporate entities, powers and responsibilities of directors and shareholders' rights. The corporate law review commission has recommended for codification of derivative action system in Pakistan so as to strengthen shareholders' enforcement power.[29]

This thesis promises to make a significant contribution to the understanding on the subject of role of derivative litigation in reducing agency costs and preventing

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[26] National Judicial Policy, Supreme Court of Pakistan <www.supremecourt.gov.pk/web/user_files/File/NJP2009.pd> accessed 10 February2016; the same was revised in 2012 to achieve its objectives such as, increasing number of judges through recruitment process, their capacity building, establishing training centres and ensuring a corruption free judiciary in Pakistan.

[27] Pakistan Vision 2015 One Nation, One Vision' <fics.seecs.edu.pk/Vision/Vision-2025/Pakistan-Vision-2025.pd> accessed 12 February. 2016

[28] Country Review: Islamic Republic of Pakistan IOSCO Objectives and Principles of Securities Regulation Detailed Assessment of Implementation July 2015, p 25.

[29] The corporate law review commission, Concept Paper , SECP,< www.secp.gov.pk/wp-content/.../May_25_CLRCPresentsConceptPaperToSECP.pdf > accessed 27 January 2016; This is body which was established by the Security and Exchange Commission of Pakistan to review the companies ordinance and make suggestion for improving the ordinance.; Common law is judge made law and based on legal precedents, and general principles.

managerial/directorial frauds against companies as well as against minority shareholders. This thesis will provide significant understanding of legal scholarship on derivative actions and guiding principles to legislators, practitioners and policy makers in Pakistan on how to make better use of derivative action system.

To that end, this thesis seeks to address three main issues that might affect the efficacy of the derivative litigation in Pakistan. First, it addresses shareholders incentive barriers and funding issues that operate as disincentives to shareholders in bringing derivative proceedings for enforcing corporate rights. Second, it addresses the problems affecting derivative actions' usefulness due to strike suits, dishonest and unfounded actions. Third, this thesis addresses issues surrounding standing requirements of derivative claimants in derivative proceedings (*locus standi rules*[30]).

Thesis layout

This thesis intends to explore the role and significance of derivative proceedings in the protection of minority shareholders by making a comparative reflection on the derivative action system in the UK. In order to achieve the aims of this study, it is broken down into six chapters. Chapter 1 explains the minority protection problem and helps us to understand why minority shareholders' interests deserve protection. It explains and provides for a general theoretical framework of derivative actions and the rationale for studying minority protection through derivative actions. This chapter also explains the flaws and limitations of market forces to prevent minorities' interests from being infringed.

Special emphasis is placed on derivative action system so as to see whether derivative proceedings could help to prevent self-serving decisions of controlling shareholders

[30] The right to bring action

which operate to the detriments of the interests of minority shareholders in Pakistan. It also explains the methodologies employed in this research and reasons for using those. This chapter is important in a sense that it explains why it was important to study the use of litigation for the protection of minority shareholders and preservation of corporate assets what this research aims to achieve.

Chapter 2 presents a critical review of literature regarding minority rights which helps to understand the unique context of managerial opportunism and minority protection, to develop research questions and to address the research gap. This chapter reviews literature on the necessity of statutory provisions which could serve as an indispensable deterrent against wrongdoers in corporate entities. It identifies what previous scholars have contributed and summarises the key concerns and gaps in the existing literature. This chapter is important in a sense that it provides for the basis for the introduction of a meaningful derivative action system which could be used in complement with other managerial disciplinary mechanisms in Pakistan.

Chapter 3 is broken down into two parts. The discussion in the first part focuses on examining minority rights and remedies under the company law in Pakistan. The first part of chapter 3 highlights infirmities and shortcomings in the law not only as regards provision of evidence to an inadequate minority protection in Pakistan, but also to demonstrate why statutory derivative action system is indispensable in Pakistan. In particular, it focuses on examining financial, voting and enforcement rights of minority shareholders. This chapter recapitulates that the company law of Pakistan does not provide for an adequate protection to minorities therein.

There are a few of instances of provisions here and there in the Ordinance regarding minority protection. The current enforcement mechanism employed in the Ordinance in the form of voting rights and remedy against unfair prejudice is defective and does not

ensure protection to minority shareholders. Moreover, the Ordinance does not provide a key enforcement mechanism in the form of derivative proceedings. Statutory framework for derivative actions is vital in terms of complementing other managerial disciplinary frameworks in order to provide an effective managerial accountability mechanism in Pakistan.

The second part of chapter 3 takes care of the application of Sharia law in commercial matters and discovers the possibility of Sharia considerations in circumventing of minority sufferings in Pakistan. It is mainly intended to examine how Sharia business principles may complement laws regarding minority protection in Pakistan and how it may serve as a remedy to the noticeable statutory gaps. It is expected that this principle will function just as the concept of equity in the UK.

Chapter 4 presents a kind of case study examples in which controlling shareholders misused their authority in disregard of the interests of the companies as well as minority shareholders therein. The investigations of these specific examples of corporate abuses were selected in order to develop the basis for having in place statutory framework for derivative action in order to provide a greater enforcement power in the hands of small shareholders. The chapter is important in a sense it exemplifies misconduct on the part of corporate management which is ill-reputed for its self-serving behaviour in Pakistan. Further, it accentuates how controlling shareholders behave opportunistically in disregard of minority shareholders and sometimes even against the companies which provides theoretical underpinnings of statutory framework for derivative actions in Pakistan.

Chapter 5 is broken down into two parts. In its first part, this chapter considers reform proposals made in this thesis relating to the statutory framework for derivative actions. The proposals are aimed at codification of derivative action system in Pakistan. This

chapter addresses problems with the derivative proceedings in Pakistan and it proposes what may work effectively in the particular context of Pakistan underscoring the striking issues of common law rules on derivative actions, procedural complexities and the issues of disincentives to shareholders in derivative proceedings. Towards that end, this explains different approaches to deal with issues surrounding legal costs and procedural complexities. It provides for reform proposals regarding funding issues that can best address the problems concerning economic disincentives to derivative claimants.

The chapter also analyses the functioning of common law derivative action system and reviews how it has been reformed in the UK. It presents the problems which used to exist under common law derivative action system which would more or less be similar to those shareholders might face in bringing derivative claims in Pakistan. It examines the recommendations of the Law Commission and the Company Law Review Group regarding the introduction of statutory derivative action system in the UK.

This chapter also provides an understanding of statutory derivative action system in the UK which was developed in response to difficulties minority shareholders faced under old common law derivative action system. Finally, this chapter evaluates common law rules on derivative actions and the statutory framework for derivative actions in comparison. The analysis in this chapter has been carried out bearing in mind that to what extent, Pakistan can draw lesson in order to find ways for a functional derivative action framework which could better address the issue of corporate accountability in Pakistan. It demonstrates, in this regard, that although legal transplant can be a useful strategy to facilitate a meaningful statutory framework for derivative actions in Pakistan, yet, it never mean to adopt each and every single rule on derivative actions in

force in the UK which may not be suitable to the local conditions and a particular business environment in Pakistan.

The second part of chapter 5 offers an analysis of empirical study which involves semi-structured interviews with domestic corporate lawyers, academics and senior officials from Security and Exchange Commission of Pakistan in order to look into how statutory derivative action system works effectively in the marketplace. It provides evaluation and reflection of this empirical study undertaken to evaluate reforms proposals as to the statutory framework for derivative actions in Pakistan. This part is important as it helps to assess reform proposals made in this thesis by giving a sense of multiple interpretations and, by reflecting the reactions of the participants which helped in finding a more workable and functional derivative action framework in Pakistan.

Finally, chapter 6 draws conclusions that the company law of Pakistan does not guarantee minority protection that provides theoretical underpinnings for the introduction of statutory framework for derivative actions in Pakistan. It provides summary of the thesis and makes comments to any future study. This chapter bring together arguments made throughout in this thesis. It examines research questions in the light of reform proposals. The examination of research question is carried out in order to see whether the research aim has been achieved? Finally this chapter concludes by elucidating that statutory derivative action system can substantially improve corporate accountability in Pakistan and explains the final contribution of this research.

Chapter 1. Theoretical Framework of Derivative Action

1.1 Minority Shareholders in Family-Owned and State-Owned Enterprises in Pakistan

There is concentration of shareholder ownership in Pakistan with families, business groups and the State as the dominant stakeholders in both private and the public companies.[1]These dominant stakeholders maintain control over companies either by holding majority equities or through indirect and complex ownership structures such as interlocking, cross-shareholding or pyramid ownership structures.[2] The complex ownership structures are not normally understood by the outside investors. The majority shareholders may appoint trusted persons and friends as board members and other non-executive directors. They normally do not consider factors such as corporate sector knowledge, relevant qualifications and professional expertise while filling in directorial positions.

Important decisions are made by the controlling managers without considering the rights of other stakeholders such as small investors.[3]Most of the public companies in Pakistan are governed by majority shareholders and they thereby exercise a

[1] Attiya Y. Javid, Robina Iqbal, 'Corporate Governance in Pakistan: Corporate Valuation, Ownership and Financing' (2010) PIDE Working paper < pide.org.pk/pdf/Working%20Paper/WorkingPaper-57.pdf> accessed 13 May 2016 ; Faisal Javaid, Abdul Saboor, 'Impact of Corporate Governance index on Firm Performance: evidence from Pakistani manufacturing sector (2015)5 (2) *Journal of Public Administration and Governance*1-21,19; Ali Cheema, 'Corporate governance in Pakistan: issues and concerns' (2003) 8(2)*The NIPA Journal* 7-19.

[2] Abid A. Burki Shabbir Ahmad, 'Corporate Governance Changes in Pakistan's Banking Sector: Is There a Performance Effect? CMER WORKING PAPER No. 07-59 < https://core.ac.uk/download/pdf/6256587.pdf> accessed 04 April 2016.

[3] Arshad Hassan and Safdar Ali Butt , Impact of Ownership Structure and Corporate Governance on Capital Structure of Pakistani Listed Companies (2009) 4 (2) *International Journal of Business and Management* 50-57,55

disproportionate amount of control over the companies[4]. The majority shareholdings, complex corporate ownership structures such as interlocking directorship, cross-shareholdings and pyramid structures are often used by controlling shareholders with a view to subverting minority interests. Common allegations include complaints on mismanagement of business[5], the expulsion of a petitioner from management[6], misappropriation of corporate assets[7], share dilution[8], tunnelling of companies' assets[9], public interest[10], directors' self-interest[11], inter-corporate financing[12] and non-payment of dividends,[13] in Pakistan.

The State is the second largest business entity in the corporate sector of Pakistan after corporate groups controlled by business families. The State Owned Enterprises (SOEs)

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[4] Faiza A. Chaudary, Marc Goergen and Shoeb I. Syed, 'Corporate Governance in the Financial Sector of Pakistan' <www.eaber.org/sites/default/files/.../LUMS_Chaudary_2006.pdf> accessed 06 December.2015.

[5] Muhammad Fikree v Fikree Developmentg Corp Ltd [1992] M.L.D. 668; Associated Biscuits International Ltd v English Biscuits Manufacturers (Pvt) Ltd (EBM) [2003] C.L.D. 815 (Karachi).

[6] Ch. Muhammad Hussain v Khiali Paper and Board Mills (Pvt) Ltd [2005] C.L.D. 636

[7] Brothers Steel Ltd. And Others vs. Mian Miraj Din [1995] PLD SC 320; Attock Refinery Ltd.Vs. Executive Director Enforcement and Monitoring Division, SECP [2010] PLD SC 946.

[8] Razzak Usman v Golden Plastics [1998] C.L.C. 1109 (Karachi); Associated Biscuits v EBM [2003] C.L.D. 815 (Karachi)

[9] Shahmatullah Qureshi v Hi-Tech Construction Pvt Ltd [2004] C.L.D. 640; Daily Dawn newspapers 23 December, 2012, Murky Corporate Segment available <www.dawn.com/news/773559/murky-corporate-segment> accessed 21 February 2016.

[10] Shahbazud Din Chaudhry v Messrs Services Industries Textiles Ltd [1988] PLD 1 (Lahore)

[11] Muhammad Anwar Manoo v Muhammad Waqar Monnoo [1987] C.L.C. 1943; Israrul Haq v Al-Tahir Industries (Pvt) Ltd [2002] C.L.D. 325 (Lahore)

[12] Shahid Anwar, Tariq Aleem, Dr. Wasim Azhar , Mazurul haq, Shaid Latif Dar, Ifran Qamar& others, Mehmood Ahmed Shezi Nackvi v Chairman Securities and Exchange Commission of Pakistan [2015] Appellate Bench Security and Exchange Commission of Pakistan; See Daily Dawn Newspaper, 04 December 2011, 'Making inter-corporate financing transparent'<www.dawn.com › Newspaper › Business & Finance> accessed 05 November 2016.

[13] Aliya Bushra and Nawazish Mirza, 'The Determinants of Corporate Dividend Policy in Pakistan' (2015)20(2) *The Lahore Journal of Economics*, 77-98, 80 ;Qureshi v Hi-Tech Construction [2004] C.L.D. 640; Talat Afza, Hammad Hassan Mirza, 'Ownership Structure and Cash Flows As Determinants of Corporate Dividend Policy in Pakistan'(2010)3(3)*International Business Research* 211-221, 217 ; Ahmed, Hafeez and Javid, Attiya Yasmin, 'Dynamics and determinants of dividend policy in Pakistan (evidence from Karachi stock exchange non-financial listed firms)'(2008)25 *International Research Journal of Finance and Economics* 148-171,149

are listed as well as private companies. The government has corporatized a number of SOEs during the last two decades under the pressure of international financial institutions[14]. The government owns 14 out of top 40 companies listed on Karachi Stock Exchange (KSE)[15].

In SOEs, the government of Pakistan holds control. The management in SOEs guard the interests of the government at the expense of minority shareholders. The government generally appoints managers and members of the board on the basis of their political affiliations with the government. The government has also been found not to consider the corporate sector knowledge, relevant experience and required qualification while making appointments in the board of directors in SOEs[16].

Normally, the State being controller of SOEs is unlikely to act against the company and its minorities' interest. This is because the State has legitimate concerns to protect companies' interest including that of other constituencies of the company such as non-controlling shareholders. However, it might not always be true that the State interest aligns with the interest of other constituencies of the company or even the company

[14] See the daily DAWN an English newspaper dated 01 November, 2015 <www.dawn.com/news/1216663> accessed 25 December 2015 : Federal Minister and Chairman of Privatisation Commission of Pakistan Muhammad Zubair has stated that the government will pursue privatisation plan extensively and will not withdraw from its plans due to opposition pressure in order to achieve high growth rate and boost economy.. the government of Pakistan has started process of divestment in SOEs such Faisalabad Electric Supply Company (FESCO), Islamabad Electrical Supply Company (IESCO) and has attracted of general public in the equity market. 'PM stops privatisation of power companies - The Express Tribune' The Express Tribune 21 July 2016< tribune.com.pk › Business > accessed 18 October 2016.

[15] Karachi Stock Exchange is the largest stock exchange of Pakistan (KSE)

[16] Ali Cheema et al, 'Corporate Governance in Pakistan: Ownership , Structure and Control'(LUMS) paper series 11-12

itself.[17]The State may have its overarching objectives and may use SOEs' resources to achieve its own policy objectives.[18]

Minority shareholders are a vulnerable group, also in SOEs and so they are apt to be targeted and abused by the controllers where the State being the controller of SOEs attempts to gain its own benefits at the cost of the minority interest. There are a number of corporate scandals such as Pakistan Steel Mills,[19] Railways,[20] Pakistan Telecommunication Company Limited,[21] National Insurance Company Limited[22] and many more that offer evidence to the managerial wrongdoings in SOEs.

Many commentators have recommended for the protection of minority shareholders against managerial/directorial transgressions. For example, Low regarded minority protection as an essential objective of good corporate governance.[23] La Porta *et al* consider minority protection instrumental to the growth of the capital markets. They argue that law has a crucial role to play in improving corporate governance and ensuring shareholder protection.[24] Minority protection stands out among important company law provisions. As explained earlier in the research background section of this

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[17] Andrei Shleifer and Robert W. Vishny, 'A Survey of Corporate Governance' (1997) *52(2) Journal of Finance* 737-783,761

[18] Manish Singhai, 'Shareholder Rights and the Equitable Treatment of Shareholders' OECD , The Fourth Asian Roundtable on Corporate Governance; 4 <www.oecd.org/corporate/ca/corporategovernanceprinciples/2484854.pdf >accessed 20 April 2016

[19]The Daily DAWN 07, February 2013< www.dawn.com/news/784195> accessed 24 May 2015.

[20] The Business, 02 February 2016 < www.pakistantoday.com.pk › Business> accessed 19 April 2016.

[21]Pakistan the Banker m financial tribune of Pakistan 09 January 2015 < www.thebanker.com.pk/ptcls-privatization-the-biggest-financial-scam-in-pakistans-his.> accessed 24 April 2015

[22] The Daily DAWN Newspaper 26 January 2011 < www.dawn.com/news/601723> accessed 24 April. 2015.

[23] Low Chee Keong, *Corporate Governance, An Asia-Pacific Critique* (Sweet & Maxwell Asia 2002) 612.

[24] Rafael La Porta; Florencio Lopez-de-Silanes; Andrei Shleifer; Robert W. Vishny, 'Law and Finance' (1998) 106(6) *The journal of political economy* 1113-1155,1117; Ibid (n 17)774.

thesis, this thesis aims to explore the role of derivative litigation in improving corporate governance and addressing the issue of corporate accountability in Pakistan.

This chapter first succinctly goes on explaining different enforcement mechanisms such as the public enforcement of law- the use of police, inspectors or public prosecutors, and private-sector enforcement of shareholder rights- the use of shareholder voting and derivative litigation. Then, it attempts to highlight flaws and the scope of the public enforcement mechanism that makes a point to encourage private- sector enforcement of the laws for disciplining management.

While examining private enforcement mechanisms, it attempts to bear out that private enforcement mechanisms such as shareholder voting and independent directors have their own well-known limitations; therefore, they cannot be a substitute for derivative litigation. Thus, derivative action system as one of the ways for private-sector enforcement has an important role to play in undoing managerial wrongdoings and recovering compensation for the companies wronged by their directors.[25]

1.2 Enforcement of Shareholders' Rights

Corporate laws together with securities regulations confer a wide range of rights upon shareholders to protect their interests. Enforcement of these laws is essential because shareholders feel secure in investing in firms where adequate protection is in place so that they might make good wrongs done to their investment.[26] Business firms in normal cases show regard to corporate laws but if they fail to comply with the laws and allow

[25] Richardson Green shields of Canada Ltd v Kalmacoff [1995] BLR (2d) 197 (CA) at 205, see the decision in the court of appeal; Diamond v Oreamuno [1969]24 New York 2d 494, 248 NE 2d 910, 301 NYS 2d 78.

[26]Howell .Jackson and Mark J Roe, 'Public Enforcement of Securities Law: Preliminary Evidence'(2009) 93(3)*Journal of Financial Economics* 207-38 ; Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, ' What works in Securities Law?' (2006)61(1*) Journal of Finance* 1-32,3.

their directors to breach their fiduciary duties then the enforcement of the laws happens to be of a paramount importance.[27]

As mentioned above, corporate laws can be enforced through different mechanisms such as the public enforcement and private enforcement of the laws.[28] However, this thesis focuses only on derivative action system as one of the ways for private sector enforcement mechanism. The public enforcement is related to government-initiated proceeding. The violator of law is punished here by imposing civil or criminal penalties.

On the other side, private enforcement is shareholders-initiated proceedings and here, aggrieved shareholders seek corporate remedy in terms of compensation.[29] As the public enforcement provides for monetary sanctions and physical confinement; therefore, such severe punishments can act as deterrent against illegal activities of managers. As such, imprisonment not only means suffering from physical agony, it may also damage the reputation of wrong-doing professionals. In Pakistan like most other jurisdictions, a criminally convicted director is also barred to hold a public office in future.[30]

It is, however, important to underscore that a meaningful deterrence effects for future managerial misbehaviours cannot be exercised by dint of stringent punishments in books but it is possible only if it is effectively enforced.[31] In fact, weak enforcement

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[27] John Coffee, 'The rise of Dispersed Ownership: the roles of law and the state in the separation of ownership and control'(2001) 111(1*) Yale Law Journal* 12-78,28

[28] Ibid, 68

[29] Chrispas Nyombi and Alexender Kibandama, *Principles of Company Law in Uganda* (Law Africa Publishing (k) Ltd,2014) 117.

[30] See Section 15 of National Accountability Ordinance 1999, Pakistan.

[31]Polinsky, A. Mitchell & Shavell, Steven, 'The Theory of Public Enforcement of Law' in A. Mitchell Polinsky and Steven Shavell (eds) *Handbook of Law and Economics* (North Holland, 2009) Ch 6, 406

mars the benefits of such severe punishments provided.[32] Unfortunately, this is the case with the public enforcement hierarchy, where due to strict evidentiary requirements; criminal prosecution of corporate misconducts is difficult to prove that makes the point for the private enforcement alongside to play its role in disciplining management. Following are the major problems with the public enforcement mechanism.

First, it is difficult to prove a criminal guilt entailing physical confinement and monetary sanctions.[33] The standard of proof required for proving a criminal case is, 'beyond reasonable doubt' that follows all the attendant facts and circumstances are consistent with the guilt of the accused.[34] On the other hand, civil lawsuits are not subject to such a strict standard of proof. Here we simply need preponderance (balance of probability) signifying that if evidence of one party overshadows that of the other party, the evidence of the former party will be given weightage.

Second, illegal evidence 'exclusionary rule' applies to criminal trials. Illegal evidence exclusionary rule signifies that evidence put forward by a complainant in contravention of the defendant's constitutional rights is not permissible.[35]Third, evidence required to be produced in a criminal case is subject to aggressive scrutiny. Civil lawsuits, on the other hand, are subject to more relaxed and flexible rules of evidence. Since corporate frauds and wrongdoings are perpetrated by intelligent minds and are executed with

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[32] Sandefur R.L (ed.) Acess to Justice (Bingley: JAI , 2009)9; Peter-Jan Engelen, 'Structural problems in the design of market abuse regulations in the EU'(2007) 19(1) *The Journal of Interdisciplinary Economics* 57-82,60

[33] Peter-Jan Engelen, 'Structural problems in the design of market abuse regulations in the EU'(2007) 19(1) *The Journal of Interdisciplinary Economics* 57-82,64

[34] State v Anwar Saifullah Khan [2002] Supreme Court of Pakistan, Criminal Appeal No,264.

[35] Malcolm Richard Wilkey, 'Exclusionary Rule: Why Suppress Valid Evidence'(1978) *62The Judicature* 214; Donald L. Willits, 'The Fourth Amendment Exclusionary Rule: The Desirability of a Good Faith Exception'(1982)32(2) *Case Western Reserve Law Review* 443-462,443.

caution; such a high burden of proof and rigorous scrutiny procedures make it difficult for the prosecution to prove criminal prosecution of a corporate misconduct.[36]

Besides procedural restraints and rigorous evidentiary requirements, there are other problems with the public enforcement that render it potentially impracticable option to deal with all directorial misconducts. For example, public organisations/agents are not able to pursue each and every single illegal activity in the corporate world.[37] The public agencies do have enforcement priorities due to their limited official capacity and financial resources. Hence, it becomes difficult for them to deal with all managerial misconducts apt to arise.[38] Moreover, the public enforcement suffers from flaws such as the possibility that public agents may succumb to the pressure of private interest groups contrary to the interest the law intends to protect and political control.[39]

In view of limitations of the public enforcement, this thesis argues that the private enforcement via derivative litigation has a valuable role to play in enforcing investor protection laws. In fact, the private enforcement can complement the public enforcement as it would help reduce burden of the public organisation[40]and bureaucratic oversight of corporate conduct.[41]

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[36] Naylor J M, 'The Use of Criminal Sanctions by UK and US Authorities for Insider Trading: How Can the Two Systems Learn from Each Other (1990) 11(3) *Company Lawyer* 83-91,85.

[37] Arad. Reisberg, *Derivative Actions and Corporate Governance: Theory and Operation* (Oxford University Press 2007) 31; Ibid (n33)64.

[38] Ian Ramsay, 'Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action' (1992) 15 *University of New South Wales Law Journal* 149- 175, 156

[39] Steven Van Uytsel, Collective Actions in a Competition Law Context-reconciling multilayer interests to enhance access to justice ' in Stefan Wrbka, Steven Van Uytsel and Mathias Siems, Collective Actions (Cambridge University Press 2012) 99

[40]American Law Institute, Principles of Corporate Governance and Structure: Restatement and Recommendations, Tentative Draft No 1 (1982) 232

[41]Pearlie Koh Ming Choo, 'The Statutory Derivative Action in Singapore- A Critical Examination' (2001) 13(1) *Bond Law Review* 64,68

The private sector enforcement is, therefore, needed particularly in dealing with managerial misconducts. For example, disgruntled shareholders are abreast of the identity of the wrongdoer and the wrong they suffer, which normally public enforcement agents come short of.[42] The disgruntled shareholders do have benefits to put forward such information because gains arising out of the private enforcement would go into their hands.[43]The private enforcement, therefore, has a significant role to play in improving corporate governance.

La Porta *et al*'s study shows that private enforcement causes growth of the capital markets that can wield its significant governance role in aligning the interests of management and shareholders.[44]Nevertheless, a consideration of private sector enforcement cannot justify disregard of the public enforcement. In fact, the public enforcement does have deterrence effects against future managerial/directorial misconducts.

Since the public enforcement suffers from various kinds of limitations and flaws; private sector enforcement needs to be relied on for the enforcement of the laws. Both the private and the public enforcement mechanism should go hand in hand in complementing each other to deal with managerial misconducts. This is because no isolated mechanism of accountability is sufficient enough to deal with managerial misconducts under all circumstances. A pertinent question that needs to be answered is that if private enforcement mechanisms are already in place in the form of shareholders' voting and independent directors? Then, giving a consideration to

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[42] William M Landes and Richard A Posner, ' The Private Enforcement of Law'(1975)4 (1) *The Journal of legal Studies* 1-46,31

[43]Mitchell A Polinsky and Steven Shavell,'The economic theory of public enforcement of law. No. W6993. National bureau of economic research, (1999) 3

[44] Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer 'What Works in Securities Laws?'(2006) 61 (1) *The Journal of Finance* 1-32,25

derivative suits needs more justification. The answer is, those are in place, yet, they are lacking managerial disciplinary mechanisms due to various limitations.

The next part of this chapter attempts at articulating the limitations of other private sector enforcement tools such as shareholder voting and independent directors. As this thesis presents the argument that derivative action system has a key role to play in protecting corporate assets, the next section briefly shows where other types of private-enforcement mechanisms such as shareholders voting and independent directors cannot be an effective substitute for derivative litigation.

1.2.1 Shareholder Voting

Voting right is one of the private sector enforcement mechanisms that can serve as an alternative to shareholder litigation.[45] As directors are required to serve in the best interests of companies and their shareholders,[46] failing which, shareholder can get rid of them through exercising their voting power. As a result, shareholder voting power may influence managerial behaviour and hence, it may help reduce agency costs. However, there are various factors that render shareholder voting as an insufficient enforcement mechanism.

For example, normally shareholders are unwilling to vote even if voting mechanism is made easier through electronic means.[47] Shareholder voting is also an imperfect managerial disciplinary mechanism due to collective action problem.[48] Furthermore,

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[45] Gerard Hertig, 'Convergence of Substantive law and Convergence of Enforcement: A Comparison' In J. Gordon and M. Roe (eds.), *Convergence and Persistence in Corporate Governance* (Cambridge University Press 2004) 328, 336-338

[46] Greenhalgh v Arderne Cinemas Ltd [1950] 2 ALL ER 1120. See section 172(1) of the UK Companies Act 2006.

[47] Ibid (n37) 25.

[48] Brian R. Cheffins, *Company Law: Theory, Structure and Operation* (Oxford University Press 1997) 238-241.

shareholders show an indifferent attitude known as 'rational apathy' towards casting votes due to time and cost factors.[49] Last but not the least, research has shown that shareholder proposals have not changed or influenced governance policies and firm valuations.[50] Shareholder voting thus seems to be an insufficient type of private sector enforcement, particularly in the context of Pakistan to discipline errant directors and managers. (Problems with shareholder voting to discipline managers has been discussed in detail in chapter 3 section 3.3).

1.2.2 Independent Directors

The presence of independent directors commonly known as Non-Executive Directors (NEDs) is another private sector enforcement mechanism. The NEDs are purported to be the monitors in a number of ways. For example they are thought to monitor managerial performance and review board performance. In addition, they are expected to ensure alignment between the interests of major and minor shareholders and take lead where there arises conflict of interest problem.[51]They are also expected to contribute to the valuation of the corporation.[52]

However, the effectiveness of NEDs as unbiased monitors and to control agency costs is subject to criticism due to various reasons.[53] Evidence shows that the effectiveness of the NEDs suffers from the problem of their real independence, additional cost and

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[49] Though casting voting is becoming easier through electronic means, some shareholders still want to attend meetings in person.

[50] Karpoff J M, Malatesta P .H, and Walkling R.A, 'Corporate Governance and Shareholder Initiatives: Empirical Evidence' (1996) 42 (3)*Journal of Financial Economics* 365-395,383

[51] Gibbs D, 'Non-Executive Directors' Self Interest: Fiduciary Duties and Corporate Governance' (PhD Thesis University Anglia 2014)

[52] Derek Higgs, Review of the role of and effectiveness of non- Executive directors, Consultation Paper 7 June 2002 < www.ecgi.org/codes/documents/higgs.pdf> accessed 03 June.2016.

[53] Eilís Ferran, *Company Law and Corporate Finance* (Oxford University Press 1999) 122.

insufficient business related knowledge.[54] Moreover, an empirical study indicates the presence of a negative relationship between the NEDs and firm performance.[55] As such, board composition does not have any significant impact on the valuation of the corporation.[56] Additionally, the presence of the NEDs affects the managerial freedom to take risk-based, profit-generating and innovative decisions.[57]

The evidence as to whether the NEDs are proper monitors and an adequate managerial disciplinary mechanism is unclear. The financial crisis in 2008 uncovered the truth that the NEDs framework stands out only as one of the tools to improve corporate governance and is not meant to replace other managerial disciplinary mechanisms in this respect.[58] Under the Code of Corporate Governance, Pakistan has introduced and encouraged firms to appoint independent directors and accordingly, many listed companies have incorporated the NEDs framework.[59] However, the independence of the NEDs to effectively monitor managers effectively is subject to criticism.[60] For example, many experts opine that although the idea of having in place the framework of

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[54] Ronald J Gilson and Reinier Kraakman, 'Reinventing the outside director: An agenda for institutional investors'(1991) 43 *Stanford Law Review* 863-906,875; Daniel R. Fischel, 'The Corporate Governance Movement' (1982) 35 *Vanderbilt Law Review* 1259-1262.

[55] Anup Agrawal and Charles R. Knoeber, 'Firm Performance and Mechanisms to Control Agency Problems between Managers and Shareholders' (1996) 31(3) *Journal of Financial and Quantitative Analysis* 377-397,379.

[56] Andy Cosh and Alan Hughes, 'The Changing Anatomy of Corporate Control and the Market for Executives in the United Kingdom' (1997) 24 (1) *Journal of Law and Society* 104-123,113

[57] Brian. R. Cheffins, *Company Law: Theory, Structure and Operation* (Oxford University Press 1997) 624-625.

[58] See Walker Report, (London,the United Kingdom 2099) <webarchive.nationalarchives.gov.uk/+/http:/...hm-treasury.gov.uk/.../walker_review_2...> accessed 22 May 2016.

[59] The Code of Corporate Governance 2002, Pakistan <http://www.ecgi.org/codes/documents/code_corporate(revised).pdf>accessed 11 January 2016; Valeria Kozhich and Haroon H Hamid, 'Corporate Governance in an Emerging Market; A perspective on Pakistan (2007) 1 (1)*Journal of Legal Technology Risk Management* 22-33, 25

[60] Haroon H Hamid and Valeria Kozhich, 'Corporate Governance in an Emerging Market; A perspective on Pakistan (2007) 1 (1)*Journal of Legal Technology Risk Management* 22-33; Arshad Hasan, Safdar Ali Butt, 'Impact of Ownership Structure and Corporate Governance on Capital Structure of Pakistani Listed Companies'(2009)4(2*) International Journal of Business and Management* 50-57,55.

the NEDs is well conceived, yet ensuring independence of such outside directors is impracticable.[61] (In chapter 3, section 3.3, problems with the framework of NEDs have been discussed and it follows possible solutions to the problem in Pakistan).

To sum up, no single managerial disciplinary tool is likely to yield intended results in every situation. Given the context, derivative claim as one of the ways for private sector enforcement is becoming increasing important particularly in this modern corporate world that encourages shareholder activism to enforce corporate rights.[62]

1.3 Derivative Action; A theoretical review

A derivative suit is commenced by a shareholder usually minority shareholder in order to rectify any wrong done to a company.[63] It is a fundamental principle of company law that a company defrauded or wronged by its directors is the rightful claimant to bring the wrongdoers to book. However, if the company fails to do so, the right to take action against the wrongdoers is transferred to its shareholders. Shareholder's right of this action against wrongdoers emanates from the company's right of action and it is why it is named a 'Derivative Action'.[64]

Derivative litigation is important in the sense that when a company is defrauded and the board of directors fails to commence litigation against the wrongdoers due to the reason that the board members are themselves the wrongdoers. In another case, if the company is in control of dominant shareholders who, involved in wrong-doings, would supress

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[61] Independent director's integrity, Daily DAWN newspaper, 13 January 2013 <www.dawn.com/news/776832/independent-directors-integrity > accessed 03 February 2016.

[62] Ibid (n37) 20; James Kirkbride, Steve Letza, Clive Smallman, 'Minority shareholders and corporate governance Reflections on the derivative action in the UK, the USA and in China (2009)51(4) *International Journal of Law and Management*206-219,206- 207.

[63] Ibid (n 29) 117.

[64] See Schiowitz v IOS Ltd [1971]23 DLR 3d ,102 ; EStmanco (Kilner House) v Greater London Council [1982]1 WLR 2QBD , the word 'derivative claim' was borrowed from the US.

litigation against them, then, it should be someone else who should call the wrong-doers to account. This is necessary because otherwise the law would fail in achieving its objective of preventing corporate injustice and misdoings.[65]

As such, when a company is wronged, the company itself is purported to be the initiator of legal proceeding against the wrongdoers. For example, it was remarked by Lord Davey in *Burland v Earle* case, that only the company wronged by its directors is the 'proper plaintiff' and not an individual shareholder.[66] In fact, the 'proper plaintiff' rule derives its justification from the fundamental principle that A cannot claim damages from B for the loss B has done to C.[67]

Moreover, similar to the 'proper plaintiff' rule are the 'majority rule' and the internal management concept which mean that decisions as to the internal affairs of a company have to be made on the basis of the 'majority rule'. Courts have, therefore, no right to intervene at an individual shareholder's civil petition in the decision makings of a company. Likewise, in a case, the court held that shareholders are bound by the majority decision except where such decisions are violative of law.[68] The 'majority rule' and the 'proper plaintiff' rule together[69] are named as the 'Foss v Harbottle' rule (hereinafter called the Foss Rule).[70]

Over a period of time, some exceptions as to the 'Proper plaintiff' rule have been developed that allow individual shareholders of a wronged company, in some situations, to initiate litigation against errant directors. However, exceptions developed

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[65] Wallersteiner v Moir (No 2) [1975] QB 373, 390.

[66] Lord Davey in Burland v Earle [1902] AC 83 PC , 93

[67] Prudential Assurance Co Ltd v Newman Industries Ltd no 2 [1982] Ch 204 , 210

[68] Sammel v President Gold Mining Co Ltd [1969] 3 SA 629 (A), 678

[69] See Foss v Harbottle [1843] 2 Hare 461, 67 ER, 189 ; Wedderburn KM, ' Shareholders Rights and the Rule in Foss v Harbottle' (1957)15(2)*Cambridge Law Journal 1*94-215,198

[70] See Edwards v Halliwell [1950]2 ALL ER 1064 , 1066,

as to the 'Proper Plaintiff Rule' are very limited and do not cover modern conditions and all managerial transgressions.

For example, a breach of directors' duty is not actionable unless it is shown by an applicant 'fraud against minority shareholders' and the 'wrongdoer control'.[71] In this respect, it is difficult to assess the extent of a wrong which really amounts to a fraud on minority and it is why there are conflicting judgments as regards fraud on minority.[72] More so, it is also ambiguous whether a wrongdoer who is not in control of a company or a de facto controller can be proceeded against.[73]

Furthermore, the exceptions to the Foss Rule do not include claims of negligence which can provide shelter to errant directors to absolve themselves of their liabilities.[74] The limitations of the exceptions to the Foss Rule have been discussed in detail in chapter 3 (Section 3.5.2).

A statutory framework for the derivative actions is, therefore, needed so as to simplify the derivative actions and to improve their accessibility. This is necessary to prevent controllers' abuse of the 'proper plaintiff' rule which signifies that it is the wronged company itself to bring wrongdoers to book as being a separate legal entity, not the shareholders of the company.[75] Most of the jurisdictions have introduced statutory derivative action system. As a result, they have enabled minority shareholders to take

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[71] Prudential v. Newman Industries (No.2)[1982] Ch. 204, 210-11

[72] Regal (Hastings) Ltd v. Gulliver [1942] 1 All ER 378; North-West Transportation Ltd v. Beatty (1887) 12 App Cas 589; Queensland Mines v. Hudson (1978) 52 ALJR 399; Pavlides v. Jensen [1956] Ch 656.

[73] The UK Law Commission para 6.4, Consultation Paper, para 6.6, 14,1-4, 16.21.

[74] Foss v Harbottle [1843] 2 Hare 461, 67 ER, 189; Ibid (n 37) 90-102, Reisberg has discussed exceptions to the Foss v Harbottle principle.

[75] Richardson Greenshields of Canada Ltd v Kalmacoff [1995] 123 DLR (4th) 628 at 635 (Ont CA)

actions against errant directors and to prevent potential abuse of the 'proper plaintiff' rule by the controllers.[76]

1.4 Scope of Derivative Action in Pakistan

This section explains the features of derivative suits and conditions under which the derivation suits are desirable. The aim of this explanation is to see how a particular corporate environment of Pakistan measures on those conditions which underpin derivative litigation to prevent directorial and managerial misbehaviours.

It is believed that presence of diffused shareholder ownership, weak institutional structures and collective action problems make a case for derivative litigation to be considered.[77] In diffused ownership structures, shareholders face collective action problems that ultimately let managers to abuse corporate assets. Therefore, derivative actions are considered important in diffused ownership structures.[78] On the contrary, where there is ownership concentration, direct action might be considered a proper remedy for shareholders wronged by the controllers. This is largely because a successful derivative action would recover losses for the company and the major portion of this recovery would go into the hands of majority shareholders thereby reducing the value of a derivative suit for minority shareholders.[79]

Since Pakistan's corporate ownership structure is concentrated, one might question the need for derivative litigation so as to undo wrongs done to the companies in Pakistan. It

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[76] Many countries such as South Africa, China, Singapore, Canada, New Zealand, Australia, the US and the UK have introduced statutory derivative action in their company laws providing an exception to the proper plaintiff rule.

[77] Harald baum and Dan w. puchniak, 'The derivative action: an economic, historical and practice-oriented approach' in Dan W. Puchniak (eds), The Derivative Action in Asia : A Comparative and Functional Approach (Cambridge University Press 30 July 2012)370

[78] See generally, William T Allen, Reinier Kraakman, Guhan Subramanian, *Cases and Commentaries on the Law of Business Organisation* (3rd edition, Aspen Publishers 2009).

[79] See generally, Ibid

is submitted that this is too static a view of the ownership structure. The government of Pakistan has divested in a number of state owned enterprises by floating more than 26 per cent shareholdings in the privatised entities through initial public offerings (IPOs). The Finance minister of Pakistan, *Ishaq Dar* has reiterated his commitments to speed up the divestment of 40 per cent shares of the Pakistan Stock Exchange.[80]

In addition, listed companies are required in Pakistan to make sure minimum 25 per cent public shareholdings.[81] Given the trend of divestments in SOEs and in family-controlled companies, it is expected that the retail investment in Pakistani companies will grow.[82] Although it is very likely that the corporate sector of Pakistan will remain controlled, expected increase in minority shareholdings suggest that minority shareholders should have an adequate protection against majority abuse and accordingly, the case for derivative suits makes a ground. The assumption as to the necessity of derivative litigation only in jurisdictions with the diffused ownership has been proved wrong by a number of jurisdictions of highly concentrated control of shares, and derivative litigation is considered a key element for corporate accountability in these jurisdictions.[83]

When the main concern is disciplining errant directors and controlling shareholders, one may argue for a direct suit to be an appropriated choice. However, a direct action is not an attractive option due to various reasons. For example, a salient feature of

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[80] See Daily DAWN, a national newspaper <www.dawn.com/news/1268766> accessed 08 July 2016 ; Even in some SOEs , the government has divested its shares more than 26 per cent, for example in Habib Bank Limited , the government of Pakistan has divested all of its 45 per cent shares. See Daily Dawn, national newspaper < www.dawn.com/news/1175302> accessed 09 July 2016.

[81] SECP Report, 'Capital Market Development Plan - Karachi Stock Exchange, April 2016, p 20 <https://www.psx.com.pk/newsimage/80942-1.pdf> accessed 01 June 2016.

[82] Pakistan IPO Summit Series (2011-2015) Business Recorder; a DAILY newspaper on Financial and Business News <www.brecorder.com › Supplements.> 17 August 2016.

[83] Ibid (n 39)144. Japan, South Africa and Germany are the jurisdictions with highly concentrated control of shares where derivative litigation is considered is an important corporate accountability mechanism.

derivative litigation is that the wronged companies ultimately pay the legal costs.[84] This is in contrast with the situation in direct actions where shareholders themselves pay the legal cost. Therefore, an individual shareholder would prefer not to commence direct suit thinking that legal cost would be higher than the potential benefit of the successful direct suit.

This legal cost-benefit analysis by small shareholders is referred to as collective action problem. As mentioned above, due to privatisation of a number of state owned enterprises and the growing trend of disinvestment in family based companies, retail investment in Pakistan is expected to increase. As a result, enlargement of retail investor would obviously cause collective action problem to bring suit against errant directors.

One way to address the collective action problem can be claim aggregation. However, claim aggregation also suffers from the problem of small shareholders' inability, due to time and risk factor, to unite with other shareholders and join hands in the suit.[85] This state of affairs supports derivative litigation so as to incentivise individual shareholders to bring suits against wrongdoers as the legal costs in the derivative proceedings are borne by the companies.[86]

Besides individual shareholders of a wronged company, institutional shareholders and entrepreneurial lawyers would probably have sufficient incentives to bring direct suits. Institutional investors, however, have so far been rather passive in Pakistan and they

[84] The plaintiff shareholder pays the costs only in proportionate to their shares in the corporation.

[85] Kris Panijpan, ' Market Dynamics in Corporate Governance: Lessons from recent developments in English Law (PhD Thesis London School of Economics 2014)14

[86] See generally, Stefan Wrbka, Steven Van Uytsel and Mathias Siems, *Collective Actions* (Cambridge University Press 2012)

prefer to stick to the 'Wall Street' rule.[87] However, professional lawyers would be more promising to do this job. In this regard, the contingency fee can be an economic incentive for such lawyers to take such riskier cases as they can be tempted to the benefits of the successful suits.[88] However, the contingency fee is not allowed in Pakistan[89] which makes a case for derivative litigation. In this state of affairs, derivative suits would be a meaningful option so as to avoid legal costs purported to be incurred on direct actions.

There are also some institutional conditions such as lengthy delays in courts proceedings and mispricing in the stock markets that provide reasons as to why statutory framework for derivative actions is needed in Pakistan. For example, a lengthy delay in courts' proceeding is the hallmark of the Pakistani Judicial system that ultimately reduces the potential gains of a suit.[90] This may cause the potential gains from a suit discounted.

For instance, suppose that there is 3000 pounds non-reimbursable legal cost of a suit and the potential benefit of the successful suit is 8000 pounds. If decision is made say after one year, (say further) the current value of the benefit is 7000 pounds and the legal cost of the suit is 3000 pounds. This means the suit earns 4000 pounds and it is worthy of bringing the suit. However, suppose that decision of the suit is made after ten years and the current value of the benefit is 3000 pounds but the legal costs of the suit remains the same because much of the legal costs are incurred at the initiation of the

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[87] Talat Afza, Mian Sajid Nazir, Role of Institutional Shareholders' Activism in Enhancing Firm Performance: The Case of Pakistan(2015)*Global Business Review* 16(4) 557-570 , 559; Wall Street Rule , is when dissentient investors opt cut and run strategy rather to play an active role to push management to act in the best of the company.

[88] See generally, Ibid (n 78).

[89] Rule 5 , Principles of professional conduct adopted by the Pakistan Bar Council

[90] Faqir Muhammad , The Judicial System of Pakistan - Supreme Court of Pakistan 4th edition May 2015 < www.supremecourt.gov.pk/web/user.../thejudicialsystemofPakistan.pdf> accessed 18 January 2016.

suit, then commencing the suit is of no worth. In such a situation, derivative litigation would be an attractive option to sue wrongdoers as the legal cost in derivative proceedings would be paid by the corporations.[91]

Moreover, an efficient stock market reflects information in share prices quickly which is relevant in the sense that the stock prices will adjust to reflect the net gains of the suit once the suit has been initiated.[92] Even though shareholders were to sell their shares before the pronouncement of judgment, their stock price would reflect the value of the suit and hence, they would implicitly receive it when they sold their shares. However, the situation in Pakistan is discouraging as the stock market is not that much efficient to reflect accurately information in share price; therefore, one should be more concerned about shareholders selling their shares before judgments and having no incentives to commence suits. This problem can be addressed by the provision of incentives to shareholders via derivative litigation in which legal cost is paid by the companies.

All in all, increase in retail investment, the prohibition on contingency fee,[93] application of the English rule 'loser to pay legal costs to the winner',[94] institutional factors such as stock exchanges mispricing[95] and excessive delays in judgments[96] make a strong case for the statutory framework for derivative actions in Pakistan.

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[91] Wellersteiner v Moir No 2 [1975] QB 373.

[92] Ginsburg, Tom and Glenn Hoetker, 'The Unreluctant Litigant?:An Empirical Analysis of Japan's Turn to Litigation' (2006) 35 *Journal of Legal Studies* 31: Thompson, Robert B. and Randall S. Thomas, 'The Public and Private Faces of Derivative Lawsuits' (2004) 57 *Vanderbilt Law Review* 1747; John Armour, Bernard Black, Brian Cheffins, Richard Nolan, 'Private Enforcement of Corporate Law: An Empirical Comparison of the UK and US' (2009) 6(4) *Journal of Empirical Legal Studies* 687- 722,689.

[93] Rule 5, Canons of professional conduct adopted by the Pakistan Bar Council

[94] See section.35 (A) Civil Procedure Code 1908, Pakistan.; See also, Cost of litigation Bill 2017.

[95] Arjmand Ahmed shah, Director's Liability Insurance: A shield?" (Pakistan Institute of Corporate Governance, Featured Article <www.picg.org.pk/.../Arjumand%20A.%20Shah-Directors'%20Liability%> accessed 15 July 2015.

[96] Faqir Muhammad , The Judicial System of Pakistan - Supreme Court of Pakistan 4th edition May 2015 < www.supremecourt.gov.pk/web/user.../thejudicialsystemofPakistan.pdf> accessed 18 January 2016

In this context, it may also be added that the culture of Pakistan is a litigious one.[97] If legal remedies happen to be conducive and for that matter meaningful for retrieval and redressal, the aggrieved shareholders would not lag behind in having recourse to the relevant judicial forum for putting in claims of their staked rights. Previously, it has been the shareholder apathy posed by the lack of legal remedies such as inaccessibility to derivative litigation that stood restraining them from bringing claims against wrongdoers in corporations. In this supportive environment, the stance of the statutory framework for derivative actions is expected to receive wide acclaim by the commercial society in Pakistan.

In relation to view on the utility of derivative litigation to discipline management, academics differ. Some scholars contend that from an economic perspective, litigation is not supportive to achieve good corporate governance.[98] However, many others argue that derivative litigations has a key role to play in achieving good corporate governance, ensuring shareholder protection and punishing misbehaviour of directors.[99] The next part provides views from both sides and attempts to demonstrate that derivative actions have attained the attention of corporate law scholars as a meaningful solution to agency problems.

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[97]Yasser Latif Hamdani, INP 'The Crisis of Legal Aid in Pakistan' <www.inp.org.pk/sites/.../The%20Crisis%20of%20Legal%20Aid%20in%20Pakistan.pd> accessed 12 April 2016.

[98] Henry W. Ballantine, Abuses of Shareholders Derivative Suits: How Far Is California's New Security for Expenses Act Sound Regulation(1949)37(3) *California Law Review* 399-418, 400; Michael J Whincop, 'Role of the Shareholder in Corporate Governance: A Theoretical Approach' (2001)25 *The Melbourne University Law Review* 418-464, 432-8.

[99] John C Coffee, and Donald E. Schwartz, 'The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform'(1981) 81(2) *Columbia Law Review* 261-336, 302,9; Ian Ramsay, Corporate Governance , Shareholder litigation and the prospects for a statutory derivative action' (1992) 15 University of New South Wales Law Journal 149, at 156; Oliver C Schreiner, 'Shareholder's Derivative Action-A Comparative Study of Procedures'(1979)96 The South African Law Journal 203 , at 211;Thomas P Kinney 'Stockholder derivative suits: Demand and futility where the board fails to stop wrongdoers'(1994)78 Marquette law Review 172- 189, 174,5; Kristina De Vere Stevens 'Should We Toss Foss?: Toward an Australian Statutory Derivative Action'(1997) 25 Australian Business Law Review 127-139, 130.

1.5 Theoretical underpinning of Derivative Action

The need for the derivative actions has been widely recognised.[100] As explained earlier, derivative actions are valuable not only to recover compensation for the loss suffered by a company but they can also act as a deterrent against future managerial malfeasance.[101] Thomas contends that derivative litigation can play an important function in reducing agency costs and in preventing managerial/directorial misconducts.[102] As such, a successful derivative action imposes liability on errant directors that causes damage to their reputation and other attendant financial loss.[103]Derivative action, in doing so, act as a deterrence not only against future managerial wrongdoings in the company on whose behalf shareholders took action but also against future misbehaviour of directors of other companies.

Thus, both compensatory objectives and deterrence effects of derivative actions together play an important role in aligning the interests of majority-minority shareholders that, in turn reduces agency costs. [104]

However, it is claimed that the central role derivative suits play lies in acting as a deterrent against future managerial wrongdoings but not in recovering insignificant

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[100] In the US, Canada, New Zealand and Singapore, courts have recognised importance of derivative actions for managerial accountability. Diamond v Oreamuno (1969)24 NY 2d 494; Richardson Greenshields of Canada Ltd v Kalmacoff [1995] BLR 2d 197 (CA), 205; Frykberg v Heaven [2002]9 NZCLC 262,966 at 262,974; S. 260-264 UK Companies Act 2006; See s .327 Delaware General Corporation Law; See Sections 165-168, New Zealand Companies Act, 1993; See s. 237-242 Australian Corporations Act 2001; See 216 A, 216 B , Singapore Companies Act 1994.

[101] Richardson Greenshields of Canada Ltd v Kalmacoff (1995) 123 DLR (4th) 628 , 637- 638.

[102]Thomas P Kinney 'Stockholder derivative suits: Demand and futility where the board fails to stop wrongdoers' (1994)78 *Marquette law Review* 172- 189, 174,5.

[103] John C Coffee, New Myths and Old Realities; The American Law institute faces the derivative action(1993) 48 *The Business Lawyer* 1407-144, 1429.

[104] John Amour , Henry B Hansmann and Reinier Kraakman, 'Agency problems and legal strategies in Reinier , Kraakman et , The Anatomy of corporate law; A comparative and Functional Approach (2edn oxford university press 2009)36-37; William Kaplan and Bruce Elwood, 'The Derivative Action: A Shareholder's "Bleak House"?'(2003) 36 *University of British Columbia Law Review* 443-481,451; Posner, Richard A Posner, *Economic Analysis of Law* (3rd." Boston: Little Brown 1986) 389.

financial benefits.[105] It does so for two basic reasons. First, it is perceived that shareholders selling their shares before a successful derivative suit are deprived of the benefits of the suits rather the shareholders who purchase the shares of outgoing shareholders enjoy the benefits of the successful suit. Second, since minority shareholders own small stakes; they get little compensatory benefits of a successful derivative suit as they are entitled to benefit proportionate to their shares in the company provided where minority shareholders are reasonably large to benefit the financial recovery of suit.[106]

In fact, a significant benefit of derivative suits extends beyond the financial recovery.[107] As such, the significant benefit of derivation litigation is to act as deterrent agent that is essential to inhibit controlling managers from committing frauds on the companies and against minorities.[108]The deterrence effects of derivative actions yield a generic and public benefit as shareholders normally diversify their investments. As a result, it conveys the message of deterrence to all potential wrongdoers in firms.[109]

In situations where directors are alleged to have breached their fiduciary duties, shareholders should be enabled to have an access to a judicial remedy. Reisberg argues for the derivative litigation and considers it an important tool to prevent breach of

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[105] John C Coffee, Donald E Schwartz, 'The Survival of the Derivative Suit: An Evaluation and Proposal for Legislative Reforms'(1981) 81(2) *Columbia Law Review* 261-336,295 -308

[106] Ibid 302, 305, 308.

[107] Companies and Securities Advisory Committee, Report on a Statutory Derivative Action (July 1993) 4.

[108] The American Law Institute, Principles of Corporate Governance : Analysis and Recommendations (1994), 590-601 ; Arad Reisberg, Derivative Actions and Corporate Governance : Theory and Operation (Oxford University Press 2007)185 ;James D Cox and Randall S Thomas, 'Common challenges facing Shareholder Suits in Europe and the United States'(2009) 6(2) *European Company And Financial Law* 348-57,351

[109] Derivative action system is not the only mechanism to improve corporate governance and reduce agency cost , as already explained that other mechanisms such the capital market, the market for corporate control and shareholder voting have their own limitations, derivative claims have, thus, an important role to play in promoting good corporate governance and corporate accountability.

directors' duties.[110] He maintains that the enforcement of directors' duties very much depends on shareholder enforcement; therefore, derivative litigation as one of the ways for private-sector enforcement can play an important role to enforce directors' duties.[111]

1.6 Problem of Abusive Litigation

Although derivative actions are very useful to discipline management, yet there can be a risk of abuse of shareholders' right of derivative litigation.[112] For example, shareholders' right of derivative litigation can be misused by the opportunistic shareholders for achieving bad motives. They can harass directors by bringing meritless and vexatious actions and hence, they can obtain private benefits.[113]

Settlement and voluntary discontinuance of a derivative suit may also affect shareholders' interests. For example, shareholders may collude with management to settle dispute in return of bribe money and other unethical payments. The management may offer litigating shareholders repurchase of their shares at a price higher than the fair market value to win over their consent to discontinue the suits.[114] Such settlements and discontinuances of derivative suits might be disadvantageous to the interests of the company and other shareholders who would lose indirect benefits that might have arisen from the successful derivative suit.

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[110] Ibid (n 37) 50-53.

[111] Ibid (n 37) 52.

[112] Henry W. Ballantine, Abuses of Shareholders Derivative Suits: How Far Is California's New Security for Expenses Act Sound Regulation(1949)37(3) *California Law Review* 399-418, 400.

[113] Maleka Femida Cassim, The statutory derivative action under the Companies Act 2008: Guidelines for the exercise of the judicial discretion. (PhD thesis , University of Cape Town 2014) 153

[114] In Manufacturers' Mutual Fire Insurance Company of Rhode Island v Hopson,[1940]25 NYS 501

However, this argument lacks justification because all such dubious settlements and discontinuances of derivative actions are subjected to the courts' approval.[115] The courts must ensure that such settlements and discontinuances of actions are not against the company's and its shareholders' interests. Moreover, to address this concern, there needs to be special measures of screening and filtration mechanism to prevent strike out suits and to allow only genuine and valuable derivative suits.[116]

It is also argued that permission to the derivative action may affect directorial capacity to take risk-based business decisions sometime necessary to achieve high goals of profit maximisation.[117] Additionally, it is thought that giving shareholders the right to take derivative actions would lead to open the floodgate of litigations.[118] As a result, directors and corporate officers would spend their valuable time in defending allegations against them instead of fulfilling their professional duties.

However, this argument lacks support in the light of the experience of countries such as Canada, the US, the UK, New Zealand and Australia where flexible and shareholder friendly approach has been adopted regarding derivative actions, nonetheless, there was no deluge of litigation in such countries.[119] It means that if well-designed rules and

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[115] See section 7.45 Model Business Corporation Act.

[116] This is in a sense , derivatives suits involve a triple agency concern, with these agency concerns, there is fair chance of misaligned incentives; See Steven Van Uytsel, Collective Actions in a Competition Law Context-reconciling multilayer interests to enhance access to justice ' in Stefan Wrbka, Steven Van Uytsel and Mathias Siems, Collective Actions (Cambridge University Press 2012) 98

[117]Paul F Banta, 'New Indiana Business Corporation Law: Reckless Statute or New Standard'(1987)*Columbia Business Law Review*233, at236.

[118] English law commission Shareholder Remedies (Law com , 246 October 1997) para 1,8,1,9

[119] Brian R Cheffins, and JM Dine, 'Shareholder Remedies: Lessons from Canada'(1992)13(5) The Company Lawyer 89-95, 90,92; Ian M Ramsay & Benjamin B Saunders, 'Litigation by Shareholders and Directors: An Empirical study of the Australian Statutory Derivative Action' (2006) 6(2) *Journal of Corporate Law Studies* 397- 446; Maleka Femida Cassim, The statutory derivative action under the Companies Act 2008: Guidelines for the exercise of the judicial discretion. (PhD thesis , University of Cape Town 2014) 156

adequate safeguard are provided, the possibility of abuse of derivative actions can be avoided.

After having examined the arguments of both sides, it is submitted that derivative litigation is necessary to hold wrongdoers accountable. It particularly holds significance in the context of Pakistan where majority shareholders control board of directors and members' general meetings. Thus, in situations where they themselves are the wrongdoers; it is very likely that they would supress litigation against them. This is why the derivative litigation is regarded a paramount minority protection tool as it enables minority shareholders to bring action against errant directors and provides an important mechanism for managerial accountability.[120]

The next section of this chapter aims to examine the role of derivative litigation in the public and private companies. A pertinent question arises here that since disgruntled shareholders in the public companies are vested with choice to leave the company by selling their shares; the need for derivative litigation requires more justification. This argument is erroneous on a number of grounds. For example, denying shareholders of the right to derivative litigation in the public companies would mean to ignore the deterrent role of derivative actions against future directorial misconducts.[121] Moreover, denial of derivative litigation to shareholders means giving go-ahead to managers to loot company's assets as they would get away scot-free knowingly that they would not be subjected to any legal action.[122]

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[120] Arad Reisberg,' Promoting the use of Derivative Actions' (2003)24(250)*Company Lawyer*, 251, 277

[121] Ibid (n37) 178.

[122] It was explicitly stated by Lord Denning in Wallersteiner v Moir No 2 [1975] QB 373 395, that without derivative action, managers would loot company assets knowingly that they are not subject to any legal actions.

It must be borne in mind that shareholders have right to derivative litigation where the board of directors fails or is unwilling to take action against the wrongdoer. In the sense, derivative litigation is premised on preventing wrongdoers going unpunished.[123] Basically, derivative suit is a remedy for shareholders who choose to stay with the company and to take action against the wrongdoers.

Although, it is believed that the outgoing disgruntled shareholders, who choose to leave the company, are not the beneficiaries of a successful derivative suit, even in that case they might not get good price of their shares if directorial illegal actions have caused decrease in the share price.[124]A study conducted in the US indicates that derivative suits were filed in the public companies more than in the closely-held corporations against the wrongdoers.[125] Derivative actions are, thus, important in Pakistan where business families and the State hold majority shares in both the public and private companies and they, due to their dominant position in firms, could supress litigation against them.

It might be argued that since the ratio of minority shareholders is low in family controlled companies in Pakistan, therefore, derivative proceedings needs not to be emphasised in Pakistan so as to discipline errant management in Pakistan. This shade of argument is not well-grounded as the doctrine of minority shareholding varies on case by case basis and even in a family-owned company, one family member might need protection against the possible abuses by the controlling family members. It is evidenced from the total number of 22 suits filed by minority shareholders to seek

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[123] *Smith v Croft No 2* [1988] Ch 114,185

[124] Simon Deakin, Ellis Ferran, and Richard Nolan,' Shareholders' Rights and Remedies; An Overview (1997)2 *Company Financial and Insolvency Law Review* 162-171,163

[125] Robert B Thompon and Ronald S Thomas, 'The Public and Private Faces of Derivative Lawsuits'(2004) 57 *Vanderbilt Law Review*1747-1780, 1763,1767

remedies from courts in Pakistan and the data shows that out of the total, 12 suits were initiated by shareholders occupying shares between 20 to 50 per cent.[126]

Thus, derivative litigation is even more important in closely-held companies.[127] This is because unlike the situation in the public companies, managerial and directorial misconducts in the closely held corporations are not punished by market forces.[128] As a result, vulnerability of minority shareholders in closely-held corporations exposes them to majority abuse. The derivative action system enables minority shareholders to protect their interests by bringing actions against errant directors in private companies. Empirical studies conducted in Canada and Australia show that derivative actions were taken frequently in private companies to undo wrongs done to the interests of the companies.[129]

1.7 Derivative actions versus Market based Mechanisms

Besides derivative litigation, there are market-based disciplinary mechanisms such as the capital markets and the takeover market, which may prevent management from oppressing shareholders' interests.[130] In order to see whether market-based managerial disciplinary mechanisms can act as alternatives to derivative suits, it is important to examine the role of such mechanisms in disciplining management.[131]

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[126] This information (data source) is based on the data searched from reported company law cases, available at Pakistan Law Journal, Pakistan Law Digest and Pakistan Law site.

[127] Simon Deakin, Ellis Ferran, and Richard Nolan, 'Shareholders' Rights and Remedies: An Overview' (1997) 1 *Company Financial and Insolvency Law Review* 162-171, 164; Brian R Cheffins, *Company Law: Theory , Structure and Operation*(Oxford University Press 1997) 463-71

[128] Ibid (n 37) 183.

[129] Ian Ramsay and Benjamin B Saunders, 'Litigation by Shareholders and Directors: An empirical Study of the statutory derivative Action'(2006) 6(2) *Journal of Corporate Law Studies* 397-446,419 : Ibid (n 37) 8.

[130] Amir N Licht, 'Accountability and Corporate Governance'(2002) < ssrn.com/abstract=328401> accessed 14 March 2016

[131] See generally, ibid (n17).

It might be argued that when market mechanisms are in place to discipline management, then derivation litigation need not to be emphasised as both the market-based mechanisms and derivative litigation are meant to do the same task and that is to discipline management. Next section of this chapter is premised on explaining shortcomings and well-known limitations of the market forces which render them inadequate and imperfect tools for managerial accountability.

1.7.1 The Market-based Managerial Disciplinary Mechanisms

Market mechanisms can operate as monitors of management.[132] According to the modern economic theory, market forces have ability to play an important role in enhancing managerial efficiency and corporate accountability.[133] In addition, it is contended that the market-based mechanisms have a major role to play in the growth of the stock markets.[134]A pertinent question arises here that if the market mechanisms are efficient in terms of disciplining management, then it is implausible to look at costly private litigation intended to rescue minority shareholders abused by majority shareholders.

However, scholars opine that the market- based mechanisms have their own characteristics and well-known limitations. Their view, in this respect, is that derivative actions have a key role to play in redressing wrongs suffered by the companies and

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[132] Eilis Ferran, *Company Law and Corporate Finance* (Oxford University Press 1999)119-22; Ibid (n 57) 521-4.

[133] Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* (Harvard University Press 1991) see generally: Caroline Bradley ' Corporate Control: Markets and Rules'(1990) 53(2)*The Modern Law Review* 170-186, 269, 272.

[134] Ajit Sing Alaka Singh and Bruce Weise, Corporate Governance , Competition, the New International Financial Architecture and Large Corporations in Emerging Markets' ESRC Centre for Business Research, University of Cambridge Working Paper No. 250 available <www.cbr.cam.ac.uk/fileadmin/user_upload/centre-for-business.../wp250.pdf> accessed 10 March 2016; Ibid (n 57) 118-22.

their minority shareholders.[135] Given the limitations of the market mechanisms, most of the jurisdictions have legislated on shareholders' derivative right of action so as to enable shareholders to punish blatant breach of duty on the part of managers or directors.[136]

The role of market mechanisms to punish managerial misbehaviour cannot be examined in general rather it needs to be examined from the perspective of the particular capital markets.[137] Next section aims at examining the role of market-based mechanisms to discipline management in Pakistan. The purpose of this examination is to consolidate problems with and limitations of the market mechanisms that underpin derivative litigation to be accessed for punishing wrongdoing directors and managers.

1.7.2 The capital Market

The capital market is one of the market-based disciplinary mechanisms. It may function to discipline management on the following grounds.

Where controlling managers abuse corporate assets for their private gains, shareholders normally prefer not to stay with the company and they sell their share that ultimately affects the company's share price. Decline in share price is detrimental to the company

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[135] Simon Deakin, Ellis Ferran, and Richard Nolan, 'Shareholders' Rights and Remedies: An Overview' (1997) 1 *Company Financial and Insolvency Law Review*162-171, 167:John E Parkinson, *Corporate Power and Responsibility –Issues in the Theory of Company Law* (Clarendon Press 1993) 132; Ibid (n37) 21-23.

[136] Many countries such as South Africa, China, Singapore, Canada, New Zealand , Australia , the US and the UK have introduced statutory derivative action in their company laws providing an exception to the proper plaintiff rule; Asian countries which have statutory derivative action system include , Japan , Article 847, Companies Act ; South Korea ,Article 403-406 Korean Companies Code; Taiwan , Article 214 Company Act ; China Article 152 , Company law ; Hong Kong Part 1VAA of the Companies Law (Amendment by the Companies Amendment Bill 2003) ; Singapore s 216 A Companies Act 1994. South Africa, Company Act 2008

[137] Luca Enriques,'The Law on Company Directors' Self-Dealing: A Comparative Analysis'(2000) 3(2)*International and Comparative Corporate Law Journal* 297-333, 298.

interest in a number of ways. First, it becomes difficult for the company to raise capital where its share price has fallen due to directorial misconducts that in turn, creates liquidity problems for the firm.[138] Second, the fall of shares price of a company also exposes the company to fall prey to a takeover.[139]

It must be borne in mind that when we say that the capital markets function as to push management to align its interests with those of the shareholders, it means that we are assuming that publicly available information is reflected in share price. In fact, this assumption is based on Eugene Fama's theory of efficient market hypothesis.[140] In theory, it may be correct to say that in an efficient market, the securities price reflect available information. However, the 'market efficiency thesis' becomes questionable when we apply it to the inefficient markets where share price does not reflect available information.

The collapse of dot.com bubble during 1999-2001 offers strong evidence to the fact of capital markets' mispricing and as a result, various companies failed.[141] Andrew Lo's study spreading on several years indicates that it is very controversial as to securities price reflecting available information.[142] Academics differ widely on the market

[138] Amna Tahir, 'Capital Market Efficiency: Evidence from Pakistan'(2011)3(8) *Interdisciplinary Journal of Contemporary Research in Business* 947-953, 948

[139] Taylor L, 'The Derivative Action in The Companies Act 1993,(1999)< ir.canterbury.ac.nz/bitstream/10092/3238/1/40095_Taylor_Derivitive%20action.pdf> accessed 15 April 2016.

[140] In fact, Eugene Fama's research was his PhD thesis. See Eugene F Fama,' Efficient Capital Markets: A Review of Theory and Empirical Work'(1970)25 (2)Journal of Finance 383, 383 : Eugene F Fama,' Efficient Capital Markets 11'(1990)46 (5) *Journal of Finance* 1575-1617, 1575

[141] See Roger Lowenstein, *Origin of the Cash: The Great Bubble and its Undoing* (Penguin Books Press: New York 2004)111-116 , Roger has explained the market mispricing and finally the burst in 2000.

[142] See generally Andrew W Lo, 'Efficient Markets Hypothesis' in Lawrence E Blume & Steven. Durlauf (eds), The New palgrave : A Dictionary of Economics (2nd Palgrave Mcmillan 2008)

efficiency thesis as regards the securities price accurately reflecting available information.[143]

When it comes to Pakistan, the prevalence of financial frauds in Pakistan indicates that the equity prices do not reflect available information.[144] In a number of studies, the market efficiency hypothesis has been tested and results have shown that the securities price have not reflected available information in the companies in Pakistan.[145]

It is, thus, risky particularly in the context of Pakistan to rely singly on the capital markets for disciplining errant management. In fact, the capital market as managerial disciplinary mechanism cannot function in isolation; therefore, derivative litigation should be in the list of managerial disciplinary tools to prevent corporate assets from being abused by controlling managers. The capital market, therefore, cannot serve as an alternative to derivative litigation as the effectiveness of the capital market is subjected to market efficiency hypothesis. It is strongly doubtful that the capital market is efficient and is capable of punishing errant managers/directors in Pakistan.

1.7.3 The Corporate Control Market

It might be argued that the corporate control market can be a substitute for derivative litigation. Henry Manne was the first scholar who propounded this thesis that the market for corporate control has a central role to play in disciplining management.[146] The market for corporate control works on the principle that where managerial wrongdoings cause reduction in share price of a company, the company may fall prey

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[143] See generally, Ibid.

[144] SECP Report 'Stock Market Task Force Report 2005', SECP , 7.

[145] Amna Tahir, 'Capital Market Efficiency: Evidence from Pakistan'(2011)3(8) *Interdisciplinary Journal of Contemporary Research i*n Business 947-953, 948; SECP Report 'A Study of the Pakistan Stock Market Crisis of 2008' July 2015, <https://www.secp.gov.pk/ accessed 04 June 2016.

[146] Henry. Manne, 'Mergers and the Market for Corporate Control' (1965) 73 (2) *Journal of Political Economy* 110-120,114

to a takeover.[147] Therefore, the underperforming managers due to the fear of being sacked by the acquirer are pushed to act in the best interests of the company.[148] In this sense, the takeover market could influence managerial behaviour and prevent managerial malfunctioning.

The effectiveness of market for corporate control is based on the assumption that managerial misconducts would be reflected in the capital market that in turn, would cause fall of securities price. The fall of securities would ultimately pose threat to the company to be acquired.

The corporate control market to punish incompetent managers is also subject to various contingencies and limitations. For example, in practice, larger companies take over the smaller ones.[149] In principle, it is possible other way round where a smaller company takes over the larger one but it is not a usual practice.[150]The objectives of takeovers by the larger companies are normally empire-building motivated rather than disciplinary ones.[151]

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[147] Susanne Trimbath, Halina Frydman and Roman Frdman, Corporate Inefficiency and the Risk of Takeover (2000) Economic Research Reports from CV Starr Centre For applied Economics Working Paper 17-35.

[148] David Scharfstein, The Disciplinary Role of Takeovers(1988) 55(2) *Review of Economic Studies* 185, 184-186

[149] Ajit Singh , Takeovers, their relevance to the Stock Market and the theory of the Firm (Cambridge University Press 1971); Ajit Singh, 'Corporate takeovers' in J Eatwell M Milgate and P Newman(eds) The New Palgrave Dictionary of Money and finance (Macmillan 1992) 478-7

[150] See Alan Huges ' Mergers and Economics Performance in the UK: A survey of Empirical Evidence 1950-1990' in J Fairburn and J A Kay (eds) *Mergers and Mergers Policy* (2edn Oxford University Press 1991)

[151] Ajit. Singh, Alaka Singh and Bruce Weisse, 'Corporate Governance, Competition, the New International Financial Architecture and Large Corporations in Emerging Markets' ESRC Centre for Business Research, University of Cambridge Working Paper No.250,29 <www.cbr.cam.ac.uk/pdf/WP250.pdf > accessed 02 March 2016

This can be seen in the UK where takeover markets particularly, hostile takeovers have not been seen 'inefficiency driven'.[152] The research also indicates that large outside share blocks have not significantly influenced managerial behaviours.[153] As such, there is no significant evidence regarding improved corporate governance after takeovers.[154]

Second, the takeover market mechanism is an expensive route to dislodge incompetent management as it involves substantial transaction costs.[155] Therefore, the bidder has to think of the issues as agency costs, undervalued company and transactions costs before making decision of the takeover. Third, the takeover market mechanism has its little application to closely-held companies.[156] Although, closely-held companies have relatively less significance in economic terms, yet they constitute the vast bulk of companies in Pakistan.[157]As a result, this limits the scope of takeover market mechanism in Pakistan.

Last but not the least; the takeover market mechanism works in a very limited range. Normally, most of the firms are out of this range where they could become takeover targets. For example, if managerial inefficiency does not significantly cause fall of share price, then the company is out of the range so as to fall prey to a takeover. Similarly, if managerial inefficiency is so extreme that could cause takeovers, then it

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[152] Franks and Mayer, 'Governance as a Source of Managerial Discipline' Prepared for the Company Law Review , Committee E on Corporate Governance (2000) 18.

[153] Ibid 18.

[154] Andrew Cosh and Paul Guest, The long run Performance of Hostile Takeovers: the UK Evidence (2011) ESRC Centre for Business Research , University of Cambridge Working Paper ,1-4,30

[155] Pauline O Sullivan , 'Governance by Exit, An Analysis of the market For Control in Kevin Keasey and Steve Thompson, *Corporate Governance :Economic and Financial Is*sues (Oxford University Press, 1997) 122

[156] Ajit. Singh, Alaka Singh and Bruce Weisse, 'Corporate Governance, Competition, the New International Financial Architecture and Large Corporations in Emerging Markets' ESRC Centre for Business Research, University of Cambridge Working Paper No.250,30 <www.cbr.cam.ac.uk/pdf/WP250.pdf > accessed 02 March 2016.

[157] There are 67,623 total companies in Pakistan as of 2015. Among those, 90 per cent companies are private companies on 12 December 2016.

can become a risky undertaking for the acquirer. The corporate takeover market, thus, have serious limitations in its operations as its effectiveness depends on variables such as ownership structure, informational requirements and defensive tactics used by managers of the companies which are subject to potential takeovers.

When it comes to Pakistan, liquidity problem in the capital markets of Pakistan[158] informs that relying on the takeover market for disciplining errant managers may not be effective where families and the State hold majority equities even in the listed companies which can be used to avoid takeovers. Without floating shares in the market, control of companies remains under the heel of controlling families and in SOEs, under the State. The takeover market, therefore, would not be effective to discipline management in Pakistan where the ownership structure is concentrated and capital market is illiquid.

The corporate takeover market, thus, suffers from flaws and limitations.[159] Scholars argue that extra-regulatory mechanisms may not be helpful in disciplining managerial misbehaviour as anticipated.[160]This thesis argues that changes in the law ought to be made in order to provide minority shareholders with greater access to the courts to seek

[158]Faiza A. Chaudary, Marc Goergen, Shoeb I. Syed, 'Corporate Governance in the Financial Sector of Pakistan' 2006 < www.eaber.org/sites/default/files/.../LUMS_Chaudary_2006.pdf > p 9 accessed 01 February 2016

[159]Rita Cheung, 'Corporate Governance in Hong Kong'(2008) *International Company and Commercial Law Review* 181

[160] Deakin Simon and EillisFerran , and Richard Nolan, 'Shareholders' Rights and Remedies: An Overview'(1997)1 *Company Financial and Insolvency Law Review* 162, 167–169; John.E Parkinson, *Corporate Power and Responsibility; Issues in the Theory of Company Law* (Oxford: Clarendon Press, 1993)132

appropriate remedies. Empirical work suggests that strengthening legal protection to minority shareholders causes the stock markets develop.[161]

1.8 Concluding Remarks

In the light of foregoing examination, it is submitted that the use of derivative action is not a primary protection for minority shareholders against the misbehaviours of directors. Indeed, it holds a very significant position in the list of managerial disciplinary measures. The importance of derivative actions stems from the genesis where majority shareholders commit frauds on a company and its minority shareholders and they, by virtue of their control over the company, manage to supress litigation against them. The derivation litigation is, in this respect, premised on preventing managerial/directorial misconducts going unpunished and without being redressed.

The discussion in this chapter has canvassed the limitations of internal and external managerial disciplinary mechanisms such as shareholder voting and independent directors which thus encourage the role of the private sector enforcement through derivative litigation. Finally, with these observations, this chapter examined the role of the market forces to discipline management. A conclusion has been reached after having examined the market based managerial disciplinary mechanisms that they seem to play an insignificant role in disciplining management in Pakistan. In a business environment in which the threat to minority interests is negligible, imperfect managerial disciplinary frameworks seem to be inconsequential.

It comes with no surprise that the derivative actions have an important role to play in deterring managerial misconducts. Various countries specific studies have been carried

[161] Randall Morck and Bernard Yeung, "Some Obstacles to Good Corporate Governance in Canada and how to Overcome them" (Task Force to Modern Securities Legislation in Canada, 2006)341; La Porta *et al*, 'What Works in Securities Law'(2006) 61(1) *The Journal of Finance* 1-31,27

out to explore the role of the derivative suits to deter reckless behaviour of controlling managers.[162] No study, in this regard, has been carried out that focus solely on the subject of derivative proceedings in the context of Pakistan. This thesis aims at bridging this gap in the literature by examining the role of derivative litigation to glass over the sufferings of small investors and enforcing corporate rights.

1.9 Research Questions

A key argument this thesis makes surrounds the need to encourage the private-sector enforcement of the laws through the use of derivative litigation so as to prevent directorial opportunism and minimise minority sufferings at the hands of controlling shareholders in Pakistan. In order to provide a statutory framework for derivative action system, the derivative action systems in other jurisdictions, particularly that of the UK would be looked at while bearing in mind what lesson Pakistan could learn from them in this regard.

In relation to the role of derivative action system to prevent managerial opportunism and protect minorities' interests, this thesis seeks to answer three main questions.

[162] Arad. Reisberg, *Derivative Actions and Corporate Governance : Theory and Operation* (Oxford University Press 2008); Deborah A DeMott, Shareholder Derivative Actions: Law and Practise 2016,2017 (Clark Boardman Callaghan (26 September, 2016) Deerfield , IL: M. Siems, 'Private enforcement of directors' duties: derivative actions as a global phenomenon', Working Paper no. 2010-MS-1 (2010), University of East Anglia Law School, Norwich< www.uea.ac.uk/law/Research/Papers> – dealing, briefly, with the United States, Japan, France, the United Kingdom, China and Germany; John. Armour, B. Black, Brian. Cheffins and Ronald Nolan, 'Private enforcement of corporate law: an empirical comparison of the UK and US' (2009)6(4) *Journal of Empirical Legal Studies* 687–722; Li, Xiaoning, A Comparative Study of Shareholders' Derivative Actions: England, the United States, Germany and China (Deventer: Kluwer 2007); Brian R Cheffins, and Bernard S. Black, 'Outside director liability across countries' (2005)84 *Texas Law Review* 1385–1480; Shaowei Lin, Derivative Actions in China (The university of Edinburgh 2014); Maleka Femida Cassim, 'Statutory Derivative Actions under the Companies Act of 2008:Guilines for the exercise of judicial Discretion (University of Cap Tow , 2014). Georgios Zouridakis,'The Introduction of the Derivative action into the Greek law on public limited companies as a means of shareholder protection. A comparative analysis of the British, German and Greek law (PhD thesis, University of Essex, UK ,2016).

(1) To what extent the insiders (controlling shareholders and directors) misuse their authority in taking business decisions in disregard of companies and small investors' interests?

(2) What role do derivative actions play in promoting good corporate governance and in preserving corporate assets?

(3) How can company law be reformed, simplified and modernised so as to reinforce enforcement power of shareholders for safeguarding their interests in Pakistan?

1.10 Research Methodologies

This part explains the research methods used in this study. It explains the reasons for choosing the methods in this PhD study. This thesis employs a multi-methods approach so as to answer its research questions.[163]It combines doctrinal, historical, case study, comparative and semi-structured interviews methods to examine in detail all dimensions of difficulties minority shareholders facing in Pakistan in relations to the enforcement of their rights.

1.10.1 Doctrinal Analysis

The doctrinal analysis is meant to locate and analyse the laws to reach a tentative conclusion, premised on solving a specific legal problem and visualising future developments.[164]A doctrinal approach has been applied in this thesis so as to encompass the theme of this thesis and to answer the research questions. As in chapters

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[163] On mixed method approach , see generally , Abbas Tashakkori and Charles Teddlie (eds), *SAGE Handbook of Mixed Methods in Social & Behavioral Research* (2nd edn SAGE Publications 2010); John W Creswell and Vicki L Plano Clark, *Designing and Conducting Mixed Methods Research* (2nd edn SAGE Publications 2011)

[164]Terry Hutchinson and Nigel Duncan, 'Defining and Describing What We Do: Doctrinal Legal Research' (2012) 17(1) *Deakin Law Review* 83, 101–18.; Cownie says that law is examined from black letters approach by focusing on assessment of legal resources and the reports of judicial decisions as the sole mean of understanding the law; Fiona Cownie, *Legal Academics: Culture and Identities* (Oxford Hart Pub 2005)31

3 and 4, we shall see that the doctrinal research method was important (1) in locating laws relating to minority rights and remedies, and (2) then analysing them. The legal analysis is adopted to accentuate the shortcomings in the company law of Pakistan in relation to minority shareholders rights and remedies. This is significant in developing and providing guidelines or proposals for the improvement or reform in the country's current legal system.

1.10.2 A Historical Approach

A study that involves expropriation of minority interests by controlling managers can be carried out using a historical approach. Historical approach helps a researcher to understand the context of a phenomenon relating to the past events. It involves developing an understanding of the past that holds some significance for the present.[165] This is useful as the future, in any case depends on the past: future is not completely foreseen but equally it is not the result of a chance.[166] Moreover, historical approach helps a researcher to understand the context of a phenomenon relating to the past events.

This study adopts a historical approach in order to identify factors which led to block-holding ownership structure posing threats to minority interests, and to analyse the evolution of company law and legal system of Pakistan. Watson states that historical background is essential to understand a particular law for the purpose of legal transplant.[167] The adoption of historical approach is helpful in understanding the

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[165] Diana Hacker and Barbara Fister, *Research and Documentation in the Electronic Age* (5th edn Bedford / St Martins 2010) 54

[166] Bill Mcdowell, *Historical research: A guide for writers of dissertations, theses, articles and books* (Routledge, 2013.)5-6

[167]Alan Watson, 'Comparative Law and Legal Change' (1978) 37(2) *Cambridge Law Journal* 313-336,322.

historical insight and context to assist in proposing an effective minority protection mechanism notwithstanding the significant concentrated control of shareholders in Pakistan provides an enormous scope for corporate abuses.

1.10.3 A Case Study Approach

Yin recommends that case study approach should be used when a research needs answering 'why' and 'how' structured questions.[168] Case study approach has been used in this thesis to investigate conflict of interest problem between minor and major shareholders in the selected cases and find out why and how corporate management takes self-serving decisions in business entities in Pakistan. According to Yin, case study method focuses on deep understanding of a phenomenon in an individual situation.[169] Bromley also defines a case study method in a similar way. According to him, case study method is a systematic investigation of a phenomenon so as to describe and explain the studied phenomenon.[170] In the light of the definitions, the case study method is a systematic investigation of a phenomenon by explaining its evolution and carrying out the inquiry so as to gain necessary information that could be referred in arriving at certain conclusions.

Case studies can be explanatory, descriptive or exploratory.[171] The explanatory case study enables cases to be used with greater rigour in a research as a tool to support

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[168] Robert K Yin, *Case Study research, design and methods* (3rd edition , SAGE Publications, Thousand Oaks 2003) 13.

[169] See generally, Robert K Yin, *Case study research: Design and methods* (4th edn SAGE Publications 2009).

[170] See generally, Dennis B Bromley, Academic Contributions to Psychological Counselling: I.A philosophy of science for the study of individual cases (1990)3(1) *Counselling Psychology Quarterly* 229-302.

[171] Ibid (n 169) 6.

arguments.[172] Accordingly, the explanatory case study format employed in this thesis helps to analyse the micro of the conflict of interest problems, and also to set this within a wider understanding of expropriation of corporate assets by the controllers in Pakistan.

A case study research method is not necessarily to be either qualitative or quantitative.[173]It can be a combination of both; therefore, both qualitative and quantitative data collection tools can be used so as to gain the relevant information for studying a phenomenon. There is a range of data which can provide a flesh to fill in the skeleton of case study method. Data required to carry out a case study may come from archival records, participant observation, interview, direct observation and documentations.[174]In this study, documentations such as the annual reports of the companies, investigation reports, applicable legislations, case laws, newspaper reports, articles and archival records are used to understand the problem of fraud committed by controlling shareholders on companies and their minority shareholders.

In this thesis, multiple case study approach has been chosen to develop a theoretical framework for this thesis. A multiple case study approach helps to look at the findings from a comparative perspective that enables developing theory.[175] The cases studied indicated that controlling shareholders misuse their dominant authority in disregard to the interests of the companies and small investors.

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[172] Robert K Yin, 'The Abridged Version of Case Study Research' In Leonard Bickman and Debra J. Rog (eds.) (Eds) *Handbook of Applied Social Research* (Thousand Oaks, California: Sage Publications 1998) 236

[173] Pamela Baxter and Susan Jack, Qualitative Case Study Methodology: Study design and implementation for novice researchers (2008)13(4) *The Qualitative Report* 544,546-551

[174] Ibid (169) 98.

[175] Kathleen M Eisenhardt and Melissa E Graebner, Theory building from cases: opportunities and challenges(2007)50(1) Academy of Management Journal 25-32,25

The findings from the case studies are not different to the extent of expropriation of corporate assets by the controlling managers that too gains support for theory creation.[176] Moreover, in order to avoid reliability issues, same variables have been studied to create theory and allow replication of findings. Studying same variables makes comparisons across expropriations cases possible and supports theory creation. The variables studied are expropriation of corporate assets, managerial misconduct and weak enforcement power of small shareholders as to safeguarding corporate rights.

An important issue that needs to be addressed explicitly relates to generalising findings of the cases studied to exemplify expropriation of minority interests by the controllers and to provide a theoretical framework for this thesis. In a qualitative research, generalisation of findings is problematic where those findings are based on a single case. However, this is not the case with multiple case studies which may provide a strong basis for generalising findings. As explained earlier, in this study, conclusions are based on investigations of multiple cases. Thus, findings from the cases studied can be applied to other acts of expropriation of corporate assets though modes of managerial misconducts and expropriation in other cases may be different.

1.10.4 A Comparative Approach

This thesis also employs a comparative approach[177] for which the jurisdiction of the UK has been chosen as analysis sample. This is because the UK is the most advanced commercial law jurisdiction and it holds a significance influence over legal frameworks of common law countries. Being a common law country, the company law of Pakistan

[176] Robert E Stake, *Multiple Case Study Analysis*(The Guilford Press, New York 2006)24

[177] For explanation of comparative research approach , see generally , John C Reitz, 'How to Do Comparative Law' (1998) 46(4*) American Journal of Comparative Law* 617-636, 620-25

is a remnant of colonial legal legacy and stands largely in its original form.[178] Furthermore, Pakistan and Britain share a common heritage of history extending over a period of more than one hundred year. Therefore, a comparative reflection on Pakistan's legal framework cannot avoid analysis of relevant laws in its birthplace.

A significant argument this thesis makes relates to inadequacies of law which facilitate pyramiding arrangements and lead to the expropriation of minority interests by controlling managers in Pakistan. This thesis contributes to the literature by putting forward future legal reform proposals regarding statutory derivative action system in Pakistan. Consequently, the selection of the UK for comparative analysis becomes important as the UK is the originator of the derivative action system which is expected to bring a good reference for Pakistan.

However, it might be argued that the US is also an advanced jurisdiction and has a long history of derivative action system. As such, the courts are not as much willing in the UK as the US courts are, in accepting the application of derivative claims. To that, it is submitted that the main focus is on the UK derivative action system while reference would also be made to other jurisdictions where necessary so as to learn from their experiences.

In fact, the derivative action system is not the only way of disciplining errant management and protecting minorities. There are other mechanisms such as the capital markets, the market for corporate control, the product markets, shareholder voting and the framework of independent directors that may function to discipline errant management. The role of the derivative actions depend not only on its own legal rules but also on other intuitional factors and managerial disciplinary mechanisms. This is

[178] Shaukat Muhmood and Nadeem Shaukat, *The company Law*(Legal Research Centre Vol-1 , Pakistan) 8

because corporate governance is a system that sets out the internal relations between various constituencies of a company. Therefore, it is right to say that the role of derivative actions is inversely proportional to the effectiveness of other managerial disciplinary mechanisms. The more effective other mechanisms are, the less the role of derivative actions is.

It is, therefore, not apt to say that one jurisdiction has a better derivative action system than the other. As such, one cannot say that the US derivative action system is better than the UK's where courts hold relatively more conservative attitude towards derivative claims. This is mainly due to the reason that unfair prejudice remedy is readily available to disgruntled shareholders in the UK and hence, derivative actions are not that much important. Thus, borrowing rules from other jurisdictions does not depend on whether those rules are good or bad but it depends on the suitability of those rules in the receiving jurisdictions.

The purpose of using a comparative approach is to analyse where Pakistan can draw lesson from the UK so as to devise its statutory derivative action system.[179] However, it is debateable whether borrowing from other jurisdictions is useful for improving legal frameworks. The debate over borrowing from other jurisdictions has been carried out in this part bearing in mind whether borrowing from the UK is possible for Pakistan.

Alan Watson defines legal transplant, 'as moving laws from one jurisdiction to another jurisdiction'.[180] He is of the view that legal transplant is very useful for a legal change in a jurisdiction. Therefore, he recommends that understanding of legal developments in other jurisdictions is useful for lawmakers to have new insights into how to reform

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[179] Helen Xanthaki, 'Legal Transplants in Legislation: Defusing the Trap' (2008) 57 (3) *International & Comparative Law Quarterly* 659-673, 660.

[180] Alan Watson, *Legal Transplant: An Approach to Comparative Law* (2nd edn, University of Georgia Press 1993)21.

their particular laws.[181] Watson also opines that the 'voluntary legal transplant' can be a good source for developing laws in receiving jurisdictions. Given the importance of voluntary legal transplant, he attempts to establish his view that relationship between law and society is a misconceived notion. His believes that the legal origin in a society does not develop usually by virtue of a logical outgrowth of the society's own experience.[182]

However, contextualist and culturalist schools have criticised Watson's view on legal change. The contextualist school levels charges against his 'legal transplant' thesis by stating that he ignores social structural factors and undermines the rationale for developing a theory of law and society.[183] Moreover, Watson's thesis on legal transplant did not remain unchallenged by the culturalist school. For example, they hold that a particular culture determine the development of law in a jurisdiction. They reject Watson's 'legal transplant' thesis by claiming that law evolves historically and Watson overlooks a specific culture inherent in every legal system.[184]

Given the concerns raised by the contextualist and culturalist schools, two important questions needs to be answered so as to justify the adoption of a comparative approach for this thesis. First question relates to the prospects of legal transplant in the context of Pakistan. Second question that requires answering relates to the efficacy of legal transplant in Pakistan. The first question is answered on the basis of following reasons.

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[181] Alan Watson, 'Aspects of Reception of Law' (1996)44 *American Journal of Comparative* Law 335-351,335

[182] Ibid (n 180) 16-19.

[183] Otto Kahn-Freund, ' On Uses and Misuses of Comparative Law'(1974)37(1) *Modern Law Review* 1-27

[184] Pierre Legrand, 'What' Legal Transplants' in David Nelken and Johennes Feest (eds), Adopting Legal Cultures(Oxford , Hart Publishing 2001)55-68; Anne W. Seidman & R.B.Seidman, *State and Law in the Development Process*(St. Martin's Press 1994) 44

First, Pakistan is a member of World Trade Organisation (WTO) that requires national laws to be more liberal and to be in congruence with international standards.[185] To that end, legal transplant becomes necessary and inevitable for Pakistan. Second, cultural and political conditions that may resist legal transplant are inherent in the public laws such as criminal and constitutional laws. However, commercial laws are not that much closely linked to cultural and political conditions as they function according to their own ground rules and they work relatively in an autonomous system of law. The cultural differences, though important, are not fatal to the comparison in the area of commercial laws. Therefore, legal transplant is possible in the area of commercial laws and the one model governance thesis at least confirms the veracity of this statement.[186]

Whilst legal transplant is possible, it does not mean copying laws from one jurisdiction to another one. The potential benefits of borrowing from other jurisdiction can only be achieved if it considers the legal culture and other extra-legal conditions.[187] Though the legal transplant does not face as resistance in commercial laws as it may in the public laws-closely linked to local conditions; therefore it is important to pay heeds towards local conditions as each and every single rule may not function in a receiving jurisdiction as effectively as it does in its birthplace. Thus, when this thesis uses a comparative approach, it means comparative approach based on the UK's experience provides guideline where relevant, in order to establish an effective derivative action system in Pakistan based on both doctrinal and empirical grounds.

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[185] 'Pakistan Ratifies WTO deals' Daily Dawn newspaper <www.dawn.com/news/1215829> accessed 27 February 2016.

[186] See generally ,Arthur R. Pinto, Globalisation and The Study of Comparative Corporate Governance'(2005)23 *Wisconsin International Law Journal* 477

[187] Daniel Berkowitz, Katharina Pistor and Jean-Francois Richard, 'The Transplant Effect'(2003)51(1*) American Society of Comparative Law* 163-203; Ibid (n183).

1.10.5 Semi-Structured Interviews

Lack of case law, case commentaries together with weak relevant knowledge base require another useful source material necessary to assess and inform reform proposals made in this thesis by giving a sense of multiple interpretations and, by reflecting the reactions of the interviewees. The qualitative empirical approach employed in this thesis consisted of eight semi-structured interviews[188] from local corporate lawyers, academics and the senior SECP officials so as to look into how statutory derivative action system works effectively in the marketplace.

Six interviews were conducted through *SKYPE*. Whereas two interviews were conducted face-to-face in the UK when some domestic corporate lawyers from Pakistan visited UK to attend condolence seminar organised by the Law Society, UK for the suicidal attack on lawyers community in Quetta, Pakistan. The aim of such interviews was to provide an evaluation of reform proposals made in this thesis and to incorporate their insightful and illustrative suggestions that had helped in proposing a workable and meaningful derivative action framework in Pakistan.

The interviews included open-ended questions instead of closed ended questions where normally questions are sought to be answered with 'Yes' or 'No' responses.[189]The open-ended questions format was chosen so as to allow the participants to develop their own view on a specific legal argument and provide their comments and opinions. The

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[188] Some set questions were divided in three categories, the purpose of the first of which was to identify the problems minorities face in practice, the second to reflect the current remedies available to minority shareholders and the third to gather any proposals from participants by eliciting their views on how statutory derivative action system would work better and to what extent. For explanation of in-depth interviews, see generally, Irving Seidman, *Interviewing as Qualitative Research: A Guide for Researchers in Education and the Social Sciences* (2ND edn Teachers College Press 1998); Steinar Kvale, *Interviews: An Introduction to Qualitative Research Interviewing* (SAGE Publications, 1996).

[189] Robin Legard, Jill Keegan and Kit Ward, 'In Depth Interviews' in Jan Ritchie and Jane Lewis, (eds*) Qualitative Research Practice: A Guide for Social Science Students and Researchers* (SAGE Publications 2003) 138

advantage of semi-structured interviews was to understand in-depth of an individual's perspective by giving a sense of multiple interpretations.

According to Kvale, the purpose of semi-structured interviews is to understand the qualitative descriptions of the phenomenon of interest.[190]This work helps to assess what problems minorities actually face in the enforcement of their rights in Pakistan, by reflecting the views of people who are involved in private litigations and policy making that helps in finding appropriate reform proposals. In order to undertake field work, the interview plan received formal ethics clearance from Research Graduate School, University of Bedfordshire, UK. (See Appendix 1 ethics form approval)

The SECP officials were identified through employee's information available at the SECP website, in order to recruit suitable interviewees. Other interviewees i.e domestic corporate lawyers and academics were selected using the 'snowball' sampling technique.[191] This meant I approached some of the interviewees using my own personal contacts and then extended the sample size following the suggestions made by initially approached interviewees.

In order to achieve the objectives of the research, I introduced interviewees to the research purposes, expected duration of interviews and the procedure employed for maintaining their confidentiality. I also made it clear to the participants that they might withdraw from participating at any stage of the interview process. Each participant was provided with the 'Consent Form' approved by Research Graduate School, UOB. All

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[190] See generally ,Steinar Kvale, *An Introduction to Qualitative Research Interviewing* (London: Sage Publications 1996)

[191] Snowballing sampling is an interview technique by which some of the interviewees introduce the researcher to, or suggest, another relevant person who also fits the interview selection criteria. See Jane Ritchie, Jane Lewis and Gillian Elam, 'Designing and Selecting Samples' in Jane Ritchie and Jane Lewis (eds), *Qualitative Research Practice: A Guide for Social Science Students and Researchers* (SAGE Publications, 2003) 77, 94.

the participants were requested to read and sign the form before consenting to their participation.

As privacy and confidentiality is essential in all research,[192] I assured all participants of keeping their identity confidential. Participants were selected from different backgrounds and experiences deliberately with the purpose to elicit their views on reform proposals. The interviews comprised of open-ended probing questions necessary to allow participants to respond in more depth on issues under exploration.[193]I recorded interviews in form of written notes and then shared those written notes with the interviewees so as to avoid any misunderstanding. After having got the agreement of the interviewees, I transcribed interviews into Microsoft Word.

The interview data was subject to thematic analysis. Braun and Clarke's[194] six phases'[195] format for thematic analysis was adopted that assisted this study by providing a transparent data analysis to assess the reforms proposals, results and contribution of this thesis.

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[192] The confidentiality of the participants becomes more important in the context of Pakistan where public official are not allowed to comment on government's policies according to Estacode Civil Establishment Code, Islamabad.; Irving Seidman, *Interviewing as Qualitative Research: A Guide for Researchers in Education and the Social Sciences* (3rd edn Teachers' College Press 2006)56.

[193] Robin Legard, Jill Keegan and Kit Ward, in Depth Interviews' in Jane Ritchie and Jane Lewis (eds) *Qualitative Research Practise ; A guide for Social Science Students and Researchers*(SAGE Publications Ltd 2003)141,153

[194] Virginia Braun and Victoria Clarke, 'Using thematic analysis in psychology'(2006)3 *Qualitative Research in Psychology* 77-101, 86

[195] This six phase format include , becoming familiar with data, generating initial codes, searching for Themes , Reviewing Themes, Defining and Naming Themes.

1.10.6 Reliability and Validity

In a qualitative research, concerns regarding reliability and validity needs to be addressed clearly.[196] Frost explains reliability, an evaluation criteria for the trustworthiness of the research.[197]A reliability of research can be achieved by clearly showing the audit trail of evidence.[198] In this study, reliability has been ensured by clearly stating the data collection process, data analysis tool and the process of developing findings.

According to Frost, validity refers to a true reflection of a research's findings.[199] Concerns regarding the validity of a research affect credibility of the research. In this study, validity was ensured by making clear the research schedule based on the doctrinal analysis and participants' views and opinions to evaluate reform proposals made in this thesis. With validity concerns acknowledged, it helped avoid research bias. Secondly, the interview transcripts were shared with the interviewees so as to make correction of any misunderstanding that helped gain accurate information and sufficient assessment of the reform proposals.[200]

1.10.7 Data Required

In order to study managerial opportunism and protection of corporate and small investors' interests, information regarding expropriation problems and shareholders' enforcement powers is needed. Data has been collected from a number of authoritative

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[196] See generally, Robert k Yin, *Case Study Research, Design and Method* (Applied Social Research Methods) (5th edn SAGE Publications,2013).

[197] See generally, Nollaig Frost, *Qualitative Research Methods In Psychology: Combining Core Approaches*(1st edn Open University Press, 2011).

[198] Marian Carcary, 'The research audit trial–enhancing trustworthiness in qualitative inquiry'(2009) 7(1)*The electronic journal of business research methods* 11-24,11

[199] See generally, Ibid (n197).

[200] See generally, Louis Cohen, Lawrence Manion, *Keith Morrison, Research Methods in Education* (6th edn Routledge 2007).

sources; applicable legislation, case law and other official publications. In addition, this study relies on secondary sources such as journal articles, practitioner textbooks and electronic legal databases such as Westlaw, Lexis, BAILLI, Pakistan law journal, Pakistan law site and Pakistan Law Digest. As explained above, eight semi-structured interviews were conducted in order to assess and incorporate respondents' insightful suggestions as to reform proposals made in this thesis.

Chapter 2. Literature Review

2.1 Introduction

This chapter reviews literature that significantly helps to develop understanding as to the unique context of managerial opportunism and dimensions of shareholder protection. The review of literature would shed light on the objectives of this thesis and strong empirical and conceptual foundations thereof. It identifies what previous scholars have contributed to the literature on subject of derivative litigation as to disciplining errant managers and recapitulates key concerns and gaps in the existing literature on derivative proceedings. This chapter serves as a signifying benchmark that this thesis advances in the literature on the subject of derivative litigation.

This chapter reviews scholarly work on six main areas. First, it reviews a key literature on the subject of corporate ownership structures and protection of shareholders. Second, it uses agency theory tending to locate conflicts of interests between shareholders *inter se* in Pakistan. Third, significant research on Contractarian, legal and Communitarian theories is reviewed. Fourth, it underscores key research on corporate governance models and minimisation of agency costs. Fifth, this chapter largely examines literature on the need for law and justification as to protecting minorities. Finally, the gap in the existing literature is identified that this thesis aims to fill.

2.2 Corporate Ownership Structure

It is imperative to first discuss literature on corporate ownership structures in order for providing a basis for the major issue this research seeks to address. Academics regard ownership structures a highly important element in governance mechanism.[1] This is mainly due to the reason that the ownership structures have an immense influence over both governance problems as well as on formulation of governance policies.[2] This part briefly explains the two mainstream structures of ownership structures namely; 'the concentrated ownership structure and the dispersed ownership structure, and it culminates in an examination of the ownership structure in Pakistan.

In concentrated ownership structure, shareholders use different techniques so as to gain control over a company. They may use 'block-holding strategy' in which they own blocks of shares which happen to be large enough to gain control over corporations.[3] Issuance of shares with enhanced voting rights may also provide shareholders with an opportunity to have control over the company.[4] Furthermore, shareholders may gain control of a firm through the use of pyramid ownership structures.[5] The pyramid ownership structures help majority shareholders to control both the company wherein they happen to be majority shareholders as well as its other subsidiaries even though with small equities.

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[1] Andrei Shleifer and Robert W. Vishny, 'A Survey of Corporate Governance' (1997)52(2)*Journal of Finance* 737-783; Attiya Y Javid, and Robina Iqbal, 'Ownership concentration, corporate governance and firm performance: Evidence from Pakistan'(2008)*The Pakistan Development Review* 643-659,643.

[2] Brian L Connelly et al, 'Ownership as a Form of Corporate Governance' (2010) 47(8) *Journal of Management Studies* 1561-1589,1561.

[3] Brian R. Cheffins, *Corporate Ownership and Control* (Oxford University Press, 2008) 27

[4] Milton Harris and Artur Raviv, 'Corporate governance: Voting rights and majority rules'(1988)20 *Journal of Financial Economics* 203-235,203

[5] Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, 'Corporate Ownership around the World' (1999) 54(2) *Journal of Finance* 471-517,471.

For example, in pyramid ownership arrangements, a family based company may control a publicly traded company A, and then the company A controls another publicly traded company B and then the company B controls another company namely; C and in doing so, the company positioned at the upper tier of the pyramid also controls the company that is at the lowest tier of the pyramid often with very low shareholding. Thus, such ownership arrangements help the ultimate controller to control other firms in the pyramid structure even though with very small equities and enjoy voting rights disproportionate to their cash flow rights.[6]

Cross shareholdings structures may also be used by shareholders to have control over the company. The cross-shareholding structures help shareholders maintain control over different firms by owning shares therein. For example, if majority shareholders, due to their majority shareholdings, have the control of a company A and if company A owns majority shares of company B, this phenomenon helps the majority shareholders of company A to control company B alongside though they are not owning majority shares in the company B.[7]

Dispersed ownership structures are typified with low ownership concentration. Due to scattered shareholding in the dispersed ownership structure, it becomes problematic for shareholders to reach an agreement in relation to decision making as it is difficult to persuade all the shareholders at a time. It may also be an expensive exercise and sometime impracticable to call and unite all the shareholders for the purpose of making

[6] Atif Ikram, Syed Ali Asjad Naqvi, Family Business Groups and Tunneling Framework: Application and Evidence from Pakistan' Centre for Management and Economic Research Working Paper No.5-41, (2005)1<saber.eaber.org/sites/default/files/documents/LUMS_Ikram_2005.pdf> accessed 12 January .2016.

[7] Ibid (n5) 477.

decisions.[8] Therefore, dispersed ownership structures are marked with the characteristics of shareholders' indifferent attitude towards their participation in decision making and possible disagreements in making decisions.[9]

Most shareholders owning small securities show an apathetic attitude towards corporate activities considering that their action may not bring forth significant benefits for them. This apathetic attitude of shareholders allows management to control and manipulate corporate decision making whimsically.[10] Consequently, the management is afforded with an opportunity to control the agenda of meetings which, in turn, further weakens the control of shareholders on corporate actions.[11] This was established by Jensen and Meckling's research that the more the percentage of ownership, the less the agency costs shareholders have to bear.[12] This was also supported by Deakin and Hughes's study which posits that in situations where the board holds more than 50 per cent shares, there are less chances for agency issues to arise.[13] Dispersed ownership structure is not a common phenomenon.[14] With exception of the UK and the US, there are mainly concentrated corporate ownership structures with business groups and the states dominating the corporate sectors.[15]

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[8] Stephen M Bainbridge,'Director Primacy and shareholder disempowerment' (2006) 119(6) *Harvard Law Review* 05-25, 20.

[9] Ibid 20.

[10] On rational apathy , see Robert C Clark , *Corporate Law* (Little Brown 1986)390-2

[11] John Cubbin and Dennis Leech, 'The Effect of Shareholding Dispersion on the Degree of Control in British Companies: Theory and Measurement' (1983) 93(370)*The Economic Journal* 351- 369,355

[12] Michael C. Jensen and William H. Meckling, Theory of the Firm: Managerial Behaviour, agency costs and ownership structures'(1976)3(4) *Journal of Finance Economics* 305,308,317.

[13] Simon Deakin and Alan Hughes , ESRC Report(ESRC Centre for Business Research, University of Cambridge 1999) para 4.2 , Grant Thornton Corporate Governance Review, A Changing Climate: Fresh Challenges ahead ? (2011) <http//www.grant.thornton.co.uk/en/publications/2011/Corporate Governance-Review-2011/> accessed 01 January 2017.

[14]Ibid (n5) 497.

[15]Ibid (n5) 497.

In Pakistan, there is a shareholder concentration with families and business groups taking the dominant positions in family based as well as in the listed companies. Cheema *et al* examined factors which stood instrumental to the corporate sector development in Pakistan. They found that private sector was the major factor which led to the industrialization in Pakistan after its independence.[16] Few families continued to be the main beneficiaries of the financial policies of the government of Pakistan (GOP). The families were given fiscal incentives, different subsidised credits and cheap import of capital goods which helped them gain control of the corporate sector in Pakistan.[17] Zulfiqar Ali Bhutto (1972-1977) contested election on the manifesto of nationalization of industrial sector and introduced a plan of reducing industrial concentration in the corporate sector of Pakistan.[18]When he came into power, his government nationalised a large number of industrial units. The banking industry was also nationalised which helped the GOP to gain control over the financial sector of Pakistan.

However, the subsequent democratic governments in 1990s abandoned the policy of nationalization and revived the role of private sector in Pakistan. Nevertheless, the corporate ownership structure remains unchanged and business families and the government of Pakistan are still enjoying dominant position in the corporate sector of Pakistan.[19] The researchers highlighted that due to the pyramid structures, interlocking directorships and cross-shareholdings, controlling stockholders extract private benefits at the cost of the companies' interests. They further maintain that this high level of the

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[16] Ali Cheema, Faisal Bari and Osama Siddique, 'Corporate Governance in Pakistan: Issues of Ownership, Control and the Law' in F. Sobhan and W. Werner (eds) A Comparative Analysis of Corporate Governance in South Asia: Charting a Road Map for Bangladesh (Bangladesh Enterprise Institute, Dhaka 2003)

[17] See generally, Ali Cheema,' Rent-Seeking, Institutional Change and Industrial Performance: The Effect of State Regulation on the Productivity Growth Performance of Pakistan's Spinning Sector, 1981-94' (PhD Dissertation, Department of Economics, University of Cambridge, Cambridge 1999)

[18] See generally, ibid.

[19] See generally Ibid (n16).

intra-group ownership concentration poses threats to corporations' as well as to the rights and interests of small investors in Pakistan.[20]

Tunnelling is a common form of corporate misconduct in Pakistan which is facilitated by complex cross-shareholding structures and further the intricate coordination of businesses of group of companies. The dominance of a group of shareholders can be a family group or can be a coalition or collection of investors dominating the corporations in leagues with each other's support. These ownership settings pose threats to minority rights through abusive related party transactions, illegal intra-corporate financing, inflated salaries to managers and exploitation of corporate opportunities. This state of affairs underpins the introduction of statutory derivative action system in Pakistan so as to provide shareholders with an effective weapon of corporate accountability.

2.3 Background to Agency Costs

Since Berle and Means first presented the theory of control over the corporate form,[21] the term 'agency' used in economic context is now being used in legal scholarship. Berle and Means have pointed out in their work, 'The Modern Corporation and Private Property' that, due to division of ownership and control, the decision making control has shifted into the hands of managers.[22] This division of ownership and control is necessary due to several reasons.

First, since it is not feasible for shareholders to run and look after the business operations in companies, it is necessary to transfer the control of company to

[20] See generally Ibid (n16).

[21] See generally, Adolf. A. Berle and Gardiner. C. Means, *The Modern Corporation and Private Property* (2nd revised edn, Transaction Publishers, 1991) Book 1 , Chapter V.

[22] Paul. Redmond, *Companies and Securities Law: Commentary and Materials* (3rd edn, Law Book Co 2000) 181

professional managers in order to run companies effectively. This separation is also useful for owners themselves in a sense as it allows them to focus on their investments and hence, this helps capital markets develop.

Second, the profits of a company very much depend on the efficiency of professional managers instead of investors' energy and initiatives in view of the rapid growth of the capital markets. Originally, investors are more concerned with their property they invest in the companies. However, the situation is no more the same in the modern capital markets where investors invest in different companies and they do not worry about the actual property in which they have invested. In this sense, shareholders have become a mere supplier of capital in listed companies.[23]

Third, professional managers are necessary to run the company in the sense that in the modern capital markets, quicker responses are required for market reactions which are unlikely to be made without professional management. Therefore, employment of professional management with managerial skills is highly needed in order to achieve competitive advantages. The division of ownership and control is, thus, necessary in a sense that it helps companies increase profits and also helps capital markets expand.

However, the division of ownership and control may give rise to conflict of interests issues referred to by economists as 'agency problems' where management prefers its personal interests over the interests of shareholders at times when their interests conflicts with each other.[24] The management is supposed to serve as being the agent of shareholders in the supreme interest of the company and its shareholders.

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[23] Blanché SteynI, Lesley Stainbank, 'Separation of ownership and control in South African-listed companies'(2013)16(3) *South African Journal of Economic and Management Sciences* 316-328,318

[24] Stephen A. Ross, 'The Economics Theory of Agency: The Principal's Problem' (1973) 63(2) *American Economic Review* 134-139,134

However, it comes with surprise that there exist no agency problems without having legal and extra-legal mechanisms to reduce the same. In fact, management normally possesses smarter access to corporate information than the shareholders have which makes it difficult for shareholders to make sure that managerial actions serve the best interest of the company.[25] Consequently, it may lead to managerial opportunism and encourage management to pursue its personal interests at the expense of the company and its shareholders.

Such abuse of authority affects managerial performance and hence reduces shareholders' confidence to invest in the company. The conflict of interest problem generates monitoring cost for shareholders wishing to monitor managerial actions and bonding costs for management to assure shareholders that managerial actions are focussed on the maximisation of shareholders' value.[26] Given the threat management poses to the interests of shareholders, Berle and Means suggested that law is the answer to discipline and control management.[27]Agency theory has explained the disjunction between ownership and control and the conflict of interest arising out of this agency relationship.

2.4 Agency Theory

Jensen and Meckling presented the agency theory that suggests that controlling shareholders, by virtue of their dominant position, may act opportunistically and hence, they may expropriate corporate assets at the cost of minority interests. It is, thus,

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[25] Reinier H Kraakman at el, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2nd edn, Oxford University Press 2009) 35

[26] Ian Ramsay, 'Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action' (1992) *15(1) University of New South Wales Law Journal* 149, at 156

[27] Adolf Berle and Gardner Means,*The Modern Corporation and Private Property* (Commerce Clearing House, New York 1932) 132.

important to reduce agency costs in order to foster the confidence of shareholders and to improve the performance of management.[28] In Pakistan, there are horizontal agency problems as there is no separation of control and ownership. Controlling shareholders place their family members and the trusted persons in managerial and directorial positions in family-owned companies. Similarly, managers are selected in the state-owned enterprises on the basis of their political affiliations and personal connections with the government. Since management is controlled by majority shareholders; the actual conflict of interest emerges between shareholders *inter se* instead of shareholders and management conflict of interests in Pakistan.[29]

The agency theorists recognise that it is not feasible that managerial contracts should include all aspects of managerial actions, thus allowing management to rule on such voids left in the managerial contracts. Such an incomplete nature of managerial contracts may lead to managerial misconduct and potential misbehaviour on the part of managers.[30] This is mainly due to the reason that shareholders become part of contracts by merely purchasing shares in the public companies and hence, they are unable as to negotiating the terms of managerial contracts. Therefore, it is impracticable to renegotiate the contracts once shares have been allocated.

Eisenhardt argues that agency theory is relevant in three eventualities; (a) where there is conflict of interest leading to managerial opportunism,(b) where there are attendant uncertainty, (c) where monitoring is difficult to perform.[31] Such eventualities are present with managerial opportunism and shareholder protection. For example,

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[28] Ibid (n12) 308.

[29] See generally Ibid (n16).

[30] See generally, Ibid (n12).

[31] Kathleen. M Eisenhardt, Agenct Theory: An Assessment and Review'(1989) 14(1) *Academy of Management Review* 57-71,55.

independent directors are required to monitor executive directors; however, due to their close connections with executive directors and dependence on executive members of the board for their re-election are few of the instances that can lead to a creation of conflict of interest. Therefore, the company will bear the agency costs so as to align interests of the constituencies. Reducing agency problems has been a principle point to agency debate.

Agency theorists argued that there is an existence of agency relationship between owners and managers. Although, there is no as such direct link of law on agency relationship, yet the agency theory erstwhile used in economic terms is now being recognised in legal scholarship as a means to explain intra-corporate relations and has gained the position in legal scholarship as a basis for formative suggestions. In view of managerial opportunism necessitated by agency relationship, agency theorists recommend that there must be an effective mechanism to police managerial actions in order to avert conflict of interest problem.[32] To that end, legal origin theory recommends that legal systems are essential to discipline delinquent managers and the protection afforded to minority shareholders helps the capital markets develop.[33]

This thesis extends Jensen and Meckling's research that there must be an effective mechanism to police managerial actions by arguing that agency costs can be controlled in Pakistan by enabling shareholders to initiate derivative proceedings against managerial misconducts. Without an adequate legal protection, management may ignore the interests of minorities and may expropriate corporate assets for their private gains. One of the mechanisms to reduce agency cost can be to allow minority

[32] See generally, Ibid (n12).

[33] Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, Investor Protection and Corporate Valuation'(2002) 57(3)*Journal of Finance* 1147-1170,1147

shareholders to litigate in the name of a company in case any wrong is done to the company.

In Pakistan, inadequate legal protection available to minorities exacerbates the conflict of interest problem between minority-majority shareholders. Well-designed statutory protection in the form of derivative action system may better protect minority as well as company interests and may reduce opportunities for controlling managers to expropriate corporate assets in Pakistan.

2.5 Legal Contractarian Theory

The contractarians are critical of legal intervention. They opine that shareholders are protected through private contractual system.[34] They opine that managerial actions are bound by contractual commitments and shareholders may safeguard their interests by exercising their contractual rights.[35] The legal contractarian theory is subject to well-grounded criticism. For example, Clark disregarded legal contractarian theory on grounds of incomplete nature of contracts and the role of corporate laws to fill void left in incomplete contracts. Clark criticises contractarians mainly on grounds of (1) limited liability concept that can exonerate errant shareholders from personal liability, (2) transferability of shares that may create opportunities for large shareholders to commit fraud on small shareholders, (3) ownership concentration that sets a governance environment where agency costs are obvious.[36]

[34] Klausner Michael, 'The Contractarian Theory of Corporate Law: A Generation Later'(2006)31 *Journal of Corporation Law* 779-796,782.

[35] Ibid 784.

[36] Robert C Clark, *Corporate Law* (Aspen Publishers ,Inc 1986)2-4.

Additionally, corporate law communitarians are opposed to the legal contractarians theory.[37] The communitarians are also sceptical about the efficiency of private contractual system. They pay regards to the interest of multilateral community and hence, seek legal protection for non-shareholder constituencies as well as small investors in firms where they are affected by managerial actions.[38] They favour legal intervention in corporate affairs and regulating managerial actions. According to them, imposition of legal duties on managers is important to promote fair play for all the non-shareholder and shareholder constituencies of corporations. Sharia business principles as embraced and required to be adhered to by the constitution of Pakistan are analogous to communitarian view that is to seek protection of public interest through state intervention in business enterprises.[39]

Moreover, two American law and economics theorists, Easterbrook and Fischel explain that managerial contracts are inherently incomplete and do not cover all managerial aspects. This is mainly due to the reason that contractual provisions are not sufficiently detailed to cover future contingencies and they are incapable of meeting every contingency. Moreover, fiduciary duty and structure rules fall short of covering all aspects of managerial actions.[40] As a result, the incompleteness of contracts allows directors to behave opportunistically. Therefore, such an incomplete contractual relationship cannot guarantee protection of shareholders in case of any violation of their rights.

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[37] Million David, New Direction in Corporate Law; Communitarians, Contractarians and the Crisis in Corporate law'(1993) 50(4) *Washington and Lee Law Review* 1373-1393,1381

[38] Ibid 1381.

[39] Hussain Hamid Hassan, *An Introduction to the study of Islamic Law* (Leaf Publication Islamabad, 1997)194-210.

[40] Frank H. Easterbrook and Daniel R. Fischel, 'Voting in Corporate Law Corporations and Private Property,' (1983) 26(2) *Journal of Law and Economics* 395-427,402.

Upon bankruptcy, shareholders are a tier below the other claimants and as a result, they are paid last.[41] Therefore, there should be a route by which they could make good wrong done to theirs' and corporate interests. Bankruptcy laws and the terms of contracts protect other stakeholders such as bondholders, preferred shareholders and creditors in case of financial difficulty putting their investments at risks.[42] However, ordinary shareholders remain unprotected being residual claim-holders. In some cases, even shareholders go empty-handed if nothing is left in liquidation proceedings. Thus, Easterbrook and Fischel supported legal protection for shareholders due to their residual claim-holding status and incomplete contractual relationship.[43]

Keay and Zhang have also explained the incomplete contractual relationship in the context of private companies. They opine that parties sometimes cannot foresee future events which may affect this contractual relationship; therefore, contracts cannot be sufficiently and comprehensibly graphic to cover future happenings and all aspects of managerial actions.[44] This is a well-known problem with the formation of contracts that they cannot exist in an ideal form as it has been described by Williamson, 'the foresight is, at best, imperfect'.[45] This incomplete nature of contracts may provide managers with opportunities to engage in illegal activities because small investors may not be able to

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[41] Eugene F Fama and Michael C Jensen,'Agency Problems and Residual Claims'(1983) 26(2) *Journal of Law and Economics*327-449,328.

[42] Ibid 401.

[43] Frank H Easterbrook and Daniel R Fischel, *The Economic Structure of Corporate Law*(Cambridge MA: Harvard University Press, 1991) 16-24.

[44] Andrew. Keay, Hao Zhang, 'Incomplete Contracts, Contingent Fiduciaries and a Director's Duty to Creditors'(2008)32(1) *Melbourne University Law Review* 141-169,154.

[45] Oliver E Williamson, 'Markets and Hierarchies: Analysis and Antitrust Implications' (1977) 22(3) *Administrative Science Quarterly* 540,544.

foresee the misuse of incomplete provisions of contracts and consequential ex-post opportunism at the time of signing contracts.[46]

Goddard has further explained the concept of incomplete contracts. He points out that in view of an asymmetrical relationship, minority shareholders are not acquainted with necessary information to negotiate a detailed contract that could safeguard their interests. Consequently, he observes that this asymmetric information leads to incomplete contracts.[47] Thus, standard contractual provisions may not resolve all problems arising out of contractual relationship between shareholders and directors. The concept of incomplete contracts necessitates that there should be additional mechanisms which could complete these contracts. These mechanisms may include independent board directors, incentive compatible compensation and takeover markets.

However, Michael Jensen, a famous financial economist, notes that financial markets and internal governance systems have their own limitations and thus, they are unable to push managers to serve in line with the best interests of the companies and shareholders.[48] He, therefore, recommends that the imposition of legal liability on malfeasance managerial actions is vital in order to protect shareholders who suffer due to incomplete contractual provisions.[49]

This thesis advances literature on shareholder remedial rights by arguing that law needs to intervene as the standard contracts do not cover all aspects of managerial actions. Therefore, legal remedy via derivative litigation should be available to shareholders and

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[46] Ibid (n44)155.

[47] Robert Goddard, Enforcing the Hypothetical Bargain: Sections 459-461 of the Companies Act 1985'(1999)20(3)*Company Lawyer* 68-69.

[48] Michael C Jensen, ' The Modern Industrial Revolution , Exit , and the Failure of Internal Control System' (1993) 48(3)*The Journal of Finance* 831-880,831

[49] Ibid 864.

be used in complement with other minority protection measures such as voting rights, independent directors and market-based managerial disciplinary mechanisms in order to provide a robust enforcement mechanism in the hands of shareholders so as to safeguard corporate assets.

2.6 Reducing Agency Costs

This thesis argues that law has a crucial role to play in reducing agency costs. However, a question may crop up that if capital markets can effectively punish directorial misconducts and reduce agency costs then the legal provisions for minority protection lose their justification. Likewise, if law can be instrumental to reducing agency costs, then the argument to explore market based mechanisms is weakened as both market mechanisms and legal provisions serve the same purpose that is to protect corporate assets. As this thesis argues that market based disciplinary mechanisms have their own well-defined limitations, at least, in the context of Pakistan due to various reasons that underpins shareholder litigation in order to protect their rights.[50]

Therefore, law needs to be relied on so as to make good wrongs done to the companies and their minority shareholders. The limitations of market-based mechanisms have already been discussed in chapter 1(section 1.7).

2.7 Legal intervention and shareholder Protection

Literature on minority protection is mainly divided into two schools. One who believes in legal intervention for safeguarding shareholders' interests and regards it essential for

[50] Deakin Simon, Ellis Ferran, and Richard Nolan, ' Shareholders' Rights and Remedies; An Overview (1997)*1Company Financial and Insolvency Law Review*162-171, 167; John E *Parkinson, Corporate Power and Responsibility –Issues in the Theory of the Firm* (Clarendon Press 1993)132

improving corporate governance and enhancing shareholder confidence.[51] The other school refutes the role of law in the protection of corporate and shareholders' interests. I examine arguments of both sides in this section to see whether the law needs to be relied upon to protect shareholders in Pakistan or otherwise.

The legal intervention for shareholder protection was strengthened by Rafael La Porta *et al*'s research that the success of the capital markets very much depends on legal protection of shareholders. They, after having conducted empirical research across 49 jurisdictions, argue that jurisdictions embracing adequate protection attract investors and encourage Initial Public Offering (IPO) which ultimately provides liquidity to corporations that leads to the growth of the capital markets. On the other hand, jurisdictions where the law does not offer adequate protection to minorities, the capital markets do not work well. Their research concludes that investor protection and the developed capital markets are concomitant.[52] In protected countries, outside investors such as minority shareholders feel secure and protected and hence, they finance corporations which, in turn, help the capital markets develop.[53]

They argue that jurisdictions with diffused structures are more protective and the capital markets grow faster than the ones with block-holding ownership structures. As such, if investors feel insecure, they may use the strategy of owning blocks of shares to protect their interests which, in turn, encourage block-holding ownership structures. In principle, a block-holding ownership structure cannot be termed as an inefficient governance structure; in fact, it can better monitor managerial actions due to block of

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[51] Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, 'Legal Determinants of External Finance' (1997)52(3) *The Journal of Finance* 1131-1150,1149; Ibid (n26)149.

[52] Ibid,1149; Ibid (n33)1147; La Porta et al carried out empirical research in a number of countries which finds positive relationship between legal protection of minority shareholders and economic growth.

[53] Ibid (n33)1147

shares. However, problem arises in the block-holding ownership structures where large investors expropriate corporate assets for their personal gains at the cost of minorities' interests. Rafael La Porta *et al* conclude that large investors may expropriate small investors' interests by dint of their dominant authority in firms. They suggested that improved shareholder protection has potential to reduce disinformation detrimental to contractual grounds and decrease expropriation of corporate assets. They, therefore, recommend that in order to reduce managerial opportunism, law needs to intervene to protect minority shareholders in the block-holding ownership structures.[54]

Dam is of the same view and opines that legal protection to shareholders and economic growth are concomitant. Therefore, he suggests that adequate legal protection needs to be in place for fostering economic growth.[55] This can also be seen in the discussion of Judge who contends that law is a key to economic development particularly in those jurisdictions where protection available to shareholders is inadequate.[56]

Coffee and Schwartz have emphasised the need for law in the context of providing a threat of liability on errant managers who are found involved in corporate misconducts. They believe that offering shareholders with the right of action against wrongdoers would have a public benefits and would serve as deterrent value in the long term. According to them, derivative litigation can provide this useful deterrence in terms of social and economic values to improve shareholders confidence.[57] It is also contended by Ramsay and Saunders that law needs to be relied on, if not for other reasons such as

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[54]Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, 'Investor Protection and Corporate Governance' (2000) 58(1-2)*Journal of Financial Economics* 3-27,24.

[55] Kenneth W Dam 'China as a test case: is the rule of law essential for economic growth?' (2006) U Chicago Law & Economics, Olin Working Paper 275

[56] Judge Stephen , *Company Law* (1st Oxford University Press , 2008) 138-144

[57] John C Coffee & Donald E Schwartz, 'The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform'(1981) 81(2*) Columbia Law Review* 261-336, 308.

the economic advantages of shareholders protection, pre-eminently from the perspective of equity and justice in order for rectifying corporate misdoings on the part of directors and managers.[58]

The viewpoint of interventionary role of law is also supported by Abugu who opines that the principles of justice and equity require equal treatment of shareholders in terms of protecting their rights.[59] A number of other scholars argue that law has valuable role to play in preventing controllers from making decisions in favour of their personal interests where their interests conflict with the companies'.[60]

2.7.1 Literature against Legal Protection

Under company law principles, the shareholders are not to litigate in the name of the company in view of proper plaintiff rule.[61] As such, the argument against legal intervention is supported by jurisprudential rules namely; business judgment rule,[62] internal management rule[63] and majority rule.[64] However, the argument presented in this thesis is that if a company is defrauded by someone who is in control of the same, it will lead to such wrongs go unpunished. This state of affairs underpins shareholders-

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[58] Ian M. Ramsay, and Benjamin B. Saunders, 'Litigation by shareholders and directors: an empirical study of the Australian statutory derivative action'(2006) 6(2)*Journal of Corporate Law Studies* 397-446, 397,380

[59] Joseph EO Abugu, 'A comparative analysis of the extent of judicial discretion in minority protection litigation: The United Kingdom and United States'(2007)18(5)*International Company and Commercial Law Review* 181-198,181

[60] Ibid (n12) 308; See generally, John Lowry and Alan Dignam, Company Law (Oxford University Press ,2006); And many other researchers, discussed in different parts of this thesis who have argued for the need of law in protecting shareholders from the misdoings of managements.

[61] Jonson v Gore Wood & Co(No.1)[2002]2 A.C.1,60,63.

[62] Business judgment rule is a presumption that decisions taken by management are informed, based on good faith and taken in the best interest of the company.

[63] MacDougall v Gardiner [1875]1CHD 13.

[64] Foss v Harbottle [1843]2 Hare 461.

initiated litigation on behalf of the company in order to punish wrongdoers in the companies.

It was argued by Bainbridge that a corporate governance system is designed to function independently and without shareholders' interference;[65] which the argument presented by him was also recognised by UK Law Commission that managerial actions should be independent of shareholder interference.[66] This concern of the Commission was contested in the parliament on grounds that there are already adequate safeguards to avoid meritless litigation against managers. The concerns regarding the meritless litigation against management were considered and thus, a two-phased litigation procedure was suggested so as to assess the legal merits of derivative actions.

In addition, Payne contends that the minority protection principle is deceptive and obscure.[67] It is believed that enabling minority shareholders to litigate on behalf of a company will result in excessive litigation which, in turn, would cause waste of a company's resources on frivolous and meritless cases brought by opportunistic shareholders.[68] The concern of meritless litigation against directors was also considered by Hannigan, requiring a balance to be struck between promoting directorial accountability and protecting directors against frivolous litigation.[69]

Ben Pettet is of the same view that some jurisdictions have restricted shareholders litigation intentionally considering that if minority shareholders are allowed to litigate,

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[65] Stephen M Bainbridge, Shareholders Activism and Institutional Investors (2005) <http://ssrn.com/abstarct=796277> accessed 05 December 2016.

[66] Consultation paper, para 14.11.

[67] Jennifer Payne, 'Section 459-461 Companies Act 1985 in flux: The Future of Shareholder Protection'(2005)64(3) *The Cambridge Law Journal 647-677*,658

[68] Ibid 658.

[69] Brenda Hannigan, *Company Law* (4th edition Oxford University Press, 2015) 526.

it will encourage shareholders to bring suits without merits.[70] However, it is submitted in this regard that denying shareholders' right of derivative action is not justified where controlling managers have harmed the company as well as other minorities' interests simply under presumption that courts would not be able to manage a high expected volume of litigation. Since minority shareholders are vulnerable in controlled firms, the law must be responsive to protect these vulnerable status holders in case they are wronged by controlling managers. So far as the question of malicious and vexatious litigation is concerned, courts are always able to control and manage meritless litigation brought by sheer opportunistic shareholders intending to exploit management for their private benefits.

2.7.2 The Need for Minority Protection

Question arises who should make decisions in today's modern corporate world? Decisions in a company can be made either through consensus or through majority rule. As such, it is difficult to arrive at a consensus in decision making and further it may result in deadlock in making corporate actions. If decisions are made on the basis of majority rule, it may allow majority shareholders to indulge in activities of malfeasance which, in turn, may harm minorities' interests. The expropriation of corporate assets at the cost of minorities' interests by majority shareholders is exacerbated by weak statutory protection given to minority shareholders.

This is mainly due to the reason that sometimes, general securities' regulations and company's constitution fall short of protecting minority shareholders where majority shareholders expropriate corporate assets without apparent violation of these regulations. Voting rights also do not really resolve majority-minority problem as

[70] Ben, Pettet, *Company Law* (2nd edition Pearson Education Limited, London, 2005) 213

majority shareholders control firms through majority votes and thus, voting rights serve only the interests of shareholders holding majority votes. Law, thus, should intervene and prevent controlling shareholders from expropriating minority interests. Well - designed laws can enable shareholders to safeguard their interests and hold errant managers and directors accountable.[71]

In order to augment the minority protection argument, it is necessary, first to establish that minority shareholders are vulnerable in corporations and are subject to managerial misconducts. Rock and Wachter contend that, in view of extremely strong association between directors and majority shareholders in block-holding ownership structures, minorities are exposed to majority abuses as majority shareholders are able to elect directors of their own choice and, they, in turn, take decisions to appease majority shareholders.[72]

Goddard also contends that minority shareholders are subject to majority abuses as the exit option for minorities is not always available. Consequently, they are left with no option but to stay with the company at the mercy of majority shareholders. He, therefore, maintains that this may endanger minority interests.[73] Furthermore, Lazarides advances a similar view on the vulnerability of minorities. He opines that minority shareholders are amenable to expropriation at the hands of greater interest holders in a company as the small powerless minorities do not have adequate representation on the board. They further suffer due to their relative unsophisticated understanding of affairs

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[71] Ian Ramsay Benjamin B Saunders, , ' Litigation by Shareholders and Directors: An empirical study of the statutory derivative action' Research Report ; Centre for Corporate Law and Securities Regulation The University of Melbourne (2006) 6

[72] Edward Rock, Michael L. Wachter, Waiting for the Omelette to Set: Match Specific Assets and Minority Oppression in the Close Corporation'(1999) 24(4)*Journal of Corporation Law* 1913-1947,1923.

[73] Robert Goddard, Taming the Unfair Prejudice Remedy: Sections 459-461 of the Companies Act 1985 in the House of Lords,(1999) 58(3)*The Cambridge Law Journal* 487-490,488

of the company.[74] It, thus, follows that scholars are of unanimous view regarding the vulnerable status of minority shareholders in the concentrated ownership structures.

2.7.3 Need for Minority Protection Law in Pakistan

Law has a crucial role to play in protecting minorities in the context of Pakistan in view of widespread expropriation of corporate assets by the controlling shareholders exploiting their dominant authority in firms. According to Rafael La Porta *et al s'* law theory, consideration must be given to the law in order to protect minority interests that ultimately improves corporate governance and helps capital markets develop.[75] Similarly, it is argued by communitarians that use of law is necessary so as to enforce the duties of directors they owe to the companies and shareholders.[76]

This thesis argues that minority interests are subject to majority abuse in Pakistan and the current minority protective mechanism contains shortcomings and suffers from various limitations. Statutory derivative action system, thus, needs to be introduced in Pakistan in order to enable minorities to hold errant managers, accountable.

There are mainly two factors namely; the economic and, the law factor that aims to achieve the ends of justice and fairness for all shareholder and non-shareholder constituencies of corporations. It is important to explain each factor in order to appreciate minority protection doctrine in Pakistan.

From economic aspect, minority protection doctrine is understood to have many virtues. Minority protection is necessary in a sense it provides shareholders with security of their investments necessary for the functioning of a business operations and

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[74] Themistokles Lazarides , Minority Shareholder Choices and Rights in the New Market Environment (10 July 2009)p 3 < http://ssrn.com/abstract=1432672> accessed 15 March .2016

[75] Ibid (n51) 1149.

[76] Ibid (n37) 1381.

hence, companies are urged to utilize resources more effectively, thus, supporting economic development and growth.[77] Protection which can draw investment is vital in light of the fact that, unless shareholders are attracted to invest in a company, that company would not have the capacity to grow and develop steadily. Rather, that company will lose the capital necessary for its business operations. [78]

Minority protection can be instrumental to the growth and progress of the capital markets. It may happen where minority shareholders are vested with rights to hold errant managers or directors, accountable. As a result, they may be willing to pay high prices for shares, which in turn, may inject more capital to companies on new issuance of shares.[79]It is accepted that jurisdictions which offer adequate protection to minority shareholders possess more valuable stock markets and higher capital demand than the ones where protection is inadequate.[80] It is, therefore, argued that, from an economic perspective alone, the minority protection doctrine is justified. John Amour *et al* argue that the economic benefit of shareholder protection can be achieved by shareholders-initiated derivative proceedings which have the potential to reduce conflict of interest problems between the major and minor shareholders.[81]

In addition, from justice and fairness point of view, it appears to be unjustified to deny legal protection to minorities merely by virtue of their low ratio of shareholdings in firms. As such, in a number of family-controlled companies, minority shareholders are more in numbers than the majority shareholders; therefore, the shareholders who are

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[77] Organisation for Economic Co-operation and Development (OECD) 2004,11

[78] Len S. Sealy and Sarah Worthington, *Cases and Materials in Company Law* (8th edition, Oxford University Press 2008)371

[79] Ibid (n 54) 15.

[80] Ibid (n 54) 15.

[81] John Armour, Henry Hansmann and Reinier Kraakman, 'Agency problems and legal strategies' in Reinier Kraakman et al, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (3 edition Oxford University Press 2017) 29.

more in number though they hold fewer shareholdings, deserve an adequate protection against the majority abuse. Undoubtedly, this does not conform to what justice and fairness aim in reference to achieving the ends of justice. Thus, both the standards of justice and fairness together with the dynamism of capital input provide a solid legitimization for the minority shareholder to be vested with sufficient protection against majority misconducts.

It might be argued that since majority shareholders are major stakeholders in a firm, they should be legitimately, at the helm of the affairs of the company. However, extraction of personal benefits by majority shareholders to the detriments of the company's as well as small investors is by no wise acceptable. Moreover, regardless of the fact that majority shareholders in firms are occupying say 50 per cent, 60 per cent, or even 80 per cent of the shares in a firm, it is not acceptable that they should disregard minorities' interests. Minority shareholders, thus, should have right to take legal action against wrongdoers which may serve as an effective tool to reduce opportunities of expropriation.[82]

To this end, OECD has also stressed upon striking balance between the rights of majority and minority shareholders and has required States to have in place legal frameworks which could strengthen enforcement power in the hands of outside shareholders or small investors as to safeguarding their interest.[83]

This thesis advances literature on the need for statutory protection to minority shareholders keeping in view their vulnerability in firms. There is an amount of consensus among legal scholars that puts forward the argument for reinforcing

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[82]Ibid (n 54) 4.

[83]See OECD Principles of Corporate Governance 2004 Edition, <www.oecd.org/corporate/ca/.../31557724.pdf > p 40 accessed 16 July 2016.

enforcement power of shareholders so that they may have recourse to courts in order to seek redress for any violation of their rights.[84] Minority protection is essential in the context of Pakistan if not for any other reason, pre-eminently from the perspective of justice and fairness. The literature reviewed above has pointed out that law has a crucial role to play in reducing agency costs and thus, protecting minority shareholders.

According to a fundamental rule of corporate law, a company is a legal person distinct from its members; therefore, it is the company itself responsible for its attendant legal liabilities and entitled to rights.[85] Based on this independent legal entity concept of corporate law, the company is the 'proper plaintiff' to take action against those who have defrauded it.[86]

However, one must be aware of the fact that the application of the 'proper plaintiff' rule gives birth to problems of injustice when directors of the companies are themselves the wrongdoers. For example, they may usurp corporate opportunities for their private gains that otherwise belong to the company. A classic example for the justification of derivative action can be where directors of a company commit fraud on the company and later they, by virtue of their dominant position in the company, prevented the company to commence litigation against them.

It is, therefore, very unlikely that the company will commence litigation against such errant directors.[87] The situation gets worse where wrongdoers involved in alleged fraud are the majority shareholders and controlling the decision making forums of the

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[84] Ibid (n59); Lowry John and Dignam Alan, *Company Law* (Lexis Nexis Butterworths 2003) 171; Ian M Ramsay, and Saunders B Benjamin, 'Litigation by shareholders and directors: an empirical study of the Australian statutory derivative action'(2006)6(2) *Journal of Corporate Law Studies*397-446,446.

[85] The fiction theory was applied in a famous English court, Solomon v Solomon [1896] UKHL 1.

[86] Salmon v Salmon& Co [1897] AC 22

[87] Burland v Earle [1902] AC 83,93(PC) Lord Davey; Kenneth B Davis, ' The Forgotten Derivative Suits'(2008)61 *VAND. L. REV* 387-397, 390

company such as the board of directors and the shareholders' general meetings. Thus, enabling shareholders to take actions derivatively is necessary in order to prevent majority shareholders or managers from frustrating all intended legal actions against them in corporations.[88] Derivative proceedings have emerged as a valuable corporate governance tool in the modern corporate law.

2.8 Derivative proceedings and Corporate Governance

Reisberg analysed the pertinent developments of derivative action system in the UK and looked at the circumstances which were under consideration of the English Law Commission (the Law Commission) while investigating the doctrinal position of shareholders.[89] The Law Commission raised objection on common law position relating to shareholders' right of derivative action against management.[90] The Law Commission termed the rule of Foss v Harbottle as rigid, redundant and inaccessible.[91] As such, the Law Commission recommended the introduction of statutory derivative action system. It was aimed by the introduction of statutory derivative action system to develop the jurisprudence of minority protection as flexible and accessible.[92] The Company Law Review Steering Group endorsed the reforms proposals made by the Law Commission.[93] Finally, the reforms proposals of the Law Commission were accepted

[88] Prudential Assurance Co Ltd v Newman Industries Ltd no 2 [1982] 1 All ER 354, 364

[89] Arad Reisberg, *derivative Actions and Corporate Governance: Theory and Operation* (Oxford University Press 2007)129-131.

[90] See Law Commission, ' Shareholder Remedies' Report no.246(1997), Law Commission London, para.1.4

[91] See Ibid para.1.4

[92] See Ibid para.6.15

[93] See especially Company Law Review Steering Group, 'Modern Company Law for a Competitive Economy: Final Report' (July 2001) URN 01/942 (CLR Final Report)7.46–7.51

and the statutory regime of derivative action system started with the enactment of the Companies Act 2006.[94]

According to Reisberg, it is arguable that the full utilisation of shareholders' powers such as the right to appoint and remove directors may exert pressure on management to serve in accordance with the companies' interests. As such, it is assumed that if so done; the management would behave fairly, failing which, they would be under threat to be dislodged by the shareholders through the use of their voting power. The voting power has a significant influence over managerial actions which, in turn, can reduce agency costs to some extent.[95]

However, the supposition that shareholders are willing to use their voting power is a misconstrued notion. Indeed, shareholders show an apathetic and indifferent attitude towards the use of their voting power even if it were made easier through electronic voting system.[96]Furthermore, in corporate ownership structures with high level of concentration such as that is in Pakistan, minorities show a 'rational apathy'[97] considering their vote will not have any significant influence over managerial actions.[98] In multinational companies and groups of companies, minorities do not even get to know where the real governance problems lie.[99] Locating real problems is essential to consider an appropriate course of action which may include either a shareholder's

[94] Part 11 , Chapter 1 (ss.260-4)the Companies Act 2006.

[95] Eilís Ferran, *Company Law and Corporate Finance* (Oxford University Press 1999) 118-22

[96] Ibid (n89) 25.

[97] On rational apathy , see Robert C Clark , *Corporate Law* (Little Brown 1986)390-2

[98] Ibid (n89) 25.

[99] Prentice DD ' A Survey of the Law Relating to Corporate Groups in the United Kingdom' in E Wymeersch (ed) Groups of Companies in the EEC (Walter de Gruyter 1993); J Dine The Governance of Corporate Groups (Cambridge University Press 2000) ch 4

resolution or initiation of litigation against wrongdoers.[100] However, it has been found that shareholder voting in large companies does not have any significant influence over managerial actions. This is largely because of 'collective action problem'.[101]

Reisberg is of the view that derivative litigation is instrumental to promoting good corporate governance and preserving corporate assets. Derivative proceedings can reduce agency costs in a sense it poses threat of liability on potential misbehaviour of the management and hence, it pushes directors to serve in the best interest of the company.[102] He further goes on saying that derivative action system pushes directors to fulfil their duties they owe to the companies. Directors are required to fulfil their duties in the line with the company's interests and effectively represent shareholders who place them there to look after their investment. Prevention of directors' breach of their duties is essential in order to confine their behaviour towards maximisation of corporate value. Since enforcement of directors' duties very much depends on shareholders enforcement, he contends that derivative proceedings, in this regard, have a valuable role to play in enforcing directors' duties.[103]

This study extends Reisberg's argument on the role of derivative litigation in disciplining corporate management and protecting corporate assets in the context of Pakistan. Since there are flaws and constraints in the current managerial disciplinary framework, a functional derivative action system ought to play a key role in preventing the potential misbehaviour of corporate management in Pakistan.

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[100] 'A Modern Regulatory Framework for Company Law in Europe'14 <ec.europa.eu/internal_market/company/docs/modern/consult_en.pdf> accessed 23 April 2016.

[101] Brian R. Cheffins, *Company Law; Theory , Structure and Operation*(Oxford University Press 1997) 521-4

[102] Ibid (n89) 23.

[103] Ibid (n89) 52.

Some researchers seek to achieve the purpose of disciplining management in Pakistan by taking into consideration two-tier system of corporate governance and, by looking at reforms initiatives of civil law countries such as South Korea and Japan. For example, Adnan has analysed regulatory framework of Pakistan and outlined the legal structure governing the corporate sector of Pakistan.[104] He finds problems with the current minority protection mechanism and recommends that minority shareholders deserve due protection. He is of the view that in contrast with the Berle and Means's ownership model signifying division between owners and controllers, the situation is other way round in Pakistan signifying shareholders concentration with families and the State taking the dominant positions in corporate entities. The majority shareholders normally place their friends and family members in directorial positions and as a result, they maintain control over corporations.

Being a common law country, Pakistan inherited her legal system from the United Kingdom. However, its ownership structure does not resemble with that of the UK which is characterized as a dispersed ownership structure. He maintains that the Code of Corporate Governance was designed in line with the reforms initiatives in the UK without considering dissimilarities between the ownership structures of Pakistan and the UK.[105]

He believes that governance strategies designed for a market with dispersed ownership structure will not provide effective solutions for governance issues connected with a market based on a concentrated ownership structure. He recommends that looking at reforms initiatives of East-Asian countries, though they are civil law countries, may

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[104] Ali Adnan Ibrahim, 'Corporate Governance in Pakistan: analysis of current Challenges and Recommendations for future Reforms' (2006)5(2)*Washington University Global Studies Law Review 323-332,328.*

[105] Ibid 328; See, Manual of Corporate Governance, 1

provide a better solution to the governance issues in Pakistan. He, therefore, recommends that a regulatory analysis of Japanese and South Korean markets based on concentrated ownership structures will be more informed in order to address the governance issues connected with the concentrated ownership structure of Pakistan and thus, it may provide useful insights into devising future reforms.

It is essential to comprehend that Japan and South Korea are civil law countries whereas Pakistan falls under the common law category of legal systems. Being a former British colony, Pakistan inherited her laws and judicial system from the United Kingdom. This thesis argues that it is more appropriate for Pakistan to look at the reforms initiatives of the UK for the purpose of learning from the English derivative action system. Miles and Goulding observe that Anglo-Saxon model of corporate governance has attained a high level of recognition all over the world in terms of ensuring shareholders' protection and improving the standards of corporate governance.[106]

They further suggest that Anglo-Saxon model is also useful for the countries with sharia law background in order to draw lesson for improving their regulatory and statutory frameworks. Therefore, they recommend that Anglo-Saxon model needs to be looked at by all the jurisdictions for evolving tools of economic developments and providing level playing field for all the shareholders so far as the Anglo-Saxon model suits the individual corporate environment of jurisdictions.[107] Furthermore, La Porta *et al* found after undertaking comprehensive empirical research on different jurisdictions across the world that Anglo-Saxon legal framework offers stronger protection to

[106] Lilian, Miles and Simon Goulding, 'Corporate governance in Western (Anglo-American) and Islamic communities: prospects for convergence?(2010) 2 *Journal of Business Law* 126-146,127.

[107] Ibid 128.

shareholders in contrast with civil law countries, which confer the weaker protection to shareholders.[108]

It is important here to recall that the legal system of Pakistan is heavily influenced by the British legal system. After its independence in 1947, Pakistan inherited her legal framework from the UK and owes a common heritage of history of over one century.[109]A question arises here if Pakistan has already adopted the legal system of the UK in major proportions, then, why Pakistan has not adopted British laws regarding shareholders' protection? There may be different factors which hindered the adoption of British scheme of minority protection in Pakistan. It can safely be elicited that one of the reasons is the government's intention (being dominant player) to control the powers of judges in dealing with cases regarding expropriation of corporate assets. As a remedial measure, shareholders should be conferred with statutory rights to bring action against miscreants and recover compensation for the loss sustained by the companies.

This thesis contributes to the research by arguing that the easiest and practical scheme or ways for disciplining management can be introduced in Pakistan by following the footsteps of the Anglo-Saxon statutory model of shareholder protection as long as it meets the local requirements. This is due to the reason that shareholders' enforcement power in the form of derivative litigation to discipline management is still being dealt with common law rules in Pakistan which have been laid to rest in the UK. Therefore, such a transformation of shareholders remedies from common law system to statutory remedies would help legislators and policy makers in Pakistan to understand problems with the common law remedies and hence, devise statutory remedies in order to remove

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[108] La Porta, Lopez-de-Silanes, Shleifer and Vishny, 'Law and Finance'(1998)106(6) *Journal of Political Economy* 1113-1155,1116

[109] Malik M Hafeez, *Corporate Governance and Institutional Investment: Rules, Regulations and best practices to monitor corporate affairs and balance the interests of managers and shareholders*(Universal Publishers Boca Raton Florida 2015)285.

anomalies in common law remedies. It is, therefore, easier and appropriate way to learn from the system on which Pakistan's legal system is fundamentally based.

2.9 Two-tier boar structure as a mechanism for enforcement in Pakistan

Under two-tier corporate governance, two separate boards namely; executive board and supervisory board function independently. It is perceived that there should be a 'third party' as a part of internal monitoring mechanism which could oversee managerial actions. [110] Tahir et al have reviewed German two-tier corporate governance model and termed it a useful solution to the problem of directorial opportunistic misbehaviour in Pakistan. They suggest, besides, executive board, supervisory board (composed of the independent directors and representatives of shareholders and employees) should form part of the board structure in Pakistan in order to prevent conflict of interest problem between minor and major shareholders in Pakistan.[111] Shabbir is of the same view that two-tier system of corporate governance can be an answer to the managerial disciplinary issues in Pakistan and thus, it can entice executive directors to perform their duties in line with the best interests of the companies.[112]

In two-tier governance system, a hierarchical system is created in which the control of managing executive board lies in the hands of supervisory board. The supervisory

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[110] Goo S H and Fidy Xiangxing Hong, 'The Curious Model of Internal Monitoring Mechanisms of Listed Corporations in China: The Sinonisation Process' (2011)12(3)*European Business Organization Law Review* 469-507,470

[111] Safdar Hussain Tahir, Hazoor Muhammad Sabhir, Adnan Arshad, Muhammad Anawar ul-haq, 'Two-Tier Corporate Governance Model for Pakistan'(2012) 4(6) *European Journal of Business and Management* 38-47,38

[112] Syeda Saima Shabbir, 'The Role of Institutional Shareholders Activism in the Corporate Governance of Pakistan'(2012)1(2*) Journal of Humanistics & Social Sciences1*-23,16

board is composed of the representatives of shareholders, these of employees and the independent directors. The rationale behind this hierarchical system is to put restraints on directors' power, which, in turn, may reduce agency costs.[113]

2.9.1 Criticism against Two-Tier Board structure in Pakistan

There are various reasons which suggest that the two-tier system may not function effectively in the context of Pakistan. For example, the representatives of shareholders on the supervisory board would, in fact, represent large shareholders as they are required to be elected democratically. This means the supervisory board is meant to appease large shareholders and small shareholders will continue to be unrepresented on the supervisory board and thus, may remain unprotected against managerial wrongdoings. The representatives of employees will be equally ineffective in disciplining dishonest behaviour of directors in view of the fact that the leaders of trade unions, who due to their political connections and fear of being sacked by directors, are expected to become puppets in the hands of controlling managers in Pakistan.[114] Independent directors are expected more, if given independence, but their role to supervise executive board can be compromised being family members and close friends of controlling shareholders.[115]

Furthermore, inadequacy of professional knowledge of the representatives of employees and shareholders on the supervisory board may render the supervisory board an unnecessary mechanism in the context of Pakistan. The cost overruns might be another problem of this dual board system. Co-existence of supervisory board and the

[113] Carsten Jungmann, 'The Effectiveness of Corporate Governance in One-Tier and Two-Tier Board Systems – Evidence from the UK and Germany'(2006)3 (4)*European Company and Financial Law Review* 426-474,432

[114] See Daily Dawn, a national newspaper,< www.dawn.com/news/1112918 > accessed 09 March 2016.

[115] Ibid (n16) 20.

current system of the non-executive directors (NEDs) may cause an overlap and create ambiguities in the rights and responsibilities of both. The failure of supervisory board in China offers evidence as to such ambiguities over the rights and responsibilities of supervisors and the NEDs.

German scholars Schoenbaum and Lieser pointed out that supervisory board may not be suitable for small or medium sized companies because it is too easy for the controlling shareholders in these companies to control the board.[116]The problem is almost the same in Pakistan where the Controlling shareholders take the dominant position. Thus, the independence of supervisory board to monitor executive board is subject to question as its members are to be appointed by the large shareholders. As a result, the supervisory board members would be as under the subjugation of the large shareholders as the executive board members are in Pakistan.

This thesis argues that law has to intervene to put constraints on directors' duties in order to reduce agency costs. In this context, Kraakman *et al* opine that carefully designed legal strategies can facilitate actions to be brought against dishonest management, which, in turn, may reduce agency costs.[117] Reisberg, as discussed earlier, holds derivative action system as an effective tool for managerial discipline in the sense it poses the threat of liability which may bring forth the alignment of shareholders' interests with those of management.[118] Likewise, McDonough maintains that derivative

[116] Thomas J Schoenbaum and Joachim Lieser, 'Reform of the Structure of the American Corporation: The "Two-Tier" Board Model' (1973) *62 Kentucky Law Journal* 91,92.

[117] Ibid (n25) Chapter 2, 37

[118] Ibid (n89) 23.

action system has a key role to play in reducing agency costs as it empowers shareholders to make good wrongs done to the company.[119]

This thesis contributes to the research by advancing argument in favour of rationale and functional derivative action system in Pakistan which can be achieved by the introduction of statutory derivation actions in order to reinforce shareholders' enforcement power to preserve corporate assets. A coercive authority in the form of the state lies behind the imposition of legal liabilities on the dishonest management. Consequently, managerial wrongdoings can be made good; supervisory board as such has no role. Thus, law has an important role in rectifying infringements of shareholders' rights, restoration of damaged interests and retrieval of expropriated assets.[120]

The unfair prejudice remedy has received a world-wide approval due to its wider scope and accordingly flexibility of relief it provides to minority shareholders.[121] However, remedy against managerial oppressions on private rights of shareholders as provided under section 290 of the Ordinance suffers serious shortcomings and hence, this provision has rarely been sought in Pakistan owing to strict requirements it demands and very narrow scope it seeks to cover.[122] An effective unfair prejudice remedy like that in the UK does not exist in Pakistan which the situation underpins need for legislative amendments in order to afford due protection to minority shareholders.

Khan has investigated minority rights and remedies provided under the Ordinance and termed the enforcement remedies as imperfect, remediless and claims that they fall

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[119] Darryl. D. McDonough, 'Proposed New Statutory Derivative Action-Does It Go Far Enough?' (1996)8(1) *Bond Law Review* 47-72,63

[120] Ian Ramsay Benjamin B Saunders, , ' Litigation by Shareholders and Directors: An empirical study of the statutory derivative action' Research Report ; Centre for Corporate Law and Securities Regulation The University of Melbourne (2006) 6

[121] Ibid (n89) 277.

[122] The WB and IMF Report on Corporate Governance and Country assessment Pakistan June 2005 <http://www.worldbank.org/ifa/rosc_cg_pak.pdf > accessed 23 May 2015

short of ending up minority sufferings.[123]He finds that the open-ended statutory language of section 290 of the ordinance poses a considerable degree of uncertainty that gives unfettered discretion to the courts to decide on the question of 'managerial oppression'. As a result, courts in Pakistan have interpreted the expression of an 'oppressive act' differently on similar cause of action.[124]

For example, he maintains, that in Registrar v PICLD case,[125] the court gave a very restricted interpretation[126] of the term, 'oppressive act' on the part of the management whereas in Pfizer Laboratories' case,[127] the court decided by providing a very liberal explanation[128] to the term of 'oppressive conduct 'of the management. He has suggested that there should be explanations for courts to interpret managerial oppressions against private rights of shareholders in order to avoid conflicting assessments in interpreting section 290 of the ordinance. In addition, he recognises that the pre-requisite to seek remedy against managerial oppression is too strict as it stipulates that disinterested shareholders may litigate only if they occupy shares not less than 20 per cent in a firm.[129] Shareholders representing less than 20 per cent shares are left at the mercy of controlling managers and hence they are either forced to leave the company or stay in the company unprotected.

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[123] See Generally, Imtiaz khan, Adoption and Convergence in Corporate Governance to International Norms in Pakistan'(PhD thesis, University of Glasgow 2014).

[124] Ibid,151.

[125] Registrar of Companies v Pakistan Industrial and Commercial Leasing Ltd [2005]CDL 463,SHC,P480

[126] According to the court's observation, the overriding objectives of the legislature seemed to be that the section does not provide punishment for any individual violation. However, if there is series of violations and those remain unaddressed, it, then, amounts to an oppressive conduct of management.

[127] Pfizer Laboratories Ltd v Parke Davis & Co Ltd[2007] CDL 1047 SHC

[128] The court observed that even non-payment of returns to minorities on their investments would be deemed as an 'oppressive conduct' of the management.

[129] See section.290 , the Companies Ordinance 1984

Khan has pointed out that unfair prejudice remedy is deficient and suffers a number of limitations in protecting minor shareholders. This is why the remedy against managerial oppressions on minorities' interests has rarely been sought by disgruntled shareholders owing to the strict requirements and narrow scope of this remedy in Pakistan.[130] Moreover, he highlights problems with the common law principles of derivative actions and recommends that the situation needs to be rectified by introducing a codified derivative action system in Pakistan.

This thesis extends Khan's argument that law regarding enforcement powers of shareholders needs to be strengthened. This thesis goes one step further and contributes to the literature by putting forward reform proposals concerning statutory framework for derivative actions in Pakistan as other managerial disciplinary tools individually may not provide an effective substitute to derivative litigation. As such, the original contribution that differentiates this thesis from other studies can be found mainly in three aspects.

First, this thesis contributes to the topic by providing an in-depth theoretical examination to enrich legal scholarship on derivative proceedings in Pakistan. Prior to this, there is no study in the context of Pakistan that determines solely the extent to which derivative litigation can serve as a tool to promote good corporate governance and prevent corporate rights from being infringed.

Second, this study contributes by suggesting guidelines and reforms in relation to the statutory framework for derivative actions, clarifying the procedural route for an effective use of derivative litigation and prevention of abusive suits. Since the major

[130] Despite widespread expropriation of minority interests by controlling shareholders, only few actions have been brought by minority shareholders under section 290 of the Ordinance; this is based on the authentic search engine of legal database in Pakistan, Pakistan Law Journal, Pakistan Law digest, Civil Law cases.

problem in Pakistan relating to derivative litigation is in reference to incentivise and encourage shareholders, this study also contributes to the subject of derivative litigation by suggesting an alternative approach to funding problems that largely operate as disincentives to shareholders in derivative proceedings.

Third, prior to this thesis, there is no qualitative empirical study so as to see how statutory derivative action system works effectively in the marketplace. This thesis also contributes to the legal scholarship on derivative actions in Pakistan by reflecting the viewpoint of interviewees regarding the reform proposals. The comments and opinions of the interviewees are expected to help in providing more realistic solutions of enforcement problems and to suggest a meaningful and functional derivative actions framework for Pakistan.

2.10 Concluding Remarks

After having reviewed literature on current corporate governance status and managerial misbehavioral issues in Pakistan, it found that most of the studies are introductory in nature highlighting how the concentrated ownership of Pakistan poses threats to the interests of corporations and their small investors. There is no study so comprehensive and exhaustive in nature in the context of Pakistan that determines the extent to which derivative proceedings can promote good corporate governance and thus, help minorities to receive adequate protection. A significant argument this thesis makes relates to inadequacies of law which facilitate pyramiding arrangements and lead to the expropriation of corporate assets in Pakistan.

The current commercial environment of Pakistan requires that laws regarding corporate governance should keep pace with the latest developments of laws in the world. The commercial society in Pakistan is progressively developing. With the

commercialisation and industrialisation in Pakistan, the Pak-China Economic Corridor project- the mother of associated enterprises, in the most magnificent leading factor set to, where has generated a tremendous economic activity, would also attract the attention of legislators and policy makers towards law reforms regarding shareholder protection in Pakistan. The momentous economic activity is likely to encourage significant investments in stocks and corporate sector.

This stir up in economic field and corporate enterprise has boosted incentives across the society and also provided legal awareness of rights and liabilities. The recent unprecedented performance of the Pakistan Stock Exchange (PSE), where enhanced the confidence of investors, has also attracted global attention. The president of World Bank Jim Yong Kim has acknowledged the performance with high resounding remarks and word of commendation.[131] In this context, legal conflicts are likely to emerge. This flourishing economic environment is, of course, likely to lend rise to legal issues, needing effective legal framework to keep the wrongdoers disciplined.

[131] See Daily 'The News' 22 July 2016 'Pakistan Stock Exchange declared Asia's best market' International' <www.thenews.com.pk › Today's Paper › Top Story> accessed 07 July 2016.

Chapter 3. Legal Position of Minority Shareholders in the Companies Ordinance of 1984

3.1 Introduction

The preceding chapter examined the structure of corporate ownership in Pakistan. It found that most of the companies (public or private) in Pakistan are governed by controlling shareholders exercising a disproportionate amount of control over companies through the use of pyramid structures of control. It affirms that controlling shareholders, due to their dominant position and voting power might take business decision in disregard of the companies' and small investors' interests. Furthermore, the previous chapter reviewed the existing empirical evidence on the necessity of derivative litigation as to protecting corporate and minorities' interests. After review of scholarly work that addressed the question of how to deal with corporate accountability problem in Pakistan, a conclusion was reached that adequate legal remedies should be in place to discourage managerial misconducts.

Corporate accountability is important in the sense that it fosters shareholders confidence and thus, attracts them to invest in companies. As such, shareholders feel secure and confident when remedial measures are available to them.[1] There is no standardised legal framework that may be invoked to deal with specific issues regarding the protection of small investors in Pakistan, it is, therefore, necessary to investigate corporate laws in relevance to this area so as to gain the understanding of current doctrinal status of minority rights and to identify problems within the existing

[1] See OECD Principles of Corporate Governance 2004 Edition, <www.oecd.org/corporate/ca/.../31557724.pdf > p 40 accessed 16 July 2016.

minority protection mechanism. The investigation will be carried out by elucidating that the law needs to be reformed so as to vow optimal protection to minority shareholders.

This chapter is broken down into two parts. The discussion in the first part focusses on examining minority rights and protection under the Companies Ordinance 1984 of Pakistan (hereinafter called the Ordinance). This part of the chapter aims at highlighting weaknesses and shortcomings in the Ordinance not only with a view to suggesting evidentiary parameters with regard to weak minority protection in Pakistan, but also to identify areas that require urgent reformation. In particular, this examination will focus on various tactile manoeuvres of minority rights by the controllers and the protection provided under the Ordinance.

The second part of this chapter will discuss the application of Sharia law in commercial matters and intends to explore the role of Islamic business rules in protecting minorities. It is mainly intended to examine how Sharia business principles may complement laws regarding minority protection in Pakistan and how it may serve as a remedy to the noticeable statutory gaps. It is believed that this principle might function just as the concept of equity in the UK.

It is pertinent to mention here that Pakistan is an Islamic country where Sharia law plays a moderating role in the governance.[2]One of the main roles of Sharia law is to supplement any inherent statutory flaws.[3]For example, Sharia law is applied in The Saudi Arabian legal system as a supplementary mechanism to statutes.[4] In fact, such

[2] See article 2 of the Constitution of Pakistan of 1973.

[3] Emily Von Werlhof, 'With Sharia in Mind: Developing the Islamic Financial Market in Pakistan'(2014)*7Albany Government Law Review* 494-507,499.

[4]Sam S. Souryal, 'The Religionization of a Society: The Continuing Application of Shariah Law in Saudi Arabia'(1987) 26 (4) *Journal for the Scientific Study of Religion* 429-449,436

non-codified complementary principles to the formal laws are not only applied in Muslim countries but are also used in some western countries. For example, the UK has a similar kind of non-codified obligations in the form of equity which is meant to bridge identifiable gaps in the law.[5]In Sharia law, the principle of *Istihsan* is quite analogous to a concept of equity as both imply need for natural justice and fairness.

3.2 Sources of Rights conferred upon Shareholders

There are different categories of corporate and securities laws which confer rights upon shareholders. Each category has its own significance and legal effects. Statutory laws are given priority in terms of enforcement. On the other hand, the rules and regulations are a complementary vehicle in nature to statutory laws. The rules and regulations inconsistent and incongruent with statutory provisions are treated as null and void.

Statutory laws[6]

Statutory laws are referred to as the ones passed by the parliament of any country. So far as the statutory laws are concerned, the Companies Ordinance 1984 (the Ordinance) is the main legislation dealing with rights and remedies of shareholders, directorial powers and responsibilities and shareholders' voting rights and disclosure of related party transactions. The company law applies to both private and public companies. However, its provisions are divided into mandatory rules and default rules as regards their application; the mandatory rules require strict compliance while default rules can be dispensed with through passing a special resolution. For example, the pre-emptive

[5]Donoghue v Stevenson [1932] UKHL 100

[6] These laws include The Companies Ordinance 1984; The Securities and Exchange Commission of Pakistan Act 1997; The Listed Companies (Substantial Acquisition of Voting Shares and Takeovers) Ordinance, 2002

rights[7] and the 'One share, One vote'[8] principle are default rules; therefore, they can be subject to dis-application. Private companies, due to their nature of limited activities, are not subject to mandatory rules while the public companies, owing to their involvement in the public domain, are under legal obligation to observe mandatory provisions of the company law. The Companies Ordinance 1984 is a special legislation that means that the provisions of the Ordinance would override general laws.

The evolution of company law in Pakistan has followed the footsteps of the British corporate legislations enacted for the British India. The current company law[9] of Pakistan is based on the law promulgated by the colonial rulers in the subcontinent before the independence of Pakistan. The first piece of legislation was Indian Companies Act 1882 which was introduced by the British government for the British India and was replaced with the Indian Companies Consolidation Act, 1913. The Indian Companies Consolidation Act, 1913 was adopted with some necessary adjustments as the company law of Pakistan after its independence in 1947[10]. The companies which opted to work within the territories of Pakistan after independence were recognised as registered under the companies Act 1913.[11]

The situation remained unchanged up till 1984 when the Companies Ordinance, 1984 (the Ordinance) came into force on 8th October 1984. The development of corporate sector of Pakistan came across various challenges after the independence of Pakistan. The Ordinance replicated a number of provisions of the Companies Act, 1913 without

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[7] See section.86 The Companies Ordinance 1984

[8] See section .90 The Companies Ordinance 1984

[9]The Companies Ordinance 1984

[10]Nazir Ahmed, *Practical Approach to the Companies Ordinance ,1984* (4th Edition Federal Law House 2011) 2

[11]Shaukat Muhmood, Nadeem Shaukat , *The company Law*(Legal Research Centre Vol-1 , Pakistan) 7

considering the local conditions and needs of the corporate sector[12].The provisions relating to minority rights and remedies in the Companies Act, 1913 were retained in the Companies Ordinance, 1984. However, the Ordinance 1984 could not keep pace with the challenges, the corporate sector of Pakistan is facing. [13]Besides, the Companies Ordinance, there are securities laws[14] which apply only to the public companies. Securities laws are also important as they confer various rights upon shareholders to safeguard their interests.

The Company Constitution

The articles of association regulate the internal affairs of a company and deal with important governance issues thereof. For example, the articles of association deal with the matters of directorial appointments and removals, voting rights, rights of shareholders such as payment of dividends and divide powers between managers and owners. The articles of association have an important role to play especially in this age when it has become a common business practice to raise capital from overseas stock exchanges. In such a situation, companies may face problems of conflict of laws. The articles of associations can be a solution to this problem as it is easier to amend the articles and further, those can be conformed to the requirements of the targeted overseas jurisdictions to raise capital. Apart from the articles of association, there is the memorandum of association that deals with the object and a range of activities for which a company is formed and it is one of the vital documents required for the

[12] Ibid 8.

[13] Haroon H Hamid and Valeria Kozhich, 'Corporate Governance in an Emerging Market; A perspective on Pakistan (2007) 1 (1)*Journal of Legal Technology Risk Management* 22-33,31

[14] These laws are the Companies Share Capital (Variation in Rights and Privileges) Rules, 2000; Securities Act 2015.

registration a company.[15] The memorandum is also important as it provides penalties where managers violate the memorandum and deviate from the object of the company.

Stock exchanges' listing regulations

The listing rules apply only to the listed companies. The listing rules entails important shareholders' rights such as those of disclosure standards necessary for investors' information to get to know the future prospects of a company and decide whether to invest in a company or not. The listing rules can be a useful solution to conflict of law problems as they can fill voids left in statutory laws. For example, if foreign companies are exempted from certain statutory provisions in a country, these are the listing rules which apply equally to all the companies listed on a stock exchange without any discrimination. As a result, the listing regulations offer equal opportunities for business operations to both foreign and domestic companies in a jurisdiction. Stock exchanges have a crucial role to play in protecting minority shareholders in the events of delisting, by providing a fair price in absence of listing regulations. In this regard, stock exchanges should intervene and provide increased buyback share price to minority shareholders.

The Code of Corporate Governance

The corporate governance codes are important in improving corporate governance as they set forth minimal requirement of governance standards. These may supplement laws on the issues where States may happen to be reluctant to legislate due to the pressure of business families and in some cases, states' own reluctance due to their overarching objectives. The revised corporate governance code 2012 of Pakistan was made part of the listing regulations in Pakistan with an object to improving its

[15] Guinness v. Land Corporation of Ireland [1882] 22 Ch.D 349.

enforcement.[16]However, its enforcement is still a problem. As a routine practice, companies just use 'tick box' approach so far as the compliance of the Code is concerned rather than complying with the Code in its spirit.[17]

Other Criminal and Civil laws

Besides the corporate laws and regulations, there are civil law provisions that confer rights such as damages and declaration of corporate rights upon shareholders[18].In addition, criminal law Codes such as Pakistan Penal Code 1860 and Code of Criminal Procedure 1898 envisage penalties for criminal breach of trust and corporate frauds[19]. National Accountability Ordinance 1999 and Prevention of Corruption Act which were enacted through the acts of parliament of Pakistan too provide for criminal prosecution of corporate fraud and expropriation of shareholders' rights.[20]

3.3 Shareholders' Rights

Shareholders enjoy a wide range of rights including; (1) the right to elect and fire directors, (2) decision making rights,(3)financial rights and (4) litigation rights.[21] Apart from these rights, there are other rights available to shareholders such as information rights and rights to disclosure and inspection. The right to elect and fire directors is used by shareholders in order to elect or fire the board members. These rights are

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[16]The Code of Corporate Governance 2012, available <www.secp.gov.pk/CG/CodeOfCorporateGovernance_2012_Amended July2014.pdf> accessed 08 March 2016

[17] Country Review: Islamic Republic of Pakistan IOSCO Objectives and Principles of Securities Regulation Detailed Assessment of Implementation July 2015 at p 7

[18] The Code of Civil Procedure 1908 Pakistan is the main civil law , Limitation Act 1908 , Specific Relief Act 1877, Contract Act 1872 are other civil laws which deals with rights and remedies for civil wrongs.

[19] These laws include Pakistan Penal Code 1860 and Code of Criminal Procedure 1898.

[20] See section 5, 9 of the National Accountability Ordinance 1999; See generally Prevention of Corruption Act 1947.

[21] Julian Velasco, 'The fundamental Rights of Shareholders' (2006) 40(2) *US Davis Law Review* 407-467,413

important in a sense that they are exercised in order to hold the board members accountable. The decision making rights confer powers upon shareholders to decide on important matters such as, issuance of new capital, authorization of related party transactions, approval of dividends and other important business transactions. In addition, shareholders have entitlement to financial rights such as equal treatment of cash flow rights and the pre-emptive rights. Last but not the least, litigation rights empower disinterested shareholders to take action against errant directors. Derivative litigation and direct actions are normally used by shareholders to take action against errant directors.

A balance is required to be struck between the powers of small and large shareholders. If large shareholders are vested with more powers, it may endanger minorities' interests. The majority shareholders or block holders in such situations may misuse their unrestricted powers for private gains. Similarly, if minorities are offered more powers, it may create agency problems, which in turn, may create problems in arriving at unanimous decisions. The imbalance power structure requires to be revisited and an appropriate balance needs to be struck amongst the powers of major, minor and directors.

Both diffused and block-holding ownership structures have problems relating to shareholder protection. The agency costs may be higher in the diffused structures than the block-holding structures because it is not easy for diffused shareholders to push managers to serve in the best interest of the company. The phenomenon of globalisation further exacerbates the situation as the foreign and domestic investors find it difficult to team up in holding errant managers accountable. However, minority protection issue is far worse in the block-holding structures than the diffused structures. In the block-holding structure, majority shareholders may place their friends, family members and

other trusted persons in directorial or managerial positions. Consequently, they seize control over management and also misuse their authority for their private interests. Thus, minorities may be more vulnerable to corporate abuses in the block-holding ownership structures than in diffused ownership structures.

A principal legislation which confers powers upon shareholders to decide on various issues of their rights and empowers them to protect their rights is enshrined in a company law.[22] The company law of Pakistan have some provisions regarding minority rights and protection; however, these provisions are defective and deficient as regards minority protection. The discussion in the coming section sheds light on various ways of expropriation, examination of minority rights and protection provided in the Ordinance. The purpose of this examination is to highlight weaknesses with the current minority protection mechanism that requires legal amendments in order to offer due protection to minority shareholders against the infringement of their rights by controlling shareholders.

3.3.1 Voting Rights

Voting rights are important in governance as they provide shareholders with a self-enforcing mechanism to protect their interests. However, problem arises when shares are issued with multiple voting rights to a group of shareholders and so, giving them the control of firms more than their cash flow rights. Such multiple voting shares help equity holders to misuse their voting power for private gains at the cost of other shareholders' interests. On the contrary, shareholders who own non-voting shares are deprived of their participatory rights, necessary to safeguard their interests. The

[22] Irfan Ahmed Sheikh, *Company law in Pakistan: A book for lawyers, corporate professionals & businessmen : containing the Companies Ordinance, 1984, with up-to-date exhaustive* (general rules & forms) rules (Mansoor Book House 1986) 6.

rationale behind the adoption of 'one share one vote' principle is to prevent shareholders from acquiring voting power more than their cash flow rights in a company.[23] The 'one share, one vote' principle is meant to align economic interests with those of voting rights and as a result, preserves the corporate control market as a useful managerial disciplinary mechanism.[24]

3.3.1.1 Improving Selection mechanism for Non-Executive Directors

The framework of the NEDs is relevant for minority protection in view of the agency costs of controlling shareholders in Pakistan. Currently, the NEDs are elected or removed democratically and they serve at the will of the majority. The NEDs might, therefore, be prone to perform their duties in line with the interest of the controlling shareholders in Pakistan. This state of affairs mars the purposes of the appointments of the NEDs. Given the problems with the present board independence structure, it is important to take into account potential reforms to the selection mechanism of board of directors in Pakistan.

It is recommended in this thesis that minority involvement in the election of the NEDs should be increased. This is expected to hold the NEDs accountable to both groups of shareholders; i.e majority and minority shareholders instead of being accountable only to the controlling shareholders as currently commonly practised in Pakistan. Minority involvement can be increased by two principle methods of voting system: (1) proportional representation; and (2) election of the NEDs by majority of minorities. Next section explains both methods so as to explain the better use of these voting mechanisms in order to protect minority interests in Pakistan.

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[23]Bernard Black and Reinier Kraakman,'A Self-Enforcing Model of Corporate Law' (1996) 109 (8)*Harvard Law Review* 1911-1982, 1945

[24] Ibid 1948

3.3.1.2 Proportional Representation

Proportional representation on the board of directors is important as it helps minority shareholders to participate in the affairs of companies as to safeguarding their interests. The cumulative voting system (CVS) may provide them with this opportunity to have a voice and proportional representation at the board of directors.[25] Under the CVS, shareholders can cumulate votes and cast them unanimously in favour of their candidate and in doing so; they can elect their favoured nominee.[26]

The CVS originated in Illinois under the direction of Joseph Medill who was greatly influenced by the English philosopher, John Stuart Mill who wrote in 1861 that minorities deserve adequate representation in democratic settings.[27]The CVS helps minority shareholders to elect at least one or more directors on the board in order to have their voice heard at the board meetings. Minority representation on the board can be useful in a number of ways. For example, a minority director may help them to get relevant information useful for contesting their case at members' general meetings. The minority director can also be helpful in collaborating with the independent directors to discuss and raise matters of their rights at the meeting of the board of directors.[28]

It is explained in the following section how minority shareholders fail in electing their favoured candidate under the statutory voting system and how it can be made possible under the CVS.

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[25]JunhaiLiu, XiandaiGongsifa, *Modern Corporate Law* (FalvChubanshe, Law Press 2008)284

[26]Cumulative voting is defined in section .214 of the Delaware Law.

[27] Wendy Sarvasy, 'J. S. Mill's Theory of Democracy for a Period of Transition between Capitalism & Socialism' (1984)16(4) *Palgrave Macmillan Journals* 567-587,579

[28] Luca Enriques, Henry B Hansmann, and Reinier Kraakman, 'The Basic Governance Structure: Minority Shareholders and Non-Shareholder Constituencies' in Reinier H. Kraakman et al. (eds), *The Anatomy of Corporate Law: A Comparative and Functional Approach*'(2nd edition, Oxford University Press, Oxford 2009) 87.

Statutory Voting

Under the Statutory Voting system, shareholder holding one share may cast his one vote in favour of each nominee of directors but he cannot choose to cumulate all his votes and cast in favour of a single candidate. As a result, minority shareholders are unlikely to elect even a single member of the board who could represent them, whereas the majority shareholders manage to elect their all nominees. Thus, the minority shareholders fail to secure the seat for their favoured candidate.[29]

Cumulative Voting System

The CVS is a voting mechanism in which votes are allocated to shareholders proportionate to number of shares and then multiplied by the total number of seats of directors required to be filled. They may cast their votes to a single candidate or may distribute them among two or more candidates.[30] If minorities cast their all votes in favour of their candidate, they will be able to elect their favoured candidate.

Debate on the CVS: Advantages and Disadvantages

Academics have divergence of opinions regarding the benefits of the CVS. For example, Campbell[31] finds it a valuable tool for helping minorities to safeguard their interests. It is argued that under the CVS, minority shareholders manage to have their representative on the board and so, they are heard at the board that ultimately designate the company a going concern.[32]Moreover, Sobieski[33] holds that the board of directors

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[29] Security and Exchange Commission .gov, Cumulative Voting < https://www.sec.gov/answers/cumulativevote.htm> accessed 02 March 2016.

[30] See section 7.28 Model Business Corporation Act.

[31] Whitney Camphell, 'The Origin and Growth of Cumulative Voting for Directors'(1995)10 (3)*The Business Law* 3-16,15

[32]Bhagat, Sanjai, and James A. Brickley, 'Cumulative voting: The value of minority shareholder voting rights'(1984) 27(2)*Journal of Law and Economics* 339-365.341

should not be considered as a social club where dissidents could be overthrown by those who do not like them. The CVS facilitates minority representation on the board and hence, it helps decisions on the board to be made fairly and equitably. Additionally, it may be helpful in reducing agency costs considering the possibility of the minority director playing the role of an arbitrator in the event of conflict of interest between shareholders and management.[34]

On the contrary, the opponents of the CVS claim that it is ineffective in protecting minority interests.[35]They believe that normally minority stockholders do not have good motives; therefore, their representation on the board would affect managerial functions of the board. They are doubtful of the efficacy of the CVS in a sense that minority shareholders may not agree to vote unanimously in favour of a single candidate especially in listed companies where they have diverse interests. It is also argued that since minority shareholders are disorganised; hence the elections of directors through the CVS is a difficult task.[36] They further believe that minority director on the board may potentially create deadlock in decision making and in doing so, may cause disruption in important business transactions and endless debates.[37]

Cumulative Voting in Pakistan

The Companies Ordinance provides for the mandatory rule on the CVS.[38]However, its efficacy to allow minority representation on the board is open to question. For example,

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[33]John G. Sobieski, 'In Support of Cumulative Voting' (1960) 15(2)*The Business Lawyer* 316-330,322

[34] Ibid (n32)340.

[35] Ralph E. Axley, 'The Case against Cumulative Voting' (1950) *Wisconsin Law Review* 278-287.

[36] Independent director's integrity, Daily DAWN newspaper, 13 January 2013 <www.dawn.com/news/776832/independent-directors-integrity > accessed 03 February 2016.

[37] Zohar Goshan, 'Controlling Strategic Voting: Property Rule or Liability Rule' (1996)70 *Southern California Law Review* 701-45,741

[38] See section. 178(5)(b) the Companies Ordinance 1984.

a survey was conducted by the Association of Chartered Certified Accountants (ACCA). It showed that more than 81 per cent of the local listed companies ignore the use of the CVS.[39] The 'one share, one vote' rule is governed by default rules under the Ordinance.[40] It is pertinent to differentiate a mandatory rule from a default rule. A default rule means that companies may dis-apply it by passing a special resolution[41]. However, a mandatory rule leaves no option for companies but to comply with it. The 'one share, one vote' rule ,governed by default rules, of the Ordinance lets companies to issue weighted shares and shares without voting rights. As a result, the 'one share' one vote' rule, governed by default rules of the Ordinance, helps shareholders to own weighted shares and thereby, maintain their control over the board of directors. The rule is normally used as a legal technique to acquire control over companies.[42]

The 'one share, one vote' rule is recognised in both developed and developing countries.[43] The issuance of weighted shares by ignoring the 'one share one vote' rule may help one group of shareholders to gain voting power disproportionate to their economic interests in the company. In doing so, it helps them to misuse their powers in order to pursue private gains. Therefore, such an issuance of shares frustrates the likely returns of the CVS in Pakistan.[44] Shareholders with multiple voting rights outvote the chance for minority shareholders to elect their favoured candidate who can protect their

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[39] Corporate Governance Survey in Pakistan updated 2014 <www.accaglobal.com/pk/.../pakistan.../corporate-governance-survey.htm> accessed 25 December 2015

[40] See Section 90 , the Companies Ordinance 1984

[41] A special resolution requires from the members to pass that specific resolution by a majority of not less than three-fourth of such members at a general meeting.

[42] Safdar Butt, Financial Democracy; How it can be tweaked to liberate family controlled companies' Conference Paper, 2014 <www.academia.edu/.../Financial_Democracy_How_it_can_be_tweaked_to_liberate_fami> accessed 06 June 2016

[43] As per Black and Kraakman' s survey , the principle of 'one share, one vote' is provided in the statutory laws of 9 out of 17 jurisdictions

[44] PTCL, a state owned company, was sold with its control to the buyer of its 26 per cent shares.

interest. The CVS cannot be expected to yield positive results in protecting minorities in Pakistan until the system itself is given protection against the possible abuse by majority shareholders. As such, there is no empirical evidence showing that the CVS could be an effective solution to the minority protection problem. However, it can be made a useful tool to prevent self-serving decisions of controlling management in Pakistan if the system is complemented with some fundamental reforms.

For example, declassifying board is essential to reap the benefits of the CVS.[45] In the classified board structure, the board members are not elected *en masse,* rather, they are elected in fractions (often one third). Suppose that there are four vacant seats for which election is to be held. Under the classified board structure, the directors will be classified for the purpose of their election. The majority shareholders are likely to be able to elect all their favoured board members when election for the members of the board is held in fractions. In fact, the CVS allows minorities owning 25 per cent shares to elect at least one board member provided the election for board members is held *en masse*.

3.3.1.3 Proposal for a 'Percentage Voting System'

As mentioned earlier, a possible problem that the CVS may cause is to create division among board members resulting in mistrust and tension in the boardroom. For example, even if a group manages to have passed a resolution by majority votes at the board, nevertheless, it creates disagreement in decision-making that ultimately costs firm's efficiency. In this thesis a 'percentage voting system' is suggested to avoid division in

[45] Karpoff J M, Malatesta P .H, and Walkling R.A, 'Corporate Governance and Shareholder Initiatives: Empirical Evidence' (1996)42(3) *Journal of Financial Economics* 365-395,371.

the boardroom and at the same time, to provide minority shareholders with an opportunity to have their say in the election of the board members.

It is, therefore, proposed in this thesis that the candidates for the election of the board should exceed a certain number of votes. For example, they should be required to exceed fifty per cent of the votes before being elected as board members. Such a requirement for the election of board members would render it difficult for controlling shareholders to elect all their favoured candidates. In this situation, they would have to have recourse to minority shareholders in order to muster their support for meeting the minimum threshold. This would afford opportunity to minority shareholders to have their say in the selection of board members and majority shareholders would, therefore, be prone to nominate candidate who could potentially be able to get the support of minority shareholders. As a result, an harmonious atmosphere would be created at the boardroom and a deliberate division created through the CVS could be avoided by adopting the 'percentage voting system' in Pakistan.

Under the percentage voting system, the independent directors would be likely to perform their duties fairly and in the interest of minority shareholders instead of toeing the lines of controlling shareholders as they would be in need of support of minority shareholders in their future election. In addition, it would also help to allay gesture of hostility between the controlling shareholders and the NEDs.[46] Thus, the percentage voting system should be taken into account in the new company law as a default rule. This is because in conditions where disagreement between minorities and controlling shareholders is unavoidable, and thus , the minimum voting threshold cannot be met,

[46] This voting mechanism is suggested in this thesis, which is expected to solve the problem of minority shareholders' lack of influence in the selection of the independent directors and to help encourage a harmonious environment in the boardroom decision making; however, there needs to be a systematic review of this proposal in future.

then the CVS should be used in order to resolve the deadlock. For example, candidates showing support of more than 50 per cent votes are to be elected through the percentage voting system and where the situation is other way round, the NEDs should be elected through the use of the CVS from the rest of the nominees. Thus, this two-phased voting strategy combining both the 'percentage voting system' and the CVS together cold help to solve problems of disharmonious atmosphere and voiceless minorities in the selection of board members in Pakistan.

3.3.1.4 Election of the NEDs by Majority of Minorities

In this voting method, only minorities are required to vote for the election of the NEDs. Under this system, the NEDs enjoy directorial incumbency only if they are supported by majority of minorities. This system is expected to resolve minority representation and the NEDs' independence problems as the election of the NEDs falls outside the influence of management and controlling shareholders because they are not required to vote for the election of the NEDs under this system. Moreover, this system is also useful in conditions where the strength of the NEDs is small on the board of directors as currently practised in Pakistan, causing the cumulative voting system ineffective to solve minority representation problem. This voting system would lead to a true and effective representation of minorities on the board of directors and would make the NEDs accountable to minority shareholders for whom the framework is really meant for. Some states such as Italy and Israel have adopted this selection mechanism by having only the minority shareholders to vote for the selection of the NEDs so as to ensure the true independence of the NEDs.[47]

[47] See Article 147 of the Consolidated Financial Services Act; NSE Report, Independent Directors: Issues and Challenges – available < https://www.nseindia.com/research/content/res_sem_1.pd> accessed 23.February 2017.

However, so far as the removal of the NEDs is concerned, there are some problems which need special consideration in Pakistan. For example, the protection of the NEDs representing minority shareholders against removal by the majority shareholders could be a problem in Pakistan. Even if minorities succeed in electing the independent directors, they may be subjected to removal by majority shareholders. This is because, in practice, the members' meetings are just 'rubber stamp' for controllers' decisions in Pakistan.[48] Thus, the majority shareholders may reverse the benefits of the NEDs by removing them through using their dominant positions in the companies in Pakistan.

In order to avoid such a reversal of the benefits of the framework of independent directors in Pakistan, it is important to provide stringent mechanism for the removal of the NEDs in the Ordinance. This purpose can be achieved by two ways. First, it should be made mandatory for the removal of directors to establish 'cause' as currently directors can be removed for any reason in Pakistan which the situation allows controlling shareholders to exercise their influence in the removal of directors.[49] Secondly, the removal mechanism should be subjected to supermajority requiring high threshold to remove the NEDs. This is important to make removal of the NEDs independent of the controlling majority in Pakistan.

3.3.2 Shareholders' right to include Resolution in the agenda of members' general meetings

An important right, shareholders are granted by the UK companies Act 2006 is to allow shareholders representing not less than 5 per cent of the total number and not less than 100 members to include their proposed resolution for consideration in the agenda of

[48] ICAP report, The Effectiveness of Corporate Boards in Pakistan; An assessment and some views 2006< www.icap.org.pk/wp-content/uploads/mies/mies6.pdf > accessed 12 February 2016.

[49] See section. 181, the Companies Ordinance 1984.

members' general meeting.[50] Although the Companies Ordinance of Pakistan mimicked the UK Company Law, yet the legislators deliberately raised this threshold from 5 per cent to 10 per cent and that too without mention at all of number of shareholders in this respect.[51] This is unreasonable in the scenario of Pakistan where directors occupy majority shares directly or through proxies.

In this eventuality, it can be added that in the event of the shares held by the institutional shareholders, the 10 per cent threshold for shareholders to include resolution may mean more than 50 per cent of shares other than majority shares in addition to institutional shareholders, which given their dispersion, turns it nearly inaccessible for such shareholders to avail themselves of this right. This, in turn, gives unfettered powers to directors. It is essential to move forward from the approach where questioning of directorial actions was considered a 'corporate blasphemy'.

It is also undemocratic to deny shareholders of their rights to take part and discuss business prospects. The OECD Corporate Governance Principles provide that directorial decisions should be subject to shareholders' questions and shareholders should be allowed to include their resolution in the agendas of members' general meetings.[52] Thus, the company law in Pakistan, in this regard, should be amended as to reducing the threshold for shareholder to place their agenda in members' general meeting from 10 per cent to 5 per cent and also to permit 100 shareholders to do so, on the pattern of the UK company law section 292. Moreover, Security and Exchange Commission of Pakistan should make arrangement for E-voting in order to facilitate disorganised minorities to exercise their right of vote in members' general meetings.

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[50] See section 292 The UK Companies Act 2006.

[51] See section 164 The Companies Ordinance 1984.

[52] OECD, Principles for Corporate Governance- G20 Vision (2015) 10 <www.oecd.org/daf/ca/Corporate-Governance-Principles-ENG.pdf>accessed 02 January 2016

3.3.3 Dilution of Shares and pre-emptive rights

Improper dilution may be considered as the worst kind of expropriation of minority interest by controlling shareholders. For example, in other means of expropriation such as profit expropriation and tunnelling of corporate assets, shareholders may lose only financial interests. Here they lose both financial and controlling rights.[53]Pre-emptive rights[54] are considered a kind of ownership right. They are meant to ensure protection of shares against improper dilution. The pre-emptive rights give priority to the existing shareholders in regard to buying new issue of shares before they are offered to the general public. If the existing shareholders were not willing to subscribe to new issue of shares, it would be only then the new stock would be offered to the general public. Without having in place the pre-emptive rights, the controlling shareholders may issue shares to favoured shareholders or related parties at diluting discounts.[55] As a result, shareholders may face financial loss as well as reduction of voting rights. The pre-emptive rights are, in essence, very important in a sense they provide an 'anti -director' measure to police the opportunism of controlling managers.[56]

The pre-emptive rights of shareholders are governed by the default rules under the Ordinance[57] that means shareholders can disagree to adopt this provision through a special resolution in members meetings. A default rule on the pre-emptive rights,

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[53] OECD report , Shareholder Rights and the Equitable Treatment of Shareholders; The Fourth Asian Roundtable on Corporate Governance November 2002 <www.oecd.org/corporate/ca/corporategovernanceprinciples/2484743.pdf> p. 3 accessed 10 February,2016

[54]Pre-emptive rights give priority to the existing shareholders to purchase new issue of shares before they are offered anyone else.

[55] Manish Singhai, Shareholder Rights and the Equitable Treatment of Shareholders, The Fourth Asian Roundtable on Corporate Governance , OECD, 2002 <www.oecd.org/corporate/ca/corporategovernanceprinciples/2484743.pdf> accessed 09 May 2016.

[56] IOSCO report Protection of Minority Shareholders in Listed Issuers June 2009 <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD295.pdf> p 8 accessed 09 February 2016

[57] See section. 86 The Companies Ordinance, 1984.

therefore, does not provide for a mandated protection to minority shareholders against improper dilution as the controlling stockholders may withdraw these rights from minority shareholders any time. This is because the business groups and families control the corporate sector in Pakistan and they, by dint of their majority shares, may misuse the right of dis-application of the provision for their private interest. For example, they may issue shares to related parties, with whom their interest is attached, at diluting discounts which may harm minority interest.

The Security and Exchange Commission of Pakistan (SECP) has recommended amendments in the Companies (General Provisions and Forms) Rules 1985 to the effect that it should be made mandatory to offer new issuance of shares to the existing shareholders prior to being offered to the general public. Secondly, payments should be made through banking channel even if new issue of shares were to be sold to the existing shareholders.[58] Indeed, the Companies (General provisions and forms) Rules 1985 have not been amended so far in this respect.

It is recommended in this study that firms should have powers as to the issuance of shares at a discount to some percentage of their shares' nominal value. This is necessary in order to provide companies with opportunity to float extra shares so as to finance their future business operations. However, this power of companies should be subjected to some limitations so as to prevent any abuse of it. Issuance of shares without pre-emptive rights should be limited to a high of 20 per cent of the share capital issued with the discount being 15 per cent and no more off the market price.

[58] See Daily JANG, a national newspaper, Business Page dated 22 December 2015.

3.3.4 Dividend Pay-outs

Two possible ways of returns investors keep in their minds while investing in a public company. First, they invest in a public company expecting dividends pay-outs on their investments. Second, they may get returns on their investments in the form of capital gain.[59] Trading of shares is not easier to earn money in the form of capital gain on sale of stocks in immature financial markets. Due to lack of special expertise, small shareholders may suffer from losses in the events of sudden fluctuations in the capital markets. It is argued that non-payment of dividend is not harmful to equity holders as firms which have growth opportunities should retain their earnings to capitalize growth opportunities instead of paying out in the form of dividends.[60]

Proponents of capital gains argue that retaining and reinvesting funds, instead of pay out, is beneficial for small investors as well.[61] Although critics seem justified in presenting their view that reinvesting or retaining funds is not an issue, yet the major issue is misuse of excessive cash holdings, which ultimately attracts managers towards empire building. Therefore, payment of dividends is not only in the benefit of minority shareholders in terms of cash receipt but it also reduces the level of available free cash flows and thus, helps in curtailing opportunistic behaviour of managers.

On that background, it is inappropriate to deny dividends to shareholder in the context of Pakistan where the capital market is immature and the same is controlled by powerful broker families who may exploit sudden fluctuation in the market. Therefore, shareholders are more concerned about receiving dividend pay-outs than about getting

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[59] Profit shareholders earns from selling their shares.

[60] Sadaf Ehsan, Muqaddas Khalid and Waheed Akhtar, Dividend Payouts in Firms with Growth Potential in the presence of insider ownership concentration (A case from emerging Economy) (2014)26(4) *Sci.Int.(*Lahore) 1723-1730,1723

[61] Ibid 1723.

the capital gain by selling their shares. In Pakistan where companies most often choose not to pay dividends even though possessed with excess cash,[62]it should be considered a purported act and hence be made redressible by paying dividends to shareholders.

This is important because managers in such cases may go for empire building through opportunistic behaviour which is not beneficial for shareholders. This is also important because the State owns more than half of the total equities in the market, and the dividends received from high return yielding stocks are the main source of revenue for the state and non-payment of dividends is a major drag of its receipts.[63] In 1999-2000, the government of Pakistan made it mandatory for the listed companies to pay cash dividends to shareholders through the finance bill.

However, the government succumbed to the pressure of major business groups with profitable companies in cement, energy sector and textile and abandoned its stance on compulsory dividends pay-outs rules. In mature markets such as the markets of the UK and the US, it may be acceptable to deny dividends pay-outs. However, this may be detrimental to the interest of small shareholders in immature markets such as that of Pakistan where companies easily manipulate their books and even the share price causing damage to small shareholders. An academic when he was asked his opinion in this respect, said that 'where companies are possessed with their reservoirs at the cost of investors-they ought to be made to share the fortunes with the equity-holders'.[64]

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[62] Ibid 1728;Qureshi v Hi Tech Construction [2004] C.LD.640.

[63] Dilawar Hussain, 144 Firms not paying dividend despite earning profit Daily DAWN, National Newspaper, 23 May, 2015 < www.dawn.com/news/1183651> accessed 11 February,2016.

[64] A domestic corporate lawyer; He visited the UK to attend a condolence reference for Quetta bar association suicide -blast which took the lives of 60 senior lawyers of Pakistan , seminar organised by the Law Society, UK , I had an opportunity to have words with him on this matter.

3.4 Types of expropriation of Corporate Assets

Directors are required to apply their best business judgment, to act in good faith and to serve the best interest of the company. However, they are under question for breaching their fiduciary duties in the events of entering into transactions with third parties in order to gain private benefits.[65] This may happen where the corporate fiduciaries have major stakes in the third party and the transaction with that third party results in benefits for them at the cost of the company's and its minorities' interests.

These related party transactions have extensively been used in corporate world. This becomes much easier to do, when one company is operating in various countries. As different subsidiaries are operating under different governance mechanisms, which are not integrated, therefore, it becomes near to impossible for regulators to control and audit intra-party transactions. One viewpoint might be that such type of transfer pricing is in the benefit of minority shareholders as companies are more likely to move funds from taxed countries to tax heavens like Middle East. But it does not work always like this. Companies purchase raw material from subsidiaries located abroad at a price much higher than the market that costs a lot to minority shareholders in the purchasing company. Other way round, first company sells its finished goods to its subsidiaries at much less price causing again financial loss to first company and ultimately compromising with the interests of minority shareholders.

[65] Eric L, Talley, 'Turning Servile Opportunities to Gold: A strategic Analysis of the Corporate opportunities Doctrine'(1998)108 *Yale Law Journal* 279-298,279

3.4.1 Related Party Transactions in Pakistan

As mentioned above, related party transactions can be used by controllers to expropriate minority interests in pyramid shareholder ownership.[66]They may enter into transactions with private companies owned by them or with a public company in which they are large shareholders. Normally, business transactions entered into by a company with other companies are useful business activity to promote firms' business. However, it may turn into a source of expropriation of minority interests by the controllers where such transactions are not at arm's length. The transaction which is contracted at less than market price and the one which involves conflict of interest is termed as the one not being at arm's length.[67]Thus, minority shareholders need protection from such abusive self-dealings by the controllers.

The Companies Ordinance of Pakistan requires that transactions in which directors or corporate officers have their interests be disclosed and be put up for board approval.[68] The Ordinance also requires the directors and corporate officers to disclose their interests in transactions entered into by the company.[69] Relatives of directors are covered as well for the purpose of disclosing their interest, if any, in the transaction.[70] Directors who have interests in a transaction are not allowed to make decisions and to take part in voting for the approval of such transaction in the meeting of directors.

However, the provisions on self-interested transaction have flaws of their own that affect the interest of non-controlling shareholders in related party transactions. In 2006,

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[66] Yan-Leung Cheunga , Raghavendra Rau, Aris Stouraitis,'Tunneling, propping and Expropriation: Evidence from connected party transactions in Hong Kong (2006) 82(2) *Journal of Financial Economics* 343-386,344

[67]DIT Mumbai v Morgan Stanley & Co [2007] 7 SCC 1

[68] See section. 214, the Companies Ordinance 1984.

[69] See section 215, the Companies Ordinance 1984.

[70] See section. 214(1) the Companies Ordinance 1984.

the Companies Ordinance 1984 was amended, whereby, the Fourth Schedule to the Ordinance which defined, 'related party transactions' was abolished.[71] The Fourth Schedule was removed from the Ordinance on the recommendation of the Institute of Chartered Accountants of Pakistan (ICAP).[72] The ICAP recommended the deletion of the fourth schedule from the Ordinance arguing that disclosure of related party transactions was difficult for the SOEs and it was also costly.[73]

The SOEs could have been given exemption from the disclosure of related party transactions in view of the problems of difficulty and the issue of costs involved in such disclosure.[74] However, the SECP overlooked the option of giving exemption to the SOEs, and recommended for the deletion of the Fourth Schedule from the Ordinance. As a result, it left the term 'related party transactions' undefined. Neither the company law nor the Code of CG and Listing regulations define 'Related Party Transactions' that ultimately result in confusion regarding the scope of related party transaction.

For example, the Ordinance prohibits only directors from entering into transactions in which they have their personal gains. It does not cover the controlling shareholders, friends, business associates and family members. In view of peculiar ownership dynamics such as concentration of shareholder ownership, interlocking directorship and cross-shareholding in Pakistan, controlling shareholders may manage to get approval of transactions best suited to their private gains at the expense of the company's interests. It is, therefore, vital to bring the controlling shareholders within the purview of the law.

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[71] Substituted by Statutory Rules and Orders (SRO)589 /2004

[72] Deleted by Statutory Rules and Orders (SRO)1261/ 2008

[73] Technical E Newsletter, issued by the Institute of chartered Accountants of Pakistan April 2010 <www.icap.org.pk/icap/publications/technical-e-newsletter/> accessed 10 October 2015.

[74] Imtiaz Khan, Adoption of and Convergence in Corporate Governance to International Norms in Pakistan'(PhD Thesis University of Glasgow 2014).

3.4.1.1 Definition of Related Party Transaction

Defining 'related party transactions' is the basic element in the process of regulating such transactions. The definition of 'related party transactions' should cover all direct and indirect connected party transactions that directors or controlling shareholders may enter into. Following factors should be considered for defining related party transactions in Pakistan:

Indirect related party transactions should be brought within the ambit of regulatory framework and for that purpose, an hybrid approach should be adopted which should entail an objective rules and principles-based definition. The objective rules regarding the definition of related party transactions are important as it is difficult to enforce subjective approach in this regard. In addition, some specific related party transactions should be declared abusive unless proven otherwise.

Another problem that lies in the approval mechanism of related party transactions is to allow board members to approve 'related party transactions'.[75]The approval of 'related party transactions' by the board members cannot ensure minority protection in 'related party transactions' as the boards are under the overwhelming influences of controlling shareholders, who, thereby, may get the approval of self –interested transactions from the board. The approval mechanism of 'related party transactions' also needs revisiting. The minority protection objective in 'related party transactions' may be achieved if transactions exceeding a certain threshold are required to be placed for approval by the members' general meetings grafting along the approach adopted in section 188 of the Indian Companies Act 2013.[76]

[75] See section 214, the Companies Ordinance 1984

[76] See section 188, the Indian Companies Act 2013.

However, approval of 'related party transactions' by the members' general meetings may also be ineffective in view of the control of majority shareholders in Pakistan. Therefore, they may influence other members to get the approval of related party transaction from shareholders' general meetings. It can be avoided if the 'related party' is excluded from shareholders' meeting in which the transaction is tabled for approval. This may help shareholders to make decisions independently and approve the transactions in the best interest of the company. More so, it can also be avoided if statutory provisions are introduced in the Ordinance requiring approval of disgruntled shareholders for a related party transaction grafting along the approval mechanism under section 190 of the UK Companies Act 2006.[77]

3.4.1.2 Approval by Majority of Minority Shareholders

The problem of abusive related party transactions can also be solved by having approval of the related party transactions from the 'majority of minority' or disinterested shareholders. However, classification of disinterested shareholders might be a practical problem. To that end, definition as to an 'interested shareholder' should be introduced for determining the interested shareholder and in this regards, there needs to be guidelines so as to clarify legal presumptions. Furthermore, shareholders should be asked to clarify whether or not they hold any interest in the approval of a transaction before voting for the transaction at the members' general meeting. This would help the company to categorise interested and disinterested shareholders. More so, in order to control abuse by minority shareholders, there needs to be a certain threshold for votes in order to challenge a resolution.

[77] See section 190, the UK Companies Act 2006.

3.4.1.3 Pre-approval of related party transactions by audit committee and their evaluation by third parties

The current mechanism of audit committees' periodic review of related party transactions is faulty as the audit committees are required to review related party transactions after they are undertaken. This mechanism is of limited use as the undertaken transactions cannot be overturned even if the audit committees had disapproved them. This problem can be solved by having prior approval by audit committees of major related party transactions after examining the impact of these transactions on the companies and their shareholders. Furthermore, the audit committees should be vested with the responsibility of decisions regarding identification of abusive related party transactions.

3.4.1.4 Immediate Disclosure of Related Party Transactions

There are also problems with the disclosure requirements of related party transactions in Pakistan. For example, currently, disclosure of related party transactions is required to be made on periodic basis.[78] Disclosure of related party transactions on periodic basis might create problems as shareholders get to know self-interested transactions after they are concluded which practically mars the effectiveness of the disclosure. Immediate disclosure of the related party transactions is necessary so as to limit the possibility of abusive transactions and to enhance the quality of information. Thus, provisions requiring immediate disclosures of related party transactions need to be incorporated in the company law in Pakistan.

Furthermore, the disclosure of related party transactions should cover description of the nature of transactions, the interested controlling shareholders and nature of their interest

[78] See section 214, the Companies Ordinance 1984.

in the transaction, interested directors and accordingly, nature of their interest in the transaction, audit committees' approval of transactions along with reasons operating behind such approvals, description of dissenting directors, if any and the value of consideration and the manner of determination of such consideration.

3.4.1.5 Approval of divesture decisions in Major subsidiaries

Another problem that lies in the current legal framework is that the subsidiaries' divesture decisions are not subjected to shareholder approval. As a result, controlling shareholders of holding companies may make divestment of a subsidiary company without proper valuation, to a company in which they have larger stakes. It is, therefore, suggested that divestment in subsidiary companies should also be made subject to shareholder approval and the law in this respect needs to be amended so as to regulate controlling shareholders' divesture decisions in subsidiaries.

There are some uncertain and vague provisions in the listing Rules which aim at inhibiting 'connected party transactions' against minority interest.[79]However, the existing provisions in the Listing Rules do not appear to be protecting minority interests and may not be useful to prevent minority rights from being expropriated by the controllers. For example, the scope of current provisions in the listing rules regarding minority protection are not broad enough to cover 'related party transactions' between corporate directors and associated companies of listed companies.[80] Furthermore, without stringent legal requirements for the disclosure of 'related party transactions' and approval of disgruntled shareholders, the situation would continue allowing

[79]Listing Rules 2012, Related party transactions: cautionary tales for investors in Asia (Report by Asia Pacific Office of the CFA Institute Centre for Financial Market Integrity, January 2009)

[80]Corporate Law Review Commission , 'Concept Paper for the Development and Regulation of the Corporate Sector'(2006) at 4.7

controllers to expropriate minority interests in related party transactions by using the corporate pyramids.[81]

Statutory backing to Code of Corporate Governance and to the listing regulations is also required as the violation of the Code and listing regulations are leisurely treated by the SECP while statutory law provisions require strict and mandatory compliance. Thus, there is no reason why the law should come short of an adequate protection to minorities against managerial wrongdoings in 'related party transactions' in Pakistan.

3.4.2 Exploitation of Corporate Opportunities

Directors may harm minority interests in areas where they pursue new business opportunities by using the company's resources that serve more their interests than offering the benefits of those business opportunities first to the company. Business prospects/opportunities are considered the assets of the companies only if they were not exploited by corporate directors for their private gains.[82]

Generally, corporate laws prohibit directors from exploiting business prospects and entering into self-interested transactions for their private benefits.[83] The law has not made a significant advancement in Pakistan to restrict directors from exploiting business prospects and entering into abusive transactions that can endanger companies' as well as shareholders' interests. In Pakistan, business families and the State control the corporate sector.[84] They may misuse their authority in exploiting business prospects

[81] The Crescent Bank scandal is the classic example of this kind of majority abuse.

[82] John Lowry, Rod Edmunds , ' The corporate opportunity Doctrine: The shifting Boundaries of the duty and its remedies' (1998)61 (4) *Modern Law Review* 515-537, 515

[83] Ibid (n65) 279.

[84] Amir ShahzadBajwa, Amina Bashir, 'The impact of ownership and board composition on financial performance of the firm- Empirical evidence from Pakistan' (Master Thesis, Umeå School of Business, Sweden, 2011)15

and may enter into self-interested transactions and in doing so; they may harm the company as well as its minorities' interests. The concentration of shareholder ownership requires legal restrictions on directors so as to prevent them from entering into self-interested transactions and exploiting business prospects.

Business prospects/opportunities are otherwise useful to promote firms' business if those are not exploited by corporate fiduciaries for their private gains. Corporate laws in Pakistan are silent on this aspect of conflict of interest of the fiduciaries. The law prohibits only the Chief Executive Officer (CEO) of public companies from engaging in businesses of same nature which the company or of its subsidiaries are carrying out.[85] The term, 'CEO' also covers his/her spouse or children and hence prohibits them as well from doing a business of similar nature.[86] The CEO of a company is under a statutory obligation to disclose his /her interest in the competing businesses.[87] This provision focusses only on the disclosure of such conflict of interest. It does not; however, appear to address this problem. The Ordinance envisages only a minor penal provision against the failure of disclosure by the CEO as regards nature of competing business he/she carrying out.[88]

In addition, there is no provision in the Ordinance that prohibits directors other than the CEO of a company from carrying out a business of similar nature. The Ordinance does not prohibit directors from exploiting corporate opportunities for their private gains. As group of companies controlled by majority shareholders is a common phenomenon in

[85] See section 203 (1) the Companies Ordinance 1984.

[86] Ibid, explanation to section 203 (1) the Companies Ordinance 1984.

[87] See Section 203(2) the Companies Ordinance 1984.

[88] See Section 204 , the Companies Ordinance 1984 , the financial penalty includes RS 10, 000, equivalent to 66 pounds (approximately) and debarment for a period not exceeding three years to become CEO or a Director of a company.

Pakistan; the problem of transferring business opportunities by the controllers to business entities where they have larger stakes is apt to arise.

Such a transfer of corporate opportunities helps the controlling shareholders gain benefits from companies in which they have larger stakes. As a result, it may harm both the company and its minority shareholders' interests. Corporate opportunities have been regarded as corporate assets.[89] Therefore, regulating the exploitation of corporate opportunities by controllers is necessary in Pakistan so as to prevent directors and controlling shareholders from exploiting corporate opportunities.

Although authorisation of conflict of interest by the board of directors can be one of the ways for solving this problem yet, it may not be adequately an effective solution in Pakistan keeping in view the ownership concentration. As majority shareholders control board of directors, they may misuse their influence upon the authorisation vehicle of conflict of interest. Minority protection problem may be resolved to some extent in Pakistan if the board of directors is authorised to be seized of conflict of interest only up to a certain limit. If the conflict of interest crosses that limit, it should be referred for shareholders to approve the, 'conflict of interest' at members' general meetings.

Further, if the conflicted director possesses shares in the company, he should not be allowed to participate in the meetings of directors and in the members' meeting as it may happen that he/she may be able to persuade other members to vote in his/her favour. The law is, thus, required to regulate exploitation of corporate opportunities by the controlling shareholders so as to protect minority interest in Pakistan.

[89] Chrispas Nyombi, Alexender Kibandama, *Principles of Company Law in Uganda* (Law Africa Publishing (k) Ltd,2014) 100.

3.4.2.1 Liability of resigning directors on exploitations of corporate opportunities

As to further clarification, the resigning directors should also be the subject of derivative proceedings. This is because he/she might resign from the directorship with an intent to exploit corporate value or opportunities which were available to the company during his/her incumbency.[90] Therefore, shareholders should not be barred from bringing action derivatively against resigning or former directors who are alleged to be involved in exploitation of corporate opportunities which were otherwise available to the company. Moreover, same kind of fiduciary duty should apply to non-executive directors because if they were not prevented from competing with the interests of corporation, it might lead to disregard of shareholders' interests by non-executive directors in another capacity.

3.4.3 Pay and Perks of Corporate Management

Protection of minority shareholders against the abuse of controlling management by paying inflated salaries to management is another subject of consideration in Pakistan. Chief Executive Officers (CEOs) in certain companies in Pakistan are being paid higher than their counterparts in the foreign companies.[91] The Companies Ordinance does not specify limits on remuneration and perks of CEO. There is no overall cap on the remunerations of CEOs which the situation allows controlling shareholders to pay high remuneration and unquantifiable perks to their favourite managing directors and executives. There needs to be a limit for the remuneration of CEOs with a certain percentage of net profit of the company.

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[90] Da Silva v CH Chemical (pvt)Ltd [2008](6) SA 620(SCA).

[91] See Daily Dawn Newspaper, 29 April 2007, Pay and perks of corporate bosses' < www.dawn.com/news/244531> accessed 19 March , 2017.

In Pakistan, many companies are managed by controlling shareholders (the promoters) which the situation seeks attention towards excessive remuneration of CEOs forming part of promoters. It is, therefore, recommended that companies should be required to obtain approval of shareholders for remuneration and other perks of CEOs. However, it is also suggested that the related or interested parties should not be allowed to vote on managerial remuneration and perks if it exceeds a certain limit.

3.5 Shareholders' Enforcement Power

As mentioned above, management of a company is tasked with the responsibility to act in the best interest of the company and its shareholders. However, problem arises where decisions in companies are made on the basis of majority rule. Group of companies controlled by majority shareholders is a common phenomenon in Pakistan. They are, therefore, in a position to hijack decisions made at the boards' and members' meetings. The minority interests are at the mercy of the controlling shareholders. This is because neither they have enough shareholding to overturn decisions made against their interests nor they enjoy enough voting powers enabling them to have their voice heard at the board of directors.

Under the common law principles, remedies against managerial oppression on private rights and on corporate rights have been developed. If personal right of a shareholder is harmed, the common law provides harmed shareholders with a protection in the form of unfair prejudice remedy. Conversely, if a company is wronged (infringement of corporate right); shareholders of the company may take action against errant directors on the company's behalf. Although the Ordinance provides remedy against managerial oppressions on private rights under section 290,(borrowed from section 153 (C) of Indian Companies Consolidated Act 1913),yet it is too weak to adequately protect small

investors. The second remedial vehicle, namely derivative suit as recognised worldwide to undo wrongs done to companies, is not provided in the Companies Ordinance 1984 of Pakistan.

3.5.1 Derivative Litigation as an enforcement tool in Pakistan

As explained earlier, derivative action system is a mechanism that provides shareholders with a safety valve against managerial and directorial wrongdoers and the same has emerged globally as an important managerial accountability measure.[92] If a company is wronged, shareholders can make good the wrong done to the company by raising a motion in members' meetings. Since majority shareholders enjoy absolute power in making corporate decisions, minority shareholders are helpless in the members' meetings as they do not own enough voting shares to influence decisions taken by majorities to the detriments of minority shareholders.

As a result, legal action is left the only choice with the shareholders to bring wrongdoers in the corporations to book. Judiciary in Pakistan seems reluctant to allow flexible redressal of wrongs done to corporations. This may be due to various reasons. For example, there is no recognition of the derivative suits in the Companies Ordinance. Being a common law country, judiciary in Pakistan may have recourse to the common law principles on derivative actions for developing jurisprudence in respect of derivative proceedings. However, the judiciary has failed to develop and apply common law principle in this regard. The strict procedural requirements and courts' restrictive behaviour regarding the application of common law derivative action

[92] Mathias M. Siems, 'Private enforcement of directors' duties : Derivative actions as a global phenomenon' in in Stefan Wrbka, Steven Van Uytsel and Mathias Siems, Collective Actions (Cambridge University Press 2012)93

are criticised because of rigorous procedural and substantive rules of common law principles on derivative actions.[93]

3.5.2 Problems of Enforcement under the Common Law Rules on Derivative Actions

There are four major problems with the common rules on derivative actions. First, the common rules on the derivative suits were developed many years ago and based on cases decided over a period of 150 years. They are inappropriate to cover modern conditions and all types of managerial transgressions.[94] This was the reason why the UK Law Commission recommended for the replacement of the Foss v Horbottle Rule with its outmoded exceptions with the statutory derivative action system so as to simplify derivative litigation and to make it modernised and accessible to shareholders.[95]

Second, derivative suits are available under the *Foss v Harbottle* Rule only in cases where wrongdoers are in control of the company. It offers no clarity as to whether it covers control other than voting control because in large companies, in some cases, directors enjoy control even without majority votes. This type of control can be exemplified in situations where different family members apparently in individual capacity own shares of a company, then jointly seize control over it. However, in situations where one family member (let's say) owns 42 per cent shares, it would not be treated as being in control of the company although it may commit fraud against the company in league with another family member who holds further 10 per cent shares of

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[93] Arad Reisberg, *Derivative Actions and Corporate Governance : Theory and Operation* (Oxford University Press 2007) 126

[94] Ibid, 90, Arad Reisberg has discussed in detail all the circumstances that may and should arise as managerial oppressions.

[95]The Law Commission, Shareholder Remedies: para 6.4

the same company, making it more than 50 per cent required for reaching decision taking threshold.

Third, exception to the Foss rule exclude claims of negligence that is referred to as- (1) where management fails to act with reasonable skill, care and diligence; (2) where management fails to abide by its fiduciary duties.[96]

Fourth problem with the exceptions to the Foss Rule relates to showing significant evidences of serious matter to be tried,[97] which in itself, is a mini-trial before the intended trial of derivative action that ultimately causes the trial to be protracted with increased costs. As a result, seeking an appropriate remedy under common law rules of derivative actions for each and every single illegal activity on the part of managers is difficult to avail. Cost of litigation is another problem of the common law rules on derivative litigation that disincentives shareholders to initiate derivative proceedings.[98] Moreover, under the common laws rules, a shareholder who brings a derivative action can compromise it or may choose to discontinue the suit at his own.[99] This would mean that shareholder can withdraw suits in disregard to the interests of companies and in return of private benefits. In recognition of the problems at common law, laws in a number of jurisdictions provide in their respective company laws that derivative proceedings cannot be compromised without the leave of the courts.[100]

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[96] Ibid (n93) 127.

[97] Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)[1982] 1 Ch 204

[98] Peter Prince 'Australia's Statutory Derivative Action: Using the New Zealand Experience' (2000) 18(7) *Company and Securities Law Journal* 493-515, 494.

[99] Goodwin v. Castleton [1944] 19 Wash 2d 748,765,144 p2d 725,733.

[100] See section 168, New Zealand Companies Act 1993; Section 240, Australia, Corporations Act 2001; Section 242 (2) Canada Business Corporations Act 1985; section 216B(2) Singapore Companies Act.

Another problem with common law rules on derivative proceedings is to deny the derivative right of actions in the events of a company near insolvency or is insolvent.[101] This is necessary to permit the continuation of derivative proceedings in a company which is near insolvency or has become insolvent, at least, to take care of creditors' interests as their interests are primarily at risks in insolvent circumstances. It is submitted in this regard that 'the best interest of the company' should be readily applied to companies amenable to insolvency or liquation.

Due to the problems of the common law rules on the derivative actions, judiciary in Pakistan has, regrettably, failed to provide remedies for corporate wrongs to shareholders. As a result, shareholders have been unwilling to bring errant managers to book as there is, as such, no case available in Pakistan that can be referred as a derivative action.[102] On the contrary, the codification of derivative actions would provide clear rights and is expected to remove ambiguities and restraints in the common law rules on derivative actions.

In addition to the Foss v Harbotte rule, there are some other barriers that might affect the efficacy of derivative actions in Pakistan. For example, the 'Clean Hand' notion is applied on shareholders bringing action against wrongdoers, which implies that the shareholders must come with clean hands.[103] Being a common law country, the 'Clean Hand' notion is applied in Pakistan particularly causing inconvenience to shareholders

[101] Barrett v Duckett [1995] 1 BCLC243(CA) 250.

[102] This is based on search from authenticated search engines for law database; i.e Pakistan Law Journal, Pakistan Law Digest, Corporate Law Decisions and Civil Law Cases. Without the exception of case, Sakina Khaton v S.S Nazeer Ahsin & others [2010] CLD 1963 Sind High Court, which was not, in fact, a derivative action, however, the court provided some rules for derivative actions which replicate the common rules on derivative actions.

[103] Barret v Duckett [1995] B.B.C 362

to bring wrongdoers to book.[104] It is argued that since shareholders bring action on behalf of the company and as a result, the benefits flowing from the action go to the company; therefore, the 'clean hand' notion in that case needs more justification to be applied on the plaintiff shareholders. Shareholders' behaviour should not be considered in this respect because the ultimate purpose of the derivative suit is to look into the merits of the suits and dispensation of justice to the harmed company instead of scrutinising shareholders' propriety.[105]

Thus, the 'Clean Hand' notion should not be applied mechanically. As Payne argues there is no reason why to apply 'Clean Hand' notion in every condition where the main purpose of derivative litigation is to vindicate corporate rights and not the private rights of shareholders.[106] Pakistan should consider the approach to this effect adopted by the Australian Court in Magafas v Carantinos case, in which, the court held that while making assessments as to derivative actions, courts should not scrutinise the applicant's clean hands.[107]

The non-codification of directors' duties is another problem that might hamper derivative litigation in Pakistan. In view of the non-codification of directors' duties, judiciary in Pakistan has to take guidance from common law principles in determining directors' duties.[108] However, the judicial response in determining directors' duties has been very discouraging. Section 488 of the Companies Ordinance provides for the

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[104] Muhammad Azhar Siddique v Federation of Pakistan [2012] PLD 212 SC 774

[105] Jennifer Payne, ''Clean hands'' in derivative actions'(2002) 61 (1) *The* C*ambridge Law Journal* 76-86,76

[106] Ibid 84.

[107] Magafas v Carantinos[2006]NSWSC1459.

[108] See Paul Davies, *Gower and Davies' Principle of Modern Company Law* (7th edn London: Sweet & Maxwell 2003)ch 16. The common law directors' duties involve care, skill and diligence on the parts of directors while performing their duties. Fiduciary duties imply common law principle to act in accordance with the best interest of the company and surrender where their private interest happen to conflict with that of the company.

protection of directors from liability where they have acted reasonably and honestly.[109] Under the umbrella of this very section, the directors in Pakistan, in normal practice, seek protection where they are confronted with actions of breach of their duties. The protection as provided to directors under section 488 is similar to the concept of Business Judgment Rule that grants relief to directors when acting reasonably and honestly.[110]

However, the protection of directors from liability is troublesome in jurisdictions like Pakistan where directors are not subject to reliable threat of being called to account against breach of their duties. Such events happen to arise where derivative actions are not available to shareholders.[111] If derivative suits are made accessible to aggrieved shareholders to safeguard their interests, then application of business judgment rule would be useful as it would enhance legal certainty and would also help reducing managerial risk aversion -necessary to pursue projects of net present value.[112]

Furthermore, the ordinance does not bring controlling shareholders within the scope of fiduciary duty. Historically, fiduciary duty was developed in order to protect the trusted property from the abuse of trustee. Later on, the UK courts applied fiduciary duty to corporate directors and officers of companies with an object to discourage oppression

[109] See section 488, the Companies Ordinance 1984.

[110] Aurelio Gurrea-Martinez, The Law and Economics of the Business Judgment Rule: Notes for its Implementation in Non-US Jurisdictions; Working Paper Series 2/2016 ; Percy v Millaudon [1829] Supreme Court of Louisiana.

[111] Martin Gelter, Why do shareholders' derivative suit rare in continental Europe? (2012) 37(3) *Brooklyn Journal of International Law*,844-887,855

[112] John Armour and Jeffrey Gordon, 'Systematic Harm and Shareholder Value'(2014)6 (1)*Journal of Legal Analysis* 35-85,51.

corporate rights.[113] Fiduciary duty involves two kinds of obligations; firstly, it involves duty to care and secondly, it calls for duty of loyalty.[114]

The duty of care requires controllers' adherence to a standard of reasonable care to act in the interests of the companies. As regards duty of loyalty, controlling shareholders are expected to abandon their private interests for the sake of the company's.[115] The ordinance does not prohibit controlling shareholders, from violating provisions against conflict of interest which they may do by exercising their voting powers in members' general meetings. This is unlike the situation in developed countries where anyone can be subjected to derivative actions under any corporate cause of action if wrongdoers are not brought to book by the board.[116]. Likewise, the US courts have extended fiduciary duty to controlling shareholders so as to protect minority shareholders in freeze-out mergers.[117]

As mentioned above, the ownership structure in Pakistan is concentrated and so, the controlling shareholders place their relatives, friends and trusted persons in managerial positions. As a result, the managers pursue illegitimate interests of the controlling shareholders and not those of the company's and its minorities' interests. The problem arises when they function in a double character i.e both as shareholders and managers.

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[113]Iman Anabtawi, Lynn A Stout, ' Fiduciary Duties for Activist Shareholders'(2008)60 *Stanford law Review* 1257-1307,1270

[114] Robert Clark, *Corporate Law* (Aspen Publishers , Inc 1986)511

[115] Paul Davies, Sarah Worthington, Sarah Worthington, Gower & Davies: *Principles of Modern Company law* (8th edition Thomson Sweet & Maxwell , London 2011)520

[116]Andrew Keay, 'Assessing and rethinking the statutory scheme for derivative actions under the Companies Act 2006 (2016) 16(1) *Journal of corporate Law Studies* 39-68,48 ; Controlling shareholders may, due to their dominant positions, gain the full ownership of a subsidiary company and as a result they may push minorities to sell their shares stipulated by the parent company. It may, therefore, be harmful to minority interest.

[117]Brundage v New Jersey Co.[1967] 48 N.J 450,470; Singer v Magnavox [1977]380 A.2d 969; Tanzer v International General Industries [1977]379 A.2d 1121;Robert Biggart, 'The Fiduciary Duty of Majority Shareholders in Freeze out Mergers: A Suggested Approach'(1978)47(2) *Fordham Law Review* 223-241,224

Being members of the board, they may directly influence boards' decisions and alongside, they may indirectly influence boards' decisions being the controlling shareholders.[118] Dominance of controlling shareholders and inadequate legal protection place minorities at the risk of majority abuse because under the ordinance, the controlling shareholders are not bound by provisions against conflict of interests.

In addition, Pakistan follows the English rule, 'losers to pay legal costs to the winner'.[119] Although, the courts in Pakistan award reasonable costs to winners in normal civil matters, yet the amount is likely to be quite significant for minority shareholders in matters of corporate disputes if they fail to win the suit. Thus, the 'loser pays' rule might discourage potential shareholder claimants to bring even genuine and valuable derivative actions. Now, the parliament of Pakistan has passed, the Cost of Litigation Bill, 2017.[120] This means that the losing party will have to bear the litigation costs of the case and to pay fine RS.5000 per hearing as well. This state of affairs is expected to discourage shareholders to take derivative actions in Pakistan unless a viable funding mechanism is introduced in Pakistan that could truly incentivise shareholders to take action against the wrongdoers in corporations.

Additionally, the problem of plaintiff bar is one more issue that could befall against derivative proceedings in Pakistan as the aggregation of plaintiffs with an object to take collective action is not an easy job in the context of Pakistan. Besides legal costs, court

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[118] Malik M Hafeez, *Corporate Governance and Institutional Investment: Rules, Regulations and best practices to monitor corporate affairs and balance the interests of managers and shareholders* (Universal Publishers Boca Raton Florida 2015) 200

[119] See section .35 (A) Civil Procedure Code 1908 , Pakistan

[120] See Daily DAWN, 19 January, 2017, Bill to make losing party bear cost of litigation approved <www.dawn.com/news/1309315 > accessed 02 April 2017.

fee on *ad-valorem* basis[121] and protracted proceedings seeking in judicial decisions could be other reason behind shareholders' apathy in bringing errant managers/directors to book, in Pakistan.

3.5.3 Alternative Remedies

The Ordinance empowers courts to make order for a company to be wound up where there is irreconcilable deadlock and there are no prospects of the company continuing.[122] The courts are also vested with the power to strike down winding up petition when the petitioners are seeking remedy for winding up unnecessarily.[123]The remedy against unfair prejudice has been provided to serve as an alternative to drastic option of shutting down the enterprise. Judicial level confusion on the application of both remedies ultimately leads towards difficulty in seeking these remedies in Pakistan. For example, in ABIL v EBM case,[124] it was held that unfair prejudice remedy can be granted on ground(s)(1)Where managerial actions are harming members' interests,(2) where there exist circumstances that provide grounds for seeking winding up remedy; and if the winding-up petition is successful it would unfairly prejudice members' interests.

In other words, the court held that unfair prejudice remedy could be sought on grounds similar to those required to seek winding up remedy. It means that losing an unfair

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[121] See Section 21 of the Suit Valuation Act 1958, Pakistan; legal cost for a suit in Pakistan is not limited to lawyer's fees. Plaintiff party is also required to pay court fees and stamp duty. Although in some cases, court fees is not that much high, it goes very high when it is collected on ad valorem basis. As a successful derivative suit recovers money for the company from wrongdoers, an ad valorem determination of court fee could take it very high and thus making litigation too expensive. Therefore, small shareholders are not expected to benefit directly from a successful derivative suit. Since minority shareholding is increasing in Pakistan, this could weigh in favour of having in place a functional derivative actions system which could be handily available to shareholders.

[122] See section .305, the Companies Ordinance 1984.

[123] See section.314(2) the Companies Ordinance 1984.

[124] ABIL v EBM [2003] CLD 815

prejudice remedy would result in unsuccessful petition for winding up remedy as well. Since winding up remedy is an unattractive route for both litigating parties to end up their dispute, therefore, it should have wider scope than the unfair prejudice remedy and so, it should be sought after the latter has been exhausted.[125] The condition to seek for remedy against managerial oppressions on private rights is to occupy at least 20 per cent shares. This makes the remedy practically inaccessible. Minorities are left with the only option to seek for the winding-up remedy which as stated above, is never a happy and reasonable resolution of a dispute. Furthermore, empirical data shows that from out of the total suits filed under section 290 of the Ordinance, in two suits, the courts rendered orders for the purchase of shares of the minority plaintiffs by the majority shareholders. However, it turned out to be a difficult situation for courts to change the orders of share purchase into the winding-up orders as there were insufficient funds with the majority shareholders to purchase the shares of minority shareholders.[126]

On that context, derivative proceedings can provide a viable solution of the issue of seeking winding-up remedy because they have got no other choice. This is because derivative actions are purposed at correcting corporate wrongs in line with the best interest of the company. This signifies derivative actions for the welfare of business entities.[127] In situations where a company has potential to operate profitably, this would never be in the interest of the company to be wound up.

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[125] Imtiaz Khan, 'The Unfair Prejudice and Investor Protection Remedy in Pakistan' (2014) 5 *Journal of Business Law* 388- 406,396

[126] Tasnim v Rustom Ali [2000]CLC 364; Israrul Haq v Al-Tahir Industries [2002] CLD 325. Empirical data source based on legal search engines. Civil Law Cases (CLC), PLD, Pakistan Law Journal (PLJ), Monthly Law Digest(MLD).

[127] Charlton v Baber [2003] NSWSC 745; Maher v Honeysett[2005]NSWSC 859.

The Ordinance provides for the remedy to wind up companies where courts find it just and equitable.[128]The winding up remedy has been provided by courts in Pakistan in some suits but with reluctance thinking that its consequences are drastic for both petitioner and respondents who might not be unwilling to shut down their enterprise if an aggrieved party is remedied adequately. This is why the remedy against managerial oppressions has been developed in English Law in order to provide an alternative to shutting down a business enterprise.[129]

Similarly, section 314 (2) of the Companies Ordinance 1984 provides for courts in Pakistan to consider first alternatives remedies before making an order for putting the enterprise to an end. In this regard, the judiciary has recognised the logic behind section 314 (2) to the effect to deny winding up remedy where making such order would likely prejudice respondent shareholders. For example, in Integrated technologies and Systems ltd v Interconnect Pakistan (pvt) Limited case, the court remarked that where making winding up order is likely to prejudice the respondent shareholders and the creditors, the petitioner should be directed to apply for oppressive remedy provided under section 290 of the Ordinance.[130]The unfair prejudice remedy is specifically aimed at protecting minority shareholders as majority shareholders do not really need it because they have voting power to safeguard their interests via passing special resolutions in members' meetings.

Section 290 of the Ordinance deals with the oppressive remedy and pre-condition provided for the right to litigate is to occupy at least 20 per cent voting shares.[131] This

[128] See section 305, the Companies Ordinance 1984.

[129] See section 994, the UK companies Act 2006.

[130] Integrated technologies and Systems ltd v Interconnect Pakistan (pvt) Limited[2001] CLC 2019 Lahore High Court.

[131] See section 290 , the Companies Ordinance 1984

demanding condition for seeking oppressive remedy has practically turned it into an inaccessible and an imperfect remedy. Consequently, it does not provide a mandated protection to minorities owning less than 20 per cent shares. There was some petitions dismissed *ab-initio* by courts merely because they did not meet the qualifying number of shares to bring actions against the wrongdoers.[132]The courts turned down even some genuine petitions lacking required 20 per cent voting shares to apply for oppressive remedy.

This is the reason why there are only few instances in which minorities sought judicial redress for the infringement of their private rights.[133]In fact, shareholders who own more than 20 per cent voting rights in listed companies are substantially capable of safeguarding their interests. Shareholders who own less than 20 per cent voting rights are the real vulnerable shareholder community which deserve protection against managerial misconducts. It is not always true that owning a certain percentage of shares would best measure the managerial wrong and the benefit of suit on share value.[134]

As a result, minorities representing less than 20 per cent are left with the only option of seeking remedy from civil courts provided under general civil laws. The remedies provided under general civil laws may be inadequate for disgruntled shareholders due to a number of reasons. First, it is inadequate in the sense that courts provide remedy

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[132] The cases turned down by courts for not meeting pre-condition of holding 20 per cent shares are; Shaukat Azizur Rehman v. Ghafur Textile Mills Ltd [1987]CLC 577; There are four cases from out of the total 32 application under section 290 of the ordinance which were rejected by courts for shareholders not meeting up 20 per cent shareholding requirement: This is based on search from authenticated search engines for law database; i.e Pakistan Law Journal, Pakistan Law Digest and Civil Law Cases.

[133] Since 1984 (after the Companies ordinance came into existence), only few cases were filed in courts by minorities against managerial actions unfairly affecting minorities' interests. This is based on search from authenticated search engines for law database; i.e Pakistan Law Journal, Pakistan Law Digest and Civil Law Cases.

[134] Harald baum and Dan w. puchniak, 'The derivative action: an economic, historical and practice-oriented approach' in Dan W. Puchniak (eds), The Derivative Action in Asia : A Comparative and Functional Approach (Cambridge University Press 30 July 2012)214.

only in terms of damages rather providing a specific remedy of corporate nature.[135] Second, on an average, civil court in the first instance takes five to six years to render a judgment and this time is further extended in first and second appeals.[136] Third, Claimants routinely seek interim and permanent injunctive relief against management before the final disposal of the case and the relief is granted as a matter of right, which ultimately engenders hindrance to firms' business.

The UK Companies Act 2006 confers right on every disgruntled shareholder to bring action against the wrongdoers in the company and there is no limit of particular number of shares to allow for litigation against errant managers.[137] Unfair prejudice remedy is an adequate legal redress mechanism in the UK for shareholders to safeguard their interests as it covers a wide range of managerial misconducts. Similarly, the Indian Companies Act 2013 allows every individual disgruntled shareholder to bring action against the errant managers.[138] Thus, there appears no justification why the law should not allow individual shareholders to bring action against the errant managers and to seek an appropriate remedy against managerial oppressions.

Moreover, section 290 has its open-ended language that on the one hand, creates a significant amount of ambiguity and uncertainty and on the other hand, confers excessive discretion on courts to exercise in defining 'oppressive act'. The provision does not provide guidelines for defining the managerial oppressive acts. The term 'oppressive act' can be illustrated in the context of company law; as where majorities exploit or waste corporate opportunities which are otherwise valuable to the company's

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[135] Ibid (n125) 392.

[136] Shah, Raza Ullah, Khan , Shadi Ullah, Farid , Sumera , 'Causes for delay in civil justice in Lower Courts of Pakistan : A review'(2014) 6(1) *Pakistan Journal of Criminology* 47-75,60.

[137] See section .994,The UK Companies Act 2006.

[138] See section 37, The Companies Act 2013, India.

future prospects,[139] compromising litigation on terms prejudicial to the interest of the company and ratifying wrongs in prejudicial manners.[140] Additionally, a managerial oppressive act may include management's deviation from the objects of the company.[141]A managerial oppression may also be defined in a sense where management deprives shareholders of their voting rights.[142] Also, the term, 'oppressive act' applies to claims of negligence provided that the managers were the beneficiary of the negligence.[143]

As stated above, section 290 of the Ordinance grants vast discretion to courts to exercise in determining managerial oppressive acts. As a result, courts interpreted managerial oppressions differently. For example, In Registrar v PICLD case,[144]the 'oppressive act' has been defined in restricted meanings. The court has ruled that an isolated violation of any provision of the Ordinance does not amount to an 'oppressive act' and therefore, the violator would get punishment for that particular violation but not for unfairly prejudiced act.

However, if management is involved in a series of violations of the provisions enshrined in the Ordinance, this would amount to an 'oppressive act' on the part of the management. In other words, a restricted interpretation of, 'purported act' allows minority interests to be expropriated by controlling shareholders so far as it involves an individual violation of any provision of the Ordinance. It is because of this reason that

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[139] Cock v Deeks [1961] 1 AC 554(PC)

[140] Atwool v Merryweather [1867] LR 5Eq 646; Burland v Earle [1902] AC 83,93;

[141] Estmanco (Kilner House) Ltd v Greater London Council [1982] 1WLR 2

[142] Andrei Shleifer, Robert W. Vishny, 'A Survey of Corporate Governance' (1997) 52(2)*The Journal of Finance* 737-783,751

[143] Pavlides v Jensen [1965] Ch 565; Daniel v Daniel [1978]CH406.

[144]Registrar of Companies v Pakistan Industrial and Commercial Leasing Ltd,[2005]CLD 463 Sind High Court 484

petitioners normally move courts and bring various allegations of unfair prejudice acts together in single petition with the purpose of reinforcing their claim. To prove various allegations of unfairly prejudicial act together in one petition is not easier as it requires rigorous evidence to produce in support of the claim which ultimately causes an over-lengthy pleading and further reduces chances to win the case.[145]

There are also instances of 'liberal' interpretation of managerial oppressions. For example, in the Pfizer Laboratories case, the court held that denial of dividend pay-outs amounts to managerial oppression on private rights of shareholders.[146] In fact, the term 'oppressive act' has been borrowed from the common law to the company law in Pakistan. The term, 'oppressive act' is applied in restricted meanings in common law whereas the term, 'unfair prejudice' possesses a wider scope as developed and enshrined in the UK Companies Act 2006.

In the UK, the word, oppressive act' was supplanted with 'Unfair Prejudice' with an object to give this remedy a liberal interpretation.[147] As a result, unfair prejudice remedy pursuant to section 994 of the Companies Act 2006 has become an attractive remedial tool in the UK to protect minorities because it covers a wide range of managerial oppressions and in doing so, provides an effective alternative to winding up remedy.[148]

Although, section 290 of the Ordinance extends excessive discretion and autonomy to courts in Pakistan to rule on managerial oppressions, yet they have failed to develop jurisprudence in this regard as either judiciary have given restricted interpretations to

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[145] Ibid (n125) 399.

[146] Pfizer Laboratories Ltd v Parke Davis &Co [2007] CLD 1047 SHC

[147] Scottish Co-operative Wholesale Society Ltd. v. Meyer [1959] A.C. 324, 342, as Earlier in the

[148] Ibid (n93) 277.

managerial oppressions or it has showed an apathetic attitude towards providing wide range of remedies to shareholders.

3.5.4 Why Derivative litigation is a more appropriate Remedy?

As stated earlier, derivative action and remedy against unfair prejudice are two different remedial vehicles.[149] In derivative action, shareholders bring action against wrongdoers on behalf of a wronged company; whereas, infringement of private rights are sought to be redressed by the use of unfair prejudice remedy. In unfair prejudice remedy, an aggrieved member of the company litigates in his own name and thus, he seeks the enforcement of his personal rights.[150] Derivative litigation ensures more added values for the company defrauded by its directors or controlling shareholders than the unfair prejudice remedy.[151] The following example highlights difference between the two and signifies the presence of derivative litigation as an important and separate remedy.

Suppose that a minority shareholder is seeking court order to have the majority shareholders buy his shares by reason of the wrongdoings of the majority shareholders. Suppose that the company was deprived of expected benefits worth eight million pounds to which the company otherwise would have been legally entitled but for the actions of the wrongdoer. This would obviously have a positive effect upon the value of the company and its shares.

If a lawyer advises a minority shareholder to present a simple petition of unfair prejudice remedy to seek court order for his shares to be purchased by the majorities, the lawyer would be giving an incorrect advice to his client. This is because the

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[149] Ibid (n93) 276; Darryl D. McDonough, 'Proposed New Statutory Derivative Action – Does it go far Enough?' (1996)8(1)*Bond Law Review* 47-72,62

[150] See, Altasview Ltd v Brightview Ltd [2004]All ER (Apr), [58]-[64]

[151] Law Commission, Shareholder Remedies (1997): para 6.11.

minority shareholder would lose uplift in the capital value which was apt to rise by reason of a successful derivative suit.[152] An appropriate advice would be to initiate derivative litigation and to apply for remedy against unfair prejudice. The unfair prejudice remedy proceedings could be stayed pending resolution of the derivative action, which, if successful, would result in ordering the wrongdoers to reimburse the company in respect of that loss. The stay on unfair prejudice remedy proceedings could then be lifted, safe in the knowledge that the increased value of minority shareholders' securities availed by the blessings of the successful derivative suit would be captured in any valuation of the shares ordered by the court as a result of successful petition for unfair prejudice remedy.

In this hypothetical scenario, a successful derivative suit can uplift the capital value of shares and pursuant to remedy against unfair prejudice would gain benefit for shareholders on transfer of their shares. This variability highlights the distinction between a derivative claim and an unfair prejudice remedy. Although these are similar and can operate hand in hand to make sure that both the harmed company and its shareholders can benefit the added value gained as a result of the successful derivative suit.[153] This has also been recognised by Australian courts that in situation where unfair prejudice remedy is actionable, derivative proceedings should also be preferred if the facts of both of the claims are similar.[154] It is, therefore, necessary to bear in mind that both the remedies are not alternative to each other and are not meant to seek the same redress. This was the reason the UK Law Commission recommended for these remedial

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[152] David Cabrelli,' Derivative Actions: Part of the Minority Shareholder's '' Forensic Arsenal'' in Scotland'(2003) 9 *Scots Law Times* 73-77,74

[153]As Lord Eassie stated in Wilson v Inverness Retail [2003] SLT 301,308 ; the consequent restoration to the company of its entitlement to its shares of the profit …does not necessarily resolve the issue of unfairness to the minority extensively canvassed in (CA 2006 , s. 994) proceedings .

[154] Ehsman v Nutectime International Ptv Ltd [2006]58 ACSR 7051.

vehicle to be treated as two separate remedies because, in some situations, derivative litigation is the most suitable remedy.[155]

The, 'no reflective loss' policy is another factor which underscores the importance of derivative claims. The 'no reflective loss' principle means that shareholders are not allowed to apply for a direct action where a loss suffered by them springs from the loss done to the company.[156] In the Stein v Blake case,[157] shareholders suffered loss in terms of decrease in the value of their shares and the same was caused by misrepresentation of the management. Indeed, loss of shareholder was not distinct from that of the company. In pursuant to the facts of the case, the court remarked that direct action is not available in events where a loss suffered by shareholders flows from the loss done to the company. Therefore, the court held that remedy available, in such situations, is a derivative suit, not a direct action.

For example, if a direct action is allowed in such situations, errant directors would be under obligation to pay damages to both companies as well as to their shareholders. This would result in multiple recoveries of damages, which are not allowed by the civil law provision which provides that damages for one wrong cannot be recovered twice.[158] It would, therefore, be appropriate to have the company recover damages and thus, aggrieved shareholders of the company would automatically be remedied. The, 'no

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[155] The UK Law Commission, Shareholder Remedies(1997): para 6.11.

[156] Day v Cock [2002] 1.B.CL.C.1 at 15; Johnson v Gore, Wood & Co [2002] 2 AC 1 (HL) 62; for more discussion on reflective loss see, Stephen Griffin, 'Shareholder remedies and the no reflective loss principle: problems surrounding the identification of a membership interest' (2010) 6 *Journal of business law* 461-473.

[157] Stein v Blake (No 2) [1998] 1 All ER 724 (CA)

[158] Article 13 of the Constitution of Pakistan, 1973; See section 26 of the General Clauses Act 1897;This principle traces back its history from a Latin Maxim, '*nemo debet bis vexeri prona at eadem causa'* that means that somebody should not be disturbed twice for same cause.

reflective loss' principle is, therefore, meant to avoid the risk of multiplicity of financial recoveries from the respondents.[159]

Moreover, the unfair prejudice remedy is, actually, considered as an exit remedy. Shareholders seek this remedy when they decide to leave the company by seeking court order for their shares to be purchased by the respondent.[160] In this respect, if the complainant's shares are purchased by the respondent upon the court order, it does not mean that the wrong done has been rectified in favour the company. On the other hand, in derivative litigation, shareholder claimants want to stay with the company and hence, bring action against wrongdoers for rectifying wrong done to the company and enforcing directors' duties they owe to the company. This means that derivative litigation is aimed at preserving corporate assets in the long term business prospects of the company.

Furthermore, chances of vexatious litigation in unfair prejudice remedy are more than in the derivative actions. To avoid vexatious litigation in derivative litigation, there is a filtration mechanism so as to allow only potentially genuine actions against the managers. For instance, a derivative action is based on two-stage trial. At first, it is ensured that application for a derivative suit is based on sufficient grounds in order for granting leave for the full hearing. On the other hand, there is as such no mechanism in unfair prejudice remedy. Additionally, it is not easy to establish a single irregularity on the part of management which is cause of action in unfair prejudice remedy. On the other hand, in derivative litigation, the cause of action is breach of directors' duties which is not as difficult to establish as a single irregularity is.

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[159]Stein v Blake (No 2) [1998] 1 All ER 724 (CA)

[160] The UK Law Commission, Shareholder Remedies (1997): para 6.11.

In fact, the basic purpose of shareholders' litigation is to punish wrongdoers by imposing civil and criminal liabilities and thus, to act as a deterrent against future managerial misconducts. The derivative proceedings have greater deterrence effects and economic benefits than the direct actions. For example, in the successful derivative suits, all the shareholders and non-shareholders stakeholders receive benefits whereas in the direct actions, only an individual aggrieved shareholder is enriched and no benefit comes to the company. As such, a successful direct action enriches an individual aggrieved shareholders and the central purpose of shareholder litigation which is to ensure that justice is done, is ignored.[161]

Additionally, it is possible that some aggrieved shareholders might not have resources to bring direct suits and as a result, the wrong would go unaddressed. This is opposed to the situation in derivative litigation where legal costs incurred on the litigation is borne by the company More so, in derivative proceedings , shareholders take actions on behalf of the wronged companies and other stockholders, and accordingly, success of the suits carries benefits for all the shareholders and even for stakeholders as well. The economic incentives for plaintiff's lawyer are also greater in derivative actions than in direct actions as a derivative action seeks redress of the violations of corporate rights but in the direct actions, only violation of the private rights of shareholders is sought to be remedied.[162]

Last but not the least, derivative actions are preferable in situations where the issue in dispute is common to all the shareholders or in the events where the affected shareholders are so large in number that taking all of them to courts is not viable.

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[161] Payne, Shareholders' Remedies Reassessed'(2004) 67 *MLR* 500,504

[162] John C Coffee , Donald E Schwartz, 'The Survival of the Derivative Suit: An Evaluation and Proposal for Legislative Reforms'(1981) 81(2) *Columbia Law Review* 261-336,295

3.6 Concluding Remarks

After having examined the rights and remedies of minority shareholders under the ordinance against wide-ranging managerial oppressions in Pakistan, it is found that the Ordinance does not provide for an adequate enforcement power to small investors as to safeguard their interests. There are a few toothless provisions placed here and there in the Ordinance regarding minority protection, but, these are imperfect and deficient and do not guarantee an adequate protection to minority shareholders. The Ordinance as such does not provide for an important remedy in the form of derivative action system - a major policeman of managerial integrity and accountability.

Significantly, it is found that the absence of derivative suits in Pakistan is due to restraints in common law derivative actions, legal impediments, legal costs incurring on derivative actions, prohibition of contingency fee and absence of statutory duties of directors and shareholders with majority voting power. It is, therefore, essential to consider the codification of derivative action system that may be used in complement to other minority protection mechanisms so as to offer a robust minority protection system in Pakistan.

Evidently, as it emerges from the problems as identified in the Foss v Harbottle rule, flaws of section 290 of the ordinance and the issue of legal costs combined together hamper shareholders' actions against directorial and managerial wrongdoings. Thus, the company law needs to be delineated on aspects of the enforcement powers of shareholders in order to keep pace with the new demands of the corporate sector. The legislators, policy makers and regulators need to take the issue of the expropriation of corporate assets into consideration and ought to devise tools for checks and balances against the wrongdoings of controlling shareholders.

The next part of this chapter will undertake an overview of the origin of Sharia law and its influences upon Muslim jurisdictions like that in Pakistan. Moreover, it will dilate upon discussion on the application of Sharia law in corporate matters and will elucidate the application of the Sharia concept of accountability in the Pakistani business environs. Finally and most importantly, the next part of this chapter will examine how sharia business principles can complement statutory law and further how they can work to fill in statutory law gaps in the protection of minority shareholders in Pakistan.

3.7 Role of Islamic considerations (Sharia law) to complement gaps in the statutory law

3.7.1 Role of equity: complementing rules/ laws

The term 'equity' connotes variegated ideas including body of rules and doctrines that emerged along the evolution of common law. Scholars relate its genesis to Aristotle's concept of '*epieikeia'* which is referred as to imparting flexibility to the law to avoid injustice. Exercise of equity is the sole discretion of the Courts.[163] There were problems such as the inadequate remedies of the common law, formality of the common law, non-recognition by the common law of certain essential remedies, in the common law system which gave way to the emergency of Equity.

Scholars appreciate the role of equity in a legal system not only as repository of rules or doctrines but consider it facilitating the dispensation of justice through its approach in legal reasoning, empowering courts for law-making process and providing a set of

[163] Shyamkrishna Balganesh, and Gideon Parchomovsky,'Equity's unstated domain: The role of equity in shaping copyright Law (2015) 163*University of Pennsylvania Law Review* 1859-2131, 1859

principles that render flexibility to broaden or restrict the legal interpretations. [164] Legal rules reflecting equity are an imperative for good corporate governance.[165]

Equity is a tool to complement the judicial system to administer justice on natural and ethical basis, fills lacunas of narrow definitions and supplements inadequate remedies. It ensures 'fairness, impartiality and justness' even going against the statutory laws. It may be inherent in the law or can be a borrowed principle from outside the system used to soften the judgements where callousness is imminent in following the law strictly.[166] Equity can replace the legal rules if they are found unyielding. It lies somewhere between law and ethics. Law would be rendered unjust without it.[167] It brings harmony and helps adapt law to the modern needs for a healthy societal development and moral improvement.[168]

Equity helped devise the procedures by which judicial power is used to dispense the specific relief.[169] In absence of legal norms to resolve a problem, equity comes to the rescue of judges. Even it can be preferred over a legal norm or taken as a workable alternative if an institutional injustice is feared.[170] It complemented the common law in a range of subjects by inventing new rights, relevant remedies and soft procedural mechanism in order to remove legal rigidity. New remedies created by equity were the

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[164] ibid 1859

[165] Olawale Ajai, 'Profit creation, intra and inter-generational Equity: Need for New Company Law' (2012) 2(2) *The Business and Management Review* 64, 64

[166] Andre-Jean Arnaud, 'Equity in Law' (2015) *International Encyclopaedia of the Social and Behavioural Sciences* 924-928, 924

[167] ibid 924

[168] Ibid 924

[169] Sheldon Tefft, 'A Note on the Role of Equity in the Curriculum of the Modern Law School' (1967) 3 *Duke Law Journal* 552-557, 555

[170] Ibid (n166) 924.

specific performance, rectification, rescission and injunctions which have wide application in dispensation of justice in the common law jurisdictions.

Issue of appropriate compensation confronts the minority in case a law permits freezeout. They resort to judiciary for a fair price determination. The shareholders can prefer action in equity for damages. Some courts allow only judicial appraisal as an appropriate remedy while other grant relief in equity.[171] Resort to equity by national and international courts is becoming a recurrent feature due to globalisation of views on law, justice and equity which is eradicating dissimilarities among the jurisdictions.[172]

3.7.2 Misconceptions about Sharia Law

Sharia is an Arabic word that literally means '*the way'.* Technically, it is an epitome of Islamic science of jurisprudence based on *Quran and Sunnah* (tradition of the Prophet Muhammad-PBUH)[173] as the primary sources. It determines the Muslims' way of life covering all aspects of their life be it temporal or divine.[174]

Sharia law has been viewed as 'primitive', 'inferior to Western law' or 'impracticable'[175] being a religious law. It is due to lack of knowledge about Sharia law, even amongst the public figures. Remarks of US Judges, Dobie of the Fourth Circuit Court of Appeals in 1941 and later Justice Frankfurt in 1944 while recording their dissenting notes, in *Clark v. Harleysville Mut. Casualty Co.* and *Terminiello*

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[171] Arthur Pinto, 'Protection of Close Corporation Minority Shareholders in the United States' (2014) 62.1 *American Journal of Comparative Law* 361-385, 370-71.

[172] Ibid (n 166) 927.

[173] Sharia law given by Prophet Muhammad (PBUH), came with his revelation, with a message calling for the oneness of worshipping one God.

[174]Abdulrahim Ali Ali, 'the role of Islamic Jurisprudencein finance and development in the Muslim world' (2013) 31(4) *Company Lawyer* 121-127,121

[175] Nicholas HD Foster, Islamic Perspectives on the Law of Business Organisations I: An Overview of the Classical Sharia and a Brief Comparison of the Sharia Regimes with Western-style Law' (2010) 11(1) *European Business Organisation Law Review* 3-34, 3-4.

v.Chicago respectively, are reflection of this stereotypism.[176] Max Weber also said that '*systematic law-making, aiming at legal uniformity or consistency, was impossible*' in Islamic Law.[177]

Currently, it has been witnessed reassertion of Islamic identity and increasing influence on the world economy. Consequently, awareness of importance of sharia law has been on rise though many of its areas, especially of business law, remain relatively inaccessible.[178] Sharia-compliant business solutions /practices that existed since centuries, attracted international attention and a boom thereafter consequent to the high increase oil prices.[179] Recent popularity of Sharia-compliant commercial products like Islamic banking, Islamic finance and Islamic insurance indicate revival of faith in Islamic corporate governance system. These Islamic commercial institutions complement and operate alongside secular (mainly Anglo-American) systems.[180]

Compatibility of Sharia-compliant (i.e. religion based) business framework with that of Anglo-American system has attracted tremendous interest due to rise in significance of Islamic business principles due to mutual trade amongst Muslims and Western world .[181] Therefore, now we find many experts like Makdisi, rebutting misconceptions about Sharia law. He opines that corpus of Islamic Law has been developed by its jurists not only from primary sources of *Quran and Sunnah* along with confirmatory sources and

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[176] *Clark v. Harleysville Mut. Casualty Co.* [1941] 123 F.2d 499, at 502 and *Terminiello v. Chicago* [1949] 337 U.S. 1, at 11 referred in John Makdisi, 'Legal Logic and Equity in Islamic Law' (1985) 33(1) *The American Journal of Comparative Law* 63-92, 64

[177] John Makdisi, 'Legal Logic and Equity in Islamic Law' (1985) 33(1) *The American Journal of Comparative Law* 63-92,64.

[178] Ibid (n175) 5.

[179] Aluyah Imoisili, 'Get the Facts on Dispute Resolution before Entering into a Takaful Venture' (2009) 113 (40) *National Underwriter*. P&C 14-16, 16

[180] Lilian Miles and Simon Goulding, 'Corporate Governance in Western (Anglo American) and Islamic Communities: Prospects for convergence?' (2010) 2 *Journal of Business Law* 126-149, 131

[181] ibid 128

consensus but a variety of legal reasoning techniques like *qiyas*, *istishab*, *istislah* and *istihsan* have been employed effectively.[182]

In another work, while discussing impacts of Sharia law on common law, Makdisi posits that, at least, three characteristics of the English law namely '*action of debt, the assize of novel dissesin, and trial by jury*,[183] are a direct outcome of Islamic influence. Similarly, the English law borrowed and adopted the concept of contractual obligation based on commutative justice from Islamic law in 12th century.[184]

However, commercial aspects of Sharia law remained under researched until recent growth of Islamic finance.[185] Islamic law is taken as 'religious law'- a contrast to state-based 'Western-style law, i.e. totally independent from ruler or the state [186] yet it covers every aspect of human life including rules and mechanisms for commercial transactions.[187] Sharia and western legal systems have been influencing each other and many a Sharia models were borrowed and adapted in Europe through interaction of traders from both the regimes.[188] Similarly, *Qadi* (judge) in Islamic courts is an impartial and neutral umpire like a judge in the English Courts.[189]

As both the systems served different societies with different needs, differences between the two would be a natural consequence.[190] Europe's industrial and institutional revolution, e.g. banking system, gave birth to modern concepts of stock / capital

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[182] Ibid (n 177) 66.

[183] John A. Makdisi, 'Islamic Origins of the Islamic Law' (1998) 77 *N.C.L. Rev* 1635-1740, 1635.

[184] Ibid 1653

[185] Ibid (n175) 3-4.

[186] Ibid (n175) 7.

[187] Ibid (n175) 7.

[188] Ibid (n175) 29.

[189] Ibid (n 183) 1707.

[190] Ibid (n175) 29.

markets and corporations having legal personality. On the other hand, sharia law functioned in simpler societies; therefore, it remained barren of producing such mechanisms.[191]

Capitalism was taken as a challenge to Islam and due to its over-emphasis on individualism and materialism; it lacks balance and harmony and ignores ethical dimensions of the society.[192] Many Muslims did not accept modern day stock business as permissible until recently and adhered to simple partnership businesses only. Now Islamic jurists have allowed ownership and businesses in modern forms, e.g. mutual funds, stocks, etc.[193] Countries like Saudi Arabia where Sharia is the main source of law or Pakistan where Islam is the state religion[194], sharia rules supplement the legal system.[195] Even in states with minority Muslim population, demands are made to apply Islamic laws on the Muslims at least. In Muslim-majority states, states continuously face pressures to Islamise legal orders.[196]

3.7.3 Sources of Sharia Law

The Quran, direct revelations to Muhammad (PBUH)-the Prophet of Islam, and Sunnah, the words and deeds of the Prophet are the major sources of Islamic law. In addition to this, reasoning techniques like *Qiyas* (analogy), *Ijma* (consensus), *Urf*

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[191] Ibid (n175) 30.

[192] Ibid (n180)131.

[193] Mahmoud A. El-Gamal, Partnership and Equity Investment' in *Islamic Finance: Law, Economics, and Practice* (Cambridge University Press 2006) 117-134, 117

[194] The State constitution Article 2 provides that no law will be legislated repugnant to Islamic injunctions**.** For this purpose institutions of Federal Shariat Court **(**Article 203C of the Islamic Republic of Pakistan) and Council of Islamic Ideology **(**Article 228 of the Islamic Republic of Pakistan) have been set up where the former is empowered, at its own or on the petition of a citizen or Federal and / or Provincial government, to review the conformity of existing laws with the Sharia (Article 203D of the Islamic Republic of Pakistan) and whereas the later shall be a recommendatory body advising the parliament and the federal and provincial governments on legislating laws according to injunctions of Islam, i.e. Sharia law, so to say **(**Article 230 of the Islamic Republic of Pakistan)**.**

[195] Ibid (n175) 8.

[196]Ibid (n175) 4.

*(*custom), *Ijtihad* (an effort to interpret the will of God in light of Quran and Sunnah) have also helped to erect edifice of the Islamic jurisprudence (*Usul al Fiqh*). These tools helped promote creativity in Sharia Law and its congruence to the modern condition and requirements.[197]

The reasoning techniques helped an organic growth of Sharia law imbibing the changes of time. For example, it is *Istihsan that* allows admission of new rules into the body of Islamic law. It also allows extension or restriction of the existing laws on the basis of social necessity, interests, convenience or social ease.[198] It helped *Qiyas* broaden its scope through use of arguments by analogy, argument *a fortiori*, argument *a majore ad minus*, argument *a minore ad majus* or argument a *contraria*. Ultimately, legal reasoning developed and applied through *Qiyas* imparted flexibility to law. *Istihsan* is indeed a hidden analogy (*Qiyas)* which helped reconcile the solutions to sources of Islamic law. This reconciliation keeps the spirit and ends of law in sight rather than literal interpretation.[199] Establishing a similarity or difference between two things through reasoning by analogy is 'methodological device for correcting mistakes or omissions'. [200] *Istihsan* performs this role quite aptly.

Imam Malik used *Istihsan* in some of his fatawa (formal legal opinions).[201] Later on, this Sharia tool was exercised by many Islamic jurists and judges of the Islamic era in delivering their legal opinions. Yahya ibn Yahya, the then chief justice of Spain had the best knowledge of the fiqh of Malik. Moreover, some cases and problems taken by

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[197] Ibid (n175) 6.

[198] Emile Tyan 'Méthodologie et sources du droit en Islam (Istiḥsān, Istiṣlāḥ, Siyāsa šarʿiyya)' (1959) Studia Islamica 79-109 referred in Ibid (n 177) 68.

[199]Ibid (n 177) 68-69.

[200]Ibid (n 177) 84.

[201] Dr. Hussain Hamid Hassan, *An Introduction to the Study of Islamic Law* (Leaf Publications 1997) 104.

some of the Iraqi people to Asad ibn al-Furat upon which Ibn al Qasim gave his formal legal opinions according to the Malik' legal doctrine.

The jurists have given its example by the case of imposition of a liability on the artisans for the destruction or damage of the article handed over to them for working on payment of charges to them for the work.[202] The general rule inquires that there should be liability on their part, because originally they are the trustees of a deposit in trust, and a trustee is not liable for loss of the deposit, as if the view of imposing a liability on the artisans were an exception to the general rule in public interest. The reason of public interest is that imposition of a liability on them ensures protection of the property of owners of the articles. That happened after the power of religion over the hearts of the people had become weak and treachery prevailed among the class of artisans. If we do not to take decision of imposing a liability on them, the artisans would make that a means to the claim of damage or destruction, the owners of the articles will be unable to establish their transgression or negligence, and thus the property will be lost. Therefore, Malik held that they would be liable until they proved that damage or destruction, was not caused by a transgression or negligence on their part, even some scholars impose a liability on them even through they prove that in order to block the means.

The sharia law fills the crevices appearing in its own building blocks through time change. The techniques, especially *Istihsan* and *Istislah* played a role to fill the statutory gaps and complement laws as was done by equity in English law. Business based on the principles of equity and fairness only can qualify as Sharia-compliant

[202] Ibid 182.

deal.[203]Thus, it erects ethical system on such sound and universal basis where every good corporate practice becomes as mandatory as religious obligation and commercial act of a Muslim becomes *ibadah* (worship of God).

3.7.4 Objectives of Sharia Law and its fundamental business ethics

The Quran also declares trade as an act liked by God and does not prohibit creation of wealth through rightful means, i.e. it should base on *ihsan* (goodness), *tawhid* (unity of God), *tawakkal* (trust in God) and *falah* (material and spiritual wellbeing of self and others/ society).[204] Prophet Muhammad (PBUH) himself had been involved in trade personally before launch of his prophetic mission since trade was an important activity among the Arab tribes and different commodities from the interior of Africa and Europe were brought and sold there. The standards of morality applied in commerce were at par with religious morality. Hence, these standards coupled with pragmatism found way into business ethics/ legal system of Islam.[205]

Business ethics in the modern times are being globalised rapidly and their success depends on defining a universal discourse on normative behaviour patterns.[206] In Islamic world, Arabic word *'Ekhlaq El-Mahayne'* is the term used for religious morality but has been adopted in the business world as an equivalent to professional morality.[207] Unlike western law, where morality and religion are separate from each

[203] Ibid (n 179) 14.

[204]Ibid (n180) 133.

[205]Ibid (n175) 8.

[206] Dove Izraeli, 'Business ethics in the Middle East' (1997) 16 (14) *Journal of Business Ethics* 1555-1560,1559

[207] Ibid 1556.

other,[208] sharia does not separate secular and religious principles.[209] Therefore, sharia is corpus of mandatory laws for a Muslim in his business affairs as well.[210]

Justice is fundamental to any ethics or law. It is the very cardinal principle of Islamic legal system and plays a pivotal role in business ethics as well. Verse 135 of Chapter IV (surah Al-Nisa) in the Quran demands believers to maintain justice and stand witness for justice, be it against one's own self or parents or the near relative, rich or poor. Such an injunction calls for equal treatment in commercial relationships/ partnerships. [211]

Similarly, integrity, honesty and good ethics, etc. are the hallmark of Islamic way of life which being the ideal morals for strong corporate governance are not foreign to Islamic financial institutions. Without these morals, the corporate governance is rendered weak which may damage the social, environmental and human spheres.[212] Islamic ethics do not differentiate between secular and religious obligations. Every act of a Muslim, (including business activities), is *ibadah (*worship of God) if it is according to morals and ethics of Islam.[213]

In business ethics, it is the fiduciary relationship which makes or breaks a business. Mostly its break is the cause of litigation. The modern business Corporations exist on basis of contracts that determine the legal relationships among the stakeholders. The most important feature of the contract is the fiduciary relationship among the

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[208] Nicholas HD Foster, Islamic Perspectives on the Law of Business Organisations II: The sharia and Western-style Business Organisations' (2010) 11(02) *European Business Organisation Law Review* 273-307, 296.

[209]Lu'aay Minwer AL-Rimawi, 'Relevance of Sharia in Arab Securities Regulation with particular emphasis on Jordan as an Arab Regulatory model' (2006) 27(8*) Company Lawyer*, 227

[210]Haykel Hajjaji, 'Shareholders' agreements and Islamic Financing' (2009) 5 *International Business Law Journa*l, 556

[211] Ibid (n 175) 9.

[212] Ashraf Wajdi Dusuki, 'Corporate governance and stakeholder management: An Islamic perspective' (2011) 15(2) *Review of Islamic Economics* 5-23, 6.

[213] Ibid (n180)133.

shareholders and between management (Directors) and the shareholders. Sharia law's concepts of *wakala* (agency) and *kafala* (guarantee) defines relationships of partners or co-owners of an interest as agent and guarantor. Role of directors in a company can be that of *'inan* (literally meaning 'reins') where a partner/shareholder is restrained (as if by reins) from enjoying the wealth of co-owners/ shareholders unbridled. [214]

Contracts are basically legal promises. Sharia business ethics also impress upon its importance to the extent that it is considered extension of the covenant (*al mithaq)* between God and man which imposes on him duty to be faithful to Him and the breach of which will entail dire consequences in this world and the hereafter as well. This primordial covenant determines nature of human relationship in society including secular relationships in commercial arena which demands cooperation and forbids damage to others.[215]

Another fundamental of human (including commercial) life is removing hardships to create ease - one of the cherished objectives of Sharia. [216] Therefore, enjoyment of property for lawful profit making is allowed but using it to create nuisance for people through means like extravagance, hoarding, etc. is clearly *haram (*forbidden). [217] The agency problem arises when the agent (management) tries to maximise their interests at the expense of principal (shareholders).[218] Sharia law, contrary to a purely materialistic approach, ordains to attain societal justice and equality through obligation of *zakah* (compulsory charity) and *sadaqah* (voluntary charity). This approach is equally

[214] Ibid (n 175) 16.

[215] Ibid (n212) 12.

[216] Ibid (n 175) 9.

[217] Ibid (n 175) 10.

[218] Ibid (n212) 7.

applicable in business dealings, to help the less fortunate by the well off. [219] Thus, Sharia law envisages a corporate governance system where organisation is obliged to protect small investors through ease or removal of hardships and 'sensation of equality'.[220]

Protecting the stakeholders against the business risks is cardinal ingredient of governance structure expounded by Islamic law. It is reinforced through the concepts of *masalahah* {seeking benefit (*manafah*) or removing harm (*mudarra*)} which become a tool to achieve sublime objectives of Shariah to preserve human life, reason and property, etc. Opposite of *masalah* is '*mafsadah'* which is construed as a failure on part of a believer to fulfil the divine obligation.[221] Following this objective, Sharia does not allow profit making on the expense of others. Other concepts of *al-kharaj bi aldaman* and *al-ghunm bi alghurm* call for profit through risk and corresponding liability only.[222] These determine very sound principles of business ethics that promote the positive within an organisation and curb the negative.

Sharia law also recognises essential elements of a contract like parties, free consent, intention and offer and acceptance, etc. [223] Keeping agreements after conclusion of contracts is the most important objective of western as well as Sharia law. Quran clearly ordains to fulfil obligations or 'undertakings'[224] that include commercial as well as other temporal commitments (Verse 1 of Chapter V- *Al M'aida*) which is equal of

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[219] Ibid 14.

[220] Nawal Kasim, Sheila Nu Htay, Syed Ahmed Salman, Conceptual Framework for Sharia Corporate Governance with Special Focus on Islamic Capital Market in Malaysia (2013) 4(5) *International Journal of Trade Economics and Finance* 336-338,336.

[221] Ibid (n212) 15.

[222] Ibid (n 175) 10.

[223] Ibid (n 175) 10.

[224] Ibid (n 175) 10.

the legal maxim '*pacta sunt servanda'*.[225] Islam considers the fulfilment of contracts (business or of any other type) in high regard and their fulfilment is a duty to God.[226] These promises/contracts are equally binding before God (Quran 17:34) and are enforceable.[227]

A Muslim businessman should not cheat or manipulate in his business dealings. Mutual consent, with the full disclosure of information, is must for sale and purchase of goods. Violators of these ethics are bound to lose blessings of God.[228] Islam prohibits *riba* (usury) for it being exploitative but encourages equity holdings, partnerships and trading. Islamic law is distinct due its value system like respect for private property, reward for work, aversion to hoarding and monopoly and social responsibility through (zakat/tax). Concepts of partnership, reward, and risk are identical between Islamic and western laws.[229]

Sharia law, therefore, provides a set of ethics, moral principles, values and standards for a model corporate behaviour not of a company as an entity itself but for all the stakeholders thereof. These Sharia injunctions can complement business ethics in any law, culture or a legal system.

3.7.5 How Sharia Law can play a moderating role in corporate governance.

Sharia law can play a moderating role in finding solutions to the challenges besetting the corporate governance in the modern especially the developing world. One of such challenges is excessive debt creation by the companies. The panacea for these

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[225] Ibid (n 175) 11.

[226] Ibid (n180)133.

[227] Ibid (n 183) 1654.

[228] Ibid (n180)134.

[229] Ibid (n 201) 230.

challenges is risk-sharing rather than risk-shifting. Islamic corporate governance envisages promotion of risk-sharing policy. Substituting debt-creating instruments with risk-sharing ones can work as anti-crises for a dilapidated corporate culture.[230]

Sharia law, like modern western commercial law, offers a variety of mechanisms to put in place a flexible and pragmatic regime for facilitation and regulation of capital exploitation either through a *sharika (*partnership) or *mudaraba* (a limited company). But an enormous challenge within the corporations (*mudaraba*) is maintaining fiduciary relationships among the stakeholders. Legal thinking of Islamic and western systems is similar. For example, concept of fiduciary relations and duties of English law are similar to that of *'amana'* (trsut) in Sharia law.[231]

The businessman must fulfil moral (fiduciary) obligations towards his co-businessmen, employees, consumers and even environment through trustworthiness, equity, and benevolence. Resources available at one's disposal cannot be misused, corrupted or polluted.[232] Therefore, Sharia plays a moderating role by directing to follow Islamic ethics not for one's own benefits only but for the welfare of others, including the society as a whole.

On the other hand, benefit of shareholders gets supremacy in Anglo-Saxon corporate governance model where morality and religion are separate from each other. Religion is a personal matter and secondary to profit maximisation duty of the management.[233] Every believer, called a shepherd in a *Hadith*, is supposed to be guardian of those under his care or to those whom with he has a fiduciary relationship. Hence, it is obliged to

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[230] Mohammad Al-Suhaibani, and Nadar Naifar, 'Islamic Corporate Governance: Risk-Sharing and Islamic Preferred Shares' (2014) 124 (4) *Journal of Business Ethics* 623-632, 623.

[231]Ibid (n 175) 28.

[232] Ibid (n180)135.

[233] Ibid (n 208) 296.

provide the best possible care, advice, guidance and vision within his business enterprise.[234]

The gigantic challenge for indigenous (stakeholders) as well as extraneous (state, courts, etc.) actors is to put in place the effective measure for corporate accountability. State-enacted laws or systems (i.e. western system to be precise) keep on legislating and adjudicating to reinforce these protections. Sharia law, along with playing a moderating role discussed above, also overcomes this challenge through its complementary role to fill the statutory gaps.

Apart from imparting this fervour and zeal to its followers, Sharia law envisages a business to work not for benefit maximisation only but for the value maximisation which encompasses the larger objectives of societal welfare too, that have become basis of modern corporate social responsibility (CSR). Unlike western law, Sharia does not separate secular and religious morality principles.[235] Therefore, integrity, honesty and good ethics, etc. do not remain the moral principles only but become mandatory law in the corporate world. We find Sharia playing an overarching complementary role, i.e. it fills legal gaps not for an individual organisation but for the legal, economic and social systems simultaneously.

Though many scholars show indifference to Islamic commercial systems, yet there are some who think that it cannot only reform but complement the ethical corporate governance.[236] It can be taken as an alternative model because it promotes instruments which ensure equity and risk sharing.[237] Abu Tapanjeh, comparing Islamic principles

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[234] Ibid (n180)135.

[235] Ibid (n 209) 227.

[236] Ibid (n 230) 631.

[237] Ibid (n230) 631.

with OECD principles of 1999, which are considered as standardised and fundamental corporate governance principles, opines that Islamic corporate structure embodies the same conventional principles of justice, honesty and fairness and prohibits all forms of exploitation.[238] According to the OECD definition of corporate governance, it denotes 'the set of relationships between a company's management, its board, its stakeholders and other stakeholders'.[239]Corporate accountability and material information to shareholders are essential ingredients of good corporate governance that help achieve objectives of fair treatment of all the stakeholders.[240]

Twelve principles of OECD focus business ethics, fair and just decision making, accountability and the mechanism for maintaining books of accounts.[241] Like OECD's concept of business ethics, Sharia law also promotes transparency and equal rule of law when it ordains not to betray or exploit one's partners, business should not be for maximising profit only (i.e. should not ignore the welfare) and a believer should not be lazy or unproductive. Even the Holy Quran clearly says that the believers are ranked according to (degree of goodness of) their deeds (6:132).[242] In this context, we find western corporate governance 'profit driven' (being product of market economy) while the Islamic obligations call for 'value maximisation'. Therefore, Islam's requirements go beyond profit-seeking that cover the modern day concept of Corporate Social Responsibilities (CSR) equally.[243]

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[238]Abdussalam Mahmoud Abu-Tapanjeh, 'Corporate governance from Islamic Perspective: A comparative analysis with OECD Principles' (2009) 20 (5) *Critical Perspective on Accounting* 556-567, 557.

[239] Ibid 558.

[240] Ibid 558.

[241] Ibid 560.

[242] Ibid 562.

[243] Ibid (n180)136.

There are experts who view Sharia law as a practical regime that can serve the contemporary commercial legal requirements.[244] But fact of the matter is that in the corporate arena, development of Sharia-compliant products could not keep pace with the demand due to non-availability of sharia law experts in the relevant field.[245] On the other hand, interest in sharia-compliant business is increasing due to the perception that conduct of business in today's world lacks a moral dimension. [246]

Many academics advocate and highlight the need for associating business transactions with religious faith and ethical beliefs. They are of the view that Western ethical values are of purely utilitarian nature and are void of spiritual approach.[247] In contrast, Islamic business ethics are considered as utilitarian and humane alike due to their clear emphasis on sacrifice, brotherhood, truthfulness, trustworthiness, justice, brotherhood and above all the fear of divine accountability before God. Unlike 'shareholder primacy' model of the West, corporate governance and the corporate social responsibility become one under sharia law.[248] This is why Sharia-compliant commercial products like Islamic banking, Islamic finance and Islamic insurance have gained popularity. However, sharia law cannot act exclusively and directly so as to address the issue of managerial transgressions and protection of shareholders; the states shall keep on resorting to the western model for installing the complex corporate system and chipping in the ethics code from Sharia law.

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[244] Ibid (n 175) 27.

[245] Wafik Grais, and Wasim Rajhi, 'Islamic finance, contagion effects, spillovers and monetary policy' (2015) 6 (2) *Journal of Islamic Accounting and Business Research* 208-221, 210.

[246] Ibid (n180)129 30.

[247] Nicholas HD Foster, Islamic Perspectives on the Law of Business Organisations II: The sharia and Western-style Business Organisations' (2010) 11(02) *European Business Organisation Law Review* 273-307, 297.

[248] Ibid 297.

3.7.6 Its function as the concept of equity in UK to fill statutory gaps

Sharia law is not stagnant as its critics have been describing it. It allows exercising various legal reasoning techniques in addition to primary sources. Logically, allowance for expanding the scope through reasoning techniques developed to overcome new problems, is evidence that this legal systems allows its sources to play a complementary role to fill the statutory gaps. One such source in addition to primary sources Quran and Sunnah and the secondary sources based on reasoning techniques discussed above is the use of legal maxims in Islamic law. Islamic legal maxims come from variety of sources, Quran, traditions of the prophet (PBUH), sayings of his companions or / and *fuqaha* and *mujtahid (*jurisprudence experts). [249] Opinion or *fatwa* (decree) of *fuqaha* and *mujtahid* attains the force of a valid law. Imam al-Shafi is famous for his saying that *'who practices juristic preference, legislates'*.[250]

Every science has certain basic rules. In Arabic, the word '*qa'ida'* which means 'a foundation' is also used for a 'comprehensive rule that is applicable to all parts or components'.[251] Hence, *qai'da* or a basic rule in Islamic jurisprudence[252] is such that is generally applicable in cases falling under that particular subject but may not be covering everything. These rules may not be all-embracing maxims but may comprise legal basics capable of dealing with similar subject and circumstances. [253] However, they cannot be taken as permanent proof of Sharia law as they remain subject to

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[249] Dr. Hafiz Abdul Ghani, 'A Study of the History of Legal Maxims of Islamic Law' (2012) 1(2) *International Journal of Arts and Commerce* 90-99, 95.

[250] Felicitas Opwis, 'the Construction of Madhhab Authority: Ibn Taymiyya's Interpretation of Juristic Preference (Istihsan)' 2008 15 (2) *Islamic Law and Society* 219-249, 224

[251] Ibid (n 249) 90-91.

[252] Muhammad Hashim Kamali, 'Legal maxims and the other genres of literature in Islamic Jurisprudence' (2006) 20 (1)*Arab Law Quarterly* 77-101, 77

[253] Ibid (n 249) 90-91.

primary sources, i.e. *Quran and Sunnah*. The 'synoptic and abstract' character of maxims renders them versatile and timeless.[254]

Kamali explains the maxims in Sharia law as under:-[255]

"Legal maxims are theoretical abstractions in the form, usually, of short epithetical statements that are expressive, often in a few words, of the goals and objectives of Sharia. They consist mainly of statements of principles that are derived from the detailed reading of the rules of 'fiqh' on various themes"

In Western law, legal maxims are neither source of law nor a law in itself but a tool to understand or explain a law. Muslim jurists (*fuqaha)* take agreed upon rules as legal maxims for they are applied to derive meanings from injunctions.[256] Legal maxims in Islamic law also function to make a reconciliatory bond between different sources of Sharia and formulate a new law.[257]Discussing the history and functions of legal maxims in Sharia at length, Kamali aptly concludes that "…..*the legal maxims and statutes are not substitutes for one another. Legal maxims can play a supplementary role to substantial legislation in the Sharia dominate fields.*"[258]

Solving issues without maxims in sharia law will create complication.[259] Determination of these basic rules, i.e. maxims in Sharia law was started by the Companions of the Prophet (PBUH).[260] The practice of referring to precedents (*stare decisis)* is same in

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[254] Ibid (n 252) 100.

[255]Ibid (n 252) 80.

[256] Ibid (n 249) 92.

[257] Ibid (n 249) 93.

[258] Ibid (n 252)101.

[259] Ibid (n 249) 94.

[260] The companions of the Prophet (PBUH) had started inferring basic principles/ rules from the Holy Quran, e.g. the principle that later injunction supersedes the earlier one was determined by Abdullah bin Masud, the Governor of Kufa, while deciding the case of period of *idaa'* for woman whose husband had

Western law. They did not emerge abruptly rather matured and were refined by the sage minds, i.e. *fuqaha* over a long span of time[261] and play a complementary and moderating role as the *stare decisis* do.

Legal maxims are derived from Quran and Hadith and their wording subsequently refined by the leading jurists. Even if they do not reiterate a ruling of Quran or Hadith, these maxims are not meant to have binding effects on judges and jurists but entail a persuasive influence on the application of judicial mind and decisions. Legal maxims are meant to help understand a subject matter rather than its enforcement.[262] Some of them fit in legal systems just like equity in the English law.[263] Kamali classifies legal maxims into two groups. First group (normative legal maxims) contains five leading maxims which he considers most comprehensive applying to all matters related to *fiqh*. They are; *"harm must be eliminated"*; *"acts are judged by their goals and purposes"; "certainty is not overruled by doubt"; "hardship begets facility";* and *"custom is the basis of judgement".*[264]

At times, legal maxims of Sharia law look exact replica of those found in the English law. For example, *'equity looks to the intent rather than the form'*[265] is exactly what Islamic legal maxim *'"acts are judged by their goals and purposes"*[266] means and stands for. Almost every legal maxim of English equity law can find an exact equal in

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passed away while she was pregnant. He compared two verses from surah Al Talaq and Surah Alnisa.Ibid (n 249) 94.

[261] Ibid (n 249) 95. For a list of works by Muslim *fuqaha* containing Islamic legal maxims see pages 96-98.

[262] Ibid (n 252) 80.

[263] Few examples, which can be taken legal maxims of equity, are worth quoting here: "Matters go with their aims and objectives", "neither suffer loss nor cause others to suffer loss"; "The punishment (*hud)* is suspended where suspicion creeps"; "the responsibility of paying penalty lies on the shoulder of the one who benefits", etc. See Ibid (n 249), 95.

[264] Ibid (n 252) 82.

[265] Ibid (n166) 925.

[266] Ibid (n 252) 82

Sharia law or one that would be very close in meaning and purpose. Another type, subsidiary maxims are the ones that have been derived from these leading maxims.[267] Some maxims are direct rendering of Hadith, e.g. "*the profit follows the responsibility*." Therefore, here we see that Sharia law fills a law gap by providing an equity principle that the ones responsible for upkeep and maintenance of an asset will enjoy the profit/ yield.[268]

Modern codified law is descendent of laws contained in legal maxims. Brevity, illustration and ratiocination are the characteristics of maxims endowed to the statutes now days.[269] Continuing the same streak in his conclusion, Kamali further elaborates that application of these maxims is being revived in banking and finance sectors. He proposes that Islamic legal maxims can also play a supplementary role to the statutory laws by adding them as appendix, introduction or explanatory memorandum not only for understanding and consolidation of legal concepts but also for facilitating interpretation and enforcement of laws by lawyers and judges to protect shareholders.[270]

In sharia law, inter-scholastic differences over legal maxims are negligible. They provide useful insight into purpose of the law.[271] Legal maxims provide an efficient understanding of *maqasid (*objectives) of sharia.[272] Main role of sharia in commercial

[267] Ibid (n 252) 88.

[268]Ibid (n 252) 90.

[269] Ibid (n 252) 101.

[270] Ibid (n 252) 101.

[271]Ibid (n 252) 77.

[272] Ibid (n 252) 77.

transactions is to fill statutory gaps.[273] Therefore, sharia can help draw general principles to fill gaps as the non-codified laws in the form of equity do in England.

A legal solution derived from *Quran and Sunnah* by employing analogy for legal reasoning may be rejected by the Islamic Jurists in favour of a solution justified by equity.[274] Some scholars hold that the concept of *Istihsan* in Islamic law, which stands for 'good' or 'what deems well', embodies the notion of equity.[275] Some Islamic law experts take principle of *Istihsan* as counterpart of English concept of equity,[276] 'preference of stronger base of law over the weaker',[277] and as a 'mitigating agent'[278] in the body of law. Equity as a tool to achieve public utility or common good finds support from Islamic law scholars. Therefore, *Istihsan* was used as a tool to seek the best/ the most suitable equitable solution. It also helped implement law through application of human reason in absence of specific injunction from *Quran and Sunnah* to achieve the sublime goal of 'equity' and 'public interest'[279] which are the objectives very dear to God. For example, on the basis of *Istihsan*, methods of evidence in the law were extended to photograph, audio and video recording and acceptance of deoxyribonucleic acid (DNA) as a means of evidence in view of current changing social conditions.

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[273]Ibid (n 209) 228.

[274] John Makdisi, 'Legal Logic and Equity in Islamic Law' (1985) 33(1) *The American Journal of Comparative Law* 63-92, 67.

[275]Ibid (n 177) 67.

[276] Ibid (n 177) 70

[277] Ibid (n 177) 71.

[278]Ibid (n 177) 72.

[279] Ibid (n 177) 69-70.

But many a scholars viewed the application of *Istihsan* limited within the sources of *Quran and Sunnah* and do not consider it an equal of 'equity'. [280] However, there is another alternative concept of equal efficacy, called *Istislah* (consideration of the public interest), construed to be a '*process of legal reasoning used to fill the gaps in the law*'. [281] It added a new dimension to Islamic jurisprudence and broadened its scope to find solutions to new problems as it permits finding intention of the lawgiver even beyond the literal confines of *Quran and Sunnah.*[282] Therefore, *Istihsan* combined with *Istislah* comes closer to the English concept of equity and can play effective role for minority protection in the same fashion and style. [283]

Gaps in the law cannot be filled through Qiyas (analogy) in every condition. The common law recognises 'a reasoned distinction of precedent' as corrective equivalent whereof is the *Istihsan* (Juristic Preference) in Islamic law to replace a faulty reasoning by analogy with better one. *Istihsan* fills the gap in law through notion of public policy by applying what is 'right, just, fair, convenient or conducive' to harmony.[284] Further, even statutory gap unaddressed by *Istihsan* can be filled by *Istislah* (consideration of public interest, another model of legal reasoning in Islamic law).[285]

The English concept of equity is considered as antithesis of Islamic law because the former is considered to derive its acceptance and legitimacy from the doctrine of natural right or Aristotle's concept of justice beyond legal positivism whereas the later

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[280] Hussain Hamid Hassan , An introduction to the study of Islamic Law (Leaf Publication Islamabad , 1997) 194-210. for detailed discussion under the sub-heading 'CONCEPT OF ISTIHSAN HELD BY ISLAMC JURISTS' 222.

[281]Ibid (n 177) 79.

[282] Ibid (n 177) 80.

[283] Ibid (n 177) 80.

[284] John Makdisi, 'Hard Cases and Human Judgement in Islamic and Common Law' (1991) 2 *Indiana International and Company Law Review* 191-219, 203.

[285] Ibid 202

places its reliance on revealed word of God in the form of *Quran and Sunnah*.[286] But now there is a clear tendency among the Islamic scholars towards rational interpretations of *Quran and Sunnah* narratives and eliminating the supernatural ones.[287] Consequently, it is eliminating the notional differences on equity between the two systems. As far as importance and nature of role of equity is concerned, both Sharia and the English law systems are identical. But again, the Sharia law gets precedence due to divine emphasis on observance of equity when we find Quran saying "those who avoid equity are fuel of hell." (Quran 72:15).[288]

3.7.7 Complementary role of Sharia Law in the protection of Shareholders

The field of business ethics is underdeveloped and not institutionalised yet. Governments keep on fighting the managerial and directorial transgressions, in businesses through various agencies and mechanisms.[289] Sharia does not address issue of small investor protection directly. Nor it is the role of sharia to provide a complete framework for protection of minority rights or enforcement of compensatory measures.[290] It acknowledges diverse interests and rights of stakeholders proportionate to their investments and sets an efficient foundation for minority protection by making their treatment under the principles of justice, fairness and equality before the eyes of law.[291]

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[286] Ibid (n 177) 67.

[287] Serjeant RB, JMS Baljon: Modern Muslim Koran Interpretation (1880-1960). X, 135pp. Leiden: E. J. Brill, 1961. Guilders 19' (1963) 26 (2) *Bulletin of the School of Oriental and African Studies, University of London* 428-429, 428.

[288] Ibid (n 183) 1707.

[289] Ibid (n 206)1555.

[290] Fath el Rahman Abdalla El Sheikh, *The legal regime of foreign private investment in Sudan and Saudi Arabia* (Cambridge University Press 2003) 354

[291]Haykel Hajjaji, 'Shareholders' agreements and Islamic Financing' (2009) 5 *International Business Law Journal*,563

The rules for protection against abuse by the majority are to be determined from within the Sharia ideals.[292] Sharia law provides general principles leaving the detailed mechanism to be devised by the state authorities. However, Sharia principles and state enacted laws combined together can form a sound edifice for minority protection. Similarly, procedures are the bylaws or *modus operandi* which cannot be found in Sharia. However, a corporation can benefit from Sharia in formulating these procedures imbibing high standards of corporate accountability.

Where there are no explicit rules, *masalaha* or *istisla*, implements the intent of law. It provides venue for open-ended development, breaks rigidity, and rejuvenates the law by giving it a new meaning.[293] This concept discourages stagnation by allowing incorporation of changes with the passage of time. One *masalaha* useful today may become redundant or an '*evil*'[294] tomorrow. If this is not the case, Sharia law, or any other law for that matter, will fail to serve the needs of public interest which will be contrary to its purpose. The principle of *ibaha (*permissibility) keeps avenues for innovation open but within the domain of sharia objectives,[295] thus, performing the moderating and complementary roles incessantly and universally.

Though many scholars show indifference to Islamic commercial systems yet there are some who think that it cannot only reform but complement the ethical corporate governance.[296] It can be taken as an alternative model because it promotes instruments

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[292] Ibid (n 290) 122.

[293] Ibid (n 284) 216.

[294] Malcolm H. Kerr, *The Political and Legal Theories of Mohammad Abduh and Rashid Rida* (Berkley: University of California Press 1966), 84

[295]Ibid (n 175) 10.

[296] Ibid (230) 631.

which ensure equity and risk sharing.[297] Social and ethical purpose, in addition to profit maximisation, is the unique hallmark of Islamic corporate governance.[298] Islam idealises 'value maximisation' rather than 'profit maximisation', to rule out a selfish behaviour altogether.[299] Narrowing the distributional gap and maximum utilisation of economic resources is objective of Sharia law.[300]

Expropriation of corporate assets by the controllers is the biggest venue for managerial transgressions in corporations in Pakistan. The equitable rule demands that a director as a fiduciary must not enter in engagements in which he has a personal interest conflicting the interests of shareholders.[301]

It is not only a fiduciary duty of directors but a legal obligation as well, in majority of jurisdictions, to disclose the facts to the minority or provide them a reasonable access to relevant information. [302] Under Sharia, disclosure of information to all the stakeholders honestly is an obligation for which one is not only answerable to temporal authorities but to Allah as well. Hence, true and accurate disclosure of information is a divine obligation as well. Similarly, another important theme of corporate governance is book keeping. Emphasis on this aspect comes from the foremost source of Sharia, i.e. the Quran when it says. "O you who believe! When you deal with each other in contracting a debt for a fixed time, then write it down; and let a scribe write it down between you

[297] Ibid (230) 631.

[298] Ibid (230) 631.

[299] Ibid (n180)135.

[300] See generally, Ibid (n 201).

[301] Brenda Hannigan, *Company Law* (4th edn, Oxford University Presss 2016) 257. Also see *Aberdeen Rly Co v Blaiki Bros* (1854) 1 Macq 461

[302] Ibid (n 171) 366.

with fairness; and the scribe should not refuse to write as Allah has taught him, so he should write" (Al Baqarah 2:282). [303]

The directors are obligated not to advance their personal interests over corporate interests. So to say, always act in good faith to meet their loyalty obligations. [304] They should not adventure opportunism on shareholders' interest even when the firm is in the vicinity of insolvency.[305] It is a fiduciary call of duty not to profit unfairly through assigned corporate role or take advantage of the corporate information to profit personal gains.[306] Sharia law complements rather reinforces this fiduciary call of duty when it binds it to divine responsibility and accountability.

It can never be construed that all Muslims will be following Sharia ethics squarely[307] as there is always tendency among the subjects of a system to deviate from it.[308] The foremost in commercial transactions is the breach of fiduciary obligations. The Anglo-American laws consider Directors' fiduciary role in terms of agency and not stewardship. Therefore, self-centred directors need to be watched over. On the contrary, Sharia law requires them to act in total fairness and honesty not only as an obligation to company and stakeholders but as a duty to God,[309] where the latter inculcates more emphatic self-control.

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[303] Ibid (n 238) 563.

[304] Ibid (n171) 369.

[305] Ibid (n171) 167.

[306] Ibid (n171) 369.

[307]Wafik, Grais. And M, Pellegrini., Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options, *World Bank Policy Research Working Paper.* No. 4052, (01 November, 2006) p 6

[308]Albert. O., Hirschman,(1970) *Exit Voice and Loyalty: Responses to Decline in Firms, Organizations and States* (Harvard University Press, Cambridge, Massachusetts, USA) in W, Grais and M, Pellegrini, Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options, *World Bank Policy Research Working Paper.* No. 4052, 01 November 2006) p 6

[309] Ibid (n180)136.

Decision making is the core dimension of the corporate governance. This area is of utmost importance in the subject of corporate accountability. Sharia considers humans as trustees of Allah and accountable to the Divine authority here and in the hereafter. Islam binds its followers to maintain good relations with superiors, clients and management along with observance of truthfulness, fairness, tolerance and justice.[310] The most important element of decision making is consultation which ensures participation of all the stakeholders. Even the Holy Quran assigns it very high importance and demands those in power to consult all the stakeholders. [311] It says: *"And counsel with them in the affair; so when you have decided, then place your trust in Allah".*[312]and

"And those who respond to their Lord and keep up prayer, and their rule is to take counsel among themselves, and who spend out of what we have given them" (Ash-Shu'ra, 42:38)

In addition to mandatory participation in decision making, tradition of accountability in Islam is rich. In Abbassids era, there was an institution called *Hisbah* which, *inter alia*, was responsible for ensuring the compliance of Islamic principles of business ethics. Therefore, concept of corporate governance enunciated by Shariah is broader and more encompassing than any model law, principles or rules, e.g. the OECD principles, on the subject. [313] By making universal business ethics as religious duty (to God especially),

[310] Ibid (n 238) 562-63.

[311] Ibid 562-63

[312] Al Imran 3:159.

[313] Ibid (n 238) 563.

the Sharia law principles on business even go beyond model OECD principles and are clearer and more comprehensive and enforceable.[314]

3.7.8 Concluding remarks

Improvement of corporate governance has always been a challenge. There is a continual effort on the intellectual plane and by every class of stakeholders be it the legislators, judges, academics or the practitioners. This task becomes more challenging for the systems like *Sharia* which has a huge following and is emerging as a popular subject. It becomes even more daunting when many of its areas, especially the commercial aspects, remain under researched, its applicability or relevance in the modern world is questioned by the opponents and its own scholars show aversion to the modern demands for seeking new meaning. But now the scholastic efforts to rebut the misconceptions about its practicability are on the rise and there have been recognition that Sharia legal system can be utilised to improve the legal frameworks in jurisdictions where Sharia law has an influencing role on the frameworks.

The discussion in this part of the chapter has shown that the revival of faith in Islamic corporate governance system has invited the scholars to research on its efficacy to fill the statutory gaps and complement laws, especially in corporate accountability issues. Western and Sharia systems emanate from different sources and have been serving different societies and cultures, therefore they resort to different institutional arrangements for realising the cherished objectives of a just, fair and transparent governance culture however the basic principles have been almost the same.

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[314] Ibid (n180)136.

Thus, Sharia law has the potential to fill gaps in statutes/ laws through techniques of legal reasoning namely *Qiyas, Istihsan, and Istislah.* Abuse against arbitrary interpretations of these techniques is always checked by the supreme sources of Islamic law, i.e. *Quran and Sunnah*. However, they help fill the statutory gaps and assimilate whatever is right, just, fair, convenient or conducive. Conflict among rules is common which is removed by resorting to precedents to attain consistency, coherence and certainty. The conflict may occur even between a precedent and a newly enacted legislation. In such a case, statute being source of law will prevail. Same is true about Sharia law where *Quran and Sunnah* get precedence for being primary source.

Chapter 4. Case Studies on Self-Serving Behaviour of Corporate Management in Pakistan

4.1 Introduction

This thesis argues that derivative litigation has a crucial role to play in promoting good corporate governance which would eventually help shareholders receive adequate protection against managerial misconducts. In order to develop the basis of functional derivative action framework in Pakistan, this study needs examples of managerial opportunism providing data source for carrying out further analysis. There are theoretical claims in the existing academic literature regarding the self-serving behaviour of corporate management in Pakistan. However, there is no study that reflects this unhappy situation, explaining at length the means of expropriation of corporate assets and the analysis of relevant provisions of the Companies Ordinance and the role of SECP in respect of its objective to protect investors. The purpose of this chapter is to present analysis of specific examples of managerial misconducts and to reflect how management behaves opportunistically detrimental to the interests of shareholders and sometimes even against the companies. The cases studied are Crescent Standard Investment Bank Limited, Dewan Sugar Mills Ltd and Fazal Textile Mills Ltd. The analysis of these cases is aimed at illustrating that small investors are placed at a vulnerable position which the situation calls for them to be vested with adequate enforcement power to safeguard their interests. The chapter has been designed to examine the key issues that determine the outcome of these specific cases about managerial self-serving behaviour, to more general concerns of managerial opportunism in Pakistan.

4.2 Case Study: 1 Dewan Sugar Mills Limited.

4.2.1 Introduction

Before taking up the analytical study of this case,[1] a generalized picture of the issue of unauthorized investments and siphoning of funds by the companies in associated undertakings may be worthy of consideration. It would unveil how often CEOs of the companies hand in hand with directors of the companies arbitrarily violate the mandatory provisions of law as laid down, in particular, under section 208(1) of the Companies Ordinance 1984, under one or the other excuse. This frequent phenomenon shed sufficient light on the aspect that although legal safeguards are provided, yet their enforcement mechanism is so poor that these are hardly taken seriously. Managers of companies are fearlessly inclined to make the best of the weaknesses in the enforcement mechanism, serving to escape from the mischief of law. This is because of many factors operating in the corporate sector, particularly, in the context of Pakistan. Out of these, the major factors seem to be the inadequate enforcement power of small shareholders to enforce the laws. This state of affairs has encouraged the tendency of tunnelling the funds of the holding companies to associated companies or associated undertakings carelessly without following legal formalities.

The case, herein under, to be studied reflects this issue in details.

4.2.2 Case Background and Brief Facts

Dewan Sugar Mills Ltd. is a public limited company and is listed under Companies Ordinance, 1984 on stock markets Karachi and Lahore. The authorized share capital of the company is RS.500,000,000 divided into 50,000,000 ordinary shares of RS.10 each

[1] Dewaan Sugar Mills Ltd. vs. SECP [2009] CLD 1636.

and paid up capital of the company is RS.365,119,290, divided into 36,511,992 ordinary shares of RS.10 each.[2]

This company made huge advances to Bawany Sugar Mills Ltd.,(BSML) its associated company, a sum of RS.284,700 millions and associated company AL-Asif Sugar Mills Ltd.,(ASML) RS.25,004 millions without approval of shareholders through special resolution in General Meeting as required under section 208 of the Ordinance.[3] Further, it did not charge any interest/mark up thereupon treating the advances as normal trade debt. This argument (normal trade debt) of the company could not find favour with the Securities and Exchange Commission of Pakistan, which, in turn, imposed penalty on CEO and five directors of the company. The case reflects siphoning of funds of the company without the authority of special resolution in contravention of law as envisaged under section 208 read with 476 of the Ordinance.[4]

Brief facts of the case as disclosed from the record and examination of annual audited accounts of the company for the relevant year, reveal that huge amounts were advanced to the company's associated undertakings without observing legal requirements in this regard. It was found in the annual audited statement that such advances were made without seeking the requisite approval of shareholders through special resolution.[5] It was also found that these advances were not in the nature of normal trade credit and that no interest thereupon was charged.[6] Obviously, such unauthorized heavy advances beyond the scope of mandate, exposed the company to huge losses. Thus, prime

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[2] See Dewaan Sugar Mills Ltd. vs. SECP [2009] CLD 1636, Para. 1 ; RS (rupees) the currency used in Pakistan , Exchange rate pound to RS is 1 pound equivalent to RS 135.10. on 15.May 2017.

[3] See Section 208. the Companies Ordinance 1984.

[4] Ibid, Section 208 and 476, the Companies Ordinance 1984.

[5] See, section 208, the Companies Ordinance 1984.

[6] Ibid (n1) para. 1

objective of the legislation on the subject as reflected in section 208 of the Ordinance was defeated, which is primarily meant to secure the interest of, particularly minor shareholders of the company and guard against misuse of its funds by diverting unwarranted benefits to associated companies or associated undertakings.

The law is simple and clear on the point that authority of special resolution is mandatory while making any investment or extending any loans or advances, whatsoever, to associated companies or associated undertakings.[7] Since there was not only formal breach of legal provisions in this respect but also huge losses to the company were caused by neglecting or conniving with the charging of mark-up/interest, a very serious view was taken by the Commission.[8] Thus, having found gross neglect and contravention of provisions under section 208 of the Ordinance, the Commission imposed penalty as prescribed under sub-section (3) section 208 of the Ordinance for violation of the mandatory provisions as laid down under sub-section (1) of the same. As such, a fine to the tone of RS.3, 500, 000, in totality, was levied on Chief Executive Officer of the company and its five directors.[9]

4.2.3 Key Issues before the Commission

During course of proceedings, the Commission, called upon the company to provide information as given below in respect of advances extended to associated undertakings;

(a) Name(s) of the associated undertakings and breakup of RS.309,704 millions;

(b) Dates since when these undertakings became associated with the company;

(c) Certified copy of approval authorizing making of these advances ensuing from Board of Directors‘ resolution and special resolution of shareholders passed in

[7] See section 208, the Companies Ordinance 1984.

[8] Security and Exchange Commission of Pakistan, the regulatory body.

[9] Dewaan Sugar Mills Ltd. vs. SECP [2009] CLD 1636, Para. 6.

General Meeting, as specifically required under the provisions of section 208 of the Companies Ordinance;[10]

(d) Copies of current accounts and ledger accounts of these associated undertakings maintained in the company's book with effect from 1st October 2006 to 28th February 2009; and

(e) Certified copies of toll manufacturing agreements and details of subsequent changes, if any.

The company, to reply to the aforesaid queries, submitted the required information as follows;

(a) The advances were made to Bawany Sugar Mills Ltd., and AL-Asif Sugar Mills Ltd., the associated companies, to the tone of RS.284,700 millions and RS.25,004 millions respectively;

(b) The said companies became associated of the company (Dewaan Sugar Mills Ltd.) on 15 November ,2006 upon acquiring of majority shareholdings of BSML (Bawany Sugar Mills Ltd.) and ASML(AL-Asif Sugar Mills Ltd.) by Dewaan Mushtaq Group;

(c) As far explanation to the contravention of section 208 of the Ordinance, the company contended that the provisions of section 208 were not applicable to their case since these advances were in the nature of normal trade debt and did not fall within the definition of "investment" as laid down under section 208 of the Ordinance;

(d) Copies of current and ledger accounts of BSML and ASML provided;

(e) Copies of toll manufacturing provided.

[10] See section 208, the Companies Ordinance 1984.

On being dissatisfied with the reply furnished by the company, a show cause notice dated 24 April, 2009 (as earlier mentioned) under section 208 of the Ordinance, was served on the Chief Executive of the company (namely; Deewan Mohammad Yousaf Farooqi) and five Directors as to why penalty for violating the provisions of section 208, sub-section (1) of the Ordinance should not be imposed on them, in terms of sub-section (3) of the same.[11]

4.2.4 Plea of the company:

In reply to the show cause notice, Mr. Haroon Iqbal , Director and Mr.Abdul Basit, the Company Secretary, reiterated the earlier argument to the effect that company had toll manufacturing agreements with BSML and ASML and the advances extended to these companies were being adjusted against the toll manufacturing charges. They further contended that aforesaid advances made to the aforementioned associated companies were in the nature of normal trade credit and as such did not fall within the purview of section 208 of the Ordinance. That is why interest was not charged thereupon.[12]

The company's representative, during course of proceedings, added that in the beginning, the agreements entered into between Dewaan Sugar Mills Ltd. (the company) and ASML and BSML, required that the manufacturing fee will become due in favour of the companies (ASML and BSML) within twenty days of the invoices issued by them and will become payable accordingly. However, the aforesaid two companies later made requests for advance payments against the toll manufacturing charges, just to enable them to carry out the working capital requirements and ensure the supply of sugar to the company well within time. The stance of the company was

[11] See section 208 (1)(3), the Companies Ordinance 1984.

[12] See section 208, the Companies Ordinance 1984.

that such sort of mutual arrangement was on the strength of common practice prevalent with sugar industry that sugar manufacturing companies receive payments in advance and then make arrangements for delivery of goods by issuance of delivery orders to the customer company, which is left to its choice as when to collect it (sugar) according to its convenience. Based on this general practice, the company (Dewaan Sugar Mills Ltd.) acceded to the request for making advance payments and in this regard supplementary agreements were entered into with ASML and BSML accordingly.

It was further submitted by the counsel of the company that on the basis of these agreements, whatever advances were made by it to ASML and BSML, were adjusted against toll manufacturing charges. At the time of entering into agreements with the companies ASML and BSML, on 1st September, 2004, these were not related to each other and these advances were just in the nature of usual trade deals. This status was kept up till 15 November, 2006 when these companies acquired the status of associated companies; however, the toll agreements remained the same as these were before the establishment of associated company relationship. The representative of the company (Dewaan Sugar Mills Ltd.) maintained that the purpose of agreements struck between the company ASML and BSML was just to carry out normal trade between the companies as customer and supplier by acquisition and provision of toll manufacturing services. As such, there is no embargo under law on extending advances in terms of normal trade credit to an associated company as it is not subject to the mischief of provisions laid down under section 208 of the Ordinance.[13]

The company's major stance, in nutshell, was that it is not the case of siphoning of funds of the company with vested interest of the CEO and its directors. In fact, the

[13] See section 208,the Companies Ordinance 1984.

advances in question, were made against toll manufacturing services bargained by it with ASML and BSML before the establishment of associated relationship which continued even after the creation of such relationship; as such the advances remained in the nature of normal trade transaction falling outside the reach of provision of section 208 sub-section (1) of the Ordinance.

4.2.5 The Commission' findings

The Commission, in turn, gave consideration to the legal propositions advanced by the company and concluded that it was very much case of tunnelling of company's funds beyond the scope of mandate extended by law.[14] The company had been making advances to ASML and BSML since 2005 and maintained this exercise even after these companies acquired the status of associated companies with effect from 15th November, 2006 without authorization for the same by the shareholders through special resolution as required under law. Further, this practice continued without charging any interest/mark-up thereupon.

It was observed by the Commission that Annual Audited Accounts of the company disclosed that since the year 2006 (after attaining the character of associated relationship) onwards, the company rather chose to make added huge amounts of advances which even excelled the aggregate amount of charges paid by the company against toll manufacturing services received from the said companies, during the relevant years. For example, on 30th September, 2005 (i.e. before attaining associate relationship) advances were RS.160.562 million against 248.847 million charges of toll manufacturing. On the other hand, during the year ended on 30 June, 2007 (i.e. after attaining associate status) advances of RS .440, 980 millions were due against toll

[14] Ibid

manufacturing cost of only RS .284, 733 million. Statistically, the coming years witnessed the same trend.[15]

4.2.6 Analysis of findings

It transpires from the above case that advances made by the company to associated companies ASML and BSML, can be, by no reason, termed as normal trade credit. The fact that the parties to agreement have adjusted the amounts advanced by entering into toll manufacturing agreements thereby showing these as current assets and current liabilities in the respective balance sheets, do not help treating these advances as normal trade credit. Perusal of ledger accounts of ASML and BSML maintained in the books of the company reveal that the advances were open ended credit without specified repayment schedule, from time to time adjustments map for the outstanding amounts against toll manufacturing charges. Hence, these advances were just in the nature of open ended credit or running finance but without any interest or mark-up thereby causing tremendous losses to the company. The commission went to the extent of working out year wise split of advances outstanding against toll manufacturing charges indicating vast difference there between i.e. gradual increases in the advances against the decreases in toll manufacturing charges for the corresponding period.

The Commission also observed (as example) with special reference to the fact that during the year 2008, toll manufacturing agreement with ASML was ended due to sale of its controlling shares by the responsible/sponsors of the company. As a result, the advances of ASML were adjusted/cleared out with visible fall in the total outstanding balance during the year. On the other hand, as regards BSML, which continued its associated relationship, huge amounts continued to stand unsettled. In this view of the

[15] Dewaan Sugar Mills Ltd. vs. SECP [2009] CLD 1636, Para. 5

matter, the Commission categorically set aside the plea of the company that the advances extended to associated companies were normal trade credit falling outside the range of section 208 of the Ordinance. The Commission further repelled the plea of the company to the effect that it had been extending advances to ASML and BSML before these companies acquired the status of associated relationship and it simply continued the earlier practice (and did not introduce anything new).

The Commission maintained that earlier practice cannot validate the act of the company subsequent to the date ASML and BSML became associated companies from 15 November, 2006 onwards. According to the observations made by the Commission, the provision of section 208 of the Ordinance came into play strictly the day on which the companies started enjoying the character of associated relationship.[16] The above referred provisions of the law are clear and self-evident. The facts and circumstances of the case and in-depth examination of the record, reveal that the Directors of the company failed to comply with the provisions of section 208 of the Ordinance while making advances to its associated companies.[17]

Moreover, the advances had been extended to the said associated companies without any interest/mark-up and without obtaining the authority of special resolution by the shareholders of the company. As such, these advances are not normal trade credit as controverted by the company. Due to interest free loan/unauthorized advances, the company had to suffer huge losses and for meeting the situation, had to get (as transpired from the Annual Audited Accounts for the year ended on 30th September,

[16] See section 208, the Companies Ordinance 1984.

[17] Ibid see. S..208 of the Ordinance.

2008) short term loan of RS.2.754 billion from various banks at a price ranging up to three hundred basis points above the Karachi Inter Bank Offered Rate.[18] (KIBOR)

Another plea of the company to the effect that as a result of these transactions (unauthorized advances) there appeared positive improvement in production and sales over years, has also been turned down by the Commission with observation that despite enhanced turnover (production and sales whatever) the overall financial position of the company, its profits and liquidity, have declined over the period consequent to its toll manufacturing agreements with the said associated companies. The Commission has remarked so with special reference to a year wise diagrammatic picture indicating evident increase of out standings with visible decrease in adjustments. The financial statements of the company for the year ended on 30th September, 2008 clearly depict its losses. It discloses that after adjustment of taxation, the losses have accumulated to very high levels which have eroded its capital and its current liabilities have exceeded its current assets.

Alongside the company remains no longer able to ensure timely repayments of debts of the concerned banks. This state of affairs signals a perceptible uncertainty for the company to survive as a growing entity. The Commission, in its judgment, observed that Directors owe fiduciary duties to the Company they serve and its shareholders. They must treat all the shareholders, irrespective of their being sponsors of the company or general public at large, alike. In the case under review, the Directors have failed to exercise the sense of responsibility expected from them by the law and principles of fairness. They, clearly, breached their fiduciary duty they owed to the

[18] Dewaan Sugar Mills Ltd. vs. SECP [2009] CLD 1636, Para. 4

company and its shareholders with resultant voluminous losses which posed question mark even on the very survival of the company.[19]

It is with these facts in view, the Commission imposed penalty of RS.3, 500, 000 in aggregate on the CEO and five Directors of the company, with the remarks that keeping in view the gravity of charge, no leniency could be exercised. Having discussed violation of law on the part of directors, opinion is formed on the facts and remarks made by the regulators that CEO and Directors of the company ruthlessly committed wrong against the company while extending unauthorized huge advances and those too interest free and so they, by no reason, deserve any leniency.

The regulatory body imposed only 1/3rd of the maximum fine provided under law.[20] Sub-section (3) of section 208 of the Ordinance provides that if default is made in a company in complying with the requirements of this provision of law, every Director of the company, who is knowingly and wilfully responsible, shall be liable to fine which may extend to RS ten million and, in addition, the Directors shall, jointly and severally, reimburse to the company any losses suffered by it in consequence of any investment having been made in contravention of the law.

As is clear from the wording of above said provision of law (section 208(3), the upper limit of fine is RS. ten million while in the case in hand, in spite of highly resentful observation by the regulatory body, only, 1/3rd of the maximum fine provided, has been imposed. This would mean, it is nothing less, leniency, in terms, which the regulatory body itself excluded in his remarks. Therefore, it should have been at least half of the upper limit or double of the volume as imposed. In fact, such are the leniencies which have tremendously encouraged the phenomenon of fearless violation

[19] Dewaan Sugar Mills Ltd. vs. SECP [2009] CLD 1636, Para. 3

[20] See Section 208 (3), the Companies Ordinance 1984.

of law as the wrongdoers do not care much for low-line fines against high earnings through wrongful acts.

4.3 Case Study: 2 Fazal Textile Mills Limited

4.3.1 Case Background and Brief Facts

A flagship company Fazal Textile Mills Ltd. made equity investment of RS.500 million in an associated company named "Lucky One" (Private) Ltd. ("Lucky One") to build and develop a mega mall and residential towers on the company's 10.22 acres of land and then run, manage and maintain it upon the terms to be settled between the parties. The audited financial statement of Fazal Textile Mills for the financial year ended 30 June 2012, after having been examined by the Director Finance SECP (Respondent of the case) under section 233 and section 160 (1)(b) of the Companies Ordinance 1984, disclosed that the company (Fazal Textile Mills Ltd.) allegedly received approval of the shareholders as required under section 208 of the Ordinance in Extraordinary General Meeting (EOGM),for equity investment of RS.500 millions in the said associated private company "Lucky One" for carrying out aforementioned mega project.[21]

The above said approval of the shareholders at the Extraordinary General Meeting dated 14 September, 2010, came subsequent to the earlier meeting of the company's shareholders, held on 20th October, 2012, intended to carry out a joint venture agreement with Lucky Textile Mills Ltd. ("Lucky One") for execution of the aforesaid project. The terms and conditions of the agreement as transpired from the notice of EOGM, disclosed that associated company "Lucky One" shall fall under joint ownership and operational control of both Fazal Textile Mills Ltd. and Lucky Textile

[21] Muhammad Sohail Tabba-Appellant vs. Director Enforcement, SECP [2016] CLD 1697

Mills Ltd. itself and both shall invest in the project on share and loss basis with the ratio of 66.28 per cent and 33.72 per cent respectively which would be assessed on the basis of the land provided by each of them. On examination of the annual audited statement of the company for the year 2012 and 2013, it stood transpired that an amount of RS.157, 075,000 and RS.655, 612,000 respectively was advanced to "Lucky One".[22]

4.3.2 Key Issues before the Commission

During examination by the Director Finance SECP, it was found that the company had acted unfairly against approval in the Extraordinary General Meeting held on 14th September, 2010 and failed to make equity investment of RS.500 million in "Lucky One" as approved by the shareholders. More so, the company failed to satisfy the mandatory requirement of disclosure of its intent to shareholders regarding its further plans, in clear disregard of SRO,865 (1)/2000 Dated 06 December, 2000 and the regulation 4(2) in subsequent General Meetings of 30 June 2011, and 30 June 2012.[23]

It is understood that the above said SRO and regulation stipulates disclosure of certain material facts in the statement under Section 160 of the Ordinance accompanied by the notice of Meeting meant for obtaining shareholders' approval as required under section 208 of the Ordinance.[24] Further, section 160 sub-section (1) requires that in case any decision to make investment pursuant to a resolution is not implemented till the holding of a subsequent meeting, the Company's position along with the required information (herein under mentioned) must be shared with the shareholders through a statement as

[22] Ibid para.2 of the judgment.

[23]SECP issued Notification No. SRO 865 (1)/2000- dated 06 December, 2000< https://www.secp.gov.pk/wp-content/uploads/2016/05/dec_06_00.pdf> accessed 27 June 2016.

[24] Section 160, read with section 208 of the Companies Ordinance 1984.

per requirement of the above said provision of law (Section 160 (1) of the Ordinance.[25] Such statement is required to contain;

1. Reasons for not having made investment till date;
2. Major change in financial position of investee company since date of last resolution;
3. Total investment approved in the shareholder's meeting;
4. Extent of investment made so far;
5. Reasons for not making complete investment till date when resolution required it to be made within stipulated time; and
6. Material change in financial statements of associated company or associated undertaking since date of the resolution of the approval accorded for investment in the investee company.

As has been mentioned above, the company (Fazal Textile Mills Ltd.) failed to fulfil the above mentioned requirements and was called upon to explain the default identified on examination of the relevant record. In reply thereto, the company contended that it had reached a decision not to make equity investment in "Lucky One"; rather chose to directly carry out the project by direct financing. It further explained that the share capital of "Lucky One" was subscribed by two shareholders of the company (Fazal Textile Mills Ltd.) and one shareholder of Lucky Textile Mills Ltd. under the control of both the companies. Thus, the joint venture agreement was revised and submitted on 23 February 2013 according to which "Lucky One" was accorded the role of supervision of the project with entitlement to supervision remuneration/fee at the rate 0.25 per cent of payments made to subcontractors on quarterly basis. This revised arrangement of

[25] See Section 160(1), the Companies Ordinance 1984.

directly bearing the cost involved in the project and alongside granting mobilization advances to "Lucky One" instead of equity investment as initially agreed, was, evidently, a clear departure from the aforementioned approval extended by the shareholders under section 208 of the Ordinance.

The company published a notice of Annual General Meeting on 7th October, 2013 in the newspapers seeking approval for amendments in the resolution passed on 14th September, 2010. The company, by circulation of its notice to that effect, invited approval of shareholders for making funding directly for the financial requirements involved in running the project, instead of making equity investment in "Lucky One". This exercise took place consequent to modified agreement dated 23 February, 2013 entered into between the parties on joint venture basis for direct funding along with supervision fee to "Lucky One" as mentioned earlier.

On disclosure of these facts through audited statement, the director finance, SECP was seized of the investigation of the matter and called upon the directors of the company to explain for defaults in compliance of mandatory provisions contained in sections 160 and 208 read with section 476 of the Ordinance. For facility of reference, section 160(1) (b) and section 208 of the Ordinance are summarized as under;

According to section 160(1) (b) when usual company business is to be transacted at a General Meeting, the notice of the meeting shall be accompanied with a statement setting out all material facts regarding such business, particularly, including the nature and extent of direct or indirect interest, if any, of every director and where any

contingency of business relates to the granting of approval to any document, the time, as to when and the place where the document may be inspected.[26]

According to section 208 of the Ordinance, subject to sub-section 2(A) a company is debarred from making any investment in any associated company or associated undertaking except under the authority of special resolution which shall indicate the nature, period and volume of investment and related terms and conditions agreed and settled therein. In case of default in observance of these provisions of law or regulations, every director of a company who is found to be wilfully at fault, shall be liable to fine which may extend to RS. ten million and additionally the directors shall be bound jointly and individually to indemnify any loss suffered by the company resulting from any investment made without complying with the condition precedents as set out in the foregone provision of law.[27]

As has been discussed at length in the foregoing lines, an obvious departure is evidenced from the company's act. Such tactics on the part of managements seem to have been just adopted to hide the default. This situation led the things to be inquired into at the relevant forum.

4.3.3 The Commission's Investigation of the Case

On having taken up the matter, SECP's authority(Director Finance) went into detailed probe and examined the provisions of the law, which relate to investment in associated companies and associated undertakings, laid down under sections 160, 223, 208, and 476 of the Ordinance. Regulation 2012, 4(2)-SRO NO.865 (1)/2000 dated 06 December

[26] See Section 160(1), the Companies Ordinance 1984.

[27] See section 208 (2)(A), the Companies Ordinance 1984.

2000 was also referred to.[28] According to the facts, the company was accorded approval by the shareholders under section 208 of Companies Ordinance, 1984 in Extraordinary General Meeting (EOGM) for equity investment of RS.500 million in the associated company "Lucky One". The company failed to act in obedience to shareholder's approval as it had not made equity investment according to the mandate. Further, the company also failed to satisfy the requirement of disclosure as required under SRO NO, 865(1) 2000 dated 06 December 2000 and regulation 4(2) relating to companies' investment in associated companies or associated undertakings as also regulation 2012 in subsequent General Meeting.

The Directors of the company were required to justify the defaults (show cause notice) in reference to requirements of sections 160 and 208, read with section 476 of the Ordinance. After due deliberations, the commission, being dissatisfied with the reply tendered by the company, imposed penalty of RS.100,000 under sections 160 and 208 of the Ordinance on the Chief Executive Officer of the company and the Directors of the company were issued warning for ensuring strict compliance of the relevant provisions of the Ordinance, in future. The reasoning and rationale in reaching this verdict was that the shareholders of the company accorded approval for equity investment in terms of section 208 of the Ordinance and SRO NO.865 (1)/2000 dated 06 December 2000 which required listed company to furnish update information regarding the progress on implementation of the project approved by the shareholders through resolution in subsequent General Meeting. Such information was required to include reasons for not investing in the project so far and major changes in the financial position of Investee Company but the company failed to do so. Thus, the company was

[28] See section 160,223, 208,476, of the Companies Ordinance 1984; SECP issued Notification No. SRO 865 (1)/2000- dated 06 December, 2000 < https://www.secp.gov.pk/wp-content/uploads/2016/05/dec_06_00.pdf> accessed 27 June 2016.

found to have committed wilful default and was penalized accordingly as it published the notice of Annual General Meeting in the newspapers in a bid to get shareholders' approval for modification in earlier resolution only, after receipt of the notice issued by the SECP, which, itself seems to be evidently an afterthought move in itself.

4.3.4 Analysis of findings

This verdict of penal action against the company was challenged by way of appeal before the tribunal comprised of Zafar Abdullah Commissioner (SCD) and Fida Hussain Sumoo Commissioner (insurance) against the impugned order (of imposing penalty on the company i.e. its CEO of the company and its Directors).[29]

The appellant (company) raised, amongst others, the following grounds;

1. That the appellant had been confirmed with the requisite authority by the shareholders vide special resolution to perform and take any acts, deals and decisions as may be required from time to time,
2. That the management of the company wields more than 92 per cent shareholding of the company and 100 per cent of its joint venture associate Lucky Textile Mills Ltd. and thumping majority in Director's meeting as well as in General Meeting and as such they could have no problem in getting approval of any special resolution and modification therein as may be required;
3. That the company alongside kept aware of the shareholders about the advancement of the project through Director's report and changes, if any;
4. That the company belongs to a renowned Younis Brothers Group, reputed for best practices.

[29] Muhammad Sohail Tabba-Appellant vs. Director Enforcement, SECP [2016] CLD 1697.

The Appellate Bench, as per procedure, called upon the SECP investigator/respondent to put up their reply to the above mentioned contentions agitated by the company in its appeal.

The SECP representative strongly rebutted the argumentative stance advanced by the company, summarized as below;

1. The company's contention that it was conferred with the authority by special resolution dated 14 September, 2010, to take and perform all acts, deals and decisions, wherever required, is contravention of express provisions contained in section 160 of the Ordinance which calls for the company to update the shareholders of resolutions passed, which the company failed to do;
2. According to special resolution dated 14 September, 2010, the company was authorized only to make equity investment of RS.500 millions in "Lucky One" but no such investment was made; instead, investment was made in "Lucky One" through mobilization advance which the act of the company was contrary to the mandate given in this regard;
3. The company issued notice of Annual General Meeting on 7th October, 2013, only on receipt of explanation letter from SECP, in order to get approval from shareholders for modification in resolution of September, 2010, which the act of the company clearly indicates that where it was fully aware of legal requirements was also bold enough to go for contravention thereof.

The Appellate Bench, after detailed discussion, dismissed the appeal of the company upholding the decision of SECP of imposing penalty of RS.100, 000 upon the Chief Executive Officer of the company and issuance of warning to its directors to behave in

future as per legal requirements expressly set out in the relevant law. The Bench particularly took keen notice of two major irritants widely prevalent in corporate sector of Pakistan and those are the expropriation of minority interests by tunnelling and like methods and exercise of personal influence regarding deals of choice without taking into confidence the minority shareholders of the company.

The majority shareholders, loudly, contended during hearing that they enjoyed overwhelming majority of 92 per cent in company's shareholdings and 100 per cent of its joint venture associate (Lucky Textile Mills) and that it is a privileged giant YB, Group one of the largest business group of Pakistan. These two stances, in particular, seem to have not found favour with the Appellate Bench, rather irritated it for the obvious reasons that the company in its defence proudly relied upon and, in a way, owned what otherwise is a major causative factor leading to frequent managerial wrongdoings. These factors count on overwhelming statistical majority and owning social influence as reflected in the stance raised on the strength of Y.B Group's social position.[30]

The Bench, in a way, ridiculed these contentions observing that what they (the company) own and contend in their favour, the same, in essence, goes against them, independent of any other piece of evidence, if any. In fact, this contention is counterproductive which leads to the detriment of oppressed minority at the hands of majority shareholders. For example, a few cases may be referred here in this context, having identical issue of tunnelling and the flagship companies by dint of their dominant positions, with resultant similar outcome at the end of the day. In Monno Industries Ltd.-Appellants v. Executive Director (CLD) Securities and Exchange

[30] Muhammad Sohail Tabba-Appellant vs. Director Enforcement, SECP [2016] CLD 1697.

Commission of Pakistan-Respondent,[31] annual audited statement of Monno Industries Ltd., disclosed an amount of RS.8.516 as due from associated undertaking made as advance thereto, without authority through special resolution.

Later, requisite ratification was attempted to be made through subsequent special resolution. It was found that post facto approval of investment in associated company through special resolution, could not relieve the company of accountability. This act was found to have violated the express provisions contained in section 160(1) (B) and section 208 of the Companies Ordinance. During course of investigation as also at judicial level, the company begged pardon which, nevertheless, meant its acknowledgement of the wilful default. In the context of proceedings in the instant case, reliance was also placed on Gharibwal Cement Ltd. v Executive Director SECP[32] wherein it was held that prior consent of shareholders is mandatory and is a prerequisite and as such any investment made in associated company cannot be regularized or validated on account of subsequent ratification by shareholders.

Eventually, being dissatisfied with the contentions urged by the company's representative, penalty to the tone of RS.10, 000 was imposed on the Chief Executive Officer of the company and its directors for each default aggregating to a sum of RS.30, 000 each.

Similar tunnelling mischief cropped up in another case namely; Nasim Saigal v/s SECP.[33] In this case, the company made unauthorized investments in associated companies and undertakings and advanced amount thereto for the purchase of Textile

[31] Monno Industries Ltd.-Appellants v. Executive Director (CLD) Securities and Exchange Commission of Pakistan-Respondent[2012] CLD 691

[32] Gharibwal Cement Ltd. v/s Executive Director SECP [2003] CLD 131

[33] Nasim Saigal v/s SECP [2013] CLD 1179

machinery and Cotton etc. Such advances were not in the nature of normal trade credit thereby coming within the mischief of section 208 of the Companies Ordinance.[34] Later, that project was abandoned due to the machinery not being up to the mark. In this eventuality, instead of recovering the advance from the associated company, the company extended further credit, which was too not in the nature of normal trade debt. Although according the explanation contained in section 208, "investment" includes "advance" but the provision of law in the aforementioned section (208) stipulates it to be made through special resolution and with the prior approval of the shareholders. The company, instead, made unauthorized advance payment and converted the same into open ended credit to associated company and failed to recover the same.

4.4 Case Study: 3 Crescent Standard Investment Bank Limited

4.4.1 Introduction

This case portrays another picture of corporate wrongs.[35] The list of misdoings is so wide that hardly there seems anything to have escaped from the excesses of the management. It includes omissions, commissions, transgressions, negligence, and other corporate frauds. It also includes frank admissions of irregularities having taken place although with certain untenable stance. For instance, appellant NO.8 raised the contention that he submitted his resignation from his office as he came to know about the irregularities and made excuse of his ignorance when the same were in progress. The CEO and the Director of the CSIBL who was also director of an associated

[34] See section 208, the Companies Ordinance 1984.

[35] The case titled Shahid Anwar, Tariq Aleem, Dr. Wasim Azhar , Mazurul haq, Shaid Latif Dar, Ifran Qamar& others, Mehmood Ahmed Shezi Nackvi v Chairman Securities and Exchange Commission of Pakistan [2015] Appellate Bench Security and Exchange Commission of Pakistan.

company, in clear terms declared in a press conference that he was unaware of self-interest transactions within the bank.

The irregularities at a glance are;

1- Maintaining two parallel books of accounts with undisclosed balance of assets and liabilities;
2- Investment in associated companies/undertakings without approval of the shareholders through special resolution;
3- Real estate transactions without license(legally required) for Housing Finance Services;
4- Violation of prudential regulations; and
5- Violation of delegated authority of Board by the Chief Executive Officer (of CSIBL).

4.4.2 Brief Description of the Company

Crescent Standard Investment Bank Ltd. (CSIBL) was a public limited company incorporated as Non-Banking Finance Company (NBFC). It was a listed company with its shares offered on the Stock Markets of Pakistan operating in various cities. CSIBL obtained licenses from the Securities and Exchange Commission of Pakistan to carry out the business of Investment Finance Services and Leasing services within the meaning of Non-Banking Finance Companies (Establishment and Regulation) Rules, 2003 (NBFC Rules).

4.4.3 Nature of the Scam

Security and Exchange Commission of Pakistan (SECP) had been receiving unofficial reports since May 2006 regarding a number of acts of expropriation of corporate assets by the management of Crescent Standard Investment Bank Limited (CSIBL) .It was

further confirmed when CSIBL did not circulate the audited accounts for the year ending on 31 December, 2005 even as late as August 2006. After investigations carried out by the SECP, the internal management was found involved in acts of misappropriations, concealments, maintenance of parallel accounts, misrepresentation and massive unauthorized funding to the companies of crescent group.[36] CSIBL was a well reputed Pakistani concern business company and its shareholding structure consisted of general public and the crescent group of companies being the majority shareholders.

The Crescent Investment Standard Bank developed after mergers with other companies and started its business venture in the capital market after the mergers of First Standard Investment Bank Limited and First Crescent Modarba[37] in the year 2003.In 2005, the Modarba business gained growth but at the same time, it faced a tough competition from commercial banks. Some gains were achieved on the stock market; however, the spread income was poor with low profitability. The government of Pakistan established the Religious Board for the *Modarba* in 2005 with the expectation of opening up new business opportunities.

The Security and Exchange Commission of Pakistan encouraged acquisitions and voluntary mergers in order to improve the risk absorption capacity of the *Modarba* sector. There were a number of mergers of various companies which bespeaks of general strategic shift towards consolidation, being really required for the financial stability and operational flexibility. Security and Exchange Commission of Pakistan also issued the prudential regulations with the purpose of facilitating the operation of

[36] See Daily Business Recorder 16,2006.

[37] Modaraba is a kind of partnership by which one party provides the capital to the other to carry out business. The profits made are shared between the parties.

non-banking companies in 2006.The objective of issuing prudential regulations was to improve the governance of *Modarba* companies.[38]In the year 2005, the Bank appeared progressing well as per the rating of the JCR-VIS Credit Rating Company limited which categorized it as ‘’BBB+/A-2’’ uplifting it from BBB/A-3. The rating was based on all financial indicators.[39]

However, in the year 2006, it came as a surprise for the market to see a huge loss of RS 2.118 billion shown by the company and the loss per share was calculated as RS 16.85 and the share price was negative by RS.6.85. Although the CSIBL had in place the main corporate governance mechanisms such as, consistent board meetings, internal audit committee, and statement of compliance with the corporate governance code and also, as stated earlier, the bank was rated good by the JCR-VIS Credit Rating Company, yet the bank suffered a huge loss. The CEO and director of the CSIBL who was also CEO of an associated company declared in a press conference that he was not aware of the self-interested deals within the bank. He asserted that the board’s approval was not taken in self-interested transactions with connected parties such as the Javid Omar Vohra transaction and in selling bank’s assets, practically rendering the board of the bank irrelevant in this behalf.[40] Furthermore, another board member confirmed that board resolutions were overlooked, and also ignored.

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[38] Prudential Regulations for Non-Banking Finance , SECP <www.secp.gov.pk/corporatelaws/pdf/.../Prudential Regulations_2004_Amended.pdf>> accessed 27 June 2016

[39] See JCR-VIS < www.jcrvis.com.pk/docs/CSIBLComment.pdf> accessed 27 June 2016.

[40] CEO and Director Mazhar ul Haq made this statement in a press conference, Business Recorder, 19 September, 2006.

4.4.4 Commission's Proceedings

On receipt of complaints/reports, the Securities and Exchange Commission of Pakistan took up the matter and made orders as to on-site inspection of the records of CSIBL in exercise of its powers under section 282(1) of the Companies Ordinance, 1984.[41] A team of experts comprised of seven members, was appointed to carry out on-site inspection of the company (bank) at its main office supposed to be in safe custody of all relevant record. The team of inspectors traced a series of mismanagements, omissions and transgressions, in the record and operations of CSIBL, in contravention of law, rules and regulations in this regard. The inspectors drew up the detailed report dated 10 March 2006, highlighting all the irregularities committed by the management.

Each irregularity as detected and incorporated in inspectors' report needs to be recapitulated in some detail as below in order to have a complete picture of the state of affairs;

4.4.4.1 Parallel Books

The report disclosed that two parallel books were maintained by the CSIBL management with undisclosed balance of assets and liabilities under the pretext of "Managed Portfolio". This undisclosed balance amounts to RS.5.252 billion. On the other hand, the statement of accounts published by CSIBL for the half year ending 30 June 2005 depicted an asset volume of RS.9.559 billion while, on inspection, the parallel balance sheet reflected an assets balance of RS.5.252 billion which indicates that the balance RS.5.252 billion which was not incorporated in the published financial statement of CSIBL, for the notice of shareholders and general public. It was obviously an attempt towards camouflaging.

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[41] See Section 282(1), the Companies Ordinance 1984.

In fact, this parallel balance sheet was hidden with ulterior motives and published report was publicized with an intent to dishonestly misinform and defraud all the people staked on the company. The ulterior motives operating behind the undisclosed accounts as transpired from the investigation report of the SECP were making illegal payments to various parties from the money raised through borrowing from various financial institutions as well as the general public and getting away with the liability.[42] The inspection report by the inspection team has elaborated item wise as to on what footing above said assets of RS.5.252 billion were generated and then hidden through parallel books of accounts. As per inspection report, this all fell within the purview of the violation of provision envisaged under section 230 and 234 of the Companies Ordinance and rule 7(1)(a) of the NBFC Rules.[43] The said provisions of law clearly demanded CSIBL to keep proper books of account, balance sheet and profit and loss statements reflecting a true and a fair picture of the company's operations.[44]

4.4.4.2 Investment in associated companies/undertakings without proper approval.

The report further disclosed that CSIBL had invested in its associated companies and associated undertakings through investment in their shares amounting to a total of RS.562.027 million for the year ended 30 June 2005, without obtaining shareholders' approval through a special resolution, which the act constitutes contravention of section

[42] See Shahid Anwar, Tariq Aleem, Dr. Wasim Azhar , Mazurul haq, Shaid Latif Dar, Ifran Qamar& others, (former auditors of CSIBL), Mehmood Ahmed Shezi Nackvi v Chairman Securities and Exchange Commission of Pakistan [2015] Appellate Bench Security and Exchange Commission of Pakistan.

[43] See Section 230 and 234 of the Companies Ordinance 1984; See Rule, 7 (1), Non-Banking Finance Companies (Establishment and Regulation) Rules, 2003 (NBFC Rules).

[44] Ibid

208(1) of the Ordinance.[45] Further, as it transpired from the inspection report, CSIBL was also found to have entered into "Musharka" ventures involving real estate business with its associated company namely Mughreb Development Corporation Ltd. (private) for an aggregate amount of RS.1.540 billion (RS.655 million shown on parallel books of accounts maintained by CSIBL under the head of "Managed Portfolio". As per the borrower's basic fact sheet and corporate application form provided to the inspection team, appellant NO.7 namely Mr. Mahmood Ahmad was at the same time CEO of associated company MDPL and Mr.Tariq Saleem was at the same time director of the same. Evidentially, MDPL was an associated company of CSIBL but no authorization as to investment in or strike financial arrangement with the associated company, was obtained from the shareholders or the Board of Directors.

4.4.4.3 License for Housing Finance Services

On the one hand, CSIBL entered into real estate transactions with MDPL and alongside carried out similar financial arrangements of real estate venture with property dealers. However, the point to be noted is that CSIBL struck all these deals without having a proper license required for Housing Finance Services. The inspection report taking keen notice of this omission took it as violation of section 282 (2) c of the Companies Ordinance.[46]

4.4.4.4 Violation of Prudential Regulations

CSIBL had invested in group companies by way of investment in their shares to a total sum of RS.2.163 billion for the year ending 30 June 2005. Besides, as mentioned earlier, CSIBL was affording financial facilities to the tone of RS.1.540 billion, to its

[45] See section 208(1),the Companies Ordinance 1984.

[46] See section 282(2), the Companies Ordinance 1984.

associated company MDPL. Thus the total CSIBL's exposure to its group companies comes to RS.3.703 billion which considerably exceeded the statutory limit as provided in regulation 1(2) of part 2 of the Prudential Regulations. The inspection team calculated it item wise which perhaps needs not to be put in detail here to avoid unnecessary length.

4.4.4.5 Violation of Board Authority

Besides the above said irregularities, the CEO of CSIBL transgressed the power delegated to him by the Board of Directors of the company. The Board in its meeting held on 19 July 2003 clearly fixed limit requiring the CEO to remain within that. Regarding these exposure limits, the CEO was empowered to approve long-term and short-term financing through "Modarba" and "Musharka", discount/purchase of promissory notes against Bank Guarantees and cash collateral (deposit certificates) of an amount not exceeding 25 per cent of the liquid net worth of CSIBL. The liquid net base of CSIBL was RS.415 million on 30 June 2005. Thus, keeping in view the condition of 25 per cent limit, only 103 million could have been approved by him. The CEO, however, stepped far beyond his authority as per item wise analysis by the inspectors in their report.

On these bases, the Commission issued SCN dated 17 March 2006, 03 May 2006 and 04 May 2006 served on appellant Mr. Mahmood Ahmad CEO, Mr. Shahid Latif Dar appellant NO.5 CFO of CSIBL and other directors of the Board who are appelants1.2.3.4.8. SCN dated 11 May 2006 was also served on appellant NO.6 (M/S Syed Hassan & CO. Chartered Accountants) being the auditors of CSIBL.

The submissions made by the appellants in reply thereto, are summarized as below;

1- Appellant 2's major thrust was that he was non-executive director and could not be equated with CEO of the company. According to him, he had no role to play in operations of CSIBL.

2- Appellant NO.5 contended that decisions taken by him in his capacity as CFO of CSIBL were taken bona fide. He rebutted the allegation that he failed to maintain proper books of accounts of CSIBL and wilfully made statements which were false knowing them to be false. He further submitted that financial statements were checked by the Chief Internal Auditor and also by Chartered Accountants Firm as External Accountants before his signing or recommending to the Board of Directors.

3- Appellant 7 submitted that investments in real estate were undertaken by MDPL, hence, it could not be alleged that CSIBL made investments in real estate without possessing a license for House Financing Services, in violation of section 282 (c) of the Ordinance. He further submitted that maintenance of separate books of accounts in respect of "Managed Portfolio" was based on bona fide understanding that CSIBL was required to treat such accounts as separate from its other activities. As soon as CSIBL apprised that it was not in accordance with Commission's advice, it immediately took steps to rectify the situation.

4- Appellant NO.8 submitted that non-executive directors (including him) were informed by CEO and CFO and Internal Auditors that accounts were in order in all respects. He alleged that real situation was kept suppressed and he immediately resigned as soon as instances of mismanagement of the affairs of CSIBL came to his knowledge.

5- Appellant NO.6 submitted that impugned order was full of contradictions. He as "External Auditor" acted under the provisions of sections 255, 260 and 292 of the Ordinance and had no mala fide intention and had not gained any benefit from the alleged defaults.[47]

The respondent, Chairman SECP, in response thereto, rebutted the arguments relied upon by the appellants. These are put briefly as under;

1- CSIBL had undisclosed investments in Musharka/Mudarba real estate ventures and in doing so used its owned subsidiary i.e. MDPL whose CEO was also respondent NO.7.

2- CSIBL was not in possession of license for Housing Finance Services, as required under section 282c of the Ordinance read with NBFC Rules.[48] The appellant NO.7 failed to explain as to why some of the accounts were shown on the books of accountants CSIBL while the rest kept off?

3- Appellant NO.5, being the CFO of CSIBL was supposed to be aware of each and every financial transaction taking place within the company. He pleads unawareness and lack of knowledge but according to globally accepted principle, it is by no means a tenable excuse. Further, he did not raise his voice on these irregularities and so is unmistakably, considered a privy and party to the wrongdoings of the management.

4- Appellant NO.2 claimed his non-existence during alleged irregularities and non-acceptance of the offer of his duties. This contention is not supported by the factual position. He had been appointed as CEO on 04 June 2005 as per record, but in support of his non-acceptance stance, no email was received from him

[47] See sections 255, 260, 292 of the Companies Ordinance 1984.

[48] See Section 230 & 234 of the Companies Ordinance 1984; See Rule, 7 (1), Non-Banking Finance Companies (Establishment and Regulation) Rules, 2003 (NBFC Rules).

clarifying his position that he had not accepted the offer. It is pertinent to note that half yearly accounts were drawn during that period.

5- As far appellant NO.6, obviously the duties of External Auditors are supposed to be in the best interest of the shareholders of the company under audit. However, they failed to highlight the violations and dubious transactions in their audit report.

In the purview of the above given facts and figures, the Commission/the Chairman having found violation of regulatory framework by the management of CSIBL, imposed a penalty of RS.1,000,000 for contravention of section 208 of the Ordinance, and also a further penalty of RS.5,000,000 for violation of section 282(j) of the same.[49] The appellant NO.6 as auditors was found to have violated the provisions of section 260 of the Ordinance and a penalty of RS.100, 000 was imposed on every partner of the auditor's firm. Further, appellant NO.6 was also found to have violated the provision of section 492 of the Ordinance and a further penalty of RS.100, 000 was imposed on every partner of the Audit Firm.

4.4.5 The Judgement of the Bench

The impugned order imposing aforementioned penalties, was challenged by way of independent appeals NOS, 22, 23 24, 25, 29, 30, 31, 33 of 2007 before the Appellant Bench comprised of Mr. Fida Hussain Sumoo Commissioner (insurance) and Zafar Abdullah Commissioner (SCD) , which were jointly taken.

The Appellate Bench, having given consideration to both the contesting parties, dismissed the appeal, maintaining the impugned order vide its order dated 13 October 2015, with no orders as to costs.

[49] See section 208, 208(j) of the Companies Ordinance 1984.

The Bench, in nutshell, maintained and reiterated the stance of the Commission based on inspection report and made item wise observations to the effect that there is found an email on the record informing the management of CSIBL that appellant NO.2 had accepted the responsibility of the office of CFO. However, contrarily, there is nothing of the sort on record to show that he had turned down the offer (his main contention) to act as the CFO of CSIBL. This state of affairs clearly indicates that the irregularities in question occurred during his incumbency.

Respondent NO.7 in his turn, failed to show satisfactorily how the affairs of the company escaped his notice and knowledge. He also failed to convince that separate books of accounts were of discretionary clients as opposed to what the inspection report claimed. Moreover, the findings of the Commission/inspectors that CSIBL had undisclosed investment of RS.1.3 billion in Musharka/real estate without possessing license for Housing Finance Services in violation of section 282 (c) of the Companies Ordinance, 1984, also carry weigh.[50] Therefore, there appears no reason to interfere with the impugned order. Hence, the commission dismissed their appeal.

4.5 Evaluation of Findings

The findings from the case studies have shown that directors failed to discharge their duties in accordance with the law on four key aspects. First one relates to unauthorised inter-corporate financing and extending unauthorised advances and loans. Second, shareholders were deprived of their right to participate in the affairs of the companies due to the reason that annual general meetings of the companies were not held. Third, directors misstated facts to shareholder and failed to provide material information to shareholders. Fourth, directors abused their powers in keeping parallel books of

[50] See section 282(c) , the Companies Ordinance 1984.

accounts and straightaway misappropriating corporate assets for their private gains. The findings from the case studies are consistent with the problem of self-serving behaviour of corporate management in Pakistan.

According to a former SECP chairman, listed companies by and large in Pakistan hold eight, on average, subsidiaries or non-listed small business entities. He expressed that it is a normal practise in Pakistan that the holding companies advances loans to their subsidiaries and in most cases, these loans and advances are not recovered.[51] Mr. Fawad Hashmi, the head of the Pakistan Institute of Corporate Governance in his off-hands comments indicated that no denying the fact, it is a burning issue required to be looked into, monitored and meticulously taken care of, in the country.[52]

Another businessman from Karachi, with different business interests, remarks that some daring steps need to be taken. He had the reservation to point out names, but made gestures as to who were misdoing.[53] He was afraid of saying that tunnelling and associated party transactions were being carried out with least fear of punitive action. He maintained that the conditions are the same, be it textile, media, cement, fertilizers, drugs, FMCG companies and auto giants, etc. According to him, the big concerns were growing bigger in the shortest time and enjoy liberty to have recourse to any malpractices which paves way to multiplicity of their riches. Majid Aziz, a leading business man in Karachi is of the view that earning of a flagship companies who have earned unlimited wealth, are at liberty to support associated smaller companies in the

[51]See Daily DAWN, 06 January 2013, Independent Director's Integrity' <www.dawn.com/news/776832 > accessed 21 March 2016.

[52] See Daily DAWN , Murky Corporate Segment 23 December 2012< www.dawn.com/news/773559/murky-corporate-segment> accessed 24 March 2016

[53] Ibid

ownership of a group on business friendly terms with it. He commented that many people do not hesitate while appeasing regulators and abusing laws on the subject.[54]

Khalid Mirza, a member of Corporate Appellate Tribunal in his comments, classified it a core global issue of governance, in particular, in the context of Pakistan, where institutions are not strong enough to ensure effective implementation of laws and a segment of corporate players is not prepared to take things seriously. Very often directorial body disregards their prime responsibility and fiduciary duty to behave responsibly and manipulates decisions serving their personal ends in disregard of their mandate subordinated to the companies' interest.[55]

Managerial transgressions go mostly by tunnelling which denotes the utilization of the companies' assets for benefitting small firms under their control. It is a frequent phenomenon that they (the dominating shareholders) siphon off finances from where they wield low cash flow rights to firms where the situation is other way round i.e. high cash flow rights. Despite that, derivative proceedings are not recognised in the company law in Pakistan. Although, SECP, being a regulatory body, took notice of these managerial irregularities and to some extent punished the violators of law, yet as mentioned in chapter 1, public agencies do have enforcement priorities due to their limited official capacity and financial resources. Hence, it becomes difficult for them to deal with all managerial misconducts apt to arise. Moreover, the SECP also suffers from problems such as non-professionals serving in the SECP, the possibility that employees may succumb to the pressure of private interest groups, corruption and political control of the regulatory body.

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[54] Ibid

[55] Ibid

For instance, numbers of managerial transgressions have been reported in SOEs, however, there is no worthwhile example in which the SECP took up the matter and punished the wrongdoers in SOEs.[56] Thus, this study argues that apart from the public enforcement, the private-sector enforcement has to play its role via derivative litigation to discipline errant management in Pakistan. On that background, it is the primary duty of shareholders to come forward and take actions against the violators of law in corporate entities. In order to incentivise and activate shareholders to play their role in directorial accountability, there needs to be an effective enforcement power in the hands of shareholders to enforce their rights. In the light of findings from the case studies, law in relation to reinforcing shareholders' enforcement power so as to preserve corporate assets is justified.

4.6 Concluding Remarks

In order to provide basis and justification for studying the subject of derivative actions to discipline corporate management in Pakistan, a question was asked in the beginning of this thesis as to what extent theoretical claims made by a number of researchers about managerial misconduct in Pakistan are true. The findings from the case studies have illustrated the managerial misbehaviour that supports strengthening of shareholders' enforcement power to enforce laws in relations to corporations' rights. The introduction of a statutory framework for derivative actions is compounded by the weak alternative disciplinary mechanisms to discipline directors and managers in case they choose to ignore corporate and small shareholders' interest and serve their private interests. In order to address problems shareholders are facing in enforcing corporate rights, reform are suggested in the next chapter to facilitate a functional derivative

[56] Scams in SOEs in Pakistan such as, PIA, Railways, Pakistan Steal Mills, NICL and PTCL and many more have been reported in the national Newspapers.

action framework as an instrument for shareholders to redress corporate wrongs. It is hoped that reform proposals made in this study would help to revise enforcement power mechanism of shareholder as to vindicating their rights.

Chapter 5. Reform Proposals for a functional Derivative Action framework

5.1 Introduction

The findings in the previous chapters have provided a platform for a discussion on reform proposals made in this thesis to find ways for an effective use of derivative actions in Pakistan. The previous chapters have shown that small investors are placed in a vulnerable position in predominantly family-dominated and state-controlled companies in Pakistan. Most importantly, the evidence in chapter 4 reflects that controlling shareholders misuse their dominant positions and make self-serving decisions detrimental to the companies' as well as small investors' interests. In order for reducing conflict of interest problems occurring largely between controlling and non-controlling shareholders, regulatory and market-based managerial disciplinary mechanisms have been examined in chapter 1. It has been found that the extra-regulatory mechanisms have their own limitations; they cannot be a substitute for derivative litigation. Towards that end, chapter 1 suggests that derivative litigation as one of the legal mechanisms can be a meaningful disciplinary framework in Pakistan.

In chapter 3, problems as regards the rights of minority shareholders and their possible solutions have been discussed in the process of analysis of minority rights under the Ordinance. As discussed in chapter 3, the Ordinance does not recognise derivative litigation. In order to provide a greater enforcement power to minorities, it is imperative to consider codification of derivative action system that could be used in complement to other deficient managerial disciplinary mechanisms. The need for the statutory framework for derivative actions as identified in chapter 3 emerges from the problems

reflected in the Foss v Harbottle rule, inadequacy of alternative remedies and the issue of legal costs combined together, hamper shareholders' actions against wrongdoers.

In this thesis, a complete framework for statutory derivative action system is offered for improving the enforcement of shareholders' rights in Pakistan. According to Watson, borrowing from other jurisdictions can be a useful source of law reforms in a particular jurisdiction.[1] To that end, the UK statutory derivative action system has been chosen for comparative analysis so as to see what is replicable while making reform proposals in order to facilitate a meaningful statutory framework for the same in Pakistan.

The jurisdiction of the UK can be a good candidate for this comparative analysis because the UK has codified derivative action system and it would be helpful to learn from her experience and avoid mistakes. Moreover, where necessary, reference has also been made to other jurisdictions with a view to meeting the specific needs of Pakistan as to simplification, modernization and improvement as regards accessibility to derivative actions. In the light of problems with the shareholders' enforcement power, following three concrete recommendations are considered in this chapter, explaining how codified derivative action system can function effectively and if rendered more simplified with easier access to shareholders enabling them to have sufficient ability to oversee managerial and directorial decisions.

1 To develop a functional statutory framework for derivative actions.

2 To simplify and clarify the procedural route for derivative actions.

3 To improve accessibility to derivative actions.

Each reform proposal made in this study is discussed hereunder;

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[1] Alan Watson, 'Aspects of Reception of Law' (1996)44 *American Journal of Comparative Law* 335-351, 335

5.2 To develop a functional statutory framework for derivative action

Being a common law jurisdiction, it might be argued that the common law rules on the derivative actions can be invoked by the Pakistani courts so as to enable minority shareholders to seek actions against wrongdoers. The problems of the common law derivative action system have been discussed in detail in chapter 3. However, it is pertinent to reiterate briefly the problems of the common law. In order to understand the scattered common law rules, one has to examine reported cases decided over a period of 150 years; therefore the law in this respect is virtually inaccessible, save to the lawyers specialising in the field.

Furthermore, these cases come short of covering modern conditions and all types of managerial transgressions.[2] To exemplify, claims of negligence which are referred to as- (1) where management fails to act with reasonable skill, care and diligence; (2) where management fails to abide by its fiduciary duties, are not actionable under the common law.[3] Moreover, infringement of a personal right of an individual shareholder is not actionable under the common law rules of derivative actions.[4] This would mean that if an individual aggrieved shareholder does not have resources to take direct action, the wrongdoers would get away with their liability. This is because in direct actions, aggrieved shareholders themselves have to bear the costs of the suits.

Additionally, derivative actions are available at common law only in situations where wrongdoers have control over the company and the right of derivative litigation is not available outside these circumstances. There is also little guidance as to what

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[2] Arad Reisberg, *Derivative Actions and Corporate Governance: Theory and Operation* (Oxford University Press 2007) 90, he has discussed in detail all the circumstances that may and should arise as managerial oppressions.

[3] Ibid 127.

[4] Matthew Berkahn, 'Derivative Action in Australia and New Zealand: Will the Statutory Provisions Improve Shareholders' Enforcement Rights'(1998) 10 (1) *The Bond Law Review* 74-100,76

circumstances would evidence control.[5]This situation might operate to the detriment of shareholders in companies where directors enjoy control even without majority votes. This type of control can be exemplified in situations where different family members apparently in individual capacity own shares of a company, then jointly seize control over it. However, in situations where one family member (let's say) owns 42 per cent shares, it would not be treated as being in control of the company although it may commit fraud against the company in league with another family member who holds further 10 per cent shares of the same company, making it more than 50 per cent required for reaching decision taking threshold.

In recognition of the problems of common law, many common law jurisdictions have introduced codified derivative action systems in their legal framework so as to make shareholders' remedies more affordable and appropriate in modern conditions.[6]Likewise, the English Law Commission recommended for putting the common law regime of derivative actions to an end with statutory derivative action framework in the UK so as to achieve greater transparency and accountability in an age of increasing globalisation of investment.[7] In response to the recommendations of the UK Law Commission, a new statutory regime of derivative actions has started in the UK with the enactment of the Companies Act 2006. [8] Under this statutory regime, the cause of action and range of applicants have been broadened. The courts have been conferred with wide powers and discretion to determine whether a derivative action is in the interest of a company and if so, to permit the continuation of the suit.

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[5] Chrispas Nyombi and Alexender Kibandama, *Principles of Company Law in Uganda* (Law Africa Publishing (k) Ltd, 2014)121.

[6] Countries such as the US, Australia, Canada, New Zealand, Japan, South Korea, China, Hong Kong, South Africa among others which have codified derivative action systems.

[7]The UK Law Commission, Shareholder Remedies: para 6.4,6.9, 6.1

[8] See section 260-264, the UK Companies Act 2006

Many commentators have also urged the expediency of codification of derivative action framework. For example, according to Reisberg, common law rules on derivative actions are complicated and ambiguous; hence, there is a need for more flexible, modern and easily accessible criteria for permitting the continuance of derivative actions.[9] This is also seen in the discussion of another commentator who argues that if derivative litigation has to be a key element in preventing breach of directors' duties, it needs to be simplified and modernised so as to make it accessible to shareholders.[10]

Moreover, Nyombi and Kibandama have criticised the common law situation on derivative proceedings and highlighted three key problems namely, restricted standing requirements, ratifying issues and litigation costs as the fundamental restraining issues for shareholders to initiate actions which the situation needs to be rectified through codified derivative action system.[11] In the light of the problems at common law, codified derivative action system also needs to be considered in Pakistan so as to offer clarity in reference to the rights of shareholders for bringing derivative actions. As opposed to the common law that is scattered, outdated and confines the courts to follow old case law, a codified law offers following advantages;

First, clear statutory rules would remove all ambiguities at common law and provide a certainty as to the procedural route of shareholders' right of derivative litigation. Second, courts would be having an independent view in relation to the determination of derivative proceedings in the interest of the companies. Third, statutory provisions would enable courts in exercising their powers as to order legal costs instrumental to

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[9] Arad Reisberg, 'Shareholder Remedies: The Choice of Objectives and the Social Meaning of Derivative Actions' (2005)6(2)*European Business Organizations Law Review* 227-268, 258

[10] Andrew Keay, 'Assessing and rethinking the statutory scheme for derivative actions under the Companies Act 2006 (2016) 16(1) *Journal of Corporate Law Studies* 39-68, 47

[11] Ibid (n 5) 132-133.

encourage shareholders to step forward and initiate actions against wrongdoers. Fourth, without statutory right of the derivative actions, a local shareholder of a company listed in any other country would be barred by the operation of the derivative action under the common law.

Last but not the least, ratification would not operate as a bar to derivative litigation as it is not always clear in which circumstances ratification would be effective and it might, in some situations, result in the unjust outcome.[12] In this respect, some guidelines are recommended for courts in Pakistan to exercise their discretions in accepting ratification of wrongs by the wrongdoers.

It is submitted that ratification by the defendants of their own misdoings should not be accepted by courts in order to deny continuation of derivative litigation. The courts should, in particular, disregard ratification when made by the wrongdoers who have substantial influence over the decisions of the company. Moreover, the courts should consider the quality of information shareholders had at the time of ratifying the wrong. If material information is not disclosed to shareholders causing ill- informed decision of ratification of the wrong by the shareholders, the courts should disregard such shareholder ratification. Additionally, types of companies should be taken into account by the courts as to whether accept or deny the ratification. For example, ratification of wrong should be reluctantly accepted in the public and widely-held companies. This is because shareholders in such companies show apathy and remain inactive in corporate affairs.

[12] Ibid 125

5.3 To simplify and clarify the procedural route for Derivative Action

5.3.1 Derivative Claimants

As stated above, derivative litigation is not recognised by the Companies Ordinance in Pakistan. Likewise, judiciary in Pakistan has not advanced jurisprudence in respect of standing rules and the range of actions in derivative proceedings. As opposed to the situation in Pakistan, the UK Companies Act 2006 provides for the range of applicants who can bring derivative proceedings and ample scope of actions which can be subjected to derivative litigation.[13] It provides that an individual shareholder regardless of his/her voting power has the *locus standi* (standing) to initiate litigation against errant directors and managers.

The right to bring a derivative action is also vested with shareholders who become shareholders by the operation of law.[14] The term, 'by the operation of law' means, transfer of right or liability to a party by the operation of legal principles without the intention of the party to that effect. The Act provides that there is no condition for minimum requirement of shares to bring a derivative suit. In other words, a shareholder who owns even a single share may bring a suit derivatively. However, the UK Company Act does not recognise standing rules namely; 'Contemporary Stock ownership', 'Continuous Ownership Requirement', the 'Double Derivative Actions' and the rule of 'Adequate Representation of Companies' and other Stockholders' Interests'.

These standing rules are of paramount importance in the context of Pakistan so as to bring greater clarity as to the standing rules of derivative claimants. It is recommended

[13] See section 260 (5) (C), the UK Companies Act 2006

[14] See section 260(5), the UK Companies Act 2006

in this thesis that these rules need to be taken into account in the future legal amendments in the company law in Pakistan. Explanation and basis for the consideration of these standing rules are discussed below;

5.3.1.1 Contemporary Stock Ownership

The rule of 'contemporary stock ownership' requires a shareholder applicant to be the owner of shares at the time of the occurrence of an alleged fiduciary wrong.[15]Under this rule, a shareholder who purchases shares after the alleged wrong is disqualified from suing errant wrongdoers. Under the UK Companies Act, there is no such restriction to commence derivative proceedings.[16] However, the 'contemporaneous ownership requirement' is necessary in the context of Pakistan so as to prevent vexatious litigation and to discourage malicious purchasing of shares simply for bringing suits.[17] In the absence of 'contemporary ownership requirement' a shareholder might purchase shares with an object to bring a derivative suit and may have ulterior motives operating behind bringing the suit.[18]

However, it might be argued that derivative litigation is initiated by a shareholder where the board of directors fails to hold wrongdoers in the corporation, accountable. In this situation, the board commits a wrong in the sense that it fails to hold the wrongdoers accountable. The omission on the part of the board of directors eventually leads all the present shareholders to suffer regardless of the fact as to when they

[15] See section 327, Delaware General Corporation Law.

[16] See section 260 (4), the UK Companies Act 2006.

[17]AlaBy Prods. Corp v Cede & Co[1995] 657 A.2D 254,264

[18] Sarah Wells, 'Maintaining Standing in a Shareholder Derivative Action'(2004) 38 *UC Davis L. Rev* 343-359,354; Rosenthal v. Burry Biscuit Corp[1948] 60 A.2d 106, 111;Schoon v Smith [2008]953 A.2D 196,203

purchased the shares. Therefore, an after-acquiring shareholder,[19] along these lines, should be qualified to initiate derivative proceedings.[20]

Moreover, it is contended that since in a derivative suit, a corporate wrong is sought to be remedied and for that matter not a private wrong; question of present or after-acquiring shareholder in this respect becomes immaterial.[21] This is why because benefits of successful derivative suits accrue to the wronged corporation in either way whether the suit is brought by a contemporaneous shareholder or by an after-acquiring shareholder.[22] However, in this respect, it is submitted that despite the fact that a successful derivative suit promises compensation for the wronged company, the 'contemporary stock ownership requirement' holds its significance in Pakistan for discouraging purchasing of litigation.

For example, without 'contemporary stock ownership requirement', a market for claims is apt to arise. Some unscrupulous investors may buy shares in companies where managerial illegal activities have been unleashed so as to commence litigation with ulterior motives operating behind this option. Unfounded litigation motivated by personal hatred, family feuds, other ulterior agendas such 'gold digging' might be such bad motives bringing no benefit but the cost to the company.[23] In other words, purchasing of shares might be advantageous to companies in financial terms, however, in the long run; it may encourage a market for claims to grow which, of course, cannot

[19] Who purchases shares after the occurrence of the alleged wrong.

[20]Travis J Laster, 'Goodbye to the Contemporaneous Ownership Requirement'(2008) 33(3)*Delaware Journal of Corporate Law* 673-694,677

[21] Ibid 677.

[22] Ibid 677.

[23] Franklin .A Gevurtz, Who Represents the Corporation? In Search of a Better Method for Determining the Corporate Interest in Derivative Suits (1984) 46 *U. Pitt. L.Rev* 265, 288, 73.

be morally justified. Growing of a market of claim would also have detrimental impacts on the progress of the capital markets in Pakistan where society is litigious. [24]

Thus, allowing after-acquiring shareholder to initiate derivative proceedings might aggravate the situation and may create a culture of litigation feuds detrimental to the emerging commercial society in Pakistan. In the corporate world, a healthy competition is necessary for bringing about socio-economic change. However, a society which is already a litigious one, absence of 'contemporary stock ownership requirement' may boost baseless litigation which, in turn, would affect business operations.

Therefore, it would be better to accommodate the 'contemporary stock ownership requirement' in the statutory framework for derivative actions in Pakistan. The contemporaneous ownership requirement is recognised in a number of jurisdictions so as to prevent unjust enrichment of shareholders who get to be the shareholders after the occurrence of the alleged fiduciary wrong.[25] Likewise, the rule is recognised by the company law and accordingly, by the judiciary in South Africa.[26] For example, in the case of Brown v Nanco (Ptv) Ltd, the court denied continuation of the suit due to the fact that the appellant had walked away from the company by selling his shares and the existing shareholders were not in favour of bringing the suit.[27] Moreover, in recognition of the utility of contemporary stock ownership requirement, many commentators have

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[24]Yasser Latif Hamdani, INP 'The Crisis of Legal Aid in Pakistan' <www.inp.org.pk/sites/.../The%20Crisis%20of%20Legal%20Aid%20in%20Pakistan.pd>accessed 12 April 2016.

[25] Ralph C. Ferrara, Kevin T. Abikoff, Laura Leedy Gansler, *Shareholder Derivative Litigation: Besieging the Board* (Law Journal Press 2013)4.2(2); Rosenthal v. Burry Biscuit Corp [1948] 60 A.2d 106, 111;Schoon v Smith [2008]953 A.2D 196,203; AlaBy Prods. Corp v Cede & Co [1995] 657 A.2D 254,264; Danielewicz v Arnold [2011] 769 A 2d, 274, 291. The Contemporaneous Ownership Requirement is provided in, Federal Rules of Civil Procedure Rule 23.1.

[26] See Section,165(2) of South African Companies Act 71 of 2008.

[27] Brown v Nanco (Ptv) Ltd [1977] 3 (SA)761(W).

argued in favour of this standing requirement for derivative claimants in order to discourage purchasing of litigation.[28]

5.3.1.2 Continuous ownership requirement

Under 'Continuous ownership requirement', a shareholder applicant must maintain his status of being shareholder up till the derivative litigation is disposed of.[29]A shareholder applicant, who chooses to sell his shares before the final disposal of the suit, ceases to be the rightful plaintiff in the suit. The reason behind the 'continuous ownership requirement' is the prevention of vexatious and unfounded litigation.[30] For example, a former shareholder who has quitted the company, before the final disposal of the suit, may be tempted to accept bribe for the purpose of withdrawing from the suit. To that end, he might be willing to accept an inappropriate settlement as he/she no longer occupies any financial stakes in the company.

In this context, a pertinent question arises as to whether a former shareholder, who commenced the suit and later on, walked away from the company, should be allowed to continue to follow the suit? And if the answer is not in affirmative, what would be the legal basis to restrict him/her from continuing to pursue the suit?

In respect of the 'Continuous Ownership Requirement', the British company law provisions on the standing rules of derivative actions are silent.[31] However, it is submitted that 'continuous ownership requirement' ought to be considered as far as the

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[28] Ibid (n 25); Sarah Wells, 'Maintaining Standing in a Shareholder Derivative Action'(2004) 38 *UC Davis L. Rev* 343-359,354.

[29] Oliver v. Boston Univ [2006] No. 16,570-NC, 2006 Del. Ch. LEXIS 75, at 83; Parfi Holding AB v. Mirror Image Internet Inc. [2008]954 A.2d 911.

[30]Malajka M Eaton, Leonard J. Feldman, and Jerry C. Chiang, 'Continuous Ownership Requirement in Shareholder Derivative Litigation: Endorsing a Common Sense Application of Standing and Choice-of-Law Principles'(2010) 47 *The Willamette L. Rev* 1-23,3

[31] See section 260, the UK Companies Act 2006.

standing requirements of derivative actions are concerned in Pakistan. This is because a former shareholder, who has quitted the company, might not behave honestly and adequately represent the interest of the company as he/she no longer carries any financial stake in the company.

Moreover, even if a former shareholder is allowed to pursue the suit, the suit may be dismissed by courts on grounds of non-existence of his/her direct interest in the suit. This is because the Pakistan Code of Civil Procedure provides that a suit in which the applicant has no direct interest is liable to be dismissed except in the interpleader suit. [32] Therefore, the applicant should be disentitled to pursue the suit. Furthermore, a shareholder claimant derives his standing to derivative proceedings from his position of being a shareholder in the company and, if he ceases to continue as such, he, as the logic follows, loses his right of a corporate action.[33]

5.3.1.3 Double Derivative Actions

The rule of 'Double Derivative Actions' is recommended in this study so as to enable shareholders of holding companies to bring suits against errant directors/managers of the subsidiaries. A derivative action initiated by a shareholder of a holding company against the errant directors/managers of one of the subsidiaries is called 'Double Derivative Action'.[34] For example, A is a minor shareholder in a company M Ltd that owns a company N Ltd- the subsidiary of M Ltd. If A wishes to bring suit against the

[32] See Order 7, Rule 9(2) &4 The CODE OF CIVIL PROCEDURE 1908; see section 88 and order 35, rule 3 Code of Civil Procedure 1908 for Interpleader suit, interpleader suit is initiated to determine the rightful owner.

[33] Eric S Waxman, Peter B Morrison and Virginia FMilstead, 'Recent spate of US federal decisions elucidates parameters of Continuous Ownership Rule'(2009)2(4)*Journal of Securities Law, Regulation & Compliance 353-359,353*

[34] Ibid (n 10) 47.

errant directors of the company N Ltd, it is called a double derivative action or a multiple derivative action.

Although, a shareholder applicant of a holding company does not have direct interest in the subsidiaries, yet he/she may suffer indirectly from a wrong done to a subsidiary company and also, the holding company itself does not remain unaffected by the wrong done to its one of the subsidiaries. In this respect, permitting multiple derivative actions would be a useful standing rule in the context of Pakistan where groups of companies are controlled by majority shareholders. The aim is to hold wrongdoers in direct or indirect subsidiary companies which are not independent of the control of the board of directors of the holding company, accountable. This is important to avoid unwanted situations where fraudsters may choose direct or indirect subsidiaries instead of holding companies for commission of wrong.

Multiple derivative actions have received acceptance and approval in many jurisdictions such as Canada, Australia, New Zealand, the US and Germany.[35] The legislative position as to the multiple derivative actions was not clear in the UK as section 260 of the Act does not expressly provide for multiple derivative actions. However, in the recent past, courts have cleared ambiguities regarding the acceptability of the double derivative actions in the UK. For example, in *Universal Project Management Services Ltd v Fort Gilkicker Ltd ors*[36], the court held that the multiple derivative actions are available to shareholders of holding companies to call errant directors of the direct or indirect subsidiaries to count. The court referred the judgment

[35] See section 309 (f), 317, German Stock Corporation Act; Harald baum and Dan w. puchniak, 'The derivative action: an economic, historical and practice-oriented approach' in Dan W. Puchniak (eds), The Derivative Action in Asia: A Comparative and Functional Approach (Cambridge University Press, 2012)8; See section 236 (1)(a)(i) The Australian Corporation Act 2001; See section 165(1)(a) Companies Act 1993, New Zealand.

[36]Universal Project Management Services Ltd v Fort Gilkicker Ltd ors[2013] All ER D 313

of *Slington Borough Council v Uckac*[37]in which it was held that if it is not expressly provided, the common law principle would be construed as survived.

Moreover, in a very recent case, '*Bhullar v Bhullar*'[38], the court ruled that the double derivative action is necessary to avoid the risk where wrongdoers may choose subsidiary companies instead of the holding company, to commit frauds. Thus, 'Double Derivative Action' is recommended to be incorporated in the statutory framework of derivative actions in Pakistan in order to enable shareholders of holding companies to bring suits against errant directors/managers of the subsidiaries. In addition, it is also important to allow, 'Double Derivative Action' in view of international joint venture disputes involving structures with layer of companies incorporated in different states.

5.3.1.4 Adequate representation of the companies' as well as other stockholders' interests

Another standing requirement for derivative claimants namely 'adequate representation of the companies' as well as other stockholders' interests, needs to be taken into account in Pakistan. Since derivative proceedings are initiated by shareholders for redressal of corporate wrongs, adequate representation of the companies' interest is essentially needed to be considered in this respect.[39] In order to ensure adequate representation of the companies' as well as other stockholders' interests, following factors need to be taken into account by courts.

First, it is necessary to make sure that the claimant shareholder's personal interest does not overshadow that of the company and to ensure further that the suit would not

[37]Slington Borough Council v Uckac [2006] 1 WLR 1303

[38]Bhullar v. Bhullar [2015] EWHC 1943 (Ch)

[39] George S. Geis, 'Shareholder Derivative Litigation and the Preclusion Problem' 2014 <m.law.uchicago.edu/files/files/geis_paper.pdf> accessed 02 August 2016.

operate to the detriment of the company's interests. Second, it is to be ensured that the claim is represented by competent lawyers and should not be put in the hands of an inefficient counsel. Third, courts must also ensure that the suit is pursued vigorously and prosecuted diligently. The UK Companies Act does not expressly provide for the conditions requisite for 'adequate representation of the companies' as well as other stockholders' interests.[40] It is worth mentioning here that the requirement of adequate representation of the companies' as well as other stockholders' interests cannot be compromised in Pakistan due to the following reasons;

First, society in Pakistan is highly litigious; as such risk of vexatious litigation is ever so impending. In this respect, courts must ensure adequate representation of the companies' as well as other stockholders' interests before granting leave for derivative litigation. Second, an individual shareholder applicant might engage an incompetent lawyer to pursue the suit which may result in the dismissal of the suit. Such a lawyer may also enter into dubious deals with the management to receive illegal gratification as a reward for not pursuing the suit with vigour. Third, adequate representation of the companies' interest is also necessary so as to avoid multiplicity of proceedings relating to the same corporate wrong.

For example, other shareholders, besides the original shareholder applicant, or even the company itself may choose to bring suit on same cause of action under the presumption that the former suit was not pursued proficiently. The company itself or other shareholders inclined to bring a twin suit, in such situations; would be barred by law as suits already adjudged by courts cannot be reinitiated. The rule of res-judicata applies

[40] See section 260, the UK Companies Act 2006.

to such situations and bars the commencement of a fresh suit, already adjudicated upon by a competent court.[41]

Application of the rule of 'adequate representation of the companies' interest' is essential because it allows shareholders to bring suits only where these advance the companies' interest at an optimal level. An insufficient and abortive derivative litigation is always likely to result in the corporate wrong going without being rectified as the rule of res-judicata forbids double jeopardy, i.e a fresh suit on the same cause of action and aims at avoiding conflicting treatment of wrongs by courts.[42]

It is, therefore, suggested in this thesis that the requirement of 'adequate representation' of the companies' interest' should be taken into account so as to avoid shareholders' manipulation in respect of derivative suits.

5.3.2 Actionable Wrong

This part of the discussion aims at clarifying corporate cause of action and elucidates as to who should be subjected to derivative proceedings. The Companies Ordinance holds only directors accountable for breaching their fiduciary duties. Corporate actions which are independent of the actions of directors are not actionable under the Ordinance. The Ordinance does not regulate shareholders enjoying majority voting power (controlling shareholders) and accordingly absolves them of their fiduciary duty.

Fiduciary duty involves two kinds of obligations; first, it seeks duty to care and second, it envisages duty of loyalty.[43]The duty of care requires controlling shareholders to adhere to the standards of reasonable care to act in the interest of the company. As to

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[41] See Section 11 of Civil Procedure Code 1908 , Pakistan

[42] Ibid

[43] Robert Clark, *Corporate Law* (Aspen Publishers , Inc 1986)511; John H. Farrar, Nigel Furey, Brenda Hannigan Philip Wylie , *Farrar's Company Law* (4th edition Butterworths Law 1998)297,245.

duty of loyalty, controlling shareholders are expected to abandon their private interest for the sake of securing the company's interest.[44]The Ordinance does not expressly prohibit controlling shareholders from violating provisions against conflict of interest which they can do by exercising their voting powers in members' general meetings.

5.3.2.1 Regulating Majority Voting Power

It is suggested in this thesis that the Companies Ordinance should regulate majority voting power. This is because group of companies controlled by majority shareholders is a striking feature of the corporate sector of Pakistan. Controlling shareholders place their relatives, friends and trusted persons in managerial positions. As a result, the managers advance the interests of the controlling shareholders in disregard of the company's and its minorities' interests.

The problem arises when they function in a double character i.e both as shareholders and directors. Being members of the board, they may directly influence boards' decisions and also, they may indirectly influence boards' decisions as being the controlling shareholders.[45] Dominance of controlling shareholders and insufficient legal protection place minorities at the risk of majority abuse as under the Ordinance, the controlling shareholders are not bound by provisions against conflict of interests. Manipulations at the hands of controlling shareholders by their dominant positions, generate a serious agency problem that signifies mistreatment to minority shareholders.

Normally, shareholders are vested with voting power so as to safeguard their interests regardless of the concern whether the voting power is exercised in accordance with the

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[44] Paul Davies, Sarah Worthington, Sarah Worthington, *Gower & Davies: Principles of Modern Company law* (8th edition Thomson Sweet & Maxwell , London 2011)520.

[45] Malik M Hafeez, *Corporate Governance and Institutional Investment: Rules, Regulations and best practices to monitor corporate affairs and balance the interests of managers and shareholders* (Universal Publishers Boca Raton Florida 2015) 200.

company's or other shareholders' interests.[46] However, voting power of shareholders needs to be subjected to some limitations. It must be exercised bona fide where it is used for the alteration of the articles of association. As such, it is difficult to assess, in practise, the bona fide use of the voting power. The bona fide use of voting power should be subjected to pass the *Allen Test* that interprets the use of voting power, for the benefit of the companies as a whole.[47] The *Allen Test* requires that a resolution for the alteration of articles of association should not place minority shareholders at a disadvantageous position. If it does so, it fails the *Allen Test*.[48]The test is treated as passed where a person of ordinary prudence considers alteration of the articles of association in the interest of the company.[49]

Moreover, the use of majority voting power should not be exercised to ratify breach of directors' duty. It is a fundamental rule of the fiduciary law that breach of fiduciary duty can be excused by the beneficiary.[50] However, application of this rule in the company context would mean to allow controlling shareholders to ratify breach of directors' duty by passing an ordinary resolution in members' general meeting.[51] Directors may breach their fiduciary duties to reward controlling shareholder and the controlling shareholders, in return, may absolve the errant directors of their liability, by ratifying the breach through passing of an ordinary resolution. Controlling shareholders, therefore, should not exercise their voting power so as to commit fraud

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[46] Robin Hollington, *Shareholders' Rights* (Sweet & Maxwell 2004)8

[47] Brenda Hannigan, 'Altering the articles to allow for compulsory transfer: dragging minority shareholders to a reluctant exit'(2007) *Journal of Business Law* 471-501, 480

[48] Ibid 479

[49] Ibid 477

[50] Paul L. Davies, L.C.B. Gower, *Gower's Principles of Modern Company Law* (6th revised edition Sweet & Maxwell 1997) 644.

[51] Ibid 645.

against small investors as well as to ratify a breach of directors' duty detrimental to the interests of the company.

As such, regulation of controlling shareholders is inseparable from the regulation of directors.[52] The regulation of controlling shareholders may be done in two different ways. First, they can be directly recognized as the 'shadow directors'[53] and thus, be made subject to fiduciary duties owed by directors. Second, directors can be made liable for the conduct of controlling shareholders in disregard of the companies' as well as other shareholders' interests.

5.3.2.2 Standing of companies in derivative action

It is important to determine the standing of a company in derivative proceedings. This is because derivative proceedings are initiated by shareholders in the name of the wronged company when the company or the board of directors fails to hold wrongdoers accountable.[54] In this context, the companies are isolated from litigation because shareholders step into the shoes of the company and thus, they are called the claimant. However, so far as the outcome of derivative litigation is concerned, the companies do not remain unaffected by the derivative proceedings. As the Companies ordinance does not recognise derivative litigation, there is no clarity as to the position of companies in derivative litigation. A decision of a court, however, determines the status of companies as the defendants in the derivative proceedings.[55]

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[52] Stephen M Bainbridge, *Corporate Law and Economics* (Foundation Press 2002) 513; Reinier R. Kraakman et al, *The Anatomy of Corporate Law* (Oxford University Press, 2004)11-14.

[53] The term 'Shadow directors' has been defined in the UK Companies Act 2006, 'the person in accordance with whom directions or instructions the directors of the company are accustomed to act' See section 251 (1) of the UK Companies Act 2006.

[54] Ibid (n5)118.

[55] Mst Sakina Khatoon and 6 others v.S S Nazir Ahsan and 17 others [2010] 12 CLD 963

It is submitted that the companies should not be regarded as defendants in the derivative actions. This is because of the existence of conflict of interest between the fraudsters and the companies in derivative proceedings. As such, considering companies as defendants would lead to confusion as to identification of the real defendants in derivative suits. However, it might be argued that if a company is not a defendant in a derivative suit, then, naturally, it has to be designated as the applicant. As the logic follows, companies cannot be referred to as 'applicants' in the derivative suits. This is because the right to sue wrongdoers in corporations is transferred to shareholders when companies fail to hold wrongdoers accountable. In that context, the companies cease to be the rightful applicants.

The companies can neither be identified as the applicants nor as the defendants in the derivative ligation. Nonetheless, companies need to be recognised with a legal status in derivative litigation. This is because the ultimate beneficiary of the successful derivative suit is the company and in this respect, it remains connected with the litigation. In this regard, it would be worthwhile that the companies should be categorised as 'third parties'.

The 'third party' is a legal concept which denotes that a party who has no direct claims in the litigation, yet it has legal interests in the litigation is referred to as the 'third party'. However, one may argue against it that since companies are the beneficiaries of successful suits, it gets for the companies 'direct claims'; therefore, the companies cannot be categorised as 'third parties'. In this respect, it is submitted that the companies lose their position as direct claim holders when they refuse or fail to bring suits against wrongdoers; then naturally, the right to direct claim is transferred to the shareholders.

5.3.2.3 Derivative Proceedings against Non-Executive Directors

According to the common law rules of derivative actions, in order to initiate derivative litigation, the wrongdoer has to be in control of the firm.[56] The 'wrongdoer control' bar under the common law rules absolves non-executive directors of their liability. In this context, derivative proceedings against non-executive directors would be difficult to prove due to the 'wrongdoer control' barrier as the non-executive directors do not own majority voting power to exercise control over the companies. This state of affairs gave rise to the problem of establishing cases against wrongdoing non-executive directors in the UK. For example, there were only two suits brought against non-executive directors prior to the Companies Act 2006 and the same were unsuccessful.[57]

In response to the problems of common law rules of derivative actions, the 'wrongdoer control' bar has now been removed under the Act and thus, shareholders are now allowed to take actions against errant non-executive directors in the UK.[58] The real independence of non-executive directors is a problem in Pakistan due to the adoption of conventional so-called practice of hand picking while filling in non-executive directorial positions. Therefore, it is recommended in thesis that wrong-doing non-executive directors should be subjected to derivative proceedings for the breach of their duties in order to provide an effective ex-post control over executive directors in Pakistan.

[56] Ibid (n5)118.

[57] Equitable Life Assurance Society v Bowley [2003]EWHC 2263(Comm).;Prudential Assurance Co.Ltd v Newman Industries Ltd (No.2)[1982] Ch 204.

[58] See section 261(1) The Companies Act 2006; Bamford v Harvey [2012]EWHC 2858 (CH)

5.3.2.4 Corporate cause of action

Under the present law, only directors are accountable for the breach of their fiduciary duties in Pakistan. As opposed to the situation in Pakistan, the corporate cause of action has been broadened in the UK by the enactment of the Companies Act 2006. In fact, this enactment has not done away with the common law rules on the cause of action rather; it has enlarged the range of corporate cause of action.[59]It provides that the cause of action arises where there is an act or omission involving negligence, breach of trust and breach of duties on the part of the directors.

The Act retains the common law concept of fiduciary duties of directors (duty to care and duty to loyalty) and in doing so, it extends the range of the cause of action to directors' breach of fiduciary duties. The Act also includes the claims of negligence within the scope of corporate cause of action without showing that the defendant directors gained personally. The claims of negligence were not earlier treated as corporate cause of action under the exceptions to the *Foss v Harbottle* Rule.

It is, therefore, recommended that this aspect of the company should be subjected to serious deliberations. The sphere of cause of action should be broadened enough to make all types of directorial transgressions such as abusive transactions, exploitation of corporate opportunities, excessive salaries to managers, tunnelling of corporate assets and other acts of mismanagements, actionable. The company law should expressly provide for the directors' duties.

Accordingly, violation of statutory and fiduciary duties of directors, articles of association and other legal provisions premised on protecting the interests of companies and their shareholders, should be considered as the corporate cause of action in the

[59] See section 263(3) of the Companies Act 2006.

derivative litigation. Statutory framework of derivative actions of many jurisdictions such as Canada, Australia and New Zealand provide no limit in relation to the corporate cause of action.[60] Therefore, it would be pertinent if the framework for derivative actions in Pakistan permits derivative litigation against anyone and under any cause of action where the board chose not to bring actions against the wrongdoers.

5.3.2.5 International Corruption and Derivative proceedings

Derivative litigation is also important in the fight against bribery, corrupt payments and waste of corporate assets. The cause of action in derivative proceeding should also be extended to matters of questionable payments made by the companies. Such corrupt payments might be used in furtherance of the interests of the companies; however, shareholders are entitled to challenge such payments on grounds of the waste of corporate assets and breach of fiduciary duty which the directors owe to the shareholders. This element of cause of action in derivative proceedings is recognised in the US. For example, in the case of Auerbach v Bennet, corrupt payments and kickbacks paid by the corporation were challenged by a shareholder through a derivative action. The court permitted the action to be continued on the cause of action involving acts of bribery and illegal payments.[61]

Likewise, international corruption was also recognised in the UK in the judgment of Konamaneni and others v. Rolls Royce Industrial Power (India) Ltd and others in the context of derivative proceedings and it became a cause of action in derivative litigation as an exception to the Foss v Harbottle.[62] In this case, minority shareholders of an Indian company namely; Spectrum Power Generation Ltd levelled allegations of

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[60] Ibid (n 10) 48.

[61] Auerbach v Bennet ,[1979]419 NYS 2d 920.

[62] Konamaneni and others v. Rolls Royce Industrial Power (India) Ltd and others [2002]1 ALL ER 979.

bribery against British enterprises for bribing managing director of the Indian company in return of getting business contracts relating to the installation of power station in India. The claimant shareholders sought court permission to commence litigation against Spectrum Power Generation Ltd Company in the UK. The claimants were allowed to commence derivative action. The claimants contended that the issue as being fraud against minority fell within one of the exceptions to the Foss rule. The court held in favour of the claimants and accepted the case holding that the English courts possess jurisdiction over derivative proceedings pertaining to foreign corporations.

The suit gave new insight into how to interpret fraud on minority as being one of the exceptions to the Foss Rule. Acts of bribery and illegal payments are now also actionable under the statutory derivative action system provided in the Companies Act 2006.[63]

International corruption is a subject which also needs to be given attention in Pakistan. Scams such as Karkey[64] and Reko Diq[65] offer ample testimony to such kind of corruption which the situation calls for an attention of legislators to extend cause of action to international corruption and illegal payment in derivative proceedings so as to strengthen the enforcement powers of shareholders to punish the wrongdoers involved in acts of bribery and receiving kickbacks in return of transacting business deals on less than market rates. In Karky scam, the managing director of Private Power and Infrastructure Board (PPIB) and three chief executives directors of Lakhra Power Generation Company along with other government officials were found involved in

[63] See section 260 of the UK Companies Act 2006.

[64] See Daily Dawn Newspaper, 22 June, 2016, Arrest made in Karkey Scam Case <www.dawn.com › Newspaper › Islamabad> accessed 30 December 2016.

[65] See Daily Dawn Newspaper, 26 March, 2017, The Reko Diq Disaster < https://www.dawn.com › Newspaper › Editorial> accessed 03 April, 2017.

award of contracts for Karkey in return of receiving kickbacks and other illegal payments.

It is, thus, recommended in this thesis that the extension of cause of action in derivative proceeding to international corruption ought to be considered by the policy makers and legislators in the new company law in Pakistan.

5.3.3 Assessment of derivative Action

Like most of the common law jurisdictions where derivative litigation is recognised by the law, courts also assume a paternalistic role relating to assessment of derivative actions in the UK.[66] The aim of assessment of derivative actions is to determine whether the suit is in line with the interest of the company and whether it should be permitted to continue or dismissed. However, 'court approach' pertaining to the assessment of derivative actions is not operative in all the jurisdictions. For example, in the US, it is the board of directors which is required to make assessment as to derivative proceedings. This part of the discussion evaluates both the approaches in regard to determining whether if the court approach is adopted; it would ensure more corporate accountability in Pakistan.

5.3.3.1 The Board approach pertaining to the assessment of derivative action

The 'Board Approach' is the salient feature of the US statutory framework for derivative actions. In this respect, a special litigation committee (comprised of independent directors and disinterested directors) is established by the board of

[66] See Section 167, New Zealand Companies Act, 1993; See section 237 Australian Corporations Act 2001; See section 263 of the UK Companies Act 2006.

directors for making assessment as to derivative proceedings.[67]A shareholder in his/her first step towards derivative litigation is required to refer the case to the board of directors to take action against wrongdoers.[68] In situations where the board dismisses the demand unjustifiably or the board members are themselves the wrongdoers, then it is very unlikely that the board would approve litigation against themselves.[69]

In this context, a concept of special litigation committee (selected by the board) was provided to avoid problems which were likely to arise in getting approval of litigation from the board of directors. The special litigation committee is supposed to assess derivative actions and further, the assessment/investigation of the committee is subject to judicial scrutiny. In relation to the acceptance of assessments of the committees, the US courts have laid down some conditions to evaluate reasonability of the assessments. For example, In the *Aronson v. Lewis,*[70] the court set out two conditions namely; business judgment rule[71] and independence of the committees while making assessments as to derivative actions. In another landmark case, *Zapata corp v. Maldonado,* the court required that assessments of derivative actions should be made by independent committees and that in good faith.[72]

However, so far as the courts' attitude towards compliance with the rules set out by the Zapata case, is concerned, they just follow the 'rubber stamp' approach in accepting the committees' decisions. They do not normally apply their independent judgments on the

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[67] Alice A. Seebach,'Special Litigation Committees a Practitioner's Guide' (1990)24 *Loy. LAL Rev* 1-33,8

[68] Scalisi v. Fund Asset Mgmtt.,L.P.[2004] 2d Cir 380, F.3d, 133, 138

[69] Abramowitz v. Posner [1982]2d Cir 672 F.2d ,1025, 1030

[70] Aronson v. Lewis [1984] Del 473, A.2d, 805, 812.

[71] Business judgment rule is the supposition that the directors acted in good faith while taking corporate decisions.

[72] Zapata corp v. Maldonado [1981] Del 430 A.2d,779,787

merits of the investigation of the committees in relation to admitting derivative actions.[73]

When the 'Board Approach' is referred, it means a 'special litigation committee' chosen by the board to assess derivative proceedings.[74] In that context, it is argued that since a company is an independent entity,[75] the insiders should decide upon the matters of derivative litigation like other business decisions. This is because the company is affected by the business decisions and by the decisions in respect of litigation. Therefore, the board of directors acting in accordance with the company's interest should decide upon the issues regarding the grant of permission to continue derivative actions.

Rebuttable Presumption

The board supremacy in regards to legal claims and litigation decisions is based on the concept of rebuttable presumption. As such, the courts are required to deny shareholders' derivative right of action if it does not show its grounds and proceedings in the best interest of the company. It might be possible that the grant of leave to a derivative action may not be in line with the best interest of the company and the presumption as to the usurpation of the best of company is referred to as a 'rebuttable presumption'. The rebuttable presumption is justified on grounds of corporations' internal affairs to be managed by the commercial judgments of management and therefore, the external intrusion into the internal affairs of companies should be discouraged. Moreover, it gains its justification that litigation decisions could better be

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[73] Zhang, Zhong, The Shareholder Derivative Action and Good Corporate Governance in China: Why Is the Excitement Actually for Nothing? (10 February 2012) < https://ssrn.com/abstract=2641863>or <http://dx.doi.org/10.2139/ssrn.2641863> accessed 21 July 2016

[74] William Klein, John Coffee Jr, Frank Partnoy, Business Organization and Finance, Legal and Economic Principles (9th edition Foundation Press 2004) 209

[75] Salomon v Salomon & Co Ltd [1896] UKHL 1

judged by the management to determine the viability of legal claims considering matters effecting operations of companies' businesses.

Problems with rebuttable Presumption

There are a number of defects of the rebuttable presumption which make crucially important an intrusion of outsiders to decide upon the issue of admissibility of derivative proceedings in an impartial and independent manner. This is because allowing board of directors to make assessment of a derivative action in a situation where the board members themselves are the wrongdoers would lead to frustration of the derivative proceedings.

Although there are cogent reasons to assign the board of directors with the task of assessing the derivative suits, yet it would give rise to serious problems in situations where the board members are themselves the wrongdoers. In this context, it is also widely recognised that for the assessment of derivative actions, the board Approach is not an appropriate approach.[76] This is because where the majority board members are alleged to have been involved in malfeasances, the board principally loses its right to investigate upon the derivative suits and accordingly, should not determine the admissibility of suits of such a nature. Even where some of the board members are alleged for wrongful acts, the other board members might tend to protect and exonerate such directors by reason of structural and subconscious bias.[77] This fellow directorial empathy was considered and acclaimed in the case of Zapata Corp v Maldonado.[78]

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[76] Arad Reisberg, 'Theoretical Reflections on Derivative Actions in English Law: The Representative Problem'(2006)3(1) *European Company and Financial Law Review* 69-108,69

[77] Julian Velasco, 'Structural Bias and the Need for Substantive Review' (2004)82(3)*Washington University Law Review* 821-917,821; Andrew Keay, *Board Accountability in Corporate Governance* (Routledge, 2015)88

[78] Ibid (n 72).

Therefore, under this viewpoint, it would be appropriate not to let the board of directors assess derivative actions.

Furthermore, since the derivative suits are aimed at enforcing directors' duties,[79] it seems implausible to assign the task of assessing derivative suits in relation to which they are alleged to have breached their duties. The errant directors, under the rebuttable presumption, are unjustifiably protected. Indeed, it may further deepen agency problem in Pakistan and would adversely affect the corporations' performance. Most importantly, a judicial response to such a situation would be to ensure independence of the special litigation committees instead of looking at the main problem in reference to resolving the matter in issue in accordance with the interest of the company. Thus, the courts' focus would shift from dispute resolution to ensuring independence of the special litigation committees. As a result, courts' role to ensure the efficacy of the derivative suits as to undo corporate wrongs may be misapplied.

Moreover, assessment of the special litigation committees in relation to admissibility of the derivative suit is subject to judicial scrutiny.[80] The judicial scrutiny as to the committees' recommendations is premised on ensuring the independence of the committees in exercising their function of assessing derivative actions. However, this would be a hectic process to pursue in reference to the assessments of derivative suits. It would also lead to causing duplication of the company's resources as the company would first incur cost on the investigation of the derivative suits and second, on the judicial scrutiny proceedings. And if the court happens to reject the assessment made by the committee on account of lack of independence and failing good faith

[79] See generally Georgios Zouridakis , ' The Introduction of the Derivative Action into the Greek law on public limited companies as a means of shareholder protection. A Comparative analysis of the British , German and Greek Law' (PhD Thesis University of Essex 2016).

[80] Ibid (n 72).

investigation, all the resources incurred by the company on the assessment of the derivative action would go in vain.

Thus, according to this dimension of argument, the board approach pertaining to the assessment of derivative actions would not necessarily solve the issue of fair assessment of the applications for derivative proceedings in Pakistan.

5.3.3.2 The Court Approach pertaining to the assessment of Derivative Action

As stated above, courts take a paternalistic position in assessing derivative actions in the UK.[81] There is a two-stage procedure for bringing derivative proceedings under the UK Company Act. Courts are required to establish first a prima facie case before it is taken up for the regular hearing.[82] Courts are tasked with preliminary investigation and to make sure that there is a sufficient ground to pursue the suit before it is taken up for the regular trial. The litigating shareholders are required to file an application to courts for seeking approval of derivative actions.

The courts have to decide upon the application in accordance with the filtration mechanism provided in the section 263(2) of the Act. Section 263(2) of the Act provides that in a situation where a person bound to act in line with the promotion of the interest of the company would not seek to continue the claim, the courts, in such a situation, are required to refuse derivative actions. Moreover, the section also requires courts to refuse suits where a matter complained of, has already been made good or authorised by the corporation.

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[81] See section 263, the UK Companies Act 2006.

[82] See section 261(2) ,the UK Companies Act 2006.

However, courts in the UK possess wide discretionary powers to decide upon the application of admissibility of the derivative suits. For example, courts are not bound to refuse actions even if the action had not passed the 'good faith' test.[83] In addition, courts have the power of judicial review. It means that courts are not bound by the decision of the companies in respect of withdrawal of a suit. They are, nonetheless, empowered to permit derivative action. This gives courts a decisive role in the assessment of derivative actions in the UK.

Bearing in mind the dominance of controlling shareholders in the corporate entities in Pakistan, it would be more appropriate for Pakistan to adopt similar 'court approach' for assessing the applications for derivative actions. This is because courts are independent from the influences of insiders to establish first the prima facie case and then to take up the case for full hearing.[84] If an applicant fails to establish a good case at first stage, the court must refuse the suit in line with the British company law requirement.[85] The 'Court Approach' pertaining to the assessments of derivative actions is envisaged to avoid problems with the board approach which is criticised for lacking independence and for failing good faith investigation.[86]

However, one may argue that the board of directors, being insiders, possess sufficient relevant information for establishing a case, which the courts come short of. Moreover, it might be argued that judges lack business related expertise for deciding upon

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[83] See section 263(3)(4), the UK Companies Act 2006.

[84] The Court Approach is in use in most of the common law jurisdictions which have codified derivative action systems. Under this approach, a two-stage procedure is adopted in the assessment of the derivative suits. The courts are required to establish first a prima facie case and then to take up the case for full hearing. See section 263 of the UK Companies Act 2006.

[85] See section 261(2) and 263(4) of the UK Companies Act 2006.

[86]Kenneth B Davis Jr, 'Structural bias, special litigation committees, and the vagaries of director independence'(2004) 90 Iowa L. Rev 1305- 1357, 1306

corporate conflicts.[87] Furthermore, it is also argued that the judicial control of derivative action would mean to intervene in the independence of directors which they require for exercising their business judgment to decide on how to promote the interest of the company.[88]

In this respect, it is submitted that criticism on the 'court approach' is clearly misplaced. For example, assessment of the derivative actions is not a business decision which necessitates business related knowledge; rather it is a legal matter which requires application of a legal mind. Assessment of derivative actions does not require business related special expertise.[89] Judges of commercial courts possess sufficient knowledge as regards matters of violation of corporate rights and thus, stand at an appropriate position to decide upon questions in relation to assessment of the derivative suits.

Since a derivative action is litigation in nature; the courts are well-experienced in dealing with variety of corporate litigation in this respect. Moreover, judicial forums are characterised as neutral and independent from the influence of insiders. Such an objectivity of judicial forums would help avoid issues concerning lack of independence of the special litigation committees in assessing the derivative suits. Last but not the least, judges have vast and diverse experiences of dealing with the breaches of directors' fiduciary duties as they get to acquire in due course of time, adequate knowledge relevant to corporate abuses necessary to determine the merits of corporate disputes.[90] In this regard, courts can also be assisted by business experts and corporate

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[87] Daniel R. Fischel, 'The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis' (1986)71 *Cornell Law Review* 261-297,273

[88] Re Smith & Fawcett Limited [1942] All ER 542; AI Airports International Limited and PI Power International Limited v Pirrwitz [2013] JCA 177

[89] John C. Coffee, Jr. and Donald E. Schwartz, 'The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform' (1981) 81(2)*Columbia Law Review* 261-336,383

[90] Ibid (n 2) 110.

lawyers of very high calibre where they require their advice and insight on particular matters of law.[91]

In the light of the above discussion, the better approach would be to consider judicial control of derivative actions in Pakistan. This is necessary for the following reasons;

First, the 'Board Approach' is not suitable in Pakistan as in situations when the board members are alleged to have been involved in corporate wrongs; it is not justifiable to let them decide upon their own wrongdoings. This would invariably mean to let them off the hook. Although, they are required to appoint a special litigation committee in this respect, yet the independence of the committee selected by the board of directors is subject to many questions marks.[92]

Second, the framework of independent directors is envisaged to protect minority interests and to avoid misaligned interests between major and minor shareholders.[93] The framework was adopted in Pakistan with an object to have an adequate corporate accountability mechanism.[94] However, independent directors lack independence, in real sense, in Pakistan in view of the conventional so-called practice of hand-picking.[95] The role of special litigation committee to assess the derivative suits would be, in fact, a reminiscence of the failure of the independent directors to counter-act directorial wrongdoings. It, therefore, seems to be unlikely that the committee selected by the

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[91] Amicus Curiae (friend of court but not a party to suits) is a concept, meaning thereby, courts can seek help and guidance from experts in areas where the courts require their advice.

[92] Ibid (n 52) 227

[93] Pranav Mittal, 'Role of Independent Directors in Corporate Governance'(2011)4 *The NUJS Law Review* 285-298, 285

[94]See The Code of Corporate Governance 2002, Pakistan <http://www.ecgi.org/codes/documents/code_corporate(revised).pdf>accessed 11 February 2016; Valeria Kozhich and Haroon H Hamid, 'Corporate Governance in an Emerging Market; A perspective on Pakistan (2007) 1 (1)*Journal of Legal Technology Risk Management* 22-33, 25.

[95]Independent director's integrity, Daily DAWN newspaper, 13 January 2013 < www.dawn.com/news/776832/independent-directors-integrity > accessed 03 February 2016

board would function fairly and independently to assess the derivative suits in right perspectives.

Additionally, the appointment of the committee for the assessment of derivative litigation would result in extra financial burden on corporations. Cost incurred on the investigation of the allegations would be borne by the companies regardless of the consequences and outcome of the committees' investigation. If investigation of the committees as to admissibility of the derivative suits happens to be dismissed by the court, the expenses incurred and the time spent on the committees' investigation would be wasted. The 'court approach' would be helpful in avoiding duplication of the companies' resources which are otherwise likely to be incurred by the companies if the board of directors are tasked with making assessments to derivative actions.

5.3.4 Guidelines for courts in order for making assessments of derivative proceedings.

In order to make better use of derivative litigation, courts in Pakistan ought to consider factors such as the promotion of derivative litigation, prevention of meritless suits and to proffer the supreme interests of the companies while making assessments of derivative proceedings. In this respect, some guiding principles are suggested in order to achieve the optimal use of derivative actions in Pakistan.

5.3.4.1 To determine the Best Interest of the Company

The cause of action in derivative proceedings is construed as "to allow derivative action that serve the best interest of the company". The best interest of the company is understood in the terms of the benefits of the collective body of investors as a whole.[96]

[96] Ibid (n5)130-135.

This very concept of the best interest of the company applies to the derivative action as well. For instance, when derivative actions are commenced, they need to be allowed in accordance with the best interest of the company. For the guidance of courts in Pakistan, the open textured term of, 'the best interest of the company' should be interpreted considering the factors such as the likelihood of success of the suit, legal costs involved, subject matter or amount at stake, financial position of defendants because the judgment debtor might be unable to meet the judgment, possible damage to the company' s reputation and downfall of share price due to the litigation factor and potential gains accruing to the company, and availability of other possible solution to the dispute.

The derivative cause of action should be premised on establishing the case in the best interest of the company and not merely on proving a prima facie case. This interpretation of 'the best interest of the company' matches with the provisions relating to the best interest of the company in the Australian and South African Company laws and is recognised by the courts in these countries.[97]

It is submitted that the best approach for consideration in Pakistan is to learn from the jurisprudence developed by the New Zealand courts in which the element of reputational damage was given little weightage while assessing derivative actions.[98] This is necessary because it might have negative effects on the advantages of derivative proceedings if reputational element is given significance while making assessment of derivative actions in Pakistan. However, where litigation is prone to cause fall of share price of the company, then the reputational factors should be taken into account as loss

[97] See section 327 (2)(c) The Australian Corporation Act 2001; Australian case, Swansson v R A Pratt Properties Ptv Ltd [2002] 42 ACSR 313; See section 165, South African Companies Act 71 of 2008.

[98] McFarlane v Barlow[1997] 8 NZCLC261(HC).

of share price would, indeed, mean loss to the interest of the company and the litigation, in such case, cannot be regarded as the one initiated in the best interest of the company.

5.3.4.2 To promote derivative litigation

Another pertinent issue in relation to courts in Pakistan might be confronted as to whether to assess derivative proceedings on the basis of cost-benefit analysis or otherwise? It is submitted in this regard that the best interest of the company should not be determined through cost-benefit analysis. The financial aspect of derivative proceedings need not to be overemphasized as the real benefits of derivative actions go beyond the corporate compensation. Adoption of the cost-benefit criteria by the courts in Pakistan to determine the best interest of the company might lead to frustration of potential gains of derivative proceedings, which are, in essence, the deterrent objectives. Thus, in this regard, it is recommended that even if the legal costs of the suit overshadow the potential recovery, the leave application should not be turned down by courts on compensatory terms. If the suit is brought on merit and has the potential of public deterrence against future corporate misconduct, it should be permitted to be continued for the full trial.

However, it does not mean that the cost-benefit criterion for assessing derivative proceedings has no relevance in the context of Pakistan. In fact, a balance needs to be struck between compensatory objectives and deterrence value of derivative litigation. For instance, in situations where there is clear and blatant violation of law, the deterrence aspects of derivative proceedings should be taken into account by the courts in Pakistan in order to promote derivative proceedings. This approach has also been recognised by Australian and New Zealand courts holding that the cost-benefit analysis

is not the sole factor to assess derivative proceedings in line with the best interest of the companies.[99]

5.3.4.3 To prevent Meritless Suits

Applicants bringing derivative suits only with 'Good Faith' should be granted leave to continue with the derivative proceedings in order to prevent meritless suits. The term 'Good Faith', however, is an elusive one and is not so easy to be comprehended. The simple course is that it should be presumed that derivative proceedings have been commenced in 'Good Faith', unless proven otherwise. The 'Bad Faith' of shareholders for initiating derivative actions can be ascertained where the applicants were unnecessarily delaying the actions. Another useful guideline for courts in Pakistan to ascertain the good faith test lies in a British court judgment holding in the case of, Harley Street Capital v Tchigirinsky (No 2) that if the claimant shareholder get to be the shareholder after the alleged wrong, he/she will be presumed as failing good faith test in reference to continuing with the suit.[100] However, apart from above stated good faith tests, an overall liberal approach is recommended to be considered in Pakistan in order to promote derivative proceedings to protect corporate assets. This is necessary because a narrow approach, in this respect, would adversely affect the potential benefits of the use of derivative litigation in Pakistan.

[99] Metyor Inc v Queensland Electronic Switching (Ptv) Ltd QCA[2002]269; Frykberg v Heaven[2002]9 NZCLC 262,966.

[100] Harley Street Capital v Tchigirinsky (No 2) [2006] BCC 209.

5.4 To improve accessibility to derivative action

Litigation is not desirable for most litigating parties and sometimes it is very expensive and labour intensive.[101] A claimant makes decision as to litigation after having carried out a cost/benefit analysis.[102] This is more relevant in derivative litigation because shareholders might not be willing to bring suits against wrongdoers on behalf of companies due to various reasons.

For example, they might not find any significant financial benefit in taking the time and bearing legal costs for derivative litigation because proceeds of successful derivative actions would accrue to the company. The litigating shareholders are entitled to benefit from successful derivative actions only in proportion to their shares in the companies. Moreover, shareholders might not choose to commence derivative litigation expecting it from other shareholders to do this job. They might also think that shareholders other than the derivative claimant would be free-riders, then why should they take all the risks whereas benefits arising from successful suits are to be shared indirectly by all.[103]

In this context, shareholders might prefer to quit the company by selling their shares instead of bearing the litigation costs. If shareholders choose to bring suits against the wrongdoers, they have to bear litigation costs which may include lawyers' and courts' fees and sometimes, it may also include the costs of defendant if the claimant loses the suit. In view of the litigation costs and the indirect benefits flowing from derivative actions, there is a lack of incentive for the claimants to bring suits against wrongdoers. In order to encourage and incentivise shareholders, in most of the common law

[101] This justifies contingency fees arrangement.

[102] Ibid (n 10) 44.

[103] Maleka Femida Cassim, The statutory derivative action under the Companies Act 2008: Guidelines for the exercise of the judicial discretion. (PhD thesis , University of Cape Town 2014)160.

jurisdictions like the UK, the funding issue has been tried to address through indemnification of derivative claimants for the cost incurred by them on derivative litigation.[104]

The rule for the indemnification of derivative claimants was established in the Wallersteiner v.Moir case (No.2).[105] In this case, Wallersteiner, the director of the company successfully protracted the case for over 10 years and Moir, the claimant failed in recovering losses done to the company. Considering the litigation costs incurred and time spent by Moir, Lord Denning set out the rule for indemnification of the claimants against costs incurred by them in the course of the agency, stating that a minority shareholder who acts as an agent of the wronged company in good faith should be indemnified against costs incurred by him/her because the benefits of the suit will be ordered in favour of the company.[106] Moreover, the court held that derivative claimants are entitled to indemnity costs orders at the stage of obtaining permission to continue derivative action.[107]

However, Watlon J regarded the rule for indemnification of costs unfair to the companies in the *Smith v. Croft* case.[108] He set out the financial need criteria for shareholders to claim indemnification of costs incurred by them on the derivative proceedings. He stated that shareholders would be entitled to indemnity order for costs

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[104] Arad Reisberg, ' Funding Derivative Actions: A Re-examination of Costs and Fees as Incentives to Commence Litigation' (2004) 4 (2) *Journal of Corporate Law Studies* 345-383,347

[105] Wallersteiner v.Moir (No.2)[1975] 1 All ER 849.

[106] *Wallersteiner v.Moir (No.2)[*1975] QB 371 at 391-2

[107] Ibid (n 105) 871.

[108] Smith V, Croft (No.1)[1986]2 All ER 551.

only if the derivative claimant was genuinely in financial need. The same narrow approach was followed by courts in many other cases.[109]

5.4.1 Contingency Fee Arrangements

With the exception of Pakistan,[110] contingency fee arrangements are recognised in a number of countries so as to task lawyers with supporting genuine litigants who do not have resources to bring violators of their rights to book. Under the contingency fee arrangement, a claimant is not required to pay lawyers' fees if he/she loses the case. However, a lawyer is entitled to fee if the claimant wins the case. As such, contingency fee arrangement is based on the, 'no win, no fees' rule. Lawyers may be encouraged to support claimants by offering them either percentage of the benefits of suits or their fees may be determined on the basis of time they spent, normal fees charged on hourly basis and their quality of work.[111] This might operate to the benefits of derivative claimants who do not have resources and have no incentives to bring suits against the wrongdoers in corporations.

On the basis of unjust enrichment theory, the rules of common fund and substantial benefit have been established.[112] Under these rules, companies are required to indemnify derivative claimants from out of the company fund created as a result of

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[109] Carsten A Paul, 'Derivative Actions under English and German Corporate Law–Shareholder Participation between the Tension Filled Areas of Corporate Governance and Malicious Shareholder Interference'(2010)7(1)*European Company and Financial Law R*eview 81-115,96

[110] Rule 5 , Principles of professional conduct adopted by the Pakistan Bar Council; Contingency fees is allowed in the US, Australia, Canada, France , Brazil, Japan, New Zealand and it provides a strong incentive to shareholders to step forward and take actions against wrongdoers in corporations in the US.

[111] This rule was established by a court in which the lawyers' fees was required to be determined on the basis of the quality of work they render, working hours, normal hourly fees and further the complexity of the matter can also be added in this regard to determine the lawyers' fees in contingency fees arrangements; Mills v Electric Auto-Lite Co[1970]396 US 375, 391-2.

[112] Dan W. Puchniak , Masafumi Nakahigash, 'Japan's Love for Derivative Actions: Irrational Behavior and Non-Economic Motives as Rational Explanations for Shareholder Litigation'(2012) 45(1) *Vanderbilt Journal of Transnational Law* 1-82, 18.

successful derivative actions.[113] This is for the reason that if a derivative suit succeeds and the costs of the suit are not paid by the company to the claimant, the company is unjustly enriched. The shareholders by their efforts get benefits not only for the company but also for other shareholders as well. Therefore, the claimant is entitled to be indemnified against legal costs incurred on the derivative litigation.[114]

This part of the discussion examines both the approaches i.e; indemnification of derivative claimants and contingency fee arrangements to determine as to whether, if contingency fee approach is adopted in Pakistan, it would incentivise shareholders and improve accessibility to derivative actions.

5.4.2 Problem with the Indemnity Costs Approach

As mentioned above, levying of costs is always a disincentive for derivative claimants. Cheffins and Black, in this regard, consider that legal costs is central to the disincentives problems shareholders face in bringing derivative proceedings.[115] The UK Companies Act does not provide for indemnification of shareholder applicants. However, the rule for indemnification of claimants is provided under the Civil Procedure Rules in the UK.[116]. Under the Civil Procedure Rules, rule 19.9E, courts may indemnify shareholders against the costs incurred by them on the application for leave for the suit or derivative suit or against the legal costs incurred on both. The rule of indemnification of claimants was thought to be a solution of disincentives for shareholders in derivative proceedings. However, this is not the case all around. There

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[113] John D Wilson, 'Attorney Fees and the Decision to Commence Litigation: Analysis, Comparison and an Application to the Shareholders' Derivative Action'(1985) 5 *Windsor Yearbook of Access to Justice* 142- 180,177.

[114] Ibid (n5)130.

[115] Brian R Cheffins and Black Bernard,'Outside director liability Across Countries'(2006) 84 *Texas Law Review* 1385-1403,1407.

[116] See Rule 19.9 E Civil Procedure Rules, Rule.

are various major flaws with the indemnity orders approach that do not provide incentives to shareholder claimants in the real sense.

First, the rule 19.9E of the Civil Procedure Rules does not clarify the conditions under which the claimants are entitled to be indemnified against legal costs incurred and hence, it is left to the courts' discretion to award costs or otherwise. The vast discretion given to courts denies derivative claimant assurance of the reasonable costs.[117] As a result, legal cost is just a prospect and it depends on the courts' discretion which creates uncertainty as to the indemnity costs orders.[118] For example, in many cases, courts in the UK have been more cautious in relation to ordering indemnity costs in full.[119]

In this regard, the financial need test established in the case *Smith v Croft* is unjustifiable.[120] Under this test, a shareholder who applies for indemnity costs order has to show that he/she is in real need for the funding support, failing which, they are not entitled to indemnity costs order. The financial need test has been regarded unfair and inappropriate.[121] This is because a shareholder brings suit against wrongdoers in a representative character and the proceeds of the suit accrue to the company. Hence, it is not worthwhile to consider the financial status of shareholders in this regard.

In recognition of the problem with this financial need test, a Canadian court held that the financial need test is of no relevance to making indemnity costs orders.[122]Anybody who fails the financial need test may convince any other shareholders who meet the

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[117] Fletcher, K. L, 'CLERP and minority shareholder rights'(2001) 13(3)*Australian Journal of Corporate Law* 290-303,299.

[118] Anil Hargovan,'Under Judicial and Legislative Attack: The Rule in Foss v. Harbottle' (1996) 113 *South African Law Journal* 631- at 648.

[119] Ibid (n 109) 96.

[120] Smith V Croft (No.1)[1986] 1 WLR 597.

[121] Ibid (n2)238.

[122] *Turner v Mailhot* [1985] 50 OR (2d) 567.

criteria to bring suit and thus can be indirectly beneficiary of indemnity cost order. Thus, the financial need test is unjustified rule in determining whether to indemnify the claimant or not. It would also be difficult for Pakistani courts to apply the financial need test fairly and in a systematic way in awarding legal costs to the successful claimants.

Second, the fundamental problem with the indemnity costs approach is that it does not provide an incentive to shareholders in the real sense.[123] This is because although the potential derivative claimant expects to be indemnified against the legal costs incurred on the derivative litigation, yet this does not mean that it serves as an incentive to shareholders for putting in derivative claims for the enforcement of corporate rights. Basically, provision of an incentive means to offer something additional to the legal costs incurred by the shareholders on derivative actions. The indemnity costs approach does not promise anything additional to the indemnified claimants and maintains the original position in respect of any gains for derivative claimants. In this respect, the claimant might also lose costs incurred against consultancy with solicitors, which remains out of consideration for indemnification purposes. This is manifested from the fact that courts in the UK awarded only limited costs to claimants and that too was only in a few cases.[124]

Third, there are other disincentives for claimants which might not be met by the indemnity costs order as it offers nothing more than the actual legal costs incurred. For example, a shareholder claimant is entitled to benefit the proceeds of the successful derivative suit proportionate to his/her shareholdings in the company. Sometimes,

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[123] Ibid (n 104) 355.

[124] In total, out of eight cases, only in two cases, the legal costs was awarded in the UK. *Stainer v. Lee* [2010] EWHC 1539; (Ch)56.*Cullen Investment Ltd. V Brown* [2015] EWHC 473 (Ch).

proceeds of the successful derivative suit might not be granted by the companies to the shareholders as the company may choose to reinvest the recovery instead of sharing it with the shareholders. Moreover, it might not always be the case that a successful derivative suit would invariably result in monetary benefits for the company. It may happen that a successful suit leads to a mere declaration of corporate rights without bringing any monetary benefits to the company.[125] Thus, these disincentives to potential shareholders claimants cannot be always expected to be lowered by the indemnity costs orders.

Another problem with the indemnity costs approach is that shareholder claimants have to take the risk of losing their money spent during the course of the derivative action if the company in whose name the action was taken happens to be insolvent. This would operate to the detriment of the claimants even if they were granted indemnity costs. Obviously, this would operate as strong disincentive to the potential shareholder claimants as they might not be willing to put their good money at risk.

To sum up, the indemnity costs approach suffers from various flaws which render it an inadequate incentive for shareholder to step forward and take actions against wrongdoers. The approach to indemnify claimants against legal costs was envisaged by the UK Law Commission to incentivise shareholders to take derivative actions.[126] However, in reality, this approach provides little incentives for claimants. Thus, in view of problems with the indemnity costs approach, it is submitted that Pakistan should learn from the experience of the UK to avoid problems faced by the UK in providing incentives for shareholders claimants through indemnity costs approach.[127] This is

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[125] *Mills v Electric Auto-Lite Co.*,[1970]396 US375.

[126] The UK Law Commission, Shareholder Remedies, Consultation Paper, 142, 1996, para 18.1.

[127] Ibid (n 10) 49.

because although the derivative claimants by and large expect to be indemnified, yet there are real concerns for them in this approach which does not address the issue of disincentives for derivative claimants with an amount of certainty.

5.4.3 Why the contingency fee approach is suitable for Pakistan?

On the other side, as stated above, principles of contingency fee are based on an arrangement between a claimant and a lawyer to pursue litigation. In this arrangement, the claimant is not liable for the legal costs including the lawyer's fees regardless of the outcome of the action. In return of the services rendered by a lawyer for pursuing the suit, the lawyer is rewarded by way of sharing some percentage of the total proceeds of the suit or he/she is paid on the basis of 'loadstar method'.[128] As such, the lawyer takes the responsibility of the legal costs purported to be incurred on the litigation. The derivative claimants get away with the risk of legal costs and on the other hand, they are entitled to share the benefits of successful suits indirectly. At least, they have nothing to lose in the course of taking derivative actions under the contingency fee arrangements. This approach is expected to work effectively in Pakistan so as to provide a real incentive to shareholders to step forward and bring suits against wrongdoers.

It may also be added in this respect that in view of shareholders' apathy caused by the dominance of business families and the State in the business sector, the indemnity costs orders are not expected to incentivise shareholders to have a dynamic rule in the corporate sector of Pakistan. In family-controlled companies which form a major portion of the business sector in Pakistan, the families hold control and powers. It comes with no surprise to challenge the authority of such dominant controllers with the

[128] Under the Loadstar method, a lawyer is paid on the basis of hours spent by the lawyer, market hourly charges of lawyers and the quality of services the lawyer rendered.

risk of gaining less and losing more. In the SOEs, the management is represented by influential bureaucrats and they are placed on the managerial positions on the basis of their political connections with the government.[129]

For these reasons, although the society in Pakistan is litigious, the corporate actions cannot be expected without providing certain incentives by considering contingency fee arrangements in Pakistan. The US experience in this regard can provide a good lesson for Pakistan that derivative actions cannot be employed without contingency fee arrangements.[130] Moreover, lowering legal costs is manifested as a strong incentive for shareholders to take derivative actions in Japan where lowering the costs leads to a significant increase in derivative proceedings.[131]

In Wallersteiner v. Moir, Lord Denning remarked that the US and Canadian contingency fee approach should be considered for derivative litigation. He was of the view that there are strong arguments in favour of contingency fee arrangements to be recognised by public policy in derivative proceedings. He thought that without contingency fee arrangements in derivative proceedings, there are chances that wrongdoers in corporations would get away scot free.[132] Thus, contingency fee approach would be more advantageous than the indemnity costs orders in Pakistan to improve accessibility to derivative actions for shareholders to enable them to take actions against wrongdoers for enforcing corporate rights.

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[129] See Daily DAWN Newspaper 28 October , 2013 'Privatisation of state-owned enterprises' available < www.dawn.com/news/1052356 > accessed .02 October 2016

[130] Ibid (n5)130.

[131] Mark D. West, 'Why Shareholders Sue: The Evidence From Japan'(2000)30(2) *The Journal of Legal Studies* 351-382,351; Mark .D West, The Puzzling divergence of Corporate Law: Evidence and Explanations from Japan and United States (2001)149 *University of Pennsylvania Law Review* 579-580,527.

[132] Ibid (n 106) 395.

However, one may argue that if the proposal as to contingency fee arrangements is adopted, it may lead to strike suits and unfounded litigations. The rationale behind such argument might be that under the contingency fee arrangements, shareholders happen to lose nothing although benefit from the proceeds of successful suits. Moreover, it might also be argued that if the problem of costs is addressed adequately, it would lead to open the floodgates of litigations.

However, this seems to be not a positive view because wrongs in number and resultant litigation cannot be ignored because of deluge of litigation. As regards the concern that the contingency fee would create unmeritorious derivative proceedings, practically there is no authentic empirical evidence that indicates the risk of unmeritorious litigation facilitated by contingency fee arrangements.[133]

It is obviously expected that contingency fee arrangements would improve accessibility to derivative actions but it does not mean that suits facilitated by contingency fee arrangements would be without merit. Furthermore, under the contingency fee arrangements, business minded lawyers enter into arrangements in which they take the liability of legal costs and in return, expect percentage of the proceeds of the suits. Therefore, it is very unlikely that the lawyers would accept such risky and unmeritorious suits as probability of success happens to be very low in such suits and losing these suits would mean waste of lawyers' services rendered and the costs incurred in the course of litigation.

On the whole, the benefits of the contingency fee approach overshadow its disadvantages. In order to ameliorate the plight of small investors and prevent the

[133] M. I Weiss, 'Shareholder Litigation -Reform Proposals to Shift Fees: Limit 'Professional Plaintiffs' and Cap Punitive Damages' in Corporate Law and Practise Course Handbook Series (Practising Law Institute Westlaw Database 1994) No.B4-7068.

violations of corporate rights, shareholders' enforcement power needs to be strengthened otherwise wrongdoers would continue getting away with the liabilities for their wrongful acts. Thus, with an acknowledgement that there might be some vexatious litigation in this respect, however, overall contingency fee approach would, to a great extent, improve accessibility to derivative actions which is expected to encourage shareholders to challenge controllers' authority, currently considered as 'corporate blasphemy'.[134]

In relation to other concern that contingency fee approach, if adopted, may lead to open the floodgates of litigation. In this respect, it may be added to what earlier submitted that courts should make sure that the claimant has either direct financial stakes in the company or should has legitimate concern over the way the company is being run. In fact, the concern that floodgates of litigation would be opened by lowering disincentives for shareholders is over-emphasised. For example, the experience of the countries such as Canada, the US, the UK, New Zealand and Australia where flexible and shareholder friendly approach has been adopted regarding derivative actions, indicates that there was no deluge of litigation in such countries after lowering disincentives for shareholders to take actions.[135]

The reform proposals made in this thesis have been discussed with the interviewees from both the public and private sectors. The aim is to share with them the reform proposals and to incorporate their insightful and illustrative suggestions. Deficiency of operating rules on derivative proceedings and dearth of case law and case commentaries together with weak relevant knowledge base is elaborated by giving an

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[134] See daily DAWN 25 December 2004, Minority Shareholders need to be empowered' < www.dawn.com/news/378077/minority-shareholders-need-to-be-empowered > accessed 01 October 2016.

[135] Ibid (n 103) 156-7.

insight of multiple interpretations and, by reflecting the reactions of the interviewees. The next section of this chapter provides analysis of interview data.

5.5 Analysis of Interviews

The interview component of this thesis consisted of eight semi-structured interviews (probing questions) from both private and public officials. The aim of conducting interviews was to inform and assess the viability of reform proposals made in this study. With acknowledgment that although the number of interviewees may not be that big in size, yet this number has provided sufficient assessment as to the reform proposals. Thus, qualitative brevity instead of unnecessary length has been preferred. The interviewees from various backgrounds such as local corporate lawyers, senior official from SECP and renowned corporate law academics and their coding references are given in the table below;

Table 2 Interviewees and their Coding References

Categories	Number of Respondents	Coding References
Local Corporate Lawyers	4	A,B,C,D
Senior SECP officials	2	E,F
Academics	2	G,H
	Total = 8	

Source: developed by the author.

5.5.1 To develop statutory framework for derivative actions

As far as question of strengthening shareholder enforcement power is concerned, there is an overwhelming consensus amongst the interviewees to the effect that there is a need for statutory framework as regards derivative actions in Pakistan. This is to

remove confusion and offer clarity in relations to the rights of shareholders to take derivative actions.[136] Interviewee B, in this respect, expressed that

"Due consideration should be given to the common law rules on derivative litigation alongside codified derivative action system".[137]

The interviewee was of the view that this will be helpful as the codified law might not cover all demanding future eventualities. As such, the common law rules on derivative actions, in such situations, can be invoked to fill in the unforeseen voids left in the codified law.[138]

The view expressed by the interviewee in this respect appears to be apparently well grounded; however, after having given a close thought to the common law rules on derivative actions, it may be added adversely that it may not be proper to have two parallel frameworks for derivative actions. This is because such state of affairs might tend to create confusion and uncertainties in relation to the procedural and substantive rules on derivative actions. As a result, shareholders may be confronted with confusion in selection of more suitable option for fighting corporate wrongs.

Many commentators have disapproved two parallel frameworks applying to derivative actions. For example, Paul Von Nessen *et al*, have pointed out problems shareholders are facing in Hong Kong as a result of two parallel systems of derivative actions as the common law rules were retained there after the codification of derivative actions

[136] Respondents; A, B, C, D, E, F, G , H (28, 23, 29,26, 27, 28 , 25, 30 September 2016) See Appendix 5.

[137] Respondent B, a local corporate lawyer (23 September, 2016, London, UK) See Appendix 5.

[138] Respondent B, a local corporate lawyer (23 September, 2016) See Appendix 5.

system.[139] Moreover, Andrew Keay is sceptical as to whether two parallel frameworks for derivative actions with different rules would be helpful.[140] He is of the view that statutory derivative action system is aimed at simplifying rules on derivative actions and thus, invoking common law rules in league with the codified derivative action system might frustrate its potential benefits as it is primarily meant to avoid uncertainties and overlapping which may tend to weaken enforcement operations.[141] Further, in recognition of the problems of the common law, the UK Law Commission has recommended for the replacement of the common law rules with codified derivative action system in order to make derivative litigation more opportune to modern conditions and accessible.[142]

As this thesis argues that the public enforcement singly cannot ensure effective shareholder protections, therefore private sector enforcement needs to be capitalized via derivative actions. Thus, in the light of the argument advanced and the proposal made as to statutory derivative actions in this thesis articulated and supported by all the interviewees, policy makers and legislators should consider codified derivative actions system in Pakistan.

5.5.2 To simplify and clarify the procedural route for derivative actions

In respect of reform proposals made in this thesis so as to simplify the procedural route for derivative actions, there are varied opinions of the interviewees. The proposals as to

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[139] Paul Von Nessen , S.H Goo and Chee Keon Low, ' A parallel path to shareholder remedies: Hong Kong' derivative actions in Dan W. Puchniak (eds), *The Derivative Action in Asia : A Comparative and Functional Approach* (Cambridge University Press 30 July 2012) 303

[140] Ibid (n 10) 47.

[141] Ibid (n 10) 47.

[142] Law Commission; Shareholder Remedies para.6.51 -6.55; Poole, Jill and Roberts, Pauline isobel, 'Shareholder Remedies: Corporate Wrongs and the Derivative Action'(1999)*Journal of Business Law* 99-125, 100.

the range of claimants, actionable wrongs and the 'Court Approach' pertaining to the assessment of derivative actions were discussed with them at length whose comments on each of the proposal are discussed below;

5.5.2.1 The range of derivative claimants

In respect of derivative claimants, almost, all interviewees agreed that every individual shareholder regardless of number of shares in a company defrauded by a wrongdoer should have the right to take actions. However, as submitted that a shareholder who gets to be the shareholder after the occurrence of alleged fiduciary wrong should be disentitled to commence derivative suits. Likewise, a shareholder who initiates derivative suit and later on, walks away from the company, should also be disqualified to continue to pursue the suit. In reply to the question as to whether the contemporaneous and continuous ownership requirements, if considered in the context of Pakistan, can help prevent cheap settlements and unmeritorious litigation; all the interviewees were of the unanimous view (though with some clarifications) that these requirements are necessary in order to avoid misuse of derivative litigation.

Contemporary stock Ownership

All interviewees agreed unanimously that attention needs to be paid to the proposal made in this thesis for the requirement of contemporaneous ownership so as to discourage purchasing of shares with ulterior motives.[143] Interviewee B in this respect opined that;

[143] All respondents (local corporate Lawyers A, B, C, D), (High-ranking official of the SECP E, F), (Academics G, H 23 -30 September 2016) See Appendix 5.

"Due consideration should be given to the situations where after-acquiring shareholders purchase shares without having the knowledge of an alleged fiduciary wrong in a company".[144]

A similar view was also expressed by interviewee F.[145] They suggested that 'Contemporaneous Ownership Requirement' should be relaxed to such situations where after-acquiring shareholders were not aware of the alleged fiduciary wrong for the reason that it was not disclosed to them.[146]

The explanation made by the interviewees regarding the above said exception to the contemporaneous requirement has enough to be viewed favourably. This flows from the fundamental principle of law that bona fides and mala fides are separate in consequences and cannot be treated alike. Thus, a shareholder, who acquires shares with bona fide intention and in good faith considering the future prospects of a company and without having the knowledge of an alleged fraud, should not be disqualified from bringing derivative actions. In fact, applying the contemporaneous requirement to bona fide buyer of shares after the alleged wrong is not appropriate.

Applying the exception of bona fide purchases of stocks to contemporaneous ownership requirement is not a something new in law. In a number of jurisdictions, shareholders who purchase stocks without having the knowledge of alleged wrongful acts in a company are treated competent to take derivative actions.[147] Thus, in the light of comments made by the interviewees, it is added that while considering standing rules of

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[144] Respondent B, a local corporate Lawyer (23 September, 2016) See Appendix 5.

[145] Respondent F, a senior SECP official (28 September, 2016) See Appendix 5.

[146] Respondent B, a local corporate lawyer, and Respondent F, a senior SECP official, (23, 28, September 2016) See Appendix 5.

[147] Ibid (n25); Rosenthal v. Burry Biscuit Corp[1948] 60 A.2d 106, 111;Schoon v Smith [2008]953 A.2D 196,203; AlaBy Prods. Corp v Cede & Co[1995] 657 A.2D 254,264; Danielewicz v Arnold [2011] 769 A 2d, 274, 291. The Contemporaneous Ownership Requirement is provided in, Federal Rules of Civil Procedure Rule 23.1.

derivative claimants, contemporaneous ownership requirement needs to be taken into account. Similarly, as also opined by interviewees B and F, the contemporaneous ownership rule should not apply to situations where alleged wrongs were not divulged to after-acquiring shareholders who purchased shares unaware of the wrong intended to be rectified through derivative action.

Continuous Ownership Requirement

Six out of eight interviewees supported the proposal as to the adoption of 'Continuous Ownership Requirement' and considered it an essential standing requirement for derivative claimants. They expressed their opinions that the adoption of the requirement would help avoid abusive and dishonest litigation by the outgoing shareholders.[148] This is likely that the outgoing shareholders who hold no more financial stakes in the company would probably pursue their private benefits instead of pursuing litigation in accordance with the best interest of the company.

However interviewees G and H were sceptical as to the adoption of 'Continuous Ownership Requirement'. Both were of the view that by adoption of continuous ownership requirement, some genuine claimants who are dispossessed of their shares by corporate actions or by reason of mergers would be precluded from continuing derivative actions.[149] The concern shown by the interviewees appears to be based on a strong rationale that shareholders who are dispossessed of their stocks as a consequence of merger or otherwise dislodged should not be affected by the operation of 'Continuous Ownership Requirement'.

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[148] Respondents A, B,C, D, (23,26,28,29, September , 2016) all local corporate lawyers supported the adoption of the 'continuous ownership requirement'; Moreover, SECP official; E, F also agreed to the core issue that when somebody who has no stakes in a company should be disallowed to take actions because these actions might be dishonest and with bad motives.

[149] Respondents; G, H, Corporate Law academics (25, 30 September 2016) See Appendix 5.

It may be added that the requirement of continuous ownership in its turn is widely recognised in a number of jurisdictions.[150] Likewise, the requirement is also recognised by the US regulations; as such the courts in the US allowed shareholders who were dispossessed of their stocks by reason of mergers to continue to follow the suits.[151]

Keeping in view the importance of 'Continuous Ownership Requirement' and in the light of concerns shown by interviewees G and H, it is submitted that instead of discarding continuous ownership requirement altogether, an exception to the requirement may be appended so as to allow shareholders disowned as a consequence of mergers to continue to pursue the derivative proceedings. As such with necessary improvements, continuous ownership requirement in its place is virtually paramount as this would help in preventing outgoing shareholders from exploiting any situation. Likewise, as articulated by interviewees G and H, the requirement of continuing ownership should not apply to cases where shareholders are disowned by reason of manipulated mergers. This is necessary, keeping in view the phenomenon of concentration of shareholder ownership in Pakistan where controlling shareholders might prevent shareholder claimants from pursuing even genuine and merit based suits by the use of stock for stock mergers.

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[150] Ibid (n25);Malajka M Eaton, Leonard J. Feldman, and Jerry C. Chiang, 'Continuous Ownership Requirement in Shareholder Derivative Litigation: Endorsing a Common Sense Application of Standing and Choice-of-Law Principles'(2010) 47 The Willamette L. Rev 1-23,7; Parfi Holding AB v. Mirror Image Internet Inc. [2008]954 A.2d 911.

[151]Alford v. Shaw [1990]68.398 S.E.2d 445;Shelton v Thompson[1989] 544 So.2d 845; Fitzpatrick v Shay [1983]79.461 A.2d 243; Lewis v Ward [2004]852 A.2d 896,904; Grosset v Wenaas [2008]42 Cal. 4th 1100

Adequate representation of companies and other stockholders' interests

Almost all interviewees expressed that it should be ensured that a derivative claimant is representing the company's as well as other stockholders' interests adequately.[152] The interviewees suggested that the principle of adequate representation of companies' interests needs to be considered so that companies' interests may be protected effectively. They were of the view that while assessing derivative application, it should be ensured that the claimants are representing the companies' interests adequately and permit only those suits to continue which advance the companies' interests vigorously.[153]

Interviewee D in this respect emphasised upon the adoption of the principle and shared his views in the light of his experience as legal advisor to an organisation.[154] The interviewee mentioned that companies normally have their own panel of lawyers to deal with their legal and judicial issues. It is very likely that at times, these lawyers strike under carpet deals and compromise derivative proceedings as they are obliged to mostly act in the interest of the company managers being their nominees and selectees and thus vulnerable to sacking if they proceed and perform to their displeasure. It might happen in situations where there is a serious issue of managerial wrongdoings; the companies' lawyers may act in favour of the managers on personal relation basis

[152] Respondents , local corporate lawyers A B,D and a senior SECP official F ; while other respondents; C, E , G and H just agreed that shareholder applicants should adequately represent the interests of the company as well as its stockholders without making further explanation to the adoption of the rule (28,23,26,28,29,26,25,30 September 2016). See Appendix 5.

[153] Respondents, local corporate lawyers A B,D and a senior SECP official, F (28,23,26,28 September 2016) See Appendix 5.

[154] Respondent, D- a domestic corporate lawyer (26, September 2016) See Appendix 5.

instead of being fair to their duty to the companies. In that case, the interviewee recommended that outside lawyers should be hired for pursuing derivative litigation.[155]

Interviewee D also recommended that apart from shareholders, the range of derivative claimants should be extended to non-shareholder constituencies of companies. In this regard, the interviewee, particularly, suggested that employees of the companies should be allowed to take derivative actions. According to the interviewee D, shareholders sometimes lack sufficient knowledge of a wrong due to informational asymmetries. In this regard, the interviewee was of the view that employees, as being insiders, are expected to be more conversant with the managerial wrongdoings than the shareholders. Therefore, if employees were allowed to initiate derivative proceedings against wrongdoers in corporations, the suits may be based on more rich information of the wrongs. This would help increase in the incidence of corporate rights being enforced effectively.[156] The proposal made by the interviewee appears to be appropriate and may not be contentious in the sense that this is not a new rule in the law as we see that employees often function as 'whistle-blowers' tipping off managerial and directorial wrongdoings in corporations.

5.5.2.2 Actionable wrong

All interviewees unanimously supported the proposal made in this thesis, that besides directors and corporate officers, shareholders with majority voting power should also be brought within the scope of fiduciary duties.[157] The interviewees voiced that the major conflict of interest lies between major and minor shareholders in corporate

[155] Ibid respondent D- a domestic corporate lawyer(26 September, 2016) See Appendix 5.

[156] Ibid,Respondent D. See Appendix 5.

[157] Respondents- local corporate lawyers A, B, C, D; Senior SECP official E, F ; Academics G, H (28, 23,29,26,26/27,28,25,30 September 2016). See Appendix 5.

entities in Pakistan. They were of the view that controllers are the real power in both the family owned and the State-Owned Enterprises which the power needs to be regulated so as to prevent misuse of their positions instrumental to expropriating corporate assets.[158]

Interviewee B was of the view that

"Other parties wrongfully benefiting from directorial manoeuvrings should also be held accountable".

The interviewee explained that ''board of directors might avoid proceedings against 'other parties' associated with controlling shareholders or with any of the board members''.[159] The interviewee further elaborated that transactions entered into by 'other parties with directors, in good faith, should not be subjected to derivative litigation.[160] The interviewee in this respect explained that 'other parties' transacting with directors in 'good faith' should not be subject to derivative actions for the reason that this may affect business operations adversely. Accordingly, the proposal made by interviewee B seems to be plausible and ought to be considered in future amendments in the company law.

The legal frameworks of Australia, New Zealand and Canada provide that anyone can be subjected to derivative proceedings under any corporate cause of action where the board of directors fail to bring suit against wrongdoers.[161] More so, in the UK, the Companies Act provides that any other person who knowingly benefits from directorial

[158] Ibid all respondents. See Appendix 5.

[159] Respondent B, a local corporate lawyer (23 September, 2016) See Appendix 5.

[160] Respondent B, a local corporate lawyer (23 September, 2016) See Appendix 5.

[161] Ibid (n 10) 48.

breaches can be subjected to derivative litigation.[162] Thus, in order to prevent controlling shareholders from expropriating corporate assets, the ambit of law should be stretched to controlling shareholders. Similarly, in the light of the proposal made by interviewee B, company law in Pakistan needs to be deliberated in direction to hold 'other persons' benefiting wrongfully from directorial misconducts, accountable.

In response to the proposal made in this thesis that the range of actionable wrongs need to be enlarged. Almost all the interviewees supported the view that the range of corporate cause of action in derivative suits should be broadened enough to include all serious illegal activities on the part of directors, corporate officers and controlling shareholders. In this respect, all the interviewees stressed the need for streamlining and codifying directors' duties and added that besides common law fiduciary duties, breach of statutory duties by the directors should also be made actionable.[163] However, interviewee H was sceptical to the proposal in favour of British style codified framework of directors' duties in Pakistan.[164] The interviewee argued that

"Although such framework would enlarge directors' responsibilities and thus, would help broaden corporate accountability, yet it might lead to 'managerial apathy' resulting in paralysis of business operations".[165]

In view of the concern expressed by the interviewee H, it is submitted that an appropriate balance needs to be struck amongst corporate cause of action, protection of corporate rights and safeguarding directors against threats of vexatious proceedings. To that end, courts should play their role to control meritless litigation brought against

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[162] See section 260(3), the UK Companies Act 2006.

[163] Respondents local corporate lawyers A, B, C, D; Senior SECP official and Academics E, F, G, H(28, 23,29,26,26/27,28,25,30 September 2016) See Appendix 5.

[164] See section 172 to 177 of the UK Companies Act 2006.Directors' statutory duties.

[165] Respondent H , an academic, (30 , September 2016), See Appendix 5.

directors. (The 'judicial approach' has been suggested in this thesis to assess derivative actions so as to avoid meritless litigation).

5.5.2.3 Assessment of Derivative Actions

It is pertinent to mention here that assessments of derivative actions are required to be made so as to filter out baseless suits and to determine whether to allow derivative proceedings or not. Six out of eight respondents supported the proposal made in this respect that conferring on courts powers of assessing derivative actions would be more in the interests of the companies.[166]

In opposition to the judicial approach, interviewee G argued that instead of leaving this area to judicial scrutiny, shareholders, in members' general meetings, may be tasked with deciding as to whether to turn down or grant leave for derivative actions.[167] The interviewee was of the view that

''shareholders, as being residual claimants, should have authority to decide upon litigation affecting their rights''.[168]

The interviewee went on to explain that adoption of the 'court approach' would mean nothing less than undermining the boardroom authority of decision-making processes in corporations.[169] The interviewee's view was that since members' meetings are source of powers of board of directors; therefore, making decision of derivative proceedings at

[166] Respondents A, B,C,D, local corporate lawyers and senior SECP officials E and F (28,23,29,26 September 2016) See Appendix 5.

[167] Respondent G (25 September 2016) See Appendix 5.

[168] Respondent G (25 September 2016) See Appendix 5.

[169] The respondent G referred that according to The Companies (Model Articles)Regulation 2008 SI 2008/3229 reg 2 and sch 1 article 5 ; Reg 4 and sch 3 , article 5, judicial intervention in internal affairs of corporations amount to undermining boards' decision making authority.

such meetings would not amount to a trespass upon the decision making powers of board of directors.

The interviewee argued that decision making as to the assessments of derivative actions at the members' meetings would help empower shareholders to decide in accordance with the interests of the companies. Moreover, they would not be subject to arbitrary decisions of board of directors who are criticised for being biased in deciding upon initiation of litigation against other board members.[170] Argument made by the interviewee as to conferring on shareholders the authority of assessing derivative actions may be, by the principle of shareholders' ownership rights, true. However, this approach, if adopted in Pakistan, would lead to various problems. For example, in situations where controlling shareholders are themselves the wrongdoers or for that matter the directors are under their control, assessments of derivative actions made at the members' meetings would be likely to be intended to letting them off the hook.

Moreover, it is not easy to unite shareholders for summoning meetings for assessing derivative actions. There is a legal impediment in this respect as the right to include proposed resolution for consideration in the agenda of members' meeting is not available to every individual shareholder singly under the Companies ordinance of Pakistan. Only shareholders representing not less than 10 per cent of the total number are allowed to include their proposed resolution for consideration in the agenda of members' general meeting.[171] Shareholders' unwillingness to vote and participate in members' general meetings is another major problem in this regard. It is particularly relevant with reference to minority shareholders who, being under impressions that

[170] Respondent G (25 September 2016) See Appendix 5.

[171] See section 164 of the Companies Ordinance 1984.

their vote would not necessarily influence decisions to be made at members' meeting, remain mostly inactive.[172]

In addition to shareholders' rational apathy and legal impediments, shareholders by and large lack relevant information and expertise necessary for understanding the nature of corporate wrongs and accordingly assess derivative actions.[173] Information to corporate wrongs and relevant expertise are necessary in considering as to whether grant leave for the suit or otherwise. In order for assessing derivative actions, shareholders might have general information regarding allegations of corporate wrongs through media reports; however, they lack sufficient information and related knowledge about wrongs. Thus, in view of problems noted above, decisions making in respect of assessment of derivative actions at shareholders' meetings may not be fair and impartial.

In this respect, with regard to the assessment of derivative actions, interviewee H was of the view that

''impartial arbitrators should be appointed for assessing derivative proceedings''.[174]

The interviewee underscored the need of a neutral person possessed with relevant expertise and professional repute to be hired for the purpose of assessment of derivative actions. The interviewee maintained that this sort of approach would help solve issues of legal costs and help prevent board of directors from exonerating their errant colleagues. Further, the interviewee went on to explain that it would help avoid unnecessary procedural requirements and rule-bounded management of cases as in traditional courts' litigation proceedings.

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[172] Stephen M Bainbridge, 'Director Primacy and shareholder disempowerment'(2006) 119(6)*Harvard Law Review* 05-25, 19.

[173] Ibid 20.

[174] Respondent H, (30 September 2016) See Appendix 5.

The interviewee was of the view that since parties to the disputes, agree and bind themselves to the decisions of arbitrators, naturally, it helps resolution of disputes amicably and potentially leads to win-win settlement of disputes instead of win-lose litigious settlements.[175] The interviewee's proposal as to appoint arbitrators seems, on the face of it, to be appropriate and would not be contentious as it is not something new because it is inseparable part of all civil jurisdictions in receipt of wide acclaim across the world.

On the other hand, although arbitration is a popular dispute resolution mechanism, yet this too is not entirely free from problems when it is viewed to be utilized for assessing derivative actions. It is claimed in its favour that arbitration is a cheaper and speedy dispute resolution mechanism. At first glance, although it may look so, yet it is not. It is not as cheaper as one may presume. In essence, it may also involve heavy expenditures like procedural costs of arbitration and arbitrators' fees. Undoubtedly, arbitration as a tool to resolve disputes has gained wide popularity; yet, one cannot overlook the fact that the target of justice cannot be hit without state intervention and the use of its coercive authority to push the parties to come to terms. In this context, even in the enforcement of arbitral awards, judicial intervention is essential,[176] without which, arbitral awards are nothing but declarations of rights.

The arbitration mechanism may be questioned for the assessments of derivative actions from another angle. At times shareholder claimants might accept less than a fair and just settlement which the company would have been entitled to as a result of courts' assessment of derivative actions. In fact, positive view as to the popularity of dispute resolution mechanism through arbitration appears in terms of resolution of international

[175] Respondent H, (30 September, 2016) See Appendix 5.

[176] See section 3 of the Arbitration Agreements and Foreign Arbitral Awards Act, 2011.

commercial disputes and family matters instead of redressing wrongs committed by directors of the companies.[177]

Further, a distinction between a normal suit and a derivative suit also needs to be borne in mind. In a derivative suit, a shareholder commences litigation in the name of a wronged company and accordingly, the shareholder represents the company and other stockholders. On the other hand, arbitration is focussed at assisting parties to reach an amicable possible agreement. Alongside, a party unwilling to put dispute to arbitration cannot be forced to go for that. Even if both the parties agree to arbitration, the shareholder party might accept something less than an adequate settlement of the dispute. This incidence would not mean that the wrong has been remedied in line with the best interest of the company. In this context, the company can be a rightful party to arbitration. However, it becomes problematic in situations where the company happens to be in control of the wrongdoers who, obviously, would not be willing to put the issue of assessments of derivative suits to arbitration.

Thus, analysis of views of both the interviewees G and H shows that assessments of derivative actions at shareholders' meetings and through arbitration mechanism are not wholly free from problems. In this purview, the judicial approach, if adopted in Pakistan, as suggested in this thesis and supported by majority of the respondents would necessarily solve the issues of making assessment of derivative actions on merit.

5.5.3 To improve accessibility to derivative action

In order to address the problem of costs, contingency fee approach has been suggested in this thesis so as to incentivise shareholders to take derivative actions against

[177] Richard Abel L, 'The contradictions of informal justice'(1982) *1The politics of informal justice* 267-320, 270,285

wrongdoers in corporations. Six out of eight respondents supported that contingency fee approach, if adopted in Pakistan, can solve issues of costs in derivative actions.[178] Interviewee E excused making comments on the use of contingency fee concept.[179]

Interviewee D was of the view that contingency fee may cause derivative proceeds unnecessarily delayed because lawyers might prolong proceedings in order to increase their fees and rewards. The interviewee suggested that

"Shareholders can be incentivised to take derivative actions if a reasonable percentage of benefits of derivative actions are shared with them".[180]

The concern shown by the interviewee that contingency fee arrangement may engender unnecessarily delayed proceedings is a valid argument that needs to be answered. It is so because delaying proceedings unnecessarily by lawyers with intent to increase rewards would be unfair to the companies because they would get less than actual recoveries from suits as the more the lawyers' fees; the less the proceeds of suits would accrue to the companies.

In fact, the interviewee was sceptical about contingency fee approach considering that lawyers would charge fees on the basis of hours they spend and the quality of work they render. To the extent that lawyers would charge on hourly basis, argument made by the interviewee seems to be convincing as unscrupulous lawyers might protract proceedings with intent to increase their working hours. However, it would not be a favourite choice for the lawyers to protract proceedings, if their fees are determined on the percentage method.

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[178] Respondents, A, B, C, F, G, H (28, 23, 29, 28, 25, 30 September 2016) See Appendix 5.

[179] Respondent E, a senior SECP official (28 September, 2016) See Appendix 5.

[180] Respondent D , a local corporate lawyer (26 September , 2016) See Appendix 5.

Under the percentage method, lawyers are not paid on the basis of their hourly services and quality of work but they are paid proportionate to the proceeds of suits. The percentage method may serve as an answer to the concern shown by the interviewee that lawyers may protract derivative proceedings with bad motives. However, one may also argue that the percentage method would result in windfall benefits for lawyers which would also be unfair to the companies. In this respect, it is submitted that this problem can be solved by setting a maximum limit for lawyers' fees. This would mean that lawyers would be paid proportionate to the proceeds of suits but they would not be entitled to charge more than the ceiling fixed for maximum fees.

The proposal as to reward successful claimants with part of the proceeds of suits made by the interviewee D provides a reasonably convincing way forward to consider the merits of this approach in the context of Pakistan.

The proposal made by the interviewee D gets support from the approach adopted in New Zealand where courts may order to pay a reasonable percentage of proceeds of suits to derivative claimants instead of paying full recovery to the companies.[181] This proposal can be a second solution to the issue of disincentives for shareholders in derivative proceedings in Pakistan. This is because most of companies in Pakistan are family-controlled and if a company happens to be in control of a wrongdoer, all benefits flowing from successful suits might be used improperly by the controllers. Therefore, ordering a reasonable percentage of proceeds of suits in favour of shareholders may help compensating them against expenses incurred by them on derivative proceedings.

[181] See Section 167(d) , the Companies Act 1993. New Zealand.

This proposal also remained under consideration with the UK Law Commission which did not favour it remarking that it might jumble up the distinction between direct and derivative actions. In this respect, it is submitted that without providing an incentive either through paying shareholders with part of the proceeds or through contingency fee arrangements, accessibility to derivative actions would not be enhanced. Without the enhancement of the accessibility, there would be not an effective use of derivative litigation. As discussed earlier, indemnity costs orders as intended by the UK Law Commission to incentivise shareholders, do not really provide an incentive to shareholders encouraging them to step forward and take derivative actions. This is because indemnifications of legal costs means to claimants simply return of their expenses incurred on derivative proceedings and not something additional in return of their time spent and other expenses not included in the costs orders. If, in this regard, shareholders are rewarded by ordering a reasonable percentage of the benefits of successful suits, as recommended by interviewee D, they would necessarily be incentivised to take derivative actions.

The proposal made by the interviewee also gets support from the stance that if directors can be paid for their work they do in rectifying wrongs done to companies, then why shareholders should not be paid for their efforts in making good losses caused.[182] Even otherwise paying proceeds of suits to the shareholders would not be beneficial for them in the sense that shareholders are not paid in full against the costs they spent on derivative actions as costs incurred on instructing solicitors, meetings with counsels and attending to sign witness statements is not included in indemnity costs orders.

[182] Ibid (104) 375.

Reisberg, in this perspective, argued before the enactment of statutory derivative actions system in the UK that shareholders should be rewarded through paying a reasonable percentage of the recovery of successful suits. He suggests that courts should consider factors such as complexity of a case, quality of effort rendered by the claimants and the extent of risk likely to be borne by them, while determining percentage of the recovery of suits to be paid to derivative claimants.[183]

Nyombi and Kibandama are of the same view that rewarding shareholders with part of the recovery of derivative suits can be a solution to the problem of disincentives with them in derivative litigation.[184] They consider that shareholder can be adequately incentivised through rewarding them with part of the recovery from the successful derivative proceedings. According to them, this is because in indemnity costs orders, there is always a gap between the actual finances spent by claimants and the costs ordered by courts which the deficiency can be made up by rewarding derivative claimants with part of the proceeds of successful suits.[185]

Thus, the above analysis shows that rewarding successful claimants with part of the recovery of derivative suits can be another way to improve accessibility to derivative actions. It is worth noting that this approach is being utilized successfully in Canada.[186] However, it cannot be a substitute for contingency fee approach which has benefits of its own. Therefore, as a solution to the issue of disincentives for shareholders in derivative proceedings, both the approaches may be capitalized for future legal amendments in Pakistan.

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[183] Ibid p 373; Ibid (n5) 131.

[184] Ibid (n5)130.

[185] Ibid (n5) 131.

[186] Ibid (n5)131.

5.6 Concluding Remarks

Based on argument, the experiences of some other jurisdictions, particularly, those of the UK and on the insightful suggestions of the interviewees, this chapter stood focussed on the long-awaited statutory framework for derivative actions in Pakistan. This defines with an amount of clarity, the shareholders' rights of derivative actions which are known for their complexity under the common law. In order to simplify the procedural route for derivative actions, defining the range of derivative claimants, delimitation of actionable wrongs and the 'Court Approach' have been discussed in detail. Issues which can lessen the efficacy of derivative proceedings have been highlighted and the guiding principles derived from the experience of other jurisdictions have been provided for consideration of legislators in Pakistan.

In regard to standing requirements of shareholder claimants, it is suggested that only actual shareholders of a company should be allowed to initiate actions against wrongdoers. To that end, contemporaneous and continuous ownership requirements have been suggested to legislators for their consideration for future amendments in the company law in Pakistan. These standing requirements have been suggested to be helpful to prevent unmeritorious suits by outgoing and after-acquiring shareholders.

In view of the fact that controllers of parent companies may choose one or more their subsidiaries to commit wrongs and thus, push shareholders of the parent companies to suffer indirectly through suffering of subsidiaries, double derivative actions have been recommended to hold wrongdoers in subsidiaries, accountable. Further, the requirement of 'adequate representation of companies and other stockholders' interests, have been emphasized in this thesis. This is to avoid multiplicity of litigation and to reap optimal benefits of derivative actions. In regard to assessments of derivative actions, different

approaches derived from the proposals of the respondents and from other jurisdictions have been evaluated. The British 'court approach' has been recommended to be the most suitable for Pakistan to adopt highlighting shortcomings of other approaches in this context and the appropriateness of the 'Court Approach' to decide whether to grant leave for a derivative action or not.

Given the lack of sufficient incentives for shareholders in indemnity costs orders approach as adopted in the UK, it has been argued in this thesis that solution to the issue of disincentives to shareholders in derivative proceedings lies in contingency fee arrangements and in rewarding claimants with part of the recovery from the successful derivative suits. Proposals made in this chapter have been discussed with the interviewees and accordingly, their views and illuminating suggestions have been incorporated so as to provide a cutting analysis of the attending issues. This comprehensive analysis has helped to provide more realist solutions of the problem of controllers' misuse of their positions and self-serving decisions detrimental to companies' business operations. It is, thus, hoped that the reform proposals made in this thesis will be taken into account for futuristic guidance as to amendments in the company law in Pakistan.

Chapter 6. Conclusion

6.1 Introduction

The purpose of this chapter is to summarise all the research issues discussed in this study together with comments on their relevance and meanings. This recapitulates and identifies contribution resulting from this research as well as directions for future research. This also highlights limitations of this study so as to provide a ground for the areas of future research.

At the start of this thesis, three questions were set to be answered;(1) to what extent the insiders (controlling shareholders and directors) misuse their authority in taking business decisions in disregard of companies' and their minority shareholders' interests? (2) What role do derivative actions play in promoting good corporate governance and in preserving corporate assets? (3) How can law on derivative actions be reformed, simplified and modernised so as to reinforce enforcement power of shareholders for safeguarding their interests? These questions have been answered in this thesis with a conclusion reached that derivative litigation can play an valuable role, if given full life, in preventing insiders from taking business decisions in disregard of the companies and small investors.

Key findings in this study and their relevance in the context of directions of future research is explained. This chapter considers six main elements of the study. First, the justification for conducting this research is elaborated. The purpose is to shed light on the background of this research with resultant research questions and the research gap this thesis helped filling. It refers to preceding chapters that shed light on the procedural and substantive barriers to minority shareholders seeking adequate remedies and the

role of derivative proceedings in promoting good corporate governance and ensuring better corporate accountability. Second, key findings have been given and it has been shown how they addressed the research questions. Third, reform proposals made in this thesis are explained in the light of findings. Fifth, the research limitations and areas of future research are elaborated. Last but not the least, at its conclusion, the central theme of the thesis, is explained.

6.2 Justification for conducting this research

The issue of managers' self-serving attitudes and preserving corporate assets is widely debated. In view of shareholder ownership concentration and vulnerability of minorities in both the private and public companies in Pakistan, this thesis argues that derivative litigation has a crucial role to play in strengthening the enforcement power of minority shareholders to protect their rights. The debate over shareholder protection started with Berle and Means' study that evidenced a division between control and ownership. This division between ownership and control was theorised by Jensen and Meckling acknowledging that where controllers' interest diverges with non-controlling shareholders', the controllers would invariably decide in line with their own interests. Therefore, legal rules and an effective monitoring mechanism need to be in place in order to prevent controllers from pursuing their private interests at the cost of the companies' and non-controlling shareholders' interests.

According to modern economic theorists, market forces have ability to play a role in enhancing managerial efficiency and corporate accountability. The claim of the modern economic theorists is based on the Eugene Fama's theory of efficient market

hypothesis.[1] When we say that the capital markets function as to push management to align its interests with those of the shareholders, it means that we are assuming that publicly available information is reflected in share price. In theory, it may be correct to say that in an efficient market, the securities price reflect available information.

However, the market efficiency hypothesis becomes strikingly questionable when we apply it to the inefficient markets like that of Pakistan where share price does not reflect available information. The collapse of the dot.com bubble during 1999-2001 offers sufficient evidence to the fact of the capital markets' mispricing with consequential failure of many companies. Likewise, the prevalence of financial frauds and a number of empirical studies show that the equity prices do not reflect available information in Pakistan. Academics like Andrew Lo are strongly sceptical as to singly rely on the capital markets to discipline errant management particularly in countries like Pakistan where the publicly available information is not reflected in equity prices.

The debate over market-based disciplinary mechanisms was popularised by Henry Manne, an American researcher who argued that the market for corporate control can act as a managerial disciplinary mechanism. The market for corporate control works on the principle that where managerial wrongdoings cause reduction in share price of a company, the company may fall prey to a takeover. Therefore, the underperforming managers, due to the fear of being sacked by the acquirer, are pushed to act in the best interest of the company. In this sense, the takeover market could influence managerial behaviour and prevent managerial malfunctioning.

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[1] See Eugene F Fama,' Efficient Capital Markets: A Review of Theory and Empirical Work'(1970)25 (2)*Journal of Finance* 383, 383 : Eugene F Fama,' Efficient Capital Markets 11'(1990)46 (5) *Journal of Finance* 1575-1617, 1575.

However, in chapter 1, it has been shown that the efficacy of market for corporate control is subject to various contingencies and limitations. For example, takeover market mechanism works in a very limited range. Normally, numerous companies are out of this range where they could become takeover targets. For example, if managerial inefficiency does not significantly cause fall of share price, then the company is out of the range of falling prey to takeover. Similarly, if managerial inefficiency is so extreme as to cause takeovers, then it can become a risky undertaking for the acquirer. The corporate takeover market thus have serious limitations in its operations as its effectiveness depends on variables such as ownership structure, informational requirements and defensive tactics used by managers of the companies which are subject to potential takeovers.

Second, the takeover market mechanism is an expensive route to dislodge incompetent management as it involves substantial transaction costs. Therefore, the bidder has to think of the issues like agency costs, undervalued company and transactions costs before making decision of takeover. Third, the takeover market mechanism has its little application to closely held companies. Although, closely held companies have relatively less significance in economic terms, yet they constitute the vast bulk of companies in Pakistan. As a result, this limits the scope of takeover market mechanism in Pakistan. Last but not the least, liquidity problem in the capital markets of Pakistan informs that relying on the takeover market would not necessarily solve the issue of disciplining errant managers.

The contractarian theory of corporate law explains the concept of company law that the modern business corporations exist on basis of contracts that determine the legal relationships among management and shareholders. The contractarians are critical of legal intervention. They believe that shareholders are protected through private

contractual system. They opine that managerial actions are bound by contractual commitments and shareholders may safeguard their interests by exercising their contractual rights. However, the legal contractarian theory is subject to well-grounded criticism. Many researchers like Clark,[2] Easterbrook and Fischel,[3] and Keay and Zhang[4] have criticised contractarians' view on the grounds of incomplete nature of contracts. This is a well-known problem with the formation of contracts that they cannot exist in an ideal form as it has been described by Williamson as, 'the foresight is, at best, imperfect'. This incomplete nature of contracts may provide controlling shareholders with opportunities to engage in illegal activities because minority shareholders, due to information asymmetries, might not be able to predict the potential misuse of incomplete terms of contracts and consequential ex-post opportunism at the time of signing contracts.

The concept of incomplete contracts necessitates that there should be additional mechanisms which could complete these contracts. These mechanisms may include independent board directors, incentive compatible compensation and takeover markets. However, Michael Jensen, a famous financial economist, notes that financial markets and internal governance systems have their own limitations and thus they are unable to push managers to act in the best interests of the company and the shareholders. He recommends that the imposition of legal liability on malfeasance managerial actions is vital in order to protect shareholders who suffer due to incomplete contractual provisions. Furthermore, legal origin, communitarian and agency theories recommend that imposition of legal duties on managers is important for promoting fair play for all

[2] Robert C Clark, *Corporate Law* (Aspen Publishers ,Inc 1986)2-4.

[3] Frank H. Easterbrook and Daniel R. Fischel, 'Voting in Corporate Law Corporations and Private Property,' (1983) 26(2) Journal of Law and Economics 395-427,402.

[4] Andrew. Keay, Hao Zhang, 'Incomplete Contracts, Contingent Fiduciaries and a Director's Duty to Creditors'(2008)32(1) *Melbourne University Law Review* 141-169,154.

the non- shareholder and shareholder constituencies of corporations. These theories favour legal intervention for regulating corporate affairs and managerial actions.

A pertinent question arises as to if a company is wronged, then who should be the 'proper plaintiff' to take action against the wrongdoers. According to fiction theory, a company is a legal person distinct from its members; therefore, it is the company itself responsible for its attendant legal liabilities and rights. Based on this independent legal entity concept of corporate law, the company is the 'proper plaintiff' to take against those who have defrauded it. Chapter 1 (fiction theory of law) has shown that it would leads to problems where the company is in control of wrongdoers. It would mean to infer that wrongdoers would not approve litigation against themselves. This state of affairs makes the case for derivative litigation enabling shareholders to come forward to take actions against wrongdoers and thus, preserve corporate rights.

It is expected that public enforcement would share a significant burden of enforcing corporate rights role. However, the public enforcement i.e government initiated proceedings is not free from problems and suffers from inherent limitations. Chapter 1 has shown problems with the public enforcement mechanism. For instance, in public initiated proceedings, a wrong committed by directors is treated as a criminal act and not a civil wrong. It is difficult to prove a criminal guilt as the standard of proof required for proving a criminal case is, 'beyond reasonable doubt' which is difficult for prosecution to establish. Moreover, it is potentially impracticable option to deal with every single wrong committed by directors and managers through public enforcement mechanism. The public agencies do have enforcement priorities due to their limited official capacity and financial resources. Hence, it becomes difficult for them to deal with all managerial misconducts apt to arise. The public enforcement also suffers from

flaws such as the possibility that public agents may succumb to the pressure of private interest groups contrary to the interest the law intends to protect.

Thus, the legal control and enforcement of corporate rights depends principally on shareholders' derivative proceedings. The company law in Pakistan does not recognise derivative proceedings. On the other hand, law governing derivative actions has received world-wide approval. This makes the situation worth exploring in the context of Pakistan. Various countries specific studies have been carried out to explore the role of the derivative suits to deter reckless behaviour of controlling managers. However, no study, in this regard, has been carried out that focusses solely on the subject of derivative proceedings in the context of Pakistan. This thesis aims at abridging this gap in the literature by examining the role of derivative litigation in promoting good corporate governance and vindicating the corporate rights.

6.3 General Findings

In this thesis, three main findings were made;

(a) Self-serving behaviour of corporate management in Pakistan,

In order to test the theoretical claims made by a number of researchers about widespread violations of corporate rights by the insiders, the case studies in chapter 4 have shown that directors failed to discharge their duties in accordance with the law on four key aspects. First one relates to unauthorised inter-corporate financing and advancing of soft loans to associated companies. Second, shareholders were deprived of their right to participate in the affairs of the companies due to the reason that annual general meetings were not held. Third, directors misstated facts to shareholder and failed to provide material information to shareholders. Fourth, directors abused their powers in keeping parallel books of accounts and straightaway misappropriating

corporate assets for their personal gains. These case studies are, amongst many others which exemplify managerial misconducts in Pakistan that need to be disciplined through an adequate disciplinary tool.

(b) Derivative litigation can, indeed and should play a role in reinforcing enforcement power of shareholders,

Findings in Chapter 1 have shown that other legal and extra-legal managerial disciplinary mechanisms have their own limitations that underpin the use of derivative litigation to discipline management. After having examined the market-based disciplinary mechanisms such as the capital market and the market for corporate control, conclusion was reached that these mechanisms fall short of adequately disciplining management due to their inherent limitations. For example, the capital market works to discipline management on the basis of reflecting publically available information in share price. However, a number of financial frauds and empirical studies have shown that capital market in Pakistan does not reflect available information in share price and hence does not operate to discipline management efficiently. Similarly, the market for corporate control works in a limited range and suffers from various other flaws which render it an inadequate managerial disciplinary mechanism.

Likewise, shareholders' voting rights and the framework of non-executive directors are not free from problems. Shareholder voting is an insufficient type of self-enforcing mechanism due to the problems of shareholders' rational apathy, collective action problems and information asymmetries. The effectiveness of NEDs as unbiased monitors and to control agency costs is also subject to criticism. Empirical evidence shows that the effectiveness of the NEDs suffers from the problem of their real independence, additional costs and insufficient business related knowledge, in the context of Pakistan.

Findings in chapter 3 have shown that the existing law enforcement mechanism under the Companies Ordinance is deficient and does not guarantee adequate protection to minorities. Four major problems were highlighted by the analysis of minority protection mechanism under the Companies Ordinance;

(1) lack of sufficient legal rights such as right to include resolutions in agenda of members' meetings, voting rights, pre-emptive rights and right to dividends (2) inadequate enforcement right in the form of remedy against unfair prejudice,(3) non-availability of derivative litigation and problems reflected with the Foss v Harbottle rule (4) litigation costs as the major disincentives to shareholders in taking actions against wrongdoers. In a business environment in which the threat to corporate interests is negligible, imperfect managerial disciplinary frameworks seem to be inconsequential.

(c) It comes with no surprise that the derivative actions, if given full life, have a potential to prevent insiders(directors, controlling shareholders and other corporate officers) who are making the best of weaknesses of inadequate enforcement mechanisms in Pakistan, from taking self-serving decisions in corporations. The need for the statutory framework for derivative actions as identified in chapter 3 emerges from the problems reflected in the Foss v Harbottle rule, inadequacy of alternative remedies and the issue of legal costs combined together, hamper shareholders' actions against wrongdoers in corporations.

6.4 Theoretical implications

The findings in this thesis should further our understanding of derivative proceedings and show how a functional derivative action framework contributes to strengthen enforcement power of shareholders.

This thesis contributes to the literature by putting forward reform proposals concerning statutory framework for derivative actions in Pakistan. As such, the original contribution that differentiates this thesis from other studies can be found mainly in three aspects.

First, it provides an in-depth theoretical examination to enrich legal scholarship on derivative proceedings in Pakistan. Prior to this, there is no study in the context of Pakistan that solely determines the extent to which derivative litigation can serve as a tool to promote good corporate governance and prevent corporate rights from being infringed. This thesis examines legal and extra-legal managerial disciplinary mechanisms and concludes that they have limitations of their own and hence cannot be a substitute for derivative proceedings, at least, in the context of Pakistan.

Second, based on arguments put forward in this thesis, on the original experiences of some other jurisdictions, particularly, those of the UK and on the insightful suggestions of the interviewees, guidelines and reforms in relation to the statutory framework for derivative action have been suggested for policy makers, legislators and practitioners in three main prospects. First, it clarifies the procedural route for derivative proceedings catering for standing rules of derivative claimants, actionable wrongs and assessment of derivative actions. Second, it suggests guidelines for an effective use of derivative litigation and prevention of abusive litigation. Third, it provides an alternative approach to funding problems that operate as disincentives to shareholders in derivative proceedings. It has been shown that the British indemnity costs orders approach would not provide adequate incentives to shareholders to step forward and take actions against wrongdoers. Basically, in Pakistan, the major problem relating to derivative litigation is in reference to incentivising shareholders. This thesis considers contingency fee

approach as the most suitable solution to the issue of disincentives to shareholders in taking derivative actions.

Third, prior to this thesis, there is no qualitative empirical study so as to see how statutory derivative action system works effectively in the marketplace. Lack of legal material and references on derivative claims necessitate the inclusion of the opinion of domestic corporate lawyers and policy makers over the structure of statutory derivative action system. This is important in the context of Pakistan where legal material, derivative cases and accordingly case comments are not available, which are essential for the consolidation of substantive and procedural problems with derivative proceedings in Pakistan. This thesis also contributes to the legal scholarship on derivative actions in Pakistan by reflecting the viewpoint of interviewees regarding the law reform proposals made in this thesis. The insightful and illustrative suggestions of the interviewees significantly helped to provide more realistic solutions of enforcement problems and suggest a meaningful and functional derivative actions framework for Pakistan.

6.5 Recommendation for future Research

Following are the challenges and identified areas that need to be researched in future;

(A): Although this thesis has provided theoretical underpinnings of derivative litigation and suggested the law reform proposals in respect of the derivation actions framework, yet, the efficacy of derivative litigation depends on the efficiency of a judicial system. In 2006 onwards, the turbulent- out burst of so-called judicial activism started from the hallmark agitation of Mr Iftikhar Chaudry- former chief justice of Pakistan who was illegally ousted from his office by the military dictator General Pervaiz Musharraf. It was followed by glorious lawyers' movement that significantly changed the things. The

judicial system earlier working without adequate facilities has now been equipped with latest technological facilities and further, a number of faculty enrichment measures, through judicial policy 2012, have been taken such as installation of judges' training centres, recruitment of additional judges and liability-bound improvised overview mechanism. Moreover, under Pakistan Vision 2025 One nation, one Vision' separate commercial courts, specialised commercial chambers in the existing courts and modernisation of corporate laws has been emphasised in order to achieve the optimal results of ensuring investor protection. However, still it needs to be researched in future to see the role of judiciary in the effective use of derivative litigation.

(B): Institutional investors have a key role to play in promoting good governance in the investee companies. Due to their large shareholdings, the institutional investors may exert pressure on management to perform its duties in line with the best interest of the company. In contrast, the individual shareholders, due to their small shareholdings in the investee company, may not play such an emphatic role in order to influence the affairs of the company. In fact, institutional investors are the culprits of this apathy in Pakistan. The institutional investors in Pakistan have so far been rather passive to play their role in this regard. Institutional investors have a valuable role in improving good corporate governance and ensuring corporate accountability. Researchers must study the participatory role of institutional investors in improving the accessibility to derivative suits for safeguarding corporate rights.

(C): The role of derivative litigation cannot be restricted to only preserving corporate assets and preventing management from expropriating minorities' interests, it can also be utilized against acts of bribery, and violation of health and safety laws. The scope of derivative litigation in relation to corporate social responsibility issues such as violations of labour rights, anti-bribery, environmental and health and safety laws also

need to be studied in future. In this regard, Law and Economic research method could be employed by future researchers in order to study the impact of derivative proceedings upon economic growth and safeguarding all stakeholders' interests in Pakistan.

(D); Although this thesis argues that derivative litigation has a crucial role to play in fostering corporate accountability, however, litigation of any kind is never meant to be the most favourite choice to safeguard corporate interests. For instance, litigation involves costs issues and it may also damage the reputation of a business entity involved in legal proceedings. In this perspective, litigation is never meant to be a primary solution to disputes. Softer options to resolutions of disputes such as arbitration, mediation and negotiation (ADRs) should be encouraged before initiating legal proceedings. Therefore, researchers must study to find ways for encouraging the role of ADRs in resolving issues of shareholder protection in Pakistan, which would help reduce burden of litigations on courts and would encourage amicable settlement of disputes.

6.6 Closing Remarks

This study provides a comprehensive legal scholarship on the subject of derivative litigation which has received a world-wide acclaim. In particular, it provides a detailed overview; theoretical underpinnings and informed explanations of the law governing derivative litigation by explaining the principles operating behind derivative proceedings, and making it a valuable source of understanding for legislators, policy makers and practitioners in Pakistan. It brings into use the principles operating behind derivative actions and suggests reform proposals as to developing a statutory framework for derivative actions in Pakistan. This study also included a comparative

perspective for looking at other jurisdictions to explain how derivative actions system might develop in Pakistan. It has provided a comprehensive assessment of reforms suggested to make better use of derivative proceedings by having insightful opinions of the interviewees.

This study also endeavours to have a fundamental rethink of the objectives of derivative proceedings. Putting these objectives into a comprehensive framework for derivative actions, it argues that the actions needed to be taken at three different levels so as to inspire life into this managerial disciplinary tool;(1) conceptual i.e a meaningful and functional derivative actions framework;(2) strategic, i.e provision of adequate incentives to shareholders so as to advance objectives underlying derivative proceedings ;(3) doctrinal, i.e clarifying the procedural route for taking derivative actions thus, maintaining the exclusiveness of this remedy for the realisation of its valuable objectives in preserving corporate assets.

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Appendix 1: Ethics Form

UNIVERSITY OF BEDFORDSHIRE

Research Ethics Scrutiny (Postgraduate Research Students)

When completing this form please ensure that you read and comply with the following:

Researchers must demonstrate clear understanding of an engagement with the following:

1. *Integrity* - The research has been carried out in a rigorous and professional manner and due credit has been attributed to all parties involved.
2. *Plagiarism* - Proper acknowledgement has been given to the authorship of data and ideas.
3. *Conflicts of Interest* - All financial and professional conflicts of interest have been properly identified and declared.
4. *Data Handling* - The research draws upon effective record keeping, proper storage of date in line with confidentiality, statute and University policy.
5. *Ethical Procedures* - Proper consideration has been given to all ethical issues and appropriate approval sought and received from all relevant stakeholders. In addition the research should conform to professional codes of conduct where appropriate.
6. *Supervision* - Effective management and supervision of staff and student for whom the researcher(s) is/are responsible
7. *Health and Safety*- Proper training on health and safety issues has been received and completed by all involved parties. Health and safety issues have been identified and appropriate assessment and action have been undertaken.

The **Research Institutes** are responsible for ensuring that all researchers abide by the above. It is anticipated that ethical approval will be granted by each Research Institute. Each Research Institute will give guidance and approval on ethical procedures and ensure they conform to the requirements of relevant professional bodies. As such Research Institutes are required to provide the University Research Ethics Committee with details of their procedures for ensuring adherence to relevant ethical requirements. This applies to any research whether it be, or not, likely to raise ethical issues. Research proposals involving vulnerable groups; sensitive topics; groups requiring gatekeeper permission; deception or without full informed consent; use of personal/confidential information; subjects in stress, anxiety, humiliation or intrusive interventions must be referred to the University Research Ethics Committee.

Research projects involving participants in the NHS will be submitted through the NHS National Research Ethics Service (NRES). The University Research Ethics Committee will normally accept the judgement of NRES (it will never approve a proposal that has been rejected by NRES), however NRES approval will need to be verified before research can commence and the nature of the research will need to be verified.

Where work is conducted in collaboration with other institutions ethical approval by the University and the collaborating partner(s) will be required.

The **University Research Ethics Committee** is a sub-committee of the Academic Board and is chaired by a member of the Vice Chancellor's Executive Group, appointed by the Vice-Chancellor and includes members external to the University

Research Misconduct: Allegations of Research Misconduct against staff or post graduate (non-taught) research students should be made to the Director of Research Development.

UNIVERSITY OF BEDFORDSHIRE

Research Ethics Scrutiny (Annex to RS1 form)

SECTION A To be completed by the candidate

Registration No: 1126698

Candidate: Aamir Abbas

Degree of: PhD

Research Institute: BMRI

Research Topic: Protection of Minority Shareholder in Pakistan: A case for statutory derivative action system

External Funding:

The candidate is required to summarise in the box below the ethical issues involved in the research proposal and how they will be addressed. In any proposal involving human participants the following should be provided:

- clear explanation of how informed consent will be obtained,
- how will confidentiality and anonymity be observed,
- how will the nature of the research, its purpose and the means of dissemination of the outcomes be communicated to participants,
- how personal data will be stored and secured
- if participants are being placed under any form of stress (physical or mental) identify what steps are being taken to minimise risk

If protocols are being used that have already received University Research Ethics Committee (UREC) ethical approval then please specify. Roles of any collaborating institutions should be clearly identified. Reference should be made to the appropriate professional body code of practice.

The proposed study involves protection of corporate assets and investigates the role of derivative action system which it could play in preserving corporate assets in Pakistan. Since I had worked as lawyer and have strong ties with domestic corporate lawyers therefore, I am sure I will be able to get the access to data required to complete this study.

In-depth interviews in the form of informal conversation with eight participants' i.e SECP officials, domestic corporate lawyers and academics will be conducted to understand the phenomena and to evaluate reforms proposals. As Government employee cannot record / disclose their opinion about any of the Governmental affairs without the prior permission of authorities, and if someone will channelize the permission and luckily gets it even then he/she will narrate Government's version instead of their own. Therefore, to get the insight, informal conversations with the employees will be made through positive indirect questions like "how to improve" instead of direct "what went wrong" will be posed to get the essence. The feedback received through these conversations will be interpreted to support

Answer the following question by deleting as appropriate:

1. Does the study involve vulnerable participants or those unable to give informed consent (e.g. children, people with learning disabilities, your own students)?

   No

   If **YES**: Have/will Researchers be DBS checked?

   Yes No

2. Will the study require permission of a gatekeeper for access to participants (e.g. schools, self-help groups, residential homes)?

   No

3. Will it be necessary for participants to be involved without consent (e.g. covert observation in non-public places)?

   No

4. Will the study involve sensitive topics (e.g. sexual activity, substance abuse)?

   No

5. Will blood or tissue samples be taken from participants?

   No

6. Will the research involve intrusive interventions (e.g. drugs, hypnosis, physical exercise)? **No**

7. Will financial or other inducements be offered to participants (except reasonable expenses)? **No**

8. Will the research investigate any aspect of illegal activity?

   No

9. Will participants be stressed beyond what is normal for them?

   No

10. Will the study involve participants from the NHS (e.g. patients) or participants who fall under the requirements of the Mental Capacity Act 2005?

No

If you have answered yes to any of the above questions or if you consider that there are other significant ethical issues then details should be included in your summary above. If you have answered yes to Question 1 then a clear justification for the importance of the research must be provided.

*Please note if the answer to Question 10 is yes then the proposal should be submitted through **NHS research ethics approval procedures** to the appropriate **NRES**. The UREC should be informed of the outcome.

Checklist of documents which should be included:

Project proposal (with details of methodology) & source of funding	x
Documentation seeking informed consent (if appropriate)	
Information sheet for participants (if appropriate)	
Questionnaire (if appropriate)	

(Tick as appropriate)

Applicant declaration

I understand that I cannot collect any data until the application referred to in this form has been approved by all relevant parties. I agree to carry out the research in the manner specified and comply with the statement of ethical requirements on page 1 of this form. If I make any changes to the approved method I will seek further ethical approval for any changes.

Signature of Applicant: …… Admir Abbas …… Date:04.08.2016…..

This form together with a copy of the research proposal should be submitted to the Research Institute Director for consideration by the Research Institute Ethics Committee/Panel

Note you cannot commence collection of research data until this form has been approved

SECTION B To be completed by the Research Institute Ethics Committee:

Comments:

BMRI Research Ethics Approval No. BMRI/Ethics/Student/2016-17/002

Dear Aamir,

The BMRI Research Ethics Committee has considered your application with revised consent form for Ethics approval for your research project. I am providing ethics clearance for this project in my capacity as the Chair of the BMRI Ethics Committee with the following conditions:

1. The confidential data should be shared with your supervisory team to ensure transparency in your research. All personal data should remain anonymous outside the researcher and supervisory team.
2. Please include reference to your supervisory team in the introduction letter and invitation for interview form and encourage the participants to contact supervisors in case they needed to contact.

While executing your project, please ensure that you adhere to the ethics principles of the University (http://www.beds.ac.uk/research-ref/rgs/research-ethics) at all times. Please note that if there is substantial change in your research project, you may have to seek ethical approval again.

Since this project is not externally funded, this clearance is not forwarded to the University Research Ethics Committee for further approval.

The BMRI Research Ethics Committee wishes you success in your interesting research project.

Approved

Signature Chair of Research Institute Ethics Committee: 

Date:

This form should then be filed on the student's record

If in the judgement of the committee there are significant ethical issues for which there is not agreed practice then further ethical consideration is required before approval can be given and the proposal with the committees comments should be forwarded to the secretary of the UREC for consideration.

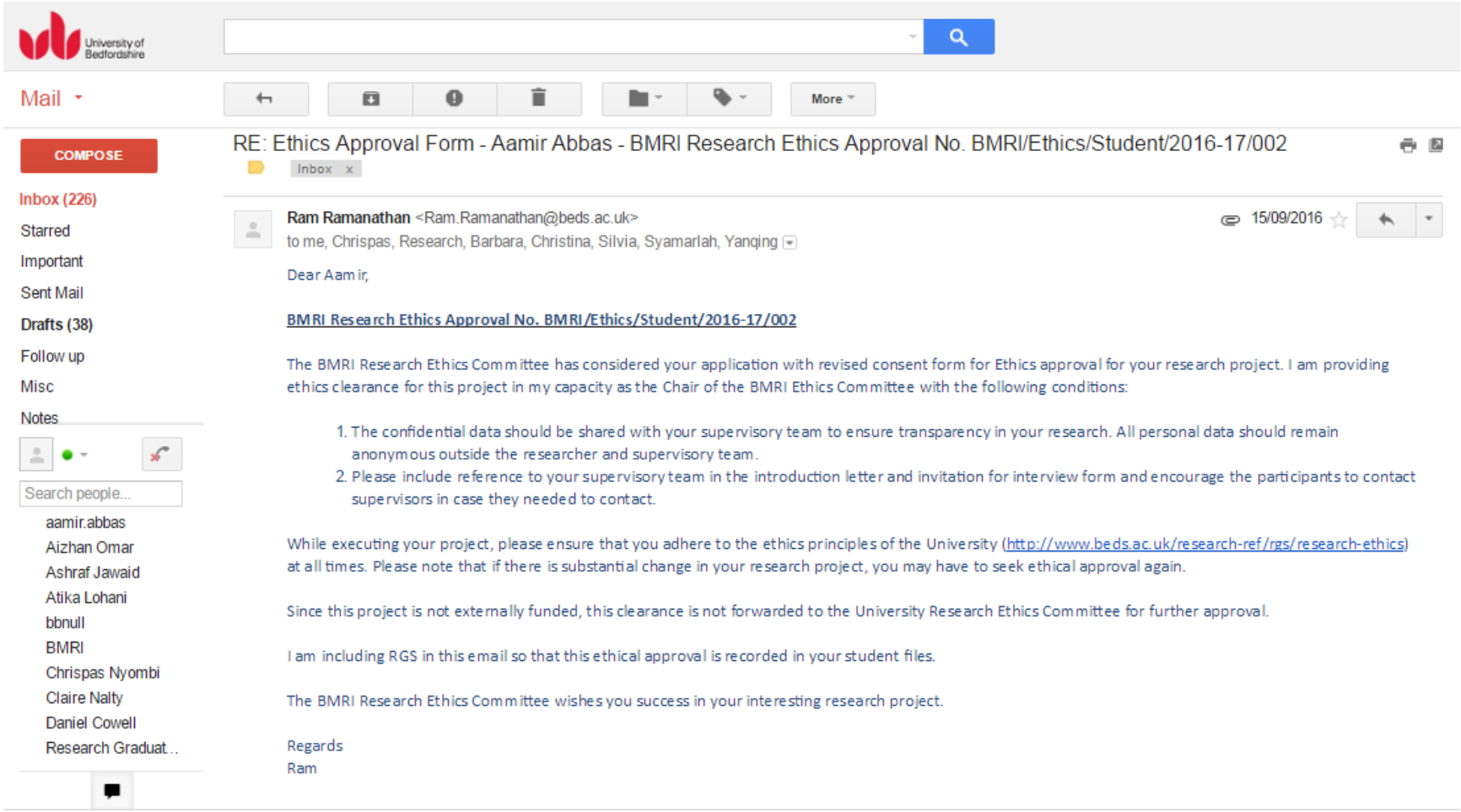
There are significant ethical issues which require further guidance

Signature Chair of Research Institute Ethics Committee:

Date:

This form together with the recommendation and a copy of the research proposal should then be submitted to the University Research Ethics Committee

Appendix 2: Ethics Approval Email



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Atika Lohani
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Chrispas Nyombi
Claire Nalty
Daniel Cowell
Research Graduat..

RE: Ethics Approval Form - Aamir Abbas - BMRI Research Ethics Approval No. BMRI/Ethics/Student/2016-17/002

Inbox x

Ram Ramanathan <Ram.Ramanathan@beds.ac.uk>
to me, Chrispas, Research, Barbara, Christina, Silvia, Syamarlah, Yanqing

15/09/2016

Dear Aamir,

BMRI Research Ethics Approval No. BMRI/Ethics/Student/2016-17/002

The BMRI Research Ethics Committee has considered your application with revised consent form for Ethics approval for your research project. I am providing ethics clearance for this project in my capacity as the Chair of the BMRI Ethics Committee with the following conditions:

1. The confidential data should be shared with your supervisory team to ensure transparency in your research. All personal data should remain anonymous outside the researcher and supervisory team.
2. Please include reference to your supervisory team in the introduction letter and invitation for interview form and encourage the participants to contact supervisors in case they needed to contact.

While executing your project, please ensure that you adhere to the ethics principles of the University (http://www.beds.ac.uk/research-ref/rgs/research-ethics) at all times. Please note that if there is substantial change in your research project, you may have to seek ethical approval again.

Since this project is not externally funded, this clearance is not forwarded to the University Research Ethics Committee for further approval.

I am including RGS in this email so that this ethical approval is recorded in your student files.

The BMRI Research Ethics Committee wishes you success in your interesting research project.

Regards
Ram

Appendix 3: Consent Form

Participant information Statement and Consent Form

***Title of Study* ;A Functional Derivative Actions Framework in Pakistan**

Introduction and Purpose
My name is Aamir Abbas, I am a Phd (Law) scholar at University of Bedfordshire in Law School. I would like to invite you to take part in my research, which concerns, the role of derivative litigation for corporate accountability in Pakistan.

Procedures
If you agree to participate in my research, I will conduct an interview with you at a time of your choice. The interview will involve questions about how to improve derivative action system. It should last about 40 minutes to one hour. With your permission, I will audiotape and take notes during the interview. The recording is to accurately record the information you provide, and will be used for transcription purposes. If you choose not to be audiotaped, I will take notes instead. If you agree to being audiotaped but feel uncomfortable at any time during the interview, I can turn off the recorder at your request. Or if you do not wish to continue, you can stop the interview at any time.

Benefits
There is no direct benefit to you from taking part in this study. It is hoped that the research will help to understand the issues regarding derivative actions at a time when the government of Pakistan is considering legislating on derivative action system. It could significantly help the government to address those issues highlighted in this study while legislating on derivative claim system.

Confidentiality
Your study data will be handled as confidentially as possible. If results of this study are published or presented, individual names and other personally identifiable information will not be used. Tapes and notes will be kept in the locker at Law School and the same will be destroyed one year after the research is completed.

Compensation

You will not be paid for taking part in this study.

Rights
Participation in research is completely voluntary. You are free to decline to take part in the study. You can decline to answer any questions and are free to stop taking part in the project at any time. Whether or not you choose to participate in the research and whether or not you choose to answer a question or continue participating in the project, there will be no penalty to you or loss of benefits to which you are otherwise entitled.

Questions
If you have any questions about this research, please feel free to contact me or my supervisor. I can be reached at;
Aamir Abbas, 00447424884704, *Email Address; aamir.abbas@study.beds.ac.uk* ,
Supervisor, Dr. Chrispas Nyombi; Email Address; Chrispas.Nyombi@beds.ac.uk

CONSENT

You will be given a copy of this consent form to keep for your own records.

If you wish to participate in this study, please sign and date below.

[redacted]
Participant's Name *(please print)*


Participant's Signature

23 September, 2016
Date

Appendix 4: Interview transcript

Interviewee, B

Time of Interview: 48 minutes

Date: 23 September, 2016

Position: a senior corporate lawyer cum company law teacher.

Asslam-o-Alaikum,

Yeah, Wa-Alaikum Asslam, who you speaking?

Question. Sir, I am Aamir Abbas. I have learnt you are senior corporate lawyer, having long served as senior public prosecutor and District Attorney, in Public Sector and currently teaching Company Law at Various Universities in Pakistan.

Answer. Yeah, it is.

Question. Will you kindly like to share your illustrious views on some questions, i have in my mind. These questions emerge from the reform proposals I have made for reforming company law in respect of a functional statutory derivative action system in Pakistan?

Answer. Yeah, why not? It is my pleasure. But what is it needed for? It has many angles to explore. Have you any selective questions or you want general discussion?

Question. Sir, I have some selective questions. In fact, as i have explained in the consent form that I have to submit my PHD thesis shortly and I intend the reform proposals made in my PhD regarding the statutory framework for derivative actions should be well-informed and comprehensive.

Answer. Okay! Go ahead.

Question. Sir, Is there an effective legal mechanism for the enforcement of minority rights in the company law in Pakistan? What's your personal opinion?

Answer. Although express remedial measures are there in the statute, yet, by no means, adequate. We can safely say there is no effective legal mechanism in Pakistan for guarding against minority rights subversion.

Question. Sir, I fail to understand. When you say express provisions are available in statute, then why and how these can fail to address this problem?

Answer. My answer cannot be speaking without making reference to certain provisions of law on the subject, section 290 of the companies ordinance 1984, according to the Ordinance, confers rights on shareholder to start legal proceedings against unfair acts of the directors but that is just conditional. They can exercise this right provided they have 20 per cent votes in the company. It means that if their votes are less than 20 per cent, they have no right to bring actions against offenders. It can be safely inferred from this that up till minorities remain minorities in real sense, that is to say, below 20 per cent threshold, they are deprived of voting right However, when they cross the stipulated line, only then they reach the stage of enjoying this enforcement right. The question is when 20 per cent limit is crossed how they can be termed as minorities. Evidently they step into majority category and rank in to majority shareholders. In this way, the real minors remain the sufferers at the end of day. Am I clear on the point?

Answer. Yeah, very clear no ambiguity left but is it the only remedy, though inadequate, provided in the statute?

Answer. The statute provides another remedy under section 305 of the Companies Ordinance and that is winding up of a company. Perhaps it is cosmetically provided in the law as literally it is no remedy at all. In fact winding up of a company is highly

drastic step in ordinary conditions. Such an extreme and extraordinary step is neither a favourite choice nor feasible ordinarily. It is obliged to many panicky factors and is possible only when structure of a company becomes entirely shabby and unable to stay on its feet. Simple question is who would go for winding up a company, otherwise healthy, simply on the complaint of a minor or minor segment of the company? Is it sufficient?

Question. Of course, but is it all about it?

Answer. Okay! There are other usual remedies like Securities and Exchange Commission to take action against offenders; but these also have their own limitations, bottlenecks and repercussions. Probably you might know that all. Major problem to me, is the political control of this Securities and Exchange Commission of Pakistan which halts the functioning of this body independently.

Do you need any elaboration?

Question. Sir, I need not any explanation on the point I am fully cognizant but I have other questions.

Answer. Welcome!

Question. Sir, in your valued opinion, can derivative litigation ensure effective managerial accountability mechanism in Pakistan? Is there any need for statutory framework for derivative actions in Pakistan?

Answer. Yeah, there is no second opinion that derivative actions are inevitable in Pakistan. It is mostly for two reasons. First, public enforcement has quite inadequate operational capacity. Government launched institutions have limited resources and resultant limited employees strength and related facilities. So, these are unable to cater to the wide-spread requirements. So, definitely, there should be a fool proof alternative

system capable of taking notice of each and every wrong coming to light and no rogue element should be allowed to escape simply due to insufficient accountability mechanism.

Second, if a company is in control of managerial lobby and is itself at fault or involved in malpractices, then obviously no action by the management against themselves can be imagined. So, a shareholder should be adequately equipped with necessary armament to move for action on behalf of the company against the management breaching their fiduciary duties.

Are you satisfied?

Sir, I am fully satisfied, but my linked question remains as to whether statutory law in line with common rules on derivative actions should be relied? and if so why and how? Can you explain?

Answer. I believe both the statutory enactments and common law rules should work in tandem.

Question. Will you please justify this duality?

Would it not create confusion or overlapping?

Answer. No not at all. A statute is an independent express provision of law, mandatory to be followed. Company law is a special enactment and any special enactment or law not only over rules unwritten rules of law like those of common law but also even codified general laws, whatsoever. It has overriding effect, hence creates no confusion or overlapping. Common law lays down guiding principles and comes into play only when a codification is exhausted or silent on a point .common law is based on common sense which appeals to folk mentality but cannot be substitute of codified law. This is why in the UK unwritten common law was utilized over centuries till necessity of

codification was left and the bill of Magna Charta came into light, perhaps as the first instances. For example, statute does not expressly provide for the order or sequence in which witness are to be examined to court. In such situations, common law formula, "first come first served" may be applied. A witness first in attendance is preferred to be examined leaving the others for later occasions. Stretching it further, importance of a witness or uncertainty about his availability on the next date is also given weigh.

Is it clear now?

Question; to some extent but it is not clear how common law rules can complement codified law?

Answer. It is so simple. Do you know principle of "Caveat Emptor"?

Question; to some extent I think it means "Buyer should be alert".

Answer. Yeah, of course now let's see if it is provided in any statute? To my knowledge, nowhere. It is under common law principle that a buyer while buying a property should first make sure that it is free from all encumbrances, to avoid future controversies.

Similarly, a statute simply provides for maximum punishment which is seldom awarded in ordinary crimes. Under common sense, it is the degree of the gravity of offensive act which decides the issue of quantum of punishment. I may further add, for example, that statute does not provide for the number of questions to be put during cross-examination.

Do you know that?

Yeah, I do.

Okay! Under common law principle “Brevity is the soul of wits” the questions and answers during cross-examination are weighed and not numbered. Under law there is no limit to questions but common sense demands there should be an end. A ‘reasonable time’ is to be allowed as of law but beyond that, a judge may stop the questions. This “reasonable time” is issue of common law and not of codified law. That is left to the direction of a judge as judges’ discretionary powers also owe their moral strength to common law rules. I may add in this context that sometimes common law rules are so demanding that they are formulized into codification. For example, the common law rule ”Nemo Debit Bis Vexari” that is “a person should not be harassed twice” has been codified under section 403 Criminal Procedure Code of Pakistan and Article 13 of the constitution of Islamic Republic of Pakistan,1973, where it is provided that a person once tried cannot be tried again on the same facts in issue. Similarly, “Res judicata” in civil jurisdiction has also been codified under section 11 Civil Procedure Code of Pakistan, meaning that a case finally and conclusively decided cannot be tried again.

Thus, I suggest derivative actions are necessary to be included in the law in order to enhance shareholder activism. However, I do not recommend to discard common law rules on derivative actions altogether, those are necessary because at times a codified law does not cover all conditions , in that case, the common laws rules can be examined and invoked to cover those problems.

Q. Sir, so far discussed, I am fully satisfied but I have further a few questions, if you do not mind?

Answer. Oh! Welcome, no problem.

Q. Sir what is your personal opinion? If contemporary stock ownership and continuous ownership are necessary elements in relation to standing rules in derivative proceedings?

Answer. Yeah, it is. As regards contemporaneous ownership, it is necessary and should be duly considered for its application in Pakistan. Logic is very simple to this turn, a gentleman having no stakes at time when the wrong was committed, has not rights to initiate legal proceedings. This is a basic civil law principle as you might know, that personal entailing no interest in the litigation has no right to initiate litigation except for the interpleader suit. Interpleader suit concept, you would be knowing it, litigation is started to determine the rightful owner of the subject matter. However; one thing I want to make it clear to you that due consideration should be given to the situation where after acquiring shareholders purchase shares without having the acquaintance of an alleged wrong in the company. As regards continuous ownership, it is also necessary because a person who has quitted the company cannot be relied to be serious in rigorously pursuing a case. A leaving-shareholder should be disentitled to pursue the litigation because he may withdraw from the litigation for receiving kick-backs or any other gratification from the errant directors.

Question; Based on your opinion are adequate representation of companies' interest and so-called double derivative actions necessary elements in relation to standing rules in derivative actions?

Answer. Yeah, of course. Court should make sure that a claimant is adequately representing the company' interest. My opinion regarding this requirement is obviously clear, you should not allow an abortive attempt to enforce corporate rights, it must be meticulously met that shareholders adequately representing not only the company but also the interests of all other shareholders in the company. Indeed, this rule needs to be

enforced in Pakistan. Likewise, the rule of double derivative action is also very important needed to be introduced in Pakistan. The shareholders of a parent company should be allowed to move for action against the wrongdoers in subsidiaries because Companies in Pakistan are mostly affiliated with each other; therefore for litigation purposes, the rights of all the affiliated companies should be taken care of.

Do you follow?

Yeah, I do. My next question, please.

Question; In regard to assessment of leave application for a derivative action, which forum, whether court or board of directors would be more appropriate to see prima facie feasibility of derivate proceedings?

Ans. An independent forum like court is decidedly better forum to decide the issue of granting or otherwise the leave application for these proceedings. Evidently, a directive action is mostly required to be initiated against wrong doing directors of the board of directors being in dominating position to do whatever they like. If they are tasked with crucial issue of deciding upon the feasibility of derivative proceedings, they can hardly be expected to go against their business kinship. In fact, impartial and unbiased forum is required and not the persons who are themselves the subject matter of the proposed proceedings. There is no ambiguity in my mind, courts are the appropriate forum, derivative actions are initiated for enforcing the duties of directors. It is by no means justified to allow directors to decide upon their illegal activities. Further, I would add to your question of court approach that on the scope of cause of action in derivative litigation other parties wrongfully benefiting from directorial manoeuvrings should also be held accountable via this litigation because board of directors might avoid

proceedings other parties associated with controlling managers or with any of the board members.

Next question if any?

Yeah, I still have another question.

Okay, carry on.

Q. In your valuable opinion, how potential shareholders can be incentivized to bring suits against wrong doers? In this context, if contingency fee arrangement has any role to play in Pakistan? If so, why and how?

Ans. Yeah, contingency fee arrangement can be a valuable choice to encourage shareholders to take action against wrong-doers because this is based on the concept of no win, no fees. This would mean that shareholders will not bear risk of losing their money spent in the course of litigation. With no fear having in mind, shareholders, creditors and even employees would be encouraged to come forward and take on the fraudsters". Similarly, indemnity costs is also one of the options to address this issue. However, I am of the view, that although these may be conducive to some extent yet would not promise something conspicuously additional to incentivize shareholder claimants.

Now it is to be seen if it stands out while juxtaposed with some other solutions, say indemnity costs order. In indemnity costs the litigant claimant is hardly repaid whatever he actually incurred. Indemnity in a successful suit does not include miscellaneous expenditure involved in counsels' meetings facilitating witnesses, transport expenses, documentation etc and at the end of the day the litigant finds himself standing where he was after off-setting his miscellaneous litigation expenses against whatever he receives as indemnity costs. So in my opinion it is not an ideal and efficacious solution as it does

not promise any net benefits substantially accruing to the litigant. As against it, in contingency fee arrangement the litigant shareholder has neither to pay anything prior to or subsequent to the conclusion of a suit.

In this arrangement, a lawyer takes upon himself to advance the suit without receiving his professional fee under an agreement that he would be entitled to a specified share of a successful suit proceeds. So as result of a successful suit, the litigant shareholder receives his proportionate share of suit proceeds whereas in case of losing the case at least he suffers nothing as he had neither paid any fee to the counsel nor suffered any charges incidental to case proceedings. So, the concept of contingency fee arrangement is based on the rationale that there is a chance to get but no chance to lose.

Do you get the point?

Yeah, perfectly

Okay, now its suitability in the scenario of Pakistan may be evaluated in view of attending conditions. You know, litigation, in Pakistan is drawn over years together. This cumbersome process involves not only lot of roughs and rigors of the trial but also considerably high budget of expenditure say counsel's fee, transportation, witnesses catering preparation of records so on and so forth. On the other hand, there happens to be an overwhelming uncertainty about concrete positive results. Rather there is all probability of losing because of exercise of influence by the influential management. In such a situation a shareholder even if substantially wronged would think hundred times to go for proceedings which not only fail to compensate the untold agony suffered by him over a considerable span of time but also do not ensure, even in a successful suit, at least the recovery of whatever expenses actually borne during proceedings. This is

primarily responsible for generating general apathy in wronged shareholders who keeping in view uncertainties, strife and struggle and incidental charges would mostly prefer to ignore the wrongs and excesses done to them. In this scenario, a mechanism like contingency fee arrangement may be high degree suitable for Pakistan as it nothing claims from you prematurely and leaves you tension free as the lawyer takes the responsibility of fighting the case through and through against settled share of suit proceeds agreed upon. So in this backdrop of the matter contingency fee arrangement may be a blessing in guise and I would not be lagging behind in recommending it for Pakistan.

Is it clear?

Perfectly, I am really grateful.

Is that all now or anything left?

Sir I am fully satisfied. I thank you from the core of my heart for sparing your valuable time.

Thank you. I wish you best of luck.

Appendix 5: Interview Responses

The purpose of interviews is to gather information from participants by eliciting their views on reform proposals made in this thesis; how derivative action system be improved to get better results.

	Question. 1 Based on your opinion, is there an effective enforcement power in the hands of shareholders to enforce corporate rights in Pakistan?
A	'There is minority protection remedy under section 290 of the Companies ordinance , but the problem with this remedy is that it is available only to shareholders holding more than 20 per cent shares . This means that real minority shareholders have no legal remedy except to apply for winding up remedy which is readily available. However, courts hesitate to offer this remedy because they refer first avail other available remedies ''
B	''There is Wind Up Remedy for shareholders, if shareholders are unfairly prejudiced by the management, they can apply for winding up remedy provided under section 305 of the companies Ordinance' Second, remedy provided under section of 290 of the statute is inadequate because it requires conditions to seek this remedy only if you have 20 per cent shares in the company.''
C	Remedy is there under 290 section of the ordinance but in my 22 years of corporate law practice, I could not redress a single client of mine through this section, major hurdle of this remedy is high percentage of shareholding to avail this remedy , it requires 20 per cent shareholding''.
D	''Enforcement rights for minority shareholders should be strengthened because the existing enforcement mechanism is weak that in fact protects weak majority shareholders but not to the small investors in the real sense because the small investors shareholders are individual aggrieved shareholders who need protection against wrongful acts of majority shareholders''.
E	No! there are many shortcomings in enforcement mechanisms of corporate rights. As the Companies Ordinance provides cumulative voting system but due to the reason minority are disorganised they fail to select director on the board who could protect their rights'' Government is planning to improve minority protection by making amendments in the law''
F	''There is remedy available to minority shareholders under section 290 of the companies ordinance but minority rarely avail this remedy '' reason might be procedural complexities ''SECP has established a task force to suggest reforms to improve minority protection''.

G	‘’Small investors are the neglected part of companies in Pakistan and they are most often mistreated at the hands of controlling shareholders and directors’’
H	‘‘Companies do not have any written policy for minority shareholders, and there is no sufficient protection for shareholders in the Code of Corporate governance’’ for the protection of minority shareholders, the representation of independent directors should be increased, Independent directors should trained and their presence on the board of directors should be doubled’’.

	Question. 2 In your opinion, can derivative litigation be an effective managerial accountability mechanism in Pakistan? Is there a need for statutory framework for derivative actions in Pakistan’’.
A	‘‘Derivative actions can be a good enforcement right in the hands of shareholders. Shareholders do not take derivative actions in Pakistan and the reason is very simple that they are not available in the company law. in my opinion, this right of action should be provided in the law as this right is available to shareholders in many jurisdictions’’.
B	‘‘Derivative actions are necessary to be included in the law in order to enhance shareholder activism , However, I do not recommend to discard common law rules on derivative actions altogether, those are necessary because sometimes a codified law does not cover all conditions , in that case, the common laws rules can be examined and employed to cover those condition’’.
C	‘‘It is an important enforcement tool, I expect from legislators to consider to make amendment in the company law to accommodate derivative actions’’ I am not well-versed in common law rules on derivative actions’’ But I can say that common law is cases based law and courts in Pakistan generally are reluctant to apply old case based laws due to the reason that it might be against the public policy or against the constitutional provisions ’’.
D	Derivative litigation is a cost effective remedy as oppose to remedy provided under section 290 of the companies ordinance. This remedy is attractive because the legal costs incurred on the litigation is paid by the company in derivative actions, this would end of the day encourage investors to call culprits to account’’.
E	Yes! in my opinion this is an important remedy, I think Pakistan is one of the few countries where derivative actions are not available. The government of Pakistan in this regard has assigned the task of The Corporate Law commission review to suggest reforms in the company law. The commission has recommended for statutory derivative action system which has not yet been finalised’’.

F	‘‘My opinion is that derivative actions are important in Pakistan because, private sector enforcement should be encouraged. I do not know common law position on this litigation but in a sense it provides evidence that common law position is not helpful for shareholders’’. Second, I recommend public enforcement agencies such as SECP and FIA and NAB should be strengthened to play their role in punishing and preventing misdoings in companies by the management.’’
G	‘’Shareholders enforcement power is weak in Pakistan, small investors prefer selling their shares instead of taking actions, if derivative actions like in the UK are provided in the company , it would help them to take on fraudsters.’’ Reason is that the company is to pay the costs this will encourage shareholders to take steps against wrongdoers.’’
H	‘‘My view on derivative actions is clear, it needs to be there in the company law but with proper safeguards, shareholders can exploit this power against the management of company. It would be because they do not pay litigation costs, therefore, they might be they use derivative actions improperly.’’

	Question.3 based on your opinion, Contemporaneous Stock ownership and Continuous ownership are necessary elements relating to standing rules in derivative proceedings?
A	Yes’’ “Shareholders should be the stockholder at the time when wrong was committed if they want to bring actions against the offenders who has wronged the company‘’ --------- Second, “Shareholder who has quitted the company, principally he has no right to continue the suit, obvious reason is that he has no financial stake in the company, this shows he does not intend to pursue the case rigorously.”
B	Yes, I think , it is important requirement but in my opinion ’due consideration should be given to the situations where after-acquiring shareholders purchase shares without having the knowledge of an alleged fiduciary wrong in a company’’ ---------- Second, “A leaving shareholders should be disentitled to pursue the litigation because he may withdraw from the litigation for receiving kick-backs or any other gratification from the errant directors’’
C	“This is American Standing rule, shareholders who was not shareholder at the time of the commission of the offence is not entitled to take derivative action, I think, it should be in Pakistan to stop baseless and

	vexatious litigation against the managements of the companies". ---------- Second, "This is also US standing rule in derivative actions, shareholder who has sold his shares in the company, then how can he be diligently pursuing the case while he himself is not part of the company, so I recommend this requirement should be adopted in Pakistan".
D	"Contemporary ownership should be necessary for taking derivative action , otherwise anyone can buy a share of the company and start litigation against the company which is not good for the company itself and for its management to perform their duties properly'' --------- "Somebody who start litigation and meanwhile leaves the company cannot be trusted to rigorously pursuing the litigation; therefore he should not be allowed to pursue the suit".
E	"Yes I agree with the stock requirement to start derivative litigation for stopping unnecessary litigation". --------- "I favour this requirement also, basically current stake or financial benefit must be there in the company, so that the shareholder will consciously pursue the case".
F	"I think it should be cleared that if somebody buys shares, and he is not disclosed the wrong , he comes to know the wrong after buying the wrong , then he should be allowed to take derivative action against management". --------- Second, "Somebody who left the company, it means he has no interest in the company, there is no logic to allow him to continue the suit."
G	"Contemporaneous ownership is necessary in my opinion because somebody buys shares knowing the current status of the company and secondly his interest in the company has not been violated therefore, he has no legal right to take action". ---------- "I do not agree with this proposal because. For example shareholder starts litigation, later he is ousted from due to mergers then this will be unfair with the shareholder to stop him from litigation".
H	"It is good standing rule, it clears the situation about the rightful claimants in derivative actions as otherwise it will be confusion that somebody coming in the company later than the commission of the offence is entitled to take action or not I recommend he should not be entitled to take derivative action because his rights direct or indirect has not been violated". ---------- "Continuous ownership requirement is not justified in my view because

	anybody who brings action against the management and later before the case is finalised, he loses his shareholding in the company due to mergers then it would unjustified for that litigant".

	Question. 4 Based on your opinion, adequate representation of companies' interests and the so-called double derivative actions are necessary elements relating to standing rules in derivative actions?
A	"It should be part of locus standi rules on derivative actions , one should understand that derivative actions is representative litigation and if the company is not adequately represented then the purpose of this litigation will not be met'' ----------= "Upon your explanation about the concept of double derivative action, I totally agree to allow shareholders of a parent company to bring suit against other affiliated companies because there is groups of company, almost all listed companies have their subsidiaries, so the management of the holding company may commit wrong in the subsidiary company therefore, shareholder of the holding company should be allowed to bring actions against the offenders".
B	My opinion regarding this requirement is obviously clear, you should not allow an abortive attempt to enforce corporate rights, it must be meticulously met that shareholders adequately representing not only the company but also the interests of all other shareholders in the company''. ---------- Yes! to me this is equally important to incorporate double derivative actions, because Companies in Pakistan are mostly affiliated with each other; therefore in litigation, they should be taken as single corporate entity''.
C	''Yes I favour this requirement because ultimately if company interests are not adequately represented, then derivative actions are of no use''. ---------- "I do not know very well about this concept but as it appears , it should be considered bearing in mind the affiliated companies structures which are connected with each , it means harm to one company would be to all affiliated companies, therefore shareholders of flagship company should be allowed to take actions against culprits who have done wrong in the subsidiary companies".
D	"Very much support your view about this requirement''. Because normally companies have their own legal counsels, these counsels may strike under carpet deals and compromise derivative proceedings as they are obliged to mostly act in the interest of the

	company managers being their nominees and selectees and thus vulnerable to sacking if they proceed and perform to their displeasure." "I also suggested that not only shareholders but employees of the companies should also be allowed to take derivative actions. because shareholders sometimes lack sufficient knowledge of a wrong due to informational asymmetries. Thus the employees of the company, as being insiders, are expected to be more conversant with the managerial wrongdoings than the shareholders".
E	"I support your proposal on this point because without adequate representation, all the shareholders would be sufferer, if you taking the lead to correct the wrong, you should do it in an effective way.'' --------- "This is new to me, however, the way you explained its purpose, it agree and support this suggestion."
F	"My view is that while assessing derivative application, it should be ensured that the claimants are representing the companies' interests adequately and permit only those suits to continue which advance the companies' interests vigorously". --------- "Managers or directors of parent companies may choose one or more their subsidiaries to commit wrongs and can push shareholders of the parent companies to suffer indirectly through suffering of subsidiaries, I support double derivative actions to hold wrongdoers in subsidiaries, accountable."
G	"It should be imperative, because resources should not be wasted on weak and inadequately initiated litigation which would not bring benefit to the company whose assets were expropriated". --------- "Derivative action is to put check on managers and stop them from doing frauds, therefore, in affiliated companies situation , double derivative actions rule will of particular importance."
H	"Proper representation of the company and for the interests of other shareholders must be ensured, without which the wrong against the company will not be rectified properly". --------- "I confirm your suggestion about double derivative suits, because both the holding and other affiliated companies are inseparable'', wrong in one company would leave impact on other associated companies".

	Question.5 In regard to assessment of leave application for a derivative action, which forum, whether court or board of directors would be more appropriate to see prima facie feasibility of derivate proceedings?
A	"Court is the proper forum to assess the merit of the application for derivation litigation'' it will be useful for courts to further enquire into the issues of case as already established by it at first stage of assessing the application for derivative actions".
B	Yes! "I am very clear, no ambiguity in my mind, courts are the appropriate forum, derivative actions are initiated for enforcing the duties of directors. it is by no means justified to allow directors to decide upon their illegal activities"
C	"When final hearing is to be tried at courts, then application for assessing the merit of the application for derivative should also be made to courts, it would help court to understand the background of the litigation and so it would be merit-based assessment".
D	"I would support court approach, board might be an effective forum to assess application for derivative litigation in the US, but I do not support in Pakistan where board of directors of business entities are under control of governments or in private companies, under the majority shareholders".
E	"Judicial Approach is my suggestion, because board of directors

	involves issues of independence , if independence of board body is ensured then it might be fine but in Pakistan , this is very difficult that board of directors would take decision independent from the influence of majority shareholders".
F	''Although courts have problems but from available options, courts would be appropriate to decide the application for litigation against the illegal act of the insiders.''
G	In my view, "Instead of leaving this area to judicial scrutiny, shareholders, in members' general meetings, may be tasked with deciding as to whether to turn down or grant leave for derivative actions. ''shareholders, as being residual claimants, should have authority to decide upon litigation affecting their rights''
H	"With regard to the assessment of derivative actions impartial arbitrators should be appointed for assessment of derivative actions."

	Question .6 In your valuable opinion, how potential shareholders can be incentivized to bring suits against wrongdoers? In this context, if contingency fee arrangement has any role to play in Pakistan? If so, why and how?

A	"Contingency fees is recognised by the laws of various countries and it can provide a good incentive for shareholders to sue the culprits in corporations' The reason in my view is that it is to support aggrieved party who has no resources to litigate and due to lack of resources, the offender would not be punished".
B	Yes, "contingency fee is effective solution to incentivise shareholders, because this is based on the concept of no win, no fees. this would mean that shareholders will not bear risk of losing their money spent in the course of litigation. With no fear having in mind, shareholders, creditors and even employees would be encouraged to come forward and take on the fraudsters".
C	Shareholders can be attracted to sue people alleged for wrongful acts through allowing contingency fees. Moreover, if law ensures full indemnification of shareholders for the legal costs they spend on litigation, it be promote corporate accountability''
D	''Under contingency fees approach, lawyers may protract legal proceedings to enhance their fees which would negatively affect the suits and it would be unfair to company pay these unnecessary fees of lawyers.'' 'shareholders can be incentivised to take derivative actions if a reasonable percentage of proceeds of derivative actions are shared with them instead of paying full recovery flowing from successful suits to the companies''

E	Excused to answer ; “Not well aware of the benefits and disadvantages of contingency fees concept “
F	“Contingency fee is a strong incentive save it is not misused because when shareholders know that nothing will go out of their pocket, they will tend to bring frivolous cases. This concern must be considered, if proper safeguards are there , then this can provide a strong incentive”
G	“The US is a good example of contingent fees and third party funding, where these concept are helpful to ameliorate aggrieved parties to litigation who have no adequate resources to fight his case”.
H	“If an aggrieved party has no resources to enforce his/her rights, then public enforcement agency should be accessed but otherwise contingency can be an alternative to the public enforcement agencies”.