ENFORCEMENT IN RELATION TO CORPORATE LAWS IN PAKISTAN: A CASE FOR LEGAL REFORMS

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Abstract
This article examines the enforcement problems of the corporate law in Pakistan. It critically analyses the legal and regulatory problems of enforcing corporate matters. The out-dated and inefficient laws are major problem for effective enforcement in Pakistan. There is a need to revamp the corporate laws for the safeguard of the interests of the investors keeping in view the prevailing circumstances in the country.
Key Words: Corporate Law; Corporate Governance; Minority Protections; Enforcement; Reforms; Pakistan.

I.Introduction

The protection of rights depends not only on effective enforcement of rights but the provision of those rights in law (Pound, 1910). The scholars of corporate law have been discussing the issue for quite a long time. In the new world scenario, this has become more relevant than it was before. The enforcement of laws is very important in an era of globalisation and competition where cross-border investment has increased (Enriques, 2002). The investment in foreign stock markets is a common modern phenomenon of overseas investment (Coffee, 2000). The foreign investment depends on the quality of laws and their enforcement mechanism. The investors both foreign as well as domestic are concerned with protection of their investment. The protection of investment is directly related to protection through laws and enforcement through institutions.

The effective enforcement comes through three core corporate institutions: Legislation, Judiciary and Stock Market. However, judiciary and stock market can be effective only when there are good laws. The corporate laws in Pakistan are inefficient and out-dated. They fail to provide sufficient protection to the investors on a number of occasions which results in deprivation of their life savings. The present state of corporate governance in Pakistan demands reforms in these three core corporate governance institutions. However, this paper will cover only

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legal reforms. The focus of this article is on corporate law reforms in Pakistan in the light of global trends including India in general and British corporate governance system in particular as the Pakistani system was borrowed from Britain, the former colonial power.

II.Enforcement Issues in Corporate Governance

In recent years, globalisation and competition have brought about towards convergence trend in corporate governance. In convergence, the less developed country transplant the laws of some developed country with better corporate governance mechanism. The transplantation of foreign corporate laws has remained a main phenomenon in recent years. In this process the home countries tried to adapt these features according to their circumstances but lack of synchronisation with home social, cultural, political and religious norms and a weak enforcement mechanism did not produce optimum results.

La Porta et al. have discussed in detail the protection of investors, especially minority shareholder. According to them, the protection of investors is the main factor for the good corporate governance. They further emphasised the fact that the enforcement mechanism can be effective only when there are good laws (La Porta et al., 1997). The focus of La Porta et al. was on the provision of the rights of the investors in the laws. The 'law in books' is, therefore, important in the first phase of reform, even if there is a weak enforcement mechanism; for instance, EU accession in central and eastern European countries suggest that features of foreign corporate governance can play at least a positive role on reform agendas and in their implementation (Berglof, 2004). In the second phase, the law in action can be ensured by enhancing institutional capacity (Cooter, 1998). Therefore, host jurisdictions must improve their enforcement mechanism in order to make the transplanted laws more effective. The mere provision of good laws in books cannot substitute weak enforcement mechanisms; for example, transitional economies transplanted laws from advanced jurisdictions, including the US, but weak enforcement mechanisms allowed the expropriation of minority shareholders. The transplantation of 'law in books' without 'law in action' from more developed jurisdictions may be counterproductive. Therefore, for an effective system of corporate governance, rights must be protected and enforced;

in other words, both good laws and an effective enforcement mechanism complement each other. In the absence of good laws, enforcement will not be successful and, conversely, in the presence of a weak enforcement mechanism mere good laws cannot protect investors (Cooter, 2000). However, the good laws are precondition for good enforcement mechanism.

Reforms in corporate laws and enforcement mechanisms have been on the agenda of both developed and developing countries in the recent past. Developed countries had taken the initiative long before developing countries. As far as enforcement is concerned, it is embedded in the system that developed over the time. The developed jurisdictions have strong enforcement mechanisms due to their ability to enforce the rights provided in their laws; in other words, the ability of the system to enforce laws is directly proportional to compliance with the regulations that provide the rights (Kraakman et al., 2009). For example, the US has the powerful Securities and Exchange Commission (SEC) to provide investors with protection. It has a strong judicial system and a developed market that enforces the rights provided in the laws. In the UK supporting institutions such as the stock market, institutional investors, *laissez-faire*[1], professionals and a developed judicial system have provided sufficient investor protection, which has developed the system of corporate governance (Cheffins, 2001). The problem of enforcement is more severe in developing countries than in developed countries. In some cases the problem does not lie with the 'law in books' but with the 'law in action' in developing countries (Berglof & Claessens, 2004). Many developing countries have laws that are transplanted through globalisation, colonisation or other financial interests. Despite this transition of good laws, enforcement remained a core issue in these countries. Systems of enforcement have also been reformed in some developing and emerging economies; for example, India has taken some initiative to reform its enforcement mechanism. It has introduced new Companies Act 2013 with many reforms including revamped rights for the investors. It has also introduced quasi-judicial authority known as the National Company Law Tribunal to enhance the enforcement mechanism

[1]*laissez-faire* is an economic theory which refers the system in which the contracts between private parties are free from government interference through different regulations, privileges, tariffs, and subsidies.

in the corporate sector and to provide protection to the investors (The Companies Act 2013, s. 408).

In Pakistan there have been some reforms during the past three decades. The reform agenda started with the enhancement of the regulator’s capacity in corporate law. The establishment of the Securities and Exchange Commission of Pakistan (SECP) through the Securities and Exchange Commission of Pakistan Act, 1997 was the first step on this agenda. The SECP made some laws and amended existing laws, rules and regulations to provide investors with rights and to safeguard them. Many state owned enterprises were privatised and the state disinvested some of its shareholding to the general public. This phenomenon stimulated family-owned enterprises to disinvest some of their shareholdings to the general public. The general public was involved in the process and invested their savings in the market. These reforms caused a boom in the stock market but the market crashed many times and major was in March 2005 and small dispersed shareholders lost their life savings. The regulator and stock market failed to avoid the market crash, and, subsequently, also failed to identify and punish the culprits. Stock brokers had manipulated the market and derived undue advantage from their position (Khawaja & Mian, 2005). This phenomenon is common in Pakistan due to old dated, inefficient and insufficient regulations.

In addition to this, Pakistan’s weak enforcement mechanism failed and the poor legislation and the inefficient institutional and judicial system could not provide the victims with an adequate remedy. This necessitates revamping the whole legal system of the country. Therefore, there is a need to reform the system in order to enhance the investor protection. The investor protection is key factor for development of the market which can attract not only foreign as well as domestic investment which will in turn boost economy of the country.

III.Reforms

Corporate governance is regarded in the same way as economic and legal institutions that can be reformed but it requires political support (Shleifer & Vishny, 1997). Good corporate governance is linked with better enforcement of investor rights. Reforms are necessary for underdeveloped jurisdictions such as Pakistan where corporate governance institutions are weak and fail to protect investors. In order to enhance the enforcement mechanism and improve corporate governance, the system needs to be reformed. This will enhance investor confidence, which may be beneficial to the economy in general and investor in particular.

Legal Reform

Pakistan is an underdeveloped country with complicated, cumbersome and out-dated statutes (Cheema, Bari, & Siddique, 2003). Most of the laws are based on those dating back to the British colonial era. Company law, which is the core corporate law, is based on pre-independence company law issued by the British rulers for their former colonies. Similarly, other corporate laws including securities laws and listing rules are also out-dated. The regulator is slow in reforming the statutes. Pakistan has made only one company law since its independence in 1947 and the same was based on the colonial company law of 1913. Other jurisdictions revised their company laws rapidly and brought them into the realm of modern needs and requirements. The UK introduced at least seven new versions of, or substantial amendments to, its company laws since 1947.[2] For example, in 1948 a new company law was formed to incorporate new features in company law which *inter alia* included (1) requiring companies to have consolidated accounts (2) to make more disclosure and (3) the power was delegated to the shareholders to remove a director by a simple majority vote.

In 1985, some new features were introduced by making a new company law, such as (1) introduction of unfair prejudice remedy and (2) exclusion of default articles of association from the Act. The unfair prejudice remedy deals with circumstances where the membership or personal rights of shareholders are infringed. In this remedy the members are the proper party for the enforcement of personal rights. This remedy is specifically designed for minority shareholders as if the majority comes to court for an unfair prejudice remedy against the conduct of a director, the court can simply direct that a resolution be passed or that a director be removed for breach of duty by the members themselves in their meeting (Pettet, 2001). The unfair prejudice remedy has a wider

[2] These new versions or substantial amendments in the company law were made in 1948, 1967, 1976, 1980, 1985, 1989 and 2006.

scope than other remedies such as a derivative action. The court may even demand that directors pay the shareholders whose rights are infringed instead of paying to the company. The default articles are those regulations for the companies which are annexed with the Act and the companies can adopt them as their regulations. Even if a company do not adopt they have automatic applications if the companies do not make their own articles. The objective to exclude default articles is to force companies to make their own articles instead of adopting default regulations.

In 2006, some major changes were made in the company law, such as (1) codification of directors' duties (2) introduction of statutory derivative action, and (3) incorporation of certain provisions in the company law to meet European Unions' Directives such as Takeover and Transparency Obligations Directives.

Fiduciary duty applies to the directors and executive officers of the company so that they act for the benefit of the company and its shareholders. Fiduciary duty was created for trusts in order to avoid the misuse of trust property at the hands of the trustees. The objective was to prevent the wastage of trust property by the trustees for the benefit of the beneficiaries. It was common law remedy applied by the courts in the UK. The courts applied the same duty to entrepreneurs to avoid the misuse of company assets at the hands of the directors for the benefit of the shareholders. In 2006, the fiduciary duties were codified in order to make it more viable due to inherent problem of common law which is in scattered form.

A derivative action is a mechanism by which the shareholders can take action on behalf of the company in the case of breach of duty by the directors. The action is called derivative action as it is derived from the company. This is minority protection because the minority shareholders do not have enough votes to take direct action through a meeting of shareholders. Derivative action is a minority protection remedy as it provides minority shareholder with an opportunity to take action for the wrong done against the company acting on behalf of the company. They are authorised to take action against the directors if the majority is not willing to take action against the directors. This remedy is so wide that the shareholders can take action against the directors even if they have only one vote.

India has also revamped its company law. It introduced the Companies Act 2013 with major changes that are mostly concerned with investor protection. These include but not limited to revamping the existing rights and to introduce new concepts for the purpose of investor protection. It introduces quasi-judicial authority that may provide speedy remedy to the investor without recourse to the normal judiciary. The formal judiciary has its own inherent problems of providing speedy justice. It is normally slow in providing remedy due to formalities connected with the whole judicial system. In business the time is money and the businessman cannot afford lingering on decisions. One aspect of investor protection is to provide them with speedy remedy through quasi formal authority. Therefore, the new Act has provided quasi-judicial authority in order to provide speedy remedy. There is other range of investor protections mechanisms introduced in the Act.

It introduces right of shareholders to take class action. In class action, a group of persons can take action in case of infringement of their rights or of the company to the Tribunal. If the members of the company are of the opinion that the management of the company is being conducted in a manner against the interest of the company and its shareholders, they can file an application to the Tribunal for the remedy (The Companies Act 2013, s. 245).

There is global trend in reforming the laws especially the corporate laws as foreign investment is directly linked with the better corporate laws and their enforcement. Therefore, corporate laws in Pakistan must be reformed to meet the changed circumstances and new needs. The SECP established the Corporate Laws Review Commission in November 2005 to make recommendations to amend the existing company law or to draft new company law. It published a concept paper for the development and regulation of the corporate sector. After eleven years of work, the Commission recommended a new company law which was promulgated through Presidential Ordinance on 11th November 2016. It got public resentment especially from the parliamentarians as the same was passed bypassing the democratic process of law making. Therefore, the Parliament rejected the Ordinance on 15th December 2016. The Government then presented the bill in the Parliament by reinforcing the repealed Companies Ordinance 1984. The new proposed bill has suggested making some major changes in the company law. The main focus is on the use of technology for quick corporate actions and decision making. These include but does not limited to notice to the shareholders through email, E-voting, postal balloting, submission of documents and notices through electronic mails. The proposed law also encourages management to register and file the registration documents through online portal of SECP. The other proposed significant changes with respect to investor protection include the provisions to empower shareholders and enhanced duties and powers of the directors to ensure good governance.

Firstly, the Companies Ordinance 1984 provided that a member or members having not less than 20% voting power to apply to the court that election of directors may be declared invalid on the basis of irregularity. New proposal has extended this facility and provides that the members having at least 10% voting power can apply to the court for declaring election of directors as invalid on the basis of irregularity found in the election within thirty days of election of directors. Secondly, the Companies Ordinance 1984 provided that a member of a listed company after acquiring 12.5% or more voting power may apply to the Commission for fresh election of directors in the forthcoming annual general meeting. This facility has been curtailed and this is available only in case of non-listed companies. Under the proposed bill a member having acquired such number of votes which entitled him to become a director of the company may apply to the company for fresh election of directors and the board of directors are bound to hold fresh election as soon as practicable but not later than 30 days from the receipt of requisition. This facility is only available to non-listed companies. The previous provision was more effective because of public interest involved in listed companies. This should have been available for all types of companies. Thirdly, the Commission has been empowered to remove and disqualify a director for a period of five years if he is found to be involved in insider trading, fraudulent activities and other offences specified in the law in public interest companies. The public interest companies have been defined widely and include but not limited to a listed company, a public sector company, a non-listed company which is involved in business of essential public service and public utility, a non-government organisation (NGOs) within specified threshold of turnover, a foreign company within a specified threshold of turnover. These public interest companies are proposed to comply with enhanced provisions of the law due to public interest involved in these companies. Fourthly, the law requires certain companies to have independent directors in their board of directors. Therefore, a facility has been provided for the companies to select an independent qualified director from the data bank to be maintained by any institute, body or association as may be notified by the Commission.

These proposed amendments have enhanced to some extent the investor protection but some major investor protection mechanisms are still missing and some needs improvement in the context of new trends in the world. The major ones that are missing include derivative action, class action and doctrine of corporate opportunity. A derivative action is a remedy in which the shareholders can take action acting on behalf of the company for the wrong done against the company in those cases where the directors or majority shareholders are either involved in wrong doing or unwilling to take action due to vested interests. A class action is a remedy which provides certain class of shareholders to take action in case their rights are infringed. The doctrine of corporate opportunity is a mechanism to have check on the directors, corporate officers and majority shareholders who take personal benefits by using the resources of the company.

The major ones that need improvement include unfair prejudice remedy, related party transactions, pre-emption rights, and just and equitable winding up. The remedy against unfair prejudice conduct deals with circumstances where the membership or personal rights of shareholders are infringed. This remedy is specifically designed for minority shareholders, however, under certain circumstances the remedy may also be sought by the majority shareholders and the creditors. The remedy is important in corporate governance as this provides wide scope of remedies to the investors.

The conflict of interest between controlling shareholders, directors, and corporate officers (insiders) and the company may arise in any situation. It may arise when insiders have interest in any transaction in which company is involved as a party. This may occur when any transaction is made between a company and its insiders or between a company and a third party in which such insiders have direct or indirect interest. For example, if a contract is made between a company and a third party and in such contract, the insiders are third party themselves, or owners or shareholders of third party. These kinds of transactions are called related party transactions.

Pre-emption rights provide safeguards against dilution. These rights affect the voting powers and the financial interests of the existing shareholders. These rights mean that the existing shareholders have a priority to subscribe to a new issue of shares on a pro rata basis. If existing shareholders are not interested, then the directors can issue these shares to the general public or to other existing members. Pre-emptive rights are important for minority shareholders. If they are not offered a new issue of shares, it may dilute their voting powers. They may also lose potential benefits in new shares in the form of a lower share price that may normally be less than the market value.

This slow process of reforming the law affects investment from both domestic and foreign investors. There is a need to revamp the corporate laws in order to improve corporate governance in Pakistan.[3] However, it must be noted that the mere creation of laws will not solve the problem. Those laws and rules are best that can be enforced. Legal convergence is effective only when there is a sound enforcement mechanism in place, otherwise any reform may be counterproductive (Pistor, Raiser, & Gelfer, 2000). Therefore, in the first instance the corporate laws need to be revamped and should be made according to new needs and requirements. The laws from more developed countries can be helpful but that must be considered in accordance with the social, cultural and political norms of the home jurisdiction. As misfit transplantation from more developed to underdeveloped markets can be

[3] The authors have discussed different aspects of corporate laws that need improvement, elsewhere. For this see Khan, I.A. (2014). The unfair prejudice and investor protection remedy in Pakistan. *Journal of Business Law*, 5, 388-406. ; Khan, I.A., Abrar, M. (2014). Fiduciary duties and investor protection in corporate law of Pakistan.*Comp;any Lawyer*, 35 (5), 146-157. ; Khan, I.A. (2012). The role of international organisations in promoting corporate governance in developing countries - a case study of Pakistan.*International Company and Commercial Law Review*,23 (7), 223-233. ; and Khan, I.A. (2016). The derivative action remedy for minority shareholders in Pakistan.*Pakistan Journal of Social Sciences*, 36 (1).

counterproductive (Pistor et al., 2000). Therefore, any transplantation must be undertaken keeping in view the prevailing social, political, cultural and religious norms in the country.

Conclusion

This article discussed enforcement in corporate governance in Pakistan. The corporate laws in Pakistan are inefficient, out dated and failed to protect the investors. Therefore, for effective enforcement in corporate governance there is a need to revamp the corporate laws in Pakistan. In addition, it demonstrated that the ‘law in books’ is important in the first phase of reform then ‘law in action’ can be effective in the second phase for better corporate governance and investor protection.

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