Adaptation and Convergence in Corporate Governance to International Norms in Pakistan

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ABSTRACT

This thesis discusses the adaptation and convergence in corporate governance to international norms in Pakistan. Pakistan is an underdeveloped but an emerging market with inefficient legal, regulatory, judicial, institutional and governance norms. In recent times there have been some reforms in the corporate sector of Pakistan but lack of infrastructure and a dearth of research were barriers to reform generally. Therefore, this thesis seeks to identify corporate governance issues in Pakistan, and discusses analytically the possibility and effectiveness of convergence in corporate governance to international norms in Pakistan.

To this end, it focuses on three aspects of convergence in corporate governance in Pakistan. First, it discusses the prospects and application of convergence in corporate governance in Pakistan. Second, it analyses critically, from a comparative perspective, three core corporate governance issues in Pakistan. The corporate sector in Pakistan is highly concentrated with an underdeveloped capital market and inefficient enforcement mechanisms. The conflict between shareholders and management, and shareholders *inter se* are major issues of corporate governance in Pakistan. The former conflict is addressed by reducing agency cost and the latter by ensuring minority protection. These conflicts are analysed comprehensively through comparative studies. Furthermore, the market and judiciary in Pakistan have failed to provide investors with protection. This thesis discusses the reform process in the market and judiciary in order to improve enforcement mechanisms. In addition, it discusses the possibility of convergence and effectiveness of adaptation in these issues. Third, as Pakistan is an ideological country whose constitution prescribes Islam as the state religion which, in turn, prescribes Islamic injunctions as basic norms, convergence to any foreign corporate governance feature will have to pass the litmus test of Islamic norms. Therefore, the thesis also identifies the possibility of filtration of foreign governance features through Islamic norms.

The thesis concludes that the corporate sector in Pakistan is underdeveloped with weak investor rights and enforcement mechanisms. There is, therefore, a need to enhance investor protection in order to improve corporate governance which, in turn, will improve the economy of the country. In addition, the conclusion is reached that in convergence to Western corporate governance features in Pakistan, Islamic norms may act as a litmus test which may not be as problematic as it appears at first sight.

List of Publications

1. Imtiaz Ahmed Khan, ‘The Role of International Financial Institutions in Promoting Corporate Governance in Developing Countries: A Case Study Of Pakistan’ (2012) 23 (7) *International Company and Commercial Law Review* 223-233

2. Imtiaz Ahmed Khan, ‘The Fiduciaries Duties and Investor Protections in the Corporate Law of Pakistan’ 35 (5) *Company Lawyer* 146-157

3. Imtiaz Ahmed Khan, ‘ The Unfair Prejudice and Investor Protection Remedy in Pakistan’ (2014) 5 *Journal of Business Law* 389-408

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Declaration

I hereby declare that, except where explicit reference is made to the contribution of others, this dissertation is the result of my own work and has not been submitted for any other degree at the University of Glasgow or any other institution.

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Dated

Contents

Figures

Tables

Religious Sources

The *Qur'ān* (Holy Book for Muslims)

Traditions of Holy Prophet Muhammad (peace be upon him)

Laws, Rules, Regulations and Codes

Pakistan

The Anti-Terrorism Act, 1997

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The Companies Act, 2005 (Japan)

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Hassan Al-Adawi v M/s Hama International Pvt Ltd, 2009 CLD 1043

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Abbreviations

ABIL:	Associated Biscuits International Limited
AC:	Appeal Cases
ACCA:	Association of Chartered Certified Accountants
ACLC:	Australian Company Law Cases
ADB:	Asian Development Bank
ADR:	American depository receipt
AEIB:	Arab Emirates Investment Bank
AGM:	Annual General Meeting
AIM:	Alternative Investment Market
All ER:	All England Reports
AMC:	asset management company
ASIC:	Australian Securities and Investment Commission
BCLC:	Butterworth Company Law Cases
BESOS:	Benazir Employees Stock Option Scheme
BMM:	Berle–Means Model
CARD:	Consolidated Admissions and Reporting Directives
CDC:	Central Depository Company
CEO:	chief executive officer
CES:	closed end scheme
CFL:	Coronet Foods Pvt Limited
Ch:	Law Report, Chancery Division
CJP:	Chief Justice of Pakistan
CLA:	Corporate Law Authority
CLD:	Corporate Law Decisions
CLRC:	Corporate Law Review Committee
CMDP:	Capital Markets Development Programme
CMER:	Centre for Management and Economics Research
CSIH:	Court of Session Inner House
CSRC:	China Securities Regulatory Commission
CVS:	Cumulative Voting System
DTR:	Disclosure and Transparency Rules
EBM:	English Biscuits Manufacturers Limited
EEA:	European Economic Area

EEC:	European Economic Community
EFF:	Extended Fund Facility
EMS:	entity maximization and sustainability
Etisalat:	Emirates Telecommunications Corporation
EU:	European Union
EWHC:	High Court of England and Wales
EWCA:	England and Wales Court of Appeal
FBR:	Federal Bureau of Revenue
FCA:	Financial Conduct Authority
FMGP:	Financial (Nonbank) Markets and Governance Program
FSA:	Financial Services Authority
FSC:	Federal Shariat Court
FSMA:	Financial Services and Market Act
FTSE:	Financial Times Stock Exchange
GDP:	gross domestic product
GDR:	global depository receipt
HKCU:	Hong Kong Court of Appeal
HL:	House of Lords
IA:	The Insolvency Act, 1986
IAS:	International Accounting Standard
IASB:	International Accounting Standard Board
ICP:	Investment Corporation of Pakistan
ICSSS:	Islamic Countries Society of Statistical Sciences
IFC:	International Finance Corporation
IFI:	Islamic Financial Institution
IFSB:	Islamic Financial Services Board
IIFA:	International Islamic Fiqh academy
IH:	Inner House
IMF:	International Monetary Fund
IOSCO:	The International Organization of Securities Commission
IPO:	initial public offering
KAPCO:	Kot Addu Power Company
KB:	King’s Bench Division
KMI:	KSE–Meezan Index
KSE:	Karachi Stock Exchange

KYC:	Know Your Customer
LHC:	Lahore High Court
LLSV:	R. La Porta, F. Lopez-ed-Silanes, A. Shleifer and R. W. Vishny
LSE:	London Stock Exchange
LUMS:	Lahore University of Management Sciences
MMoU:	Multilateral Memorandum of Understanding
MoU:	Memorandum of Association
NBFC:	Non-Banking Finance Company
NIPL:	National Power International Limited
NIT:	National Investment Trust
NITL:	National Investment Trust Limited
NJP:	National Judicial Policy
NW:	North-West
OECD:	Organisation for Economic Co-operation and Development
OES:	open end scheme
OIC:	Organisation of Islamic Cooperation
OUP:	Oxford University Press
PC:	Privy Council
PICG:	Pakistan Institute of Corporate Governance
PICLT:	Pakistan Industrial and Commercial Leasing Limited
PLD:	Pakistan Legal Decisions
PPP:	public–private partnership
PRA:	Prudential Regulation Authority
PSM:	Professional Securities Market
PTCL:	Pakistan Telecommunications Limited
QB:	Queen’s Bench Division
RFP:	request for proposal
RIS:	Regulatory Information Services
ROA:	return on assets
ROC:	return on capital
ROI:	return on investment
ROSC:	Report on the Observance of Standards and Codes
RPT:	related-party transaction
SC:	Supreme Court of Pakistan
SCR:	Supreme Court Reports

SEBI:	Securities and Exchange Board of India
SEC:	Securities and Exchange Commission
SECP:	Securities and Exchange Commission of Pakistan
SFM:	Specialist Fund Market
SHC:	Sindh High Court
SOE:	state-owned enterprises
SRO:	Statutory Rules and Orders
SSM:	standard shareholder-oriented model
TA:	technical assistance
TIP:	Transparency International Pakistan
UAE:	United Arab Emirates
UK:	United Kingdom
UKLA:	United Kingdom Listing Rules
US:	United States of America
USAID:	United States Agency for International Development
WAPDA:	Water and Power Development Authority
WB:	World Bank
WLR:	Weekly Law Reports
WP:	Working Paper

Glossary

the Code	the Code of Corporate Governance in Pakistan
the Constitution	the Constitution of the Islamic Republic of Pakistan, 1973
the Ordinance	the Companies Ordinance, 1984
the SECP Act	the Securities and Exchange Commission of Pakistan Act, 1997

CHAPTER ONE: INTRODUCTION TO THESIS

1.1 The concept of convergence

Although convergence in corporate governance started long ago,[1] it achieved momentum only in recent years after globalization. Efficiency, competition, cross-country investment, interdependent economies, interrelated economic interests, the enhanced role of international financial institutions and foreign investors are the main stimulants for convergence in corporate governance. In this process the least developed jurisdictions are converging to the most developed jurisdictions in corporate governance. By contrast, although different factors force convergence to the most efficient system of corporate governance, the presence of certain barriers such as path dependency; complementary institutions; differences in culture, values, ideology, politics and religion; and vested interests such as families and groups, result in the persistence of divergence.[2]

Berle and Means identified an ownership structure of widely dispersed share ownership in which the managers control the corporate powers with shareholders being largely powerless.[3] However, this widely dispersed shareholding which emerged in the United States of America (US) is the exception rather than the norm in the world. This widely dispersed ownership structure is mostly limited to the US and the United Kingdom (UK). In most of the jurisdictions there is concentrated ownership where families, states and groups dominate the corporate sector. Historically different corporate governance systems have developed around the world due to specific political, social, economic, cultural and religious norms. In the new global world the convergence in corporate governance is taking place more rapidly than before. The features of corporate governance are being transplanted from one jurisdiction to another in order to improve the governance mechanism. This results in the merging of different systems. The question whether this convergence process will ultimately lead to a single model where other models disappear is unresolved. Hansman and Kraakman argue that the US system of a standard shareholder-oriented model (SSM) is more likely to succeed over its rival systems–managerial-

[1] Mathias M. Siems, *Convergence in Shareholder Law*(Cambridge University Press, Cambridge 2008) 17.

[2] Lucian A. Bebchuk and Mark J. Roe, 'A Theory of Path Dependence in Corporate Governance and Ownership' (1999) 52 *Stanford Law Review* 168-170; John C. Coffee, Jr, 'The Future as History: The Prospects for Global Convergence in Corporate Governance and its Implications' (1999) *Northwestern University Law Review* 641-708.

[3] Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (MacMillan, New York 1932).

oriented, labour- or stakeholder-oriented, state-oriented, family or unconstrained control shareholder models due to its inherent adaptability to all types of ownership structures.[4]

Recently, despite the presence of different corporate structures, convergence in corporate governance is taking place around the world. Gilson classifies convergence into three basic forms which may take place in competitive globalization.[5] First, according to him, formal convergence occurs where the legal framework of a given country is changed according to some other legal framework. Second, functional convergence occurs where formal legal change is not possible but the system is flexible enough to respond to changed circumstances. In this process the system starts functioning differently without change in the legal framework. Third, contractual convergence takes place where firms adopt a regulatory framework of some other jurisdictions under the terms of a contract.

Formal convergence can be further divided into three forms, namely (1) *de jure*, (2) *de facto* and (3) formal convergence with functional diversity.[6] In *de jure* convergence the rules of two systems become the same. It is possible that in *de jure* convergence of rules the corporate governance features in the home jurisdiction may not function in the same way as they do in the host jurisdiction. However, when the convergence of rules follows the functioning of the corporate governance feature in the same way, then such convergence will be *de facto* convergence. By contrast, if both systems work differently, then this will be formal convergence with functional diversity.

Corporate governance has been compared to a product market where only efficient governance features survive.[7] More efficient features may replace less efficient features through convergence in order to improve the corporate governance mechanism of a given country. This process may continue indefinitely, and may remain incomplete and transitory in nature.[8] The process of convergence can be successful if resistance from barriers to

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[4] H. Hansmann and R. Kraakman, ‘Reflections on the End of History for Corporate Law’ in Abdul A. Rasheed and Toru Yoshikawa (eds), *The Convergence of Corporate Governance: Promise and Prospects* (Palgrave Macmillan, Basingstoke 2012).
[5] Ronald J. Gilson, ‘Globalising Corporate Governance: Convergence of Form or Function’ (2001) 49 (2) *The American Journal of Comparative Law* 356-7.
[6] Abdul A. Rasheed and Toru Yoshikawa, *The Convergence of Corporate Governance: Promise and Prospects* (Palgrave Macmillan, Basingstoke 2012) 3; Iain MacNeil, ‘Adaptation and Convergence in Corporate Governance: The Case of Chinese Listed Companies’(2002) 2 (2) *Journal of Corporate Law Studies* 340.
[7] Frank H. Easterbrook and Daniel R. Fisher, *The Economic Structure of Corporate Law* (Harvard University Press, Cambridge Massachusetts 1991) 4-8.
[8] Franklin A. Gevurtz, ‘The Globalisation of Corporate Law: The End of History or a Never-Ending Story? (2011) 86 *Washington Law Review* 475.

convergence in a given system is avoided. Therefore, it is important to adapt foreign corporate governance features according to local conditions to avoid such resistance.

1.2 Research objectives, issues and questions

This research seeks to identify weaknesses in corporate governance in Pakistan and different measures to improve it. It aims to carry out a three-fold exercise. First, it attempts to identify the prospects of the process of convergence in a new world scenario in general and in Pakistan in particular. Second, it examines the application of the theory of convergence in corporate governance in Pakistan. Third, it highlights the problems of corporate governance in Pakistan, and different ways, means and measures to improve it through the application of the theory of convergence under prevailing circumstances in the country. In pursuit of this third objective, it analyses four core issues of corporate governance in Pakistan, namely (1) agency cost, (2) investor protection, especially minority shareholders protection, (3) enforcement problems, and (4) the role of religion in convergence to international norms in corporate governance in Pakistan.

The main research question is to establish the extent to which convergence to international norms may help to improve corporate governance in Pakistan. In other words, the main objective of this research question is to see the possibility and effectiveness of convergence in corporate governance in Pakistan in order to improve it according to international norms. This question is subdivided into five further questions:

1. The extent to which convergence in corporate governance is taking place and its future prospects (Chapter Three)
2. The extent to which the agency cost in corporate governance in Pakistan may be reduced by the application of convergence theory (Chapter Four A)
3. The extent to which the minority rights may be improved in corporate governance in Pakistan by the application of convergence theory (Chapter Four B)
4. The extent to which the enforcement mechanism in corporate governance in Pakistan may be improved by the application of convergence theory (Chapter Five)
5. Whether Islamic influence has a convergent or divergent effect on international norms in corporate governance in Pakistan (Chapter Six).

1.3 Research methodology

The research is undertaken mostly with reference to both primary and secondary sources. In doing so, four different types of research methods are used: (1) explanatory, (2) descriptive, (3) prescriptive and (4) comparative. Explanatory, descriptive and prescriptive methods are applied when examining the international norms and corporate governance issues in Pakistan. In particular, a comparative approach is used widely in the thesis to highlight corporate governance issues in Pakistan.

Pakistan is a least developed country in the world and is classified as an emerging market. Some reforms have been undertaken during the past three decades that started the process of convergence in Pakistan. Some reforms were undertaken due to different factors, which include, but are not limited to, the efforts of international financial institutions, globalization, competition and efficiency. However, the presence of strong path dependency forces such as families, groups and the state put up barriers to such convergence despite the fact that these reforms may benefit all, including the aforementioned groups. These limited reforms could not improve corporate governance to an optimal level. The major problem was the scarcity of research on corporate governance in Pakistan which misled the role players about the potential benefits to themselves that improved corporate governance would bring about. Therefore, the purpose of this study is to shed light on the problems of corporate governance related to Pakistan and to suggest improvement.

In pursuit of this objective, the corporate governance features of different countries will be examined. Since Pakistan is a common law country, other common law countries that have similar political, cultural, social and religious norms will be compared. However, Pakistan is a former British colony that has adopted the legal, regulatory and judicial system it inherited from its British rulers soon after independence. The present corporate laws mimic the laws made by the then British rulers for their colonies. Therefore, the main focus of this comparative study will be on the UK system of corporate governance.

Moreover, Pakistan is an Islamic country whose constitution prescribes Islamic injunctions as basic norms. Islam guides its subjects in each and every field, including business matters. Therefore, every foreign corporate governance feature has to pass the Islamic test of acceptability before converging to a system of corporate governance in Pakistan.

Therefore, the present comparative study will be shadowed by Islamic norms. In this methodology the objective is not to check each and every foreign corporate governance feature in the light of Islamic norms. Instead, the discussion will be limited to an overall Islamic methodology with respect to the acceptability of foreign corporate governance features in terms of Islamic norms.

The primary sources upon which this research is based comprise mainly the provisions of statutes, regulations and codes that are especially relevant to corporate laws in Pakistan. Other primary sources consulted were case law and the annual reports of the Securities and Exchange Commission of Pakistan (SECP), the stock exchanges of Pakistan, Transparency International, the Federal Tax Ombudsman and the major listed companies in Pakistan, including those who have foreign listing on overseas stock exchanges.

Secondary sources researched include books, law journals and other publications in legal and related fields, online articles and the top-ranked newspapers in Pakistan.

1.4 Structure

This research is divided into seven chapters. Chapter One is the introduction to the thesis. Chapter Two defines and explains relevant terms and the context of the thesis, which forms the basis of subsequent issues to be raised in the thesis. Chapters Three to Six are core chapters, each of which starts with an issue which is further divided into several related sub-issues. Each issue begins with a critical analysis and concludes with recommendations on how to improve the issue in the light of the theory of convergence.

Chapter Three discusses the theory of convergence in corporate governance and its application in Pakistan. It discusses the forms and prospects of convergence in corporate governance in the country. It analyses a few issues in respect of corporate governance in Pakistan, while others that require comprehensive discussion are analysed in Chapters Four and Five. Chapter Three also examines analytically the internal and external factors that restrict or enhance the process of convergence in Pakistan.

Chapter Four deals with the specific application of the theory of convergence in Pakistan. The chapter is sub-divided into two parts. The first part discusses agency costs and the second part analyses critically investor protection, specifically minority shareholder protection in Pakistan. It also examines the possibility and effectiveness of convergence in corporate governance in Pakistan in order to improve it.

Chapter Five is a critical analysis of the problem of enforcement of corporate governance in Pakistan. The objective is to improve the enforcement mechanism in Pakistan in the light of the theory. In essence, it discusses three core aspects of corporate governance: (1) legal, (2) judicial and (3) stock market, which require reform in order to improve enforcement mechanisms in corporate governance in Pakistan.

Chapter Six examines the effect of religion on possible convergence in corporate governance to international norms in Pakistan. As Pakistan is an ideological country whose constitution prescribes Islam as the state religion, the import of any foreign corporate governance feature will have to pass the litmus test of Islamic norms. In essence, this chapter discusses the role of Islam in corporate governance convergence in Pakistan. It has two aspects. The first aspect is to determine the possibility of convergence within the Muslim world which, in turn, may affect Pakistan in its convergence in corporate governance to the Muslim world. The second aspect is to look at the role of Islam in convergence to a Western form of corporate governance in Pakistan.

Chapter Seven concludes with a summary of the important recommendations made in the thesis.

CHAPTER TWO: THE NATURE AND OBJECTIVES OF CORPORATE GOVERNANCE

2.1 Introduction

The aim of this chapter is to discuss the nature and objectives of corporate governance. It is a foundation chapter and focuses more on explaining terms and the context of the thesis. In particular, the objective of this chapter is to analyse and discuss the nature and objectives of corporate governance in Pakistan. In addition, the objective is to examine and analyse why the present corporate governance system in Pakistan has developed, and what the problems are that face good corporate governance in Pakistan. This process will help to develop corporate governance issues in Pakistan for discussion in the following chapters.

2.2 Corporate governance

The word *governance* is a generic term and *corporate governance* is a specific application of governance. In generic terms, it may be political, economic or organizational governance. Corporate governance is a subset of governance which deals specifically with governance in the organizational structure of corporations. The word *governance* signifies two things: (1) power and (2) accountability. Therefore, the concept *corporate governance* signifies: (1) who has decision-making power acting on behalf of the organization; and (2) when this power is exercised, how is it subject to accountability.

Corporate governance can be linked to the point in history when the first enterprise came into being to conduct commercial activities; in other words, it is as old as the creation of the first economic activity in the form of a partnership. The issue remained part of policy in the form of statutes in history, including company law, but drew the specific attention of policymakers in the recent past when there were serious financial crises even in well-governed jurisdictions.[1] Since that time, there has been a special focus on legislation and non-statutory codes.

Corporate governance can be defined either in a broad or a narrow sense. In its broader sense it includes broader categories of interest such as the interests of employees, creditors

[1] Ronald J. Gilson, 'Corporate Governance and Economic Efficiency: When Do Institutions Matter?' (1996) 74 *Washington University Law Quarterly* 327.

and the public, besides those of shareholders and directors. For example, *corporate governance* has been defined in the OECD Principles of Corporate Governance in its broader sense: in its preamble, it defines the concept as ‘corporate governance includes a set of relationships between company’s management, board, shareholders and other stakeholders’.

In the narrow sense, the focus is on the idea of shareholder value. In this sense, corporate governance is essentially applied to ensure that a company acts on behalf of its shareholders and increases the value of their investment. Therefore, in this sense the entire decision-making and accountability process has the end result of shareholder value, which is both profit maximization and an increase in share value. For example, R. La Porta, F. Lopez-ed-Silanes, A. Shleifer and R. W. Vishny (LLSV) have defined the term in its narrow sense. [2] According to them, corporate governance is ‘a set of mechanisms through which outside investors protect themselves against expropriation by the insiders.’ The corporate governance mechanism thus provides an assurance to investors that they can get a return on their money, either in the form of a dividend or interest with capital return.[3]

The present version of the UK Corporate Governance Code does not contain a definition of the concept *corporate governance*. However, the same concept was defined in the old version of the code known as the *Cadbury Code*, which was issued in 1992. The Cadbury Code defined the concept as follows:

> *Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders’ role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company’s strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board’s actions are subject to laws, regulations and the shareholders in general meeting.*[4]

The Code of Corporate Governance in Pakistan (hereinafter ‘the Code’) does not provide any definition of the term. However, the *Manual of Code of Corporate*

[2] LLSV, ‘Investor Protection and Corporate Governance’ (2000) 58 *Journal of Financial Economics* 4.
[3] A. Shleifer and R. W. Vishny, ‘A Survey of Corporate Governance’ (1997) 52 (2) *The Journal of Finance* 738.
[4] ‘Financial Aspects of Corporate Governance: The Cadbury Code’ 1992.

Governance in Pakistan[5] only refers to the definitions given by the Cadbury Report, OECD Principles, Kenneth Scott of the Stanford Law School and the International Chamber of Commerce. The objectives of the Code are vague. They include both a shareholder value governance system and a stakeholder governance mechanism. The code does not provide the clear objectives it intends to achieve.

2.3 Theory of the firm

Corporations under state control were first organized through a charter from the sovereign. This concession theory of the firm states that the creation of a firm was due to an official grant from the state.[6] This theory has become redundant,[7] mostly due to the right of the entrepreneur to create an incorporated body as opposed to a privilege granted by the sovereign and, consequently, the involvement of private capital, and also the self-regulatory nature of firms.

A firm has been described as a form of political democracy or private government;[8] in other words, firms are sometimes called *mini democracies*[9] in which shareholders are the voters and the managers are the elected representatives of the shareholders.[10] This political theory of the firm is also old-fashioned.[11] A firm is not primarily designed as, or compatible with, a democracy.[12] The hierarchical structure of firms requires discipline and obedience to economic policies from the top,[13] which is considered a barrier to democratic control.[14] The theory is also at odds with basic democratic principles in many respects. The presence of different voting rights in firms where shareholders have either enhanced voting rights, say for instance, four votes per share, or have shares without voting rights is undemocratic in its very nature.

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[5] The SECP issued the *Manual of Corporate Governance* to explain the code and its objectives.
[6] Mark M. Hager, 'Bodies Politic: The Progressive History of Organisational "Real Entity" Theory' (1989) 50 *University of Pittsburgh Law Review* 579.
[7] Jennifer Hill, 'Visions and Revisions of the Shareholder' (2000) 48 *American Journal of Comparative Law* 20.
[8] Earl Latham, 'The Body Politic of the Corporation' in Edward S. Mason (ed), *The Corporation in Modern Society* (Harvard University Press, New York 1960) 218.
[9] Justice Michael Kirby, '"Legal Departures": New Directions' (1994) 10 (1) *Company Director: The Journal of the Australian Institute of Company Directors* 20.
[10] R. M. Buxbaum, 'The Internal Division of Powers in Corporate Governance' (1985) 73 *California Law Review* 1671.
[11] Hill (n 7) 20.
[12] Charlotte Villiers, *European Company Law: Towards Democracy?* (Ashgate Publishing Limited, Aldershot 1998) 194.
[13] W. Ebenstein, *Today's Isms* (3rd edn, Prentice Hall, 1961) 162.
[14] Ralf Dahrendorf, *Class and Class Conflict in Industrial Society* (Routledge & Kegan Paul, London 1959) 138.

A firm was not regarded as a separate entity from its owners until the case of *Salomon v Salomon* was decided. [15] In this case the House of Lords held that 'the company was duly formed and registered and was not the mere "alias" or agent of or trustee for the vendor'. Lord Halsbury L.C. said that 'once the company is legally incorporated it must be treated like any other independent person with its rights and liabilities appropriate to itself'. Before this case, it was not clear what the difference was between a company and a partnership as far as legal personality was concerned. After the *Salomon* case the company was considered a separate legal entity independent from its shareholders. This real entity theory prescribes that a firm exists independently from its members;[16] shareholders do not own the firm by merely holding shares.[17] This theory further states that the firm is not a collection of persons, but rather a collection of capital. The corporate vote that is associated with one share, one vote does not represent a person, but rather a share and persons are irrelevant.[18] The real entity theory, however, legitimize big business, centralized management and the passivity of shareholders in corporate governance.[19]

The aggregate theory, in contrast, prescribes shareholders as owners. Beach J. in *Re Humes Ltd* held that 'the books and property of the corporation really belong to shareholders and the reality cannot be overthrown by the fiction of law that a corporation is an artificial person or entity separate from its members'.[20] This theory is close to the classical view of the firm in which a firm was regarded as being close to a partnership, and there was no separation of ownership and control.

According to contract theory, a firm is simply one form of legal fiction which serves as a nexus of implicit and explicit contracts between different actors, including shareholders, directors and other stakeholders.[21] Bainbridge has different views on the contractual nature of the firm and says that the firm is not a nexus of contracts in itself, but rather a nexus of contracts in which the nexus is provided by the board of directors.[22]

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[15] *Salomon v Salomon* [1897] ACHL 23, 30.
[16] Hager (n 6) 580.
[17] *Re Humes Ltd* (1987) 5 ACLC 67.
[18] Hager (n 6) 652.
[19] Morton J. Horwitz, 'Santa Clara Revisited: The Development of Corporate Theory' (1985) 88 *West Virginia Law Review* 223.
[20] *Re Humes* (n 17).
[21] Michael C. Jensen and William H. Meckling, 'Theory of the Firm: Management Behaviour, Agency Costs and Ownership Structure' (1976) 3 (4) *Journal of Financial Economics* 8-9.
[22] Stephen M. Bainbridge, *The New Corporate Governance in Theory and Practice* (Oxford University Press, New York 2008) 24.

The real entity theory and contract theory of the firm negate the aggregate theory. The real entity theory postulates that the firm is a legal entity separate from its members and that mere shareholding does not make them the owners of the property of the firm. In contrast, the contract theory describes a firm as nothing but a nexus of contracts between different stakeholders. Its focus is on all stakeholders, who are connected through a web of contracts, instead of shareholders alone who are considered owners under the aggregate theory.

The contract theory also rejects the legal concept of the firm. According to this theory, a firm is not primarily a separate legal entity, but rather a nexus of contracts between different stakeholders which focuses on their interests by virtue of contracts between them.

As far as the contract theory of the firm is concerned, the constitution of a firm prescribes a standard contract in which the rights and liabilities of the parties are determined. However, contracts never dominate the firm as far as its legal personality is concerned. A contract cannot hold property nor can it sue or be sued, which are the main characteristics of the legal concept of a firm. The contract theory may well change the whole scenario of corporate governance but it has to encompass the range of conflicting firm components in order to be accepted by all its critics.[23]

2.4 Theories of corporate governance

Academics have presented several theories regarding corporate governance. In each theory the power and prevalence of the interests of relevant groups are given priority over others.

The stakeholder primacy theory recognizes the interest of all stakeholders, including shareholders, managers, directors, creditors and employees. This theory states that the interest of the entire stakeholder body should prevail and they should have some role in matters of governance. Proponents of this theory state that the firm is an economic institution that has both social service and profit-making functions. According to them, the function of a firm is not confined to profit maximization for the shareholder, but extends to securing jobs for employees and better-quality products for consumers, and to performing

[23] William W. Bratton, Jr, 'The New Economic Theory of the Firm: Critical Perspective from History' (1988-89) 41 *Stanford Law Review* 1527.

its corporate social responsibility.[24] There is currently an academic debate on whether the function of the firm is to increase shareholder wealth or on whether the managers are bound to serve in the interest of all stakeholders and society as a whole. The former is called *property theory*, while the latter is termed *entity theory*.[25] In property theory there is a dispute about the wealth maximization of the shareholders. The Michigan Supreme Court in *Dodge v Ford Motor Company* held that the directors were supposed to work for the benefit of the company's shareholders. [26] They are bound to maximize the wealth of shareholders instead of the employees or society. However, there is a conflict as to whether profit maximization is the basic objective of the firm and whether the directors have any legal duty imposed on them to maximize the profit of the shareholders.[27] At least in the UK there is no legal duty on the directors to maximize the wealth of the shareholders. In recent times the entity theory is also gaining some academic attention.[28] However, debate over the social role of the firm is unresolved.[29] Nevertheless, companies in the modern era spend some money on their social responsibilities.

According to the shareholder primacy theory, shareholders are real owners and residual risk bearers. They are residual risk bearers in the sense that their investment is locked in and they cannot take their money back from the company, except that they can sell their shares in the market. Furthermore, they are paid last, and sometimes even paid nothing, when the company becomes insolvent. Therefore, this theory suggests that the managers should focus the interests of the shareholders.[30]

Keay argues that both shareholder primacy and stakeholder primacy have major shortcomings. [31] According to him, shareholder primacy is not applicable in commercial terms due to the control and powers of the management over the firm. He argues that stakeholder primacy is defective in the sense that it is difficult to define who the stakeholders in the company are and how the management is to balance the interests of the

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[24] E. Merrick Dodd, 'For Whom are Corporate Managers Trustees?' (1932) *Harvard Law Review* 1148.
[25] William T. Allen, 'Our Schizophrenic Conception of the Business Corporation' (1992) *Cardozo Law Review* 264-6.
[26] *Dodge v Ford Motor Co.*, 170 N.W. 668 (Mich. 1919).
[27] S. Worthington, 'Shares and Shareholders: Property, Power and Entitlement (Part 2)' (2001) 22 (2) *Company Lawyer* 307.
[28] Lynn A. Stout, 'Bad and Not-So-Bad Arguments for Shareholder Primacy' (2002) 75 *Southern California Law Review* 1209.
[29] Leo E. Strine, Jr, 'The Social Responsibility of Board of Directors and Stockholders in Change of Control Transactions: Is there Any "There" There?' (2002) 75 *Southern California Law Review* 1170-3.
[30] Alan Dignam and Michael Galanis, *The Globalization of Corporate Governance* (Ashgate Publishing Limited, Farnham 2010) 48.
[31] Andrew Keay, *The Corporate Objective: Corporations, Globalisation and the Law* (Edward Elgar Publishing Limited, Cheltenham 2011) 171-3, 230.

wide constituency of stakeholders. He further argues that resolving shareholder opportunism may lead to the more serious problem of stakeholder opportunism. He has presented an alternative theory, namely, the entity maximization and sustainability (EMS) theory. According to him, managers must focus on the success of the company as a whole and the wealth maximization of the company as an entity. He further argues that all the people and groups who have invested in the company should benefit from the company.

The problem with the EMS theory is that it focuses on the same wide constituency of the stakeholder model. Keay differentiates between the EMS theory and the stakeholder theory. He explains that the managers in EMS will prefer the interest of the entity at the cost of any of the stakeholders instead of creating a balance between the interests of different stakeholders.[32] Nevertheless, the problem will still remain for the managers as they have to decide whose interest is to prevail when there is a conflict of interest between different stakeholders, even in those cases where the managers are supposed to act with the sole objective of ensuring the success of the company.

The fact that the shareholder may suffer more in the case where the company fails and may also benefit more if the company succeeds, implies that they can be the best monitors of the company. Therefore, their interest, as far as monitoring of the company is concerned, should prevail over other stakeholder. Though some scholars are doubtful that there is any legal duty on the directors to maximize the wealth of shareholders,[33] nonetheless, one of the objectives of the company is to maximize the wealth of the shareholders. Investment in the company, in most cases, is primarily meant to enhance it. Therefore, it can be said that, at least, there is moral duty on the directors and management to maximize the wealth of shareholders. As the moral duty cannot be enforced, therefore, the essence of shareholder primacy theory may be, at least, to give more powers of accountability to the shareholders.

Proponents of the director primacy theory believe that the directors have sovereignty over the company and that the company is controlled by the directors who have the ultimate right of fiat. Shareholders have powers of accountability in the form of votes attached to the shares. The directors pursue shareholders' interest by maximizing their wealth. Bainbridge is the main advocate of the director primacy theory. [34] He claims, though, that this does not explain everything about corporate governance but that it is more relevant

[32] Keay (n 31) 229.
[33] Worthington (n 27) 307.
[34] Bainbridge (n 22) 10-16.

than any other prevailing theory. However, the problem with this theory is that giving more powers to directors may lead to self-dealing at the cost of the company and its shareholders. Shareholders have powers of accountability in the form of votes but it is not feasible and cost-effective to call all the shareholders, at least of public listed companies, for every decision, which provides directors with opportunities to act in their own interests instead of that of the company.

According to the team production theory, presented by Blair and Stout, the directors of public corporations act to maximize the joint welfare of all stakeholders of the firm, including shareholders, managers, employees, creditors and the local community.[35]According to them, the function of the firm is not limited to resolving the agency problem between shareholders and the managers. The authors also presented a model to resolve the conflict of interest between different stakeholders. According to this model, all the stakeholders will relinquish their rights over the assets. Control over the assets will be exercised by a mediating hierarchy in which the board of directors will sit at the top. This hierarchy will have absolute authority over the use of assets and with the protection of law over interference by team members. The mediating hierarchy will work for the benefits of the team as a whole instead of only the shareholders as owners. The function of this mediating hierarchy will be to coordinate the activities of the team members, distribute the benefits accrued from the production and to mediate internal disputes over the allocation of such benefits. This theory is equivalent to stakeholder theory, as both have the common objective of safeguarding the interests of all stakeholders. In addition to this, this theory also proposes more powers to the directors which may allow them to proceed with self-dealing at the cost of other team members.

The shareholder primacy theory can be justified vis-à-vis other theories. As far as the stakeholders such as creditors and employees are concerned, their interest is protected through various contracts with the firm, whereas shareholders are exposed to the incomplete contractual nature of corporate law. Furthermore, the interest of creditors and employees is protected through various bankruptcy and employment laws, and mutual contract between the firm and other stakeholders. Creditors do invest capital but their capital is not locked in as is the shareholders' capital investment. The creditors can take back their capital under different circumstances. They are also given priority over the

[35] Margaret M. Blair and Lynn A. Stout, 'A Team Production Theory of Corporate Law' (1999) 85 (2) *Virginia Law Review* 251.

shareholders at the time of liquidation. Employees, however, invest human capital in the company but their matters are dealt with under other regulations which do not fall within the ambit of company law. Employees are also supposed to act under the control of the management to maximize profit for the shareholders. This creates a conflict of interest between the employees and the shareholders. This hierarchical relationship between the employees and management regards employees as having their place outside the company.[36] Shareholders are residual claimants and therefore they may suffer more in the case of failure of the company as they are paid last after fulfilling all the liabilities of the company. As the success and failure of the company affect shareholders more than any other stakeholder, shareholders may therefore be given an enhanced role in the governance in the form of accountability of the management. Keay admits that although there are some deficiencies in the shareholder primacy theory, it is more workable than the stakeholder primacy theory.[37]

Moreover, the director primacy theory may not solve the problems in concentrated structures such as Pakistan where the conflict is not between shareholders and the directors, but rather between shareholders *inter se*: majority and minority shareholders. Since the controlling shareholders also control the directors, there is therefore a need to solve the problems between shareholders. In fact, there is a need to strike an appropriate balance of the distribution of power and accountability between shareholders and the directors, and shareholders *inter se*. This may lead to good governance and objectives that corporate governance may intend to achieve.

2.5 Objectives of corporate governance

2.5.1 Accountability

Accountability is linked to power. In the modern form of companies, especially companies in the public domain, it is not feasible to give powers to shareholders to decide in each and every matter of the company. Therefore, the powers are delegated to a group of people selected by the shareholders. When the power is given to the board of directors, then they must be made accountable. Since shareholders are real owners, the board must therefore be accountable to the shareholders. The removal of a non-performing director is one

[36] Villiers (n 12) 193; Alan Gewirth, *The Community of Rights* (University of Chicago Press, Chicago 1996) 266.
[37] Keay (n 31) 173.

mechanism of accountability; for example, in the UK the directors control all the powers of a company yet, at the same time, there is an easy process for their removal. A director can be removed at any time by a simple resolution of shareholders. Accountability is not only linked to directors, but also to controlling shareholders. Controlling shareholders may also expropriate company funds by virtue of their position; for instance, they may enter into a contract with the company that is not at arm's length, in other words, they may approve a contract that is not according to market value and that favours them at the cost of the company and, consequently, the minority shareholders. Therefore, the whole concept of accountability in corporate governance is directly linked with the powers of shareholders to hold directors and controlling shareholders accountable.

Fiduciary duties, court overview through petition of aggrieved shareholder and shareholder actions are other forms of accountability that are present in the form of the formal legal framework.[38] Furthermore, accountability can exist outside the legal framework; for instance, codes make provision for accountability that is not implemented in a formal legal way. The code requires disclosure which helps shareholders to take actions and also facilitates dissident shareholders, if they are not satisfied with management, to exit through the sale of their shares in the market. The takeover is a form of accountability in the sense that the successful bidder may remove non-performing directors.

2.5.2 Financial performance

Whether good governance will improve financial performance is an unresolved and a difficult question. There are different indicators for performance of firms and stock exchanges. Stock price, return on capital (ROC)[39] and return on asset (ROA)[40] may be evidences for firm performance, whereas stock market indices may be evidences for stock market performance.

No doubt, financial performance is evidence of the success of companies and good corporate governance has always been linked to better financial performance. However, empirically, it is difficult to show what the connection or what the causality is. Many

[38] These accountability mechanisms will be discussed in Chapter Four, section B.

[39] In simple terms, ROC means the return that a shareholder may get, either in the form of a dividend or share increase after a certain period and provides a percentage of shareholders' capital.

[40] In simple terms, ROA, or return on investment (ROI), shows how much the assets of a company are profitable, in other words, how efficient the management is in generating profit from the assets of the company.

studies have been conducted into the effect of a particular component of corporate governance on financial performance in which some components have been shown as positively related to financial performance and some negatively related. Furthermore, specific measures of governance may show some correlation with financial performance, but the relationship of the overall governance mechanism with financial performance is unresolved.[41] It is also difficult to establish to what extent an individual, specific governance feature has affected overall financial performance. Besides these governance mechanisms, there are other factors that may affect financial performance. There are endogenous and exogenous forces that affect the firm's performance; for instance, the share price of a firm may be affected by other factors such as overall political, economic or security issues. A series of domestic and global incidents may affect share prices in the market, and may also affect the market index. These external factors that affect performance are exogenous factors. In the realm of endogenous forces is the overall corporate governance structure of the company, for example, the way in which the board of directors is structured; the distribution of powers between shareholders and the directors; an effective market mechanism for disciplining non-performing companies; statutory governance mechanisms; and enforcement mechanisms. Therefore, determining and establishing the relationship between particular corporate governance features and financial performance is problematic as it is not easy to separate the effect of both exogenous and endogenous forces; in other words, it is difficult to establish a causal link between financial performance and overall governance components.[42]

MacNeil and Li argue that investors are more concerned with performance than compliance with good governance practices. If companies are performing, then investors may ignore compliance with specific governance features.[43] However, caution is required in adopting such an approach to underdeveloped markets such as Pakistan. No doubt, financial performance is important to investors but if performing companies follow good governance practices, it may act as a disciplining mechanism for other companies. This may create a culture of compliance to good governance practices which in turn may boost investment. In addition, as discussed earlier, since a direct linkage between specific

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[41] Eddy Wymeersch, 'The Corporate Governance "Codes of Conduct" Between State and Private Law' (2007) Working Paper Series, WP 2007-07, 21. <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1032596> Accessed 20.12.2013.

[42] Sanjai Bhagat and Brian Bolton, 'Corporate Governance and Firm Performance' (2008) 14 *Journal of Corporate Governance* 272.

[43] Iain MacNeil and Xiao Li, '"Comply or Explain": Market Discipline and Non-compliance with the Combined Code' (2006) 14 (5) *Corporate Governance*: *An International Review* 494.

governance features and financial performance cannot be demonstrated, compliance with overall good governance practices in underdeveloped markets such as Pakistan is therefore important as this may enhance investors' confidence. This, in turn, provides investment and incentives for poorly performing firms and stock markets to perform.

2.6 Structures of corporate governances

2.6.1 Dispersed ownership or market-based governance structure

In this structure shareholders are dispersed. Therefore, any action on the part of shareholders is problematic in the sense that it is not feasible to call, gather, discuss and to convince all the shareholders at the same time. It is also costly and sometimes impractical to do so. Therefore, problems with collective action and the apathetic attitude of shareholders is a basic feature of this kind of structure.[44] The majority of shareholders who have small equity ownership are not interested in corporate actions as they feel that the cost incurred by such action may exceed potential benefits. This allows managers to manipulate corporate decision-making. They control the agenda of meetings and the proxy mechanism, which further weakens shareholders control.[45] These problems led the market to play its role in corporate governance. The development of dispersed ownership is not a universal phenomenon,[46] and is mainly limited to the US and the UK. In the rest of the world there is a dominance of concentrated ownership structures with families, the state and groups holding and controlling the corporate sector. These groups, families and states are considered the best monitors of management due to their control over the firms. However, this does not mean that the dispersed ownership structure is an inferior monitor of the performance of mangers.[47] Over time, different mechanisms have developed in such governance systems in which the managers are monitored and held accountable. The role of the market is very important in this regard. A developed and active market can punish non-performing firms and their managers. Takeovers, institutional investors, minority rights, enforcement mechanisms and strong regulators are powerful features of the market

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[44] L. C. B. Gower, *Gower's Principles of Modern Company Law* (4th edn, Stevens, London 1979) 553-4.
[45] John Cubbin and Dennis Leech, 'The Effect of Shareholding Dispersion on the Degree of Control in British Companies: Theory and Measurement' (1983) 93 *The Economic Journal* 355.
[46] R. La Porta, F. Lopez-ed-Silanes and A. Shleifer, 'Corporate Ownership Around the World' (1999) LIV (2) *Journal of Finance* 474.
[47] H. Demsetz and K. Lehn, 'The Structure of Corporate Ownership: Causes and Consequences' (1985) *The Journal of Political Economy* 1155.

to protect investors, and to monitor and hold managers accountable. Therefore, a dispersed ownership structure is also known as a *market-based governance mechanism*.

There are different views on the development of such a system, particularly in the UK and the US. Roe argues that it was not economic efficiency but rather political forces and historical developments that led to dispersed ownership in the US.[48] This is not, however, the main explanation of dispersed ownership elsewhere, at least not in respect of the evolution of the UK system of dispersed ownership.[49] The strong legal protection of investors provides greater security of property rights against political interference and, empirically, such protection is associated with effective corporate governance which is reflected in dispersed ownership and a developed market.[50] Cheffins argues that the law was not the main factor in the evolution of the dispersed ownership structure in the UK.[51] According to him, alternative institutional structures also played their role. He further argues that the financial and social environments; the tradition of self-regulation; and the independent, professional and impartial judiciary were the main factors that contributed to this structure in the UK.[52] In the absence of this institutional structure in the UK, the legal environment can be the driving force for effective corporate governance where investors can invest with confidence even with small investments. Legal protection against expropriation by insiders gives investors confidence and they spread their finance without any reluctance, which leads to dispersed ownership structures. This phenomenon also stimulates the development of the capital market.[53] If investors are not provided with strong legal protection, they will be reluctant to be minority shareholders and will prefer to be block holders as protection against expropriation.[54] Different writers have described different reasons for the evolution of dispersed ownership. However, legal protection is still a dominant force in such a development.

Market discipline plays an important role in jurisdictions with dispersed shareholdings. The way the UK Code of Corporate Governance is implemented in the UK shows the role

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[48] Mark J. Roe, 'A Political Theory of American Corporate Finance' (1991) 91 *Columbia Law Review* 10.
[49] Iain MacNeil, 'Adaptation and Convergence in Corporate Governance: The Case of Chinese Listed Companies' (2002) 2(2) *Journal of Corporate Law Studies* 293.
[50] LLSV (n 2) 24.
[51] Brian R. Cheffins, 'Law, Economics and the UK's system of Corporate Governance: Lessons from History' (2001) *Journal of Corporate Law Studies* 89.
[52] Brian R. Cheffins, 'Does Law Matter?: The Separation of Ownership and Control in the United Kingdom' (2000) ESRC Centre for Business Research, University of Cambridge, Working Paper No. 172, 37- 40 <www.cbr.cam.ac.uk/pdf/WP172.pdf > Accessed 20.12.2013.
[53] LLSV, 'Legal Determinants of External Finance' (1997) LII (3) *The Journal of Finance* 1149.
[54] John C. Coffee, Jr, 'The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications' (1999) 93 *North-Western University Law Review* 644.

of market discipline. This code is annexed to the listing rules but does not form part of it. The code is part of soft law and not part of the legal framework. The code is introduced on a self-regulatory basis, and is based on the ‘comply or explain’ principle. This is applicable to companies that have a premier listing on the London Stock Exchange (LSE).[55] The listing rules of the LSE require conformance with the code. Companies are required to comply with the code or explain themselves in the case of non-compliance. United Kingdom Listing Authority (UKLA) listing rules, however, require that certain information associated with the code be disclosed, and non-compliance may be sanctioned in the form of public censure, fine or suspension in terms of the UKLA Listing Rules regulated by the Financial Services and Markets Act, 2000. As the ‘comply or explain’ principle is designed on a self-regulatory basis, there is therefore an assumption that the market will monitor the compliance with the code or accept non-compliance, provided the reasons for non-compliance forwarded by the companies are reasonably justified. The market may discipline companies for non-compliance in the form of a reduction in the share price of the company which may consequently increase the cost of capital.[56]

2.6.2 Concentrated ownership or block-holder governance structure

In concentrated governance systems, shareholders control firms through different techniques. Firstly, they may control a firm through 51% or more shareholding. Secondly, they may hold shares with enhanced voting rights whereby they control the firm by holding fewer shares but more voting powers. Thirdly, they may control the firm through a pyramid structure[57] whereby they hold the most shares in the holding company and fewer shares in subsidiary companies, and exercise their control through the holding company. Fourthly, they may control the firm through cross-shareholdings whereby they control different groups of companies with different family members through shareholding in different companies or they control a company through controlling another company who has shareholding in the first company. In simple terms, cross-shareholding is a subset of the pyramiding structure. Concentrated shareholding is a worldwide phenomenon, including in continental Europe and Asia. Financial intermediaries such as banks and other financial institutions may play an important role in such a system. When investors feel that they are not secured through direct investment, they invest through financial intermediaries such as banks. Banks play an important role as a trustee.

[55] See LR 9.8.6R (5 and 6) of the Financial Conduct Authority.
[56] MacNeil and Li (n 43) 486-96.
[57] See Annexure I.

There are many reasons for the development of such systems. One of the reasons is that if legal and governance systems do not provide investors as minority shareholders with protection, these shareholders control firms in the form of concentration of ownership.[58] Expropriation and private rent-seeking by controlling shareholders and managers is more common in such a system. However, there are advantages to such a system. From the investors' perspective, shareholders can have better direct monitoring of management. From the management's perspective, the managers of such firms focus on the long-term benefits of the investment as against the market-centred system where managers focus on the short term to avoid market sanctions.[59]

2.6.3 The governance structure of state-owned enterprises

This is, in fact, a subset of concentrated ownership but it is different in the sense that the state is the controlling shareholder as well as the regulator. The system is less likely to be efficient as it is hardly possible for a regulator to regulate and punish itself. In socialist economies and some underdeveloped countries, including Pakistan, substantial parts of the economy are run through state-owned enterprises (SOEs). Politicians retain control of firms, either directly through state ownership or indirectly through regulations. They are sufficiently powerful to resist any reform and preserve the *status quo*, which may be less efficient[60] but beneficial for them.

This phenomenon has been changing over the past 30 years or so for many reasons. The failure of socialism, the financial crisis in Asia and the recession almost all over the world triggered the attention of host countries and international bodies to improve governance structures of poorly performing countries. International financial institutions provided a series of loans to developing countries with a reform agenda as a condition of a loan. The reform agenda includes the corporatization of SOEs.[61] These reforms reduced state control over these enterprises which used to be run bureaucratically. In Pakistan, though the state had transferred some of its shareholding to the general public, it still has significant control over the newly corporatized enterprises.

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[58] La Porta, Lopez-ed-Silanes and Shleifer (n 46) 511.
[59] Coffee, Jr (n 54) 648-9.
[60] Curtis J. Milhaupt, 'Property Rights in Firms' (1998) 84 (6) *Virginia Law Review* 1145.
[61] Barry Metzger, 'International Financial Institutions, Corporate Governance and the Asian Financial Crisis' (2003) Draft Chapter for the Ecology of Corporate Governance: The East Asian Experience <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=382840> Accessed 20.12.2013.

2.6.4 The governance structure of family-based enterprises

This is another subset of concentrated ownership. In this structure, families hold and control a major part of the economy and therefore tailor the governance structures that benefit them. Chaebol in Korea and Keiretsu in Japan are examples of this form of governance structures. [62] Chaebol is a Korean enterprise group controlled by a single family, who control firms through different forms of pyramiding, interlocking shareholding and substantial amounts of share ownership. This structuring of firms has a negative effect on corporate governance. These families perform the dual role of management and monitoring, which causes poor internal governance. These path dependency[63] forces resist reforms[64] that could check and monitor their powers.[65] This phenomenon is also common in developing countries, including Pakistan, where families hold, and even control, listed firms.

These families are normally involved in politics or have direct connections with politicians. They use their relations to preserve the *status quo* as poor governance benefits them. In such a system some shareholders have control that is disproportionate to their ownership. They control the management and thereby control the whole firm. The directors normally belong to the family or close associates and remain on the board at their pleasure.

2.6.5 Which system is better?

There is no ideal system, as all systems have merits and demerits. Concentrated ownership is considered more vigilant than dispersed ownership as controlling shareholders have enough equity to monitor, control and to hold managers accountable.[66] However, they may receive private benefits of control at the cost of the minority shareholders. They may act in a dual character and this provides them with opportunities to expropriate the funds of the firm as they are the looters as well as the monitors. In the state-owned governance

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[62] Ungki Lim, 'Ownership Structure and Family Control in Korean Conglomerates' (2001) *International Finance Review* 379.
[63] Forces that preserve the *status quo* are called *path-dependent*. 'In common interpretations, path dependence mean that current and future states, actions or decisions depend on the path of previous states, actions or decisions.' See Scot E. Page, 'Path Dependency' (2006) *Quarterly Journal of Political Science* 88.
[64] Hideaki Miyajima, 'The Performance Effects and Determinants of Corporate Governance Reform in Japan' (2005) in Masahiko Aoki, Gregory Jackson and Hideaki Miyajima (eds), *Corporate Governance in Japan: Institutional Change and Organisational Diversity*, <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=818347> Accessed 20.12.2013.
[65] E. Lee and K. S. Park, 'Determinants of the Corporate Governance of Korean Firms' (2008) *Corporate Ownership and Control Journal* <wizard.korea.ac.kr/user/aicg/data/kyungsuh4.pdf> Accessed 20.12.2013.
[66] Coffee, Jr (n 54) 648.

mechanism, the state acts both as a regulator and regulatee. It is less likely that the state will punish itself. Similarly, families are controlling shareholders in family-owned structures. In most cases these families and politicians have common interests as families are directly involved in politics or finance political parties to act for their benefit. In this situation it is less likely that they will favour reform agendas whose objective is to introduce good corporate governance. There are some advantages to the concentrated system. Firstly, the controlling shareholders are good monitors of managers as they can remove non-performing managers. Secondly, as the families finance firms mostly from their own resources and have substantial equity, they may therefore focus on return on Asset (ROA) and return on capital (ROC). This may, in turn, benefit the minority shareholder as well.

However, the managers in a dispersed shareholding system have more opportunities to expropriate the funds of the firms as small dispersed shareholders do not have incentives to monitor the activities of the managers. The benefit may not be commensurate with the cost that may be incurred for such monitoring. However, dispersed shareholding is the result of a developed market. This developed and active market can monitor the managers, and can punish them through market forces.[67]

2.6.6 Religion

Normally, religion has nothing to do with corporate governance issues but if a country is ideological, then religion may have an effect on its corporate governance. Roe believes that the development of corporate governance systems of a particular country depends upon its political and ideological conditions.[68] The culture and ideology of a country also determine the choice of corporate law and governance mechanisms.[69] Islam is regarded as a practical religion which determines and guides its subjects in each and every field of life. Islam is not restricted to a few rituals, but it extends to the whole life of Muslims. It has also established broad principles for conducting business and business ethics.

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[67] Demsetz and Lehn (n 47) 1155.
[68] Mark J. Roe, ‘Political Preconditions to Separating Ownership from Corporate Control’ (2000) 53 (3) *Stanford Law Review* 603.
[69] Lucian A. Bebchuk and Mark J. Roe, ‘A Theory of Path Dependence in Corporate Ownership and Governance’ (1999) 52 *Stanford Law Review* 168 and Amir N. Licht, Chanan Goldschmidt and Shalom H. Schwartz, ‘Culture, Law and Corporate Governance’ (2005) 25 *International Review of Law and Economics* 253.

The constitution of Pakistan is Islamic. Religion is dominant in the social, cultural, business and politics affairs of the country. The Constitution of Pakistan recognizes Islam as the state religion.[70] Furthermore, the constitution provides two safeguards for protecting the Islamic spirit of the country. Firstly, it provides that all existing laws shall be brought in conformity with the injunctions of Islam as laid down in the *Qur'ān* and *Sunnah*. Similarly, it provides that no law shall be enacted that is repugnant to such injunctions.[71] To check conformity of laws with the injunctions of Islam, it established different institutions[72] that ensure compliance with these provisions of the constitution. Under the directions of these institutions, the government is required to take the necessary steps to bring the law into conformity with the injunctions of Islam.

Pakistan, being an Islamic state, may drive its corporate governance mechanism from Islamic norms. However, historically, this remained only a weak force. Pakistan inherited its corporate laws from British rule due to colonial influence but historical circumstances developed the corporate sector, which differs from that of Britain. Nevertheless, owing to recent developments around the world in general and Pakistan in particular Islamic norms may still play a role in the corporate sector of Pakistan.[73]

2.7 Historical development of the corporate sector in Pakistan

The company law of Pakistan[74] is based on colonial company law introduced by the British rulers before independence. The Indian Companies Act, 1913 was promulgated by the British rulers for British India (i.e., the subcontinent, including Pakistan, India and Bangladesh). The Indian Companies Act, 1913 (as amended in 1936) was adopted as company law in Pakistan after independence in 1947 with necessary minor amendments.[75] The Companies Ordinance, 1984 (the Ordinance) which mimicked to the Companies Act, 1913 was promulgated on 8 October 1984.[76] The companies who continued to work with

[70] See article 2 of the Constitution of the Islamic Republic of Pakistan 1973 (the Constitution 1973).
[71] See article 227 (1) of the Constitution 1973.
[72] The role of these institutions will be discussed in Chapter Six at 6.2.
[73] This will be discussed in detail in Chapter Six.
[74] The Companies Ordinance 1984 (the Ordinance 1984).
[75] Nazir Ahmed Shaheen, *Practical Approach to the Companies Ordinance, 1984* (4th edn, Federal Law House, Rawalpindi 2011) 2.
[76] Imtiaz Ahmed Khan, 'The Single Member Companies' (LLM Thesis, International Islamic University, Islamabad, Pakistan, 2006).

their headquarters in Pakistan after 15 August 1947 were to be treated as companies registered under the Ordinance.[77]

Ali Cheema *et al*. have discussed the historical development of the corporate sector in Pakistan.[78] The private sector was the main agent for industrialization in Pakistan after independence. Specific families were the main beneficiaries of the state's financing policies with generous fiscal incentives, cheap imports of capital goods and subsidized credit, which resulted in 44 monopoly houses that controlled 48% of the gross fixed assets of the large-scale manufacturing sector in 1970.[79] There was no separation of ownership and control in these monopoly houses. The democratic government of 1972–73 had a manifesto of nationalization and reduction of industrial concentration in the private sector. After coming to power, it nationalized many industrial units, which resulted in 11 out of the top 26 monopoly houses losing more than 50% of their assets[80] and in the public sector large-scale manufacturing investment increased from 13% in 1972–73 to 78% by 1976–77. The government also nationalized the banking sector, which created political control over the entire financial sector. However, in the 1980s and 1990s the role of the private sector was revived by several governments who took power from one another. Families and the state still control the corporate sector in Pakistan. This historical background reveals the reasons for the concentration of ownership and underdevelopment of capital markets in Pakistan.[81]

The Ordinance mimicked the Companies Act, 1913. The provisions relating to minority rights were retained in the Ordinance because they were in the Companies Act, 1913. The minority protection provisions could not create dispersed ownership, which might have developed the capital markets in Pakistan.[82] Specific social, cultural, political and economic conditions led to the concentration of ownership and underdeveloped capital

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[77] S. Mahmood and N. Shaukat, *The Company Law* (Vol-1, Legal Research Centre, Pakistan) 7.

[78] Ali Cheema *et al.*, 'Corporate Governance in Pakistan: Ownership, Structure and Control' (2003) LUMS Paper Series 11-13.

[79] Rashid Amjad, *Private Industrial Investment in Pakistan, 1960-1970* (Cambridge University Press, Cambridge 1982).

[80] Another reason was the independence of Bangladesh from Pakistan. Monopoly houses lost their assets which were located in Bangladesh. Monopoly houses were characterised by family ownership under centralised decisions-making authority, usually the patriarch of the family and consisting of several legally separate companies engaged in highly diversified activities. For this, see Amjad (n 79).

[81] A. Cheema, F. Bari and O. 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, 2003).

[82] How and why minority protection causes dispersed shareholding which, in turn, develops the capital market will be discussed in Chapter Four, at 4B.2 (LLSV Theroy).

markets. Corruption, weak enforcement and bad rule of law were the main hindrance in the development of institutions.

Privatization and corporatization have been the main agenda of the Government of Pakistan since the 1990s. Globalization, international financial institutions, overseas listing and foreign investors have been the main factors in promoting corporate governance[83] and, consequently, reforms were made in the corporate sector. These reforms focused on the restructuring of the regulator, stock exchanges and divestiture by the state of its shareholding in state-owned enterprises. In 2010 the minister for privatization said that the government planned to divest its 26% equity stakes in 80 SOEs through public–private partnerships (PPPs). He further explained that out of these 26% shareholdings, 12% would be given to 500,000 employees of these entities under the Benazir Employees Stock Option Scheme (BESOS) amounting to Rs100 billion (approximately US$1.190 billion or £0.781 billion) free of cost.[84] In a recent move the Cabinet committee on privatization decided to privatize 31 state-owned organizations by floating 26% shares in the market through an initial public offering and strategic disinvestment to the private sector. The committee also decided that the administrative control of some of the organizations would be handed over to the private sector. Furthermore, the decision was made to privatize 65 more SOEs by the end of 2013. These privatization processes fall under the agreement with the International Monetary Fund (IMF) as a condition of loan.[85]

Corruption has hindered rapid privatization. The Supreme Court cancelled some key privatization processes due to corruption; for example, the privatization of steel mills (a major SOE) by the government was cancelled due to corruption and irregularities in the transaction and undervalued assessment of the assets of the enterprise.[86] Despite these privatization processes since the early 1990s, the state still dominates in SOEs and families

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[83] These factors will be discussed in detail in Chapter Three.
[84] Privatisation Commission of Pakistan, Government of Pakistan website <http://www.privatisation.gov.pk/> Accessed 17.08.2013.
[85] See the daily '*Dawn*' an English Newspaper of Pakistan (online), dated 04.10.2013, available at <http://dawn.com/news/1047333/31-enterprises-up-for-sale> Accessed 08.01.2014. In a recent move, as per agreement with IMF, the Privatisation Commission of Pakistan has approved disinvestment in some other major state owned enterprises in its meeting held on 7-9th January 2014. See the daily '*Dawn*' an English Newspaper of Pakistan (online), dated 08.01.2014 and 10.01.2014, available at <http://www.dawn.com/news/1079178/commission-approves-privatisation-of-pia-other-entities> and < http://www.dawn.com/news/1079512/govt-to-sell-its-shares-in-ogdcl-ppl> respectively, Accessed 10.01.2014.
[86] See the daily '*Dawn*' an English Newspaper of Pakistan, dated 09.08.2006, available at <http://jurist.org/forum/Pakistan%20Steel%20Mill%20Judgment.pdf > Accessed 17.08.2013.

in family-owned companies. Nevertheless, the process of privatization and divestiture may increase public shareholdings in SOEs and family-owned enterprises.

2.8 The nature of the corporate sector in Pakistan

The corporate sector in Pakistan is highly concentrated, with families and the state holding the majority of shareholdings in this sector. Families are dominant in the corporate structure both in private[87] and in public companies. According to statistics, more than 50% of private companies are held by two members, most of whom are husbands and wives, in order to fulfil the minimum requirement for the members of a private company under the Ordinance.[88] There are groups and families who hold more than 75% of the shareholding in listed companies, which is more than the minimum requirement to take any decision in the members' meeting.[89] A significant number of listed companies are held by families as well. These families hold their control either directly by holding the majority shareholding or through an indirect method such as pyramiding, cross-shareholding or interlocking management. Families retain their shares so as to keep control of the companies, which creates a liquidity problem in the market. Pyramiding, interlocking and cross-shareholding are complicated phenomena that are not easily understood by general investors. These families also maintain control by appointing their family members or at least some persons in whom they have confidence as executive and non-executive members to the board of directors. These people normally lack the requisite qualifications and experience. Major policy decisions are taken by these families by themselves without going to a formal meeting of the board or shareholders. This concentration of control is maintained for the sake of getting private benefits, keeping cash flow in their own hands, and controlling the board and the management in the company.

The state is the second largest stakeholder after families in the corporate sector in Pakistan. State-owned companies include both incorporated and unincorporated companies. Many SOEs operate listed as well as private companies. During the past two decades the state corporatized many SOEs and others are on the agenda. As far as the top 40 listed

[87] According to the Companies Ordinance, 1984, private companies other than single-member private companies must have at least two members and a maximum of fifty members.
[88] Khan (n 76).
[89] This threshold is different from the UK where it is required under the listing rules that at least 25% shareholding must be held by the public for the purpose of an active market. In Pakistan there is no such requirement and groups and families hold maximum shareholding to exercise control. The cumulative voting may allow minority shareholders to elect directors to the board of directors but the groups and families try to have maximum shareholding in their own hands in order to avoid minority representatives on the board.

companies on the Karachi Stock Exchange (KSE)[90] are concerned, the state[91] owns 14 of the top 40 listed companies. SOEs account for 52.8% of the capitalization of the total capitalization of the top 40 listed companies on the KSE.[92] SOEs are politically motivated and every government, after coming into power, takes control of these companies. The directors and management of the boards of directors remain in their positions at the pleasure of the state. The government's focus is not on the qualifications and experience of the directors, but rather the political affiliation of the persons for appointment to the boards.

Though family- and state-owned corporations are important sources for corporate growth in Pakistan, control maximization discourages such growth and capital market development. Most of the smaller and family-owned companies in Pakistan have little awareness of the potential benefits of improved corporate governance.[93] This is one reason for the lukewarm response to reforms or improved governance, at least at firm level. The strong family and state control of public companies is a serious governance problem. These companies resist reforms of corporate governance and also threaten to delist their companies.[94] There was substantial delisting after the promulgation of the Code of Corporate Governance in 2002 and revision in 2012.

Multinational companies are the third major stakeholders in the equity market in Pakistan. As far as the top 40 listed companies in the KSE are concerned, there are 5 multinational companies that constitute 17% of the capitalization in the top 40 listed companies on the KSE.[95] The presence of foreign companies, both as listed and non-listed private companies, in the corporate sector in Pakistan is a healthy sign for the economy of the country. They are a major source of foreign direct investment in the country. This encourages the state to play its role to improve its overall corporate governance with an empowered and effective regulator. There can be further foreign direct investment if corporate governance is improved. Major foreign companies are from the UK and the US. The foreign companies belong to those countries where there are strict disclosure

[90] The Karachi Stock Exchange (KSE) is the biggest stock exchange in Pakistan.
[91] The state includes the federal government, provincial government and semi-government.
[92] Ali Cheema *et al.*, 'Corporate Governance in Pakistan: Ownership, Structure and Control' (2003) LUMS Paper Series 11-13. This is the latest data available on ownership structures in Pakistan.
[93] IMF Report on the Observance of Standards and Codes (ROSC).
[94] This observation was made by senior official of the SECP during an interview with the researcher.
[95] Cheema *et al*. (n 92) 11-3.

requirements and mature governance structures, hence these foreign companies can set an example for local companies in terms of disclosure, and managerial and other matters.

2.8.1 Voting in the corporate law of Pakistan

The 'one share, one vote' principle is only a default rule under the company law of Pakistan and companies can issue enhanced voting shares as well as shares without voting rights,[96] which help family members to control the board and the management. Differential voting rights is a commonly recognized legal technique to control firms. Although it is a legal technique, different stakeholders do not consider it to be good; for example, in the UK companies are allowed to issue shares other than one share, one vote but they do not issue such shares because this is not liked by the influential institutional shareholders in the UK. In Pakistan this is allowed and the companies, including listed companies, do issue such shares. This may dilute the shareholding of the minority shareholders.

2.8.2 The judiciary and enforcement mechanism in Pakistan

Shareholders' rights are considered to be an important determinant of good corporate governance and necessary for the development of a market.[97] Minority shareholders' rights are not properly protected in Pakistan. Some rights are provided in the law but the issue is their enforcement. Corruption, inefficiency, cost, inordinate delays in decision-making, judges' lack of expertise and political influence over the judiciary are important hurdles to effective enforcement of shareholders' rights in Pakistan.[98]

2.8.3 Institutional investors and corporate governance in Pakistan

Other substantial shareholders are the banks and institutional investors but they have a minor role in corporate governance. Institutional investors are represented on boards of directors and some banks have members on the board due to an agreement of loan according to the provisions of the Ordinance. The institutional investor industry is underdeveloped in Pakistan. It is not playing the role that is being played by the

[96] See s. 90 of the Companies Ordinance, 1984 and the Companies Share Capital (Variation in Rights and Privileges) Rules 2000 which allow all types of companies, including listed companies, to issue such shares.
[97] See text to notes 12-3 in Chapter Four, at 4B.2 (LLSV Theory).
[98] This will be discussed in detail in Chapter Five.

institutional investors in the UK. There is a need for the role of institutional investors in Pakistan to be activated and enhanced.[99]

2.8.4 Compliance with the Code of Corporate Governance in Pakistan

Compliance with the Code is a major problem. The Code contains many mandatory provisions relating to board structure, auditing and disclosures, which challenge the discretionary powers of families and the state. Therefore, they are reluctant to observe the Code in its true spirit. There is a lack of understanding of the potential benefits to observing the Code. Compliance with the Code is only in form and not in substance. There is merely box ticking rather than material observance of the Code in its true sense. When the issue of non-compliance with the Code was raised with a senior officer of the SECP, his reply was that the Code could not be implemented in the true sense because most of the listed companies in the public sector are either family-controlled or controlled by groups. [100] Family members are elected to the board both as executive and non-executive directors. As far as independent directors are concerned, they appoint any family member with a few shares as independent director. Since major children are regarded as independent, these families issue few shares in the name of such major children and appoint them as independent directors to fulfil the requirement of the Code.

2.9 Sources of corporate governance

2.9.1 Company law

Company law is the main source of corporate governance. It provides for the rights and liabilities of shareholders, directors and other stakeholders. Company law is the basic legislation that provides rights to shareholders, power to directors, the division of power between shareholders and directors, the power of issuing shares, and voting powers. Company law applies to all companies, including public and private ones. However, application is restricted, to some extent, with reference to the nature of a company. Private companies are exempted from certain provisions due to the limited activities by a certain number of shareholders and less involvement of the general public. In public companies

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[99] The role of institutional investors in Pakistan will be discussed in Chapter Four-A.

[100] This observation was made while going through the various annual reports of major listed companies in Pakistan. This statement was also confirmed by the Director: Securities Market of the SECP during an informal meeting with him.

the general public is involved. Therefore, stricter conditions are provided in company law to safeguard their interest.

Jurisdictions have undertaken different approaches to the nature of the provisions in company law; for instance, in the UK there is a flexible approach, with a mixture of default and mandatory rules. The default rules have automatic application unless changed by a shareholders' resolution. The mandatory rules are not subject to change by the resolution of shareholders. As to the nature of a particular rule, every rule is mandatory unless there are good reasons to believe that a rule is a default rule.[101]

In Pakistan there is a rigid approach in company law.[102] However, there are also a few examples of the default nature of the rules; for instance, companies may dis-apply the application of pre-emptive rights for the specific allotment of shares, through special resolution.[103]

2.9.2 Securities laws

Securities laws are applicable only to those public companies who wish to collect finance from the general public. Some public companies do not go to the public for financing; they rather rely on internal financing and bank loans. Securities law, therefore, does not apply to them. These laws are important in corporate governance because they provide certain safeguards to the investors. These safeguards may include the manner in which the public offering is dealt with and also the manner in which the trading of shares is controlled, for instance, in the form of the prohibition on insider trading.

2.9.3 The company constitution

2.9.3.1 The articles of association

The articles of association provide the internal regulation of companies. In the context of the UK, this is a contract between the company and shareholders, and shareholders *inter*

[101] Christopher A Riley, 'The Not-So-Dynamic Quality of Corporate Law: A UK Perspective on Hansmann's "Corporation and Contract"' (2010) 21(3) *King's Law Journal* 472-6, 494.
[102] A company limited by shares may adopt model articles of association (Table A) annexed to the Ordinance 1984. See s. 26 (5) of the Ordinance 1984.
[103] See s. 86 of the Ordinance 1984.

se, which defines the nature of the relations between the parties.[104] Many jurisdictions provide model articles of association that can be adopted by any company instead of filing their own articles. In UK company law the articles form the constitution of the company. In Pakistan the articles have secondary importance after the memorandum of association. The memorandum of association is the constitution of a company. In Pakistan the articles include provisions that deal with the internal matters of the company. Companies have the option of registering their own articles and thereby exclude the model articles. If no articles are registered, then the model articles apply.

The areas in which the articles can deal with corporate governance matters include voting rights; variation in rights and privileges; election and removal of directors; the powers of directors; and the objects that a company can undertake. Therefore, the articles are an important source of governance issues in company matters. In recent years the articles of association have played an important role at international level. When a company wants to raise capital through an overseas stock exchange, there is the matter of the difference in corporate and securities laws operating in both jurisdictions which may create a hurdle to raising capital overseas. One solution to this problem would be the formal convergence of both systems, whereby both systems become the same. However, this is not an easy task due to the different natures of securities and corporate laws. Another solution is an *ad hoc* arrangement through the medium of contract. Companies who wish to enlist overseas may amend their articles of association to fulfil the requirements of overseas stock exchanges.[105] For example, some Chinese listed companies raise capital through the stock exchanges in Hong Kong, the UK and the US and, consequently, amend their articles of association to include mandatory provisions required by the Chinese Securities Regulatory Commission (CSRC) and the stock exchange concerned.[106] Similarly, some Pakistani companies have also raised finance through global depository receipt (GDR) and American depository receipt (ADR) listing in the UK and the US respectively, and through bonds from some other stock exchanges.[107] So, the articles are important documents that deal not only with internal matters, but can also be used as a tool to raise finance from overseas markets.

[104] See s. 33 of the Companies Act, 2006.
[105] Different forms of convergence will be discussed in detail in Chapter Three.
[106] MacNeil (n 49) 317-8.
[107] See Table in Chapter Three at 3.7.4.1.

2.9.3.2 The memorandum of association

The memorandum of association is the constitution of the company in many jurisdictions, including Pakistan. The memorandum, *inter alia*, provides the objects that companies may have. If a company conducts a business other than mentioned in the memorandum, the directors may be punished for this violation. In the history of UK company law the memorandum of association remained an important document until the Companies Act, 1985.[108] The present company law in the UK (i.e., the Companies Act, 2006) provides that only the names of subscribers will appear in the memorandum.[109] Company law further stipulates that the provisions of the memorandum of association of the companies incorporated before the present Act will be considered part of the articles.[110]

In Pakistan the memorandum of association is still a very important document which provides the main functions, rights and privileges of the members. The Ordinance provides strict rules for alteration to the memorandum. It requires a special resolution and subsequent approval of the regulator for amendment to the memorandum.

2.9.4 Listing rules

Listing rules are applicable only to those companies who enlist their securities on a stock exchange; in other words, listing rules provide conditions under which public companies access the organized capital market and raise capital from the public. The listing rules, although applicable to a limited number of companies, play an important role in corporate governance. Many rights and obligation are provided in listing rules, especially disclosure, which is important for investors, both existing and potential.

The role of listing rules is more significant in global convergence, especially when overseas companies with different corporate cultures list on foreign stock exchanges. Listing rules can fill the gaps that may arise due to the different corporate laws applicable to domestic and overseas companies. They can also work to provide a level playing field to both foreign and domestic companies by lowering the competitive disadvantages to domestic companies; for instance, if foreign companies are not required to comply with certain provisions under the corporate laws of a country of incorporation that are

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[108] See s. 2 (7) of the Companies Act, 1985.
[109] See s. 8 of the Companies Act, 2006.
[110] See s. 28 of the Companies Act, 2006.

mandatory for domestic companies under that country's corporate laws, then listing rules may require such foreign companies to comply with those provisions. This may create a balance of obligations between domestic and foreign companies.

Many rights and obligations for which provision is not made in corporate law may be provided for in listing rules because these rules are applicable to public companies in which the public have an interest. The listing rules may provide a vehicle for the development of international corporate regulations;[111] for instance, the LSE requires many obligations from overseas companies who have a premium listing on it. These obligations include 'a ban on restrictions on transfer of shares by overseas companies', 'pre-emption rights', 'transactions between controlling shareholders and the company should be at arm's length', a 'continuing obligation of dissemination of information to investors', and 'directors' continuing obligation which includes their pay and privileges, shareholding, and insider trading'.[112] In this way the listing rules may provide level playing fields to both domestic and overseas companies by filling in the gaps in the corporate laws of both jurisdictions.

2.9.5 Codes of corporate governance

Codes of corporate governance have been included in the corporate arena as a form of soft law in most of the major jurisdictions, including the UK, but some countries, including Pakistan, have made the code part of listing regulations. In developed markets the codes have been introduced due to market pressures and in developing countries due to global pressure, including from international financial institutions. The codes of developed countries provide guidelines to developing jurisdictions in the form of best practices developed in their markets in the form of convergence. The best practices of developed jurisdictions such as the US and the UK are the driving force behind the development of the codes in different countries. As the codes are part of soft law and developed on a self-regulatory basis, they are therefore easy to change without the involvement of formal legal procedure. Therefore, rapid changes have been observed in the codes in different jurisdictions in recent years.

[111] Iain MacNeil, 'International Corporate Regulation: Listing Rules and Overseas Companies' (2001) 50 (4) *International and Comparative Law Quarterly* 809.
[112] See FCA Listing Regulations.

The codes may solve the problems in areas that are not addressed by the regulations. In particular, it may resolve the issues of deficiencies in the working of boards of directors and minority shareholder protection. In this way, the codes may supplement the existing legal framework, especially in those areas in which states are reluctant or unable to include and enforce governance practices through state legislation for political reasons. The state may include these governance practices in its legal framework once they have matured and been accepted by the business community.[113]

Enforcement is a major issue due to the lack of statutory status of the codes. Market discipline plays a major role in their enforcement; for instance, in the UK market discipline ensures conformance with the code through the 'comply or explain' principle.[114] As compliance with code is voluntary, therefore, reputation may play its role and may be the driving force behind compliance with the code. In recent years many credit rating companies have used compliance with the code as a tool for rating companies. Therefore, companies may comply with the code to enhance their reputation as well as their credit rating. Compliance with the code has significantly increased in recent years but that is not yet at an optimum level. In Pakistan the code is part of the listing regulations but in practice it is not implemented as part of listing regulations.[115]

2.10 Elements of corporate law that support good corporate governance

Company law is the main source for shareholders' rights, powers of directors, the division of power between shareholders and directors, voting procedures, the issuing of shares, and voting powers attached to these shares. These elements of corporate law are the basic features of corporate governance.

2.10.1 Shareholders' rights generally

Academic debate about the proper role of shareholders and the managers of firms, and the question as to whose interest is to prevail over the other in corporate governance has been waged over almost eight decades. Debate started with the Berle and Means theory of separation of ownership and control in their classic work of 1932. They described how the

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[113] Ruth V. Aguilera and Alvaro Cuervo-Cazurra, 'Codes of Good Governance Worldwide: What is the Trigger' (2004) 25 (3) *Organization Studies* 417; Wymeersch (n 41) 28-9.
[114] Christopher A Riley, 'The Juridification of Corporate Governance' in John de lacy (ed) *The Reform of United Kingdom Company Law* (Cavendish Publishing Limited, London 2002) 179-201.
[115] See text to n 100.

dispersed shareholders phenomenon had put power in the hands of the managers and how shareholders became largely powerless.[116] Berle also argues that corporate powers are meant for the interest of shareholders.[117] Smith augmented these views and considered that the only function of a firm was to maximize the wealth of its shareholders.[118] This property model[119] regards shareholders as owners as well as residual claimants.[120] Therefore, managers should pursue those policies that enhance the wealth of shareholders. Dodd does not agree with the wealth maximization norms of a firm. [121] He argues that a firm has many other functions besides the wealth maximization of its shareholders, such as jobs for employees, better quality products for customers and, more importantly, to perform its social responsibility for the welfare of society. This entity model denies the sole function of a firm as being to maximize the wealth of shareholders.

Bainbridge is the main advocate of directors' primacy norms. He argues that market competition and efficiency benefits require that the *status quo* of directors' primacy that is prevalent in the existing corporate law and shareholders' intervention through votes should not be more than a default rule.[122] He further argues that the director primacy theory is better at explaining everything than any other prevailing theory in the market.[123] However, Bebchuk advocates for more powers to shareholders.[124] He does not agree with the justifications given in favour of directors' primacy norms. Proponents of the directors' primacy theory say that because the managers of firms are well informed about the state of affairs of their firms, they can take better decisions for their firms.[125] They further argue that the firms' structure requires centralized management, otherwise shareholders may use their powers against the interest of the firms. However, there are more chances that the managers who have more powers may proceed with obtaining private benefits of control

[116] Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (MacMillan, New York 1932).
[117] Adolf Berle, 'Corporate Powers as Powers in Trust' (1931) 44 *Harvard Law Review* 1049.
[118] D. Gordon Smith, 'The Shareholder Primacy Norm' (1998) 23 *Journal of Corporation Law* 277.
[119] The words 'property model' and 'entity model' are used by Lynn A. Stout in her article 'Bad and Not-so-Bad Arguments for Shareholder Primacy' (2002) 75 *Southern California Law Review* 1189-1210.
[120] 'Residual claimant' means that the shareholders claim their right at the end after payment to all other stakeholders and therefore they either get less than their due share in the firm or sometimes they get nothing. Therefore, they may suffer more than any other stakeholders in the firm.
[121] Dodd (24) 1145.
[122] Stephen M. Bainbridge, 'Director Primacy and Shareholder Disempowerment' (2006) 119 (6) *Harvard Law Review* 1735-58.
[123] Bainbridge (n 22) 10-16.
[124] Lucian A. Bebchuk, 'The Case for Increasing Shareholder Power' (2005) 118 *Harvard Law Review* 833-914.
[125] Robert C. Clark, *Corporate Law* (Textbook Treatise Series, Aspen Publishers, Inc., New York 1986); Jeffrey N. Gordon, 'Shareholder Initiative and Delegation: A Social Choice and Game Theoretic Approach to Corporate Law' (1991) 60 *University Cincinnati Law Review* 347-385; Chesapeake Corp. V Shore, 771 A. 2d 293, 327 (Del. Ch. 200).

and establishing empire building at the cost of shareholders. Therefore, empowering shareholders may reduce agency costs, which may be beneficial to both shareholders and the firm in terms of its performance.

Velasco takes an intermediate position and argues for ensuring existing shareholders' rights instead of increasing them without intruding on the existing structure of directors' primacy norms. [126] He further argues that the law has failed to ensure even the existing limited fundamental rights[127] of shareholders. According to him, this is basically due to the dysfunctional role of the law. Therefore, there is a need to make the role of shareholders more meaningful for the proper functioning of corporate governance. Stout forwarded a third argument in favour of shareholder primacy. [128] She does not consider shareholders as residual claimants and owners as proper argument for shareholder primacy. According to her, following the interest of shareholders will reduce agency cost, which otherwise would be high if the managers were to consider the interests of all the stakeholders.

Shareholders' rights can be divided into four broad categories: (1) decision-making rights, (2) appointment and removal rights, (3) financial rights, and (4) intervention rights. These are basic shareholder rights in the shareholder primacy norms systems prevalent in the UK and many common law countries.[129] These rights are normally provided in company law. However, some rights are also provided through listing rules, securities laws and non-statutory codes.

Decision-making rights include the right to make decisions in general meetings of shareholders on some key issues such as amendment to the constitution; the issuance of new capital; approval of certain transactions between the company and shareholders, and between the company and the directors; investment in associated and subsidiary companies; loans to directors; formal approval of dividends declared by the directors; long-term service contracts of the directors; substantial property transactions, unless the company is in the process of winding up; related party transactions; and other important transactions.

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[126] Julian Velasco, 'Taking Shareholder Rights Seriously' (2007) 41 *University of California, Davis Law Review* 605-82.

[127] He prescribes voting rights to elect directors to the board and the right to sell the shares as fundamental rights of the shareholders in a firm: For this, see Julian Velasco, 'The Fundamental Rights of the Shareholder' (2006) 40 *University of California, Davis Law Review* 407-67.

[128] Stout (n 28) 1209.

[129] Iain MacNeil, 'Activism and Collaboration among Shareholders in UK Listed Companies' 5(4) (2010) *Capital Markets Law Journal* 422-3.

Appointment and removal rights are those rights that provide powers to shareholders to appoint and remove the members of the board of directors. Owing to the inherent problem of public companies not being able to call all shareholders for every decision, company law provides the board with basic powers to run the day-to-day affairs of the company. The members on the board may either be the owners themselves or professionals hired by the company to run its business. These members on the board are elected by shareholders in general meeting and may also be removed by these owners when they feel that an incumbent is not performing. These powers granted to shareholders to hold the board of directors accountable are very important. Some jurisdictions provide shareholders with strong powers to remove directors, for example, in the UK shareholders can remove a director by an ordinary resolution without showing any cause.[130] In some jurisdictions such as Pakistan the removal of a director is very difficult.[131]

Financial rights include the right of equal treatment in voting, cash flow (such as dividend rights) and pre-emption. Voting rights provide indirect control to shareholders as they can appoint and remove the directors, and can also take major business decisions. Equal treatment in cash-flow rights allows all shareholders a right to dividends according to their stake in the capital of the firm. However, some jurisdictions, including Pakistan, allow preference shares which allow the holders of such shares to have more rights than ordinary shareholders, for instance, a right of preference in dividends. Pre-emptive rights provide safeguards against dilution. Pre-emptive 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.

Intervention rights provide an opportunity to shareholders to intervene in decisions of the board or other controlling shareholders in general meeting, either through the regulator or court. The rights are provided according to the nature of the corporate governance structure

[130] R. Kraakman *et al*., *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford University Press, Oxford 2004) 138.
[131] See example in Chapter Four, at 4B.6.2.

of the given jurisdiction. In the US context, where directors' primacy norms are more common, such an intervention is disputed in the sense that it is considered harmful to the overall interest of companies.[132] It is argued that the board of directors must act free from intervention from the shareholders or court oversight because this causes harm to the efficient working of firms.[133] The stance of the US courts is that there should be accountability only in those cases where directors abuse their powers.[134] In the UK context, where shareholder primacy norms are prevalent, shareholder intervention is facilitated in the sense that they have rights to contest directors' decisions by calling a general meeting with 5% voting powers; propose a resolution in a general meeting; add agenda items for general meetings, and put an obligation on companies to answer questions raised by the members at the meeting.[135] Shareholders also have rights to intervene in the decisions of the management or the controlling shareholders through the regulator or courts. More common rights are the unfair prejudice remedy and derivative action. However, these are more minority protection rights than simply shareholders' rights. There are also other rights such as information, disclosure and inspection rights. These rights facilitate shareholder intervention in cases of abuse of powers either by the management or by the controlling shareholders.

The rights of shareholders form an important part of corporate law as this determines the nature of corporate governance. Rights may be classified into corporate, individual and class rights. Corporate rights belong to the company such as the right to own the property of the company, the right to sue and the right to enter into contracts. Individual rights belong to individual shareholders such as the right to information, disclosure rights, inspection rights, litigation rights, dividend rights, liquidity rights, equal treatment and voting rights, the right to receive financial statements, and the right to transfer shares. Class rights belong to a particular class of shareholders. If shareholders hold shares of one class, they are class shareholders and the rights attached to them shall be class rights. The Companies Act, 2006 defines *class shares* as '*class shares means shares having uniform rights*'.[136] For instance, preference shareholders who hold a 5% preference dividend or shares that confer enhanced voting rights belong to the same class.

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[132] Stephen M. Bainbridge, 'Shareholder Activism and Institutional Investors' University of California Los Anglos law and Economics Research Paper No. 05-20 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=796227> Accessed 20.12.2013.
[133] Bainbridge (n 22) 15.
[134] Stephen M. Bainbridge, 'Unocal at 20: Director Primacy in Corporate Takeovers' (2006) 31 *Delaware Journal of Corporate Law* 769.
[135] MacNeil (n 129) 423, 431; See s. 303 of the Companies Act, 2006.
[136] See s. 629 (1) of the Companies Act, 2006.

Enforcement of these rights depends upon the nature of the ownership of the rights. Corporate rights can be enforced by the company itself through the board of directors, whereas individual rights may be enforced by the individual concerned and class rights by the members of the respective class of shareholders. Corporate rights may also be enforced by an individual shareholder under certain circumstances such as through derivative action. Corporate law provides the rights and mechanism of their enforcement.

2.10.2 Minority rights

Shareholder rights are an important element of the accountability structure of corporate governance.[137] These rights determine the relationship between shareholders *inter se*, between shareholders and the management, and between shareholders and other stakeholders such as creditors and employees.[138] The objective of a corporate governance structure is to keep the interests of the shareholders as a class but it can also be to address the agency problems between shareholders and the management, and between the majority and the minority shareholders. It can also resolve and settle the interests of the minority shareholders. These interests can be ensured by either reducing the powers of the majority shareholders or by providing minority shareholders with certain rights in order to pre-empt or challenge the abuse of power by managers and controlling shareholders.

There is a trade-off between giving more power to the minority shareholder and shareholders as a class. Giving more powers to shareholders as a class may create problems for the minority shareholders and giving more powers to the minority shareholders may create agency problems between shareholders and management.[139] If more powers are given to the minority shareholders or the powers of majority shareholders are curtailed, then this may create a problem between shareholders and the management which, in turn, may create a deadlock. However, if more powers are given to shareholders as a class to reduce the managerial agency problem, then this may create problems between majority and minority shareholders. In this case, the majority may capture the whole management and use their powers for their own private benefit of control and may expropriate the funds of the firm at the cost of minority shareholders. Therefore, it is

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[137] Paul L. Davies, *Principles of Modern Company law* (8th edn, Sweet & Maxwell, London 2008) 472-3.
[138] MacNeil (n 129) 421.
[139] Luca Enriques, H. Hansmann, and R. Kraakman, 'The Basic Governance Structure: Minority Shareholders and Non-Shareholder Constituencies' in R. Kraakman *et al.* (eds), *The Anatomy of Corporate Law: A Comparative and Functional Approach*' (2nd edn, Oxford University Press, Oxford 2009).

important to strike an appropriate balance between the powers of the majority, minority and management.

Minority rights, more or less, come from shareholders' rights. Both dispersed and concentrated ownership systems have the inherent problem of minority protection. The dispersed ownership structure causes higher agency costs as compared to the concentrated ownership system because it is hardly possible for dispersed shareholders to collaborate and take any decision, and exert pressure on management to adopt good governance. This problem is exacerbated in the present era of globalization because it is not feasible for foreign and domestic investors to collaborate and take any action due to cost and lack of coordination. However, there are more minority protection problems in concentrated than dispersed ownerships structures. As the managers are appointed by the shareholders, the majority therefore control the management. They may appoint themselves or close relatives or friends as managers who may work for such majority. Therefore, a concentrated ownership system is considered to be more exposed to expropriation of the funds of the firm at the cost of minority shareholders. The majority, with the connivance of management, may use the resources of the firm for their own benefits and obtain private benefit of control. Minority shareholders are at the mercy of the majority unless the system provides them with protection. Therefore, minority protection is more important in a concentrated ownership system.

The shareholders rights in general and minority protections in particular are concerned with the division of power between shareholders and the management and shareholders *inter se*. Therefore, there is a need for an appropriate balance of power between these actors.

2.10.3 Division of power between shareholders and the directors

Shareholders, directors, employees, creditors and customers all have an interest in the success of a firm. As far as controlling the firm and running it in a professional manner are concerned, shareholders and directors are the main actors. The question of balance of power and control between two actors in a firm is a difficult task. The structure, power, composition, appointment and removal of directors from the board enhance shareholders' control over a firm.[140] As shareholders are not supposed to be well versed in running the affairs of the firm, the directors, who are normally expert and professional in running the firms, are therefore delegated the powers by shareholders. At the same time, the shareholders can watch and take action against the acts of the directors in case of any gross negligence, irregularity and abuse of powers by the directors. The appointment, removal of directors, approval of major transaction and *ex post facto* approval of certain matters by the general meeting is the mechanism shareholders use to control the firm indirectly. This accountability mechanism tries to create a balance in power between the directors and shareholders; in other words, the authority is delegated to the directors, and shareholders have accountability authority to check the performance of the directors. Each jurisdiction deals with this issue in a different manner. Some jurisdictions, such as the US and Pakistan, give more powers to the directors, while others, such as the UK, give more to the shareholders.

2.10.4 Procedure and power to issue shares

The authority to issue shares and to enhance the share capital is important in the context of corporate governance. The actual authority lies with shareholders and it is exercised by the directors through delegated powers. This authority may be delegated through a resolution of shareholders or provided in the articles. Private and public companies are dealt with in different ways due to the involvement of public interest in public companies. Company law requires more disclosures from a public company than a private company at the time of issuance of shares and enhancement of capital. The disclosure involves the issuance of a prospectus by public companies. The prospectus includes detailed provisions relating to information about the company, performance of the company, reasons for raising further capital, expected projects and performance. A further safeguard is normally provided in the form of the regulator’s approval. This procedure and power to issue shares is important because a further issue of shares may have implications for the shareholders’ rights which may affect the governance structure of the firm.

2.10.5 Voting rights

Incomplete contract theory states that corporate law provides a standard contract which is not complete in itself as legal rules are not sufficiently detailed. The fiduciary duty and

[140] Kraakman *et al.* (n 130) 34.

structural rules are also not enough to provide a detailed contract. This creates gaps in the contract which are filled by voting power attached to the shares. Shareholders are more affected by this incomplete contractual theory. The way in which the contract works makes it unfeasible and impossible in most cases to negotiate the terms of the contract. People become shareholders by purchasing shares from the market. However, other stakeholders, such as creditors and employees, are not exposed to incomplete contracts as are shareholders. They negotiate the terms and conditions of the contract: they may bargain for the best possible contract to safeguard their interests. Therefore, the incomplete contractual nature of a firm necessitates that someone must have residual power in the form of voting powers. As the shareholders take more risk, they must, therefore, be given more control through voting.[141]

Shareholders are residual claim holders as they are paid last, that is, after all the other stakeholders have been paid. Therefore, shareholders should have some control in the firm to safeguard their interests. Their voting rights provide this safeguard. Other stakeholders, such as creditors, bondholders and preferred shareholders, may also control the firm in the case of financial difficulty when their investments are exposed to more risk. The terms and conditions of the contract and bankruptcy laws provide creditors with the right to control the firm in cases of financial difficulty.[142] However, the shareholders still remain the residual claim holders, even if control is shifted to the creditors. In most cases, shareholders may get nothing at the end of the liquidation proceedings. This incomplete contract theory and residual claim-holding status of the shareholders highlight the importance of voting rights for shareholders.

Voting powers have many benefits. Firstly, they provide decision-making powers to shareholders. Shareholders can take decisions at a general meeting which provides a sense of participation. Secondly, they provide the shareholders with accountability powers, which may improve the efficiency of the firm.[143] Thirdly, recent academic literature regards legal protection as an important tool for protecting minority shareholders.[144] The voting rights may provide a substitute for legal protection as this presents them with an opportunity to take up the matter at a general meeting instead of first going to a court of law. Fourthly, voting powers increase the value of shareholding, which can be cashed at a

[141] Frank H. Easterbrook and Daniel R. Fischel, 'Voting in Corporate Law' (1983) *Journal of Law and Economics* 403-6.
[142] *Ibid* 401-2.
[143] Buxbaum (n 10) 1672.
[144] LLSV (n 2) 24.

higher price than the shares without voting powers.[145] Fifthly, voting may provide control over the firm and an incentive to resell the shares at an attractive price. This may give shareholders control premium at the time of selling their controlling shares.

Voting rights are important in governance as differential voting rights may enhance or decrease control over the firm. Shares with enhanced voting rights allow the holders of these shares to have more control over the firm than cash-flow rights. This provides them with an opportunity to obtain the private benefits of control. Similarly, shares without voting rights do not allow the holders of such shares to have any say at general meetings. For instance, UK company law allows shares with enhanced voting rights but this is not common because of the role played by institutional investors[146] who hold about 39.9%[147] of the stakes in quoted companies in the UK. Institutional investors do not like enhanced voting rights and insist on one share, one vote.[148] As they have enough shares, they are therefore in a position to exert pressure on firms to avoid enhanced voting shares.

However, the company law in Pakistan allows the issuance of shares other than one share, one vote and companies do issue shares other than one share, one vote. This may be because of the minor role that institutional investors play in corporate governance. Families and the state use these techniques to control firms, while employing investment from outside. The controlling shareholders can enhance their control by issuing shares with enhanced voting rights to themselves or shares with fewer or without any voting rights to others.

Small investors are not normally interested in voting rights, and are more interested in dividends and an increase in capital. The reason for such an apathetic attitude on the part of small investors is that casting a vote is normally not feasible for them because of the cost involved and they also feel that their vote might not have any effect.[149] However, investors may be interested if it is feasible for them to cast their votes and the cost is minimized. Nevertheless, voting plays an important part in governance as it provides shareholders with an accountability mechanism in order to safeguard their interests.

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[145] Coffee, Jr (n 54) 644 (see f. n. 12 at 644).
[146] MacNeil (n 129) 422.
[147] This includes shares held by insurance companies (13.4%), pension funds (12.8%), unit trusts (1.8%), investment trusts (1.8%) and other financial institutions (10%).
[148] See office for National Statistics, 'Share Ownership Survey 2008' <http://www.ons.gov.uk/ons/rel/pnfc1/share-ownership---share-register-survey-report/2008/index.html> Accessed 17.08.2013.
[149] Anthony Downs, *An Economic Theory of Democracy* (Harper and Row, New York 1957).

2.10.5.1 Pre-emptive rights

Pre-emptive rights have been regarded as an ownership right that protects owners from the risk of dilution in voting and financial interests. MacNeil considers this a misconceived notion. [150] He argues that fiduciary duties over the issuance of shares at the best price protect the financial interests of shareholders. The absence of pre-emptive rights may allow companies to raise capital along more efficient, and the best possible terms and conditions. Company law provides shareholders with safeguards through pre-emptive rights. However, this is not a universal phenomenon as many jurisdictions do not provide pre-emptive rights. The US has largely abandoned these rights,[151] while the UK has provided them as a default rule in new company law provisions, which means that companies may dis-apply them through special resolutions for a specific allotment of new equity securities.[152] However, the strict requirements[153] and limited scope for their dis-application contained in the guidelines of the Pre-emption Group[154] show the importance attached to these pre-emptive rights. Nevertheless, US states have largely abandoned pre-emptive rights and the default nature of these rights in the UK shows non-acceptance of this class of rights as a minority protection device by the main jurisdictions. However, some caution is required before abandoning pre-emptive rights in underdeveloped jurisdictions such as Pakistan. Firstly, the fact that companies are separate entities and that the directors have a duty to act in the best interest of the company should determine that the issuance of new capital should be negotiated on the best possible terms, even if it is to be issued to existing shareholders. Secondly, the presence of a developed and efficient market is important in this regard. Trading of shares in an efficient market may be close to the real value of the shares as compared to an inefficient market where manipulation by brokers and other interested parties may inflate the share price to obtain an undue advantage. In this way, an efficient market helps existing as well as potential investors to purchase a new issue of shares with the real value of premium[155] which the issuer may demand in case of a new issue of shares. Thirdly, there is a need for a developed fiduciary duty with an efficient judiciary to dis-

[150] Iain MacNeil, 'Shareholders' Pre-emptive Rights' (2002) *Journal of Business Law* 98-100.
[151] *Ibid* 99.
[152] See s. 571 of the Companies Act 2006.
[153] A special resolution is required to dis-apply pre-emptive rights in the UK.
[154] Davies (n 137) 835-45.
[155] Premium is an amount that an issuer demands from the subscribers (i.e., existing or potential shareholders who wish to purchase shares in the company) in an initial public offering over and above the par value of the share in case the market value of the shares is greater than the par value of a share; for example, if par value of a share is £10 but it is traded in the market at £25. In this case the issuer may demand £15 premium from the subscribers and may sell it for £25 per share. However, to attract more subscriptions, it might fix premium at £14 and might sell it for £24 per share.

apply pre-emptive rights. In the absence of these safeguards, abandoning pre-emptive rights may provide the majority with an opportunity to exploit minority shareholders to dilute their shareholding. The reasons for which pre-emptive rights are being abandoned in major jurisdictions may not be applicable to underdeveloped jurisdictions such as Pakistan. The dominance of the state and families in the corporate sector of Pakistan may lead to the misuse of the dis-application of pre-emptive rights. For instance, these owners may issue new shares at less than the market price to a party with whom they have personal interests or even to the general public, which may cause existing shareholders to suffer. An inefficient judiciary may be another problem encountered in the dis-application of pre-emptive rights. A remedy in a dispute involving the new issuance of shares without pre-emptive rights may be problematic for shareholders in such a judiciary.

2.10.5.2 The cumulative voting system

The cumulative voting system (CVS) is an important aspect of voting rights for minority shareholders. The CVS is beneficial to shareholders in proxy contests for the election of directors.[156] Shareholders can elect one or more directors to serve on the board of directors through this system, which is not otherwise feasible for them. There are certain benefits to appointing members to the board of directors. It provides them with an opportunity to have access to information, to work for, and safeguard the interests of, minority shareholders, and to collaborate with independent directors to shape or, at least, to discuss the issues in the meeting of the board of directors.[157]

There are proponents as well as opponents of the CVS. Both describe its advantages and disadvantages. As far as the benefits of the CVS are concerned, it is argued that this provides minority shareholders with representation and, hence, the firm may perform better. [158] If the CVS is eliminated, it may reduce the powers of minority shareholders to elect their member to the board, which may decrease the value of the firm.[159] It may also lower agency cost in a sense that a minority representative may act as arbitrator in case of a

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[156] Peter Dodd and Jerold B. Warner, ‘On Corporate Governance: The Impact of Proxy Contests’ (1983) 11 *Journal of Financial Economics* 401.
[157] Enriques, Hansmann and Kraakman (n 139).
[158] Whitney Campbell, ‘The Origin and Growth of Cumulative Voting for Directors’ (1955) 10 *The Business Lawyer* 3; John G. Sobieski, ‘In Support of Cumulative Voting’ (1960) 15 *The Business Lawyer* 316; Herbert F. Sturdy, ‘Mandatory Cumulative Voting: An Anachronism’ (1961) 16 *The Business Lawyer* 550; George H. Young, ‘The Case for Cumulative Voting’ (1950) *Wisconsin Law Review* 49.
[159] Sanjai Bhagat and James A. Brickley, ‘Cumulative Voting: the Value of Minority Shareholder Voting Rights’ (1984) XXVII *Journal of Law and Economics* 341-2.

conflict of interest between the management and shareholders.[160] Opponents of the CVS describe it as being useless. [161] They argue that it may create problems regarding decisions at board meetings. They describe other methods of disciplining management that are less costly, for instance, the takeover market.[162] The takeover market can discipline management in a sense that a successful bidder, after controlling the firm, can remove the incumbent managers who are not performing. Therefore, management may try to increase the value of the firm and act in the best interest of shareholders. The takeover market may be a good technique to discipline management but there are some issues with this kind of discipline. It may be used as a last resort to discipline management and also requires a large shareholding to gain control of a firm, which may be a costly method. The other problem with this technique is the absence of the liquid market. For the effective operation of the takeover market, there is a need for a liquid market. In concentrated ownership structures families or the state holds the majority voting to avoid a takeover. If shares are not in the market, then it is not possible to get control of a company without the consent of the family concerned or the state. Therefore, a takeover may not be a feasible option in underdeveloped, illiquid and concentrated ownership structures. This may work well in a dispersed ownership structure with a developed and liquid market.

As regards voting in the CVS, it is against the general principal of one share, one vote. The cumulative effect of voting is that some shareholders can add more weight to the election of directors when they accumulate votes and cast all their votes in favour of a single candidate. This is a side effect of the potential benefits of minority protection. Shareholders have to pay this cost for the potential benefits of the system.

Shareholders are the equity providers and are the residual risk bearers. Therefore, their rights are required to be protected through law. The provision of these rights is to ensure that shareholders are in a position to monitor the performance of the directors and can take timely action to avoid the company failing to remain a going concern. The financial performance of a firm benefits all, but shareholders suffer more in the case of poor financial performance or where the firm does not remain a going concern. So, it is important that shareholders should be given enough powers and rights to secure their

[160] Eugene F. Fama and Michael C. Jensen, 'Separation of Ownership and Control' (1983) 26 *Journal of Law and Economics* 315; Bhagat and Brickley (n 159) 340.
[161] Ralph E. Axley, 'The Case against Cumulative Voting' (1950) *Wisconsin Law Review* 278; Easterbrook and Fischel (n 141) 395 .
[162] H. G. Manne, 'Mergers and Market for Corporate Control' (1965) 73 *The Journal of Political Economy* 110.

interests. Appointing representative on the board is an important element for safeguarding their interests. The CVS is a mechanism by which minority shareholders can elect directors to the board which is not otherwise possible for them through a regular voting system. This can be explained by the following example:

Example

Suppose a company has 2,000 shares, and the majority shareholders have 1,500 and the minority 500 shares respectively. Suppose four directors are to be elected in an election of directors in which the majority shareholders have four candidates (i.e., A, B, C and D) and the minority have one candidate (i.e., X). The following is a practical example of how both the regular voting system and the CVS will operate, and how one is beneficial to the minority shareholders and not to other shareholders.

Method 1 (regular voting system)

In this method each share will have one vote and a shareholder who has one share can give one vote to each of the four directors but cannot give four votes to one candidate. So, a minority candidate will suffer in the following results under this system:

Table 2.1: Results of a regular voting system

Name of candidate	Total votes	Remarks
A	1,500	If the majority give all 1,500 of their votes to their candidate
B	1,500	If the majority give all 1,500 of their votes to their candidate
C	1,500	If the majority give all 1,500 of their votes to their candidate
D	1,500	If the majority give all 1,500 of their votes to their candidate
X	500	If the minority give all 500 of their votes to their candidate

According to these results, all the candidates of the majority shareholders will be elected and the candidate of the minority shareholders will not be elected.

Note: The majority who have only 51% voting rights can select all their candidates. For example, if in the case above the majority had a 51% shareholding, the majority would have 1,002 votes and the minority who have 49% shares would have 998 votes. In that case

A, B, C and C could have obtained 1,002, 1,002, 1,002 and 1,002 votes respectively, whereas X would only have 998 votes. In that case X would not have been elected.

Method 2 (cumulative voting system)

In this system, one share will have votes equal to the number of shares multiplied by the number of directors to be elected. Now, since four directors are to be elected, there will, therefore, be 8,000 votes (8,000 = 2,000 x 4). In this system, since four directors are to be elected, a shareholder who owns one share will have four votes. A shareholder may cast all his or her votes in favour of one candidate or divide them between different candidates. The above result will be changed in the following way:

Table 2.2: Results of a cumulative voting system

Name of candidate	Total votes	Remarks
A	2,002	If the majority give such number of their votes to elect their candidate
B	2,001	If the majority give such number of their votes to elect their candidate
C	999	If the majority give such number of their votes to elect their candidate
D	998	If the majority give such number of their votes to elect their candidate
X	2,000	If the minority give all 2,000 of their votes to elect their candidate

According to these results, A, B, C and X will be elected. The candidate of the minority shareholder is elected onto the board which was not possible through the regular voting system.

However, the potential benefits of the CVS can be achieved only if the one share, one vote voting system is mandatory in the system. The majority shareholders with enhanced voting rights may have multiple voting powers as compared to minority shareholders who have one share, one vote. This may help the majority shareholders who have enhanced voting shares to appoint all their candidates.

There are other tactics to frustrate the CVS too. A staggered board structure may be used for this purpose. On such a board, the directors are classified into different classes and election is not held for all directors at any one time. For example, if four directors are to be elected in a company, they are divided into two classes and the election for each class is held after a certain period. Suppose a minority shareholder who holds 25% of shares may elect one director through the CVS; provided the election of all directors is held at one time. However, if elections for each class are held on two different occasions, then the minority will not even be able to elect their representative through the CVS. Suppose there is an election of two directors in a company. Now suppose there are 2,000 shares with the majority shareholders holding 1,500 and the minority 500 shares. Suppose A and B are the candidates of the majority, and C is the candidate of the minority shareholders. The majority will, therefore, have 3,000 votes, whereas the minority will have 1,000 votes (since two directors are to be elected under the CVS, one share will carry two votes). The majority can divide their votes in such a manner that 1,600 votes go to candidate A and 1,400 to B, whereas the minority can cast a maximum of 1,000 votes for their candidate C. In this case A and B, the nominees of the majority, will be elected. Similarly, the majority will be able to elect their candidates in the second category of directors in the next elections, which may be held after a certain period. So, it is necessary that a system that provides the CVS must prohibit staggered board structures.

Another safeguard that would protect the effectiveness of the CVS is that the representative of minority shareholders must have some protection against abuse of majority power. Therefore, the removal of a director must be made difficult, otherwise the majority can remove a minority director at their whim. It is, therefore, important to provide protection against the removal of a director where the CVS is adopted.

2.11 Conclusion

This chapter discussed the nature and objectives of corporate governance in general and in Pakistan in particular. The presence of different cultural, social, political and religious norms influences the evolution of different corporate governance structures around the world. In Pakistan the ownership structure is highly concentrated, with families and the state controlling the corporate sector. Although the corporate law of Pakistan is British-based, the ownership structure in Pakistan is significantly different. Historically, cultural and political reasons led to a concentrated ownership structure in Pakistan.

The objective of corporate governance may be better financial performance, accountability and the safeguarding of the interests of all the stakeholders. Different theories have emerged, each emphasising the prevalence of the interest of one stakeholder over others. No doubt, managers should focus on the success of the company as a whole, as per the entity maximization and sustainability theory, but the fact that the shareholders benefit more from the success of the company and also suffer more in cases of the failure of the company suggests that they can be the best monitors of the company. Therefore, the shareholders may be given more accountability powers to monitor the activities of management so that they may act in the best interests of the company. This may lead to good corporate governance and better financial performance. In the context of Pakistan the shareholder primacy theory is more relevant than any other theory. As the corporate sector is highly concentrated and dominated by families and the state, it is therefore necessary to give more accountability powers to the minority shareholders in the form of rights and their protection.

In addition, the underdeveloped market, corruption, out-dated laws, an inefficient judiciary, and a weak regulator and enforcement mechanisms are the major problems in Pakistan. These issues do not allow the development of confidence among investors and the corporate sector is therefore highly concentrated with an underdeveloped capital market. They remain major problems that need to be addressed. These issues are discussed in the chapters that follow.

CHAPTER THREE: CONVERGENCE THEORY AND ITS APPLICATION IN PAKISTAN

3.1 Introduction

Chapter Two discussed the nature and objectives of corporate governance. The intention was to highlight the problems of corporate governance in Pakistan. Chapter Three discusses the mechanisms of adaptation and convergence which may help to suggest reform measures for improving corporate governance in Pakistan.

In the recent era of globalization the features of corporate governance are being transplanted from more developed to less developed jurisdictions after being adapted to local conditions. This phenomenon has fostered the merging of different corporate governance systems around the world. This chapter is dedicated to examining the process and prospects of transplantation, and convergence in corporate governance (hereinafter *convergence theory*).

Convergence in corporate governance in Pakistan gained some momentum in the late twentieth and early twenty-first centuries when there was an economic meltdown in the context of the global recession and world economic sanctions following India's and Pakistan's nuclear testing in 1998. During this economic distress some factors were indigenous, while others were exogenous. The global recession, world security issues and war against terrorism after the 9/11 attack on the US were exogenous factors, whereas bad political, economic and corporate governance, and weak enforcement mechanisms were indigenous factors in this economic climate. Global competition, efficiency, international organizations, international investors and foreign listings were involved in improving corporate governance in Pakistan. Consequently, the process of law-making and standard setting took place in Pakistan. The introduction of a code of corporate governance was a major initiative in this process. However, these reforms were not enough to improve corporate governance and economic efficiency in the country.

The objective of this chapter is to analyse the prospects, possibility and effectiveness of convergence in order to improve corporate governance in Pakistan. To this end, the discussion in this chapter is limited to an overview of some general issues in corporate governance in Pakistan while others issues that require more comprehensive discussion have been left for detailed analysis in later chapters.

3.2 Convergence theory

The term *convergence* has been used, applied and conceptualized by different writers in different ways. Some define it as 'a process which develops over time'.[1] Others consider it 'as an ideal which nations and firms are moving towards or away from'.[2] Convergence in corporate governance started long ago and is still in progress.[3] The first example in this regard may be quoted as convergence in features of corporate personality. The historical development of corporations shows that this phenomenon of convergence can be traced back centuries. With some exceptions,[4] the corporate form, which developed with the passage of time, has gained consensus as regards its characteristics. The model form of the company has five basic characteristics: (1) legal personality, (2) limited liability, (3) transferable shares, (4) centralized management with board structure and (5) investor ownership.[5] These characteristics have converged over time. Similarly, convergence in codes of corporate governance around the world may be quoted as a recent example.

In the context of globalization convergence in corporate governance has been fostered where features of one system are transplanted to another. However, convergence in corporate governance is possible when a feature of one system is detachable and capable of transfer from one system to another.[6] If a feature is not detachable, then adoption may create problems. One option may be a wholesale convergence but this may be counterproductive in case of lacunae in the host system. If institutions are not meant for foreign, transplanted laws, then misfit transplantation may be problematic.[7] Legal

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[1] Mathias M. Siems, *Convergence in Shareholder Law* (Cambridge University Press, Cambridge 2008) 17.
[2] Abdul A. Rasheed and Toru Yoshikawa, *The Convergence of Corporate Governance: Promise and Prospects* (Palgrave Macmillan, Basingstoke 2012) 3.
[3] Siems (n 1) 17.
[4] There may be some jurisdictions where the corporate form may not have all five these characteristics; for example, in Chinese corporate law the legal personality is a different concept from that understood in the West. Under Chinese company law a company does not have complete legal personality in the sense that it requires a natural person who acts as 'legal representative of the company and bears greater liability than other directors of the company'. Similarly, a company cannot own state assets. For this, see Iain MacNeil, 'Adaptation and Convergence in Corporate Governance: The Case of Chinese Listed Companies' (2002) 2(2) *Journal of Corporate Law Studies* 302.
[5] R. Kraakman *et al.*, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2nd edn, Oxford University Press, Oxford 2009) 5.
[6] William W. Bratton and Joseph A. McCahery, 'Comparative Corporate Governance and the Theory of the Firm: The Case against Global Cross Reference' (1999) 38 *Columbia Journal of Transnational Law* 213-97.
[7] Katharina Pistor, Martin Raiser and Stanislaw Gelfer, 'Law and Finance in Transition Economies' (2000) 8 (2) *Economics of Transition* 356 and Themistokles Lazarides and Evaggelos Drimpetas, 'Corporate

transplantation from a country with a similar legal heritage[8] or that has a similar ownership structure may be beneficial. For instance, if a concentrated ownership system borrows laws from a system that is meant for dispersed ownership,[9] this may not be an effective transplantation. If the system is alien to the transplanted feature, then there may be enforcement problems. Therefore, for effective convergence, the feature of corporate governance of home jurisdiction should be detachable and adapted to the recipient system. If there is wholesale convergence of corporate governance, then legal, regulatory, judicial and all other supporting institutions should be adapted according to the home jurisdiction governance mechanism. This may be a costly process, and political, institutional, cultural, ideological and religious factors may also create barriers in this convergence.[10] Therefore, partial convergence is more feasible and more likely than wholesale convergence. Partial convergence is already taking place, at least at the codes of corporate governance level.[11]

3.3 Kinds of convergence

Gilson describes three forms of convergence that may take place in corporate governance. According to him, formal convergence is change in the legal framework.[12] Harmonization in company and securities laws in the European Union (EU) through various directives from the European Commission is an example of formal convergence at a broader level. Transformation of transition economies from socialist economies to capitalist economies (e.g., Poland and the Czech Republic), and Communist China's transformation to mixed socialism and capitalism are examples of formal convergence at country level. However, at individual country level there are plenty of examples where some rules are changed and converged to other jurisdictions. According to Gilson, formal convergence will require political support and a legislative process that may not be feasible for a number of reasons. Firstly, resistance may be very strong to changing the existing structure. Secondly, the cost of change may be very high. Different interest groups may be politically strong enough to resist formal convergence as the *status quo* may benefit them. Gilson argues that functional convergence occurs where formal legal change is not possible and the

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Governance Regulatory Convergence: a Remedy for the Wrong Problem' (2010) 52 (3) *International Journal of Law and Management* 188-9.

8 D. Berkowitz, Katharina Pistor and J. F. Richard, 'Economic Development, Legality, and the Transplant Effect' (2003) 47 *European Economic Review* 192.

9 See text to n 44-7.

10 These factors will be discussed as 'forces that compel divergence' at 3.5.

11 Ruth V. Aguilera and Alvaro Ceurvo-Cazurra, 'Codes of Good Governance Worldwide: What is the Trigger?' (2004) 25 (3) *Organisation Studies* 417.

12 Ronald J. Gilson, 'Globalising Corporate Governance: Convergence of Form or Function' (2001) 49 (2) *The American Journal of Comparative Law* 356-7.

system is flexible enough to respond to changed circumstances.[13] In functional convergence, the legal framework is not changed but the governance mechanism functions differently. For example, the UK Corporate Governance Code is an example of this functional convergence. In this case there is no change in the legal framework but the firms function differently. The code is appended to, but does not form part of, listing rules. The code is subject to the 'comply or explain' principle. Companies are asked to comply or otherwise explain non-compliance. The code operates through market discipline where non-compliant companies have to suffer a share price decrease and increased cost of capital. However, MacNeil has observed that the possibility of formal convergence accompanied by functional diversity exists.[14] This means that there may be a formal change in the legal framework, not necessarily a wholesale change, but the recipient system operates differently from the system from where the rules have been borrowed; for example, in China, there is formal convergence in corporate governance but it operates differently from that in the West.

According to Gilson, contractual convergence may take place on an *ad hoc* basis in those circumstances where an existing governance mechanism lacks the flexibility to adapt to new circumstances without formal change, and a political barrier restricts the capacity to make formal legal institutional changes;[15] for example, a company may contract with investors to incorporate certain provisions in their articles of association to safeguard the interests of the investors to their satisfaction. Secondly, contractual convergence may also occur, for example, through security design. In this case special provisions may be made in the articles of association to issue shares to specific investors with special voting rights or preference in dividends. Thirdly, it may occur when a company enlists its securities overseas. In this case the company has to follow the rules and regulations of the overseas stock exchange. Fourthly, contractual convergence may occur when a company changes its seat of incorporation. In this case the company has to follow the rules of foreign incorporation with assets and functioning at domestic jurisdiction. Individual firms may borrow these provisions or practices from other jurisdictions and they may incorporate them into their articles of association. This will show convergence on the basis of contract. It will take the form of an *ad hoc* arrangement by the individual firms without the involvement of political forces to make any formal or functional change in the regulatory framework.

[13] Gilson (n 12) 356-7.
[14] MacNeil (n 4) 340.
[15] Gilson (n 12) 356-7.

Contractual convergence is, in fact, a subset of functional convergence. Contractual convergence changes the functions of companies without changing their formal legal and regulatory structure. Contractual convergence is converted into functional convergence as soon as companies start functioning but contractual convergence is limited at firm level, whereas functional convergence operates in the whole jurisdiction. The issue with contractual convergence may be the problem of enforcement; for instance, if a company changes its articles of association through a contract and a dispute arises, there may be a problem with the settlement of the issue and enforcement of the contract. The judiciary may not be acquainted with this problem and may, therefore, not be in position to interpret the rules and to solve the problem. Furthermore, the regulator may not be familiar with the kinds of problems that may arise due to contractual or functional convergence. This means that contractual convergence may be problematic for those countries where the judiciary is inefficient.

Khanna *et al*. have discussed other forms of convergence such as *de jure* and *de facto* convergence. [16] *De jure* convergence occurs where two countries adopt similar rules. If these countries implement the rules in a similar way in practice, then this will be *de facto* convergence. However, if they do not implement in the same way in practice, then this is decoupling or formal convergence with functional diversity;[17] for example, Pakistan and the UK have both introduced codes of best practice in their jurisdictions. This is *de jure* convergence. The code in the UK is introduced on a self-regulatory basis and is enforced through market discipline. However, the code in Pakistan is part of listing regulations and is enforced through the regulator. Therefore, implementation and the functioning of the codes in both jurisdictions are different. This is decoupling or formal convergence with functional diversity. Had the codes in both countries been implemented on a self-regulatory basis, then this would have been *de facto* convergence.

3.4 Factors that compel convergence

Globalization has been the main stimulant for convergence in corporate governance in recent years. In economic terms, globalisation may refer to integration of economies around the world through trade, transplantation of governance norms and financial flows. Until 1980, market forces operated within national borders but technological advancement

[16] Tarun Khanna *et al*., 'Globalisation and Similarities in Corporate Governance: A Cross-Country Analysis (2006) 88 (1) *The Review of Economics and Statistics* 71; Rasheed and Yoshikawa (n 2) 3.
[17] MacNeil (n 4) 340.

has made it easier for these forces to operate beyond their national borders.[18] To attract more trade and investment from overseas investors, and as a result of interdependence of economies and common financial interests the jurisdictions are merging in governance norms. This phenomenon has facilitated transplantation of governance norms of more developed countries to less developed countries.

In this era of globalization, jurisdictions are converging in corporate governance as a result of three main pressures: (1) mimetic, (2) normative and (3) coercive pressures. In the mimetic process a jurisdiction may copy a successful feature of corporate governance from some other jurisdiction without performance implication in order to improve the firms' legitimacy in the eyes of the firms' stakeholders. However, this may lead to inefficiency. Normative pressure is when jurisdictions are forced to improve investors' protection, disclosure and accounting standards. Coercive pressure is generated when a company lists its securities overseas. Companies who list overseas are required to comply with listing regulations. This requirement forces them to conform to the listing rules of the host country's stock exchange.[19]

Globalization has fostered capital market integration through a number of means such as overseas listings; overseas initial public offerings (IPOs); overseas mergers and acquisitions; overseas venture capital financing; issuance of overseas bonds and debt securities; and overseas investment. In the past this phenomenon was not possible for a number of reasons such as regulatory barriers. However, capital markets have integrated, to some extent, in the present global order.[20] Overseas listing to raise capital from overseas stock exchanges has become the norm. The companies may raise finance by issuing shares, bonds or other debt securities. Therefore, convergence takes place in order to fulfil the requirements of an overseas stock exchange on which a firm intends to list or from which it intends to raise capital. In mergers and acquisition, the acquirer may keep some of the governance practices of the acquired company and continue with the practices of the acquirer country's jurisdiction. In cases of investment in shares, the foreign investor, especially institutional investors, pressurize the country to improve its governance practices. Therefore, the country has to improve the governance structure to

[18] IMF, 'Globalisation: Threat or Opportunity? (2002) IMF Research Paper available online at <http://www.imf.org/external/np/exr/ib/2000/041200to.htm> Accessed 20.05.2014.
[19] Rasheed and Yoshikawa (n 2) 6.
[20] *Ibid*.

the satisfaction of these investors.[21] Major jurisdictions[22] have converged in corporate law due to cross-border investments.[23]

The recent past has also seen a proliferation of codes of corporate governance in many countries due to globalization. Different countries have developed codes of corporate governance based on codes issued by developed countries and modelled largely on the OECD principles of corporate governance.[24]

Globalization of capital markets has been the major factor in forcing different underdeveloped and developing jurisdictions to converge to advanced jurisdictions.[25] Convergence of national legal systems may also be attributed, to some extent, to economic and political affiliations and interdependency.[26] The economies of different countries have become interdependent in the global world. The economic failure of one country may affect the economy of other countries. In recent years there were examples of the possible economic failure of countries for which other countries have provided bailout packages; for example, Abu Dhabi provided a substantial amount of money in the form of a bailout package to Dubai; the EU and the IMF to Greece; and the IMF, the Asian Development Bank (ADB) and the World Bank (WB) to Pakistan on a number of occasions. This interdependence also motivates the WB, ADB and IMF to exert pressures on recipients of loans to improve their corporate governance practices, which led the convergence to good practices and corporate governance of advanced jurisdictions.[27]

Integration of product markets is also considered a driving force for convergence in corporate governance. Countries endeavour to attract foreign firms to invest in their countries and operate in their product market. This forces countries to offer attractive

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[21] *Ibid* 6-8.
[22] R. Kraakman *et al*. discussed six jurisdictions: (1) the UK, (2) the US, (3) France, (4) Germany, (5) Japan and (6) Italy in their book *The Anatomy of Corporate Law: A Comparative and Functional Approach* (1st and 2nd edn, Oxford University Press, Oxford 2004, 2009).
[23] R. Kraakman *et al*., *The Anatomy of Corporate Law: A Comparative and Functional Approach* (1st edn, Oxford University Press, Oxford 2004) 218.
[24] Roman Tomasic and Zinian Zhang, 'From Global Convergence in China's Enterprise Bankruptcy Law 2006 to Divergent Implementation: Corporate Reorganisation in China' (2012) 12 (2) *Journal of Corporate Law Studies 2*95.
[25] Mathew Tsamenyi and Shahzad Uddin, 'Introduction to Corporate Governance in Less Developed and Emerging Economies' in Mathew Tsamenyi and Shahzad Uddin (eds), *Research in Accounting in Emerging Economies: Corporate Governance in Less Developed and Emerging Economies* (Volume 8, Emerald Group Publishing Limited, Bingley 2008).
[26] Siems (n 1) 1.
[27] Imtiaz Ahmed Khan, 'The Role of International Organisations in Promoting Corporate Governance of Developing Countries: A Case Study of Pakistan' (2012) 23 (7) *International Company and Commercial Law Review* 223-33.

packages and the best regulatory framework. Other competing countries mimic this in order to attract foreign investment, which leads to convergence in rules and regulations.[28]

Furthermore, harmonization of accounting rules has fostered convergence. This phenomenon is also influenced by globalization. In the past companies of different countries had to follow their own accounting standards, and foreign investors or issuers had difficulty in understanding disclosure from the accounting practices of the host country. This was one of the barriers to foreign investment. Globalization has forced countries to adopt similar accounting and disclosure standards. The harmonization of these standards by international standards committees has led to increased overseas investment and convergence, at least, in accounting and disclosure standards across the globe.[29]

Efficiency is another important factor in the evolution of corporate governance structures. Corporate governance is like a product market where competition is the main driving force. In this competition, companies are forced to adopt the most efficient structure in order to compete with rival companies in production by reducing cost, otherwise they will suffer as a result of the competition. In similar fashion, companies are forced to adopt an efficient governance structure, otherwise they will fail in the competition. This efficiency consideration is the main stimulant for convergence to corporate governance structure.[30]

Colonization also remained an important factor for convergence of national legal systems to colonial nations. For instance, Pakistan's legal system is based on the British legal system introduced during colonial time and converged in most of the corporate governance features. It is an easy task for host nations to converge to a system on which their system is based. This transplantation may provide compatibility with the guest corporate governance feature. Convergence can take place more easily in such circumstances. This process is still in progress and, to some extent, has forced convergence for colonial nations such as Pakistan.

[28] Rasheed and Yoshikawa (n 2) 8.
[29] *Ibid* 10.
[30] Frank H. Easterbrook and Daniel R. Fisher, *The Economic Structure of Corporate Law* (Harvard University Press, Cambridge Massachusetts 1991) 4-8.

3.5 Factors that compel divergence

Although efficiency and globalization are strong factors that are pushing convergence, they may not always be driving forces.[31] Jurisdictions may converge even to an inefficient governance system; for instance, integration of European markets may lead to an inefficient convergence of corporate governance due to the presence of different cultural and governance mechanisms. A misfit foreign governance feature may produce inefficiency of the whole system.[32] Although major jurisdictions have converged over most of the features of corporate governance despite the fact that these features are fundamentally of a different nature,[33] there are still some features where there is divergence in these jurisdictions. This may partially be attributed to path dependencies, and differences in culture, ideology and politics.[34] These factors cause divergence of different systems. This divergence still exists in the world despite efforts at global level. For instance, the EU's efforts to converge and harmonize in corporate governance within the union have not obtained an optimum level and the future is uncertain, especially after the recent debt crisis in Europe. Similarly, in the UK, the laws of England and Scotland have different characters despite long-term union.[35]

3.5.1 Path dependency

The extent to which different systems of corporate governance have developed and the extent to which they persist despite the fact that alternative efficient governance is available can be attributed in some respects to the path dependency theory. Path dependency is a pre-existing condition that directs later developments in a particular direction. This does not allow deviation and tries to preserve the *status quo*. Put another way, in every system there are certain characteristics that limit its ability to develop and to converge to other systems.[36] Path dependency is a major force that shapes a particular

[31] Franklin A. Gevurtz, 'The Globalisation of Corporate Law: The End of History or a Never-Ending Story? (2011) 86 *Washington Law Review* 520.
[32] Reinhard H. Schmidt and Gerald Spindler, 'Path Dependency, Corporate Governance and Complementarity' (2002) 5 (3) *International Finance* 312.
[33] R. Kraakman *et al*. (n 5) 82-6.
[34] Amir N. Licht, 'The Mother of All Path Dependencies, Towards a Cross-Cultural Theory of Corporate Governance Systems' (2001) 26 *Delaware Journal of Corporate Law* 147; Lucian A. Bebchuk and Mark J. Roe, 'A Theory of Path Dependence in Corporate Ownership and Governance' (1999) 52 *Stanford Law Review* 168-70.
[35] Tomasic and Zhang (n 24) 296.
[36] Licht (n 34) 147.

governance structure and resists any change.[37] It impedes, or at least limits, the process of convergence even if other systems are efficient. Roe argues that the current circumstances of a governance structure in a particular country are partly dependent upon pre-existing circumstances that drive it in a particular way.[38] He explains the effect of path dependency on the establishment of a governance structure. According to him, the initial ownership structure affects the development of the subsequent ownership structure. The initial ownership structure also influences the development of rules of corporate laws that determine a particular path, which determine subsequent governance structures.[39] Similarly, Coffee argues that the initial starting point is important in corporate governance and this determines subsequent developments. [40] The initial starting point might have been established by historical accident or political compromise irrespective of the efficiency consideration;[41] for example, co-determination in Germany, lifetime employment in Japan[42] and dispersed ownership structure in US[43] are all determined by political considerations, irrespective of efficiency considerations. Path dependency determines a particular path from which it is not easy to divert. This may limit prospects for global convergence to a single system of corporate governance.[44]

Roe classifies path dependency into three categories: (1) weak, (2) semi-strong or (3) strong. These categories may resist the convergence process accordingly. Weak path dependency may resist it less and can converge easily to several efficient possibilities. In the case of semi-strong path dependency, it is still possible to converge but the cost of change may be unwise. In the case of strong path dependency, change may be difficult as society might have become stuck due to the lock-in effects arising out of path dependency.[45]

In the context of Pakistan there could be two major sources of path dependency. First, the sources of path dependency are the families and interest groups who are dominant in the country. They may resist reforms that may restrict their opportunities of private benefits of

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[37] Bebchuk and Roe (n 34) 168-70.
[38] Mark J. Roe, 'Chaos and Evolution in Law and Economics' (1996) 109 *Harvard Law Review* 641.
[39] Bebchuk and Roe (n 34) 168-70.
[40] John C. Coffee, Jr, 'The Future as History: The Prospects for Global Convergence in Corporate Governance and its Implications' (1999) 93 *Northwestern University Law Review* 660-1.
[41] Roe (n 38) 668.
[42] Coffee, Jr (n 40) 660-1.
[43] Mark J. Roe, 'A Political Theory of American Corporate Finance' (1991) 91 (1) *Columbia Law Review* 65-7.
[44] Coffee, Jr (n 40) 660-1.
[45] Roe (n 38) 667.

control. Second, the sources of path dependency may be political forces. The state is the second largest stakeholder in the corporate sector after families. The political forces may act as a barrier to reforms as this may limit their prospects of enjoying the benefits of control which they may acquire after coming into power and controlling state shareholding in SOEs. These families and politicians have close links. The families in Pakistan are directly involved in state politics or have substantial influence in politics. They finance different political parties so that they may act in their interests. This situation may make one sceptical about imminent and radical reforms in the country. However, competition, economic efficiency and global pressures through international financial institutions may be strong forces that may compel convergence to international norms and thereby act as stimulant in reforming the corporate sector of Pakistan. This process may be successful if reforms are made piecemeal, systematic and through a pragmatic approach.

3.5.2 Complementarities

Efficiency may be a driving force to compel convergence in corporate governance but it is not always possible to transplant features of a system into another system that has a fundamentally different nature. A feature of corporate governance that is efficient in one place may not be efficient in another. Corporate governance features can work efficiently in host jurisdictions only when other complementary institutions and practices are compatible with the new feature;[46] for example, the corporate governance feature of market discipline that operates through a takeover code may be efficient in dispersed ownership structures with developed and liquid markets. Under this market discipline, if a company is not performing, successful bidders may take control of the company and remove non-performing incumbent managers. For the takeover code to be effective, a developed and liquid market is necessary. If this takeover code is applied in concentrated ownership structures with an underdeveloped and illiquid market, then this may not even work. Bidders may not be able to get enough shares to control the company and remove managers sponsored and controlled by the controlling shareholders. Convergence can take place when systems are synchronized but mere efficiency may not be enough for convergence. Legal rules transplanted from home jurisdictions cannot work in the same way in host jurisdictions. Transplanted legal rules can work effectively if they are adapted to local conditions or the local conditions are conducive to such transplantation.[47] If

[46] Coffee, Jr (n 40) 659-60.
[47] Berkowitz, Pistor and Richard (n 8) 165.

features of corporate governance cannot be adapted to local conditions, such plantation will not survive even if copied from a well-recognized model.[48] Transplantation can work effectively if transplanted rules or governance features are developed to find solutions to the problems in the host country after they have been adapted to local conditions.[49] Therefore, for effective convergence, it is necessary that the features of one system be adapted according to the nature, values, culture, religion and requirements of the recipient system.

As discussed earlier, an efficient corporate governance feature in one jurisdiction may not be efficient in another that has a different environment and circumstances. This hypothesis is based on the presence of complementarity institutions in every system. '*The* c*omplementarity is an attribute of elements of a given system such as a corporate governance system, a financial system, organizational or production system of a firm or the system that constitutes the strategy of a firm*'.[50] The complementary elements are structured in a system so that they fit together in a way that increases their mutual value and reduces mutual disadvantage or cost. If a feature of corporate governance is not fit for a particular system, then this may not increase efficiency but rather create a problem. Complementary institutions such as the stock market, ownership structure, professional bodies, financial institutions and practices may play a major role in convergence to foreign corporate governance features. Put another way, if existing complementary institutions do not support a particular foreign corporate governance feature, this transplantation may be counterproductive. Bebchuk and Roe argue that in every system there are unique institutions, practices and professional communities that facilitate the efficient working of a particular system as these institutions develop according to the initial ownership structure in that particular system. [51] These complementary institutions determine the subsequent governance structure. Any transplantation of corporate governance feature that is not compatible with existing institutions may not work efficiently; for example, adopting an independent outside board in a crony capitalist system may not be efficient where firm's competitors have a management and board of directors that have close links with politicians and policymakers. Similarly, adopting a takeover code from a developed and liquid market in an underdeveloped and illiquid market may not work efficiently. Complementary institutions may cause barriers to any convergence to a foreign

[48] Coffee, Jr (n 40) 659-60.
[49] Katharina Pistor *et al.*, 'Evolution of Corporate Law and the Transplant Effect: Lessons from Six Countries' (2003) 18 (1) *The World Bank Research Observer* 109.
[50] Schmidt and Spindler (n 32) 318-9.
[51] Bebchuk and Roe (n 34) 168-70.

governance feature. Therefore, for effective transplantation, foreign governance features must be adaptable to the recipient system which is compatible with existing governance institutions.[52]

3.5.3 Politics, private rent seeking and control premium

The extent to which private rent-seeking opportunities and control premium by the managers and controlling shareholders can act as barriers to reform and, consequently, limit the process of convergence is debatable. Coffee argues that opportunities for extracting private benefits and control premium by the managers and controlling shareholders put barriers in the way of convergence as existing inefficient structures may benefit controllers. [53] According to him, the objective of reform is to protect minority shareholders and this may decrease the incentive for control which they enjoy in existing structures and under inefficient rules. They may resist any reforms whose objective is to provide more protection with the connivance of political actors.

In the context of Pakistan families and the state have control in most of the corporate sector. These families are directly involved in politics or have close relations with politicians. The control of these families in ownership and management provide them with opportunities for rent seeking and control premium. They may resist any reform whose objective is to enhance enforcement mechanisms and to provide the minority shareholders with protection. This may reduce their incentive to gain corporate control despite the fact that it may increase their cash-flow rights in the form of dividends. There is a trade-off between an existing structure where they can obtain the benefits of their controlling position, and reforms where they may get enhanced value for their shares as they have more cash-flow rights. Good governance enhances economic efficiency and, consequently, increases firm value. The controlling shareholders may have more benefits in the form of dividends as they have more stakes in the firm. However, the side effect of such reforms may be enhanced accountability, disclosure and an enforcement mechanism, which may decrease their potential to expropriate funds and their incentive to control firms through management and the directors. Politicians are supposed to compete in global competition and to improve economic efficiency in their own countries. Corporate governance is like a product market where competition is a driving force. A firm whose cost of production is

[52] Coffee, Jr (n 40) 659-60.
[53] *Ibid* 654-7.

high compared to that of competing firms may not survive, so too, a firm who chooses the wrong terms, as opposed to those selected by other competing firms.[54] So, any governance mechanism that is less efficient and unable to compete with other mechanisms may be extinguished by competitive forces. In this scenario politicians will be forced to reform even if they have a stake in the corporate arena. Abrupt and radical change in the corporate sector may create unrest among, and an outcry from, interest groups. Systematic and piecemeal reforms may counter this resistance. Once interest groups realize the potential benefits of reforms, they may welcome them.

3.5.4 Difference in culture, ideology and politics

The development of corporate governance systems of a particular country depends upon its political and ideological conditions.[55] The culture and ideology of a country also determine the choice of corporate law and governance mechanism; for instance, in German culture there is trend of codetermination, and American culture resists hierarchy and centralized authority more than in French culture.[56] Pakistan's culture is a family-controlled business structure.

As far as political ideology is concerned, it also influences the determination of a particular governance structure; for instance, a communist system will focus on a state-controlled governance mechanism. A social democracy may empower its employees more than capitalist countries. This has led owners in social democracies to control firms through concentrated ownership.[57] Capitalist countries may focus on general public ownerships which may direct towards a dispersed ownership structure such as in the UK and the US. Coffee says that it is not necessarily only economic self-interest that acts as a barrier to convergence. Rather, national cultural traditions, nationalism and xenophobia may also hinder foreign governance norms; for instance, the French may vote against any law whose objective is to introduce an Anglo-American model without good reason.[58]

Similarly, if the ideology of any country is religion, then religion can also play its role and resist any convergence to a foreign governance feature; for instance, Pakistan is an

[54] Easterbrook and Fisher (n 30) 17.
[55] Mark J. Roe, 'Political Preconditions to Separating Ownership from Corporate Control' (2000) 53 (3) *Stanford Law Review* 603.
[56] Bebchuk and Roe (n 34) 168-70 and Amir N. Licht, Chanan Goldschmidt and Shalom H. Schwartz, 'Culture, Law and Corporate Governance' (2005) 25 *International Review of Law and Economics* 253.
[57] *Ibid*.
[58] Coffee, Jr (n 40) 656.

ideological country where religion may have a role in the governance mechanism. Therefore, religion may play its role in determining the country's governance mechanism.[59] This ideological norm may direct a country in convergence to a particular governance mechanism. If a particular governance feature or whole structure is not compatible with the host culture and its ideology, then this may not converge and even if it is converged it may not be efficient. Therefore, the difference in culture, ideology and politics has an important role to play in corporate governance and may act as barriers to a foreign governance feature.

3.6 Unique convergence in corporate ownership and corporate governance

Globalization and competition are compelling convergence around the world. Ultimately, *prime facie*, features of corporate governance from different countries may merge together, on the basis of efficiency, to form a uniform corporate governance system around the world. However, there is disagreement on unique convergence to corporate governance. There are two rival systems operating in the world: (1) the concentrated ownership structure, which is dominant in continental Europe, Asia and most other parts of the world and (2) the dispersed ownership structure, which is dominant in the US and the UK. Both have merits and demerits.[60] The extent to which convergence may take place, where the one system dominates over another system or, to put it another way, whether one system will converge to another in the sense that one pattern will be followed and another will disappear, is the topic of recent academic debate.[61]

Hansmann and Kraakman predict that the American system of corporate governance based on shareholder value will dominate ultimately because of its worldwide acceptance.[62] However, some writers do not acknowledge this claim: Bebchuk and Roe maintain that there are practical difficulties in the unique convergence of corporate governance towards a single system. [63] Path dependency, and differences in culture, ideology and politics are major hurdles to cross in such convergence. Gilson observes that difference in governance, political institutions and possible response in changed circumstances across

[59] This issue will be discussed in detail in Chapter Six.
[60] See text to n 66-7 in Chapter Two.
[61] Ben Pettet, John Lowry and Arad Reisberg, *Pettet's Company Law: Company Law and Corporate Finance* (4th edn, Pearson Education limited, Harlow 2012) 65.
[62] H. Hansmann and R. Kraakman, 'The End of History for Corporate Law' (2001) 89 *The Georgetown Law Journal* 468.
[63] Lucian A. Bebchuk and Mark J. Roe, 'A Theory of Path Dependence in Corporate Ownership Governance' (1999) 52 *Stanford Law Review* 168-70.

countries and even within the same country may lead to substantial variation in national systems. This may lead to a hybrid form of convergence in corporate governance.[64] Bratton and McCahery believe that the presence of unique institutional and cultural factors operating at the national level limits the process of convergence to foreign governance systems. [65] The features of a national system are tied together in a complex web and it is difficult to separate one from the other. This interdependency limits the process of convergence. Convergence can occur only when the features of one system are detachable and are capable of transfer from one system to another system, and are compatible with the host jurisdiction. Schmidt and Splindler believe that the presence of dynamic corporate governance features around the world makes it less possible that there will be a rapid convergence to a unique and efficient system universally. [66] Path dependency and difference in complementary institutions, for example, the nature of ownership structures, stock markets, judicial systems, the composition of board structures, the role of stakeholders in corporate decisions and the nature of corporate laws (mandatory or enabling) in different systems may cause barriers in any possible convergence even to an efficient single governance system. In their latest work, Hansmann and Kraakman affirm their previous position on the dominance of the standard SSM. [67] They believe that the SSM is more likely to succeed over its rival systems: manager-, labour-, stakeholder- and state-oriented models, and family or unconstrained controlling shareholder models – due to its inherent adaptability to all types of ownership structures. Between these two extreme views some scholars have cautious view and stand in the middle: Coffee argues that two rival systems, namely (1) concentrated ownership and (2) dispersed ownership, will coexist. They are like ‘giant tectonic plates’ that grate, push and even override each other but cause friction whenever they meet. According to him, in the same way the formal convergence of one system to another may create social friction and unrest. The best way to avoid such friction is self-selection and migration by the management of firms through functional convergence.[68] He predicts convergence in securities regulations rather than in corporate laws. The driving forces behind such a convergence in securities regulations may be globalization that has stimulated cross-country investment and raising funds in the

[64] Gilson (n 12) 356-7.
[65] Bratton and McCahery (n 6) 213-97.
[66] Schmidt and Spindler (n 32) 311-2, 321-2.
[67] H. Hansmann and R. Kraakman, ‘Reflections on the End of History for Corporate Law’ in Abdul A. Rasheed and Toru Yoshikawa (eds), *The Convergence of Corporate Governance: Promise and Prospects* (Palgrave Macmillan, Basingstoke 2012).
[68] Coffee used the terminology ‘functional and formal convergence’ (see Coffee, Jr (n 38) 641-708) as opposed to the Gilson model which classified convergence into three kinds: (1) formal, (2) functional and (3) contractual convergence. Gilson also used the terminology ‘hybrid convergence’ as a fourth form of convergence (see Gilson (n 12) 329-357).

form of overseas listing.[69] According to this view, formal unique convergence to one pattern may not be an imminent possibility. Some scholars have put forward the hybridization hypothesis.[70] These scholars believe that economic institutions are not immutable and they are subject to change without complete change in the system. Foreign practices are incorporated in the system through the medium of adaptation so that they can fit into local institutional contexts. This process may lead to hybrid convergence rather than unique convergence to a system. Rasheed and Yoshikawa confirm this hybridization hypothesis. [71] According to them, the recent changes in the world show that most countries are converging, to some extent, to the shareholder model of the US but, at the same time, they are not willing to surrender their existing governance system. The process involves the adoption of certain corporate governance practices with careful adaptation and tailoring to local needs without abandoning most of the existing features of corporate governance. This process led to hybrid convergence.

In the light of the above discussion, unique convergence in corporate governance is less likely in the near future. The features of corporate governance of different systems may converge due to competition, efficiency or globalization. Most probably the partial convergence of corporate governance features may occur. Convergence in corporate governance is an on-going process that may remain incomplete and transitory in nature.[72] Put another way, convergence may occur in a way that a feature of corporate governance of one system converges to another system, possibly on the presumption of being most efficient, and may be discontinued or abolished, and revert to the old system if the feature is not compatible with existing infrastructure or simply fall into oblivion. Alternatively, the system may again converge to the corporate governance feature of some other system. This process may continue indefinitely. This all depends on the quality of adaptation and compatibility of the recipient system to the new feature of corporate governance.

[69] Coffee, Jr (n 40) 704-7.
[70] Steven K. Vogel, 'The Re-organization of the Organized Capital: How the German and Japanese Models are Shaping Their Own Transformation' in K. Yamaura and W. Streek (eds), *The End of Diversity? Prospects for German and Japanese Capitalism* (Ithaca, Cornell University Press, New York 2003) 306-33; Marie- Laure Djelec, *Exporting the American Model: The Post-war Transformation of European Business* (Oxford University Press, Oxford 1998); Jan N. Pieterse, 'Globalisation as Hybridization' (1994) 9 *International Sociology* 161-84.
[71] Rasheed and Yoshikawa (n 2) 27.
[72] Gevurtz (n 31) 475.

3.7 The application of theory in Pakistan

As discussed above, convergence in corporate governance started long ago but this phenomenon has been intensified in the recent past especially after the recent financial crisis and globalisation of capital markets. Historically, convergence in corporate governance in Pakistan started soon after independence in 1947 through the adoption of British based corporate laws and subsequent imitation of these laws in developing its own laws. Pakistan is an underdeveloped but an emerging market which has taken billions of dollars in loans from the IMF, WB and ADB; therefore, the process of convergence intensified in the recent past through pressure from these international financial institutions to reform its corporate sector as condition for loans. This process may also be stimulated through further reforms in the near future due to different factors such as international financial institutions, inter related economies, overseas investment, competition, globalisation and integration of capital markets. At the same time, as discussed above, some factors such as dominant families, groups and the state may resist such reforms. The extent to which these factors compel or resist reforms will be discussed in this part of chapter three and remaining chapters. The objective of this part is to explore the possibility and effectiveness of reforms in order to improve corporate governance in Pakistan with discussion limited to few issues while those issues which require comprehensive discussion are left for the remaining chapters.

3.7.1 Process of law making and standards setting in Pakistan

There was a recession in Pakistan in the late 1990s, following the nuclear explosion on 28 May 1998, post-explosion world sanctions and the global financial crisis. The corporate sector was dominated by families, groups and the state. Bad governance and corruption were common. The weak regulator was unable to perform and reform the corporate sector. The regulator, who was directly under government control, was staffed with employees who were not professionals. Corruption and inefficiency among employees were common. The government was unable to reform the corporate sector. Firstly, the families and groups involved were politically strong enough to resist reform that could restrict their expropriation and exploitation from the prevailing bad governance. Secondly, the government was not economically strong enough to carry out the reforms that were being undertaken in other countries.

During the 1990s the WB and the ADB focused on the support of government in the financial sector in Pakistan. The WB supported the government in the privatization of nationalized banks, whereas the ADB did so in capital market development under the Capital Markets Development Programme (CMDP). The focus of the programme was on establishing an effective regulator for better investor protection and the stock markets.[73]

To the extent that it reformed the regulator, the government established the SECP which appears to be following the US style of regulator.[74] It was given financial and administrative autonomy for the supervision and regulation of the capital market and other corporate entities, and replaced the former Corporate Law Authority (CLA) which was a wholly government owned department. The CLA was attached to the Ministry of Finance and its budget was allocated by the government through its resources. Employee pay was according to an official pay scale which was not attractive to professionals who could command good salaries in the private sector. Most of the officials at the CLA did not have professional qualifications. They were not aware of the technicalities of the corporate sector and they were corrupt as well. The purpose of creating the SECP was to minimize government control, attract professionals from the private sector and to make the SECP a strong regulator with all the administrative, functional and financial autonomy required, and to give it decision-making powers. However, the government still controls the SECP but now this control is indirect, compared to the control exercised by the CLA. Members of the Policy Board,[75] the Commission[76] and the Chairman of the SECP[77] are appointed by the government.

The Government of Pakistan passed the Securities and Exchange Commission of Pakistan Act, 1997 (the SECP Act) which describes the constitution, structure, powers and functions of the SECP. The SECP became functional from 1 January 2000 and many

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[73]Asian Development Bank, ‘Background Paper by the Asian Development Bank Structural Reforms in Legal/Judicial, Agriculture, Capital Markets and Energy Sectors’, Pakistan Development Forum, Paris (April 29–30, 2002), 7–8, available at <http://siteresources.worldbank.org/PAKISTANEXTN/Resources/Pakistan-Devp-Forum-2002/structuralReforms.pdf> Accessed 17.08.2013.

[74] Moeen Cheema and Sikander A. Shah, ‘The Role of Mutual Funds and Non-Banking Financial Companies in Corporate governance in Pakistan’ (2006) *Centre for Management and Economics Research (CMER)* Working Paper Series No. 06-47, Lahore University of Management Sciences.

[75] The Policy Board consists of nine members with five *ex officio* members, including the secretary of finance, law and commerce, deputy governor of the State Bank of Pakistan, and the Chairman of the SECP, and four members from the private sectors appointed by the government. The Policy Board decides the overall policy of SECP.

[76] The commission consists of all the commissioners appointed by the government including the Chairman of the SECP. It is the highest decision-making authority for the day-to-day affairs of the SECP.

[77] The Chairman of the SECP is appointed by the government from among the commissioners.

powers were given to it afterwards. Initially, the role of SECP was limited and included the regulation of the corporate sector and the capital market but with the passage of time its role was enhanced and now its functions include regulating the issues surrounding securities; stock exchanges; market abuse; takeovers; mutual funds; and the supervision and regulation of insurance companies and non-banking finance companies (including investment banks, discount houses and housing finance companies).[78] It also includes the regulation of a specialized type of non-banking finance institution (including *mudarabah*[79] and leasing companies[80]), private pensions, and oversight of external service providers to the corporate and financial sectors (including chartered accountants, credit rating agencies, corporate secretaries, stock exchange brokers and agents, and insurance surveyors).

The purpose of the SECP was to develop fair, efficient and transparent regulatory frameworks based on international legal standards and best practices for the protection of investors, especially minority shareholders and to develop an efficient and dynamic regulatory body that fostered principles of good governance in the corporate sector.[81] However, the reforms were not welcomed by the business community and led to substantial delisting after the issuance of the code in 2002 and revision in 2012. As reforms are meant to provide more protection to the investors, especially the minority shareholders, which limits the possibility of expropriation by the controlling shareholders, they resist such reforms. However, there was pressure on the government to adopt reforms because it was the recipient of loans from international financial institutions.

[78] These powers were delegated on July 1, 2002.
[79] *Mudarabah* will be discussed in Chapter Six.
[80] These powers were delegated on January 1997.
[81] The Securities and Exchange Commission of Pakistan (SECP) website <http://secp.gov.pk/> Accessed 17.08.2013.

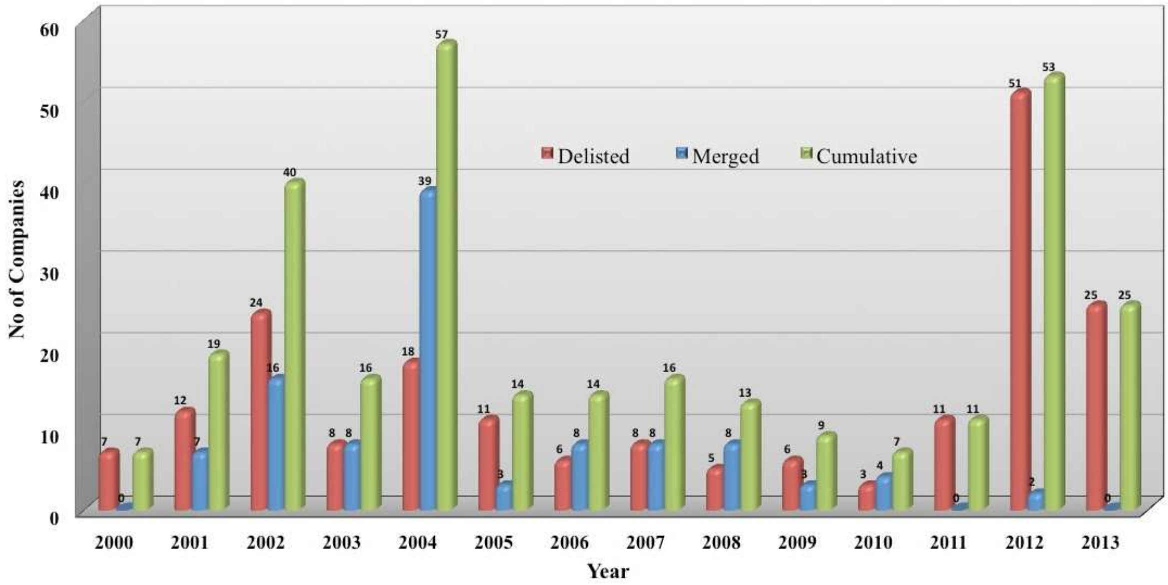

Figure 3.1: Companies delisted and merged during 1999–2013[82]

Table 3.1: Companies delisted on the KSE during 1999–2013

S. No.	Year	Delisted	Merged	Aggregate (delisted + merged)	Total after delisting and mergers
1	1999–2000	7	0	7	754
2	2000–2001	12	7	19	747
3	2001–2002	24	16	40	711
4	2002–2003	8	8	16	701
5	2003–2004	18	39	57	661
6	2004–2005	11	3	14	662
7	2005–2006	6	8	14	658
8	2006–2007	8	8	16	658
9	2007–2008	5	8	13	652
10	2008–2009	6	3	9	651
11	2009–2010	3	4	7	652
12	2010–2011	11	0	11	639
13	2011–2012	51	2	53	590
14	2012-2013	25	0	25	569

Table 3.1 shows that a substantial number of companies delisted during 2002–2004 and 2012-2013. The Code was issued in 2002 and revised in 2012. In 2012 the voluntary provisions of the Code were also converted into mandatory provisions which had more adverse effects than the initial issuance of the Code in 2002.

[82] The data were taken from the Annual Reports of the KSE and the SECP.

After attaining autonomy and independence from direct government influence, the SECP issued many laws, rules and regulations for almost every sector that came under its control. These include, but are not limited to, insider trading, institutional investment, non-banking finance companies, takeovers, insurance, stock exchange regulations, disclosure, brokerage and frequency of directors' meetings. This process converged to many international good practices of corporate governance, especially those of the UK and the US.

As a second step in these reforms, the government disinvested its shareholding in some SOEs and issued its shares to the general public. This persuaded many family-owned companies to raise capital through IPOs, which led to the involvement of the general public in the capital market. Although the market is still dominated by families and the state, this phenomenon highlighted a number of governance issues such as minority shareholder rights, agency problems and enforcement.

The series of reforms attracted the general public to become involved in equity investment in the form of shares. Lack of proper monitoring by the regulators allowed the market players to create a bubble which burst in March 2005. The general public suffered substantial losses. The market crash of 2005 further highlighted the importance of corporate governance in the market. A dearth of research on corporate governance could not provide appropriate policies for the government and policymakers to resolve these issues at an optimum level through reforms.

The following major amendments were made in the corporate law of Pakistan:

i. In 1995 s. 86 of the Ordinance was amended, which limited the pre-emptive rights of the shareholders. A public company was given power to raise capital without issuing rights shares.
ii. In 1999 s. 90 of the Ordinance was amended to allow the company to issue shares with different rights and privileges. The regulator promulgated the Companies (Variation in Rights and Privileges) Rules, 2000. This amendment changed the old common law rule of one share, one vote, and allowed the issuance of shares with enhanced voting rights or without voting rights. It also allowed the issuance of preference shares.

iii. In 2007 a new s. 178A was inserted to allow the acquirer of a listed company having not less than 12.5% voting powers to ask the commission to require a fresh election of directors. This provision was meant to provide the acquirer with an opportunity to put his or her nominee on the board of directors.

iv. In 2002 s. 193 of the Ordinance was amended and the frequency of directors' meeting was increased from twice a year to, at least, quarterly meetings.

v. In 2002 s. 196 of the Ordinance was amended, which increased the powers of directors by allowing them to write off bad debts and to compromise law suits.

vi. In 1999 a new s. 197A was introduced, which prohibited the directors from distributing gifts to the members. This provision was meant to discourage directors from inducing members to vote in favour of their election or to vote for resolutions of their choice or to pass accounts without any objection.

vii. In 2001 s. 204A was inserted to bind the listed companies to employing a company secretary. The company secretary is required to conduct secretarial, administrative and other ordinary duties.[83]

viii. In 2007 a further amendment was made to s. 204A which required listed companies to appoint a share registrar. The objective of this provision was for an independent share registrar to conduct share transfer and transmission in a fair and professional manner. This may be helpful to avoid the fraudulent and bogus transfer and transmission of shares.

ix. In 2007 a new s. 234A was inserted to give members who had 20% or more voting powers the right to ask for a special audit of the listed company.

x. In 1999 s. 236 (2) (f to h) was inserted to enhance the duties of directors. According to these provisions, the directors of public companies are required to mention in directors' report, which should form part of the balance sheet and annual report, the earning per share, reasons for the company's loss in the financial year, a reasonable indication of future prospects of profit, information about defaults in payment of debts and the reasons for these defaults.

xi. Similarly, in 2007 s. 236 (5) and s. 237 were amended so that the directors of holding companies are required to prepare the consolidated financial statements with their subsidiaries and also to make them part of directors' report.

xii. In 2002 s. 245 was amended to enhance the frequency of reports issued by listed companies. Listed companies are required to prepare and transmit quarterly reports to the members and to the regulators.

[83] See s. 2 (33) of the Companies Ordinance 1984 (the Ordinance 1984).

xiii. In 2002 the members were given powers to remove the auditors of the company through special resolution under s. 252 of the Ordinance.

xiv. In 2002 s. 254 (3) (f) of the Ordinance was amended to prohibit auditors of listed companies from holding shares in the audit client or any associated company, and to disclose their interest, if any, held by them before they were appointed. They are required to disinvest within 90 days from the date of their appointment.

These amendments provided some rights to the shareholders but, at the same time, some important rights were limited; for example, the limitations imposed on pre-emptive rights and permission to companies to issue shares with enhanced weighted voting and divided rights. These are important rights that have been curtailed in recent years. Nevertheless, by giving some rights to the minority shareholders the reform process has started. Some basic rights are still missing, such as derivative rights, and some rights are out-dated and require re-examination, such as the unfair prejudice remedy.[84]

A major amendment was made to the securities law relating to insider trading provisions. S. 15A to 15E was inserted in the Securities and Exchange Ordinance, 1969, which enhanced the scope of insider trading. Before this amendment, insider trading was a criminal offence resulting in three years' imprisonment and a fine but now it is only a civil offence with a fine set at a high amount. The objective of this conversion may be twofold. Firstly, criminal offences require strict compliance with the provisions of the law of evidence and the establishment of evidence beyond doubt. Therefore, it gives the benefit of doubt to the culprit and it is sometimes difficult to establish this kind of crime. Secondly, the intended objective may be to convert the power of cognizance from the court to the SECP. Under the law, any provision that provides punishment of imprisonment must be tried by a court and any provision in which the penalty is a fine falls within the jurisdiction of the SECP.

Some judicial powers were transferred from the courts to the SECP through amendments to the Ordinance. Some powers were also transferred through the SECP Act, 1997. The purpose was to dispose of the cases without delay. However, the final disposal power is still with the court because the decisions of the SECP are appealable in the high courts, which did not resolve all the problems.[85]

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[84] These rights will be discussed in Chapter Four, at 4B.

[85] This will be discussed in detail in Chapter Five.

The Central Depository Act, 1997 established the book entry system for the transfer of securities and therefore maintained the electronic version of securities of the companies, which helped to convert the physical shares into electronic forms to make the transaction more transparent. This helped to reduce manipulation by stockbrokers, and to stop unfair movement of the shares and the market. Many listed companies have not yet transferred physical shares into electronic form.

The Listed Companies (Substantial Acquisition of Voting Shares and Takeovers) Ordinance 2002 was passed to regulate substantial acquisitions and takeovers. The Ordinance provides disclosure obligations on the acquirer. This ordinance requires the acquirer to inform the company concerned and the stock exchange when its voting shares exceed 10%.[86] However, when such acquirer intends to enhance its voting shares or control over 25% of the listed company, the acquirer must make a public announcement in this regard.[87] Similarly, when an acquirer, who already holds or controls more than 25% but less than 51% of the shares of a listed company, intends to exceed it, another public offering must be made.[88] These requirements will be beneficial to the extent that it will restrict stealth acquisition of listed companies.

The Securities and Exchange Ordinance 1969 was amended to integrate, corporatize and demutualize stock exchanges in Pakistan. Provision was made in Section 32E of the Ordinance 1969 for stock exchanges in Pakistan to be integrated, corporatized and demutualized by the end of 2006 or a time specified by the SECP but the process has not yet been completed.

3.7.2 Development of a code of corporate governance

Corporate governance has remained the focus of developed countries, especially the US and the UK, since the early 1980s. In recent years, there were global financial crises. These crises triggered the importance of corporate governance reforms all over the world.

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[86] See s. 4 (1) of the Listed Companies (Substantial Acquisition of Voting Shares and Take-overs) Ordinance, 2002.
[87] See s. 5 (1) (a) and (b) of the Listed Companies (Substantial Acquisition of Voting Shares and Take-overs) Ordinance, 2002.
[88] See s. 6 (1) of the Listed Companies (Substantial Acquisition of Voting Shares and Take-overs) Ordinance, 2002.

The 1992 Cadbury Report was the major initiative in corporate governance in the UK.[89] The UK issued its first code based on the Cadbury Committee report on financial aspects of corporate governance in 1992. Since then there have been four new versions of the code which were issued in 1998, 2003, 2008 and 2010. Many developments have come about through reforms around the world which saw laws and regulations being changed through the development of codes of corporate governance in different countries. To improve investors' protection, and to enhance disclosure, accounting standards and the presence of institutional investors in global markets pushed the development of codes of corporate governance in those areas in which legislatures either failed to legislate or were slow in responding to new developments.[90] These codes were developed and diffused around the world more rapidly because they can be introduced through functional changes without the requirement of changing the basic legal framework. Institutional and market pressures were stimulants for development and diffusion of codes around the world. Regulators, stock exchanges, governments, directors associations, managers associations, professional associations, and investors associations were involved in promoting codes of corporate governance around globally.[91]

The reform process started in Pakistan after the international financial crisis. As part of these reforms, the SECP issued the code of corporate governance in 2002. In Pakistan the SECP, in conjunction with the chartered accountants of Pakistan and the Institute of Corporate Governance, started working on forming a code of corporate governance in early 2000. The first code of corporate governance was introduced in March 2002. Globalization, international financial institutions, competition and economic efficiency and the development of codes in both developed and developing countries were the stimulants for the development of the Code. The Code was based on the UK Code of Corporate Governance, the King Report in South Africa and principles of corporate governance published by the OECD.[92] The Code consists of best practices designed to provide a framework through which companies are directed and controlled. The objective was to safeguard the interests of the different stakeholders and to promote confidence in the market. In order to ensure compliance, the focus was on the best practices of common

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[89] Barry Metzger, "International Financial Institutions, Corporate Governance and the Asian Financial Crisis" (2003) Draft Chapter for The Ecology of Corporate Governance: The East Asian Experience <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=382840> Accessed 20.012.2013.
[90] Aguilera and Ceurvo-Cazurra (n 11) 437-9.
[91] Rasheed and Yoshikawa (n 2) 9-10.
[92] *Manual of Code of Corporate Governance* issued by the Securities and Exchange Commission of Pakistan, 1, available at <http://www.secp.gov.pk/IACCD/pub_iaccd/manual-CG.pdf> Accessed 11.02.2013.

law countries, especially those of the UK[93] as the legal framework of Pakistan is based on that of the UK. The focus of the Code was on composition, qualification, the decision-making process and practices of the board of directors. Some provisions, such as the requirement that companies facilitate minority representation on the board and representation of independent directors from institutional investors were voluntary.

As per international practice,[94] after almost ten years had elapsed, the SECP started revising the Code to incorporate further developments and to address shortcomings in previous versions of the Code. It, therefore, issued the draft Code of Corporate Governance for public opinion. The final revised version of the Code was issued in April 2012 with important amendments bearing in mind new developments and requirements since the publication of the first Code. It turned voluntary provisions of the previous code into mandatory provisions.

Wymeersch has discussed the problems experienced with the enforcement of the Code.[95] He argues that market pressures to improve corporate governance were the main driving force behind the introduction of the codes. The codes fill in the gaps left by the state legislature in providing shareholders with rights.[96] Market forces had developed those good practices of corporate governances which had not been foreseen by the legislature.[97] Efficiency considerations are another major force in developing codes of corporate governance around the world.[98] Wymeersch further argues that the degree of acceptance and application of the codes is better documented than many state-imposed regulations.[99] According to him, as market sanctions are the main force for implementing the codes, economic and financial penalty would be more effective. To avoid public law encroachment in the early stages, he emphasizes a stronger enforcement mechanism without abandoning the self-regulatory nature of the Code. He suggests that once these practices are accepted, applied, implemented and effectively enforced, they can be incorporated in the form of public law. Therefore, the nature of the Code has led many

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93 *Ibid*.
94 Major jurisdictions revise their code of corporate governance after a certain period. The objective is to accommodate new developments and needs; for example, the UK issued its first code in 1992 and later on issued revised versions of the code in 2003, 2006, 2008 and 2010.
95 Eddy Wymeersch, 'The Corporate Governance 'Codes of Conduct' Between State and Private Law' (2007) Working Paper Series, WP 2007-07, Financial Law Institute, University Gent, 1, available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1032596> Accessed 20.12.2013.
96 Aguilera and Ceurvo-Cazurra (n 11) 417.
97 Wymeersch (n 95) 1.
98 Aguilera and Ceurvo-Cazurra (n 11) 417.
99 Wymeersch (n 95) 28-9.

jurisdictions to introduce best practices through codes in their country to fill in the gaps in corporate governance. This worldwide acceptance of a code of corporate governance fosters convergence of corporate governance at least at functional level.[100]

In Pakistan, the enforcement of the Code is a major problem.[101] The Code is part of listing regulations but it is not being implemented as part of these regulations. There is no evidence of any action being taken by regulators for non-compliance with the Code. The annual reports of the major companies show that stereotype reporting is included in these reports. The boxes are merely ticked without material observance of the Code. A major problem is that the management is not used to alien governance practices, especially those adopted from developed markets which operate in different circumstances. The UK, which offers strong incentives to enforce, has not yet converted the Code into listing regulations and it is therefore not advisable to make the Code part of listing regulations *ab initio* in Pakistan. Therefore, phased implementation of the Code may be a better idea. It is better to make this voluntary and then, in time, when abiding by the Code becomes the norm it can be made part of listing regulations and even part of company law.

The other problem of enforcement is the penalty mechanism. As the Code is part of listing regulations, any non-compliance with the Code is dealt with under other violations of listing regulations. Compliance with the listing regulations is also not effective as the only penalty for non-compliance is delisting, which is too harsh under the circumstances when there is no substantial non-compliance. The regulator is also not interested in taking action in the form of delisting in the case of non-compliance. Firstly, there are already only a few companies listed on the stock exchange and delisting will further reduce the number. Secondly, many companies were listed on stock exchanges just to obtain certain benefits, for instance, tax incentives or to comply with business licensing requirements. Thirdly, delisting affects the shareholders who are not involved in non-compliance. Enforcement can be effective if there are other penalties besides delisting for non-compliance, for instance, a fine imposed on the management for non-compliance. The penalty should be commensurate with the quantum of non-compliance. This would at least ensure

[100] Aguilera and Ceurvo-Cazurra (n 11) 417.
[101] Rasul B. Rais and Asif Saeed, "Regulatory Impact Assessment of SECP's Corporate Governance Code in Pakistan" Lahore University of Management Sciences (LUMS) Paper Series, *CMER Working Paper No. 05-39 (2005)* at 13-14; Mahwesh Mumtaz, 'Corporate Governance in Pakistan-Adopt or Adapt? Paper presented at a conference in Lahore on 3-4 June 2005 organised by the Securities and Exchange Commission of Pakistan and Lahore University of Management Sciences, Lahore.

compliance with the listing regulations. As to the Code, it should not be made part of listing regulations in the early stages of reform.

3.7.3 International corporate interaction with Pakistan: An inward focus

A recent phenomenon of globalization has seen corporate interaction between countries. This process pushes countries to improve their corporate governance and this, in turn, stimulates the importation of foreign good practices and thereby convergence of different corporate governance features. Foreign investors and international financial institutions have been the main actors in this process, especially in the context of underdeveloped and emerging markets such as Pakistan.

3.7.3.1 The role of international financial institutions in Pakistan

In the recent past there have been financial crises all over the world primarily due to the failure of appropriate monitoring. There were corporate scandals even in major jurisdictions, including the UK and the US. Recent years have seen high-profile financial scandals and corporate failures such as WorldCom and Enron in the US, Maxwell in the UK, Parmalat in Italy,[102] Satyam in India[103] and the Taj company scandal in Pakistan.[104] These scandals triggered the importance of corporate governance reforms all over the world.

Crises in Asia and Russia in 1997 were a huge global trigger for international organizations to create minimum standards for corporate governance.[105] The focus of financial institutions was on the developing countries due to weakness in their corporate sector. Developing countries such as Pakistan have been the main recipients of loans and they have, therefore, introduced a series of reforms in Pakistan.

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[102] Musa Mangena and Venancio Tauringana, 'Disclosure, Corporate Governance and Foreign Share Ownership on the Zimbabwe Stock Exchange' (2007) 18 (2) *Journal of International Financial Management and Accounting* 53, 65.
[103] Ruchita Daga and Bimitrios N. Koufopoulos, 'Disclosure and Corporate Governance in Developing Countries: Evidence from India' (2010) Working Paper, 19 June 2010 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1627186> Accessed 20.12.2013.
[104] Manual of Code (n 92) 4.
[105] Alan Dignam, 'Exporting Corporate Governance: U.K. Regulatory Systems in a Global Economy' (2000) 21 *Company Lawyer* 75.

Corporate governance failure was considered a major reason for these crises as identified by the WB and the IMF, and therefore these institutions tried to prescribe a minimum standard for their assessment criteria and for this purpose they looked to the OECD for the formulation of minimum standards.[106]

In developing countries the focus of corporate governance is a recent phenomenon, especially after the financial crisis in Asia in 1997–8 and after the involvement of financial institutions such as the IMF, the WB and the ADB in bailing out countries from the crisis through huge loans and through conditions of corporate governance reform as part of the programme. One of the factors that caused these crises was deficiencies in corporate governance and it was the first time the importance of corporate governance was realized. Before it was only regarded as a policy issue.[107] The recession in some Asian countries was blamed partly on weak corporate structures.[108] It was, therefore, necessary to improve the corporate governance structure of particular countries. This attracted the attention of international financial institutions and they exerted their influence to improve corporate governance structures.

The flow of international capital for economic restructuring in developing countries by international financial institutions, the WB and IMF has highlighted the importance of transparency and disclosure which are core in corporate governance. Corporate governance was not given much importance in developing countries for a long time as compared to developed countries.[109] These institutions undertook a series of reforms in developing countries. They provided assistance in the form of loans and technical help, and set standards that formed part of the conditions of the loans.

A recession, bad governance and economic meltdown during 1990s were stimulants for international financial institutions to focus on Pakistan as these institutions had advanced billions of dollars in the form of loans to Pakistan. The economic failure of Pakistan was significant for these institutions as these loans might become bad debts that could never be recovered. In Pakistan, the WB and the ADB focused on the support of government in the banking, finance and corporate sectors. The WB supported the government of Pakistan with the privatization of nationalized banks, whereas the ADB supported capital market

[106] *Ibid* 70, 75.
[107] Metzger (n 89).
[108] Robert W. McGee, "Corporate Governance in Asia: A Comparative Study" (2008) Working Paper <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1078224> Accessed 20.12.2013.
[109] Daga and Koufopoulos (n 103).

development under the CMDP. The focus of the programme was the establishment of an effective regulator for better investor protection and the stock markets.[110]

The ADB was the major contributor in the form of a series of loans for corporate governance development in Pakistan. The main focus of the bank was on restructuring the apex regulator of the corporate sector. The ADB gave Pakistan a US$250 million loan under the CMDP in November 1997. The loan covered different aspects of capital development, including strengthening of securities market governance, institution, regulation and supervision. Besides this, the ADB provided a technical assistance (TA) loan of US$5 million for capacity building of the securities market in Pakistan.[111] The ADB extended a US$600,000 TA grant on 7 August 2001. This was in addition to an earlier loan of US$250 million at the request of the Government of Pakistan. The objective of this TA grant was to extend the capital market reform processed earlier, enhancement of corporate governance standards, the creation of international best practices and capacity building.[112]

In August 2002 the ADB approved a loan of US$260 million for Pakistan titled 'Pakistan: Financial (Nonbank) Markets and Governance Program (FMGP); Strengthening Pension, Insurance and Savings Systems; Strengthening Regulation, Enforcement, and Governance of Nonbank Financial Markets'. The focus of this project loan was on improving corporate governance standards, transparency in disclosure, and enforcement for market participants and governance of the SECP.[113]

In July 2007 the ADB granted Pakistan a loan of US$400 million with a TA grant of US$1 million titled 'Second Generation of Capital Market Reform Program'. The focus of this programme was on the development of institutional investors with the objective of long-term capital formation, improved efficiency of securities market to increase the supply of corporate securities, and strengthening the governance of the capital market to

[110] Asian Development Bank (n 73) 7-8.
[111] Asian Development Bank, 'Evaluation on the Capital Market Development Program Loan in Pakistan', <http://www.adb.org/Documents/PPERs/PAK/31108-PAK-PPER.asp> Accessed 17.08.2013.
[112] Asian Development Bank, "Technical Assistance to the Islamic Republic of Pakistan for Capacity Building for Capital Market Development and Corporate governance", <http://www.adb.org/Documents/TARs/PAK/R123-01.pdf > Accessed 17.08.2013.
[113] Asian Development Bank, 'Pakistan: Financial (Nonbank) Markets and Governance Program; Strengthening Pension, Insurance and Savings Systems; Strengthening Regulation, Enforcement, and Governance of Nonbank Financial Markets', <http://www.adb.org/Documents/PCRs/PAK/33271-PAK-PCR.pdf> Accessed 17.08.2013.

improve transparency and investors' protection.[114] The SECP promulgated different rules and regulations for the registration, formation, licensing and functioning of institutional investors in Pakistan. As a first step, it amended the Companies Ordinance, 1984 to empower the SECP to incorporate non-banking finance companies (NBFCs) and to regulate them.[115] The State Bank of Pakistan was used to regulate the NBFCs before this amendment and promulgation of rules. The SECP introduced rules[116] for the establishment and regulation of NBFCs, and then issued regulations in 2007[117] which were replaced with the regulations of 2008[118] to regulate institutional investors, *inter alia*,[119] collective investment schemes.[120] Collective investment schemes include both closed end scheme (CESs) and open end schemes (OESs). According to these regulations, a *closed end fund* means an investment company or a CES. An investment company is similar to any other trading company with its shares traded on the stock market, and individual investors can purchase and sell their shares in the secondary market. The objects of these companies are to invest their funds in the securities of other companies. The investment company must be registered as a notified entity[121] before public subscription under the regulations. These companies have to comply with regulations that provide certain restrictions with regard to operations, functions, structures and investment decisions by these investment companies. An asset management company (AMC)[122] is appointed by an investment company with the approval of the regulator to manage itself. A custodian[123] other than an AMC and an investment adviser are appointed by the investment company with the approval of the regulator for the custody of all assets held and owned by it. To avoid conflict of interest, the custodian, AMC and investment company must be independent.[124] These are given tax exemptions under the Income Tax Ordinance 2001. This favours the investors because it

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[114] Asian Development Bank, 'Proposed Program Loan and Technical Assistance Grant to Islamic Republic of Pakistan: Second Generation of Capital Market Reform Programme', <http://www.adb.org/Documents/RRPs/PAK/41108-PAK-RRP.pdf> Accessed 17.08.2013.

[115] Cheema and Shah (n 74) 11.

[116] The Non-Banking Finance Companies (Establishment and Regulations) Rules 2003.

[117] The Non-Banking Finance Companies and Notified Entities Regulations 2007.

[118] The Non-Banking Finance Companies and Notified Entities Regulations 2008.

[119] NBFCs include leasing, investment finance, housing finance, asset management and investment advisory services. For this see clause (a) of s. 282A of the Ordinance.

[120] The structure, functions, operations and nomenclature of collective investment schemes in Pakistan are different from the UK. For a detailed explanation of the fund industry in the UK, see Iain MacNeil, *An Introduction to the Law on Financial Investment* (Hart Publishing, Oxford and Portland, Oregon 2005).

[121] Regulation 2 (1) (xxx) of the NBFC and Notified Entities Regulations, 2008 defines 'notified entity' as 'a company or class of companies or corporate body or trust or any other entity or person notified by the Federal Government in the Official Gazette'.

[122] An asset management company is a public limited company incorporated under the Companies Ordinance 1984. It has to obtain a licence from the SECP to carry out the management of collective investment schemes under the NBFC Rules 2003.

[123] The custodian must be a body corporate which is normally a bank or central depository company.

[124] 'Independent' has been defined by regulations as 'having no cross shareholding or common directorship'.

provides a high percentage of return due to the tax benefits associated with these funds. Investment companies may change the AMC with the prior approval of the regulator.[125]

A CES and an OES are constituted by way of a trust deed under the Trust Act, 1882 for a definite or indefinite period, and are managed by the AMC. Both CESs and OESs are registered with the SECP as notified entities under the regulations before public offering. The AMC appoints trustees for CESs and OESs which must be a body corporate. To avoid conflicts of interest, provision is made in the regulations that trustee must be independent of the AMC. The functions of trustee are to hold and control the assets of the funds beneficially for unit and certificate holders of OESs and CESs respectively. The trustee stands in a fiduciary relationship with unit holders and certificate holders as the case may be. The AMC is involved in the management of funds regarding investment decisions and pricing in OESs. The AMC may change trustee and propose a new trustee with the prior approval of the regulator.[126] The basic difference between CESs and OESs is the capital structure of these funds. In OESs capital can be changed on an ongoing basis, whereas in CESs it cannot be changed. Unit holders in OESs can redeem their investment at any time and certificate holders in CESs cannot redeem their funds, rather, they can trade in the secondary market. These rules and regulations regulate the fund industry, and encourage the investors to invest through intermediaries which may be less risky and more attractive for individual investors than direct investment.

The international financial institutions focused on the improvement of corporate governance of the economic entities, especially the listed companies. These listed companies represent a substantial part of the economy and therefore contribute a major portion of the gross domestic product (GDP) in Pakistan. These institutions provided aid in the form of loans to the government of Pakistan. In this way they secure not only the loan that is given for the development of corporate governance, but also all other loans that are given to the country for overall economic growth.

International financial institutions have played an important role in the development of corporate governance in developing countries. These institutions imposed conditions for reform and improvement in corporate governance while extending loans to the recipient countries. These institutions have developed assessment criteria for good governance

[125] See rule 48 (6) of the Non-Banking Finance Companies and Notified Entities Regulations 2008.
[126] See rule 42 (3) the Non-Banking Finance Companies and Notified Entities Regulations 2008.

which is helpful for these institutions to assess and set goals for improvement in their own corporate governance.

Globalization is another factor that forces these international financial institutions to exert pressures on the recipients of loans to improve their structures. The economic failure of one country may affect the economy of other countries.[127] This interdependence also motivates these institutions to focus on good practices and corporate governance, especially the recipient of the loans as a common object of these institutions.

Pakistan has been the main recipient of loans from these institutions[128] and, as a result, there was radical change in the corporate structure of the country[129] with special focus on the improvement in corporate governance through series of loans and, consequently, the imposition of conditions for improvement in governance from these institutions as a condition of the loans. Adaptation and convergence in the corporate sector were the main phenomena in Pakistan due to pressure from international financial institutions to improve governance and, consequently, there were reforms in the financial sector and securities markets.

The objective of these institutions was focused on securing their lending through improvement in corporate governance as good governance and a better economy can ensure the repayment of loans.

3.7.3.2 Adoption of international standards

The International Organization of Securities Commission (IOSCO) provides international standards for securities markets. IOSCO is the primary international cooperation forum for securities market regulatory agencies. Its members represent almost 95% of the world's securities markets. The objective of IOSCO is to cooperate in developing, implementing and promoting adherence to internationally recognized standards of regulations. It also aims to enhance investor protection and investor confidence through strengthened

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[127] See text to n 27.
[128] Recently, the IMF extended a loan amounting to US$5.3 billion under the Extended Fund Facility (EFF) on 4 July 2013. The IMF instructed the Government of Pakistan to introduce reforms that include, but are not limited to, the privatisation of public sector enterprises and to improve corporate governance. For this, see the IMF website available at <http://www.imf.org/external/np/sec/pr/2013/pr13249.htm> Accessed 16.07.2013.
[129] See text to n 85 in Chapter Two.

information exchanges both at global and regional levels. Moreover, it cooperates in enforcement against misconduct, and in maintaining fair, efficient and transparent markets, and in seeking to address systemic risk.[130]

IOSCO adopted its principles known as ‘Objectives and Principles of Securities Regulations’, which are internationally recognized benchmarks for securities markets. In 2002 it adopted the ‘Multilateral Memorandum of Understanding’ (IOSCO MMoU) for the purpose of facilitating cross-border enforcement and exchange of information among international securities regulators. The ‘IOSCO Principles Assessment Methodology’ for the objective assessment of the level of implementation of IOSCO principles within its members’ jurisdictions was adopted in 2003. In 2005 the IOSCO MMoU was endorsed as the benchmark for international cooperation among securities regulators.[131]

Pakistan’s apex regulator, the SECP, is an ordinary member of IOSCO and its main stock exchange, the KSE, is an affiliate member of IOSCO. The SECP, besides being a member of the IOSCO, also signed a bilateral memorandum of understanding (MoU) with the Australian Securities and Investment Commission (ASIC) in 2005 to address issues specific to these institutions. The purpose of this is to cooperate with each other through mutual assistance, and to facilitate the exchange of information for investor protection and promotion of market integrity. The objective of this cooperation is to assist each other in preventing insider trading, market manipulation, and other fraudulent, deceptive and manipulative practices, and in supervising and monitoring stock markets and compliance with the relevant laws and regulations. Similar bilateral MoUs were also signed between the SECP and the Securities and Exchange Board of India (SEBI), the Securities and Exchange Commission of Sri Lanka, the Royal Monetary Authority of Bhutan, the Maldives Monetary Authority, the China Securities Regulatory Commission, and the Securities and Exchange Organization of Iran for mutual bilateral cooperation for good governance in securities market.

Globalization has increased the importance of this kind of cooperation. At a multilateral level there is IOSCO and at regional level there are instances of regional bilateral cooperation such as the Pakistani authority mutually cooperating with other states. Overseas investment in securities, foreign listing and the attraction of foreign capital have

[130] See IOSCO website at <https://www.iosco.org/about/> Accessed 10.11.2013.
[131] See IOSCO website at <https://www.iosco.org/about/> Accessed 10.11.2013.

increased the importance of these bilateral agreements and international cooperation through IOSCO.

3.7.3.3 The role of international investors

An effective corporate governance system attracts not only domestic investors, but also encourages foreign investors to invest. Investment from foreign investors not only prospers domestic companies, it also helps to promote the economic growth of a country.[132]

Foreign investment may either be in the form of foreign direct investment (FDI) or foreign portfolio investment (FPI). In FDI, a foreign individual or overseas company invests by buying an existing company or sets up a subsidiary company in the host country. On other hand, in FPI, a foreign individual investor or an overseas company buys shares or bonds in a target company in the host country. These investments have implications for the governance regime of the host country.

FDI may further be divided into two forms: investment through a private company or a public listed company. If FDI is through establishing a private subsidiary company then the governance regime of the host country may have minimum effect as the subsidiary company may follow the governance norms of the home country where its holding company is registered. This is made possible by the flexible nature of the default rules that typically govern private companies. On the contrast, if FDI is through establishing a public listed company then the governance regime of the host country will have implications for the subsidiary company as the companies in the public domain have to observe the governance regime of the host country. In Pakistan, the FDI through public listed companies is significant. As discussed in chapter two, multinational companies are the third major stakeholders on the stock exchanges of Pakistan. The foreign companies, including private and public listed, are mostly from the UK and the USA.[133] Therefore, these companies may set standards for the domestic companies for observance of good governance. As discussed in chapter two and three, the code of corporate governance in Pakistan converged largely to the UK code of corporate governance. Therefore, observing good practices, borrowed from the UK may not be an issue for the companies having their

[132] Aguilera and Ceurvo-Cazurra (n 11) 417.
[133] See Table 3.3.

parent company in the UK. This will act as a bonding for domestic companies to observe the code and thus facilitate convergence. Similarly, subsidiaries of US public listed companies will already be part of a group subject to a well-developed governance regime.

So far as FPI is concerned, foreign investors may have more concern regarding good governance in the host country. As the foreign investor may not have direct influence in management, therefore they may be more interested in getting maximum return on their investment. Therefore, international investors invest their money when they feel that their money is secured and may give them healthy returns. This would only be possible when the host country is a safe haven for their investment, both in respect of good governance and internal security. These investors may not be involved in direct pressure on the host country to improve governance owing to less voting rights. They exert indirect pressure on the host countries to improve their governance. This indirect pressure motivates the host countries to improve their governance to attract these investors to invest. If a host country fails to provide good governance they may move to those jurisdictions where they might get better protection and returns. This phenomenon is significant for those jurisdictions such as Pakistan which is an underdeveloped and emerging market.

In Pakistan security has been a main concern for the past two decades, especially after the 9/11 attacks on the US. These events not only affected the US, but Pakistan and the rest of the world as well. Pakistan was indirectly affected by these events. FPI decreased substantially in Pakistan after the 9/11 incidents and subsequent security measures. [134] A study also confirms that international direct investment in Pakistan is directly affected by international and domestic factors such as economic, governance and security issues.[135]

No doubt, security is an important concern for foreign investors but bad corporate governance is a severe and primary issue as far as investment is concerned. In the past few months the security situation in Pakistan has been improving but the issue is still improvement of corporate governance. As discussed earlier, the government and the regulator took some steps, but they were not enough to attract investment even from domestic investors. These steps are not as good as they look on paper. Much more work remains to be done. To attract foreign investment, better corporate governance is

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[134] See Table 3.2.

[135] Junaid Ahmed and Inmaculada Martinez-Zarzoso, ‘ Blessing or Curse: The Stablising Role of Remittances, Foreign Aid and FDI to Pakistan’ (2013) Discussion Papers, Center for European Governance and Economic Development Research, No. 153, available at <http://econpapers.repec.org/paper/zbwcegedp/153.htm > accessed 20.05.2014.

necessary. This pressurizes government and the regulator to enhance their corporate governance standards for healthy foreign investment. As international institutional investors have more leverage to invest in any country, they can, therefore be more effective in pursuing the home jurisdiction to improve corporate governance than individual investors.

Table 3.2: Foreign Portfolio Investment in Pakistan during 1996-2013[136]

S. No.	Year	US $ million
1	1996	205.2
2	1997	267.4
3	1998	221.3
4	1999	27.3
5	2000	73.5
6	2001	(140.4)
7	2002	(10.1)
8	2003	22.1
9	2004	(27.7)
10	2005	152.6
11	2006	351.5
12	2007	1,820.4
13	2008	19.3
14	2009	(510.3)
15	2010	587.9
16	2011	364.6
18	2012	(60)
19	2013	119.6

Table 3.2 and Figure 3.2 below show that FPI decreased after the 9/11 incidents and subsequent security issues in the back drop of the war against terrorism in Pakistan. In the year 2007, a general election was announced in Pakistan which saw some positive investment but in late 2007 a key political figure was assassinated by the terrorists which deepened the security issues in Pakistan and there was again a negative impact on foreign investment in 2008 and ensuing years in Pakistan. In addition to this, in the year 1999, the military takeover created political and democratic uncertainty in the country. This was a major reason for the decrease in FPI in 1999 and 2000.

[136] Information taken from website of State Bank of Pakistan available at < http://www.sbp.org.pk/> , <http://www.sbp.org.pk/departments/stats/PakEconomy_HandBook/Chap-7.10.pdf> and <www.sbp.org.pk/ecodata/NetinflowSummary.pdf> Accessed 20.05.2014

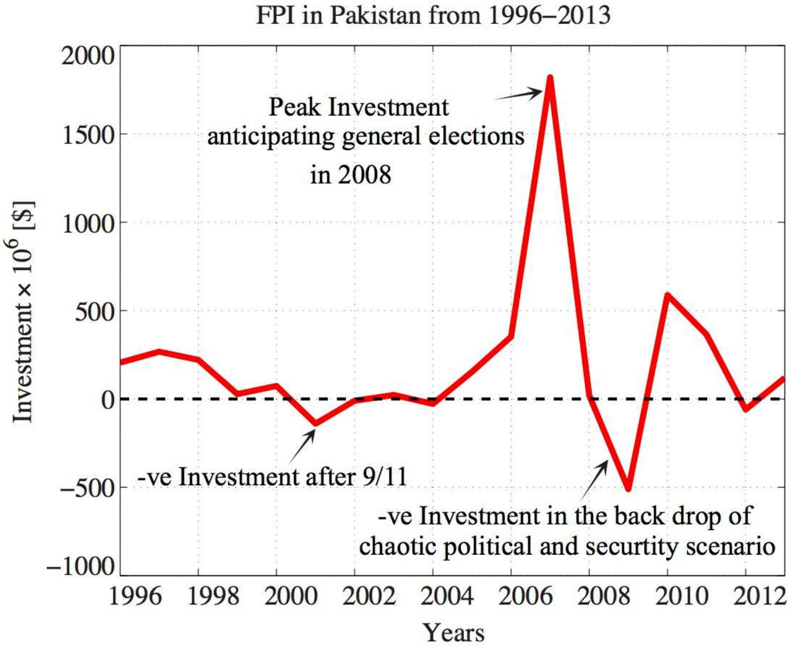

Figure 3.2: FPI in Pakistan during 1996-2013

Table 3.3: Foreign Companies in Pakistan as on 30.06.2013[137]

S. No.	Name of Country	Number of Companies
1	US	158
2	UK	119
3	France	25
4	Germany	23
5	China	38
6	Japan	37
7	Australia	21
8	Middle Eastern Countries	63
9	Far Eastern Countries	116
10	Other European Countries	129
11	Other Asian Countries	15
12	Other Countries	94

Table 3.3 shows that the US and the UK have the largest number of companies as compared to other countries.

Although International investors do not exert pressure on host nations to improve their governance, they have sufficient incentive to indirectly influence the host nations to improve their governance. Therefore, in the context of Pakistan, international investors

[137] Information taken from the Annual Report of SECP for the year ended 30.06.2013.

may play an effective role in forcing the government to adopt best practices and improve its governance structure. This phenomenon may encourage the process of adaptation and convergence to take place in Pakistan in order to improve corporate governance. Therefore, in the context of Pakistan there is a need to improve the corporate governance system with investor protection, especially minority shareholders; lowering agency cost; improving enforcement mechanism; and enhancing disclosure standards that could satisfy foreign investors. These factors will be discussed in the ensuing chapters.

3.7.3.4 Institutional investors and corporate governance in Pakistan

Institutional investors are playing an active role in capital markets in the advanced jurisdictions of the world. Investment through investment funds[138] has become more popular in recent times. This form of investment is attractive for both private and institutional investors because they offer a degree of diversification that is often not feasible for individuals to replicate in direct investment. It also provides broad market access to individual investors because some issues of securities are offered only to institutional investors such as, for example, ADRs and GDRs. They are cost-effective because they provide economies of scale in respect of dealing, custody and transfer of securities as the fund benefits from operating on a longer scale.[139] They also solve liquidity problems, at least in OESs, which is a major problem in markets of concentrated ownership jurisdictions such as Pakistan.

The role of institutional investors in Pakistan is very limited and the fund industry is underdeveloped. In developed jurisdictions such as the UK and the US, institutional investors play an effective role in the market in disciplining the management of portfolio companies. Institutional investors can solve the collective action problem. They possess sufficient stocks to press the management of portfolio companies to improve corporate governance. The managers of institutional investors are normally professional and expert, and can negotiate with the management of portfolio companies to continue with good practices. Institutional investors can help to develop capital markets due to their position. A developed market is considered an important factor for the development of a corporate governance regime. Institutional investors have not yet played their due role in the

[138] 'Investment fund' may be defined as 'an arrangement under which individual contributes to a common fund managed on their behalf by a professional investment manager' for this definition see MacNeil (n 120) 112.
[139] MacNeil (n 120) 112-3.

improvement of corporate governance in Pakistan. There is still a need for reform in this sector, especially with reference to their role in negotiating with the management of portfolio companies. The UK Stewardship Code may provide guidelines in this regard. This code was issued to regulate and make more effective the role of institutional investors in corporate governance. This code aims to enhance the quality of engagement between institutional investors and portfolio companies, and is expected to improve the long-term returns to shareholders and to discharge fiduciary obligations to ultimate beneficiaries.[140] It is, therefore, necessary to enhance the role of institutional investors in Pakistan so that they can help to improve corporate governance.[141]

3.7.4 Internationalization of Pakistani companies: An outward focus

3.7.4.1 Foreign listing by Pakistani companies

Globalization has increased the phenomenon of raising capital overseas through foreign listing. This process encouraged the convergence in corporate governance. Companies who wish to raise capital from overseas stock exchanges are required to fulfil specific foreign requirements. The companies have to incorporate certain terms in their articles of association, and have to run the companies according to the terms and conditions of the foreign exchange. This led to contractual convergence as this is a contract between issuer and stock exchange. This phenomenon is common at global level, especially those stock exchanges that are developed and liquid markets, such as the UK and the US stock exchanges.

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[140] Iain MacNeil, 'Activism and Collaboration Among Shareholders in UK Listed Companies' (2010) 5 *Capital Markets Law Journal* 419.
[141] The role of the institutional investor in Pakistan will be discussed in Chapter Four, at 4A.3.3.1.

Table 3.4: Issuance of securities by Pakistani companies on overseas stock exchanges[142]

Name of stock exchange	Type of securities	Number of companies
London Stock Exchange	GDR	6
Singapore Stock Exchange	Bonds	3
Luxemburg Stock Exchange	Bonds	1
Luxemburg Stock Exchange	Islamic bonds	1
Luxemburg Stock Exchange	GDR	3
New York Stock Exchange	ADR	2

Pakistani companies started raising capital from overseas stock exchanges through issuing securities, including GDRs, and bonds, including Islamic bonds.[143] The targets of Pakistani companies, so far, have been the LSE, Singapore Stock Exchange, Luxemburg Stock Exchange and New York Stock Exchange. As per Table 3.2, six Pakistani companies have listed GDRs on the LSE. The companies are required to follow the requirements of listing of GDRs introduced by the Financial Conduct Authority (FCA), irrespective of the requirements of domestic stock exchanges.[144]

Similarly, other Pakistani companies also have to follow the requirements of other stock exchanges. There is the likelihood that in future Pakistani companies would be issuing premier listings on the LSE as well as issuing securities on other developed stock exchanges. This will then further require these companies to enhance their corporate governance, at least to satisfy the requirements of overseas stock exchanges through their articles of association. This phenomenon will stimulate the contractual convergence with the possibility of functional or formal convergence following.

3.7.5 Convergence Theory and Pakistan

The recent financial crisis and major corporate scandals all over the world highlighted corporate governance weakness which triggered actions from the jurisdictions to improve corporate governance in order to avoid further corporate failures. Each jurisdiction had

[142] Data have been taken from the website of the SECP and from Annual Reports of the SECP until up to 2012-13.
[143] The SECP's approval is required for companies intending to raise capital overseas under s. 62A of the Ordinance read with s. 20 (5) (a) of the SECP Act, 1997.
[144] See text to n 132 in Chapter Five.

different factors and causes which pushed governments to improve corporate governance norms. This phenomenon stimulated a series of reforms around the globe but at the same time some factors restricted or limited these reform processes. In the context of Pakistan, the global financial crisis, economic meltdown after nuclear explosion and subsequent world economic sanctions, 9/11 incidents and bad political, economic, institutional and corporate governance were main factors which triggered state to reforms. In the context of Pakistan, the international financial institutions were the main forces which exerted pressures on the state to reform the system whereas dominant families were the main forces which acted as barriers to these reforms. As discussed earlier, Pakistan has been the main recipient of the loans from IFIs; therefore, these institutions attached conditions to these loans to reform the system. The apparent objective of these reforms by these institutions is to ensure their loans with interest are paid back. As good governance improves the overall economy of the country; therefore, this ensures that the loans are paid back. The economies of countries are interdependent in the new global world; therefore, economic failure of one country may affect other countries. In this backdrop, these IFIs push recipient of loans to reform their system. This phenomenon has been more visible in Pakistan. Therefore, there have been some reforms in the last three decades due to pressure from these IFIs. In future, these institutions can still be a strong force to compel the state to converge in corporate governance due to heavy reliance of loans by the state from these institutions.

Different kinds of convergence are evident in the Pakistani context. In the process of law making and standard setting in Pakistan, formal convergence was dominant where company law, securities laws and listing rules were amended to improve corporate governance in Pakistan. The issuance of a code of corporate governance in Pakistan is also an example of formal convergence. The code in Pakistan is made part of the listing regulations as opposed to the UK, where it is implemented on a self-regulatory basis. Therefore, it shows a formal convergence with functional diversity.

In recent years, some Pakistan companies have raised finance from overseas stock exchanges; therefore, contractual convergence was also visible in the Pakistani context through ‘bonding’ to foreign systems of regulations.

In the context of Pakistan, there are different factors which caused hurdles in the convergence in corporate governance. Path dependent forces such as families and state, complementary institutions and political, cultural and ideological norms all caused barriers to convergence. In particular, the dominant families in Pakistan are a strong force to compel divergence and to retain the *status quo*. In recent reforms, the dominant families have shown a negative attitude to the reforms. The issuance of a code in 2002 was a major breakthrough for reforms but resulted in substantial delisting from the stock markets in Pakistan. These families have economic and political dominance and therefore may represent a barrier to reform in the future as well. In this scenario, for successful reforms, there is a need to overcome the resistance from these forces. Therefore, the reforms can be successful if they are implemented in a piecemeal and pragmatic approach. The convergence theory can be helpful in this regard.

In Pakistan, convergence theory can help to resolve these problems by implementing the theory systematically and through a pragmatic approach. Convergence may take place in three forms: Formal, functional and contractual. However, there are some advantages to contractual and functional convergence as compared to formal convergence. Firstly, it can avoid possible resistance to formal change in a legal and regulatory framework. Any change that may be introduced through formal ways may be resisted by path dependency sources such as families, groups and politicians as the *status quo* may benefit them. Secondly, functional and contractual convergence can be economically efficient as it can reduce the cost of change that may be caused by formal changes in the rules and regulations. Companies can adopt some good foreign practices to attract capital through alteration in their articles. Once this practice is successful, then other companies may follow, and this may lead to formal action by the regulator and legislature, which will not cost too much for the regulator to introduce through the legal framework. Thirdly, functional convergence can be used on a trial basis as a test case. If it is successful, it can be incorporated in a formal way and if it does not work, then change will not cost too much. This may also provide managers, regulators, policymakers and other corporate actors with opportunities to assess the compatibility of the new governance feature and, once it is successful and corporate actors become familiar with this change, it may be formally incorporated. Functional and contractual convergence may therefore provide policymakers with a road map for formal convergence.

MacNeil says that contractual convergence may be the precursor to functional or formal convergence.[145] In the same way, as discussed above, functional convergence may be the precursor to formal convergence. It is possible for functional changes to be introduced in a particular country, for instance, through a code of corporate governance on a voluntary compliance basis, and once this is successful, then it may be incorporated into the formal legal system. To put it simply, it can be said that contractual convergence leads to functional convergence which, in turn, leads to formal convergence.

Therefore, functional and contractual convergence may overcome resistance from path dependency forces in Pakistan. In addition, these functional and contractual changes may provide a roadmap to the policy makers, regulator and the state which may lead to formal changes in the legal and regulatory framework.

3.8 Conclusion

This chapter discussed the process of convergence in corporate governance in a new global world and its implication for Pakistan. Globalization, competition and efficiency have fostered convergence through different forms of convergence: formal, functional and contractual. This phenomenon fosters the merging of different corporate governance systems but, at the same time, there are forces that restrict such convergence. Therefore, unique, imminent convergence of corporate governance is less likely in future. The presence of different barriers indicates that partial convergence with mixed features of different jurisdictions is more likely, that is, a hybrid convergence.

The convergence in corporate governance in Pakistan gained some momentum in the early 1990s when there was an economic meltdown in Pakistan in the context of the global recession. The state undertook some reforms but they were not enough to make a breakthrough. Most of these steps were good on paper only. Some changes were made in the regulatory and legal framework but most of them were too restrictive in nature to provide investors, especially minority shareholders, with rights.

A major initiative was the introduction of the Code but it was not successful due to weak compliance and enforcement. The problem was the nature of the Code itself. The Code was implemented through listing regulations which provide non-listing as the only penalty

[145] MacNeil (n 4) 340.

for non-compliance. The introduction of the Code as a soft law on a self-regulatory basis may be a good idea in the context of Pakistan where the corporate world is not accustomed to good corporate governance practices, especially foreign corporate governance features. Phased implementation may be a good idea. Alternatively, as the Code is part of listing regulations, enforcement of listing regulations must, therefore, be ensured through penalties which must be commensurate with the quantum of non-compliance. This will ensure compliance both with the listing regulations in general and the Code in particular.

Path dependency, complementarity institutions and families and interest groups, ideology, politics and religion are barriers in convergence in corporate governance in the context of Pakistan.

This situation may lead to scepticism about the imminence of radical reforms in the country. However, global and economic competition, efficiency and global pressures through international financial institutions and international investors may be strong forces that may compel convergence to international norms, and thereby act as stimulant in reforming the corporate sector in Pakistan. This process may be successful if reforms are made piecemeal, systematic and through a pragmatic approach.

CHAPTER FOUR: AGENCY COST AND MINORITY PROTECTION IN CORPORATE GOVERNANCE IN PAKISTAN

4.1 Introduction

Chapter Two discussed the nature and objectives of corporate governance. The intention was to highlight corporate governance issues in Pakistan. Chapter Three discussed convergence theory and its application in Pakistan. The focus of the chapter was on discussing and analysing the process, mechanism and prospects of convergence in corporate governance in general, and in Pakistan in particular. The intention was to formulate mechanisms for improving corporate governance in Pakistan. The following chapters will discuss the specific application of the theory of convergence in corporate governance in Pakistan. Chapter Four is limited to a discussion of agency problems and minority shareholder rights which are major corporate governance issues in Pakistan.

The agency problem is in the form of a triangle in which the managers, majority shareholders and minority shareholders are the three angles. Berle and Means claimed a century ago that the corporate world was controlled by the managers. The Berle–Means Model (BMM) was based on the presumption of dispersed ownership structures where the managers had control over the firms and the shareholders were mostly powerless. Therefore, the managers had opportunities to exploit the funds of their firms at the cost of the shareholders. This created a conflict between shareholders and the managers. However, the BMM is an exception rather than the norm in the corporate world. The BMM is mostly limited to the US and the UK. Concentrated ownership structures dominate the corporate world with families, groups and states controlling the corporate sector. In most of the corporate world, dominated by concentrated ownership, a majority–minority conflict is more visible and common than the manager–shareholder conflict of the BMM. Nevertheless, conflict also exists between the managers and shareholders in concentrated ownership. Small and minority shareholders do not have enough stock to take any action against the managers in general meetings.

However, the majority have direct control of the managers as they act as managers themselves or appoint family members, close relatives or friends as directors in family-owned enterprises. In SOEs, political affiliation may be the basic criteria for appointment as directors. Majority shareholders are in a position to pressurize the managers to act for their benefit. Therefore, in concentrated ownership, main agency conflict exists between the minority and the other two angles of the triangle, namely the managers and controlling shareholders. In this respect, there are two agency problems: (1) between the managers and shareholders, and (2) between the minority and majority shareholders.

The first part of this chapter discusses the agency problem of the first kind, namely between the managers and shareholders. In this part the focus is on exploring the causes of the agency problem and the mechanism to reduce such agency cost in the context of Pakistan. This part of the chapter will discuss in detail the extent to which convergence to a mechanism of reduction in agency cost may take place in corporate governance in Pakistan.

The second part of the chapter will deal with the agency problem of the second kind, namely between the minority and majority shareholders.

4A Agency cost in corporate governance

4A.1 The nature of agency cost

An agency relationship is a contract in which one or more persons delegate decision-making authority to one or more other persons to act on their behalf. The former are called *principals*, while the latter are called *agents*. In simple terms, an agency cost signifies the cost incurred by the principal in monitoring the activities of its agents. In the corporate world it means the cost incurred by the investors for monitoring the activities of the managers who run the firms. In a firm the shareholders are the principal, whereas the managers are agents. The shareholders as principals elect the managers as their agents and delegate decision-making authority to them. Investors invest money, whereas managers hold the control, which results in the creation of the agency problem. In public companies the separation of ownership and control creates an agency problem between the shareholders and the managers, which increases the cost of investment. As the managers use other people’s money, they are, therefore, not expected to use the money with the same vigilance as if it were their own. Therefore, negligence on the part of the managers is expected in the affairs of the company.[1] Therefore, controlling the agency cost is an important factor in the survival of the organizational form.[2]

Jensen and Meckling[3] have defined *agency cost* in the following way:

> Agency cost = the monitoring expenditure by the principal[4] + the bonding expenditure by the agent[5] + the residual loss[6]

This definition covers all aspects of cost that may be incurred in the agency relationship. This definition is, to some extent, wide in the sense that it includes loss suffered by the decisions of the agents. In business, decisions are made by the agents, but this does not provide a guarantee that every decision will produce the desired results. In business even *prime facie* good decisions may not produce better results. This may be due to different external factors that are difficult to foresee beforehand. Nevertheless, bad decisions due to the incompetency of an agent may incur extra cost for the principal.

The problem with agency cost is that it is difficult to make and enforce corporate contracts without cost.[7] This is basically due to the very nature of the corporate sector in which companies operate. Companies are run by professional managers, whereas investments are made by investors who are not normally involved in the management of the companies in which they invest. Shareholding changes hands in public companies on a daily basis. Shareholders cannot negotiate the terms of their contract with the company in which they hold shares. They become shareholders by merely purchasing shares from the market. It is not possible to amend corporate contracts frequently with the change of hands. To control agency cost through meetings of shareholders and enforcement is another costly problem in the corporate sector. Therefore, agency problems remain in the corporate form and good corporate governance tries to control or, at least, reduce it. Statutory laws, common laws and human ingenuity in drafting contracts determine the magnitude of the agency cost. In

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[1]Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Edwin Cannan ed, Volume II, Methuen and Co., London 1904) 233.
[2] Eugene F. Fama, and Michael C. Jensen, 'Agency Problems and Residuals Claims' (1998) 26 *Journal of Law and Economics* 345.
[3] Michael C. Jensen and William H. Meckling, 'Theory of the Firm: Management Behaviour, Agency Costs and Ownership Structure' (1976) 3 (4) *Journal of Financial Economics* 5-6.
[4] The cost incurred by the principal to monitor the activities of the agent.
[5] The bonding expenditure means expenditure of resources by the agent guaranteeing that he or she will not take certain action that will harm the principal or to ensure that he or she will compensate for such actions.
[6] The loss incurred by the principal for divergence of decisions by the agents which otherwise would have benefitted the principal.
[7] Fama and Jensen (n 2) 327.

order to reduce agency cost and to enhance good corporate governance, there have always been incentives to reduce this cost.[8] The legislature tries to solve this problem through statutory and non-statutory regulations. Non-statutory regulations include the codes of corporate governance, which are normally implemented on a self-regulatory basis. This reduced agency cost is important for running firms successfully.

4A.2 Causes of agency cost

4A.2.1 Separation of ownership and control

The modern concept of a company, in which there is a separation between ownership and control, creates agency problems. This problem arises largely because the interests of the agents are not always aligned with those of the principal. The agents may take such decisions as are not in the interest of the principal. The agency problem also arises due to the incomplete contractual nature of the corporate form of a company as a principal cannot specify *ex ante,* in a strict sense, the terms and conditions for employment of its capital. This problem arises more in public and big private companies than in small private companies. In small private companies there is practically no separation of ownership and control. The shareholders and the managers are the same people, and ownership and control are both vested in the same person.

The BMM provides the managers with an opportunity to expropriate the funds of the company at the cost of the shareholders[9] but that does not mean that management is in complete control of the company and free to expropriate the profits of the company at their pleasure.[10] In modern times, a good corporate governance regime could provide different techniques for reducing agency cost. Nevertheless, the agency problem is more prominent in dispersed shareholding than concentrated shareholding. In dispersed ownerships there is a separation between ownership and control. The shareholders are dispersed and the company is run by professional managers who are normally not owners. They run the company in a way that provides them with opportunities to extract private benefit of control. However, the nature of the agency problem is different in concentrated ownership. In this form of ownership, the controlling shareholders can put pressure on the

[8] Jensen and Meckling (n 3) 1.
[9] Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (MacMillan, New York 1932).
[10] H. Demsets and K. Lehn, 'The Structure of Corporate Ownership: Causes and Consequences' 93 (6) (1995) *Journal of Political Economy* 1155.

managers to work for the maximization of the wealth of the firm and may remove managers who do not work in the best interests of the firm. However, if shareholders own blocks of shares but not enough shares to remove directors or the removal of directors is difficult, the agency problem still remains. Another aspect of the agency problem in concentrated ownership is conflict of interest between majority and minority shareholders. Majority shareholders control the board of directors who focus on the interests of majority shareholders, and minority shareholders are normally at the losing end. This problem is actually between those who have and those who do not have control.

In Pakistan, families and the state control the corporate sector. There are different aspects to the agency problem in Pakistan. Here control and ownership are vested in the same people. In family-owned enterprises the directors and top management are family members themselves, relatives or persons they hold in their confidence. Similarly, people who have political affiliation are directors in SOEs. As the controlling shareholders control the managers, the actual agency problem exists between the majority and minority shareholders. Nevertheless, the agency problem exists between the managers and the shareholders, especially the minority shareholders.

4A.2.2 Incentives for private rent seeking and expropriation

In the modern form of the company, managers have substantial discretion to run the company, which provides them with opportunities to obtain the private benefit of control and to expropriate company funds. This discretion can be due to a number of different factors. Firstly, an incomplete contract between the managers and investors provides managers with discretionary powers. Investors cannot force managers *ex ante* to manage their finance, which leads to the discretionary powers of the managers to employ the investment. Secondly, lack of expertise on the part of the investors to become involved in, monitor and to decide a particular course of action in the managers' business decisions leads to problems. Thirdly, it is not feasible to involve all shareholders in the day-to-day affairs of the company. Fourthly, the courts have shown their reluctance to involve themselves in the routine matters of firms unless there is massive violation on the part of the managers. In the US though, the courts have a more extensive role compared to others but even there there is the so-called 'business judgment rule' that keeps courts out of the affairs of firms in most cases. Fifthly, the involvement of dispersed and poorly informed investors who do not know how to exercise the control rights that the law has granted them is also problematic. Sixthly, the cost of taking action through general meetings is also relevant. Seventhly, the cost of taking action through courts is an important factor that provides managers with discretionary powers. In many cases the shareholders may not be interested in approaching the courts due to the cost and time involved. Eighthly, the controlling shareholders are themselves involved in the management. They act as managers or appoint their family members, relatives or close friends as managers. They do not take any action against managers and it is also not expected that they will take action against themselves. Therefore, this provides managers with unchecked discretion. The outcome is that the managers and controlling shareholders have the right to control the allocation of funds in firms. As a result, they have an opportunity to obtain private benefits from this control and to expropriate the funds as they wish.

The private benefits of control and expropriation can take place in a number of ways. Related party transactions, empire building, tunnelling of funds and executive compensation are basic techniques used to obtain benefits. In related party transactions, the managers and controlling shareholders enter into transactions, on behalf of the company they run, with other companies, which they hold, at less than the market price, giving those companies that they hold the benefit and thus benefiting even more indirectly themselves. These transactions may include the selling of products at a lower price made by the company they run to the companies they own. The managers even sell the assets of the company that they run to the company they own at less than the market price.

In empire building, the managers and controlling shareholders are more concerned with expanding the business by either establishing more business units or incorporating new firms under their control. They are more interested in resource control and in enhancing their interest and less in the real allocation of business funds and the interests of investors. Instead of distributing profits to the shareholders, they further invest and thereby create their empire. They undertake such projects that benefit them, which may cost the shareholders. They may pursue such projects even if they come at a higher cost to the investors than benefits to the managers or the controlling shareholders.[11]

In the tunnelling of funds, the managers and controlling shareholders transfer the funds of the company they control to the company they own through secret methods. This may take

[11]A. Shleifer and R. W. Vishny, 'A Survey of Corporate Governance' (1997) 52 (2) *The Journal of Finance* 744.

a number of forms: extending loans to the company they own at an interest rate that is lower than market value or on soft terms and conditions, transferring assets and resources to such companies. Some related party transactions may also be involved in this activity.

Executive compensation is another factor that constitutes the expropriation of the funds of a company. Managers may pay excessive amounts to themselves as pay and privileges. To avoid criticism, action from the shareholders and interference from courts, they sometimes try to avoid direct personal benefits but consume perquisites such as luxury cars and company aeroplanes.[12] They also enjoy other privileges, including but not limited to, taking expensive trips; renting costly buildings for their personal residences and offices; and hiring more staff than required, which they fund by utilising the funds of their firm. Another form of expropriation may be the hiring of family members, relatives and friends for highly paid jobs. Not only do these managers compromise merit, they divert company funds to their own at the cost of the company. Managers who persist in a job when they are no longer required[13] or offer resistance when they are poorly performing are the costliest manifestation of the agency problem.[14] In short, they use their control rights to pursue those projects that benefit them personally instead of the investors or firms.[15]

The owners are normally the monitors of the managers but if managers have substantial ownership, they also become monitors. This concentration of ownership and monitoring aggravates the situation which normally arose in concentrated ownership structures. The controlling shareholders have a duty to monitor managers but if the person whose duty it is to monitor is also involved in sophisticated forms of stealing, then the situation is worsened. The separation of management and monitoring is therefore essential in concentrated ownership structures. However, Holderness and Sheehan do not believe that the concentration of ownership by majority shareholders is primarily meant to expropriate corporate resources. According to them, these shareholders concentrate shareholding merely to control the firm and not to expropriate it. The authors argue that had that been the case, the firms with concentrated ownership would not have survived.[16] Wessel wrote

[12] Bryan Burrough and John Helyar, *Barbarians at the Gate: The Fall of RJR Nabisco* (Arrow Books, London 2010).
[13] A. Shleifer and R. W. Vishny, ' Management Entrenchment: The Case of Manager-specific Investments' (1989) 25 *Journal of Financial Economics* 126.
[14] Michael C. Jensen and Richard S. Ruback, 'The Market for Corporate Control: The Scientific Evidence'(1983) 11 *Journal of Financial Economics* 5-50.
[15] Shleifer and Vishny (n 11) 742.
[16] C. G. Holderness and D. P. Sheehan, 'The Role of Majority Shareholders in Publically Held Corporation: An Exploratory Analysis' (1988) 20 *Journal of Financial Economics* 344.

in the *Wall Street Journal* that the American economy and stock market had performed better than any other on earth.[17] He negated the general presumption of stealing by American executives from the shareholders and rigging of the stock market. According to him, had this been the case, the American economy would not have surged. These presumptions are partially correct. Firstly, the expropriation may be limited to the extent that it reduces the profit margin. The firms may have earned more profit had there been less or no expropriation. Secondly, the expropriation is also not limited to executives. The majority shareholders are also implicated in activities involving the exploitation of funds. Thirdly, the agency theory presented by Jensen and Meckling suggests that the controlling shareholders and corporate managers expropriate the minority shareholders. They act in their own interest at the cost of other minority shareholders.[18] Fourthly, LLSV state that in family-owned firms the controlling shareholders are not only the best monitors of the firms, but are also part of the management who have incentives to expropriate minority shareholders. The cash-flow rights of these controlling shareholders mitigate the incentives of expropriation but do not eliminate it.[19] Therefore, the investors' rights can be protected if the problem of managers and controlling shareholders expropriating funds is addressed.

In Pakistan the expropriation of funds is a common phenomenon. The corporate sector in Pakistan is highly concentrated with families and the state controlling it. As discussed in Chapter Two, families and the state are the largest stakeholders in this sector in Pakistan, with a shareholding of more than 75% in many listed firms. In order to maintain control, they rarely sell their shares in the market. A very small number of shares are traded on the stock market which creates liquidity problems. An illiquid market is problematic for takeovers, which is the main tool for shifting control. They also maintain control by pyramiding, cross-shareholding, interlocking management and by issuing shares with differential voting rights. These families and the state have control in excess of their cash-flow rights. This provides an opportunity to dominate the board of directors and also top management which provides them with opportunities to expropriate at the cost of the minority shareholders.

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[17] David Wessel, '"The American Way" Is a Work in Progress' *Wall Street Journal* (New York 13.11.2013) <http://securities.stanford.edu/news-archive/2003/20031113_Headline10_Wessel.html> Accessed 20.12.2013.

[18] Jensen and Meckling (n 3).

[19] R. La Porta, F. Lopez-ed-Silanes and A. Shleifer, 'Corporate Ownership Around the World' (1999) LIV (2) *Journal of Finance* 511.

4A.3 Reduction of agency cost

If agency cost is not reduced, then there is the danger that firms will fail and be liquidated at the end. Agency cost is like product cost where those firms survive competition who produce products at the lowest price and sell to customers at the lowest price. Profit is earned after all costs have been subtracted. If the cost is increased and products become costly, the survival of the firm becomes difficult. In the same way, the reduction of agency cost is important for the survival of firms. If agency cost is very high, it may reduce the profit margin for the investors. This will discourage investment and organizational forms may not be successful.[20] Different factors have been considered in reducing agency cost.

4A.3.1 *Ex ante* and *ex post* mechanisms

There may be different strategies to resolve the agency problem. This may be either *ex ante* or *ex post*. In an *ex ante* mechanism, the information is available to investors through different disclosures which provide new investors with opportunities to know beforehand whether or not to invest in a particular company. The disclosure may include the directors' reports, annual financial statements and other periodical statements. In an *ex post* mechanism, the mangers are given powers to run the company and if the management is not performing, then the shareholders may take different actions such as removing the directors, participating in decision-making in general meetings and taking action against directors through the courts.

4A.3.2 Separation of control and monitoring

Separating control from monitoring is an *ex ante* strategy for controlling the agency problem. Shareholders delegate the powers to take decisions in the day-to-day affairs to the managers. As the interests of the managers and the shareholders are not always identical, it exacerbates agency problems. The large shareholders are considered the best monitor of the management.[21] However, if they involve themselves in the management, control and management will be vested in the same persons. Therefore, it is not expected

[20] Fama and Jensen (n 2) 345.
[21] The separation of management and monitoring model was presented by Shleifer and Vishny in A. Shleifer and R. W. Vishny, 'Large Shareholders and Corporate Control' (1986) 94 (3) *The Journal of Political Economy* 461-88.

that they will monitor themselves. However, if monitoring is separated from both the control and management, agency problems may be reduced to some extent.

This problem is more severe in Pakistan where there is concentration of ownership with families and the state dominating the corporate sector. They control the firms and therefore control the management. Therefore, if the monitoring of management were to be separated from both the control and management, it may solve the problem to some extent. Different strategies may be employed for this purpose. Firstly, the enhanced role of independent directors may be useful. As the independent director does not have a direct interest in the firm, he or she may monitor management independently. Secondly, allocating some seats to the directors representing minority shareholders may also solve this problem. Minority shareholders do not have controlling powers to expropriate. Therefore, they may work for the welfare of the whole firm and may act as monitors. There are certain benefits to appointing members to the board of directors. This provides them with an opportunity to gain access to information; work and safeguard the interests of minority shareholders; and to collaborate with independent directors to discuss the interests and concerns of the minority shareholders in the meeting of the board of directors.[22]

Thirdly, active institutional investors may play an important part in monitoring the management and pursuing good governance. There is, therefore, a need to enhance the role of institutional investors in Pakistan.

4A.3.3 Shareholder activism and institutional investors

Shareholders activism is a common problem in dispersed ownership structures. Shareholders are dispersed, which makes monitoring and disciplining management a difficult task. In concentrated ownership systems there are block holders or majority shareholders but there may also be small and minority shareholders who do not have enough stocks to pursue management in the interest of good corporate governance. Therefore, shareholder activism may also be an issue in these systems. Institutional investors may solve the agency problem.

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

Rapid changes in ownership due to high-speed stock trades on stock exchanges and the lack of coordination in taking collective action are major problems. The issue of rapid change in ownership structure can be solved by institutional investors. Institutional investors hold investments in portfolio companies and issue units to their investors. Unit/certificate holders may change hands but shareholding in targeted companies remains constant, at least, in closed-end funds due to the very nature of institutional investors.[23] This provides managers with the leverage to hold investments in portfolio companies for longer periods. In this way, they can exert pressure on the management to improve corporate governance.

Cost is another problem that hinders collective action. Where an individual shareholder intends to discipline management by taking action, for example, derivative action, it may be too expensive weighed up against the potential benefit to such shareholder. This may also not be an attractive course of action for individual shareholders because they have to share the benefit with other investors. Institutional investors may be the answer to this problem. The cost of activism may be reduced if action is taken through institutional investors as the cost will be shared by all the unit/certificate holders or shareholders of the institutional investors. They will be willing to pay the cost incurred as this will benefit them. There are two benefits to action through institutional investors. First, the corporate governance of the targeted firms will be improved and that will be beneficial not only to the ultimate beneficiaries of the institutional investors, but to the shareholders of the targeted firm as well. Second, 'positive externalities' will be generated that will send the right message to other companies to improve their corporate governance mechanism.[24]

Institutional activism can replace discipline imposed on managers through the threat of hostile takeovers.[25] Hostile takeover is a threat for incumbent managers who are not performing because the successful bidder may remove such managers. More engagement on the part of the institutional investors may urge managers to perform better and improve the governance mechanism. Therefore, monitoring by institutional activism provides managers with the incentive to focus on the long-term prospects of the firm.[26]

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[23] Closed End Schemes and Open End Schemes are discussed in detail in Chapter Three at 3.7.3.1.
[24] Iain MacNeil, 'Activism and Collaboration Among Shareholders in UK Listed Companies' (2010) 5 (4) *Capital Markets Law Journal* 424.
[25] Roberta Romano, 'Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance' (2001) 18 (2) *Yale Journal on Regulation* 174-252.
[26] Junghoon Park, 'Governance of and by Institutional Investors' (5th Roundtable on Capital Market Reform in Asia, Ministry of Finance and Economy, Republic of Korea ,Tokyo, November 19-20 (2003) available at <http://www.oecd.org/finance/financial-markets/19388822.pdf> Accessed 22.08.2013.

However, there are some disadvantages to institutional activism. Institutional investors have to hold enough shares and for a longer period to exert pressure on the management to improve its governance structure. The problem with holding shares for long periods for the sake of disciplining management is that it may create a liquidity problem in the market. Liquidity has to be sacrificed in order to get the potential benefits of activism.[27]

The requirements of diversification may be a barrier to an institutional investor accumulating sufficient shareholding to justify the cost of the activism or to hold enough shares to call a general meeting of shareholders to take any action. Insider trading rules and takeover regulations may be a problem in this collaboration and activism. The rules of a particular country may also be deciding factors. In the UK perspective, there are legal constraints to such activism.[28] The market abuse regime, under the Financial Services and Market Act, 2000 provides limitations on activism by constraining the ability of an investor to deal in shares if the investor can be considered to have become an insider as a result of an intervention. This act may be unintended, for example, when the shareholders collaborate, engage and negotiate with the company, the management of the targeted company may give some information which may be considered insider information. After becoming an insider, they will be prohibited from selling or buying their shares. Another problem in such collaboration are takeover laws. If any institutional investor buys shares to hold enough stock to take action, this may be problematic in terms of these laws. After reaching the 30% threshold, they have to bid for the whole targeted company. The regulatory authorities in the UK tried to explain the extent of market abuse in these circumstances but that complicated the situation.[29] Therefore, activism may be problematic under the market abuse regime of a particular country.

There are different views regarding the effect of institutional investors' activism on the performance of the targeted firms. Romano believes that, empirically, there is no positive effect on the performance of the targeted firms; rather, sometimes there is a negative effect on the share prices of the targeted firms after such activism.[30] Park argues that the managers of the funds are not considered expert enough to engage and solve the problem

[27] *Ibid*.
[28] F. Curtiss, I. Levine, and J. Browning, 'The Institutional Investor's Role in "Responsible Ownership"' in I. MacNeil and J. O'Brien (eds), *The Future of Financial Regulation* (Hart Publishing, Oxford 2010) 309.
[29] MacNeil (n 24) 428-9.
[30] Romano (n 25) 174-252.

of the portfolio companies through such activism. [31] According to him, the activism also detracts them from their primary role for which the funds are formed; for instance, if a pension fund is involved, they will focus more on the managers of the targeted firms instead of on the welfare of the pensioners.

Bainbridge argues that institutional investor activism has not and cannot solve the problems of corporate governance. [32] He believes that such activism will not solve the agency problem; it will only shift its focus. The problem that existed between the shareholders and the management of the targeted company will be shifted to a new point between shareholders and the management of the investment company. The shareholders will still suffer and the agency problem will remain. This assumption is correct but the potential benefits of activism may be greater than the disadvantage of the agency problem. Institutional investors hold the stock of different companies and may, therefore, play their role in improving the governance of the targeted companies. If they improve the governance of all the companies, the impact of the activism may be greater than the agency problem in the investment company.

Conflict of interest is also a major problem in institutional investor activism.[33] There are different forms of conflict of interest; for instance, an investment manager will be reluctant to take action against a portfolio company if such company has client relations with the bank or financial institution that is the holding company of the investment manager.[34] Conflict of interest may also be visible in the situation where the manager of the fund is also a director in the portfolio company by virtue of his personal shareholding in the target company. Such a manager is not expected to take any action against himself as part of the board of directors.

Irrespective of the aforementioned problems, the role of institutional investors has been regarded as being significant in recent years, especially after the recent financial crisis. Institutional investors have been blamed for their passive role in monitoring the board of directors of the financial institutions that contributed to the crisis.[35] They had the potential

[31] Park (n 26).
[32] Stephen M. Bainbridge, ‘Shareholder Activism and Institutional Investors’ (2005) University of California, Los Angles Law & Economics Research Paper No. 05-20, available at <http;//ssrn.com/abstract=796227> Accessed 23.08.2013.
[33] Park (n 26).
[34] MacNeil (n 24) 428.
[35] ‘A Review of Corporate Governance in UK Banks and other Financial Industry Entities: Final Recommendations (November 2009)’, p 72, available at

to discipline management and to improve overall corporate governance structures but they failed to take appropriate action even when this was in the interest of their clients.[36]

The UK Stewardship Code was issued in this regard to regulate and make more effective the role of the institutional investor in corporate governance. The objective of the code is to enhance the quality of engagement between institutional investors and portfolio companies.[37] The code does not emphasize public activism directly but provides a series of negotiations by creating a ladder according to which intervention is escalated. There are different stages in such an intervention, including confidential discussion with the firm. If this is not successful, then other options are: holding additional meetings with management; expressing concerns through the firm's advisers; meeting with the chairperson, senior independent director or with all independent directors; and intervening jointly with other institutions on particular issues.[38]

Institutional investors can play their role in improving governance in portfolio companies in a number of ways: they can conduct private negotiations with the management of the portfolio companies; they may appoint directors on portfolio companies and thereby monitor the performance of targeted companies; or they can also act as shareholders in general meetings to persuade the management to follow good corporate governance practices.

4A.3.3.1 Institutional investor activism in Pakistan

Institutional investment is in the process of being developed in Pakistan. Institutional investors are less active in Pakistan compared to the UK. They have not played their due role in corporate governance in Pakistan. Different types of institutional investors are functioning in Pakistan where some operate under state control and others act in the private sector. The National Investment Trust Limited (NITL)[39] and Investment

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<http://webarchive.nationalarchives.gov.uk/+/http:/www.hm-treasury.gov.uk/d/walker_review_261109.pdf> Accessed 24.03.2013.

[36] Myners Review of Institutional Investment: Final Report, <http:archive.treasury.gov.uk/docs/2001/miners_report0602.html> Last accessed 15.08.2011.

[37] MacNeil (n 24) 420; See also 'Preface' to The UK Stewardship Code 2010 and 2012.

[38] MacNeil (n 24) 429.

[39] NITL (National Investment Trust Limited) was the first asset management company in Pakistan to be formed as an unlisted public company in 1962. The government of Pakistan has 8.33% shareholding directly and 50% shareholding indirectly through state-controlled entities in NITL. It has shareholding in more than 400 companies out of 590 listed companies on the stock exchanges of Pakistan. The fund has 81 billion Pakistani rupee (approximately 0.4675 billion British pounds) under its management with 55,109 unit

Corporation of Pakistan (ICP)[40] are the largest investors working under state control, while most of the AMCs, international joint ventures, brokers, provident and private pension funds, and the *mudaraba* are small fund managers who work in the private sector.

Pakistan has a small and growing fund industry. This industry holds approximately 5% of total market capitalization. Institutional investors may play a major role in corporate governance. They have sufficient voting powers to sit on the board of portfolio companies. Institutional investors other than brokers can sit on corporate boards. Brokers are prohibited from becoming directors of a listed company under the code of corporate governance. Similarly, banks can appoint their nominee as a director of a client company as a condition of a loan contract under the company law of Pakistan. For example, NITL, a major investment trust in Pakistan, can appoint members on many corporate boards and thus can play a major role in improving corporate governance.[41]

The SECP issued detailed regulations for licensing, registration and the internal conduct of business for institutional investors in Pakistan but there are no statutory or non-statutory regulations for institutional investor activism. There is no guidance on engagement of these institutions in corporate governance with portfolio companies. Lack of regulations or guidance may be a hurdle in improving corporate governance in portfolio companies in particular and overall corporate governance in general.

The operation of major fund managers, for example, NITL and ICP which are under state control, is yet another problem for the development of institutional investment in Pakistan.

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holders as on 30.06.2013. The trust operates five different funds under its control. The trust was constituted under the Trust Deed dated 12.11.1962, executed between the NITL as the management company and the National Bank of Pakistan (i.e., the biggest bank in the public sector under state control) as trustee. The NITL distribution network comprises 24 branches with various authorised bank branches in Pakistan and also in the Arab Emirates Investment Bank (AEIB) in Dubai in the United Arab Emirates (UAE). Information taken from the NIT website available at <http://www.nit.com.pk/index.php?option=com_content&view=article&id=14&Itemid=3%3E%20&%20%3C%20http://www.privatisation.gov.pk/Finance/nit.htm# > Accessed 22.12.2013.

[40] The Investment Corporation of Pakistan (ICP) was established in February 1966 through an ordinance. The objectives of the ICP were to broaden the base of investments and developing the capital market in Pakistan. The corporation underwrites public issues of shares and participates in equity projects. It opens and maintains investors' accounts with a view to broadening share ownership and widening the base of the capital market through the purchase and sale of shares of listed companies for the account holders. The ICP floats and manages the mutual funds which provide a series of sound scripts for the investors seeking reasonable returns through pooled investments. The corporation also purchases and sells shares on the stock market for its various portfolios. The corporation has floated 25 mutual funds and a state enterprise mutual fund with a view to offering opportunities of pooled investment to the investors. The corporation's market transactions for its own portfolio, investors' portfolio and mutual funds' portfolios contribute towards strengthening the activity on the market. Information available from <http://www.privatisation.gov.pk/finance/icp.htm > Accessed 12.01.2014.

[41] IMF Report on the Observance of Standards and Codes (ROSC) June 2005 on Pakistan.

The state is the owner of the ICP as well as holds more than 58% shareholding of the NITL, a management company of different funds operating under its control.[42] Direct state control presents the usual governance problems. The state's appointment of directors through its executive orders may compromise merit. Political affiliation may be the major qualification for the appointment of directors in these entities.

There is a need to pay more attention to institutional investors in Pakistan. The fund industry requires development. The inactive role of institutional investors, especially those under state control, is one of the main reasons for the underdevelopment of the industry. The fund industry can develop in Pakistan, provided few steps are taken. First, by privatising state-owned fund management companies such as the NITL and ICP, the competition can attract professionals from the private sector to run these institutions in a professional manner. This may benefit the entity itself and improve the corporate governance of portfolio companies. Second, a soft law code, patterned on the stewardship code in the UK, may guide the institutional investor in active engagement in corporate governance issues of the portfolio companies through dialogue with the board of directors.

4A.3.4 Legal protection

One important strategy to reduce agency cost is to provide investors, especially minority shareholders, with legal protection. In the absence of legal protection, managers and the controlling shareholders can expropriate the minority shareholders. Agency cost can be reduced if expropriation is made difficult by an *ex ante* mechanism such as a disclosure strategy or an *ex post* mechanism such as providing minority shareholders with a remedy to sue directors and controlling shareholders.[43] In Pakistan the lack of protection of minority shareholders exacerbates the agency problem. Legal protection may reduce the incentives of expropriation by the controlling shareholders and management. The mechanism of legal protection may be provided through statutory and non-statutory regulations, the judicial system and the market.[44]

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[42] See NIT website available at <http://www.nit.com.pk/index.php?option=com_content&view=article&id=4&Itemid=5> Accessed 12.01.2014.
[43] La Porta, Lopez-ed-Silanes and Shleifer (n 19) 512.
[44] This will be discussed in detail in the second part of Chapters Four and Five.

4A.4 Conclusion

This part of Chapter Four discussed the problems associated with agency cost in Pakistan. There are different reasons for these problems: the extent of minority shareholding; the separation of ownership and control; incentives for private rent seeking; and expropriation by the managers and controlling shareholders are the main reasons. The corporate sector in Pakistan is highly concentrated, and families and the state control the sector. They have the discretion and incentives to control in order to expropriate company funds at the cost of minority shareholders. Though the separation of ownership and control is a problem experienced in dispersed ownership, the agency problem is also visible in the conflict between the management and the shareholders in concentrated ownership. There are different techniques to solve or, at least, reduce the agency problem in the context of Pakistan. They may be *ex ante* or *ex post* mechanisms. Firstly, the separation of control and monitoring through representation on the board of directors by minority shareholders and institutional investors may reduce the agency problem in Pakistan. Non-executive and independent directors can also play an effective role in this regard.

Secondly, the institutional investor industry is underdeveloped in Pakistan due to lack of proper regulations and the excessive role the state plays in this regard. The privatization of state-owned funds may foster competition, which may help to develop the industry. Thirdly, the legal protection of minority shareholders makes expropriation difficult for the managers and controlling shareholders. If minority protection is ensured, it may help to develop corporate governance in Pakistan.

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4.B Minority protection in corporate governance in Pakistan

4B.1 Introduction

The second part of this chapter discusses the agency conflict of the second kind, that is, the conflict between minority and majority shareholders. This conflict may be reduced by providing minority shareholders with protection against majority shareholders. As the managers are either under the control of the majority or the majority themselves act as managers, the protection of minority shareholders is also required against expropriation by the managers. The objective of this part of Chapter Four is to explore different mechanisms that can provide minority shareholders with protection in the context of Pakistan. Minority protection will be discussed keeping in mind the prevailing corporate structure in Pakistan and the possible convergence to international norms in order to improve the sector. The focus of this chapter will be on minority rights that include pre-emptive rights, cumulative voting rights, conflict of interest of the fiduciaries, derivative action, unfair prejudice remedy, and the just and equitable winding up of companies as minority protection devices in the context of Pakistan.

4B.2 The LLSV theory

Recent academic literature has discussed key issues of corporate governance: the nature of a particular system, either dispersed or concentrated share ownership; the development of capital markets; investor protection, especially minority shareholders; the raising of external finance; extra-legal institutions; and, more importantly, the causes and consequences of these issues. However, minority protection has remained the focus of recent academic discussion.

LLSV discuss corporate governance of different legal families in a comparative study with reference to investor protection provided by these families and the extent of their market development.[1] There are basically two legal families: (1) the common law and (2) civil law category. The civil law family is further divided into three subfamilies: (1) the French civil

[1] LLSV, 'Law and Finance' (1998) 106 (6) *Journal of Political Economy* 1113-55.

law, (2) the German civil law and (3) the Scandinavian civil law category.[2] Common law is based on judge-made law that is subsequently converted into legislation, and civil law, which is based on Roman law, is law that is basically part of scholar- and legislature-created traditions.[3] Most countries of the world have adopted legal structures of these legal families due to colonization and occupation.[4]

The basic difference between the two systems is the role of judges and the fiduciary duty developed by the case law.[5] A judge in the common law system has more discretion than a civil law judge in deciding cases where the statute is silent. In most cases where the legislation does not provide a direct remedy, common law judges apply this discretion in favour of minority shareholders.[6] This may be the main reason for the development of fiduciary duties and minority protections in common law countries as compared to civil law countries.

LLSV identified an anti-director index, in other words, a shareholders rights index comprising six key shareholder rights: (1) one share, one vote, (2) proxy by mail, (3) shares not blocked before a meeting,[7] (4) cumulative voting/proportional representation (5) oppressed minority, and (6) pre-emptive rights to new shares. The authors assigned one point in cases where the mechanism of shareholder protection was available in the corporate law, otherwise zero. They took a sample of 49 countries, including 18 from common law jurisdictions, 21 from French civil law, 6 from German civil law and 4 from Scandinavian civil law countries. They compiled the data and observed that the common law provided outside investors with better protection, whereas the German and Scandinavian countries fell in the middle, while the French civil law provided investors with the least amount of protection.[8]

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[2] William A. Reese and Michael S. Weisbach, 'Protection of Minority Shareholder Interests, Cross-Listing in the United States, and Subsequent Equity Offerings' (2002) 66 (1) *Journal of Financial Economics* 73.
[3] David Rene and John Brielry, *Major Legal Systems in the World Today* (Stevens and Sons, London 1985); Reese and Weisbach (n 2) 73.
[4] Reese and Weisbach (n 2) 73.
[5] John C. Coffee Jr, 'Privatisation and Corporate Governance: The Lessons from Securities Market Failure' (1999) Working Paper 158, available at < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=190568> Accessed 21.08.2013.
[6] Reese and Weisbach (n 2) 73.
[7] In some jurisdictions it is stipulated that the shareholder must deposit their shares in the company or with the financial intermediaries a few days before the general meeting so that the shareholders cannot sell their shares before the meeting.
[8] LLSV (n 1) 1113.

Coffee argues that it is not correct to say that the civil law system does not afford investors protection, rather, it provides investor protection that is inherent in the system of concentrated ownership.[9]According to him, the system does not specifically provide that protection that is known to dispersed ownership or in the market economy; for example, the civil law system does not provide mechanisms to control expropriation, self-dealing and private rent seeking by the managers which are inherent in the dispersed ownership of the common law system, but they do provide other protection, such as voting rights. According to him, both systems support a particular pattern of ownership: common law supports the dispersed form, whereas the civil law supports concentrated ownership. However, it is difficult to generalize this hypothesis for two reasons. First, expropriation, rent seeking and self-dealings are not the features of dispersed ownership but are common in both dispersed and concentrated ownership structures. Second, there are many common law systems in the world that have concentrated ownership. Therefore, it is not the legal family that determines a particular system of ownership, rather, other factors may shape a particular system. Politics, historical development and social norms may have been the main factors for the development of a particular system of ownership. The US and the UK are exceptions, having dispersed ownership structures, whereas in the rest of the world, concentrated ownership is dominant. Dispersed ownership was also considered a consequence of the advancement of technology, which necessitated big firms.[10] These big firms required huge capital which was not possible when a few individuals were involved. Therefore, dispersed ownership was an ultimate consequence. There are certain advantages to dispersed ownership in this kind of firm because the managers are hired on the basis of their professional and managerial skills instead of their ability to finance the firms or on the basis of their relations with controlling members.[11]

Another aspect of the LLSV theory is the link between minority protection and the development of capital markets. LLSV argue that investor protection is essential for the development of the capital market.[12] If outside investors are protected, they may spread their finance in the market. This provides investors with the luxury of diversification. The

[9] John C. Coffee, Jr, 'The Future as History: The Prospects for Global Convergence in Corporate Governance and its Implications' (1999) 93 (3) *Northwestern University Law Review* 641-708; John C. Coffee Jr, 'Privatisation and Corporate Governance: Lessons from Securities Market Failure' (1999) 25 *Journal of Corporate Law Studies* 37-9.
[10] G. A. Mark, 'Realms of Choice: Finance Capitalism and Corporate Governance' (1995) 95 *Columbia Law Review* 973; Mark J. Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* (Princeton University Press, New Jersey 1994) Ch.1.
[11] Brian R. Cheffins, 'Law, Economics and the UK's System of Corporate Governance: Lessons from History', (2001) 1 *Journal of Corporate Law Studies* 74.
[12] LLSV, 'Legal Determinants of External Finance' (1997) LII (3) *The Journal of Finance* 1149.

diversification is more beneficial in the sense that it provides less risk in the market. This phenomenon provides liquidity in the market that causes its development. This is evident from the fact that dispersed ownership is primarily in those jurisdictions where there is strong protection of minority shareholders. Therefore, the development of capital market is directly proportional to the dispersed ownership. However, if investors are not secure, they will protect themselves through blocks and that causes the concentration of ownership. Therefore, the concentration of ownership is inversely proportional to the development of the capital market. However, concentrated ownership is not the cause of an inferior corporate governance system *per se*, rather, it may be beneficial in the sense that large investors are well placed due to their shareholding to pressurize the management into working for the benefit of the firm. However, the problem with this kind of ownership structure is that the majority may be involved in the expropriation of the minority shareholders. Therefore, concentrated ownership and minority protection are complementary for an efficient corporate governance system.[13]

A further aspect of the LLSV theory is the link between the developed capital market with minority protection and the capacity of entrepreneurs to raise finance from outside investors.[14] The raising of finance is easier in countries where the legal protection of minority shareholders is strong than in those countries where the legal protection of minority shareholders is weak.[15] When financiers feel that their investment will not be expropriated by the insiders, they will not hesitate to invest.[16] Another aspect of the developed market is that it provides liquidity which is beneficial to investors because they may exit at any time when they are not satisfied with the performance of the firm.

4B.3 Critique of the LLSV theory

Scholars of corporate law have criticized the LLSV theory. Roe is the main critic. He argues that the anti-director rights index of the LLSV theory which is core to the indication, measurements and effectiveness of a particular jurisdiction, seems to be defective and a crude measure of minority protection and development of the market.[17] It is interesting to note the insight into, and application of, this index in the context of Pakistan which is a common law country. In the light of the provisions of minority shareholder

[13] LLSV, 'Investor Protection and Corporate Governance' (2000) 58 *Journal of Financial Economics* 24.
[14] *Ibid* 5-6.
[15] Reese and Weisbach (n 2) 75-6.
[16] Coffee, Jr (n 9) 644.
[17] Mark J. Roe, 'Corporate Law's Limits' (2002) 31 *Journal of Legal Studies* 233-71.

rights, the true picture is not presented. The anti-director index for Pakistan is 5, which is the highest amongst all countries. This is equal to the UK and the US, and better than Australia, France, Germany, Belgium, Japan and almost all the continental European countries. However, in reality, if one compared market development and economic growth there is a vast difference between Pakistan and other developed countries. The other aspect of the LLSV theory is that Pakistan, being a common law country, should have better enforcement and be more investor-friendly than civil law countries. In reality, Pakistan is not an investor-friendly jurisdiction. Most private and public companies are controlled by families and the state. The stock market of Pakistan is narrow and illiquid. Economic growth is very low. The enforcement mechanism is weak, and the judicial system corrupt and inefficient. In Pakistan corporate law does provide investors with some rights, but these rights are not sufficient to protect them due to the weak enforcement mechanism. Investors' rights in corporate law are present in Pakistan through colonization.[18]

Roe further argues that the LLSV theory may be useful in explaining the cases of transition and developing economies, but it is the only tool and not the central institution for developed economies.[19] It is, however, difficult to generalize Roe's theory. Each jurisdiction has its own factors and characteristics that develop a particular pattern of shareholding and development of the market. It is also difficult to distinguish between developed and developing countries with reference to the reasons and causes of dispersed ownership and developed markets on the basis of the index. According to the LLSV anti-directors rights index, Germany and Japan have 1 and 4 points respectively. Both have concentrated ownership despite the fact that Germany has only 1 point and Japan 4 points. As far as transition economies are concerned, Poland and the Czech Republic privatized state-owned firms. Both have a common Slavic culture, historical background and corporate law but had different approaches to privatization. The Czech Republic created dispersed share ownership with mass privatization without focusing on securities regulation, whereas Poland had a system of phased privatization with strict control over securities regulations. The outcome of these differences was that there was more expropriation and rent seeking in the Czech Republic than in Poland. It was not the corporate law, but rather the securities regulations that provided investors with protection.[20] In the context of developing countries, Pakistan and India have similar cultural and historical backgrounds, and have concentrated ownership in their corporate

[18] See text to n 74-77 in Chapter Two.
[19] Roe (n 17) 269-71.
[20] Coffee, Jr (n 5) 37-9.

sector. The LLSV index shows that both have 5 points on the anti-director rights index, which is better than many developed countries. These two countries have strong minority rights in corporate law but the ownership structure is concentrated.

Coffee is another critic of the LLSV theory. He observed that LLSV had overstated the importance of corporate law and understated the importance of securities laws which are an important factor in the development of the capital markets.[21] He argues that the provisions of minority protection are not sufficient for the development of capital markets, instead, the standards of securities regulations determine the development of the markets. Common law countries whose system is more favourable for dispersed ownership differ widely on corporate law and have converged functionally at the level of securities regulations. According to him, corporate law is not the main factor in dispersed ownership and minority protection is only of secondary importance. However, there are many other factors that are important for the development of capital markets. Politics, the judiciary and non-legal institutions also shape a particular system of corporate governance.[22] In addition to this, extensive disclosure requirements are also important factors in the development of capital markets.[23]

Cheffins also disagrees with the LLSV theory regarding the role of corporate law in the development of capital markets. He argues that, at least in the context of the UK, corporate law was not the main factor for capital market development. [24] According to him, in the context of the UK system of corporate governance, other factors such as market-based mechanisms were more important. He describes extra-legal institutions such as financial professionals, stock market self-regulation, listing regulations and reputational concerns as the main factors for the development of dispersed ownership and the capital market in the UK. However, he does not deny the importance of corporate law in those countries that do not share a common financial and social environment with the UK.[25]

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[21] *Ibid* 37-9.
[22] Mark J. Roe, 'Political Preconditions to Separating Ownership from Corporate Control' (2000) 53 (3) *Stanford Law Review* 600-3.
[23] R. La Porta, F. Lopez-ed-Silanes and A. Shleifer, 'What Works in Securities Laws?' (2006) LXI (1) *Journal of Finance* 28.
[24] Cheffins (n 11) 86-9.
[25] Brian R. Cheffins, 'Does Law Matter? The Separation of Ownership and Control in the United Kingdom, (2001) 30 (2) *The Journal of Legal Studies* 483-4; Brian R. Cheffins, 'Does Law Matter?: The Separation of Ownership and Control in the United Kingdom' (2000) ESRC Centre for Business Research, University of Cambridge, Working Paper No. 172, p 37-41 <www.cbr.cam.ac.uk/pdf/WP172.pdf > accessed 17.08.2013.

4B.4 Minority protection and its importance

Who should make decisions in directors and shareholders' meetings? Should all decisions be made through consensus or majority decisions? Majority decisions have their own benefits in the corporate world. If consensus is required from all the shareholders or control is shifted in favour of the minority, then this may be more problematic. Consensus is not feasible in the modern form of companies and this may create a deadlock in the smooth running of companies. However, this majority rule may harm the interests of the minority in some circumstances. This harm may be due to failure of corporate law or to the majority's abuse of power. The company's constitution and general corporate laws sometimes fail to curb this harm because the majority acts within the ambit of these laws and causes harm to the minority. Voting rights through which majority rule operates also fail to curb the abuse of the majority, and commercial law only reacts in circumstances when there is clear violation of law.[26] State intervention and well-designed corporate and securities law can save minority shareholders from abuse of their rights. Though such abuse on the part of the majority and mangers' opportunism cannot be stopped without interventionist rules, relying on such a strategy in every matter may deprive the majority of their legitimate rights and place hurdles in the effective running of companies. Nevertheless, the law must be responsive to opportunism by majority shareholders and managers in public companies.[27]

An important aspect of governance that highlights the importance of minority protection is efficiency considerations. It is argued here that if the minorities are protected, then this may also be beneficial to the majority.[28] If minority rights are not protected, then minorities will protect themselves by buying shares at highly discounted prices. The company might also lose a premium in an IPO which it would otherwise have received had there been more protection for minority shareholders. This will raise the cost of the capital of the company.[29] This cost will ultimately transfer back to the majority. The majority have more cash-flow rights; therefore, they will suffer more than minority shareholders.

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[26] Ataollah Rahmani, 'Majority Rule and Minority Shareholder Protection in Joint Stock Companies in England and Iran' (PhD thesis, University of Glasgow 2007).
[27] Paul L. Davies, *Gower and Davies Principles of Modern Company Law* (8th edn, Thomson Sweet & Maxwell, London 2008) 835-45.
[28] *Ibid* 835-45.
[29] Coffee, Jr (n 9) 644.

In addition to this, minority protection is important for the efficient operation of the market. If a system provides protection to the investors, they do not hesitate to become minority shareholders and to disperse their investment.[30] It provides investors with the luxury of diversification, which causes dispersed share ownership.[31] This dispersed ownership structure is considered investor-friendly as it provides liquidity in the market. Liquidity is important for the efficient operation of the market because it performs two important functions. First, it provides investors with an exit option when they are not satisfied with the management. Second, it also provides a corporate rider with an option to take control of the firm. The takeover threat can force managers to perform otherwise the successful bidder may remove non-performing incumbent directors after taking control.

Therefore, given this background, it can be concluded that minority protection is important for an efficient governance mechanism.

4B.5 Importance of minority protection in Pakistan

Minority protection is a key factor in the context of Pakistan due to the concentration of ownership. According to LLSV theory, minority rights must be protected in order to improve corporate governance and develop capital markets. As discussed earlier, minority rights are not properly protected in Pakistan. Therefore, corporate law in Pakistan must converge in some of the minority rights in order to improve corporate governance and develop capital markets.

However, in Pakistan there is confusion among scholars with regard to the concept of minority shareholders and importance of their protection in the Pakistani context. Mumtaz has discussed the impact and effectiveness of the code of corporate governance in Pakistan. She concludes that the code is based on Anglo-Saxon Model whose thrust is on a dispersed ownership structure with its focus on minority protections. She argues that the family-controlled corporate sector of Pakistan suggests that there is no need to protect minority shareholders as the ratio of their shareholding is very low. According to her, they will not have any positive effect on the productivity of the firm, even if their interests are protected. Therefore, the code must be adapted to local conditions in order to be effective in

[30] *Ibid* 641-708.
[31] LLSV, 'Investor Protection and Corporate Valuation' (2002) LVII (3) *The Journal of Finance* 1147-70.

Pakistan.[32] As far as protecting minority shareholders are concerned, her conclusion is defective for a number of reasons. Firstly, the corporate sector of Pakistan is dominated by families but there are other major stakeholders in the corporate structure of Pakistan that include the state and multinational companies. Although the state has a dominant shareholding in state-controlled companies, in the past three decades there has been a trend to privatize and divest. This phenomenon created general public and substantive private sector shareholdings in state-owned companies. Multinational companies, however, do have some major shareholding in the form of the managers but there are many outside investors in these companies.[33] Secondly, family-owned enterprises also have substantial shareholding in the public domain. This phenomenon of family divestiture came about due to the trend on the part of the state to privatize and divest themselves of state-owned enterprises, and a market boom which provided an opportunity for family-owned enterprises to raise finance from outside investors. Thirdly, Mumtaz confused the definition of minority shareholders: it is not just a specific percentage of shareholders who will be considered minority shareholders in every matter; for instance, 5%, 10% or 20% shareholders will not remain minority shareholders in each and every matter. This is a phenomenon that changes with the passage of time and on a case-by-case basis. This is explained in the following example: suppose there are four shareholders, namely A, B, C and D with 25% shareholding each. Suppose in one matter B, C and D collude with one another and decide in a matter that is against the interest of A. A is a minority shareholder in this case. It is quite possible, after some time, for A, B and C to collude with one another and make a decision that is against the interest of D. In this case D is a minority shareholder. Similarly, it is possible for B and D to become minority shareholder in other cases. A minority shareholder is, therefore, not a particular person or group of persons; rather, it is a phenomenon that changes with the passage of time. So, even in a family-owned firm it is quite possible for one family member to have a dispute with other members on a particular matter and need some protection from the abuse of the majority. Fourthly, as discussed earlier, minority protection is more important in concentrated ownership structures than in dispersed ownership structures. Fifthly, it is widely accepted that minority protection is an important element for the development of the markets and particularly for better corporate governance.[34]

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[32] Mahwesh Mumtaz, 'Corporate Governance in Pakistan-Adopt or Adapt? Paper presented at a conference in Lahore on 3-5 June 2005 organised by Securities and Exchange Commission of Pakistan (Regulator) and Lahore University of Management Sciences, Lahore.
[33] See text to n 95 in Chapter Two.
[34] Iain MacNeil, 'Adaptation and Convergence in Corporate Governance: The Case of Chinese Listed Companies (2002) 2 (2) *Journal of Corporate Law Studies* 333.

The inherent problem with minority protection in a concentrated ownership structure such as in Pakistan increases the importance of minority shareholder rights, and their enforcement through regulator, judiciary and extra-legal institutions. The corporate law of Pakistan provides some minority rights but most of the important rights are still missing. Most minority shareholder rights have been transferred in corporate law of Pakistan due to colonization. However, some important minority rights that are provided in the corporate law of Pakistan are inefficient, out-dated and need restructuring or improvement.

The implication of the LLSV theory regarding the link between minority rights and the development of capital markets and corporate governance is significant in the context of Pakistan. The LLSV theory states that for the development of capital markets and good governance, the protection of minority rights is important. Therefore, according to this theory, to improve corporate governance and develop capital markets in Pakistan, there is a need to protect minority rights in corporate laws in Pakistan. The ownership structure in Pakistan is highly concentrated where families, groups and state dominant the corporate sector. As discussed earlier, the minority rights are important in concentrated ownership structure such as Pakistan. However, the minority rights are not properly protected in Pakistan. Most of the standard minority rights are either missing or out-dated and inefficient to protect minority shareholders.[35] Families and politicians are strong forces which may resist reforms whose objective is to improve good governance which could challenge their discretionary powers and to provide protection to the minority shareholders. This situation makes us sceptical about possible convergence in minority rights through reforms in corporate governance.

In this context, an important question arises whether there will be reforms in Pakistan to protect minority shareholders in order to develop capital markets and overall corporate governance. There may be strong resistance in convergence in corporate governance in minority rights through reforms from path-dependent forces such as families and political forces.. However, the possibility exists that the state may proceed to provide minority protection with reforms for a number of reasons. Firstly, in the recent past, the state has divested some of its shareholdings in state owned enterprises through corporatisation, privatisation and disinvestment in the series of reforms through pressure from IFIs. The state has also plans to disinvest in major state owned enterprises in the future due to an

[35] The minority rights will be discussed in the next heading at 4B.6 (Minority protection mechanism).

agreement with IFIs as a condition of loans.[36] Corporatisation, privatisation and disinvestment may be a problem for the state in case of bad corporate governance. The state will not get good prices for its shareholding in cases of privatisation and disinvestment. One option for the state is to improve corporate governance through improving minority protection. According to LLSV theory, the provisions of the protection of minority shareholder rights will help to develop capital markets and the minority shareholders will be willing to pay higher prices for the state shares that the state intends to disinvest. Secondly, minority protection provisions may be beneficial to the state itself because divestment may ultimately convert the state into a minority shareholder, and minority shareholder protection will benefit the state as well.[37] Thirdly, family-owned enterprises that are considered a main opponent to reform may also favour minority protection mechanisms once they realize the potential benefits of improved corporate governance. The developed market with a minority protection mechanism can enhance the share value of firms and create an opportunity for them to raise external finance with lower costs of capital. They can also sell some of their shareholdings to the general public at a higher price and the minority shareholders may pay such enhanced price once they feel that their investment is safe and their rights are protected.

4B.6 Minority protection mechanism

Minority shareholders' protection mechanisms may be divided into two parts: (1) minority rights and (2) their enforcement. The discussion in this section will be limited to minority rights that include pre-emptive rights; cumulative voting rights; conflict of interest of the fiduciaries; derivative action; the unfair prejudice remedy; and winding up under just and equitable principles in the context of Pakistan. The enforcement of these rights will be discussed in Chapter Five.

The objective of this part is to examine the possibility and effectiveness of convergence in minority rights in order to improve corporate governance in Pakistan. As discussed earlier, there are strong prospects of convergence in minority rights in Pakistan in order to improve corporate governance in Pakistan due to the factors discussed above. In addition, the discussion will also focus on the kind of convergence which might take place in improving

[36] See text to n 85 in Chapter Two.
[37] Iain MacNeil has discussed these factors in the context of China in MacNeil (n 34) 333; See also *WAPDA v KAPCO*, 2000 PLD 461, Lahore High Court. In this case, WAPDA, a state-owned company, had to approach the court for a remedy under oppressive conduct (a minority protection) (see text to n 216).

corporate governance in Pakistan. As discussed above, functional and contractual convergence has certain advantages as compared to formal convergence. Therefore, the functional and contractual convergence may dominate the process of convergence in prevailing circumstances in Pakistan. In Pakistan, there are strong barriers to possible formal convergence from path dependent forces such as families, groups and state. Therefore, in order to overcome possible resistance from these path dependent forces, functional and contractual convergence may be useful to improve minority rights in Pakistan.[38]Therefore, functional and contractual convergence will remain the focus of discussion in this part to improve minority rights in Pakistan. In other words, the discussion in this part will be limited to assessing how and up to what extent minority rights may be improved for efficient corporate governance in Pakistan.

4B.6.1 Pre-emptive rights

Pre-emptive rights were discussed in detail in Chapter Two. Pre-emptive rights provide minority shareholders with protection against dilution. In Pakistan pre-emptive rights are a default rule in company law[39] and companies can exclude these rights by special resolution. As discussed in Chapter Two, pre-emptive rights are more important in underdeveloped and emerging markets such as Pakistan. There is threat of minority shareholder dilution if pre-emptive rights are made a default rule. As discussed in Chapter Two, families and the state dominate the corporate sector in Pakistan. They have more than 75% shareholdings even in listed companies. Therefore, they may dilute the minority percentage in shareholding and voting rights with a series of allotment of shares without pre-emptive rights. Therefore, there is a need to make pre-emptive rights mandatory in order to safeguard the interests of the minority shareholders in Pakistan.

4B.6.2 Cumulative voting system

As discussed in Chapter Two, the cumulative voting system (CVS) can be advantageous to minority shareholders in certain circumstances. However, it is not common in major, advanced jurisdictions.[40] In the US the CVS was mandatory until the twentieth century,[41]

[38] See discussion at 4B.5 in Chapter Four and 3.7.5 in Chapter Three.
[39] See s. 86 of the Companies Ordinance, 1984 (the Ordinance).
[40] Luca Enriques, H. Hansmann, and R. Kraakman, 'The Basic Governance Structure: Minority Shareholders and Non-Shareholder Constituencies' in R. Kraakman *et al.* (eds), *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2nd edn, Oxford University Press, Oxford 2009).

US states have abandoned it with the passage of time. Until 1982, only 24% of firms that had the CVS in their charters were listed on the New York Stock Exchange.[42] Now most of the states have abandoned this rule and only a couple have it in their corporate system. The company laws of the UK and France provide firms with the option to adopt the CVS but firms rarely do so in their charters for the election of directors.[43] As regards Germany, cumulative voting is not prohibited, but most of the companies opt out of this system. Some even dispute that it is permissible in German corporate governance, at least for listed companies.[44] Japan provides the CVS as a default rule but almost all companies also opt out of it in their constitution.[45] As far as other developing and emerging economies are concerned, the CVS is mandatory in the company law of Vietnam. The commercial law of China, India, Thailand and Korea support this system. Chinese Taipei is considering amending its company law to incorporate it as mandatory provision.[46]

In Pakistan the CVS is present in company law as a mandatory rule for companies that have share capital.[47] An interesting aspect of the CVS in Pakistan is a survey[48] conducted by the Association of Chartered Certified Accountants (ACCA) and sponsored by the International Finance Corporation (IFC) with the help of the SECP and the Pakistan Institute of Corporate Governance (PICG). A questionnaire was sent to local listed companies, large[49] local public non-listed companies and financial sector institutions. The survey, *inter alia*, includes the use of the CVS as a minority protection device. The objective of the survey was to know the extent to which the companies were following good corporate governance practices in line with codes of corporate governance and international good practices, and to provide regulators with an opportunity to focus on intended reform activities in this regard. The survey response states that 81% of companies do not have the CVS as a minority protection device. This shows lack of interest and awareness on the part of the companies in Pakistan with regard to overall governance mechanisms in general and minority protection in particular. As discussed in Chapter Two,

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[41] Jeffrey N. Gordon, ‘Institutions as Relational Investors: A New Look at Cumulative Voting’ (1994) 94 *Columbia Law Review* 124.
[42] Sanaji Bhagat and James A. Brickley, ‘Cumulative Voting: the Value of Minority Shareholder Voting Rights’ (1984) XXVII *Journal of Law and Economics* 343.
[43] Gordon (n 41) 124.
[44] Mathias M. Siems, *Convergence in Shareholder Law* (Cambridge University Press, Cambridge 2008) 172.
[45] Art. 342 of Companies Act, 2005 (Japan).
[46] OECD (2011), Corporate Governance in Asia 2011: Progress and Challenges, Corporate Governance, OECD publishing available at <http://browse.oecdbookshop.org/oecd/pdfs/product/2611011e.pdf > Accessed 22.08.2013.
[47] See s. 178 (5) of the Ordinance.
[48] A Survey of Corporate Governance Practices in Pakistan 2007 available at <http://picg.org.pk/index.php> Accessed 28.08.2013.
[49] ‘Large’ means the companies that have at least 500 million Pakistani rupees as their share capital.

in a straight voting system, it is not possible for minorities to appoint any member to the board. The Code emphasizes the fact that the management of listed companies should facilitate minority shareholders in contesting the election of directors. Non-compliance with the CVS shows minority shareholders are not being facilitated to contest the election of directors which is, in fact, non-compliance with the Code.[50] It is interesting to note that despite the fact that the CVS is mandatory under the Ordinance, it is not being implemented even by the listed companies. The regulator and the stock exchanges should ensure compliance with the Code and provisions of the company law in order to protect minority shareholders.

Another problem is the presence of one share, one vote as a default rule in the company law. This can frustrate the potential benefits of the CVS. Shareholders who have more than one vote per share can outweigh the possibility of minority shareholders electing a member to the board of directors. Therefore, the CVS can be effective only if one share, one vote is made mandatory.

Advanced jurisdictions are abandoning the CVS or have made it a default rule available as an option to firms. The majority of firms in these jurisdictions have opted out of this rule. This shows that it is not regarded as an important element for minority protection. However, this conclusion has to be hedged by observations that these are advanced jurisdictions with developed capital markets and a strong judicial system for the enforcement of shareholder rights in general and minority rights in particular. Similarly, if minority shareholders have other remedies, such derivative actions or the unfair prejudice remedy, this may provide some sort of substitute for membership on the board of directors. If the system supports other disciplinary mechanisms, then the minority may feel comfortable even without the CVS.

In Pakistan, where there is an undeveloped market, there are fewer chances for the minority shareholders to resolve their issues through market discipline. The market is not developed enough to sanction a firm for its wrongdoings. The KSE, the main stock exchange in Pakistan, is small in size but has a high turnover, with high fluctuations in prices mainly due to the manipulation by brokers and controlling shareholders. They manipulate prices with mutual trading and derive benefits from such fluctuation. Insider

[50] Clause I (a) of the Code of Corporate Governance 2012 requires listed companies to encourage minority shareholders to contest the election of directors.

trading is common phenomenon.[51] Lack of liquidity creates a problem for minority shareholders because they do not have exit options.[52] The market is not developed enough to play its role in sanctioning defaulting firms.

The nature of the ownership structure is the main factor that affects cumulative voting. The US and the UK are developed markets with dispersed ownerships; therefore, the CVS may not be effective in these jurisdictions because controlling shareholding is not common. This issue is important in concentrated ownership structures with block holders. As the ownership structure in Pakistan is concentrated, there are, therefore, fewer chances for the minority to elect a member to the board of directors as opposed to the majority block holders.

If a director is elected by the minority shareholders to the board through the CVS, this necessitates some safeguard from removal by the majority. S. 181 of the Ordinance provides this safeguard. The section stipulates that a director cannot be removed if in the resolution of removal of a director there are such number of votes against the resolution that are equal or more than the minimum number of votes that were cast to elect a director at the last AGM. This can be explained by the following example:

Example

Suppose five directors (i.e., A, B, C, D, E and F) were elected at the last AGM with the following number of votes:

Table 4B.1: Results of a resolution to remove a director

Name	Votes
A	40,000
B	35,000
C	30,000
D	25,000
E	20,000
F	15,000

Suppose there is a resolution to remove director B. Suppose at the meeting 90,000 votes are in favour of the resolution to remove B but there are 15,000 votes against the

[51] I. A. Khawaja and A. Mian, ‘Unchecked Intermediaries: Price Manipulation in an Emerging Stock Market’ (2005) 78 *Journal of Financial Economics* 203-241.
[52] Mumtaz (n 32).

resolution. B will not be removed in this case because at the last election of directors, 15,000 votes were enough to elect director F.

The problem with this provision is that the shareholders cannot remove any director who is not performing. A director who has shareholding in his own name or who has the backing of the majority shareholders cannot be removed by the resolution even if that director is not performing. This is the cost that shareholders have to pay for the CVS. One option may be to go to court to remove the non-performing incumbent director. This amounts to interference in the functioning of companies. The British courts declared repeatedly that they would not take on the management of the business of companies.[53] The shareholders are the best monitors of the directors' conduct and can, through a shareholder resolution, remove a director, but the difficulty is that the removal of directors adds costs which the shareholders have to pay. This restricts the accountability of the directors.

One solution may be the possibility of frequently electing directors, at least in listed companies in Pakistan. The recent change in the UK corporate governance code provides re-election of directors of FTSE350 companies every year. This limits the need to resort to the removal of directors.[54] The trade-off between the minority shareholders' rights to elect a director to the board of directors through the CVS and the strict requirement of removing a director from the board can be settled by the annual re-election provision in Pakistan. The functional convergence in frequent election of directors on the pattern of FTSE 350 may resolve the problem of accountability of directors at least in listed companies in Pakistan.

[53]M. J. Trebilcock, 'Liability of Companies Directors for Negligence' (1969) 32 *Modern Law Review* 502-4.
[54] Iain MacNeil, 'Activism and Collaboration Among Shareholders in UK Listed Companies' 5(4) (2010) *Capital Markets Law Journal* 422.

4B.6.3 Conflict of interest of the fiduciaries

4B.6.3.1 Introduction

A conflict of interest between controlling shareholders, directors, corporate officers and the company may arise in two different situations. First, it may arise when insiders[55] have an interest in any transaction in which the company is involved as a party. This may occur when a transaction is entered into between a company and its insiders or between a company and a third party in which such insiders have a direct or indirect interest; for example, if a contract is concluded between a company and a third party, and the insiders are owners or major shareholders of the third party. Second, a conflict of interest may arise in a situation where the insiders identify a business opportunity but they exploit it for their personal benefit without offering it to the company first. The former is called a *related party transaction*, whereas the latter is a *corporate opportunity*. Both a related party transaction and corporate opportunity may not be in the interest of the company and, consequently, not in the interest of the shareholders in general and minority shareholders in particular.

The management is meant to make decisions and conclude contracts in the best interest of the company. However, sometimes they may proceed for their own benefit at the cost of the company. They may enter into a transaction with a company that is beneficial to them at the cost of the company. Other possible conflicts of interest may be a situation in which insiders identify a business opportunity using the resources of the company but they exploit this opportunity for their personal benefit instead of offering it to the company. As every business activity is not a corporate opportunity that is the company's right, the determination of a business opportunity is, therefore, important in the sense that once it is established that a business opportunity was, in fact, a corporate opportunity then directors must exploit the same for the company and not for their personal benefit. Corporate laws generally prohibit directors from taking corporate opportunities for their own benefit without offering them first to the company.[56] The directors are considered in breach of fiduciary duty when they exploit corporate opportunities for their own personal benefit and not for the company whom they are supposed to serve.[57] Corporate opportunities are

[55] Insiders include the controlling shareholders, the directors and the corporate officers.
[56] Eric L. Talley, 'Turning Servile Opportunities to Gold: A Strategic Analysis of the Corporate Opportunities Doctrine' (1998) 108 *Yale Law Journal* 279.
[57] D. D. Prentice, 'Notes of Cases: The Corporate Opportunity Doctrine' (1974) 37 (4) *Modern Law Review* 464.

regarded as assets of the company in the sense that the directors are not allowed to exploit such opportunities for their personal gain.[58] Therefore, it is important to see to what extent a business opportunity belongs to company and to what extent the same may be exploited by the directors without breach of fiduciary duty. As far as the UK corporate context is concerned, certain restrictions and safeguards have been developed in common law. The UK Companies Act, 2006 has now codified directors' duties and further restricts directors' powers of taking away corporate opportunities for their personal benefit.[59] However, in Pakistan the law does not prohibit the controlling shareholders and the directors from exploiting a corporate opportunity for their personal benefits. The doctrine of corporate opportunity is important for concentrated ownership structures such as those in Pakistan. The corporate sector is dominated by families and the state.[60] This highly concentrated ownership by families and the state necessitates proper legislation for controlling self-interested transactions by the controlling shareholders and the directors for investor protection in general and the minority shareholders in particular.

4B.6.3.2 Related party transactions

Related party transactions are a major source of expropriation by insiders as these insiders are in a position to make decisions and take advantage of their decision-making power. They may enter into a transaction on behalf of the company with themselves or with their related business such as a private company established by them or with a public company in which they have more interest than the company concerned. Controlling related party transactions is an important minority protection device in which abusive self-dealing by insiders is avoided. There is a trend in advanced jurisdictions of controlling related party transactions that are not at arm's length. Arm's length transactions are those transactions that are not at prevailing market rates. Every transaction a company enters into with an insider does not amount to expropriation; rather, it may be beneficial to the company but there is a need to provide investors with safeguards.

In common law the conflict of interest of the fiduciaries was required to be approved by the shareholders. The courts in the UK had remained very strict about the approval of the

[58] John Lowry and Rod Edmunds, 'The Corporate Opportunity Doctrine: The Shifting Boundaries of the Duty and its Remedies' (1998) 61(4) *Modern Law Review* 515.
[59] See s. 175 (2) of the Companies Act, 2006.
[60] Imtiaz Ahmed Khan, 'The Role of International Organisations in Promoting Corporate Governance in Developing Countries: A Case Study of Pakistan' (2012) 23 (7) *International Company and Commercial Law Review* 223.

fiduciaries' conflict of interest, especially on the part of the directors of companies.[61] They could obtain relief only after authorization from the shareholders.[62] However, the problem with this common law rule was that even the courts ignored the good faith of fiduciaries in some cases. Therefore, in order to remove ambiguities, the UK codified directors' conflict of interest. The Companies Act, 2006 deals with the conflict of interest on the part of directors in any transaction between the directors and the company.[63] The directors are required to disclose to the board of directors the nature and extent of their interest in the proposed transaction or arrangement with the company.[64] The conflicted director must make such disclosure before entering into the transaction with the company.[65] The common law rule or equitable principle that may require approval of shareholders to authorize such related party transaction has been excluded effectively by the new Act.[66] However, this is not an absolute power of the directors as companies may provide in their constitution that these transactions be approved by the shareholders.[67] Moreover, the Act has excluded certain transactions from the ambit of the board of directors and has provided that they be approved by the shareholders. Chapter 4 of the Act deals with those transactions that require members' approval. These transactions include, but are not limited to, the long-term service contracts of directors;[68] substantial property transactions,[69] unless the company is in the course of winding up or is under administration under the Insolvency Act, 1986;[70] loans; and a guarantee for a loan advanced to the directors.[71]

The listing rules have further extended the scope of transactions for shareholders' approval. The objective is to provide more minority protection in companies operating in the public domain. The listing rules of the FCA require that all listed companies that have a premium listing must obtain shareholders' approval for major transactions[72] and related party transactions.[73] The listing rules define Class 1 transactions[74] and related party

[61] *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134 (HL).
[62] Andrew Keay, 'The Authorising of Directors' Conflict of Interest: Getting a Balance?' (2012) 12 (1) *Journal of Corporate Law Studies* 129.
[63] See s. 177 of the Companies Act, 2006.
[64] See s. 177 (1) of the Companies Act, 2006.
[65] See s. 177 (4) of the Companies Act, 2006.
[66] See s. 180 (1) (b) of the Companies Act, 2006.
[67] See s. 180 (1) (b) of the Companies Act, 2006.
[68] See s. 188 of the Companies Act, 2006.
[69] See s. 190 of the Companies Act, 2006.
[70] See s. 193 of the Companies Act, 2006.
[71] See s. 197 of the Companies Act, 2006.
[72] See LR 10.1.2 G (2) of Financial Conduct Authority (FCA).
[73] See LR 11.1.7 R (3) of the FCA.
[74] See LR 10.2.2 R (3) of the FCA defines Class 1 transactions. The transactions are said to be Class 1 if they cross a certain threshold provided in the listing rules.

transactions. A related party is widely defined and may include a person who is a substantial shareholder, which means a person who has 10% or more voting powers or can exercise significant influence or a director or a shadow director or an associate of the aforementioned persons.[75] Related party transactions include a transaction between the company and related party, or company and related party entering into an agreement with a third party.[76] The related party and its associates are excluded from taking part in the voting of shareholders at a general meeting.[77] However, they are not excluded from taking part in discussion for consideration and approval of such transaction. Excluding the related party and his or her associate from voting may be a good technique but allowing that party to attend the meeting and to take part in discussion may be problematic, as conflicted insiders may be in a position to pursue other shareholders to avoid raising their voice and vote in their favour. So, it may be better to exclude related parties from participating in that part of the meeting of shareholders that is to consider and approve a related party transaction. This may give shareholders an opportunity to raise independent views about the advantages and disadvantages of such transaction. Though the shareholders always have the option to turn to the courts, it may increase costs and consume much time, which affects the business of the company.

At the other end of the spectrum, related party transactions may not always be against the interest of the company; in fact, it may be beneficial to the company. As the courts have been reluctant to approve the conflict of interest of fiduciaries, an effective mechanism for approval will be beneficial to both the related parties and the company. A safeguard against misuse of related party transactions may be the approval mechanism of such transaction both from the directors and the shareholders.[78]

Another option to protect minority shareholders may be to give an appraisal right to dissident shareholders. Under this right, the shareholders who do not agree with the decision of the majority to approve related party transaction, may be given the right to exit the company at a fair price. However, this mechanism may place a financial hurdle in the affairs of the company because the company or the controlling shareholders have to purchase these shares and the company or the controlling shareholders may not be willing to do so at that stage. As this provision may create problems in decision-making, minority

[75] See LR 11.1.4 R of the FCA.
[76] See LR 11.1.5 R of the FCA.
[77] See LR 11.1.7 R (4); Davies (n 27) 651.
[78] OECD (n 45).

shareholders, therefore, do not have this appraisal right to exit from the company if they are not satisfied with the decision. This right is thus limited to the extent of the reorganization of the company in the UK.[79]

Controlling related party transactions is also present in Asian countries where the focus is on the approval mechanism. Malaysia and Korea have clarified and extended the scope of related party transactions in their recent amendments to the company law and listing rules. Indonesia, Chinese Taipei, Vietnam, Singapore and China have introduced a disclosure and approval mechanism in related party transactions in their corporate laws. In India the newly drafted Company Bill 2012 has also provided some safeguards against related party transactions. This shows that both developed and developing jurisdictions are focusing on related party transactions as a minority protection mechanism.

4B.6.3.2.1 Related party transactions in Pakistan

In Pakistan the company law requires certain transactions in which the director or officer has some interest to be disclosed and approved by the board of directors. The directors[80] and officers[81] of the company concerned are required to disclose their interest in any transaction to be made by the company. A director shall also be regarded as being interested in such transaction if relatives of such a director have some interest in the transaction.[82] The interested director is prohibited from taking part in, and voting at, a meeting of the board of directors meant for consideration and approval of such transaction. Furthermore, the presence of such director will not be taken into consideration when it comes to determining a quorum.[83] The Code requires that directors assess all related party transactions and determine their price. The Code further requires that related party transaction be placed before the audit committee, and on the recommendation of that committee the same shall be reviewed and approved by the board.[84]

The term *related party* has not been defined in the company law, the Code and the listing regulations, which may create confusion. It is interesting to note that *related party* was

[79] Davies (n 27) 652.
[80] See s. 214 of the Ordinance.
[81] See s. 215 of the Ordinance.
[82] See proviso to s. 214 (1) of the Ordinance.
[83] See s. 216 of the Ordinance.
[84] See provision x of the Code of Corporate Governance 2012 of Pakistan.

defined[85] in the fourth schedule[86] to the Ordinance and was deleted[87] on the recommendation of the Institute of Chartered Accountants of Pakistan. The institute argued that it was difficult for SOEs to disclose their transactions with other SOEs and to do so was costly as well.[88] International Accounting Standard (IAS) 24 requires related party transactions to be disclosed, but after the objections raised by some quarters regarding the cost and difficulty in SOEs' disclosure; the International Accounting Standard Board (IASB) recommended that certain detail be omitted, while still providing the shareholders with some information.[89] The effect of such disclosure, *inter alia*, was to assess the influence of the state on SOEs. The SECP, instead of providing exemption to SOEs, abolished the definition of *related party*, which led to uncertainty among other companies.

The scope of related party transactions in Pakistan is limited. The law includes only those transactions that fall within the meaning of related party transactions in which a director or officer has some interest. This does not include controlling shareholders, relatives, business associates and the friends of controlling shareholders. It is necessary to enhance the scope of related party transactions because majority shareholders may escape from prohibition. These shareholders may use their position to approve any transaction from the directors in which they have a personal interest. Family-owned enterprises in Pakistan have interlocking directorship and cross-shareholding. It is, therefore, not difficult for the controlling shareholders in such companies to get approval from the board. This provides them with an opportunity to abuse their majority power through the board. The nature of the corporate sector of Pakistan, therefore, suggests that it is necessary to subject the controlling shareholders and their associates to a fiduciary duty.

Another problem is that of the approval mechanism which vests powers in the board of directors. There is a global trend of extending the nature, scope and approval mechanism of related party transactions. Many developed and developing jurisdictions have introduced a legal framework in this regard to provide minority protection. Related party transactions

[85] Substituted by SRO 589 (I) / 2004, dated July 5, 2004.
[86] Schedule 4 describes the requirement for 'balance sheet' and 'profit and loss accounts' by the listed companies. The deleted provision that defined related party transactions focused on substantial control or influence by the entities and individuals. It also included the management, associates and their close family members. As regards substantial control or influence, no clear indication was provided. Reference was only made to International Account Standard (IAS) 28. According to IAS 28 an associate is considered having significant influence if he or she has 20% or more voting powers.
[87] Deleted by SRO 1261(I)/2008, dated 2.12.2008.
[88] *E-Technical Update*, issued by the Institute of Chartered Accountants of Pakistan in December 2008 available at <http://www.icap.org.pk/userfiles/file/e-Letter-Dec2008.pdf > Accessed 12.12.2013.
[89] *Ibid*.

can be controlled effectively in Pakistan when the scope and approval mechanism is changed according to the new trend prevalent in the world. The determination of price, consideration and approval of related party transactions from the board may not solve the purpose of minority protection. In Pakistan the corporate sector is concentrated where the directors are normally family members, relatives or close friends. The directors are under the direct influence of the controlling shareholders and may be biased in favour of their colleague director. Therefore, asking the board to consider, determine and approve related party transactions may not provide minority protection. The approval mechanism requires reconsideration. This may include transactions exceeding certain thresholds to be approved by the shareholders at general meetings. All related party transactions may be considered and approved by the board of directors but once the transaction exceeds a certain specified limit, then it may be forwarded to a general meeting for consideration and approval.

Similarly, when the transaction is referred to a general meeting for consideration and approval, then the issue will be the approval mechanism at shareholders' meetings. The interested director or dominant shareholder may be involved in and help to approve such transaction. As discussed above, it is possible that the conflicted director or the controlling shareholder may be influential enough to pursue other members to avoid raising his or her voice against the transaction or voting against such transaction. It is appropriate to exclude a related party from participating in that part of the meeting of shareholders which is to consider, discuss and approve related party transactions. This may give shareholders an opportunity to raise an independent view about the advantages and disadvantages of related party transactions, and to vote on the resolution. In the context of Pakistan, as the corporate culture is not used to this type of restrictions and authorization process, it is appropriate, in the first instance, to introduce such provisions applicable to listed companies through the code. Once they have been implemented successfully and accepted by the business community, they may be extended to all types of companies through company law.

4B.6.3.3 Doctrine of corporate opportunity

As discussed earlier, the corporate opportunity is another aspect related to the conflict of interest of the fiduciaries.

4B.6.3.3.1 Common law approach to corporate opportunity doctrine

The doctrine of corporate opportunity was developed in common law with the passage of time. Some principles with reference to directors' conflict of interest and the authorization process were developed.

a. No profit rule

The first common law principle of 'no profit rule' was established in *Regal Hastings v Gulliver*.[90]Regal (Hastings) Ltd, who owned a cinema in Hastings, was interested in acquiring leases for two more cinemas and, at the same time, was negotiating with a third party for the sale of all the assets of the company. The company formed a subsidiary company. As the company was not in a position to provide finance, therefore, the directors contributed £3,000 in equity of the subsidiary from their personal resources to satisfy the concerns of the lessor. In the meantime, the purchase of Regal Hastings was finalized with a third party, including all the assets of the subsidiary. The new directors of the company brought an action against the old directors for taking profit as a result of their buying and selling shares in the subsidiary company. The House of Lords said that no matter the fact that the company was not in a position to provide finance and take business opportunity, it was still a corporate opportunity and directors could not take profit from that opportunity. The decision of the House of Lords was harsh in the sense that it was not possible for anyone, including the plaintiff, to make profit without the personal investment of the directors.[91] However, the decision might be based on the possibility that the directors could have taken a further loan for the company or given their personal guarantee for finance in order to benefit the company.[92] However, the House of Lords did not take into account the consideration of good faith on the part of the directors.[93] The strict approach on the part of the courts may lead to uncertainty and commercial inconvenience.[94] This was a narrow approach taken by the House of Lords.

[90] *Regal (Hastings)* (n 61).
[91] David Kershaw, *Company Law in Context: Text and Materials* (Oxford University Press, Oxford 2009) 478-9.
[92] Davies (n 27) 561.
[93] Keay (n 62) 132.
[94] B. Hannigan, *Company Law* (2nd edn, Oxford University Press, Oxford 2009) 247.

b. No conflict principle

The second common law principle, namely 'no conflict', was established in *Aberdeen Ry Co v Blaikie Brothers*, where Lord Cranworth LC said that fiduciaries were not allowed to put themselves in a position where their interest conflicted or may possibly conflict with their duties.[95] Lord Herschell in *Bray v Ford* said that it was an inflexible rule of equity that a fiduciary was not entitled to place himself or herself in a position where his or her interest conflicted with his or her duties, unless expressly provided otherwise.[96] The House of Lords confirmed the same principle in *Boardman v Phipps.*[97] This was a trust case but it applies both to trustee fiduciary and directors' fiduciary as both directors and trustees manage the property of the others.[98] In this case a family trust had a 27% shareholding in a company. Boardman (the solicitor of the trust) and Tim Phipps (the beneficiary of the trust) presented themselves as agents of the trust and participated in a general meeting of the company as proxies for trustees with signature and the consent of two trustees, excluding the plaintiff (John Phipps). They were not satisfied with the performance of the management of the company and became aware of the fact that the real value of the shareholding of the trust could only be realized by obtaining control of the company. They obtained inside and confidential information of the company by representing themselves as nominees of the trust. They purchased the majority of company shares from their own pocket and took control of the company. Later on, after realising that they could earn handsome profits, they sold one of the company's undertakings in Australia and capital distribution was made thereafter. The profit was distributed between Tim Phipps (beneficiary), Boardman (solicitor) and trust (as a minority shareholder). John Phipps, another beneficiary, brought a case against Boardman and Tim Phipps to account for the profit. Wilberforce J[99] said that the defendants were accountable for the profit attributable to the share of the plaintiff in the trust but subject to payment of allowance to Boardman for his work, skill and efforts. The decision of the High Court was confirmed by the court of appeal. The House of Lords dismissed the defendants' (Boardman and Tim Phipps) appeal. The House of Lords said that the appellants had placed themselves in a special position which was of a fiduciary character. They were held accountable to the respondents as constructive trustees. The court said that they had breached their fiduciary duty by putting themselves where their interest conflicted with their duties. Therefore, they were

[95] *Aberdeen Ry Co v Blaikie Brothers* [1843-60] All ER Rep 249.
[96] *Bray v Ford* [1896] AC 44 (HL).
[97] *Boardman v Phipps* [1966] UKHL 2.
[98] Kershaw (n 91) 479-91.
[99] *Boardman v Phipps* [1964] 1 WLR 993.

held accountable for the profit made by them. The decision was based on the *Regal Hastings* case. However, the principle to account for all profits established in the *Regal Hastings* case was modified in the *Boardman v Phipps* case, where Wilberforce J. allowed the defendants to be paid out of profit for utilising their skill and efforts, as the profit could not have been made by anyone without their skills and efforts.[100]

The decision was complex and was decided through a majority vote. Lord Upjohn dissented from the decision and said that the rule of equity was stated in the most general terms and should be applied according to the circumstances of each case. He said that fiduciaries should not place themselves in a position where their interest conflicted with their duties but the rule might be departed from in certain circumstances. The rule is not founded on the principles of morality; rather, it is based on the nature of human beings that they should not prioritize their interest over their duties. It is possible that sometimes it might be advantageous for the beneficiaries when trustees act professionally.[101]

The principle that was decided on by the majority of the House of Lords implies that the fiduciaries should not place themselves in a position where their interest conflicted with their duties. In the context of companies, the directors should not put themselves in a position where their interest conflicted with that of the company.

c. In the line of business of the company

The third common law principle, namely 'in the line of business of the company' was established in *Re Bhullar Brothers*.[102] In this case the objects of the company were to run a grocery shop but the memorandum of association also included the power to acquire property for investment purposes. As the members of company were involved in a dispute and were willing to part ways from their interests in the company, they were not interested in acquiring further properties. Two directors acquired a property adjacent to the property owned by the company through their own company. The shareholders, who were also directors, brought a case against the respondent directors on the basis that the affairs of the company were conducted in a manner unfairly prejudicial to the members, and demanded that proceeding be brought as derivative action for breach of fiduciary duty. The trial court

[100] *Boardman* (n 97); Denis S. K. Ong, 'Breach of Fiduciary Duty: The Alternative Remedies' (1999) 11 (2) *Bond Law Review* 1.
[101] *Boardman* (n 97) as per Lord Upjohn.
[102] *Re Bhullar Brothers* [2003] EWCA Civ 424.

observed that '*a reasonable man looking at the facts would think there was a real sensible possibility of conflict*', therefore, in these circumstances the respondent directors had breached their fiduciary duty. The court held that it was a corporate opportunity and the directors were not allowed to exploit the same for their personal interests. The respondents then filed an appeal against the order. The appellate court confirmed the order of the trial court. The court said that it was irrelevant whether or not the company was in a position to take that opportunity had it been informed. It was the duty of the appellants to inform the company, and not informing the company showed the existence of a conflict of duty with interest.

Therefore, a director cannot take an opportunity that is in line with the scope of the business of the company. If a director exploits an opportunity that is within the line of business of the company then he or she will not be considered acting in the best interest of the company. However, a director may exploit any business opportunity that is not within the line of business of the company and has not used the resources of the company.

The principle 'within the line of business of the company' is important in the context of the new Act in the UK. The Act has abolished business restrictions on companies.[103] The business restrictions are subject to the articles of association. If it is not restricted by the articles, then the business of the company is unrestricted. Therefore, a company can undertake a business that is not authorized by its articles. Therefore, 'within the line of business of the company', a restriction established in the *Re Bhullar* case, has generally become redundant in the context of the new Act. Therefore, under the new Act a business opportunity that is not within the line of the business of the company may be considered a corporate opportunity because a company may undertake that business if it is not prohibited by its articles. So, a director is prohibited from taking it for his or her personal benefits as this opportunity may be exploited by the company after its discovery. The court in the *Re Bhullar* case has stressed the irrelevance of the capacity of the company to exploit the opportunity. The capacity of the company refers to both its authorization to undertake business through its articles of association and its financial position to undertake that opportunity. As far as the financial position of the company is concerned, the possibility exists that the company may exploit it after taking a loan from a bank if it is currently not financially in a position to exploit that opportunity. The third common law principle has become more restrictive in the context of new Act.

[103] See s. 31 (1) of the Companies Act, 2006.

However, in *Island Export Finance v Umunna*, the court took a different view. [104] In this case the court said that since the company was not interested in taking the opportunity, it was, therefore, not a corporate opportunity. The directors may proceed to exploit it for their personal benefit. Both cases have different views but since the *Re Bhullar* case was decided at the appellate stage, that case may be considered the UK approach.

The Court of Appeal in O'Donnell[105] removed ambiguities concerning directorial entrepreneurship and confirmed the principle established in *Re Bhullar*.[106] It further held that directors must inform the company regarding a corporate opportunity, whether or not the company would be interested or capable of taking advantage, and obtain authorisation from the company before exploiting the corporate opportunity for their personal benefits. A director cannot make decision at his or her own initiative that the company will not be interested and proceed at his or her own without informing the company.[107] Section 175 (5) of the Companies Act, 2006 provides an authorisation process for directors. Therefore, a director must inform the company concerning corporate opportunity and obtain authorisation before exploiting the same for his or her personal benefits.

Furthermore, under section 175 (2) of the Companies Act, 2006, it does not matter if the company is not in a position to take up the opportunity, it will still remain for the company to exploit that opportunity; an approach undertaken by the court in the *Re Bhullar* case and confirmed by O'Donnell.

Therefore, the UK approach will be more restrictive after the enforcement of the new Act and O'Donnell case.

d. Extension of the 'no conflict principle' to a director's resignation from a post

The important question with regard to the fiduciary duty of a director is the extension of the 'no conflict' principle after the resignation of the director. In *IDC v Cooley*, the court extended the principle after the resignation of the director. In this case the director

[104] *Island Export Finance v Umunna* [1986] BCLC 460.
[105] Re *Allied Business and Financial Consultants; O'Donnell v Shanahan* [2009] EWCA Civ 751; [2009] 2 BCLC 666.
[106] Deirdre Ahern, 'Guiding Principles for Directorial Conflicts of Interest: Re Allied Business and Financial Consultants Ltd; O'Donnell v Shanahan' (2011) 74 (4) *The Modern Law Review* 596.
[107] Re *Allied Business and Financial Consultants; O'Donnell v Shanahan* [2009] EWCA Civ 751.

identified a business opportunity and took that opportunity for himself after resigning. The court said that since the opportunity was identified before resignation, the director was not entitled to take that opportunity. Roskill J said that the former director took significant steps towards obtaining the corporate opportunity while he was still a director of the company. Therefore, he was taking a corporate opportunity using the resources of the company but he was not entitled to take it for his personal interest. It was still the company's opportunity.[108] The principle 'extension of no conflict rule to post resignation' established in *IDC v Cooley* has been referred to frequently in later cases but the courts have not used it independently.[109]

In *Island Export Finance v Umunna*, the court took a different view to that decided in the *Cooley* case. In this case the company had business in Africa and one of its ventures was to supply telephone boxes to Cameroon. One of its directors was not satisfied with his post and resigned. He formed his own company and obtained an order for supplying telephone boxes to former customers of the company. The court said that since the company was not interested in taking that opportunity, this was not a corporate opportunity, and the director had the right to proceed with his actions. Hutchinson J said that directors acquired a general fund of knowledge and expertise while working in a company and it was in the public interest that they should be allowed to exploit corporate opportunities.[110]

Another rule that has been established in common law about a former director taking a corporate opportunity is the maturing business opportunity approach.[111] The Supreme Court of Canada said that a former director was not allowed to exploit a maturing business opportunity that his or her former company was actively pursuing. This opportunity would be considered as if it were the property of the company which the directors – present and former – could not exploit. The court further held that the former director may, however, exploit a maturing business opportunity if his or her resignation was not prompted to exploit the opportunity.[112]

Therefore, in this context, it can be concluded that former directors may only proceed to exploit a corporate opportunity if they had informed their former company about that opportunity identified during their position as director and they are either removed by the

[108] *Industrial Development Consultants v Cooley* [1972] 1 WLR 443.
[109] Kershaw (n 91) 510.
[110] *Island Export* (n 104).
[111] Kershaw (n 91) 510.
[112] *Canadian Aero v O'Malley [1974]* SCR 592.

company or resigned from their post for any reason other than the intention to exploit the corporate opportunity.[113]

e. Common law approach to authorize conflict of interest

The courts in the UK have been very restrictive in absolving fiduciaries from conflict of interest. The fiduciaries were not allowed to put themselves in a position where their personal interest conflicted with their duties. They were not entitled to make profits from their position unless so authorized by the shareholders.[114] The only way for directors to be granted relief was to obtain the approval of the shareholders. The reason for such an authorization from the shareholders was that the shareholders were affected most in cases of conflict of interest.[115] Therefore, the courts used to ask directors to obtain shareholders' approval for such authorization.

4B.6.3.3.2 Statutory requirement in the UK: The Companies Act, 2006

Fiduciary duty has now been codified in the Companies Act, 2006. The new Act requires that directors avoid conflicts of interest with the company in whose employ they are. A director is required to avoid a situation where his or her interest conflicts with that of the company.[116] The new Act has also put restrictions on directors exploiting corporate opportunity for their personal interest. The Act confirms the common law approach established in the *Regal Hastings* and *Re Bhullar* cases. It provides that it is immaterial whether or not a company can take that opportunity.[117] So, a director cannot take any opportunity even if the company is not in a position to take that opportunity. The logic behind this provision is that if currently the company is not in a position to make use of an opportunity, it might have an interest in doing so in future. Therefore, the directors are prohibited from exploiting corporate opportunities. The directors are supposed to act in the best interest of the company and if they exploit any opportunity that belongs to the company, they will not be regarded as acting in the best interest of the company.

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[113] Kershaw (n 91) 510.
[114] *Bray v Ford* (n 96).
[115] Keay (n 62) 132.
[116] See s. 175 (1) of the Companies Act, 2006.
[117] See s. 175 (2) of the Companies Act, 2006.

The 'no profit rule' of the common law[118] has also been retained by s. 175 (2) of the Act. It states that directors are not allowed to exploit information, property or an opportunity of the company. They are not allowed to take profit from using the resources of the company. The opportunity belongs to the company and it is immaterial whether or not the company can exploit that opportunity. This is quite a strict approach adopted in the Act.

Similarly, the new Act has explicitly excluded former directors from taking a corporate opportunity that was identified by them while in the position of a director;[119] in other words, the principle 'using the resources of the company' established in the *Re Bhullar* case and the extension of the 'no conflict' principle to former directors established in *IDC v Cooley* are important in the context of new Act. Therefore, if a director has identified any opportunity by using the resources of the company, then such director is prohibited from exploiting it after resigning from the company. A summation of the above discussion is the establishment of three rules that regard the conflict of interest of the fiduciary in the context of the new Act and for the courts to interpret. The first rule is the utilization of company resources to identify business opportunity. The second rule is failure on the part of the fiduciary to disclose the business opportunity to the company. The third rule is resigning with the intention of exploiting that opportunity.[120]

a. Approval mechanism in the Companies Act, 2006

The Act also provides for an authorization process in the case of the conflict of interest of fiduciaries. The Act modified the old common law practice of authorization from the shareholders. Under the Act, the conflict of interest of a director can be authorized by the directors in the case of a private company, provided that it is not prohibited by the company's articles of association.[121] However, the conflict of interest of a director can be authorized by the directors in a public company if it is so provided in the constitution of the company.[122] In private companies, the shareholders are normally directors and therefore any approval by the directors will be considered as approved by the shareholders. However, this may be problematic in big private companies where professionals are hired as directors. As far as public companies are concerned, since it is not feasible for their shareholders to be called frequently for every conflict of interest, the Act authorizes

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[118] *Regal (Hastings)* (n 61).
[119] See s. 170 (2) of the Companies Act, 2006.
[120] Kershaw (n 91) 510.
[121] See s. 175 (5) (a) of the Companies Act, 2006.
[122] See s. 175 (5) (b) of the Companies Act, 2006.

companies to provide in their constitution that approval by the directors will be sufficient for authorising the conflict of interest. However, the power to authorize a conflict of interest by the directors is concurrent with the members. The members can also authorize a conflict of interest in addition to the board of directors as the members' decision can override the decision of the board of directors. The members also have the power to amend the constitution and take back such authorization.

In addition, when the directors are authorized to approve conflicts of interest of the directors, the shareholders may have other remedies other than amending the constitution, such as approaching the courts. However, this remedy may be costly and may adversely affect the business of the company; therefore, there is a need to make the authorization process more effective.[123] Keay argues that the present process of authorization provided in the Act may be useful in the context of the UK. The process provides that the conflicted director will not be considered against quorum[124] nor counted in voting in decision-making[125] but such director is allowed to participate in the discussion. Keay further argues that this authorization process can be further improved by excluding the conflicted directors from a meeting of directors discussing the issue, as the directors may be biased in decision-making in the presence of the conflicted director. Moreover, the possibility may exist that the conflicted director would use his or her dominance while present in the meeting.[126] Keay further suggests that the family member of conflicted directors on the board of directors,[127] if any, can also be excluded from the meeting and voting.[128]

The outcome of the discussion on corporate opportunity in the UK, established through cases and intended in the Act, is that the directors should disclose all opportunities first to the company. A director can exploit it only when it is authorized by the directors or by the general meeting, as the case may be. A director is prohibited from making a decision on his or her own whether or not the company is in a position to take that opportunity. The UK approach is very strict when it comes to directors taking a corporate opportunity compared to the approached followed by its counterpart in the US, which is quite liberal.

[123] Keay (n 62) 129-62.
[124] See s. 175 (6) (a) of the Companies Act, 2006.
[125] See s. 175 (6) (b) of the Companies Act, 2006.
[126] Keay (n 62) 129-62.
[127] As defined in s. 253 of the Act 2006. The family of a director includes (i) director's spouse, (ii) civil partner, (iii) persons living in as enduring family relationship with director or (iv) children or stepchildren of director or person mentioned in (iii) who are living with director (v) parents of director.
[128] Keay (n 62) 129-62.

4B.6.3.3.3 The US approach to the doctrine of corporate opportunity

The US approach is much more liberal than its counterpart, the UK, when it comes to directors exploiting corporate opportunity.[129] The laws on this doctrine in the different states in the US vary. The main reason for this variation is regulatory competition among the US states which has as its objective attracting more incorporation and, consequently, more franchise tax.[130] More flexible rules may influence the management to shift to a jurisdiction that serves their interests. Therefore, US states try to provide more flexible rules to attract the management to shift their business.

Important elements of the corporate opportunity doctrine developed in the US, or more specifically in Delaware, are whether the opportunity is in line with the business of the company; whether the company has an interest in that opportunity or has a reasonable expectancy in the opportunity; whether it was financially feasible for the company to exploit the opportunity; and whether the opportunity in question was encountered in the directors' personal or professional capacity.[131] Delaware provides directors with all opportunities that are not within the line of business of the company. It also focuses on the capacity of the company to exploit that opportunity.[132] In the US context, if the company is not in a position to take up a business opportunity, then the director can take that opportunity personally. However, to check the ability of the company may be problematic because it is quite possible that the new opportunity may be carried out through new finance and engagement of the company. Therefore, it is difficult to judge whether the directors have acted in the best interest of the company. The approach developed in the UK is quite different: the ability of the company is excluded. The only way to exploit a corporate opportunity is to take authorization from the board of directors or through a general meeting. In the US context, if the opportunity is out of line with the business of the company, then it is not considered a corporate opportunity and the director can exploit that opportunity. In some circumstances, even if the opportunity is within the line of business of the company, it is still possible for the director to compete with the company for the opportunity. The focus of this approach is to see to whom the opportunity belongs or who

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[129] Lowry and Edmunds (n 58) 518.

[130] David Kershaw, 'Lost in Translation: Corporate Opportunities in Comparative Perspective' (2005) 25 (4) *Oxford Journal of Legal Studies* 603-27.

[131] In Re *Digex, Inc. Shareholders Litigation* 789 A. 2d 1176 (Del. 2000); *Broz and RFB Cellular Inc. v Cellular Information Systems Inc*, 673 A.2d 148 (Del. 1995); *Guth v Loft*, 5 A.2d 503 (Del. 1939).

[132] Kershaw (n 130) 608-9.

is entitled to exploit it.[133] In the US context, if a company has no intention to pursue the business opportunity, then it is not considered a corporate opportunity. The directors may, therefore, exploit it for their personal benefit. The competition between the company and the director to exploit a business opportunity indicates that it has been focused in the US context as a personal right rather than a property or ownership right; a personal right in the sense that it is enforceable between the directors and the company and not against an unrelated third party.[134]

4B.6.3.3.4 Comparison between the UK and the US approaches to corporate opportunity

According to the US approach, the directors may proceed to exploit their office for personal benefits at the cost of the shareholders. The main focus of the UK approach is the ‘no conflict principle’, which means that the directors cannot place themselves in a position where their interests conflict with that of the company. Therefore, they cannot use their office for personal gain. The common law developed some principles that restrict directors in their use of their office for personal benefits. The statue more or less retains the same principles. The directors have a fiduciary obligation to act in the best interest of the company. If they are using their office for their personal benefit, then they are not doing so. Therefore, the UK approach seems more logical than its counterpart the US approach.

The US’ flexible approach may be due to a number of factors. Firstly, there is regulatory competition among the US states.[135] The federal system of the US is the main reason for the free corporate mobility among states’ jurisdictions. Firms that are not satisfied with the corporate regulations of one state can easily switch over to another jurisdiction with reincorporation. This leads to regulatory arbitrage among US states.[136] This corporate mobility is not common in the rest of the world. This is mainly because of the absence of a federal system such as that in the US. Some developed jurisdictions have a federal system (e.g., Australia and Canada) but there is no regulatory competition at corporate level.[137] In the EU only limited competition is permitted due to the minimum standards prescribed by

[133] In Re *Digex* (n 131).
[134] Kershaw (n 130) 608.
[135] *Ibid* 605.
[136] Coffee, Jr (n 9) 650-1.
[137] Ronald J. Daniels, ‘Should Provinces Compete? The Case for a Competitive Corporate Law Market’ (1991) 36 *McGill Law Journal* 130.

the Council of the EU through its directives for member states.[138] The states in the US compete to attract more incorporation and, consequently, more franchise tax.[139] This regulatory arbitrage may lead to a race to the bottom, and offers more flexible terms and conditions.[140] The managerial interests will be more in those jurisdictions where their interests are safeguarded. This regulatory competition attracts managers to incorporate or reincorporate in a state that is more favourable. This results in a flexible approach to restricting the exploitation of a corporate opportunity by the management in US states.

Secondly, the flexible approach of the US is based on a normative approach. In the US director primacy norms are more prevalent than shareholder primacy norms. The interests of directors are weighed more heavily than that of the shareholders in the US. In contrast, in the UK shareholder primacy norms are prevalent. Therefore, in the UK the policy of shareholder primacy norms has directed a stricter corporate opportunity doctrine compared to the US.

Thirdly, the entrepreneurial freedom of directors in the US results in a flexible approach in the country. However, property rights are more focused and protected in the UK than entrepreneurial freedom. Therefore, the corporate opportunity doctrine is more rigid than its US counterpart. In the US the entrepreneurial freedom of directors may help to develop business but, at the same time, there is a possibility of potential losses to the shareholders. The directors may, after gaining sufficient experience at the cost of the company, start a competing business or may benefit from the corporate opportunity after resigning from their directorship in the company concerned. The shareholders may suffer loss in these circumstances; in fact, there is a trade-off between the entrepreneurial freedom of directors, which may promote business, and the flexibility in offering corporate opportunities to the directors, which may cause losses to the shareholders.

Fourthly, the competition aspect in business also causes jurisdictional preferences. In the UK there is limited scope for competition compared to the US, where there is free competition. This led to the flexible approach in the US and a rigid one in the UK.

[138] Coffee, Jr (n 9) 651.
[139] *Ibid* 650.
[140] Iain MacNeil and Alex Lau, ‘International Corporate Regulation: Listing Rules and Overseas Companies’ (2001) 50 (4) *International and Comparative Law Quarterly* 788.

4B.6.3.3.5 The doctrine of corporate opportunity and Asian jurisdictions

The doctrine of corporate opportunity pervades in the Anglo-Commonwealth and in civil law jurisdictions.[141] The recent trend has been to provide legal protection against the misuse of office by directors. Malaysia amended its company law to make the management accountable for improperly using the property and information of the company, and taking up corporate opportunities for their personal benefit. It has also barred management from engaging in personal business that competes with the business of the company concerned. The Philippines introduced and elaborated the specific duties and liabilities of the directors through a code of corporate governance. In China some developments have been witnessed on the issue. The China Securities Regulatory Commission (CSRC), the Shanghai Stock Exchange and the Shenzen Stock Exchange have introduced rules and guidelines for the conduct of the controlling shareholders.[142] The nature and scope of directors' duties are being enhanced in order to restrict directors and controlling shareholders from exploiting corporate opportunities for their personal benefit, and at the cost of company and its minority shareholders. Path dependency forces (i.e., families and the state) are the main hurdle in Asian countries to controlling conflict of interest. Though it is not yet common in Asian countries some ice breaking has started.

4B.6.3.3.6 Pakistan and the doctrine of corporate opportunity

Corporate law in Pakistan does not deal with the exploitation of corporate opportunity by the directors. In that sense, there has been no convergence to the approach adopted in other common law jurisdictions. The main reason is the absence of a UK type of codification of directors' duties. The only provision that may be cited for this purpose is the prohibition on the chief executive officer (CEO) of a public company from engaging himself or herself, directly or indirectly, in any business that is of the same nature and directly competes with the business of the company or any of its subsidiaries.[143] Indirect involvement includes business carried out by the spouse or minor children of the CEO.[144] A person who is appointed as chief executive is required to inform the company forthwith of the nature and the extent of his or her interest in such business.[145] Under company law, the CEO has the

[141] Lowry and Edmunds (n 58) 515.
[142] OECD (n 45).
[143] See s. 203 (1) of the Ordinance.
[144] See explanation of s. 203 (1) of the Ordinance.
[145] See s. 203 (2) of the Ordinance.

status of a director[146] but such director is not required to be a member of the company.[147] Therefore, the objective for such a prohibition is to inform the management and the shareholders of the possible conflict of interest involving the CEO but does not provide any mechanism to avoid such conflict of interest. The section appears to focus more on related party transactions than corporate opportunity. There is no provision that prevents or authorizes the conflict of interest by the CEO of public companies who explores business opportunities, using his or her office, and exploits the same for his or her personal benefit without offering the opportunity to the company first. In contrast, the chief executives in private companies are at liberty to exploit all business opportunities to their personal benefit. No safeguard is available for minority shareholders against misuse of office by the CEO in private companies. The violation of not providing information on the nature and extent of competing business may result in such CEO only paying a minor financial penalty and debarment from becoming a director or chief executive for three years.[148] Another important issue is that the prohibition does not apply to any director who is not a CEO. The directors, other than CEO, may conduct competing businesses and exploit their office for business opportunities that are otherwise available to the company. They are not prohibited from exploiting corporate opportunities.

The directors, as fiduciaries, are supposed to act in the best interest of the company. If they act in their own personal interests, they are not acting in the best interest of the company. This conflict of interest is visible in the corporate sector of Pakistan. Families and the state control the corporate sector, which allows them to control the board. They consider even listed companies as their family business and do not hesitate to transfer business opportunities from one entity to another. The transfer of a business opportunity from one entity to another may benefit them in a way as they may gain more benefits from the entity in which they have more stakes. This phenomenon is harmful to the interests of the company and its minority shareholders. Therefore, the ownership structure in Pakistan requires suitable legislation to control the conflict of interest of the fiduciaries in exploiting corporate opportunities in order to protect minority shareholders. The judiciary in Pakistan, being a common law system, may obtain the advantage created by the common law developed in other common law countries. However, the common law approach may be problematic for Pakistan for two obvious reasons. First, the common law that developed over the centuries is scattered. The ability of the judicial system of Pakistan to apply this

[146] See s. 200 (2) of the Ordinance.
[147] See s. 187 (h) (iii) of the Ordinance.
[148] See s. 204 of the Ordinance.

scattered common law in an efficient way is questionable. Second, common law, being a foreign law, will be regarded as being merely persuasive in Pakistan under the principles of jurisprudence.

The recent trend in developed jurisdictions is to codify the common law as is the case in the UK where directors' duties have been codified in the Companies Act, 2006. The codified laws can present a clear picture of rights and obligations. This trend is also evident in regional jurisdictions. Therefore, the codification of directors' duties and the mechanism of authorization of conflict of interest are important in the context of Pakistan. The UK's strict approach in regulating fiduciaries' conflicts of interest may be more suitable in the Pakistani context where families control the boards and misuse their office for personal benefit at the cost of the company and its minority shareholders. However, the authorization process codified in the Companies Act, 2006 may, to the extent of authorization by the board of directors, be problematic in Pakistan because of the concentration of the ownership structure. Dominant families also control the board of directors and, therefore, they may hijack any authorization. The shareholders may access courts for a remedy in the case of a conflict of interests authorized by the board of directors but that course may be problematic. Firstly, the minority shareholders may not be aware of the nature and the extent of the conflict of interest on the part of the director. Secondly, the courts' ability to provide a remedy is questionable for a number of reasons such as inefficiency, corruption and the cost involved.

The common law procedure of shareholders authorising a conflict of interest may be more suitable in the context of Pakistan because of the dominance of families on the boards of directors. One option may be to authorize the board of directors to approve the conflict of interest up to certain limits and, if such interest exceeds that limit, then refer the issue to the general meeting. The methodology for such an authorization process may be to exclude the conflicted director from participation in the meeting of directors and members, if such director is a shareholder as well, whatever the case may be. Since the conflicted director may use his or her position, relation or dominance to persuade other shareholders to avoid discussing matters that are not in the interest of the company and to vote in his or her favour, his or her exclusion from the meeting of directors or shareholders may allow other directors or shareholders to discuss and vote on the issue independently. This may provide minority protection against the misuse of office by the directors.

4B.6.3.4 Fiduciary duties and the shareholders

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. At least in the UK, it is supposed to be applied to the managers. 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. The courts in the UK 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 the US the common law courts have extended the fiduciary duty to the controlling shareholders in two situations: (1) in close corporations such as quasi-partnership companies and (2) in freeze-out mergers.[149] The fiduciary duty has two aspects: (1) the duty of care and (2) the duty of loyalty.[150] In the duty of care concept the directors are expected to take decisions with due care, skill and diligence, and not to act negligently.[151] The duty of loyalty requires that the directors do not put themselves in a situation where their personal interests conflict with the interests of the firm and its shareholders.[152]

Quasi-partnership companies are formed and operate like partnerships where all the shareholders are involved in the management.[153] If controlling shareholders act opportunistically, then this may be harmful to the minority shareholders,[154] for example, in some cases joining a company may be for the remuneration for acting as a director. If controlling shareholders oust minority shareholders from the management, and also a dividend is not declared, then the minority shareholders will not get any return on their investment. The shares of the private company are not saleable on the market and,

[149] In a freeze-out merger the controlling shareholders use their influence to obtain the entire ownership of the subsidiary target firm and minority shareholders are forced to sell their shares in the target firm at a price to be determined by the parent company. This may go against the interests of the minority shareholders as the low price may be beneficial to the controlling shareholders as against the minority shareholders; for example, if the parent company has 70% interest in the subsidiary company and decides to obtain the entire ownership of the subsidiary company. In this case, if the parent company sets a low price for the shares of the subsidiary, say, for instance, £1 for each share, it may benefit the controlling shareholders at £1 per share as against at the cost of 70 pence per share. (See explanation and example quoted by I. Anabtawi and Lynn A. Stout, 'Fiduciary Duties for Activist Shareholders' (2008) 60 *Stanford Law Review* 1271-2; Robert C. Clark, *Corporate Law (textbook treatise series)* (Aspen Publishers, Inc. 1986) at 499-530).
[150] Clark (n 149) 123-262.
[151] Paul L. Davies and S. Worthington, *Gower and Davies Principles of Modern Company Law* (9th edn, Thomson Sweet & Maxwell, London 2012) 517-9.
[152] Paul L. Davies and S. Worthington discuss in detail the duty of loyalty of the directors in *Gower and Davies Principles of Modern Company Law* (9th edn, Thomson Sweet & Maxwell, London 2012) 526-613.
[153] *O' Neill v Phillips* [1999] UKHL 24 per Lord Hoffmann.
[154] Anabtawi and Stout (n 149) 1272.

furthermore, most of the time they are subject to the approval of the other shareholders who control the management. In this scenario the minority shareholders will be at the mercy of the controlling shareholders. The courts interfere in such situations and apply the duty of loyalty to the controlling shareholders. Similarly, in freeze-out mergers the controlling shareholders may act opportunistically to determine a price, which is normally below the market value, in order to benefit from purchasing the shares of the minority shareholders. The majority will sell their shares in a subsidiary target company at a lower price but they may get more benefits when the parent company purchases shares. Again, in this situation, the court will not hesitate to interfere and apply the duty of loyalty to the controlling shareholders.[155]

4B.6.3.4.1 Fiduciary duties and the shareholders in Pakistan

The US approach of extending the fiduciary duty to the controlling shareholders is relevant in the context of Pakistan. In a concentrated ownership jurisdiction, such as Pakistan, the controlling shareholders can effectively control private as well as public companies. The controlling families have control over the companies and the managers are appointed by these families. The managers may be family members, close relatives or friends. The managers, therefore, act for the benefit of the controlling families. The controlling shareholders may act in a dual character, both as shareholders and managers. Controlling shareholders are involved in taking decisions while acting as board members. They also have sufficient influence to get the decisions of their choice from the board even if they are not directly involved in decision-making.[156] Therefore, in the context of Pakistan, the duty of care may be extended to controlling shareholders who act as shadow directors. The fiduciary duty in this respect would apply to the shareholders acting in this dual manner.

In addition to this, the nature of the corporate sector in Pakistan is such that controlling shareholders control general meetings even in public companies. Therefore, the controlling shareholders may act opportunistically against the interest of the company and its minority shareholders. In these circumstances the duty of loyalty may also be extended to the controlling shareholders in public companies.

[155] *Ibid* 1273.
[156] Khan (n 60) 223.

To avoid excessive litigation, the shareholders would have the same defences of 'business judgement rules' and 'judicial test of fairness' available to the managers in their duty of care and loyalty respectively in the US context. Under the business judgement rule, the directors are supposed to act carefully and in the best interest of the companies and its shareholders, and only gross negligence will attract liability on the part of directors under the duty of care.[157] CLRC in its concept paper recommended defining the extent of directors' duties which are not properly defined in Pakistan. It further recommended that the rule established in *Smith v Fawcett*[158], which is functionally equivalent to the business judgement rule established in the US, which provides a strong presumption in favour of directors for possible liability for their decisions must also be introduced in Pakistan.[159] Therefore, the defences of business judgement rule or *Smith v Fawcett* should also be available to majority shareholders for their possible liability in their decision while acting as shadow director.

In the judicial test of fairness, the court needs to determine whether or not self-dealing is fair to the company and its shareholders. For this purpose, the courts may also rely upon the test of approval of the transaction by the majority of disinterested directors and the shareholders.[160]This defence should also be available for majority shareholders in their duty of loyalty.

4B.6.4 Intervention rights

Decisions are taken by the board of directors and, in some instances, by the shareholders in general meetings. The practical difficulty in making a decision through consensus lies in decision-making through the principle of majority rule. Majority rule is applied in the decisions made by the directors in board of directors' meetings and shareholders in general meetings. Majority rule allows controlling shareholders to make decisions of their choice. Minority shareholders do not have enough shareholding to affect the decisions taken in shareholders' meetings. They also do not have enough votes to appoint directors to control directors' meeting. This necessitates providing some kind of protection to minority shareholders against self-interested decisions taken by the board and majority shareholders

[157] *Smith v Van Gorkom* 488 A.2d 858 (Del. 1985)
[158] *Re Smith & Fawcett* Ltd [1942] Ch 304.
[159] See CLRC report.
[160] Anabtawi and Stout (n 149) 1302-3.

in general meetings. Company law provides minority shareholders with the rights to intervene in the decisions of the board of directors, general meetings and also third-party actions in certain circumstances. Corporate law tries to avoid deadlock and, therefore, puts some limitations on the right of intervention. It endeavours to strike a balance between excessive and frivolous litigation, and protection against the arbitrary discretion of the management and the controlling shareholders. Common law has developed two important intervention rights for the minority shareholders: (1) the right to intervene when the personal rights of the minority shareholders are infringed, and (2) the right to intervene on behalf of the company when the company is wronged and the company fails to take action. The first right is called the *unfair prejudice remedy* and the second is called *derivative action*. Both these remedies are important in the context of Pakistan due to the nature of its corporate sector. However, derivative action is not recognized and unfair prejudice is insufficient, out-dated and redundant, to some extent, in the context of the new corporate scenario.

4B.6.4.1 Derivative action

A derivative action is a mechanism by which the shareholders can take action on behalf of the company in the case of breach of fiduciary duty. 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 general meeting. Derivative action provides minority shareholder with an opportunity to take action for the wrong done against the company acting on behalf of the company. They have this right even if they have only one vote. Derivative action is a common law remedy established by the courts but the new trend is to make it a statutory remedy. Many jurisdictions, including the UK, are providing this remedy through commercial codes. There is a converging trend in derivative action around the globe.

However, derivative action is not a popular remedy and not frequently used for a number of reasons.[161] There are many hurdles in the path of bringing a derivative action. It is not easy for the minority shareholders to provide evidence for the breach of duty due to lack of access to the resources of the company. The violation may not be easily detectable even if they have access to information and minutes of the meeting. The minutes of the meetings

[161] Andrew Keay and J. Loughrey, ‘Derivative Proceedings in a Brave New World for Company Management and Shareholders’ (2010) *The Journal of Business Law* 151.

are sanitized and, furthermore, every decision is not required to be accompanied by reasons and justifications for such decision. The cost factor is also relevant in the sense that the minority shareholder may not derive a benefit that is commensurate with the cost of the case.[162] Therefore, derivative action is an effective remedy but may only be used as a last resort.

4B.6.4.1.1 Statutory derivative action in the UK

The Companies Act, 2006 has affectively excluded common law derivative action.[163] The Act has made this action part of the Act with certain amendments. This codification has not only combined together scattered and variable common law derivative action, but has also removed ambiguities in certain areas.

a. Scope of a statutory derivative claim

The Act has extended the scope of the cause of action in derivative claims. It has replaced the common law requirement ‘fraud on minority’ with the extended scope of derivative action, which may include corporate claims involving negligence, default, breach of duty or breach of trust by a director.[164] The inclusion of negligence in the Act has avoided the complex common law distinction between negligence *per se*, which did not qualify as fraud,[165] and negligence benefitting the wrongdoer, which qualified as fraud.[166] Therefore, a director can be held liable under the statutory derivative action if such director fails in his or her duty of care and skill unless ratified subject to s. 239 of the Act.[167] The inclusion of pure negligence has made it easy for shareholders to pursue directors. The old common law contained complex terminology. Common law courts looked beyond simple negligence when directors carried out their duties. It looked like something additional to negligence such as a fraudulent act or enrichment. Under the Act it is simply enough to bring derivative action if directors are negligent. However, the negligence will not be used in a loose sense, as the court in *Iesini v Westrip Holding Ltd* held that where the directors made decision by taking professional advice it would not amount to negligence.[168]

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[162] Keay (n 62) 153.
[163] See ss. 260 (2) and 265 (2) of the Companies Act, 2006.
[164] See s. 260 (3) of the Companies Act, 2006.
[165] *Pavlides v. Jensen* (1956) Ch 565.
[166] *Daniels v Daniels* [1978] Ch 406.
[167] Ben Pettet, John Lowry and Arad Reisberg, *Pettet’s Company Law: Company and Capital Market Law* (3rd edn, Pearson Education Ltd, Harlow 2009) 226.
[168] *Iesini v Westrip Holding Ltd* [2009] EWHC 2526 (Ch).

The extended cause of action allows taking action against a director or third party or both.[169] As a director may conspire with a third party in the appropriation of company assets, the Act has extended the scope of cause of action. Justice requires bringing the director or third party or both within the ambit of derivative action.[170]

b. Enhanced role of the court in new statutory derivative action

Under the old common law, the role of the court was limited in the sense that the plaintiff had to show certain conditions such as fraud on the minority, wrongdoer control and disinterested majority but in the new derivative action the role of the court has been enhanced. The discretion is with the court to decide whether or not a derivative action can be taken.

i. Avoiding frivolous and excessive litigation

To avoid excessive and frivolous litigation, the Act requires that the member who intends to proceed with a derivative claim obtains the court's permission. Therefore, in practice, there is two-phased litigation in derivative claims. In the first phase, an *ex parte* decision is made and the company is not a party at this stage. The court looks at the facts and circumstances of the case and decides whether there is a *prime facie* case. Once it is satisfied, it may grant the leave. In phase two there is detailed consideration of the merits of the case. At this stage an *inter partes* decision is made. The company is also a party at this stage. The objective behind two-phased litigation is to avoid frivolous and excessive litigation in the early stages. If the court goes straight into the merits of the case, it may cause disruption in the affairs of the company's business.[171]

ii. Grant of leave

The Act requires that the litigating member obtains the permission of the court before proceeding with a derivative claim. There may be two situations where the permission of the court is required: (1) permission is required where action is to be taken by the member as an original claim, and (2) where action has already been taken by the company and the

[169] See s. 260 (3) of the Companies Act, 2006.
[170] Pettet, Lowry and Reisberg (n 167) 228-9.
[171] Jonh Birds (ed), *Annotated Companies Legislation* (Oxford University Press, Oxford 2010) 318-20

shareholder asks the court to continue with the claim as a derivative action. This may happen in circumstances where the member considers that the action by the company may amount to abuse of process, or the company fails to prosecute diligently or it is appropriate for the member to continue with the claim as a derivative action.[172]

The court must refuse a derivative claim in three situations. First, it must refuse where it is satisfied that allowing a member to bring or continuing derivative action does not prioritize the interest of the company in terms of s. 172 (i.e., the duty to promote the success of the company);[173] in other words, if the member is not acting in the best interest of the company, the court will refuse the action. Although the member has no duty under s. 172 but is acting on behalf of the company, he or she must prioritize the interest of the company. In this role the member will be duty-bound to promote the success of the company as if such member was a director of the company. Second, where the cause of action arises from an act or omission that is yet to occur and such act or omission has been authorized by the company, the court will refuse the action. Third, where the cause of action arises from an act or omission that has already occurred and it was authorized by the company before it occurred or has been ratified by the company since it occurred.[174] In the last two situations it will be regarded as if the directors had not wronged the company and the court must refuse permission in these situations.[175]

The Act also provides the courts with the discretion to grant the litigating member intending to take derivative action permission to do so. The Act provides six circumstances that the court must take into account in deciding whether to give permission to continue with a derivative claim. First, the court must consider the good faith of the litigating member. The court may refuse derivative action if it is satisfied that the member is not acting in good faith. Second, the court must consider the success of the company as a whole. The court may refuse permission to a litigating member if it is satisfied that a person acting under s. 172, under similar circumstances, would not continue to take action.[176]

Third, the court must consider the possibility and fact of authorization, and possibility and fact of ratification. The court must consider the fact that if the cause of action arises from

[172] See s. 261 (1) and 262 (2) of the Companies Act, 2006.
[173] See s. 263 (2) (a) the Companies Act, 2006.
[174] See s. 263 (2) (b) and (c) of the Companies Act, 2006.
[175] Davies (n 27) 617.
[176] See s. 263 (3) (a) and (b) of the Companies Act, 2006.

an act or omission that is yet to occur and whether the act or omission could be and, in the circumstances, would be likely to be authorized before it occurs or ratified after it has occurred. Fourth, the court must consider the fact that if the cause of action arises from an act or omission that has already occurred and whether the act or omission could be and, in the circumstances, would be likely to be ratified by the company.[177] However, it is difficult for the court to determine the possibility of authorization and ratification as the court has to observe shareholders' behaviour as regards the breach of directors' duties. Nevertheless, the courts have been given wide discretion in granting leave to proceed but, at the same time, this discretion is not unconstrained.[178]

Another interesting aspect of authorization prescribed in the Act is that the members can authorize a breach of duty before it takes place.[179] The court must refuse appeal or permission in these circumstances.[180] This is possible in certain circumstances, for example, where members envisage possible breach of duty and authorizes it *ex ante* or where there is a conflict of interest between a director and the company, and members authorize the director to continue as a director. The outcome of this authorization may be to authorize the director to take the corporate opportunity out of the company and pursue it for his or her personal interest. This may be more problematic in situations where the quantum of conflict of interest is not foreseen by the members.

Fifth, the court must consider the fact that the company has decided not to take action.[181] Sixth, the court must also take into account the fact that the member could pursue a personal claim, such as the unfair prejudice remedy, instead of acting on behalf of the company.[182] As derivative action is a last resort, the court will have due regard to circumstances where the petitioner might obtain relief through a personal claim rather than acting on behalf of the company. Therefore, the court may refuse leave in circumstances where an alternative remedy is available. In *Franbar Holdings Ltd v Patel and Others*, the court refused an application for permission to continue with a derivative action on the grounds that the alternative remedy in the form of the unfair prejudice remedy in terms of s. 994 was available to the petitioner. The petitioner also conceded that there was no aspect of derivative claim that could not be compensated through s. 994. The court said that in

[177] See s. 263 (3) (c) and (d) of the Companies Act, 2006.
[178] Davies (n 27) 617.
[179] See s.263 (2) (b) and (c) (i) of the Companies Act, 2006.
[180] See s. 263 (2) of the Companies Act, 2006.
[181] See s. 263 (3) (e) of the Companies Act, 2006.
[182] See s. 263 (3) (f) the Companies Act, 2006.

those cases where the directors who were involved in breach of duty were also major shareholders, the best option was to pursue the unfair prejudice remedy.[183] The court took into account the fact that the controlling shareholders may ratify the wrongdoing of their colleague and, therefore, held to take the unfair prejudice remedy instead of a derivative claim. However, the leave was granted in *Wishart v Castlecroft Securities Ltd*.[184] In this case, the director breached his fiduciary duty and transferred a corporate opportunity to another company with the connivance of a third party. The court held that allegations might form the basis of a petition under s. 994 but that it was an indirect means of achieving something that could have been achieved directly through derivative action. The court also allowed involving a third party for the sake of a remedy against such party.

c. Preservation of non-ratifiable acts of common law

The common law distinction between ratifiable and non-ratifiable breaches established in *Cook v Deeks* is still significant in the new statutory derivative action.[185] This does not, however, require wrongdoer control as was required under the old common law. The common law requirement of wrongdoer control is replaced with judicial discretion to grant leave under the Act. [186]

The Act provides safeguards to prevent invalid ratification. S. 239 provides limits on the ratification by the general meeting by excluding the votes of the director involved, if that director is a member of the company as well, and all the members connected to such director. In refusing permission in *Franbar Holdings*, the court also discussed different factors of ratifications. [187] The court said that leave may be granted where the purported ratification had improperly prevented the petitioner from taking derivative action. This decision shows that the ratification procedure provided in s. 239 was not a simple route by which the majority shareholders and directors could collude with each other to protect their colleague. The court would look at all the circumstances of the case and would not allow

[183] *Franbar Holdings Ltd v Patel and Others* [2008] EWHC 1534 (Ch).
[184] *Wishart v Castlecroft Securities Ltd* [2009] CSIH 65.
[185] See s. 239 (7) the Companies Act, 2006 and Franbar Holdings Ltd v Patel and Others [2008] EWHC 1534 (Ch).
[186] John Birds, A. J. Boyle *et al*., *Boyle & Bird's Company Law* (6th edn, Jordan Publishing Limited, Bristol 2007) 677.
[187] *Franbar Holdings* (n 183).

ratification of breach of duty where ratification was not obtained through fair or proper means or was fraudulent or oppressive to the minority shareholders.[188]

d. Approval of an independent organ of the company

The Act provides that the court has to have particular regard to the views of members with no personal interest;[189] a common law principle established in *Smith v Croft* (No. 2). The objective of bringing this principle in statutory derivative action may be to consider the broader interest of shareholders as a whole instead of persons bringing derivative action. The idea is to look into the willingness of the court to listen to the independent shareholders view instead of just looking at the views of the shareholders bringing action. This provision of the Act is different from the common law in the sense that the court may still allow derivative action in circumstances where some shareholders are willing to take action and some are not, depending upon the circumstances of the case.

e. Disregard for interested directors' vote

Under the common law, the director was permitted to vote for a resolution to ratify his or her own breach of fiduciary duty. In the cases where a director, in the capacity as a member of the company, had voted to ratify his or her own breach of duty, the courts held that the director in such cases acted in two different capacities: (1) such director had acted as a director by virtue of his or her office and (2) such director had acted in the capacity of a shareholder. When a director voted as a shareholder, he or she was using his or her property right. Therefore, a director was allowed to exercise his or her voting power even to ratify his or her own breach of fiduciary duty. However, the courts disallowed ratification when fraud against the minority was perpetrated.[190]

In *North West Transportation Ltd v Beatty,* J. H. Beatty, director and majority shareholder of the company, sold his steamship to the company and obtained the necessary approval for the contract by way of a general meeting using his dominant voting power. Henry Beatty brought a case against the company and J. H. Beatty to ratify the contract on the

[188] Ed Weeks, 'Statutory Derivative Actions-s. 260 Companies Act, 2006' (on line article, Cripps Harries Hall LLP, September 2008), available at <http://www.crippslink.com/index.php?option=com_content&view=article&id=414:derivative-actions&catid=17:director--shareholder-disputes&Itemid=514> Accessed 23.08.2013.

[189] See s. 263 (4) the Companies Act, 2006.

[190] *Cook v Deeks* [1916] UKPC 10.

basis that the director concerned was a majority shareholder who had disregarded the objections of the minority shareholders. The Supreme Court of Canada did not allow the approval of the transaction but the Privy Council held that J. H. Beatty was entitled to vote as a shareholder in a general meeting to ratify the contract.[191] There have been discussions among commentators and the legislature over the decision of the Privy Council regarding the role of an interested director-*cum*-shareholder in voting to ratifying a transaction in which such director-*cum*-shareholder had an interest.[192] The Companies Act, 2006 has modified the rule established in *North-West Transportation Ltd v Beatty*. S. 239 disallows the voting of an interested director in any resolution of a general meeting to ratify the act of such director, provided such director is also a member of the company.

In principle, an ordinary resolution is enough to ratify a breach of duty[193] but an interested director, who is also a shareholder and other members connected to such director, are barred from voting to pass a resolution to ratify his or her own breach of duty. However, such director and members are not excluded from taking part in the proceeding and counting towards the quorum of the meeting.[194] They can take an active part in the meeting that is to consider and pass a resolution to ratify the breach of duty of such conflicted director. This process may be defective in the sense that the interested director may persuade other shareholders to favour such resolution or discussion and voting. The proper procedure may be to exclude the interested director and connected persons, who are also shareholders, from taking part in the meeting. Nevertheless, the exclusion of the interested director from voting has solved, to some extent, problems of wrongdoer control.

4B.6.4.2 Derivative action in Pakistan

In Pakistan derivative action suits are not recognized by law and there is no evidence of the acceptance of derivative suits in the courts. However, the courts have not ruled them out. In *Sakina Khatoon v S.S. Nazir Ahsan*, the honourable Sindh High Court highlighted certain principles of a derivative suit. [195] The case was not a derivative claim but the court observed the possibility of derivative action in certain circumstances. The court said that

[191] *North-West Transportation Co. Ltd v Beatty* (1887) 12 App Cas 589 (P.C.).
[192] L. Smith, 'North-West Transportation Co. Ltd. v. Beatty' (2011) available at <SSRN:http://ssrn.com/abstract=1938158> Accessed 20.12.2013.
[193] See s. 239 (2) of the Companies Act, 2006.
[194] See s. 239 (4) of the Companies Act, 2006.
[195] *Mst. Sakina Khatoon and others Vs. S.S. Nazir Ahsan and others*, 2010 CLD 963 Sindh High Court (Pakistan).

shareholders could bring a derivative action under certain circumstances: (1) the company must be under the control of the majority shareholders who are abusing their position; (2) the abuse of power by the majority must be to defraud the company; (3) the company must be unable to bring action because of the control of the majority; and (4) the company must be impleaded in such a suit. The court did not elaborate and discuss these rules because the original case was not a derivative action. These principles appear to be mimicking the old common law developed in the UK.

Pakistan is a common law country and a former colony of the Britain, therefore, the courts can take advantage of the common law derivative action developed in other common law countries especially of the United Kingdom and statutory derivative action codified in the Companies Act 2006. Derivative actions are potentially important in the Pakistani context due to nature of ownership structure, prevailed bad corporate governance, inefficient judiciary and other supporting institutions. The ownership structure is highly concentrated with families, groups and state dominant in the corporate structure. These families appoint the family members or persons of their confidence on the board and therefore control the board. Similarly, the state appoints political affiliated persons on the board and thereby controls the board. They also have sufficient voting shares to control even the listed companies. The small and minority shareholders do not have enough voting shares to resolve the issues at the meeting of board of directors or the general meetings of the shareholders.

In the cases where any wrong is committed against the company, the shareholders have two options to make good of the wrong committed. Firstly, they can resolve it at the shareholder meetings but the small and minority shareholders do not have enough shareholdings to take action against the directors at the meeting of shareholders. Secondly, they can approach the court of law for taking action against the directors. The problem with this forum is that the court has to rely on common law derivative actions. The common law derivative actions are scattered and change with passage of time. This variable common law is problematic especially for a judiciary such as Pakistan which is not efficient. The nature of common law is that it is not codified. On the other hand, codified law can present clear picture of the law. Therefore, most of jurisdictions including the United Kingdom have codified the common law derivative action in order to remove ambiguities in the law. Pakistani courts could provide corporate remedy to the minority shareholders more effectively provided the derivative action is facilitated by codifying the company law. CLRC[196] has discussed the introduction of derivative action in Pakistan due to nature of corporate sector and international trend of codification of derivative actions in corporate laws by many countries including the UK and other major regional jurisdictions. In its preliminary report submitted to SECP, CLRC has recommended to discuss further before introducing the statutory derivative actions in the company law of Pakistan.[197] However, it has not yet submitted its final report to SECP to date.

There is a convergence trend to derivative suits. Most of the jurisdictions have introduced this remedy or at least recommended that it be included in their legislation. This remedy is available in the UK, the US, Australia and New Zealand.[198] At the regional level, Malaysia introduced derivative suits in 2007, Hong Kong in 2009 and China in 2005. Thailand has also introduced derivative suits but with the restriction that shareholders must have at least 5% shares to file a derivative suit.[199] Derivative suits are also recognized by the courts in India.[200]

The acceptance of derivative actions by both advanced and developing jurisdictions highlights the importance of derivative actions. The recent trend has been to bring derivative suits within the ambit of the statutory form. The corporate sector in Pakistan is concentrated in which directors are normally from among family members, relatives or persons who are in their confidence. In this scenario it is not expected that the controlling shareholders will bring an action against such directors for breach of duty. It is also difficult for the minority shareholders to pass a resolution in a general meeting in order to get a remedy. The nature of the corporate sector in Pakistan suggests that derivative suits must be introduced through statutory form. The UK statutory derivative action can be helpful for the legislature to introduce in the Pakistani corporate arena.

However, two issues are important with reference to the introduction of statutory derivative action in Pakistan. First, the statutory derivative action can work properly if directors' duties are also codified. There is a need to define the extent of directors'

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[196] The SECP established the Corporate Law Review Commission (CLRC) in November 2005 to review the company law in Pakistan and to give its recommendations for overhauling the Ordinance or to draft a new law for the regulation of the corporate sector. The CLRC issued a concept paper with its recommendations. This commission has not as yet given its final recommendations or formulated any new law.

[197] See CLRS Report at p 18.

[198] See CLRS Report at p 17-8.

[199] OECD (n 45).

[200] See clause 10.1, Chapter VI (Minority Interests) Irani Report 2005.

fiduciary duty, which is not properly defined in Pakistan.[201] Two common law approaches to directors' duties are relevant in this context. The case law in the UK established this fiduciary duty and provides two tests: (1) the objective standard and (2) the higher subjective standard. In the objective standard test, the requirement from a director is to provide the care that a reasonable person will apply. In the subjective standard test the requirement from a director is to apply particular care, where such director has a particular skill or expertise.[202] The UK has codified detailed duties of directors, established through common law, in the Companies Act, 2006. These duties include, but are not limited to, the duty to act within the powers provided in the constitution of the company;[203] to promote the success of the company;[204] to exercise independent judgement;[205] to exercise reasonable care, skill and diligence;[206] to avoid conflict of interest;[207] not to accept benefits from third parties;[208] and to declare any personal interest in the proposed transaction or arrangement.[209]

In addition, to avoid disruption in the functioning of the company, the rule established in *Smith v Fawcett*,[210] which requires that directors act with *bona fides* in the best interest of the company and also provides strong presumptions in favour of directors from possible liability for their decisions, must also be introduced in Pakistan. In *Smith v Fawcett*, a private company, namely Smith and Fawcett Ltd, had issued capital of 8,002 ordinary shares with two directors J.F and N.S having 4,001 shares each. The articles of association of the company provided that '*the directors may at any time in their absolute and uncontrolled discretion refuse to register any transfer of shares and clause 19 of Table A shall be modified accordingly*'. J. F died and his son, as executor, applied to the company to register shares in his name but N.S refused to register the shares in his name. N.S, instead, offered to register 2,001 and to buy 2,000 shares at a fixed price. The executor applied to the court to rectify register of the company and entering shares in his name. The court held that '*the powers given in the articles are of a fiduciary nature and must be exercised in the interest of the company and there is nothing to show that they had been*

[201] See CLRC Report.
[202] *D'Jan of London* [1994] 1 BCLC 561.
[203] See s. 171 of the Companies Act, 2006.
[204] See s. 172 of the Companies Act, 2006.
[205] See s. 173 of the Companies Act, 2006.
[206] See s. 174 of the Companies Act, 2006.
[207] See s. 175 of the Companies Act, 2006.
[208] See s. 176 of the Companies Act, 2006.
[209] See s. 177 of the Companies Act, 2006. Some of the directors' duties have been discussed in relevant sections of this thesis. Directors' duties are mentioned here briefly for the purpose of reference only.
[210] The rule established in *Re Smith & Fawcett* is functionally equivalent to the business judgment rule developed in the US.

otherwise exercised'. The executor appealed the judgement. The court of appeal upheld the decision of the trial court and said '*the directors must exercise their discretion bona fide in what they consider – not what a court may consider – is in the interests of the company*.'[211]

Second, it is also important to enhance judicial capacity and efficiency for the effective application of derivative actions through the courts.[212]

4B.6.4.2 The unfair prejudice remedy in Pakistan

4B.6.4.2.1 Introduction

The unfair prejudice remedy deals with circumstances where the membership or personal rights of shareholders are infringed. It is distinct from the derivative action where action is taken for the enforcement of corporate rights. In the unfair prejudice remedy members are the proper party for the enforcement of personal rights. However, in derivative action, the company is a proper party to litigate but a member could also litigate in derivative action, acting for, and on behalf of, the company. In the unfair prejudice remedy, the damages are given to the member concerned, whereas in derivative action the damages are given to the company. This remedy is specifically designed for minority shareholders. 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.[213] The unfair prejudice remedy has a wider scope than derivative action. The court may even demand that directors pay the shareholders.

4B.6.4.2.2 The remedy against oppression and mismanagement by the controllers in Pakistan: An overview

In Pakistan the oppressive remedy is provided both in company law and in case law. The prevention of oppression and mismanagement is provided under s. 290 of the Ordinance. This section is of a preventative nature and has as an objective the prevention of the

[211] *Re Smith & Fawcett Ltd* [1942] Ch 304.
[212] This issue will be discussed in Chapter Five.
[213] Ben Pettet, *Company Law* (Longman, Harlow 2001) 253; Clark Bryan, 'Unfairly Prejudicial Conduct: A Pathway through the Maze' (2001) 22 (6) *Company Lawyer* 170-7.

oppression and mismanagement of majority shareholders.[214] This is considered a minority shareholders' remedy because the majority may not be required to go to court for the remedy as they have the power to pass a resolution in a general meeting. Therefore, if the majority approaches a court for the remedy, the court may direct that a resolution be passed at a general meeting. In the context of Pakistan there may be circumstances where the majority may ask the court for a remedy against the oppressive conduct and mismanagement by the minority. However, this may be an exception rather than a norm. This scenario may develop in various circumstances. Firstly, this may happen if the minority shareholders have shares with enhanced voting powers.[215] In this case, any resolution in general meeting may be controlled by such minority. The majority may not be able to resolve the problem in a general meeting and therefore have no option but to approach the court for a remedy. Secondly, the situation might arise where the minority has the power to control the management under a shareholder agreement. For instance, in *WAPDA v KAPCO*, the petitioner who held 64% of the shares approached the court for the remedy under s. 290 of the Ordinance. The petitioner, the Water and Power Development Authority (WAPDA), privatized one of its units, namely the Kot Addu Power Company (KAPCO) (Respondent No. 1) and sold its 36% shares in KAPCO to National Power International Limited (NPIL) (Respondent No. 2). The management and control of KAPCO was transferred to the NPIL, irrespective of its shareholding under the share purchase agreement, for twenty-five years. Under the agreement, the board of directors of KAPCO was to consist of nine directors, four of whom had to be appointed by the NPIL, including the chief executive, four independent directors and one director by WAPDA. After some time, NPIL entered into an agreement with one of its subsidiary companies to manage and operate the unit for a hefty payment. The maintenance cost that was paid to the new contractor was much higher than the price paid by another company for a plant of similar capacity and nature. The court held that the NPIL was conducting the affairs of KAPCO in a manner prejudicial to the public interest as well as oppressive to the

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[214] *Associated Biscuits International Ltd v English Biscuits Manufacturers (Pvt) Ltd*, 2003 CLD 815, Sindh High Court (Pakistan).

[215] The government of Pakistan privatised one of its SOEs, namely Pakistan Telecommunications Limited (PTCL) in 2005. It sold its 26% shareholding to Emirates Telecommunications Corporation (Etisalat), a UAE-based company, for $2.6 billion. The shares sold to Etisalat carried four votes against one share and thus issued 26% shares with more than 58% voting rights to Etisalat. This transferred control of PTCL to Etisalat with just 26% equity. Now Etisalat owns 58.43%, the Government of Pakistan 34.83% and general public only 6.74% voting powers. This provided Etisalat with control of the management and general meetings. According to the formula, there are two categories of shares: (1) category A and (2) category B. Category A shares are 74%, whereas category B shares (issued to Etisalat) are 26%. Category A shares have one share, one vote (74*1=74 votes) and category B shares have one share four votes (26*4=104 votes). Their aggregate is 74+104=178. The voting power of category A shareholders is 74*100/178=41.57 % and the voting power of category B shareholders is 104*100/178=58.43 %.

petitioner. The court ordered the appointment of a provisional manager in order to ensure the smooth running of KAPCO and restrained the NPIL from acting in a manner prejudicial to the public interest and detriment to that of the petitioner.[216] This case is unique, as the majority shareholders had to approach the court for a remedy under the oppressive conduct of the minority. This may happen in country such as Pakistan where political decisions are taken in public sector companies. In this case the arrangement of the shareholder agreement was against the general principles where the minority was given control and management of the company. An apparent objective of the government, in transferring control and management to the minority, may be to attract foreign investment. Nonetheless, the majority had to approach the court for a remedy against the oppressive conduct of the minority. The remedy under oppressive conduct may be sought by both the majority and minority. It simply depends upon who controls the company.

Moreover, the section provides the courts with vast and undefined powers.[217] The objective of this section is to provide an alternative to winding up,[218] which is not an attractive remedy. The winding up may be detrimental to both the respondents and the petitioners. The section provides that where the court is of the opinion that the winding up would unfairly prejudice the members or creditors, it may order that an end be brought to the matters complained of instead of issuing a winding-up order.[219] In *Registrar v PICLD*, the court said that to apply for an oppressive remedy under s. 290, it was not necessary that the circumstances must be such that would justify the winding up. The winding up of companies is provided under s. 305 of the Ordinance.[220] The court has been empowered to provide different remedial measures under oppressive conduct in Pakistan.

4B.6.4.2.3 Who can apply for relief?

Any member or members holding not less than 20% of issued capital may apply to the court where the affairs of the company are conducted or likely to be conducted in a manner oppressive to such member or any of the members.[221] Likewise, creditors who have an interest equivalent to not less than 20% of the paid-up capital of the company may apply to

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[216] *WAPDA v KAPCO*, 2000 PLD 461, Lahore High Court (Pakistan).
[217] *National Bank of Pakistan v Banking Tribunal No. 1*, 1994 PLD Karachi (Pakistan) 358.
[218] *Registrar of Companies v Pakistan Industrial and Commercial Leasing Ltd*, 2005 CLD 463, Sindh High Court (Pakistan) 484; *Associated Biscuits* (n 214) 831.
[219] See s. 290(2) (b) of the Ordinance.
[220] *Registrar of Companies* (n 218).
[221] See s. 290 (1) of the Ordinance.

the court against oppressive conduct of controllers or mismanagement in the company. In addition to members and creditors, the power is also delegated to the registrar of companies[222] and SECP to apply to the court against the oppressive conduct or mismanagement by the controller. [223]

4B.6.4.2.4 Nature and scope of the remedy under oppressive conduct or mismanagement

The remedy under s. 290 can be invoked in the following circumstances:

> *When the affairs of the company are conducted:*
>
> *i) In an unlawful manner; or*
>
> *ii) In a fraudulent manner; or*
>
> *iii) In a manner not provided in the memorandum of association; or*
>
> *iv) In a manner oppressive to members or creditors; or*
>
> *v) In a manner prejudicial to the public interest.*[224]

In Pakistan, the scope of the oppressive remedy is wider than in the UK in the sense that it covers the interests of the creditors and it may also be sought in the case where the conduct is against the public interest. There are some instances where the court has entertained petitions under s. 290 where a company operated against the public interest. In *WAPDA v KAPCO* the court held that the siphoning-off of money from a company belonging in the public domain amounted to conducting affairs of the company against public interest and was oppressive to the members. The court further said that this type of mismanagement caused the public to pay extra in the form of expensive electricity.[225] Similarly, the creditors could also apply for a remedy under oppressive conduct.[226]

Although the powers given to the court under s. 290 in Pakistan are wider than the corresponding powers in s. 994 of the UK Companies Act, 2006 and the Indian Companies Act, 1956,[227] the remedy is more problematic in Pakistan than the corresponding remedy in the UK. Two issues are important with regard to the oppressive remedy for the minority

[222] See s. 290 (1) of the Ordinance.
[223] See s. 271(1) of the Ordinance.
[224] See s. 290 (1) of the Ordinance.
[225] *WAPDA* (n 216).
[226] See s. 290 (1) of the Ordinance.
[227] *WAPDA* (n 216).

shareholders under s. 290 of the Ordinance. First, the stipulation of at least 20% shareholding to apply for the remedy is too demanding and many petitions have been dismissed by the courts *ab initio* for not meeting the qualifying number of shares.[228] These petitions may not *prima facie* be bogus, lacking in evidence or without merit. The only reason for dismissal was the ownership of less than 20% shares. This strict requirement of *locus standi* has denied the remedy even to genuine complainants. Fixing the percentage of minority shareholding is problematic and misleading when it comes to the term *minority shareholder*. Minority shareholder may vary from 1% to 49.99% voting shares. This all depends upon the circumstances of each case. Suppose a hypothetical situation in which the members of a public listed company have a shareholding of, for instance, 1%, 5% and 10%, and the rest of the shares are dispersed public shareholding. Suppose in a general meeting these were the only shareholders present to pass a resolution. In this situation, if two members joined forces to pass any resolution then the shareholder who holds 1% of the shares would be considered the minority shareholder. Similarly, suppose that in a company there are only two shareholders; one holding 49.99% and the other 50.01% of the shares. In this case the person who holds 49.99% of the shares will be a minority shareholder. Moreover, the minority shareholder concept fluctuates, depending upon the circumstances. One may be minority shareholder in one case and part of majority in another case.[229] Therefore, any percentage of shareholding may constitute a minority shareholder and affectee of oppression and mismanagement by the controllers. Similarly, an individual shareholder who holds only one share may also be affected by oppression and mismanagement. This provision has effectively excluded shareholders who hold less than 20% of the voting shares and left them at the mercy of controlling shareholders and the management. Furthermore, in some instances, for example, in listed companies, 20% voting shares in itself may have substantial influence in the affairs of management and the company. This high threshold has made it difficult for the minority shareholders to apply to the court for relief against oppression and mismanagement. This is the main reason that there are a few instances where minority shareholders apply to the courts.[230] The person with less than 20% voting has to approach the civil courts for civil litigation for tortuous

[228] In the following cases, the courts dismissed petitions *ab initio* for not having qualification shares: *Shaukat Ali v Amin Fabrics Ltd*, 2008 CLD 837, Sindh High Court (Pakistan); *Miss Mahenau Agha v United Liner Agencies of Pakistan Ltd*, 1990 PLD, Sindh High Court (Pakistan) 198; *Sardar Khan Niazi v Barex Lahore Ltd*, 2005 CLD 1670, Lahore High Court (Pakistan); *Rohail Hashmi v Nabeel Hashmi*, 2003 CLD 201, Lahore High Court (Pakistan); Hassan Al-Adawi v M/s Hama International (Pvt) *Ltd*, 2009 CLD 1043 (Pakistan); *Shaukat Ali v M/s Bawany Textile Mills Ltd*, 2009 CLD 497 (Pakistan).
[229] See text to n 34.
[230]The World Bank and IMF Report on the Observance of Standards and Codes (ROSC) June 2005 on Pakistan available at <http://www.worldbank.org/ifa/rosc_cg_pak.pdf > Accessed 23.08.2013.

loss. The courts in Pakistan experience inherent problems of delay, cost and inefficiency.[231] The other problem with approaching civil courts is that it may provide a remedy in the form of damages only and may not get a specific remedy that is corporate in nature. Moreover, as per routine, the decisions in such cases normally take four to six years in courts of first instance and subsequent appeals can extend this duration further.[232] Such restrictions have effectively denied minority shareholders a remedy. The remedy can be only be effective when its provisions are independent of the percentage of shareholding needed to apply for the remedy.

The Corporate Law Review Commission,[233] in its concept paper, has recommended reducing the percentage needed to apply for the remedy under oppressive conduct, from 20% to 10%. This recommendation still seems to be insufficient and may not solve the problem. In the UK there is no cap and an individual shareholder can apply to the court for a remedy. In India the Companies Act, 1956 used to have a cap[234] for applying for the remedy against oppressive conduct, but the Companies Bill, 2012 has now removed it.[235] The reason for removing the cap is that any person, notwithstanding his or her capital, may be an affectee of oppressive conduct. The remedy against oppressive conduct can only be effective when the cap is removed. However, the removal of the cap may create problems of excessive and frivolous litigation by the individual shareholders. This litigation may create hurdles in the businesses of the companies. To avoid excessive and frivolous petitions and hindrances in the business of the company, the law can make a precondition of 'leave to appeal', which was introduced for statutory derivative action in the Companies Act, 2006 in the UK.

The second issue is the word 'oppression' used in s. 290 of the Ordinance. The statute has not provided any guidelines for conduct that may be termed *oppressive*. Therefore, this

[231] Khan (n 60) 232.
[232] Ali Adnan Ibrahim, 'Corporate Governance in Pakistan: Analysis of Current Challenges and Recommendations for Future Reforms' (2006) 5 *Washington University Global Studies Law Review* 323-32.
[233] See CLRC Report.
[234] Ss. 397 and 399 of the Companies Act, 1956 provides that at least one hundred members, or one tenth of the total number of members, or members having at least 10% of total issued capital in case of a company having share capital and one fifth of the total numbers of members in case of a company not having share capital can apply to the company board for oppressive conduct.
[235] Ministry of Company Affairs, the Government of India set up the expert committee in 2005 to advise the government on the new company law. It was headed by Dr Jamshed J. Irani. On 18 December 2012, the new Company Law Bill 2012 was passed by the Lok Sabha (Lower House of the Parliament) and is still pending approval by Rajya Sabha (Upper House of the Parliament). See the website of the Ministry of Corporate Affairs, Government of India at <http://www.mca.gov.in/ > Accessed 14.05.2013; also available online at <http://profit.ndtv.com/news/corporates/article-companies-bill-likely-in-rajya-sabha-this-week-321502 > Accessed 14.05.2013.

gives the courts the discretion to determine what kinds of conduct are oppressive. In common law it has been defined as '*burdensome, harsh and wrong*'.[236] In the context of company law, it may be defined as '*an act of management affecting the shareholders or creditors which is unjust and that deprive them of their rights*'.[237] There are some instances that may be termed *oppressive conduct by the majority shareholders*, for instance, where the majority attempt to force a new and risky venture on an unwilling minority; refusal to register the transfer or transmission of shares; omitting to do something that is otherwise just and beneficial to the company; and depriving members of their voting rights may be termed *oppressive conduct* by the majority.[238] The courts in Pakistan have used this term with different meanings in different cases. In *Registrar v PICLD,* the court said that the intention of the legislature seemed to be that for individual violations of the Ordinance, the violator would be punished for that particular offence. However, if there is a series of violations and the same were not redressed, it amounted to oppressive conduct.[239] This is a very restrictive explanation of the term *oppressive conduct* and may deny the minority shareholders a remedy in many instances of individual violations. However, in some cases the courts have given very liberal interpretation to the word *oppression*. In the *Pfizer Laboratories* case, the court said that non-payment of a return on investment to minority shareholders and a recession of the value of their shares over a period would be termed 'oppressive conduct'.[240] In *PSO v POPL*, the court held that '*an attempt to oust a petitioner or to induct any third party in its place behind the petitioners' back by itself was an act of oppression*'.[241]

The word 'oppression' which developed at common law over a period in the UK had a very restricted meaning. It was transferred to the company law of Pakistan due to colonization.[242] In the UK the term 'oppressive conduct' has been replaced with 'unfair prejudice' in order to enhance the scope of the remedy and also to provide an alternative to winding up. 'Oppressive conduct' was too restrictive and the UK courts preferred winding up to granting a remedy under oppressive conduct. In the UK, before the introduction of s. 210 of the Companies Act, 1948, the only remedy against oppressive conduct of the directors and the controlling shareholders was the winding up of the company on just and equitable grounds. Since the winding up was an expensive remedy, as the oppressed and

[236] *Scottish Co-operative Wholesale Society Ltd v Meyer* [1959] AC 324 (HL) per Viscount Simonds.
[237] Imran Ahsan Khan Nyazee, *Company Law (Includes Companies Ordinance, 1984*) (Advance Legal Institute, Federal Law House, Lahore 2008) 182.
[238] *Ibid* 182.
[239] *Registrar of Companies* (n 218) 480.
[240] *Pfizer Laboratories Ltd v Parke Davis & Co. Ltd*, 2007 CLD 1047, Singh High Court (Pakistan).
[241] *Pakistan State Oil Company Ltd v Pakistan Oil Pipelines Ltd*, 1993 PLD Karachi (Pakistan) 322.
[242] See text to n 74-7 in Chapter Two.

oppressor could both suffer, an alternative to winding-up petitions was needed.[243] S. 210 of the Companies Act, 1948 provided an alternative to just and equitable winding up. The newly introduced remedy was against the 'oppressive' conduct of directors or the controlling shareholders. The Act, however, did not define the word 'oppression' which created problems of interpretation. It was interpreted differently in different judicial decisions. The word has been interpreted to mean '*burdensome, harsh and wrong*'[244] and also '*a lack of probity and fair dealing in the affairs of a company to the prejudice of some portion of its members*'.[245]

However, the floodgates of approaching the courts for a remedy for minority shareholders, which were closed by the ruling in *Foss v Harbottle,* could not provide sufficient remedy to the minority shareholders due to the strict interpretation of the term 'oppression' by the courts. The courts interpreted the term to mean conduct in the circumstances in which the company might be wound up on just and equitable grounds. The petitioners were required to establish 'oppressive conduct' which could form the basis for winding up. The courts preferred winding up on just and equitable grounds instead of providing a remedy for oppressive conduct due to its strict application. Therefore, the courts showed their reluctance to make good for the wrong committed.[246] The other problem with this remedy was the refusal of the courts to grant relief for conduct regarded as oppressive that was not *qua* member. This meant that the harm must be associated with the right to membership. The courts did not consider the removal of an individual from directorship as oppressive conduct on the grounds that harm was *qua* director and not *qua* member. Therefore, no remedy was provided in such cases.[247] This difficulty was realized by Parliament, therefore, s. 210 was replaced with s. 75 of the Companies Act, 1980, which was later replaced with s. 459 of the Companies Act, 1985.

The scope of the remedy was enhanced by the Companies Act, 1985. This new remedy was slightly amended by the Companies Act, 1989.[248] The Acts changed the idea of oppressive conduct to unfair prejudice conduct. The Jenkins Committee[249] proposed the change of terminology because the courts had crafted an understanding that the word

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243 Pettet, Lowry and Reisberg (n 167) 256.
244 *Scottish Co-operative* (n 236) per Lord Viscount Simonds.
245 *Ibid* per Lord Keith.
246 Pettet, Lowry and Reisberg (n 167) 256.
247 *Re Lundie Bros* [1965] 1 WLR 1051.
248 Victor Joffe QC *et al., Minority Shareholders: Law, Practice, and Procedure* (3rd edn, Oxford University Press, Oxford 2008) 191.
249 Jenkins Committee, Report of the Company Law Committee of 1962.

‘oppression’ required proof from the petitioner showing an independent illegal act on the part of the defendant.[250] The objective of the Jenkins Committee was to provide a remedy beyond the breach of the right.[251] The new terminology was better and capable of providing the courts with an opportunity for flexibility in interpreting the term and providing a remedy to the affected minority. This also enabled judges to be more flexible and innovative in providing petitioners with a remedy through the new statutory remedy.[252] The remedy with minor amendment was retained in the Companies Act, 2006 (ss. 994 to 999). The remedy provided in the Act conferred rights on the shareholders that were ‘*inalienable and cannot be diminished or removed by contract or otherwise*’.[253] Therefore, this put restrictions on the controllers of companies to amend or cut these rights either through the articles of association or through mutual agreements.[254] The legislature in the UK is responsive to changed circumstances and to providing a remedy to the oppressed. However, the legislature in Pakistan is too slow in revamping the company law to cope with the fast-changing circumstances in corporate law and also in the technological world. It has passed only one company law in over 66 years and that too was copied the Indian Companies Act, 1913. The existing law has been changed through minor amendments a number of times but there is a need for the overall revamping of the company law to meet the demand of new needs and circumstances. Pakistani courts are still interpreting the word *oppression* in the same way as was interpreted by the courts in the UK years ago. It is suggested that minority protection should be made more viable. As far as the oppressive remedy is concerned, it is suggested that it be redefined to enhance its scope.

4B.6.4.2.5 Statutory remedies under oppressive conduct

a. Alternative to winding up

Under the company law of Pakistan, the remedy under oppressive conduct is an alternative to winding up. S. 290 of the Ordinance provides that if the winding up of a company unfairly prejudices the members or creditors of the company, the court, instead of ordering the winding up ‘*may make such orders as it thinks fit*’. This provides wide discretion to the court to provide petitioners with a remedy. In this context the court may order financial

[250] Kershaw (n 91) 627.
[251] Law Commission Report on Shareholders’ Remedies of 1997.
[252] Pettet, Lowry and Reisberg (n 167) 257.
[253] *Exeter City AFC Ltd v Football Conference Ltd* [2005] 1 BCLC 238.
[254] Joffe QC (n 248) 192.

penalties to be paid to the petitioners. The court may also insist that the directors pay the shareholders. The Ordinance further states that the court may order the manner in which the affairs of the company will be conducted in future.[255] Therefore, the court may order the management to perform or abstain from doing certain acts.

In the UK the Companies Act, 2006 provides the courts with more discretion than the corresponding powers in the Ordinance in Pakistan. S. 996 of the Companies Act, 2006 provides very wide discretion to the court in providing remedies. The sub-sections state that '*it may make such order as it thinks fit for giving relief in respect of the matters complained of*'[256] and also '*authorise civil proceedings to be brought in the name and on behalf of the company by such person or persons and on such terms as the court may direct*'.[257] These are open-ended and the court may provide any remedy it thinks fit. In addition to the remedies discussed above in the context of Pakistan, the court may also order that derivative action be brought on behalf of the company as a relief for the unfair prejudice petition. A successful derivative action may be beneficial to all shareholders, including the petitioners. However, a problematic situation may arise where the court provides corporate relief in an unfair prejudice petition. The unfair prejudice is a personal remedy, whereas a corporate remedy is for the company. This situation may occur in cases where remedies are sought for the breach of directors' duty. In *Kung v Kou* the court said that it could order both unfair prejudice and derivative action, and both could be tried together and corporate relief could also be provided in unfair prejudice action.[258] In *Anderson v Hogg*[259] a similar decision was made and a corporate remedy was provided in an unfair prejudice claim in which the wrongdoers were ordered to pay the company. These decisions have created confusion, to some extent, as they have intermingled the unfair prejudice with derivative actions. Nevertheless, this may be beneficial to the extent of avoiding wasting time and money in bringing a separate derivative action.

b. Buyout or exit remedy

The buyout or exit is an important remedy for the minority shareholders provided in the Ordinance. The court may order the purchase of shares by other members or by the company. In case the shares are purchased by the company, the court may order a

[255] See s. 290 (2) (b) of the Ordinance.
[256] See s. 996 (1) of the Companies Act, 2006.
[257] See s. 996 (2) (c) the Companies Act, 2006.
[258] *Kung v Kou* [2004] HKCU 1453.
[259] *Anderson v Hogg* (2002) SC 190 (IH).

reduction in the share capital of the company.[260] In *Israrul Haq v Al-Tahir Industries (Pvt) Ltd*, Israrul Haq owned 42.32% shares in Al-Tahir Industries (Pvt) Ltd. Haq was not included in the management despite the fact that he had 42.32% shares in the company. He brought a petition against the controlling shareholders for mismanagement of the company under s. 290 of the Ordinance. He pleaded that the company had never paid a dividend nor was he allowed to sit in management and that the company was managed in manner that was oppressive to the minority shareholder. He prayed for the regulation of the company in accordance with the Ordinance or, alternatively, that the respondent be directed to purchase the shares of the petitioner. The High Court observed that the parties mistrusted each other, therefore, it was not just or proper that the capital of the petitioner remained locked. The court ordered the respondent to purchase the shares of the petitioner at par value.[261] The court did not order the valuation of the shares. The shares were originally purchased in 1990 and, on the order of the court, sold at the same price in 2002 despite the fact that dividends were never paid by the respondents. As the formation of a private company is normally based on mutual trust and confidence, once that trust and confidence are broken, the courts would normally allow either winding up or order the respondent to purchase the shares of the petitioner. In this case the court, instead of regulating the affairs of the company, ordered the buyout of the minority shares by the majority shareholders.

As the court also has the power to order the company to purchase the shares held by the minority shareholder and reduce the capital of the company, the courts must consider other factors before ordering such reduction in the capital of the company as such reduction may be problematic as far as the financial aspects of the company are concerned. The survival or existence of the company, after reduction in the capital, may be at risk. The courts must consider this before ordering a reduction in the capital of the company.

i Determination of price in buyout offers

In the context of the UK, Lord Hoffmann discusses the buyout offer at fair price in the *Phillip* case. [262] He discusses at length the circumstances and consequences of a fair offer. He suggests that a petition might be struck down if the respondent had already made a fair offer to the petitioner. As regards the circumstances in which a fair offer should be made, he distinguishes between a company and a quasi-partnership company. A *quasi-*

[260] See s. 290 (2) (b) of the Ordinance.
[261] *Israrul Haq v Al-Tahir Industries (Pvt) Ltd*, 2002 CLD 325, Lahore High Court (Pakistan).
[262] *O' Neill* (n 153).

partnership company may be defined as a company, though still a legal entity, formed on mutual understanding and promises, by words or conduct, either at the time of entering into association or developed later on. He says that it would be unfair for the members to ignore these understandings and promises. He further explains that though such a promise may not be enforceable at law as regards a third party, such a promise may be binding as a matter of justice and equity between the members. If a member is removed from the management by the majority on the breakdown of relations between them without serious wrongfulness or unfair conduct on the part of any member, in such a situation it is not fair that the capital of the removed member remained locked in the company.[263] In such a situation, the removed member should be offered a fair price for his or her shares. He further explains that it is also unfair for any member to declare unilaterally that trust and confidence had broken down, and to demand that his or her shares be bought at a fair value unless such member is removed from the management. According to him, unfairness does not lie in exclusion but exclusion without a fair offer.[264]

The Companies Act, 2006 does not provide any mechanism for determining price. This is left to the court to determine. The Law Commission proposed the determination of fair value on a *pro rata* basis unless the court directed otherwise. As the minority shareholders do not have control over the company, the court may direct that the shares held by the minority shareholders be discounted in those cases where the shares are held by the majority in the form of a block which carry control of the company. Therefore, such controlling shares have more value than shares without such control.[265] However, there is a problem in determining the price for private companies as the shares of private companies are not traded on the market and it is difficult to determine the discount for the minority shares.[266] Lord Hoffmann is of the view that this could either be determined by mutual agreement or by an expert agreed to through mutual consent. For this purpose, all the parties should be given equal opportunities to access the information of the companies in order for the experts to determine a fair price.[267]

The company law in Pakistan does not provide guidelines for determining the price of the shares to be purchased by other members or the company. As far as listed companies are concerned, the shares are traded on stock markets and the share price can be ascertained

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[263] *Re A Company* (No. 006834 of 1988) (1989) 5 BCC 218.
[264] *O' Neill* (n 153) per Lord Hoffmann.
[265] Law Commission Report on Shareholders' Remedies of 1997 (paras 3.8, 3.57-62).
[266] *O' Neill* (n 153).
[267] *Ibid*.

easily. However, the problem arises in the case of private and non-listed public companies as their shares are not traded and there is no mechanism for determining the share price of such companies. The valuation of the share price for such companies may be problematic and a cause for dispute. The other problem is the determination of discount on the shares held by the minority shareholders in those companies where there are controlling blocks. Purchasing the shares of such companies *pro rata* does not solve the problem as the controlling shares have more value than non-controlling shares. The shares will only be *pro rata* in those circumstances where there are no controlling shares. In Pakistan, where ownership is concentrated, there are fewer chances that the shares are without controlling blocks. In view of this, the valuation mechanism is very important in the context of Pakistan. For instance, in *Associated Biscuits International Limited* [ABIL] *v English Biscuits Manufacturers Limited* (EBM) the petitioner raised the issue of determining the price. [268] In this case ABIL owned 40% of the shares in EBM without any representation on the management in EBM. Respondent No. 2 was the managing director, while respondents Nos 3 to 7 were directors and shareholders of EBM. Respondents Nos 4, 5 and 6 were relatives of respondents Nos 2 and 3. EBM formed a subsidiary company, namely Coronet Foods (Pvt) Limited (CFL) with 51% shares held by EBM while the remaining 49% shares were held by respondents Nos 2, 3, 5, 6 and 7. Respondents Nos 2 and 3 were the managing director and director respectively in CFL. In order to make CFL a wholly owned subsidiary of EBM and to avoid conflict of interest, it was decided at the AGM of EBM that it would acquire 49% of the shares owned by respondents Nos 2, 3, 5, 6 and 7 in CFL. In order to finance the purchase, it was also decided to issue rights shares in EBM. The auditors of EMB were assigned the task of valuating the price for the rights issue and shares of CFL. The representative of ABIL, a minority shareholder in EBM, principally accepted the decision, in order to end the conflict of interest, on behalf of ABIL but requested the valuation of the shares in a transparent manner. Before finalising the reports by the auditors, the board of directors of CFL (who were also directors in EMB and relatives of other directors of EMB) and the board of directors of EMB (who were also managing director and director respectively in CFL) decided to acquire the shares of CFL with 100% premium. This decision of the board of director of EBM compelled EBM to purchase the shares of CFL at a highly inflated price in order to give the benefit to respondents Nos 2, 3, 5, 6 and 7. CFL brought a petition on the grounds that the decision of the board of directors of EBM to acquire CFL shares at a ridiculously inflated value was *mala fide*, oppressive and fraudulent under s. 290 of the Ordinance. The court observed

[268] *Associated Biscuits* (n 214).

that the valuation was manoeuvred by the board of directors and the auditors of EMB. The valuation was made on the basis of a future forecast prepared by respondents Nos 2 and 3. The Sindh High Court rejected the valuation of CFL shares made by the board of directors of EBM. It appointed an official assignee as commissioner in order to revaluate the shares of CFL by appointing an independent valuator or auditors.

Another aspect of the valuation of shares may be the determination of the control premium. It is not necessary that only the majority purchases the shares of the minority. There may also be a possibility, though in exceptional cases, that the minority may be in a position to purchase the shares held by the majority. Therefore, the minority shareholders may also be given equal opportunity to purchase shares held by the majority if they can afford to do so. The oppressor should not be at liberty to remain in management and exclude the oppressed. If oppressive conduct is proved, then the minority may also be offered shares held by the majority to purchase. In this case the valuation of the control premium becomes necessary.

It is, therefore, vital to provide a procedure for valuating shares. This may be provided that the valuation will be conducted by experts in the field with the mutual consent of the parties or by an order of court in a case of disagreement. The SECP may be empowered to grant valuators a licence and to maintain the list of such valuators.

ii Cost of litigation in buyout offers

Another aspect of the buyout offer is the cost of litigation. Lord Hoffmann says that the objective of a fair offer is to avoid the cost of litigation. He further says that if the petitioner insists on the petition, after the respondent had made a fair buyout offer and the decision by the court is also the fair offer, then the petitioner should not be paid the cost of the litigation. Similarly, if the petitioner was in hurry to file the petition, without giving reasonable time to the respondent, in this case too, the petitioner should not be paid the cost of litigation.[269]

[269] *O' Neill* (n 153).

iii Implications of fair buyout offers

As litigation takes too much of the court's time and in most cases the outcome is a fair offer, Lord Hoffmann discusses the consequences of a fair offer. He says that the petition should be struck down when a fair offer was made by the respondent and the court's decision is a fair offer. He further explains that the petitioner will not be paid the cost of litigation if he or she was in hurry to file the petition and court's decision is a fair offer.[270]

One of the advantages of a fair buyout offer, discussed by Lord Hoffmann, is that it avoids unnecessary litigation which may save time and cost.[271] However, the fair buyout offer has implications for the minority shareholders. Firstly, if the minority shareholders reject the fair offer by the majority and insist on the petition, the court may dismiss the petition in this case. They may lose the remedy that they would have received without a fair buyout offer from the majority.[272] Secondly, this may give the majority shareholders a free hand to act unfairly. The majority shareholders may offer the minority a price that is otherwise fair and the court strikes down the petition on the basis of a fair offer. The petition might not be to exit from the company due to the successful business of the company, it might be to discipline management or to obtain certain protection from the majority shareholders. Therefore, striking down the petition on a fair offer by the majority may not be a favourable result for the minority shareholders. Thirdly, there is no guideline to deal with the cases where the majority does not make a fair buyout offer within a reasonable time. In this case, in order to strike down the petition on the basis of a fair offer, the fair offer must also include the cost of the litigation.[273] Fourthly, depriving the petitioner of the cost of litigation if a fair buyout offer was made may be problematic for the petitioner. It is quite possible that a petition by the minority may be to mend the ways in which the company is being run by the majority and to avoid future unfair prejudice. However, the petitioner may arrive at a conclusion that it is better to quit the company instead of disciplining the management. Therefore, denying the cost of litigation to the petitioners, on the presumption that a fair buyout offer was made, may not be justified.

270 *Ibid*.
271 A. J. Boyle, *Minority Shareholders' Remedies* (2nd edn, Cambridge University Press, Cambridge 2004) 107.
272 Kershaw (n 91) 635.
273 *Ibid* 635.

4B.6.4.2.6 Oppression, mismanagement and the creditors

The creditors can also apply for a remedy against oppression and mismanagement by the controller, provided that their interest in the company is not less than 20% of the paid-up capital of the company under s. 290 of the Ordinance. The creditors, however, have another remedy under s. 295 of the Ordinance. The creditors who have an interest equivalent to an amount not less than 60% of the paid-up capital of the company may apply to the SECP[274] to seek relief from the mismanagement of the company. The commission may appoint an administrator to manage the affairs of the company.[275] The administrator works until the objective has been reached. The commission may permit the company to appoint directors if it is satisfied that the purpose has been achieved.[276] The section provides certain instances of mismanagement upon which the creditors can apply to the Commission for mismanagement of the company and appointment of the administrator. These include the following:

- *(i)* *The affairs or business of the company are or have been conducted or managed in a manner likely to be prejudicial to the interest of the company, members or creditors;*
- *(ii)* *If the director or any officer of the company is guilty of breach of trust, malfeasance or other misconduct towards the company, members or creditors;*
- *(iii)* *The affairs of the company are or have been conducted or managed with the intent to defraud members or creditors;*
- *(iv)* *The affairs of the company have been so conducted or managed as to deprive the members thereof of a reasonable return;*
- *(v)* *An industrial project or unit to be set up or belonging to the company has not been completed;*
- *(vi)* *The accumulated losses of the company exceed 60% of its paid-up capital.*[277]

It is interesting to note that the members are not allowed, under the Ordinance, to apply to the commission if they have been deprived of a reasonable return on their investment, as a result of mismanagement. The section further explains that the members shall be considered to have been deprived of reasonable return if, having regard to enterprises similarly placed, the company is unable to pay or does not declare any or an adequate

[274] The SECP is the apex regulator in the corporate sector in Pakistan.
[275] See s. 295 of the Ordinance.
[276] See s. 295 (6) of the Ordinance.
[277] See s. 295 (1) (a) to (f) of the Ordinance; Nyazee (n 237) 182.

dividend for a period of three consecutive years.[278] The members, in this case, have to wait for action by the creditors for the remedy against non-payment of a dividend. The important question is why a creditor should apply for non-payment of a dividend to the members as the non-payment does not affect the creditors adversely. In fact, this may be rather beneficial for them because the non-payment of a dividend enhances the value of the company and protects the interests of the creditors. This suggests that there will hardly be an instance where the creditors will apply for mismanagement under this clause. Therefore, the members should also be given rights to apply for mismanagement if they do not receive a reasonable return on their investment.

Similarly, many other instances of mismanagement that affect members fall under the jurisdiction of the creditors. The members affected by mismanagement do not have the right to apply for the appointment of an administrator. So, again, the minority interests are subject to action by the creditors. Therefore, there is a need to give powers to the members to apply against mismanagement in circumstances affecting members directly. Mismanagement that affects a company or all the members of the company may be included in the statutory derivative action. The other important point is the threshold for the creditors to apply for mismanagement which is too high. The creditors' threshold should be reduced in order to safeguard their interest.

In the context of the UK, the statutory unfair prejudice remedy can be sought as a member only and not as a creditor. The reason why the creditors are not protected under the unfair prejudice remedy is the concept of unfair prejudice attached to membership rights. The remedy under the unfair prejudice conduct is available *qua* members only. The reason is the incomplete contractual nature of the relation of members with the company. However, the nature of the contract with the creditors is complete in all respects. They can negotiate the terms of their contract; they can, therefore, protect themselves by different techniques which include, but are not limited to, disclosure through different periodical reports, right of reorganization and liquidation, and a governance mechanism. In the governance mechanism, the creditors may have the right to appoint a nominee director by virtue of the contract with the company or may also limit the payment of dividends. These may be the main reasons why the creditors were not protected under the unfair prejudice remedy. However, some references can be found, under the common law, where the remedy other than *qua* member was provided to the petitioner. Lord Hoffmann in the *Phillips* case says

[278] See explanation to s. 295 (1) (c) of the Ordinance.

that '*the requirement that prejudice must be suffered as a member should not be too narrowly or technically construed*'.[279] Moreover, in recent years, the common law courts have taken quite a flexible view in granting the unfair remedy and have extended the same to the creditors. Lord Scott of Foscote said that where a petitioner was involved in different capacities such as a member and a creditor, such petitioner may be given a remedy in his or her non-member capacity.[280] This is the Jersey unfair remedy which is similar to the UK remedy[281] to the extent that the remedy may be sought for other than a *qua* member. As the member of the company was also a creditor in this case, the court extended the unfair remedy to the creditor in his dual capacity. Nevertheless, the remedy was extended *qua* creditor.

In the UK creditors do not have access to the remedy under unfair prejudice conduct. They can invoke s. 993[282] of the Companies Act, 2006 or ss. 213[283] and 214[284] of the Insolvency Act, 1986 (IA) to protect their rights. S. 993 is too demanding, as it requires proving fraud in the criminal meaning. As the penalty is severe, in the form of imprisonment, the requirement of evidence will also be strict. Therefore, the chances are slim that the creditors will invoke the remedy under s. 993 due to the strict requirement related to the evidence. However, ss. 213–14 of the IA that protect creditors' rights are less demanding than s. 993 of the Companies Act, 2006. As there is only a financial penalty, under ss. 2013–14, the requirement of evidence is not as strict as in a criminal offence under s. 993. If creditors fail under ss. 213–14 of the IA, practically, they will not succeed under s. 993 as this section is more demanding than ss. 2013–14 of the IA. The question is whether the creditors should wait for the insolvency of the company to obtain a remedy under the IA. Most of the time the winding up is not a favourable option for all the stakeholders, therefore, the courts and the legislature try to solve the issue without liquidating the company. As the winding up is a last resort, therefore, the unfair prejudice remedy may solve the problem with ease and without going for winding up. As the demand for a remedy, at first instance, under s. 993 may be problematic due to the strict requirements of the evidence, this may not provide a remedy of the kind that is possible under unfair prejudice.

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[279] *O'Neill v Phillips* [1999] 1 WLR 1092 at 1105.
[280] *Gamlestaden Fastigheter AB v Baltic Partners ltd* [2007] UKPC 26.
[281] Kershaw (n 91) 628.
[282] See s. 993 of the Companies Act, 2006 deals with fraudulent trading.
[283] See s. 213 of the IA deals with fraudulent trading.
[284] See s. 214 of the IA deals with wrongful trading.

4B.6.4.2.7 Non-payment of dividends and oppressive conduct

Investment by the small shareholders in public companies is based on their expectation of being paid a dividend. They are not interested in participating in the management or have concerns about the other affairs of the company. The other possible return on their investment is capital gain. To earn money through the sale and purchase of shares is not a simple way to share in the profit. In underdeveloped markets special expertise is required to earn money through the sale and purchase of shares. In an inefficient market, a sudden and frequent fluctuation may harm, in most of the cases, small shareholders. Although, according to the Modigliani–Miller theorem, non-payment of dividends does not cost the shareholders much as this may increase the share value.[285] However, this theorem is dependent upon the presence of an efficient market. In Pakistan the stock market is inefficient, volatile and controlled by powerful brokers. On a number of occasions the small shareholders in the stock market had to suffer due to manipulation by these brokers. Therefore, the focus of small shareholders is on getting a dividend as a return on their investment rather than focusing on capital gain. However, it is normal phenomenon in Pakistan that the companies do not pay a dividend or pay a smaller dividend compared to their earnings. The reason for such conduct is the control of the families over the listed companies. They focus on empire building, which allows them to accommodate their family members, relatives and friends in key positions rather than focus on the payment of dividends. Their interests are focused on the private benefit of control rather than cash-flow payments through dividends. A basic source of earning for the controlling shareholders is the pay and privileges they receive by hanging on to their management positions.[286]

In this context, it is therefore suggested that non-payment or low rate of dividend, for specific continuous periods, may be considered oppressive conduct, when the companies are in a better financial position and are earning good profits. These companies should give solid reasons for the non-payment of dividends as a defence against oppressive conduct. This can be useful in the Pakistani environment as under the company law the dividend is to be declared by the directors and the shareholders have to give *ex post facto* approval only. They can decrease a dividend but cannot enhance it. Furthermore, the minority and

[285] Franko Modigliani and Merton H. Miller, 'Dividend Policy, Growth and the Valuatiton of Shares' (1961) 34 *The Journal of Business* 411-433 and Franko Modigliani and Merton H. Miller, 'The Cost of Capital, Corporation Finance and the Theory of Investment' (1958) 48 *The American Economic Review* 261-297.
[286] Khan (n 60) 223-4.

small shareholders do not have enough shares to influence and lobby against non-payment or a lesser payment of dividend in a general meeting. Therefore, the discretion to declare a dividend on the part of the directors may not be a good idea in the context of the family-controlled market in Pakistan. The idea of non-payment of a dividend as oppressive conduct may be introduced through company law or, at least, through the code of corporate governance.[287] This may encourage rather than force companies to decide in favour of the payment of a dividend whenever there is a possibility of providing cash-flow rights to the minority shareholders due to the better financial position of the company.

4B.6.5 Just and equitable winding up in the UK

4B.6.5.1 Nature and scope of the remedy

The just and equitable winding up of a company is a residual remedy.[288] The just and equitable winding up and unfair prejudice remedy are interrelated in the sense that both are an alternative to each other. The unfair prejudice remedy has been developed as an alternative to winding up, and just and equitable winding up is sought as an alternative to unfair prejudice. The principles such as bond of trust and good faith established for just and equitable winding up are often considered and applied to the unfair prejudice remedy.[289] The scope of the just and equitable winding up has been established by the courts over a period. The basis was the breakdown of the necessary bond of trust, co-operation and good faith between the partners of the partnership. These principles are also applied in companies that are quasi-partnership companies.[290] Small, private limited companies operate like partnerships where the ownership and the management are not separated. In such types of companies, the relations between the members are not limited to articles of association but may also be based on other things such as legitimate expectations[291] and equitable considerations. Consider a hypothetical example[292] of a small private company where there are four members who each holds a 25% shareholding and is also a director. Suppose the only way of getting profit is the remuneration as a director without payment of a dividend. There may be two worse case situations. First, they are

[287] The Code of Corporate Governance is applicable to listed companies.
[288] See s. 125 (2) (b) the IA.
[289] Pettet, Lowry and Reisberg (n 165) 254.
[290] *Ebrahimi v Westbourne Galleries Ltd* [1973] AC 360 (HL) per Lord Wilberforce.
[291] Jeffrey G. MacIntosh, ‘Minority Shareholder Rights in Canada and England: 1860-1987’ (1989) 27 (3) *Osgoode Hall law Journal* 636-40.
[292] This is a version of the example given by Pettet, Lowry and Reisberg (n 165) 255.

divided into two groups with two members in each group. This may create a deadlock[293] and difficulty in running the company. Second, when three dismiss the fourth member from the directorship, the dismissed director will not get any remuneration after being removed from the directorship and therefore no profit. The capital of such removed director will be locked. It will be difficult for such director to sell his or her shares to a third party as the shares of private companies are not traded on the market. However, there may also be some restrictions on the transfer of shares in private companies.[294] If such director receives the consent of the board of directors for selling shares, then it is quite possible that no one will give a reasonable price. This is a breakdown in the legitimate expectation and mutual trust, the proper way out is, therefore, to wind up the company.

4B.6.5.2 Implications

The just and equitable winding up is not an attractive remedy as compared to the unfair prejudice remedy as far as the financial aspects of the company are concerned. In winding up all parties, including the petitioner and respondents, may suffer. In unfair prejudice the company remains a going concern with damages being paid to the affected party but in winding up what is left are only the assets of the company. After liquidation, it is quite possible that everyone gets less than their due shares as the shares normally do not represent the true proportion of assets of the company. Secondly, as a director one may lose continuous profits in the form of dividend or remuneration while the company is a going concern. Thirdly, if the business of the company is based on profits from its know-how and personal contacts then winding up may not be an attractive remedy.[295] Nevertheless, this is a minority protection in the sense that it provides a bargaining chip to control the corporate powers of the controlling shareholders, which can otherwise be destructive for the minority shareholders.[296]

[293] *Re Yenidje Tobacco Company* (1916) 2 Ch 426 per Lord Cozens Hardy MR.
[294] In some jurisdictions such as Pakistan, the transfer of shares in private companies is restricted by the articles unless approved by the board of directors.
[295] Pettet, Lowry and Reisberg (n 165) 255.
[296] Kershaw (n 91) 609-15.

4B.6.5.3 Grounds for just and equitable winding up

In the *Ebrahimi* case, Lord Wilberforce said that it was neither feasible nor desirable to define the circumstances in which a just and equitable remedy could be given. [297] This depended upon the circumstances of each case. However, he discussed some of the grounds in the *Ebrahimi* case. In this case there were three members in the company who had a mutual understanding that they would all be directors with remuneration as profit without declaration of dividends. Two members, who were father and son, removed Ebrahimi from the directorship. Therefore, he lost remuneration as a director and, consequently, received nothing against his investment. He was left with no option except to go for just and equitable winding up. Lord Wilberforce said that a company that was formed on the basis of a relationship, mutual confidence, on the understanding that everyone would participate in the management and impose restrictions on the transfer of interest was like a partnership. Therefore, the principles of partnership such as ‘probity’, ‘good faith’ and ‘mutual confidence’ would apply. He further said that although removal from the directorship was their legal right, the equity consideration went beyond legal rights and there were, therefore, valid grounds for just and equitable winding up.

4B.6.5.4 Role of unfairness

An important question with reference to just and equitable winding up is whether there is a need to show unfairness on the part of the defendants. One view is that one must show unfairness on the part of defendants in order to obtain a just and equitable remedy. In the *Re Guidezone* case the judge denied winding up on the basis that the act of the majority was not a breach of good faith.[298] The other view is that when a company is established on mutual trust and confidence, and once that trust and confidence are broken, then there is no need to show unfairness. In the *Ebrahimi* case the winding up was ordered on the breakdown of mutual trust and confidence. As it is not possible to show unfairness every time, therefore, it is enough if it is shown to the satisfaction of the court that trust and confidence, on which the company was formed, had broken down. This provides wide

[297] *Ebrahimi* (n 289) per Lord Wilberforce.
[298] *Re Guidezone Ltd* [2000] 2 BCLC 321.

discretion to the courts, which can provide relief without showing unfairness on the part of the respondent.[299]

4B.6.5.5 Requirement of clean hands

The unfair prejudice remedy, and just and equitable winding up are alternatives to each other but both can be differentiated on the basis of legal rights and equitable rights. The unfair prejudice remedy is a legal remedy, therefore, it is not necessary to come with clean hands.[300] However, just and equitable winding up is an equitable remedy, therefore the petitioner, as per the principles of equity, should come with clean hands; in other words, a petitioner can ask for an unfair prejudice remedy in cases of contributory harm, otherwise winding up in cases of breaches of trust and confidence.

4B.6.5.6 The unfair prejudice remedy and just and equitable winding up

The unfair prejudice remedy was to provide an alternate to the winding up of a company because winding up may be unattractive and costly for a number of reasons, which are discussed above.[301] The winding up remedy is a residual remedy, in other words, the just and equitable winding up is a last resort and if another remedy is available, then the court will not go for winding up. A problematic situation may be where a petitioner fails in obtaining the unfair prejudice remedy, and intends to file just and equitable remedy. In the *Re Guidezone* case the petitioner, after failing to obtain the unfair prejudice remedy asked the court to convert the petition for unfair prejudice to just and equitable winding up. The court refused the application on the grounds that '*if the conduct by the majority relied on by s. 459 was not unfair for the purposes of s. 459 it could not found a case for a winding-up order on just and equitable grounds: the winding-up jurisdiction was not wider than s. 459 jurisdiction since a winding-up order was, as it were, the death sentence for a company*'.[302]

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[299] Acton Stephen, 'Just and Equitable Winding up: The Strange Case of the Disapproving Jurisdiction' (2001) 22 (5) *Company Lawyer* 134-7; Conway Mark, 'Minority Shareholder Protection and the Rule in Foss v *Harbottle*: Increasing a Foss About Nothing in Companies' in Gary Slapper (ed), *Companies in the 1990s* (Cavendish, London 1995) 17-8; Poole Jill and Roberts Pauline, 'Shareholder Remedies-Efficient Litigation and the Unfair prejudice Remedy (1999) *The Journal of Business law* 57.

[300] *Re London School of Electronics Ltd* [1986] Ch 211.

[301] See text to n 294-4.

[302] *Re Guidezone* (n 298).

In other words, the court said that the jurisdiction of the court under winding up on a just and equitable ground was no wider than jurisdiction under the unfair prejudice remedy. The decision may be problematic for a petitioner in the sense that failure in unfair prejudice may put up a barrier to the just and equitable winding up. The IA, 1986 provides that winding up is a residual remedy.[303] The winding up remedy can only be sought when there is no other remedy available. If any party goes for winding up, then the court may direct him or her to proceed first with seeking the unfair prejudice remedy. If a petitioner fails in unfair prejudice, then, according to the *Re Guidezone* case, this will debar the petitioner from proceeding with winding up on a just and equitable ground. Therefore, proceeding first with an application for an unfair prejudice remedy is risky because this may shut the doors to winding up on just and equitable grounds. In fact, the court had closed the door, to some extent, for the remedy of winding up on just and equitable grounds. The decision of *Re Guidezone* is overturned by the Court of Appeal in *Re Neath Rugby*. The court expressed doubts on the correctness of the decision of Parker J in *Re Guidezone* case.[304]

Therefore, it may be concluded that the remedy under unfair prejudice may be sought for infringement of legal rights. However, the remedy under just and equitable winding up may also be pursued in the instances where there is a break down in mutual trust and confidence.[305] Therefore, the jurisdiction of the court under just and equitable winding up will be much broader than the unfair prejudice remedy.[306] Therefore, a person may be allowed to pursue the remedy in addition to, or in lieu of, the unfair prejudice remedy. A person may be allowed to claim damages for unfair prejudice conduct and if there is a breakdown in relations, mutual trust and confidence, and be allowed to pursue the winding up remedy.[307]

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[303] S. 125 (2) (b) of the Insolvency Act, 1986 bars the courts from proceeding with winding up on just and equitable grounds when the court are of the opinion that another remedy is available.

[304] *Frederick Geraint Hawkes v Simone Francesca Cuddy, Micheal Cuddy, Neath Rugby Limited, Neath-Swansea Ospreys Limited* [2009] EWCA Civ 291 at para 106-7.

[305] *Ebrahimi* (n 289) per Lord Wilberforce.

[306] Boyle (n 271) 93-4.

[307] Stephen (n 299) 139.

4B.6.5.7 Just and equitable winding up in Pakistan

Company law provides courts with the power to order the winding up of a company on just and equitable grounds. Just and equitable winding up is provided as an alternate remedy. The law gives the court the power to refuse winding up if other remedies are available and the petitioner is pursuing winding up unnecessarily.[308] As private companies are formed and operated like partnerships, the principles of dissolution of partnerships also apply in the winding up of private companies if the apparent structure of the company is not the real structure and on piercing the veil it is revealed that in reality it is a partnership.[309] So, private companies may be wound up on just and equitable grounds in circumstances that are considered valid for dissolution of partnerships such as exclusion of a member from the management, the existence of a deadlock and lack of confidence in the management.[310] However, this is not an exhaustive list. It is neither possible nor desirable to enumerate all circumstances in which the winding up on just and equitable grounds may be made by the court.[311]

4B.6.5.7.1 Oppressive remedy and winding up in Pakistan

The oppressive remedy, and just and equitable winding up are independent and alternative to each other. However, in *ABIL v EBM*, the High Court said that '*the remedy under oppressive conduct or mismanagement can only be sought if the affairs of the company are conducted in a manner oppressive to the members and that facts justify winding up but at the same time making such winding up order would unfairly prejudice such members*'.[312] The court said that remedy under oppressive conduct could be pursued only under those circumstances that led to winding up; in other words, the jurisdiction of the court in oppressive remedy was not different from winding up on just and equitable grounds. In these circumstances a party who failed to secure an oppressive remedy will also fail in winding up. The decision limited the scope of the remedy on just and equitable grounds. The winding up can be effective only when it has a wider scope than the remedy under

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[308] See ss. 305 (h) and 314 (2) of the Ordinance.
[309] *Ladli Prasad Jaiswal v The Karnal Distillery Co. Ltd*, PLD 1965 SC (Pakistan) 221; *Messrs Nangina Films Ltd v Usman Hussain and Others*, 1987 CLC 2263 (Pakistan).
[310] *Ladli Prasad* (n 295) 221; Iqbal *Alam and another v Messrs Plasticrafters (Pvt) Ltd and 4 others*, 1991 CLC 589 (Pakistan).
[311] *Re: Kruddson limited*, PLD 1972 Karachi (Pakistan) 376.
[312] *Associated Biscuits* (n 214).

oppressive conduct. A party who failed to acquire an oppressive remedy may be allowed to proceed for just and equitable winding up as a last resort.

The other aspect of just and equitable winding up is that the oppressive remedy is too demanding in Pakistan and it may not be feasible for the minority shareholders to pursue. Therefore, they may be left with no other option but to ask for just and equitable winding up. Winding up is not an attractive remedy it is, therefore, necessary to make the oppressive remedy feasible for minority shareholders so that the winding-up remedy would only be pursued as a last resort.

4B.7 Conclusion

The aim of this chapter was to discuss the application of the convergence theory in Pakistan. The objective was to explore techniques to improve the investor protection mechanism, especially the minority shareholders in the context of Pakistan. The focus of this chapter was on minority protection that includes pre-emptive rights, cumulative voting rights, the conflict of interest of the fiduciaries, derivative action, unfair prejudice remedy, and winding up on just and equitable principles.

The investor protection mechanism in Pakistan is weak. The corporate law of Pakistan provides some minority rights but most of the important rights are still missing. The majority of the rights that have been provided were transferred in the corporate law of Pakistan due to colonization. At the same time, some important minority rights that are provided in the corporate law of Pakistan are inefficient, out-dated and need restructuring or improvement. In order to improve the investor protection mechanism, there is a need to improve minority shareholders' rights through reforms. The theory of convergence may help to improve these rights. International norms especially those of the United Kingdom may be standards for reforms in minority protection mechanism in Pakistan. Corporate law of Pakistan may possibly converge to international norms in order to improve investor protection.

The extent to which the convergence in minority rights may take place depends upon the possibility and effectiveness of convergence in these rights in Pakistan. On the basis of the degree of possibility and effectiveness of convergence in minority rights in Pakistan, the same may be divided into three forms: strong, moderate and weak convergence.

Strong Convergence

Convergence can be regarded as strong where it is most likely to occur. For instance, convergence in the unfair prejudice remedy and just and equitable winding up is most likely due to the nature and development of these remedies. The reason is that both these remedies were transferred into the corporate law in Pakistan due to colonisation. These are more or less old versions of the remedies provided in the corporate law of the United Kingdom. Also, families and the state may not resist reforms in the unfair prejudice remedy as this remedy in the context of Pakistan can be sought both by the majority and minority. This is primarily due to the presence of different shareholding structures in Pakistan. Such situations may occur in the following circumstances: (1) it may occur when the minority shareholders have shares with enhanced voting powers and (2) it may also occur when minority shareholders have the power to control the management under a shareholder agreement. In these situations, any resolution in a general meeting may be controlled by such minority. Therefore, the remedy against oppression and mismanagement may be sought by any investor irrespective of the fact that such investor is a minority or a majority. It all depends upon who controls the management.

As far as just and equitable winding up is concerned, it was also transferred into the corporate law of Pakistan from the United Kingdom through colonisation. However, the problem with this remedy is that the courts in Pakistan has intermingled it with the unfair prejudice remedy. The other problem is that the unfair prejudice remedy in Pakistan is too demanding and may not be feasible for the minority shareholders to pursue. Therefore, they may be left with no other option but to ask for just and equitable winding up. Winding up is not an attractive remedy; therefore, it is necessary to make the unfair prejudice remedy feasible for minority shareholders so that this remedy could only be pursued as a last resort.

Therefore, as a result of historical linkage there is a strong possibility of convergence in these rights to the UK system of corporate governance.

Moderate Convergence

Convergence can be regarded as moderate where it is likely but there are chances that the path dependent forces may possibly resist reforms. For instance, convergence in pre-emption rights, CVS and the derivative action appears moderate. Pre-emption rights and CVS are provided in the corporate law of Pakistan. There is only need to improve these rights. Pre-emptive rights are provided as a default rule in the company law of Pakistan and companies can exclude these rights by special resolution. The threat of dilution of minority shareholders exists if pre-emptive rights are retained as a default rule. As families, the state and interest groups have leverage to issue shares without pre-emptive rights to increase their shareholding, therefore, there are chances that they may resist reform in this direction.

The second minority protection mechanism is the CVS. The CVS is a mechanism that enhances the powers of the minority and reduces the power of the majority shareholders. The system is a mandatory provision in the company law of Pakistan but it is not being implemented in its spirit even by the listed companies. The other problem is the presence of one share, one vote as a default rule. Companies can issue shares with enhanced voting rights and may thereby frustrate the potential benefits of CVS. In order to obtain the potential benefits of the CVS, one share, one vote should be made a mandatory provision. However, the possibility exists that the path dependent forces may possibly resist reform to this right as this will limit their leverage to issue shares with enhanced voting rights and thereby control the company with less shareholding.

On the other hand, the derivative action is not provided in the company law but it is recognised by the courts in Pakistan, being a common law country. Many developed and developing jurisdictions, including the UK, provide the remedy through commercial codes. The Companies Act, 2006 has effectively excluded the common law derivative action. This codification has not only combined together scattered and variable common law sources related to the derivative action, but has also removed ambiguities in certain areas. As the corporate sector in Pakistan is concentrated, families hold the majority of shareholding and appoint directors from their family, relatives or persons in whom they have confidence. In this scenario, it is not expected that they will bring any action against directors for breach of duty. It is also difficult for the minority shareholders to pass a resolution in general meetings and to get a remedy. Minority shareholders can approach the court for a remedy through common law derivative suits but this may be problematic for them. Firstly, foreign common law decisions can only have persuasive authority. Secondly, the common law is scattered and it may be problematic for courts to interpret this scattered law. Thirdly, there is a recent trend to bring derivative suits into statutory forms in order to remove uncertainty in these suits because of the scattered common law. Convergence to introduce derivative suits in statutory form is also evident in regional jurisdictions. It is, therefore, advisable that a derivative action be introduced in a statutory form. This will help the courts to provide minority shareholders with remedies and protection. Once again the problem with this remedy is that the path dependent forces and interest groups may possibly resist reforms as there are chances that the minority may get some power of accountability which may restrict the discretionary powers of the families and interest groups.

Weak Convergence

In a similar fashion, the possibility of convergence will be weak where it is less likely in the present circumstances. For instance, convergence in controlling the conflict of interest of the fiduciaries - related party transactions, doctrine of corporate opportunities and fiduciary duties of the controlling shareholders- appears weak.

Firstly, the scope of related party transactions is limited in Pakistan. The law includes only those transactions within the meaning of related party transactions in which a director or officer has some interest. This does not include controlling shareholders, relatives, business associates and friends of controlling shareholders. The majority shareholders may use their position to approve any transaction from the directors in which they have a personal interest. Family-owned enterprises in Pakistan have interlocking directorship and cross-shareholding; therefore, it is not difficult for the majority shareholders in such companies to get approval from the board. This provides them with an opportunity to abuse their majority power through the board. It is necessary to enhance the scope of related party transactions because majority shareholders may escape from such prohibition.

Secondly, the approval mechanism of the related party transaction is problematic as it vests powers in the board of directors. There is a global trend of extending the nature, scope and approval mechanism of related party transactions. Many developed and developing jurisdictions have introduced a legal framework in this regard to provide minority protection. Related party transactions can be controlled effectively in Pakistan when the scope and approval mechanism is changed according to the new trend prevalent in the world. The determination of price, consideration and approval of related party transactions from the board may not solve the purpose of minority protection. In Pakistan the corporate sector is concentrated where the directors are normally family members, relatives or close friends. The directors are under the direct influence of the controlling shareholders and may be biased in favour of their colleague director. Therefore, asking the board to consider, determine and approve related party transactions may not provide minority protection. The approval mechanism requires reconsideration. This may include transactions exceeding certain thresholds to be approved by the shareholders at general meetings. All related party transactions may be considered and approved by the board of directors but once the transaction exceeds a certain specified limit, then it may be forwarded to a general meeting for consideration and approval.

Similarly, when the transaction is referred to a general meeting for consideration and approval, then the issue will be the approval mechanism at shareholders' meetings. The interested director or dominant shareholder may be involved in and help to approve such transaction. As discussed above, it is possible that the conflicted director or the controlling shareholder may be influential enough to pursue other members to avoid raising his or her voice against the transaction or voting against such transaction. It is appropriate to exclude a related party from participating in that part of the meeting of shareholders which is to consider, discuss and approve related party transactions. This may give shareholders an opportunity to raise an independent view about the advantages and disadvantages of related party transactions, and to vote on the resolution. In the context of Pakistan, as the corporate culture is not used to this type of restrictions and authorization process, it is appropriate, in the first instance, to introduce such provisions applicable to listed companies through the code. Once they have been implemented successfully and accepted by the business community, they may be extended to all types of companies through company law.

Thirdly, the doctrine of corporate opportunity has not developed in Pakistan. The concept is important for a concentrated ownership jurisdiction such as Pakistan. The controlling shareholders act in a dual character: as shareholders and as directors. The majority shareholders dominate the corporate boards. The directors may be involved in diverting corporate opportunity for their personal benefits at the cost of the company and its minority shareholders. Another recent trend in the developed and developing jurisdictions is to codify the common law. The codified law can present a clear picture of rights and obligations. Therefore, there is a need to codify the directors' duties and mechanism of authorization of conflict of interest of the fiduciaries in Pakistan.

Fourthly, as the majority shareholders dominate the corporate boards, controlling shareholders may get authorization for conflict of interest from the board. Similarly, the controlling shareholders also control the general meeting even in listed companies. They may act opportunistically in their own interest at the cost of the company and its minority shareholders. Therefore, the nature of the corporate sector in Pakistan suggests extending the fiduciary duties to the controlling shareholders in order to control the conflict of interest against the interest of the company and its minority shareholders. In order to avoid excessive litigation, the controlling shareholders will have the same defences of the business judgment rule and judicial test of fairness available to the directors for breach of fiduciary duties.

However, the problem is that reforms in these remedies will definitely challenge unchecked discretionary powers of families, politicians and interest groups. These path dependent forces and interest groups might have strong resistance to reforms in these rights. Therefore, convergence in these rights is less likely.

To avoid resistance from path dependent forces there is a need to reform the system in a piecemeal, systematic and through a pragmatic approach. Therefore, in the context of Pakistan, as the corporate culture is not used to this type of restrictions and authorization process, it would be appropriate, in the first instance, to introduce such provisions applicable to listed companies through the code. Once these are implemented successfully and accepted by the business community, they may be extended to all types of companies through the company law.

CHAPTER FIVE: ENFORCEMENT IN RELATION TO CORPORATE GOVERNANCE IN PAKISTAN

5.1 Introduction

The previous chapter (Chapter Four) was limited to the application of the theory of convergence in relation to the agency problem and the rights of minority shareholders in Pakistan. Chapter Five discusses the application of the theory with respect to enforcement in corporate governance in Pakistan. The concept of effective enforcement rather than merely the provision of the law in books is not new in theory.[1] 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 globalization and competition[2] where cross-border investment has increased. This phenomenon highlights the importance not only for domestic investors, but also to attract foreign investors.

This chapter discusses two issues with reference to the enforcement of corporate governance in Pakistan. The first is the role of the courts in corporate governance in Pakistan. The general courts are the main source for the enforcement of rights. These courts have failed to resolve corporate disputes by enforcing the corporate laws in Pakistan. Therefore, there is a need to enhance the judicial capacity to do so.

Enforcement may also come through other means and, in fact, these alternatives are embedded in the system. The capital market plays an effective role in enforcing corporate laws. Therefore, the second issue to be considered is the role of the market in the enforcement mechanism. The market in Pakistan failed to implement rules and regulations. Some initiatives were undertaken by the regulator and the state but they could not produce optimum results due to the vested interests of those who did not welcome even limited reform. Therefore, there is a need to reform the market keeping in mind the prevailing circumstances of the country.

The focus of this chapter is on applicability, possibility and effectiveness of convergence in enhancing the enforcement mechanism in Pakistan in the light of global trends, and

[1] Roscoe Pound, 'Law in Books and Law in Action' (1910) 44 *American Law Review* 12.
[2] Luca Enriques, 'Do Corporate Law Judges Matter? Some Evidence from Milan' (2002) *3 European Business Organization Law Review* 812.

particularly in countries that have similar social, cultural, economic and political conditions. However, the main focus will remain on the British corporate governance system as the Pakistani system was borrowed from Britain, its former colonial power. In particular, the focus will be on the form of convergence that may help to improve enforcement mechanisms in Pakistan.

5.2 Enforcement issues in corporate governance

In recent years globalization and competition have brought about the trend in corporate governance to converge. The transplantation of foreign corporate governance features has remained a main phenomenon. In this process the home countries tried to adapt these features according to their circumstances but a weak enforcement mechanism did not produce optimum results. LLSV have discussed in detail the protection of investors, especially minority shareholder, and described them as the main reason for the development of the market and good corporate governance. They further emphasized the fact that the enforcement mechanism can be effective only when there are good laws.[3] The focus of LLSV was on the provision of the rights of the investors. 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 suggests that features of foreign corporate governance can play at least a positive role on reform agendas and in their implementation.[4] In the second phase the law in action can be ensured by enhancing institutional capacity.[5] 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

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[3] LLSV, 'Legal Determinants of External Finance' (1997) LII (3) *The Journal of Finance* 1131-50; LLSV, 'Law and Finance' (1998) 106 (6) *Journal of Political Economy* 1113-55.
[4] Erik Berglof and Stijn Claessens, 'Enforcement and Corporate Governance' (2004) World Bank Policy Research Working Paper 3409, p 41, available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=625286&download=yes> Accessed 20.12.2013.
[5] Robert Cooter, 'Expressive Law and Economics' (1998) 27 *Journal of Legal Studies* 585.

good laws, enforcement will not be successful and, conversely, in the presence of a weak enforcement mechanism mere good laws cannot protect investors.[6]

Reforms in 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; in fact, enforcement is embedded in the system that developed over time. 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,[7] 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*, professionals and a developed judicial system have provided sufficient investor protection, which has developed the system of corporate governance.[8] The problem of enforcement is more severe in developing countries than in developed countries. The problem does not lie with the 'law in books' but with the 'law in action' in developing countries.[9] Many developing countries have laws that are transplanted through globalization, colonization 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 developing and emerging economies; for example, India has taken some initiative to reform its enforcement mechanism. It recently proposed new legislation in Parliament with many important proposals regarding enforcement on its agenda. It has introduced quasi-judicial authority to enhance the enforcement mechanism in the corporate sector.

In Pakistan there have been some reforms during the past three decades. International financial institutions were involved in forcing the state to reform its corporate sector. These institutions provided a series of loans to the government with a reform agenda as a condition of a loan. They also set international standards as an ideal for reforms in order to enhance the enforcement mechanism in Pakistan. The reform agenda started with the

[6] Katharina Pistor, Martin Raiser and Stanislaw Gelfer, 'Law and Finance in Transition Economies' (2000) 8 (2) *Economics of Transition* 356.
[7] R. Kraakman *et al.*, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford University Press, Oxford 2004) 219-20.
[8] Brian R. Cheffins, 'Law, Economics and the UK's System of Corporate Governance: Lessons from History' (2001) 71 *Journal of Corporate Law Studies* 86-9.
[9] Berglof and Claessens (n 4) 1-3.

enhancement of the regulator's capacity in corporate law. The establishment of the SECP through the Securities and Exchange Commission of Pakistan Act, 1997 (the SECP 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. Formal and functional convergence was dominant in these reform agendas by introducing new and altering existing laws, rules and regulations.

Many SOEs were privatized 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. These reforms caused a boom in the stock market but the market crashed 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.[10] Pakistan's weak enforcement mechanism failed and the inefficient judicial system could not provide affectees with a remedy

According to LLSV, as Pakistan is a common law country, its enforcement mechanism should be better than in civil law countries.[11] Theoretically, this may be true, but in reality the situation is different. The Pakistani judicial system lags behind that in many developed civil law countries. In Pakistan some shareholders' rights are provided in the corporate law.[12] However, minority rights are good on paper only.[13] The lack of enforcement mechanism is a basic issue in the context of Pakistan. The problem is also severe due to lack of judicial capacity to enforce these rights. Inefficiency, corruption, judicial cost and extra-ordinary delays are the main problems facing the judiciary. The regulator is also not efficient enough to ensure these rights. Most officials at the SECP are not efficient, and lack knowledge about, and expertise in, the corporate sector.[14] Other supporting institutions such as the stock markets, financial institutions and institutional investors are

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[10] I. A. Khawaja and A. Mian, 'Unchecked Intermediaries: Price manipulation in an Emerging Stock Market' (2005) 78 *Journal of Financial Economics* 203-41.
[11] LLSV (n 11) 1131-50.
[12] Attiya Y. Yavid and Robina Iqbal, 'Corporate Governance in Pakistan: Corporate Valuation, Ownership and Financing' (2010) Pakistan Institute of Development Economics Working Paper Series 2010:57, p 10.
[13] 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).
[14] Jaweria Ather, 'Ensuring Capacity, Integrity and Accountability of Regulators and Supervision' (6th Asian Roundtable on Corporate Governance, Organised by OECD, Seoul 2004) <http://www.oecd.org/document/34/0,3746,en_2649_37439_33962850_1_1_1_37439,00.html> Accessed 03.09.2013.

also not performing. Corruption, nepotism, feudalism and inefficiency are inherent in the system and the regulator, judiciary and other supporting institutions are not exempted.[15]

5.3 The role of the judiciary in corporate governance

In companies decision-making is based on the democratic principle of majority rule, that is, the majority vote. However, it is quite possible that some members may benefit through illegal means or by using their dominant power at the cost of the minority. These acts may sometimes be legal and within their mandates but the output may be the expropriation of minority shareholders, which is illegal. Many instances can be quoted for this purpose. Firstly, using voting powers to make decisions whose objective is to squeeze out or dilute minority shareholders' voting right. Secondly, using their dominant position to appoint directors or other executives whose objective is to give incentives and privileges to family members. Thirdly, entering into contracts with other firms or private companies in which the dominant shareholders have more interests, on some favourable terms. The question of what is legal and what are legal means is not straightforward, and is always left to the courts to decide.

An enhanced role for courts can be viewed against the backdrop of the development of fiduciary duty. The way in which fiduciary duty has developed in common law countries highlights the importance of the judiciary. Fiduciary duty was created for trustees who were not entrepreneurs. The objective of fiduciary duty was to avoid the wastage of trust assets in the hands of trustees. To achieve this objective, the trustees were prevented from acting in their own personal interest at the cost of the beneficiaries. Fiduciary duty requires selflessness and a duty of loyalty on the part of the trustees. When the company form was modernized, the courts extended the same duty of loyalty to the directors. Fiduciary duty was not actually developed for companies, it was developed by the courts in common law countries. This phenomenon highlights the importance of the role of the courts in corporate governance. Some countries have codified fiduciary duties; for example, the UK has introduced fiduciary duty in the Companies Act, 2006. Although fiduciary duties have been codified, there may be gaps which the courts would have to fill. In Pakistan fiduciary duty is not codified and the country still relies on scattered common

[15] Sikander A. Shah, 'Mergers and the Rights of Minority Shareholders in Pakistan' (2005) *Centre for Management and Economics Research (CMER)* Working Paper Series No. 04-31, Lahore University of Management Sciences, Lahore, Pakistan.

law. Therefore, the courts have to play an enhanced role in determining fiduciary duty in Pakistan.

Another factor that highlights the importance of the judiciary is the interpretational role of the court. The dilemma of the legislature in providing accurate legislation enhances the role of the judiciary in corporate governance. Therefore, the inability of the legislature to foresee all possible future problems enhances this judicial role.[16] The courts are to interpret the statutes where the statutes are silent on a particular point of law or where the language of the statutes is not clear. This interpretational role of the courts highlights the importance of the courts in corporate governance.

The main advantage of common law countries is that their judges have the discretion to decide matters even in those areas in which the law has not provided a solution to a specific problem, that is, they have the discretion to fill in the gaps in the laws. This role of the courts is significant for two reasons: (1) it highlights the influential role of the courts in common law countries and (2) the court’s decisions have a direct impact on further decisions. These decisions become precedent, which is a source of law in common law countries. These precedents are binding on lower courts, and persuasive for equal courts and for foreign courts. The domestic courts in common law jurisdictions can benefit from the decisions of foreign courts. The capacity of judges to interpret those decisions and apply them to their own conditions may be problematic in the context of an inefficient judicial system. The problem may be more severe when applying specialized laws such as corporate laws. The courts in Pakistan are inefficient[17] and lack expertise in corporate and commercial matters. They intentionally keep the case law vague due to lack of expertise in legal and analytical reasoning, and writing skills.[18] The weak and inefficient judicial system in Pakistan is the main problem when it comes to enforcement, which is one of the reasons for the weak corporate governance system, and a hurdle in attracting foreign and domestic investment.

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[16] Jonathan R. Macey, ‘Courts and Corporations: A Comment on Coffee’ (1989) 89 *Columbia Law Review* 1698-9.

[17] Waqar A. Ghani and Junaid Ashraf, ‘Corporate Governance, Business Group Affiliation, and Firm Performance: Descriptive Evidence from Pakistan’ (2005) Centre of Management and Economic Research Working Paper Series 05-35, Lahore University of Management Sciences, p 19; The World Bank, ‘Report on the Observation of Standards and Codes (ROSC) Corporate Governance’ (2005) Corporate Governance Country Assessment of Pakistan June 2005, p 4.

[18] Shah (n 15) 16.

5.4 Judicial structure in Pakistan

5.4.1 Regular court structure in Pakistan

Pakistan is a common law country and a former British colony. Its judicial system evolved through various stages starting with the Hindu kingdom, and moving to Muslim rule, the British colonial administration and post-independence developments. The judicial system that has developed throughout the centuries is flavoured by foreign transplantation, Islamic norms, as well as local norms and conditions.[19] The latest version of the judicial structure is enshrined in the Constitution of the Islamic Republic of Pakistan, 1973.[20] Under the constitution, the Supreme Court of Pakistan is the highest appellant forum for civil and criminal matters in the whole of Pakistan. The Supreme Court has one main sitting at Islamabad, the capital of Pakistan, and one registry in each of the four provinces, including Lahore (Punjab), Karachi (Sindh), Peshawar (Khyber Pakhtwoonkha) and Quetta (Baluchistan). The Supreme Court has original jurisdiction in intergovernmental disputes[21] and enforcement of fundamental rights.[22] It has appellate jurisdiction in both civil and criminal matters.[23] It also has advisory jurisdiction in respect of giving opinions to the government on questions of law referred to it by the President of Pakistan.[24]

In addition, there is the Shariat Appellant Bench of the Supreme Court whose function is to deal with and hear appeals on matters decided by the Federal Shariat Court (FSC).[25] The objective of the FSC is to decide whether or not any law is repugnant to the injunctions of Islam.[26] The FSC has appellate and revision jurisdictions[27] over criminal matters relating to Hudood laws.[28]

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[19] Faqir Hussain (Registrar of the Supreme Court of Pakistan), 'Judicial System of Pakistan' (2011) available at the Supreme Court of Pakistan's website at <http://www.supremecourt.gov.pk/web/page.asp?id=594 > Accessed 20.12.2013.

[20] Part VII, articles 175-212, the Constitution of the Islamic Republic of Pakistan 1973; See also Annexure II. (Judicial Structure in Pakistan).

[21] Art. 184(1) of the Constitution of the Islamic Republic of Pakistan 1973 (the Constitution, 1973).

[22] Art. 184(3) of the Constitution, 1973.

[23] Art. 185 of the Constitution, 1973.

[24] Art. 186 of the Constitution, 1973.

[25] Art. 203F of the Constitution, 1973.

[26] Injunction of Islam means the rules in accordance with the *Holy Qur'ān* or *Sunnah* ('Practice') of Prophet Muhammad (peace be upon him).

[27] Art. 203G of the Constitution, 1973.

[28] 'Hudood laws' relates to those offences for which fixed punishment has been prescribed by the Holy *Qur'ān* and *Sunnah*. These offences include *zina* and *zina bil jabr* ('sexual intercourse' and 'rape' respectively), *qazaf* ('false accusation' of *zina* (sexual intercourse)), *sariqa* and *haraabah* ('offence against property': 'theft' and 'robbery' respectively) and *intoxication* (consumption of alcohol). These offences are punishable under the *hudood* laws in Pakistan.

In each of the four provinces and Islamabad capital territory there is a High Court[29] which has a principal seat in each of the provincial capitals and may also consist of such benches at such places as the Governor may determine on the advice of Cabinet and in consultation with the Chief Justice of the respective High Courts.[30] The High Court exercises original jurisdiction in the enforcement of fundamental rights (concurrent with the SC),[31] and appellate jurisdiction in matters decided by the subordinate courts acting as civil and criminal courts. The High Court supervises and controls all courts subordinate to it,[32] and hears appeals against decisions of the District and Sessions courts, including Additional District and Session courts.[33] There are also civil[34] and criminal courts[35] comprising civil judges and judicial magistrates to hear matters relating to civil and criminal offences respectively. They work under the supervision of district and session judges and the respective High Court.

5.4.2 Administrative courts in Pakistan

The Government of Pakistan establishes special courts and tribunals under the Constitution of the Islamic Republic of Pakistan to deal with different administrative matters of a civil and criminal nature.[36] The Federal and respective provincial governments have established special courts, tribunals and ombudsmen for different objectives through statutes.[37] The executive has established special courts, tribunals and ombudsmen in those areas that are technical in nature. These fields require judges to have special knowledge and experience to understand these issues. The competency of the judges, appointed through general criteria, to handle these issues is doubtful. That is why the executive attempts to appoint special judges in specialized courts to handle cases involving technicalities.

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[29] Art. 198 of the Constitution, 1973.
[30] Art. 198 (4) of the Constitution, 1973.
[31] Art. 199 (2) of the Constitution, 1973.
[32] Art. 203 of the Constitution, 1973.
[33] Hussain (n 19) 14.
[34] The West Pakistan Civil Court Ordinance, 1962.
[35] The Criminal Procedure Code, 1898.
[36] See Annexure III (Administrative Courts' Structure in Pakistan).
[37] After the 18th amendment to the Constitution of the Islamic Republic of Pakistan, the provincial autonomy has been increased. The concurrent list has been abolished and all matters that do not fall within the federal list are to be dealt with by the provincial governments. The provincial governments can also establish special courts and tribunals under different statutes which fall within the jurisdiction of the provincial governments. See Annexures IV and V for the structure of the Federal and Provincial Administrative Courts in Pakistan respectively).

Cost-effective and speedy remedies may be another reason why administrative courts have been established. This shows that the executives are not satisfied with the lack of timely disposal of cases by the general courts. The administrative courts have their own advantages as compared to general courts in dealing with cases. The administrative courts are not required to go through technicalities of the law of evidence which is required for cases in general courts. They can proceed without fulfilling the formalities of the procedure that is inherent in general court procedure. This helps to dispose of cases in less time. The cost of the cases in general courts is always high. Litigants have to pay a court fee, lawyer's fees and other incidental costs of the cases. Specialized courts are cost-effective because there are fewer formalities in their procedures.

Another aspect of administrative courts is the appeal mechanism. The judges of administrative courts see the complaints in the light of their technical expertise and then give their independent decision at the trial stage. The general courts look at the appellate stage which may help to check the legal aspects of a case.

5.4.3 Judicature in the context of corporate law in Pakistan

The judicature for corporate matters is established under the Ordinance, the SECP Act, 1997 and the Constitution of the Islamic Republic of Pakistan, 1973. Aggrieved parties in corporate matters may lodge a complaint or file a petition in two forums: (1) the SCEP and (2) general courts. The basic forum for filing a complaint is the SECP, which can entertain complaints in two circumstances: (1) where the SECP is mentioned as the proper forum for lodging any complaint and (2) where there is a violation of any of the provisions of the Ordinance and no forum is mentioned and the penalty for the violation is a fine only without imprisonment. The second forum is a general court in two circumstances: (1) where the court is mentioned as the proper forum and (2) where the penalty for any violation includes imprisonment with or without a fine.[38]

5.4.3.1 Judicature within the SECP

The Ordinance provides that in cases where the penalty is a fine only, the officers of the SECP have the jurisdiction to hear these cases depending upon the scale of the fine. A

[38] See s. 476 (1) of the Companies Ordinance, 1984 (the Ordinance); See Annexure VI : Penalty structure in the corporate law of Pakistan.

revision application against the decisions of the assistant registrar, deputy registrar, joint registrar and additional registrar can be filed to the Registrar of Companies.[39] Similarly, a revision application against the decision of a registrar, authority and any officer authorized by the SECP may be filed with the commission.[40] The commission has the power to revise any decision of any officer of the SECP, and the decision of the commission shall be final.[41] Similarly, the commission and registrar have the power to review any decision made by them and such order shall be final.[42] An aggrieved party may prefer an appeal to the High Court instead of review, revision or appeal by the SECP.[43]

5.4.3.2 Appellate benches in the SECP

The SECP may establish Appellate Benches authorized to hear an appeal within the SECP.[44] If any decision is made by the commission comprising one commissioner, then the right of appeal is to the Appellate Bench comprising commissioners other than the commissioner who had made the original decision. An appeal against an order of the Appellate Bench shall be to the courts as per Part II of the Ordinance within 60 days.[45]

5.4.3.3 General judicature of corporate matters

Part II of the Ordinance defines the judicature of corporate matters. The Ordinance delegates jurisdictions in corporate matters to the High courts. The Chief Justice of the respective High Court is authorized to order company benches to hear cases concerning corporate matters. The federal government may also empower any civil court to hear the cases within its jurisdiction. The appeal mechanism is the same for corporate matters as is prescribed for general judicial hierarchy. An appeal against the decision of the civil court and criminal courts shall be to a district court and session court respectively. An appeal against the order of the district court or the Court of Session shall be to the High Court, and against the decision of the High Court to the Supreme Court. However, an appeal in winding-up matters to the Supreme Court is restricted. In cases where the company being wound up has share capital less than one million Pakistani rupees or where the company

[39] See s. 477 (1) (a) of the Ordinance.
[40] See s. 477 (1) (b) of the Ordinance.
[41] See s. 484 (1) of the Ordinance.
[42] See s. 484 (2) of the Ordinance.
[43] See s. 485 (1) of the Ordinance.
[44] See s. 33 (2) of the Securities and Exchange Commission of Pakistan Act 1997 (the SECP Act, 1997).
[45] See ss. 33-4 of the SECP Act, 1997.

being wound up has no share capital, the appeal will lie only when the Supreme Court grants leave to appeal. [46]

The Ordinance provides that cases that fall under the Ordinance will be dealt with by the courts under summary proceeding and will be disposed of within 90 days. Adjournment of cases may not be for more than 14 days at any one time or more than 30 days in all, except for sufficient cause. [47] The spirit of the law is to dispose of corporate matters expeditiously but, as in practice, the courts do not follow these provisions. Delay in disposing of cases is a routine matter. Courts do not follow the mandatory nature of the provision and regard it as being of only recommendatory nature.[48] This shows the non-serious attitude of the courts towards deciding these cases expeditiously. The other reason why cases are not dealt with quickly may be the burden on the courts which makes it impossible for them to decide the cases within the timeframe set by the Ordinance.

5.5 The judiciary and its problems in Pakistan

The judicial system of Pakistan has failed to provide justice to the people of Pakistan. The rulers of the country have seriously compromised the stature, independence and integrity of the courts[49] for a number of reasons. Pakistan became independent in 1947 but, unfortunately, since independence more than half of the political rule consisted of dictatorships.[50] In different periods dictatorial rulers tried to control the judiciary in order to expand their dictatorial regimes. They issued Provisional Constitutional Orders to control the judges of the apex courts. They suppressed the superior judiciary to legitimize their unconstitutional rules. They removed the judges of the apex courts who posed a threat to their unconstitutional political takeovers. These efforts led to the destruction of the judiciary as an institution.

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[46] See ss. 7-10 of the Ordinance; See also Annexure VII: Corporate judicature in Pakistan.

[47] See s. 9 of the Ordinance.

[48] The corporate cases in Pakistan are normally disposed of beyond the statutory limits prescribed by the Ordinance.

[49] Living Armytage, 'Pakistan's Law and Justice Sector Reform Experience-Some Lessons (2003) Centre for Judicial Studies, paper read in 13th Commonwealth Law Conference in Melbourne on 14 April 2003 available at <http://www.educatingjudges.com/Hyperlinks/PakistanADBProjectLessonsLearned.pdf> Accessed 20.12.2013.

[50] Pakistan has witnessed four dictatorial rules since independence in 1947. These include (1) from 7 October 1958 to 25 March 1969 imposed by General Ayub Khan, (2) the rule of General Yahya Khan from 25 March 1969 to 20 December 1971, (3) the rule of General Muhammad Zia ul Haque from 5 July 1977 to 17 August 1988 and (4) the rule of General Pervez Musharraf from 12 October 1999 to 18 August 2008. This period consists of more than 33 years out of a total of 66 years to date (December 2013) since independence.

Another problem with the judiciary in Pakistan is inefficiency.[51] The judicial procedure is complicated, which causes monstrous backlogs which, in turn, cause delays in the disposal of cases. Other reasons for these delays are the inefficiency of judges in handling cases, and a shortage of judges, facilities and support staff. Delays are normal phenomena but sometimes inordinate delays become unusual. Some cases may take 5, 10 or even 20 years to resolve, and other cases drag on from generation to generation.[52]

Some judicial reform has been undertaken but it has been insufficient to dismantle the *status quo*. In December 2001 the ADB allocated US$350 million under the 'Access to Justice Program',[53] which focused on backlogs and reducing delays by increasing the number of judges in the courts. The programme was not effective as the judicial problems of Pakistan may not be resolved by increasing the number of judges and the budget of the judiciary.[54] The corruption in society in general and in the judiciary in particular is the main problem in providing justice to the masses. The reform process failed to achieve its objective. The Government of Pakistan could only affect a change in policy because it had to meet a condition of the loan. However, as far as progress made with the implementation of these policies is concerned, the same could not be achieved. Nevertheless, this was at least a start with judicial reform.[55]

The second major initiative in the judicial reform process was the 2009 United States Agency for International Development (USAID) programme 'Strengthening Justice with Pakistan' involving US$90 million. The objective of the programme was to strengthen the judiciary with enhanced judicial efficiency, transparency, accessibility, independence and accountability. The programme further extended its underlying goals which included protection of private businesses and foreign investment.[56] The objective of this programme was political in the fast-changing global environment. The 9/11 incidents in

[51] Ghani and Ashraf (n 17) 19; The World Bank (n 17) 4.
[52] Armytage (n 49).
[53] ADB Completion Report, 'Pakistan: Access to Justice Program' (2009), p i, available at <http://www.adb.org/sites/default/files/projdocs/2009/32023-01-pak-pcr.pdf > Accessed 03.09.2013.
[54] Osama Siddique, 'Approaches to Legal and Judicial Reform in Pakistan: Post-Colonial Inertia and the Paucity of Imagination in Times of Turmoil and Change' (2011) Development Policy Research Centre (DPRC) Working Paper 4, LUMS, Lahore, p 14, available at <http://dprc.lums.edu.pk/components/com_publications/attachments/DPRC-WP4-Siddique.pdf. > Accessed 20.12.2013.
[55] USAID Program, 'Strengthening Justice with Pakistan' (2009), p 9, the copy of the document is available on the website of Federal Business Opportunities, US Government, requiring from consultants the proposals for the programme in the form of a request for proposal (RFP), available at <https://www.fbo.gov/index?s=opportunity&mode=form&id=1a353d985a6979255fe8491f0d59c8b2&tab=core&_cview=1> Accessed 03.09.2013.
[56] *Ibid*.

the US and the ‘Talibanization’ in Pakistan were the main stimulants for these series of reforms. Global powers, especially the government of the US, believed that weak social justice may lead to people’s support for the Taliban who could establish their own Islamic-based justice system in some parts of the country. Mistrust of the judiciary may lead people to look towards alternatives such as the Islamic legal system established by the Taliban.[57] One of the reasons for Taliban support in some parts of the country may be linked to the weak social and legal justice system of Pakistan. First of all, the Taliban established a so-called Islamic social justice system to obtain the support of the people. This phenomenon attracted suppressed and weak people to them because they believed that they would at least have access to legal justice. The Taliban managed to attract supporters in northern parts of the country. Although the Taliban are no longer in power, chances of such support in case of complete failure of the judicial system in Pakistan exist.[58] Though these reforms were based on the political hold of the state, this could have a direct impact on the corporate sector as this would enhance judicial capacity which, in turn, could help in enforcing corporate laws.

However, this programme also failed and was shelved for an indefinite period due to the differences between the Government of Pakistan and USAID on its design and ambit. However, it may be revived in future once these differences have been resolved.[59] The failure on the part of the international organizations and the government of Pakistan to reform the judicial system of the country may lead the people to distrust the judiciary. The lack of enforcement capacity on the part of the judiciary is one of the main reasons for the corruption in society which leads to unrest and support for terrorist elements. This lack of enforcement affects every sector of society, including corporate law. The rights of the shareholders, especially the minority shareholders, are worse in a weak judicial system. The weak enforcement mechanism affects the whole economy of the country.

5.5.1 Recent trends in the judiciary in Pakistan

The judiciary has been very active in recent years, especially after the activities of the lawyers’ movement. The movement started after the suspension of the Chief Justice of Pakistan (CJP) by the then dictator, President Pervez Musharraf, on 9 March 2007. The thirteen-member bench of the Supreme Court of Pakistan reinstated the CJP on

[57] *Ibid*.
[58] *Ibid*.
[59] Siddique (n 54) 14.

20 July 2007. The dictator again suspended the CJP and other judges of superior courts by declaring a state of emergency in the country on 3 November 2007. This act rejuvenated the movement. Lawyers, civil society and political parties protested against this act and forced Musharraf to resign. The movement did not stop as the new civil government did not restore the judges formally. The lawyers, civil society, political parties, media and the nation put pressure on the state to reinstate the CJP and the other judges dismissed by the former dictator. On 16 March 2009 the Prime Minister of Pakistan issued an executive order and the judges were reinstated.[60] The restoration of the judges to the superior courts rejuvenated the hopes of the Pakistani people. They expect speedy and cost-effective justice, literally on their doorstep, from the judiciary. The lawyers' movement revitalised the judiciary which, in turn, injected judicial activism. Unfortunately, this was limited to constitutional petitions and *suo moto* actions against acts of the state, the prime minister and the ministers. The judicial activism could not be transferred to the lower levels of the judiciary. This phenomenon created unrest among the general public. One renowned columnist, Javed Chaudhry, wrote in a famous daily newspaper that 'the Judges were restored but justice is still suspended'.[61] At several public meetings Iftikhar Muhammad Chaudhry, after his reinstatement as CJP, promised the people of Pakistan a reformed and effective judicial system according to their aspirations.[62] The CJP promised effective monitoring of the lower judiciary,[63] and took some steps towards achieving the objective of providing speedy and cost-effective justice for the people. Unfortunately, these efforts were insufficient to provide true justice. The CJP admitted on a number of occasions that corruption in the judiciary had to be eradicated.[64] In the absence of speedy and cost-effective justice, the recurrence of unrest among the masses loomed.

In 2009, after the recent judicial crisis, the restored and revitalized judiciary of Pakistan issued the National Judicial Policy (NJP). This was the latest act by the Supreme Court of Pakistan in reforming the country's judicial system. The NJP was revised in

[60] See the nationwide daily English newspaper *The Nation*, available at <http://www.nation.com.pk/pakistan-news-newspaper-daily-english-online/islamabad/17-Mar-2009/Govt-issues-notifications-for-judges-restoration> Accessed 03.09.2013.

[61] Javed Chaudhry's column 'Judges restored but Justice still suspended' in the nationwide daily Urdu newspaper *Express* dated 23.06.2011, available at <http://express.com.pk/epaper/PoPupwindow.aspx?newsID=1101270558&Issue=NP_LHE&Date=20110623> Accessed 18.01.2014.

[62] Siddique (n 54) 14.

[63] See the nationwide daily English newspaper *Dawn*, dated 25.11.2011, available at <http://dawn.com/2011/06/25/cj-wants-effective-monitoring-of-lower-judiciary/> Accessed 12.11.2013.

[64] See the nationwide daily English newspaper *The News* dated 25.06.2011, available online at <http://www.thenews.com.pk/Todays-News-13-6986-Corruption-in-lower-courts-eroding-faith-of-litigants-CJ> Accessed 03.09.2013.

February 2011. The NJP focuses on the independence of the judiciary, eradication of corruption and the expeditious disposal of cases by the courts. The disposal of backlogs, the speedy resolution of cases and a reduction in delays through the appointment of new judges are the main short-term goals of the policy. In the long term the focus is on the provision of government funds; the framing of an equitable, consistent and coherent policy by the respective High Courts; the appointment of judicial officers on an *ad hoc* basis until they are duly appointment by the respective authorities, to avoid a shortage of judicial officers; and the provision of essential paraphernalia. However, the NJP is defective in the sense that it has not mentioned the nature and quality of justice that it wished to deliver to the people of Pakistan. The policy focuses excessively on the disposal of cases and speedy justice, which may compromise the quality of justice. No doubt, the reduction in delays is an essential part of the justice system, as the famous quotation 'justice delayed is justice denied' speaks so eloquently to this phenomenon. Ignoring quality and an overwhelming focus on 'speed' may, therefore, be problematic.[65] The basic drawback is in the system itself which is corrupt and inefficient. The whole judicial system needs to be overhauled. The present focus of the SC is not on the lower courts and that is why the judicial system is not delivering. Reform of the judicial system should target the lower courts. The elimination of corruption, the enhancement of judicial efficiency and the enforcement mechanism are, thus, the major problems that need to be addressed. An improved enforcement mechanism can ensure people the protection of their rights enshrined in the constitution. This can also protect investors, especially minority shareholders, which can improve corporate governance. There is thus a need to reform the institutions that provide the enforcement mechanism in corporate governance in Pakistan.

5.6 Reform

Corporate governance is regarded in the same way as economic and legal institutions that can be reformed but it requires political support.[66] Reforms are necessary for underdeveloped jurisdiction 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. The state may reform the

[65] Siddique (n 54) 14.
[66] A. Shleifer and R. W. Vishny, 'A Survey of Corporate Governance' (1997) 52 (2) *The Journal of Finance* 738.

system for investor protection in general and minority shareholders in particular.[67] This will enhance investor confidence, which may be beneficial to the economy in general. This reform should take place in three core institutions of corporate governance in the context of Pakistan: (1) legislation, (2) the judiciary and (3) the market.

5.6.1 Legal reform

Pakistan is an underdeveloped country with complicated, cumbersome and out-dated statutes.[68] 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, for example, the UK introduced at least seven new versions of, or substantial amendments to, its company laws since 1947.[69] 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. However, the commission has failed to draft new company law after almost eight years. This slow process of reforming the law affects investment from both domestic and foreign investors. The dearth of research is a major problem in Pakistan. Chapter Four (Parts A and B) of this research is, therefore, an attempt to suggest possible legal reforms in the corporate sector of Pakistan: holistic research was undertaken in analysing shareholder rights and in suggesting improvement in the context of Pakistan. The research can provide the regulator, the legislature and policymakers with a guideline on how to improve investors' rights, especially that of minority shareholders, in corporate law in order to improve corporate governance in Pakistan.

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[67] Why the state may proceed with reforms has been discussed in Chapter Four, at 4B.5 (See text to n 37 in Chapter Four, at 4B).

[68] Cheema, Bari and Siddique (n 13) 206.

[69] These new versions or substantial amendments were made in 1948, 1967, 1976, 1980, 1985, 1989 and 2006 respectively.

Formal convergence will definitely dominate such reforms and investor rights will be incorporated in the corporate law of Pakistan. Functional or contractual convergence can be a precursor to formal convergence in some of the investor rights, which may be incorporated through a code of corporate governance or through incorporation into the constitution of companies. Once these reforms are effective and have been accepted by the business community, they can be converted into the formal legal system.

However, the mere creation of laws does 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.[70] Therefore, a reformed judiciary and capital market are needed to enhance the enforcement mechanism.

5.6.2 Judicial reform

To attract external finance, outside investors need protection against expropriation of their funds. Investor protection may be provided by the courts, government agencies and other market participants.[71] The judiciary is considered to be the main actor in providing investor protection. There may be fewer burdens on the judiciary if other institutions are strong enough to provide this kind of protection. The regulator, stock exchanges, financial institutions, institutional investors and professional experts may support to improve the corporate governance and enforcement mechanism. However, even if other supporting institutions are made strong, the importance of the judiciary cannot be ruled out. The legal aspects and interpretation of the law require the role of the judiciary. Therefore, reforming the system but ignoring the judiciary may not yield the desired results.

However, reforming the judiciary may not be an easy task. It may be difficult, lengthy, and require the support of politicians and other interest groups.[72] Political and economic constraints can hurt reform efforts and improvement in the enforcement regime due to vested interests.[73] Business and politics are intermingled; the interests of business tycoons and the politicians are connected. A further obstacle to reform may be opposition from entrenched economic interests, including those families who hold and control the

[70] Pistor, Raiser and Gelfer (n 6) 356.
[71] LLSV, 'Investor Protection and Corporate Governance' (2000) 58 *Journal of Financial Economics* 24.
[72] Leora F. Klapper and Inessa Love, 'Corporate Governance, Investor Protection, and Firm Performance in Emerging Markets' (2004) 10 *Journal of Corporate Finance* 723.
[73] Berglof and Claessens (n 4) 37-40.

corporate sector in most of the countries in the world, and who are politically powerful as well. Therefore, reform is only possible if opposition to such reform is circumvented.[74]Pakistan started reforming its judiciary in 2002. The ADB provided a loan of $350 million under 'Access to Justice Programme' in 2001 to reform the judicial system of Pakistan.[75] The programme failed to achieve its objective. The focus of the reforms was on speedy disposal of cases and not on enhancing the efficiency in the judicial system. The programme was started only to fulfil the condition of loan.[76] Another reform process started in 2009 with the help of USAID but this programme also failed due to political differences between the government of Pakistan and USAID.[77] Therefore, the reforms were not sufficient to dismantle the *status quo*.

In history, there have been different factors that have inhibited reforms of the judicial system in Pakistan due to their vested interests. In the context of Pakistan, dictators have been a basic hurdle in reforming the judiciary through the connivance of political forces. In Pakistan more than half of the political regimes consist of dictatorship. These dictators used the judiciary to expand their unconstitutional regime. They issued provisional constitutional orders to control the political and judicial institutions. They removed the judges whom they considered as a threat for their unconstitutional takeovers. These trends compromised the independence of the judiciary. They did not allow reforms in the judiciary as a reformed and independent judiciary may be a threat for unconstitutional takeovers. These acts destroyed the judiciary as an institution. This led the judiciary to be inefficient and a corrupt institution.

In addition to this, families, state and interested groups have been another hurdle in reforming judiciary. As discussed in Chapter Two, families and the state control the corporate sector in Pakistan. They expropriate minority shareholders and the firms. Therefore, they resist reforms whose objective is to improve investor protection and enhance enforcement mechanism as prevailing circumstances favour them. They resisted initiatives to reforms in Pakistan whose objective was to improve investor protection. A

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[74] LLSV (n 71) 24.

[75] Matthieu Chemin, 'The Impact of the Judiciary on Entrepreneurship: Evaluation of Pakistan's "Access to Justice Programme"' (2008) 93 *Journal of Public Economics* 114.

[76] Osama Siddique, 'Approaches to Legal and Judicial Reform in Pakistan: Post-Colonial Inertia and the Paucity of Imagination in Times of Turmoil and Change' (2011) Development Policy Research Centre (DPRC) Working Paper 4, LUMS, Lahore, p 14, available at <http://www.academia.edu/1115703/Approaches_to_Legal_and_Judicial_Reform_in_Pakistan_Post_Colonial_Inertia_and_the_Paucity_of_Imagination_in_Times_of_Turmoil_and_Change_Working_Paper_Two_ > Accessed 20.05.2014.

[77] Ibid.

reformed judiciary may limit their prospects of expropriation; therefore, they oppose reform agendas with connivance of the political forces. The powerful families are either involved in politics themselves or finance major political parties to obtain undue favours from the government. These families are, therefore, politically influential to get political favours.

Although, IFIs have been involved in reforming the judiciary through a series of loans with condition of reforming the judiciary, their efforts failed due to political differences between the Government and the IFIs.[78] The apparent objective of these hurdles by the government is to preserve the *status quo* as a reformed judiciary may be a threat for the politicians for their corruption. Pakistan has been ranked high in corruption by the Transparency International (TI) for many preceding years. It also ranks public offices in Pakistan with regard to level of corruption in these institutions. It has ranked Police, Public Officials and Civil Servants, Political Parties and Parliament as most corrupt institutions in Pakistan in its report published in 2013.[79]Therefore, their interest is to keep *status quo* and to obstruct reforms in the judiciary. An independent and reformed judiciary may be problematic for corrupt public office holders; therefore, they do not allow the judiciary to be reformed. This phenomenon did not allow reforms in the judiciary. Therefore, there is a need to circumvent opposition from these vested interest groups in order to reform the judiciary and to improve the enforcement mechanism in Pakistan.

Klapper and Love suggest an alternative to the judicial enforcement mechanism.[80] According to them, one option may be to improve firm-level governance by adopting charters with more disclosure and minority shareholder rights, and adopting good governance practices in a country. They argue that firms with a well-established governance mechanism may not need recourse to a judicial enforcement mechanism. This assumption of an alternative to a judicial enforcement mechanism may not be a good option as corporate conflict cannot be ruled out by the mere presence of shareholders' rights, disclosure and the adoption of good governance practices in the constitution of companies. Because of the way in which corporate decisions are made and firms are operated, the possibility of conflict between the parties will always exist. In the case of a dispute, the parties may have recourse to a neutral forum. Since well-established governance systems have also witnessed corporate conflicts, there is a need for a strong

[78] See text to n 49-59 in Chapter Five.
[79] For this see TI website available at <http://www.transparency.org/gcb2013/country/?country=pakistan > Accessed 20.05.2014.
[80] Klapper and Love (n 72) 723.

judicial mechanism to enforce the available laws. Private enforcement may be an effective tool but it would depend upon public enforcement.[81] Firm-level governance can be effective only when there is a well-established judicial or institutional mechanism of enforcement. Firms have to rely on public enforcement in cases of conflict.

Another major problem with enforcement in corporate governance may be the judicial infrastructure. The judges in general courts do not have the necessary expertise and special qualifications to deal with matters that are technical in nature, such as company law, accounting, finance, insider trading, mergers, acquisitions, takeovers, listing rules, securities laws and other corporate laws. One way to overcome this obstacle is to train them in these fields. The cost of this process will be very high when weighed against the potential benefits that the process may yield. As only a small portion of judges' duties concerns corporate matters, it is not advisable that money and effort be spent on such training.[82] Furthermore, this will be an uphill task. It is better to have a separate, specialized court that can deal exclusively with corporate matters. This will enhance the enforcement mechanism in corporate law. The mechanism can work well when the regulatory agencies are not dependent upon the traditional judiciary. The judges of these specialized courts can be trained for this purpose so that they have a basic knowledge of corporate finance, accounting and business administration.[83] The role of general courts will be limited and these courts should not interfere unless there is a legal defect. This legal defect can be removed by filing an appeal before general courts.[84]

The other aspect of the enforcement mechanism is the link between fiduciary duties and the enforcement mechanism. According to LLSV, common law systems have better 'law in action' than civil law countries.[85] The development of fiduciary duty in common law countries is significant in 'law in action'. The development of fiduciary duties in a particular jurisdiction also depends upon the ability of the courts to understand and to interpret corporate laws in a given situation. Fiduciary duty will be more developed in jurisdictions where there is an efficient judicial system or where there are specialized courts that deal with corporate matters. For example, fiduciary duties as law in action have been developed and enforced more in the US than in other major jurisdictions because of

[81] Berglof and Claessens (n 4) 41-2.
[82] John C. Coffee Jr, 'Privatisation and Corporate Governance: The Lessons from Securities Market Failure' (1999) 25 *The Journal of Corporation Law* 29.
[83] Enriques (n 2) 812.
[84] Coffee Jr (n 82) 30.
[85] LLSV, 'Law and Finance' (1998) 106 (6) *Journal of Political Economy* 1113-55.

the operation of specialized courts and other specialized institutions that encourage investors to litigate in cases of wrongdoing. These institutions also have the capacity to enforce court decisions.[86]This highlights the importance of specialized courts for enhancing the enforcement mechanism.

In the corporate context, some reforms were undertaken by the government and the SECP to enhance enforcement mechanism in Pakistan. The reform agenda started with transferring powers to the regulator. The regulator was also given some adjudicating powers through the Act, 1997. Some of the powers of the court were transferred to the SECP through amendments to the Ordinance at different stages. However, these were not significant transfers of powers. The following powers were transferred to the SECP:

i) In cases where the directors refuse to transfer shares, the proper forum to launch a complaint was the court. [87] This power has now been delegated to SECP.[88]

ii) Companies are empowered to purchase their own shares under certain conditions and restrictions.[89] In case of default, the power was with the court to punish the culprits. Now, this power is delegated to the SECP which may punish the defaulting director or officer of the company.

iii) A company is required to file, with the registrar, every mortgage and charges over the assets of the company.[90] The power to rectify the register of such mortgages and charges, where the default was unintentional, inadvertent, accidental or due to sufficient cause was with the court.[91] This power has now been transferred to the SECP.[92]

iv) The securities law was amended to enhance the definition of insider trading and punishment for its violation. The punishment of insider trading was converted from imprisonment and financial penalty to heavy financial penalty only.[93] The objective was to divert power from the court to the SECP.

As the weak enforcement mechanism may allow the expropriation of outside investors, judicial reform is important for investor protection. Restructuring the whole judicial

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[86] R. Kraakman *et al.*, (n 7) 219.
[87] A. G. Chowdhry, *Company Law in Pakistan (A Commentary on the Companies Ordinance, 1984)* (Reprint edition 2011-2012, Khyber Publishers, Lahore 2012) 91.
[88] See s. 78A of the Ordinance.
[89] See s. 95A of the Ordinance.
[90] See s. 121 the Ordinance.
[91] See s. 131 (1) of the Ordinance.
[92] The Companies (Amendment) Ordinance 2002.
[93] See ss. 15A to 15C of the Securities and Exchange Ordinance 1969.

system in Pakistan may not be an attractive option as far as the corporate sector is concerned due to the high cost involved in training the judges compared to the ratio of the cases that the judges have to decide. Therefore, there is a need to enhance judicial capacity to enforce at least corporate matters without changing the overall structure of the judiciary. This can be done by establishing separate specialized courts to deal with corporate matters.

The phenomenon of creating specialized courts, and/or establishing agencies, quasi-judicial authorities or tribunals in order to enhance enforcement capacity has already started in a number of jurisdictions in Asia[94] and in other parts of the world. The Financial Court in China, commercial courts in Malaysia, the Financial Reporting Council in Hong Kong, the Corporate Governance Office in the Philippines Stock Exchange, the Enforcement Division in Bursa Malaysia, and the Audit Oversight Boards in South Korea and Malaysia are examples of enhancing enforcement mechanism separately or within existing institutions.[95] The 'economic courts' in Russia,[96] 'labour courts' in Germany[97] and the 'tribunals' in India dispose of matters in specialized fields. The Federal securities law in the US also contemplates administrative courts to enhance the enforcement mechanism.[98]

The specialized courts may resolve the enforcement mechanism or at least enhance capacity to enforce corporate laws. India has proposed establishing tribunals to deal with corporate matters in its new Company Law Bill, 2012. This practice has already been introduced in Pakistan in different fields. The administrative courts, tribunals and the ombudsmen[99] are involved in providing relief to the public in different areas, and are

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[94] OECD (2011), Corporate Governance in Asia 2011: Progress and Challenges, Corporate Governance, OECD Publishing, available at <http://browse.oecdbookshop.org/oecd/pdfs/product/2611011e.pdf > Accessed 22.08.2013.

[95] *Ibid*.

[96] Karen Halverson, 'Resolving Economic Disputes in Russia's Market Economy' (1996) 18 *Michigan Journal of International Law* 59.

[97] Erhard Blankenburg, 'Patterns of Legal Culture: The Netherlands Compared to Neighbouring Germany' (1998) 46 (1) *The American Journal of Comparative Law* 23.

[98] Coffee Jr (n 82) 30.

[99] The Islamic Countries Society of Statistical Sciences (ICSSS), Lahore, conducted a research study entitled 'Citizen Report Card Study (CRCS) on the Federal Tax Ombudsman (FTO) Pakistan', which was published by Transparency International Pakistan (TIP). This information is taken from the website of Federal Tax Ombudsman, Government of Pakistan, available at <http://fto.gov.pk/userfiles/TIP%20Report%20-%20A%20Summary.pdf> Accessed 05.05.2013; The nationwide daily Urdu newspaper *Jhang* reported on 05.12.2011 that the FTO was the most effective accountability office in the public sector; TIP mentioned in the Corruption Perceptions Index 2011 released on 1 December 2011 that the FTO was the cleanest institution in the public sector.

performing better than the judiciary.[100] Dealing with corporate matters requires expertise and special knowledge, therefore, employing specialists can avoid delay and expense. A quasi-judicial authority along the lines of that in India may be a better option with a right of appeal to the High Court on legal aspects only in order to have a second, independent and judicial opinion. A formal and functional convergence in establishing special courts on the pattern of India and other countries may resolve the problem of judicial enforcement of corporate matters.

5.6.3 Market reform

The other area of concern for effective enforcement of rights or law in action is the market in Pakistan. The market is inefficient,[101] and fails to sanction non-performing firms and managers. A weak enforcement mechanism through market forces allows market manipulation and expropriation of minority shareholders by dominant business groups. In Pakistan market reform started with the establishment of a powerful regulator. The establishment of the SECP was the first step on this agenda.[102] However, failure on the part of the market to enforce the investor protection mechanism and sanction non-performing firms is the main concern about good governance in Pakistan.

5.6.3.1 Stock market reform

The state and regulator undertook some reform in the stock markets.[103] In the first phase the central depository company (CDC) was formed for the central handling of securities under the Central Depositories Act, 1997 and the Central Depository Companies (Establishment and Regulation) Rules, 1996.[104] In the second phase the decision was made to demutualise the stock market by converting it from a company limited by guarantee to a company limited by shares and to enlist on the stock market for public trade. Under the rules, the stock markets were required to be corporatized, demutualised and integrated by

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[100] TIP has reported the Pakistani Judiciary as the fourth most corrupt institution after Taxation, Police and Land Administration Departments in its ‘National Corruption Perception Survey 2011’ available at <http://www.transparency.org.pk/report/ncps2011/ncps2011.pdf> Accessed 05.09.2013; In its recent report on ‘Global Corruption Barometer 2013’ Transparency International (TI) said that Judiciary is 6th Corrupt institution after Police, Public Officials and Civil Servants, Political Parties, Parliament/Legislature and Health in Pakistan. For this see TI website available at <http://www.transparency.org/gcb2013/country/?country=pakistan > Accessed 03.12.2013.

[101] Ghani and Ashraf (n 17) 19.

[102] See text to n 74-6 in Chapter Three.

[103] There are three stock markets in Pakistan: the Karachi Stock Exchange, Lahore Stock Exchange and Islamabad Stock Exchange.

[104] See text to n 85-7 in Chapter Three.

the end of 31 December 2006.[105] The legislative process is too slow in Pakistan that the same has not yet been finalized. The President of Pakistan approved the Stock Exchanges (Corporatization, Demutualization and Integration) Act on 7 May 2012. The Act set another deadline for completion of the process by September 2012 but this is still pending. In the third phase the rules for insider trading were changed. The definition of *insider trading* was enhanced and clarified in the securities law.[106] The punishment for insider trading was converted from imprisonment and financial penalty to a heavy financial penalty only. The objective of this change was to convert criminal liability to civil liability. As the nature of evidence in criminal cases is stricter than in civil cases, trial courts in criminal offences require from the prosecution evidence beyond doubt, which may not be feasible in most of the cases involving corporate offences and white-collar crimes.

In a further step the SECP issued the Code of Corporate Governance and made it part of the listing regulations in 2002. This was a major breakthrough in the efforts to achieve good corporate governance. However, the business community received it lukewarmly. Many companies delisted in 2002 and in subsequent years.[107] They had originally listed to derive certain benefits, which included tax incentives and fulfilling licensing requirements for different businesses. Many companies do not know the potential benefits of good governance and, therefore, do not observe the code in its true spirit. Some companies, including multinationals, do observe the Code due to reputational concerns. However, the real problem was the implementation of the Code in its true spirit.[108]

These reforms were insufficient to develop the market and improve corporate governance. Therefore, there is a need to reform the market in a way that could improve corporate governance. One option to reform the market may be the phased implementation of the rules, regulations and the Code. For this purpose, the stock market can be divided into different segments, each with its own requirements depending upon the nature of the listing. This may circumvent resistance from the families and interested groups.

[105] See s. 32E (1) of the Securities and Exchange Ordinance, 1969.
[106] The Securities and Exchange Ordinance, 1969.
[107] See Figure 3.1 in Chapter Three.
[108] See text to n 100 in Chapter Two.

a. London Stock Exchange

The phenomenon of dividing the market into segments is already in operation in different parts of the world. The LSE is an important example. The LSE covers different segments of the market. In the main market, companies can have different types of listing: UK and overseas companies, including the European Economic Area (EEA), may have premium and standard listing, and GDRs on the official list.[109] It all depends upon the choice of the issuer and, subsequently, the different requirements have to be fulfilled according to the nature of the listing. [110]

There are two broad categories of listing on the main market with premium and standard listing. The premium listing is only for equity shares of trading companies, and closed and open-ended investment entities, whereas standard listing includes the issuance of shares, depository receipts, debts and securitized derivatives.[111]

i Premium listing

Premium listing does not mean 'first listing' or 'sole listing', rather, it means that companies are required to meet the highest standards of regulation and disclosure in Europe; in other words, they have to meet the UK's gold standards – described as 'super-equivalent requirements' that are over and above the 'directive-minimum'[112] requirements. Companies that have premium listing on the main market are potentially eligible for the FTSE UK Index Series, one of the most recognized in the world, which includes the well-known FTSE 100 Index.[113]

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[109] The FSA has now become two separate regulatory authorities with effect from 1 April 2013: the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA). The FCA regulates the financial services industry in the UK. Its aim is to protect consumers, ensure that the industry remains stable, and to promote healthy competition between financial services providers. The PRA is part of the Bank of England, and is responsible for the prudential regulation and supervision of banks, building societies, credit unions, insurers and major investment firms. It sets standards and supervises financial institutions at the level of the individual firm. See websites at <http://www.fsa.gov.uk/ >; <http://www.fca.org.uk/>; and <http://www.bankofengland.co.uk/pra/Pages/default.aspx> Accessed 03.08.2013; See also Annexure-VIII for structure of listing regime in the UK.

[110] Financial Services Authority, 'A Review of the Structure of the Listing Regime', (Discussion Paper 08/1) (January 2008), London, p 11.

[111]See London Stock Exchange (LSE) website at <http://www.londonstockexchange.com/companies-and-advisors/main-market/companies/primary-and-secondary-listing/listing-categories.htm> Accessed 05.09.2013.

[112] These are minimum requirements for the European directives.

[113] LSE (n 111).

The companies that have premium listing are required to comply with the following requirements:

i) A three-year revenue earning record, an independent audit within six month from the date of the prospectus and an unqualified working capital statement (Chapter 6)[114]
ii) The prior approval of shareholders before the cancellation of their listing by the FCA (Chapter 5)
iii) Compliance with six listing principles introduced in 2005 with emphasis on directors' responsibility, an adequate system, integrity towards investors, timely communication, equality of treatment of shareholders and dealing co-operatively with the FCA (Chapter 7)
iv) The appointment of a sponsor to advise on key transactions (Chapter 8)
v) After premium listing the company remains subject to continued obligations which include the following:

   a. Provision of notifications to the FCA and market about changes in the company (Chapter 9)
   b. Provision in the annual report and financial statements regarding compliance with the UK Code of Corporate Governance (Chapter 9)
   c. Information relating to directors' remuneration in the annual report and financial statements (Chapter 9)
   d. Application of pre-emption rights for UK companies unless dis-applied in accordance with ss. 570-1 of the Companies Act, 2006 (Chapter 9)
   e. Prior approval of shareholders regarding the disposal or acquisition of businesses or assets which reach certain thresholds (Chapter 10)
   f. Prior approval of shareholders for related party transactions (Chapter 11)
   g. Observance of buyback of shares rules (Chapter 12).[115]

ii Standard listing

A standard listing on the LSE does not necessarily mean a company's second listing, rather, it signifies that the company has chosen to meet EU harmonized standards as

[114] The chapter number refers to the relevant chapter of the listing rules.
[115] FSA (n 110) 21-3.

opposed to the UK super-equivalent standards required for a premium listing. Overseas companies seeking standard listing were required to have a primary listing in their home jurisdictions until July 2005 but this condition has now been waived. Before 6 October 2009 standard listings were allowed only to equity securities of overseas companies but now UK companies are also given the option of standard listing.

Companies with a standard listing have to meet the 'directive-minimum' standards.[116] Also effective from 6 April, 2010, the standard listing and GDR are required to comply with the EU Company Reporting Directive which requires, among other things, that a corporate governance statement be provided, and that the main features of the internal control and risk management systems be described.[117] The following are the requirements for a company with a standard listing:

The requirements for standard listing stem from the Prospectus and Disclosure and Transparency Rules (DTRs). The principal additional provisions relating to listing rules are as follows:

1. The company must satisfy the Consolidated Admissions and Reporting Directives (CARD)[118] requirements
2. All circulars, notices, reports and resolutions must be published through the Regulatory Information Services (RIS)[119] in the UK.[120]

Some concessions were made to overseas companies with regard to premium and standard listing. Overseas companies with a premium listing were not required to 'comply or explain' the UK Code of Corporate Governance and to offer pre-emption rights.[121] The overseas companies were only required to disclose in their annual reports and financial statements that they were complying with the corporate governance regime in their country of incorporation and also to disclose to what extent this was different from the UK

[116] *Ibid* 11.
[117] FSA website, available at <http://www.fsa.gov.uk/pages/Doing/UKLA/pdf/listing_regime_faqs.pdf> Accessed 12.11.2013.
[118] This deals with the admission of securities at official listing on a stock exchange and the information to be published for those securities.
[119] The companies who are subject to Disclosure and Transparency Rules require disseminating the information through RIS. For this purpose, the FCA provides a list of RIS and a company can choose any one of them.
[120] FSA (n 110) 23.
[121] *Ibid* 39.

code.[122] However, effective from 6 April 2010, the overseas companies with premium listing are now required to 'comply or explain' the UK code[123] and to offer pre-emptive rights.[124] However, effective from 6 June 2011, overseas issuers are exempted from the requirement of pre-emptive rights subject to the condition that the shareholders have allowed dis-application of pre-emptive rights equivalent to the authority given under ss. 570 or 571 of the Companies Act, 2006 or in accordance with the law of the country of incorporation, provided that it has implemented Chapter 29 of Directive 77/91/EEC.[125] Furthermore, effective from 6 April 2010 overseas companies with a premium listing are exempted from the application of LR 9.3.9R which empowers the issuer to impose sanctions on shareholders who fail to respond to notice to disclose their interest in shares under s. 793 of the Companies Act, 2006.[126] More concessions are made to overseas companies with a standard listing than overseas companies with premium listing.

iii Global depository receipts

GDRs are negotiable securities that represent a company's equity issued by a depository bank on behalf of a company, which is normally an overseas company. The purposes of issuing GDRs is to broaden the shareholder base, raise capital, enhance the company image globally, increase the visibility of its products and services, and to facilitate mergers and acquisitions.[127] GDRs are intended to be purchased by sophisticated or professional investors in the primary market. Retail investors are unlikely to access them in the primary market but it is possible for them to purchase GDRs in the secondary market. The prospectus clearly states that 'the securities should only be bought and traded by investors who are particularly knowledgeable in investment matters'.[128]

The GDR market is a specialist market. New admissions are often offered to institutional investors. These securities are not included in the FTSE UK index series.[129] GDR listings are normally available to overseas companies and are required 'directive-minimum' standards. UK companies can also be GDR-listed, provided that their underlying equity is

[122] *Ibid* 39.
[123] See LR 9.8.7 R of the FCA.
[124] FSA website (n 117).
[125] See LR 9.3.12 R (4) of the FCA.
[126] See LR 9.3.10 G of the FCA.
[127] FSA (n 110) 41.
[128] *Ibid*.
[129] *Ibid* 6.

a premium listing.[130] From 2000 onwards, overseas issuers are not required to have primary listing in their home jurisdiction.[131] The following are the key requirements for company with a GDR listing:

Most of the requirements for GDR listing stem from the Prospectus and Disclosure and Transparency Directives. It also requires satisfying the following requirements of CARD:

> i) *The depository must be authorized and regulated by the FCA or a financial institution accepted by FCA and must hold the certificate on trust (or other equivalent legal instrument) for the sole benefit of the certificate holder.*
>
> ii) *The issuers of GDR are expected to comply with all the continuing obligations of the Disclosure and Transparency Rules (DTRs), if they are admitted to trading on a Regulated Market.*
>
> iii) *If these are admitted to the PSM (Professional Securities Market) then they are required to comply with the provisions relating to the disclosure and control of inside information (DTR 2) and the dissemination of information (DTR 6.3).*[132]

iv Professional Securities Market

The PSM is an integral part of the LSE and is operated within the scope of its status as a Recognized Investment Exchange. The PSM enables companies to raise capital through the listing of specialist securities, including debt and depositary receipts, to professional investors.

v Alternative investment market

The Alternative Investment Market (AIM) is the LSE's international market for smaller growing companies. A wide range of businesses, including early stage, venture capital and more established companies join AIM seeking access to growth capital.[133] It is a non-listed market.[134] The companies who are admitted to trading but are not admitted to the official list can trade on AIM. This is not a regulated market and it provides companies with a different trade market. AIM does not require the UK Code of Corporate

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[130] *Ibid* 12.
[131] *Ibid*.
[132] *Ibid* 23.
[133] See LSE website at <http://www.londonstockexchange.com/companies-and-advisors/aim/aim/aim.htm> Accessed 05.09.2013.
[134] FSA (n 110) 4.

Governance. The companies that are eligible to trade on AIM are required to comply with sub-directive standards.[135]

vi PLUS Quoted Market

The PLUS Quoted Market is not a regulated market and is also called a 'non-listed market' as is AIM.[136] Companies that trade on the PLUS Quoted Market are required to comply with sub-directive standards.[137]

vii Specialist Fund Market

The Specialist Fund Market (SFM) is a specialist regulated fund market of the LSE. This market targets institutional, professionals and knowledgeable investors.[138]

b. Frankfurt Stock Exchange

The Neuer market is a segment of the Frankfurt Stock Exchange (FWB) in Germany. This market segment was created especially for listing new firms under the Deutsche Borse (an operator of the Frankfurt Stock Exchange). These companies were required to follow international accounting and greater disclosure standards as compared to existing listed firms. In the early stages it proved to be very successful in Germany with many new IPOs. The German business community accepted it because it had not directly affected them.[139] Later development, however, showed that this was not a successful experience. However, failure cannot be attributed to regulatory dualism, but rather to its design, management and the circumstances under which it operated.[140]

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[135] *Ibid* 12.
[136] *Ibid*.
[137] *Ibid*.
[138] LSE website (n 133).
[139] LLSV (n 71) 21-2.
[140] Ronald J. Gilson, Mariana Pargendler and H. Hansmann, 'Regulatory Dualism as a Development Strategy: Corporate Reform in Brazil, the US and the EU' (2011) 63 *Stanford Law Review* 475-507.

c. Novo Mercado (New Market) of BM&F (Brazilian Mercantile and Future Exchange) Bovespa, Brazil

The Brazilian Stock Exchange also established a separate segment of the stock exchange to facilitate new growing firms along the lines of regulatory dualism. This proved to be a stunning success as it had learnt lessons from the failure of the Neuer market. The regulator was successful in breaking the deadlock in reforms by creating a new segment of the stock exchange in which new and growing firms may adopt stringent requirements in addition to the existing lightly regulated regime in order to attract more external investment opportunities.[141] This regulatory dualism may be a successful avenue for those jurisdictions where path dependency forces resist reform. This may be a suitable case for a jurisdiction such as Pakistan where path dependency forces such as families and vested interests resist reform.

d. Stock exchanges in Pakistan

The regulatory dualism experience can be effective in Pakistan. The stock exchange in Pakistan may be divided into segments with primary and secondary listing. Companies with primary listing may be required to follow international accounting standards, more disclosure requirements and mandatory compliance with the Code. Companies with secondary listing may be allowed to follow domestic accounting standards with lower disclosure requirements and optional compliance with the Code. This regulatory dualism may not harm families and vested interests. Families and interest groups who have reservations about compliance due to their vested interests might not be directly affected by this kind of reform. They may carry on their listing in the secondary market and may move towards the primary market once they realize the potential benefits of primary listing with its enhanced requirements. This may be helpful in developing the market and creating good governance in the corporate sector of Pakistan.

The primary market may be attractive to multinational, big, existing and new companies. In this way, these companies can convey the message to investors that they are willing to comply with higher disclosure requirements. This may attract other companies who have a secondary listing to move towards primary listing. The bonding will play a major role in moving companies from secondary to primary listing. Small existing and new companies

[141] *Ibid*.

can enlist on the secondary market where there will be lower disclosure requirements as well as non-binding compliance with the Code, and fewer requirements for compliance with rules and regulations. This will provide these companies with some exposure in the public sector. Compliance with fewer requirements may induce management to think about moving to the strict compliance regime of primary listing. Reputation, bonding and enhancing the shareholder base may be the stimulants for primary listing. In this way, companies may create their own culture of compliance. After maturing, companies may seek entry into the primary listing. This movement of companies from secondary to primary market will assure investors of their commitment to compliance with higher standards. This may improve the companies' share price, which will help companies to raise equity finance and debt financing at lower cost. Investor confidence will be increased and good governance will be ensured. Individual investors may find it beneficial to invest in the primary market, whereas institutional investors may invest in both the primary and secondary markets. As the institutional investors have experience and expertise in investing, they can, therefore, invest in both markets. However, the primary market may be helpful for small investors as only highly reputed companies will go for primary listing.

5.6.4 Other segments of the market in Pakistan

There are other ways to enhance the enforcement mechanism too. One may be the role of intermediaries such as institutional investors, including banks and mutual funds.[142] These institutions can ensure company compliance with regulations. They can use their position to force companies to comply with the rules and regulations through participation in general and board meetings. They can also negotiate with portfolio companies for compliance with the rules and regulations instead of participating in the management. Institutional investors are working well in advanced jurisdictions such as the UK and the US. In Pakistan the fund industry is not yet developed and that may be one reason for the underdeveloped market. The industry may play its role in enforcement, but reforms are needed in this sector as well. The UK Stewardship Code may provide Pakistan with guidelines on how to development the fund industry. There are other benefits for institutional investors such as safe investment for the small financier. These investments provide diversified investment through professionals. Reforming the institutional investment industry in the country may thus help to develop the market and enhance the enforcement mechanism.

[142] Reform in institutional investors has been discussed in Chapter Four, at 4A.3.3.1.

5.7 Conclusion

This chapter discussed enforcement or ‘law in action’ in corporate governance in Pakistan. It sought to examine the ways in which the law in action can be effective in the country. It demonstrated that the ‘law in books’ was important in the first phase of reform but that ‘law in action’ must be improved in the second phase for better corporate governance and investor protection. This chapter also recommended different means of improving the law in action through reforms in Pakistan.

The enforcement mechanism is embedded in the system where the courts and market play an important role. The judiciary has a significant role to play in the law in action. Therefore, an efficient judiciary is a key to good corporate governance. The judicial system of Pakistan is inefficient and failed to provide the public with justice, even in general civil and criminal matters. Corporate matters are considered technical in nature and, therefore, to deal with it, special knowledge and experience are required. The judges who preside in general courts are normally not expert in corporate matters, which is the main cause of the inefficiency in the judicial system. There are two solutions to this situation. First, the judges of the regular court system should be trained in corporate matters so that they can deal with them in addition to dealing with other civil and criminal matters. However, the problem with this solution is that substantial cost will be incurred to train them when weighed up against the number of cases with which such judges have to deal. Second, the other solution is to establish specialized courts with persons who have special knowledge and experience in corporate matters as judges of such courts. This will reduce the burden on the general courts and may enhance judicial capacity as far as corporate matters are concerned.

The state has established a number of specialized courts and tribunals in many fields in Pakistan which are performing better than the general courts. The phenomenon of establishing specialized courts is also evident in developed, developing and regional jurisdictions. Therefore, establishing specialized courts to deal with corporate matters with judges having special knowledge and experience of corporate, accounting, finance and economics may be the answer. This will reduce the burden on the general judiciary and ensure efficiency in corporate matters. Ultimately, it may enhance the enforcement mechanism of Pakistan as far as corporate governance is concerned.

The other important aspect of law in action is the market in Pakistan which is underdeveloped. The capital market of Pakistan failed in compliance and enforcement. The institutional investors are passive and the takeover market is not performing due to an illiquid market. There is a need to reform the market keeping in mind the particular circumstances prevailing in Pakistan. Families are dominant and may resist any reform agenda as the *status quo* favours them. This resistance from families and vested interests can be overcome through piecemeal reforms in the market. The market can be divided into two segments: (1) the primary market and (2) the secondary market. The primary market may require more disclosure and compliance than the secondary market. International accounting standards, compliance with the code of corporate governance, controlling related party transactions and other disclosure may be mandatory features of this market. The secondary market may require less disclosure and compliance. International accounting standards, compliance with the Code and related party transactions may be optional. The primary market may be attractive to multinational, big, existing and new companies. Reputational concerns will attract them to enlist on this market. This market will be useful for small and dispersed investors. Institutional investors may invest in the primary and secondary markets as they have experience in, and knowledge of, where to invest. They can also use their position and voting power to ensure compliance. The secondary market may be attractive to small, existing and new companies. Once they get exposure and know the potential benefits to be gained from the primary market, they may enlist on the primary market. The bonding mechanism will be the stimulant for them to shift to the primary market. This may ensure compliance and enforcement through the market.

In addition, as the reform process moves towards convergence to international norms, the process may face resistance from religious norms in Pakistan. This is basically due to the multifunctional role of the religion of Islam. It focuses not only on worships, but also on the day-to-day affairs, including financial matters, of its subjects. Islam is the state religion in Pakistan. Therefore, any convergence to international norms has to face the litmus test of Islamic norms.

CHAPTER SIX: ISLAMIC INFLUENCE ON CORPORATE GOVERNANCE IN PAKISTAN

6.1 Introduction

The previous chapters were dedicated to examining the possible convergence to the Western form of corporate governance in Pakistan. This chapter examines the extent to which Islamic norms may act as a barrier to convergence to international norms in corporate governance in Pakistan.

The development of the corporate governance system of a particular country depends upon the country's political and ideological conditions.[1] The culture and ideology of a country also determines the choice of corporate law and governance mechanism.[2] Islam is a practical religion that involves and guides its subjects in each and every aspect of their life, including financial matters and the governance mechanism. Pakistan, being an ideological country with Islam as its state religion, may drive its corporate governance mechanism from the basis of Islamic norms. Therefore, convergence of any feature of corporate governance to international norms in Pakistan may have to be subjected to the litmus test of Islamic norms.

Islamic finance remained stagnant and has developed very slowly over the past centuries for reasons that may be associated with the colonization of the Muslim world and the triumph of capitalism in the Western world. Islamic finance has only recently developed more rapidly, especially after the recent financial crisis. Muslim jurists were forced to keep abreast of modern techniques of financing and tried to synchronize them with Islamic norms. This can be attributed to the different developments that occurred in recent years. Firstly, the rapid growth of capitalism all over the world in the recent past acted as catalyst in the finance industry. Capitalism invented different techniques of financing with which classical Muslim jurists were not familiar. Secondly, after gaining its independence from the colonization of Western powers, Muslim countries automatically adopted the legal and

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[1] Mark J. Roe, 'Political Preconditions to Separating Ownership from Corporate Control' (2000) 53 (3) *Stanford Law Review* 603.

[2] Lucian A. Bebchuk and Mark J. Roe, 'A Theory of Path Dependence in Corporate Governance and Ownership' (1999) 52 *Stanford Law Review* 168-70 and Amir N. Licht, Chanan Goldschmidt and Shalom H. Schwartz, 'Culture, Law and Corporate Governance' (2005) 25 *International Review of Law and Economics* 253.

financial structures of their masters. However, later development saw a thrust in Muslims to adopt religious norms, even in financial matters. Thirdly, the recent global financial crisis highlighted the importance of an alternative financial system that may respond more appropriately to financial distress, which capitalism failed to do. Fourthly, globalization during the past 40 to 50 years has stimulated adaptation and convergence to a Western model of financing from more developed countries to less developed countries. The challenges for Muslim jurists are to develop an Islamic finance system that provides an alternative to modern financing modes, which is borrowed from the West and also compatible with basic Islamic norms.

This chapter discusses one important issue, namely the extent to which Islamic norms may act as barrier to convergence of corporate governance to international norms in Pakistan. The issue has two aspects: (1) the extent to which convergence to business norms within the Muslim world may take place and (2) the extent to which Islamic norms may affect convergence to the Western model of corporate governance in Pakistan.

However, before discussing and answering to the sole issue of convergence in corporate governance to International norms in Pakistan, the discussion will focus on the nature and sources of Islamic law, reasons and causes of emergence of different schools of Islamic law, and nature and purposes of Islamic law and finance. This will help to understand how and why there is divergence within the Muslim world and up to what extent the same may be converted into convergence with regard to Islamic Law and finance. In addition, this will also illustrate the degree of divergence between Islamic law and finance to the western system of corporate finance and governance. In particular, this will help us to see the possibility and effectiveness of convergence to western system of corporate governance in Pakistan.

6.2 Ideology of Pakistan

Pakistan is an Islamic Republic.[3] After independence in 1947, it adopted the Government of India Act, 1935as its constitution with some necessary amendments. A Constituent Assembly was formed in 1947 to draft a constitution for the new state of Pakistan. On

[3] Art. 1 (1) of the Constitution of the Islamic Republic of Pakistan 1973 (the Constitution, 1973).

12 March 1949, the Constituent Assembly passed the ‘Objective Resolution’.[4] The resolution, *inter alia*, states that

> *wherein sovereignty over the entire universe belongs to Allah Almighty (God) and the authority which He has delegated to the State of Pakistan, through its people for being exercised within the limits prescribed by Him is a sacred trust . . . wherein the Muslims shall be enabled to order their lives in the individual and collective spheres in accordance with the teachings and requirements of Islam as set out in the* Holy Qur’ān *and the Sunnah.*[5]

The ‘Objective Resolution’ was made the preamble of all the former and present constitutions of Pakistan, namely those enacted in 1956, 1962 and 1973 respectively. The ‘Objective Resolution’ formed a substantive part of the present Constitution in 1985.[6]

The Constitution of the Islamic Republic of Pakistan, 1973 (the Constitution, 1973) provides that Islam is the state religion.[7] Furthermore, the Constitution provides two safeguards for protecting the Islamic spirit of the country. First, it provides that all existing laws shall be brought in conformity with the injunctions of Islam as laid down in the *Qur’ān* (‘Holy Book’) and *Sunnah* (an explanation, interpretation and elaboration of the *Qur’ān*). Similarly, it also provides that no law shall be enacted that is repugnant to such injunctions.[8] To check the conformity of laws with the injunctions of Islam, the Council of Islamic Ideology was established.[9] The objective of this council is to advise governments on how to bring existing laws into conformity with Islamic injunctions.[10] The government may also refer a question to the council for advice on the point at issue, that is, whether or not a proposed law is repugnant to the injunctions of Islam.[11] Second, it established the Federal Shariat Court (FSC) whose function includes examining and deciding whether or not any law or provision of law is repugnant to the injunctions of Islam.[12] The FSC is empowered to declare any law that is contrary to the injunctions of Islam and may set a

[4] The ‘Objective Resolution’ was a document that was approved by the Constituent Assembly on 12 March 1949. The purpose of this document was to describe the nature of the constitution to be formed by the assembly. The assembly did not draft any constitution but laid down the foundation for a constitution.
[5] See text to n 22-4.
[6] Art. 2A of the Constitution, 1973.
[7] Art. 2 of the Constitution, 1973.
[8] Art. 227 (1) of the Constitution, 1973.
[9] Art. 228 (1) of the Constitution, 1973.
[10] Art. 230 (1) (c) of the Constitution, 1973.
[11] Art. 229 of the Constitution, 1973.
[12] Art. 203C (1) of the Constitution, 1973.

deadline for its abolition.[13] The government is required to take the necessary steps to bring the law into conformity with the injunctions of Islam. If the government fails to provide an alternative to the impugned law or provision of law, declared being against the injunctions of Islam, the same shall be considered abolished from the date on which the decision of the court became effective.[14] The court may also review its own decision.[15] A decision of court can be appealed to the SC of Pakistan[16] and for this purpose the Constitution, 1973 has established a separate Shariat Appellate Bench within the SC to hear appeals against such decisions.[17]

6.3 *Shariah* (Divine law) and *fiqh* (Islamic law)

The terms *Islamic law* and *Shariah* are used interchangeably but there is a difference between these two terminologies. *Shariah* means the Divine law that is revealed in the form of the *Qur'ān* and the *Sunnah*.[18] As Divine law is from God, it is considered perfect and immutable, and is not subject to change. However, Islamic law, which is also called *fiqh*,[19] means the law developed through human intellect from the *Shariah*. As this law is arrived at through human intellect, it may contain errors or be defective.[20]

Usul al-fiqh is a methodology used to derive Islamic law (*fiqh)* from the Divine law (*Shariah)*. The human intellect is used to develop Islamic law and the process used to apply independent reasoning by a qualified religious scholar is called *ijtihad* ('legal reasoning'). Different schools of Islamic law have different rules of interpretation of the *Shariah* within the Muslim community; therefore, there are chances of difference of opinion among them. This led to the development of Islamic law (*fiqh)* according to each school of thought.[21]

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[13] Art. 203D (2) (a) (b) of the Constitution, 1973.
[14] Art. 203D (3) (a) (b) of the Constitution, 1973.
[15] Art. 203E (9) of the Constitution, 1973.
[16] Art. 203F (1) of the Constitution, 1973.
[17] Art. 203F (3) of the Constitution 1973.
[18] Habib Ahmed, 'Islamic Law, Investors' Rights and Corporate Finance' (2012) 12 (2) *Journal of Corporate Law Studies* 378.
[19] *Fiqh* is also called *Islamic jurisprudence* and *usul al-fiqh* is called *jurisprudence*.
[20] Frank E. Vogel and Samuel L. Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (Kluwar Law International, The Hague 1998) 23-4.
[21] Ahmed (n 18) 378.

6.4 Sources of Islamic law

The sources of Islamic law can be divided broadly into two categories: (1) primary sources and (2) secondary sources. Primary sources are those that are unanimously accepted as sources of Islamic law by all the schools of Islamic law. However, the secondary sources are those on which the Muslim jurists have differences of opinion regarding their acceptance as sources of Islamic law.

6.4.1 Primary sources

The majority of Muslim jurists regard the *Qur'ān*, the *Sunnah* and the *ijma* ('consensus of opinion') as primary sources of Islamic law. However, some jurists (who are in the minority) consider the *Qur'ān* and the *Sunnah* as the only primary sources of Islamic law.

6.4.1.1 The *Qur'ān* ('Holy Book')

The Qur'ān is a holy book. It is part of the '*iman*' ('belief') of the Muslims that this book is from God and was revealed to the Holy Prophet Muhammad (peace be upon him). No rule can be derived that is in conflict with this book. The problem with this book is that it does not provide detail on each and every aspect of life. It provides general principles. The detailed rules were left to the Prophet. He elaborated, interpreted and provided details of the verses of the *Qur'ān* in his capacity as a judge and as a Prophet. This established the *Sunnah* as a parallel primary source with the *Qur'ān*.[22]

6.4.1.2 The *Sunnah*

The Sunnah is also a primary source of Islamic law. It denotes sayings, other than what is revealed in the *Qur'ān*, and practices of the Prophet Muhammad (peace be upon him). It also includes the Prophet's tacit approval of acts of others in worship and daily life.[23] It is, in fact, an explanation, interpretation and elaboration of the *Qur'ān*.[24]

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[22] Mashood Baderin, 'Understanding Islamic Law in Theory and Practice' (2009) 9 (3) *Legal Information Management* 187.
[23] Imran Ahsan Khan Nyazee, *Outlines of Islamic Jurisprudence* (Advance Legal Studies Institute, Islamabad 2000) 133.
[24] Baderin (n 22) 188.

6.4.2 Secondary sources (rational sources)

The secondary sources are based on *ijtihad*. *Ijtihad* is applied when primary sources do not provide an explicit view on any issue. *Ijtihad* is a process of deriving a rule using human intellect. This is a process through which a qualified Muslim scholars arrived at some conclusion that is in accordance with the essence and spirit of the primary sources of Islamic law.[25]

6.4.2.1 *Ijma* ('Consensus of legal opinion')

If all the qualified Muslim jurists of one time agree on a certain issue after *jtihad* ('legal reasoning') *ijma*[26] ('consensus of legal opinion') will become a binding rule. However, its biding nature may be overruled by subsequent jurists with similar conditions.[27]

6.4.2.2 *Qiyas* ('Analogy')

Qiyas ('analogy') is an extension of an existing rule to a new issue for which no rule is available in the existing texts of primary sources.[28] Jurists try to find an underlying cause for the existing rule and then extend the rule to a new situation. As an example, the saying of the Prophet Muhammad (peace be upon him) 'a murderer will not be inherited' may be used. The *Sunnah* is silent on the prohibition that a murderer may not be a beneficiary of the will of the victim. Therefore, by analogy, the rule of inheritance is extended to bequest. The underlying cause for the first case, determined by jurists, is 'hastening the benefit prior to its appointed time by a criminal act' and the same is extended to a bequest by *qiyas*.[29] *Qiyas* is similar to *ijma* in a sense that both are an interpretation of primary sources. However, *qiyas* is an individual interpretation of the rule whereas the *ijma* is an interpretation of a rule through the consensus of all the jurists of one time.

[25] Ahmed (n 18) 378.
[26] Since there is no consensus among Muslim jurists regarding the acceptance of *ijma* as a primary source of Islamic law, it is dealt with under secondary sources of Islamic law.
[27] Baderin (n 22) 188.
[28] *Ibid*.
[29] Nyazee (n 23) 48-9.

6.4.2.3 *Istihsan* ('Juristic preference')

The literal meaning of the word *istihsan* is something that is preferred by someone or something towards which one is inclined. In its technical meaning, it means an exception to a general principle established through analogy, provided stronger evidence is available. The objective behind the application of *istihsan* is to provide relief to the people. For example, Islamic law does not allow the selling of something that does not exist at the time of the contract, but the contract of hire (*ijarah*) is allowed. In this contract the services or benefits do not exist at the time of the contract. The contract is allowed on the basis of necessity as an exception to the general rule and on the basis of evidence found in the *Qur'ān* in which Prophet Jacob entered into a similar contract.[30] *Istihsan* is similar to the concept of equity in the West as both are based on fairness and good conscience.[31]

6.4.2.4 *Istishab* or *ibahah* ('presumption of continuity')

Istishab or *ibahah* means the presumption of continuity of the *status quo* with respect to a rule. Therefore, an existing rule will prevail unless overruled through the sources of Islamic law;[32] in other words, everything is permissible unless prohibited by Islamic law. So, in the absence of a prohibition of any act by the Islamic law, the act will be considered permissible. This is analogous to common law as both focus on the continuity of a rule first established unless over turned.[33]

6.4.2.5 *Maslahah mursalah* ('Extended analogy')

Maslahah mursalah means the preservation of the purpose of Islamic law in the settlement of legal issues; for example, the rule provides that for intentional murder, the life of one person will be taken for one murder. However, jurists have decided that if more than one person were involved in the killing of a single person, then all those who were involved in the murder may be sentenced to death. The objective was to preserve the purpose of

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[30] *Ibid* 150-4.
[31] Angelo M. Venardos, *Islamic Banking and Finance in South-East Asia-Its Development and Future* (3rd edn, World Scientific Publishing Co. Pte Ltd, Singapore 2012) 20.
[32] Nyazee (n 23) 152.
[33] Venardos (n 31) 21.

Islamic law, that is, the preservation of individual life.[34] This is also termed *public interest* as it allows following a particular course of action in the public interest.[35]

6.4.2.6 *Qawl al-sahabi* (‘Opinion of a companion’)

A companion (*sahabi*) is a person who was Muslim during the lifetime of Prophet Muhammad (peace be upon him) and also met or saw the Prophet in life. Any saying by a companion is also considered a source of Islamic law by some schools of Islamic law. The reason for the acceptance of this as a source of law is that such persons were in close association with the Prophet. They, therefore, had a better understanding of the spirit of the *Shariah*.[36]

6.4.2.7 *Sadd al-dhar’i* (‘Blocking the legal means to an illegal end’)

Sadd al-dhar’i means if the outcome of a legal act is illegal and harmful to society, then it will be prohibited; for example, the cultivation of poppies is not illegal in itself but as they are used to make heroin, which is harmful to society, their cultivation is, therefore, not allowed.[37]

6.4.2.8 *Urf* (‘Custom’)

Urf is similar to a custom that is considered a source of law in the Western world. Earlier Muslim jurists used custom as a source of law but did not focus on it. Later jurists, however, has given it importance. This may be due to the Western influence [38] as the same is considered a source of law. The basic difference between *urf* and custom in the Western world is that *urf* should not be contrary to the *Shariah*.[39]

[34] Nyazee (n 23) 154.
[35] Venardos (n 31) 21.
[36] Nyazee (n 23) 155-6.
[37] *Ibid* 155.
[38] *Ibid* 158-60.
[39] Venardos (n 31) 21.

6.4.2.9 Islamic legal maxims

Islamic legal maxims play an important role in Islamic law. They have developed over a period, and show the spirit of Islamic law and are guiding principles in Islamic law.[40] These maxims help jurists to arrive at a conclusion when there is a problem with the interpretation of the sources of Islamic law, for example, 'the removal of hardship' (*raf al-haraj*), 'prevention of harm' (*daf al-darar*),[41] and 'doubt does not make an end to certainty' (Al-yaqinu la yazulu bish-shakk) are important maxims under Islamic law. They have been derived from principal sources of Islamic law but are not sources of Islamic law. Rather, these maxims only explain the ideology of Islamic law and science of jurisprudence.[42] Different schools of law have different opinions on the applicability of some of the maxims.[43] There are two important legal maxims relating to corporate finance: (1) 'the benefit of a thing is in return for the liability for loss from that thing' and (2) 'the detriment is in return for the benefit'. These maxims signify that accepting liability justifies making profit. In business, if one does not accept liability for a loss, one is not entitled to a legitimate profit under Islamic law. Therefore, interest-bearing transactions are prohibited because the debt provider does not take liability for potential loss. These two maxims of Islamic law, coupled with a prohibition on interest, clearly refer to equity investment.[44]

6.5 The purposes of Islamic law (*Maqasid al-Shariah*)

Al-Ghazali[45] has defined five purposes of Islamic law, which have been accepted by the majority of Muslim scholars. These purposes are called *primary purposes of Islamic law* and are as follows:

1. *Preservation of religion*
2. *Preservation of life*
3. *Preservation of progeny*

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[40] Mohammad H. Kamali, 'Legal Maxims and other Genres of Literature in Islamic Jurisprudence' (2006) 20 *Arab Law Quarterly* 77.
[41] Dr. Asyraf Wajdi Dusuki, 'Corporate Governance and Stakeholder Management: An Islamic Perspective' (2011) 15 (2) *Review of Islamic Economics* 18.
[42] Dr. Hafiz Abdul Ghani, 'A Study of the History of Legal Maxims of Islamic law' (2012) 1 (2) *International Journal of Arts and Commerce* 92, 98.
[43] Baderin (n 22) 189.
[44] Ahmed (n 18) 379.
[45] A well-known Muslim jurist; Imran Ahsan Khan Nyazee, *Theories of Islamic law* (Islamic Research Institute, Islamabad 1994) 238-47.

4. *Preservation of intellect*
5. *Preservation of wealth.*

All these purposes have positive or aggressive, as well as negative or defensive, aspects. A positive/aggressive aspect of the 'preservation of religion' means to create conditions that facilitate worship, and a negative/defensive purpose implies that it is the duty of every Muslim to defend his or her religion. The positive/aggressive aspect of the 'preservation of life' means to create such facilities that ease life, whereas a negative/defensive aspect is prevention as well as a penalty for taking others' life without legal justification. The positive/aggressive aspect of 'preservation of progeny' means to facilitate family life and the negative/defensive aspect is the prohibition on, and punishment for, illegal sexual intercourse. The positive/aggressive aspect of 'preservation of intellect' prescribes the provision of education and its growth, whereas the negative/defensive aspect is the prohibition on the consumption of liquor and other substances that destroy intellect, and entails a penalty for its violation. The positive/aggressive aspect of 'preservation of wealth' means to provide proper conditions for the growth of wealth and the negative/aggressive aspect is the prohibition on taking away others' property illegally, and prescribes punishment for theft and robbery.[46]

These purposes are prioritized according to the order in which they are stated. Jurists have defined some of these rules according to their applicability to Islamic law. The first rule is that the stronger interest will prevail, for instance, under 'preservation of intellect' consumption of liquor is prohibited but, at the same time, as life has priority over 'preservation of intellect' (consumption of liquor), therefore, if a person's life is being threatened, he/she may take some wine to save his/her life. The second rule is that public interest will prevail over private interest. Therefore, levying tax for public welfare is justified under this rule.[47] Another example may be that 'preservation of life' has priority over 'preservation of progeny' but the death sentence may be imposed under certain circumstances on culprits, which means 'preservation of progeny' is given priority over life. This is so because public interest will prevail over private interest. Here taking the life of a culprit is a private interest, whereas saving society from the evil effects of sexuality is a public interest.

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[46] Imran Ahsan Khan Nyazee, *Theories of Islamic law* (Islamic Research Institute, Islamabad 1994) 238-47.
[47] *Ibid.*

6.6 Applicability of the purposes of Islamic law in corporate governance

The objectives of Islamic law imply that no one can do any act whose objective is to defeat the intention of the lawgiver. In the context of corporate governance, the managers have to set their priorities in a way that preserves the purposes of Islamic law.[48] Therefore, a firm cannot complete any activity whose objective is prohibited by Islamic law irrespective of the quantum of profit it can yield. Therefore, the firm's activities must not be to produce alcohol, as this is against the 'preservation of intellect'. Similarly, the purpose of Islamic law 'preservation of life' prohibits all those products that harm life such as tobacco, heroine and other illegal drugs. Under the 'preservation of progeny' all materials that induce illegal sexual intercourse will be prohibited, such as producing pornographic films and other materials. The 'preservation of wealth' as an objective of Islamic law means to create conditions that help the growth of wealth, therefore, establishing a firm with a view to growing wealth is within the limits of the Islamic law. This implies that the interests of the investors have priority in business decisions. However, Islamic law is not limited to the interests of shareholders or stakeholders but it covers society in general. The rule 'public interest will prevail over private interest' implies that the interest of investors is subordinate to the interest of society. Therefore, this requires from the managers that they avoid such decisions that may be beneficial for the shareholders and stakeholders, but that damage society and the general public. Hence, this rule will prohibit certain kinds of businesses, such as gambling which may be beneficial to investors but is harmful to society and, therefore, prohibited under Islamic law. In general, managers are duty-bound to take decisions that do not in any way defeat the objectives of the *Shariah*; for instance, managers should not take decision to invest the surplus of a firm's money in any interest-bearing investment or to indulge in an activity that promotes *Shariah*-prohibited activities. These purposes of Islamic law are called *primary purposes*.

After achieving the primary purposes, managers may proceed further to take guidance from the secondary purposes developed by jurists. The first category of secondary purposes is called 'needs' by the jurists. These secondary purposes may be required to fulfil the primary purposes.[49] In the context of corporate governance, managers, after fulfilling the primary purposes (e.g., providing employees with fair pay and safety in the

[48] Dusuki (n 41) 17.
[49] Nyazee (n 46) 242-3.

workplace), may proceed further and provide training to enhance human quality. This will enhance human capacity to perform the primary purposes more efficiently.[50] Jurists call the second category of secondary purposes 'complementary purposes'. These purposes are meant to establish ease and facility. After attaining the primary purposes and the first category of secondary purpose, the managers may go further and discharge their social responsibilities such as donating to charity and to other institutions; providing needy students with scholarships; providing sufficient, correct and clear information regarding products offered to customers;[51] or providing accurate information and disclosure to the shareholders and to the general public for the issuance of shares. This may help to attain the highest degree of social responsibility. In corporate governance, priorities in Islamic law help managers to decide what course of action they can take in case of a conflict of interest between different stakeholders.[52] In this way, the purposes of Islamic law can be achieved in corporate governance.

The above implies that corporate governance is more important in firms that operate under Islamic law. The Islamic law will put more responsibilities on the managers because they will be required not only to act for the benefit of investors, but also to society and to preserve the objectives of Islamic law. Therefore, as the firms move towards an Islamic mode of conducting business, more focus will be on corporate governance. In the context of Pakistan, corporate governance will feature more in policy as soon as the state moves towards Islamizing the economy.

6.6.1 Public Interest and Convergence Theory

To determine what is 'public interest' is not an easy task. Feintuck writes that 'the public interest will often appear to be an empty vessel, to be filled at different times with different content.' The term varies from society to society, discipline to discipline, ideology to ideology and religion to religion. The reason may be the priorities set by each society, discipline, ideology and religion. For instance, political science may have different meaning than the economics. Capitalism may have different meaning than

[50] Dusuki (n 41) 17.
[51] *Ibid* 18.
[52] *Ibid* 20.

Socialism due to priorities set by each ideology.[53] Similarly, the capitalist western world may have different meaning for the term which is understood in Islamic finance.

The nature of public interest depends upon the nature of a society. This difficulty becomes more challenging in new world order where capitalism has dominated the world but still some capitalist countries such as Pakistan prescribe Islamic injunctions as its 'Grundnorm'[54]. The problem is historical where most of the Muslim countries including Pakistan remained a colony of the western world where capitalism was dominant. After independence these countries adopted the legal, regulatory, financial and institutional structures of their colonial masters. However, later development especially after the recent financial crisis highlighted the importance of alternative financial systems which could have responded more appropriately to which capitalism failed to respond.[55] The other development was trust in the Muslim world to revive their own Islamic identity in financial matters which provides alternative to products introduced and developed by capitalism. The challenge for modern Muslim scholars is to develop Islamic financial products which are compatible to modern needs and requirements and which are not against the Islamic injunctions. In this scenario to determine what is public interest is a methodological and an empirical challenge[56] especially when capitalist world and Islamic world have different Grundnorms. For example, Islamic injunctions are a Grundnorm in Pakistan whereas in most of the western world it may be constitutional law.

The other difficulty with the term public interest is its overlapping with private interest. Sometimes it becomes difficult to set boundaries for both terms. In other words, it is not easy to define up to what extent pursuit of private interest will not infringe public interest. For example, a professional may not focus on welfare of the society in his professional life

[53] Mike Feintuck, *The Public Interest in Regulation* (Oxford Scholarship Online, 2012) Chapter 'How is the Public Interest Determined?

[54] A 'Grundnorm' or 'Basic Norm' is a concept presented by Hans Kelsen in his famous theory of Jurisprudence, namely, 'Pure Theory of Law' or 'Theory of Positive Law'. It is a hypothetical norm. All other norms in a system get validation from such norm. It may either be constitutional law or any other law. For this see Hans Kelsen, *Pure Theory of Law* (Knight M tr, 2nd edn, Universtiy of California Press Ltd, London 1978).

[55] Angelo M. Venardos, *Current Issues in Islamic Banking and Finance* (World Scientific Publishing Co. Pte. Ltd., Singapore 2010) 1.

[56] Charles Tripp, *Islam and the Moral Economy: The Challenge of Capitalism* (Cambridge University Press, Cambridge 2006) 68-76.

while in pursuit of return on his investment made in getting education and skill development.[57]

A distinction between private interest and public interest and the extent to which a private interest may be pursued without infringing public good depends upon the ideology of a particular society. Capitalism focuses more on private rights than society as a whole whereas in Islamic economics the focus is on the society as a whole. No doubt a capitalist society may also focus on the welfare of the society but an individual may pursuit his / her private interest irrespective of quantum of negative impact on the society. He / she may pursue his/ her private interest unless such acts are not unlawful. For example, it may allow businesses which have a moral negative effect on the society such as businesses relating to gambling, alcohol and pornography. On the other hand, Islam is a practical religion which provides complete guideline through its revealed sources even in business and commercial dealings. It does not allow immoral and unethical businesses. Therefore, an Islamic society will not allow pursuit of private interest which in any form is immoral or harmful for the society as a whole. The emphasis of Islam is on ethical business conduct which does not allow dominance of private interest over public interest. Therefore, it does not allow business of alcohol, gambling or pornography and other immoral businesses.[58]

In the realm of Islamic economics, the private and public interest are better defined than in its counterparts capitalism and socialism. Although the term public interest is a modern terminology but classical Muslim jurists have discussed this terminology in interpreting the basic sources of Islamic law in defining the nature and philosophy of Islamic society and in establishing Islamic law. The sources of Islamic law such as *Maslahah mursalah* (extended analogy or public interest), *Istihsan* (Juristic preference), *Sadd al-dhar'i* (Blocking the legal means to an illegal end) and *Urf* (Custom)[59] have been used by the Muslim jurists to define the nature and extent of Islamic law. While using these sources, Muslim jurists used public interest as a yardstick to define the Islamic law.

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[57] Timothy J. Fogarty, 'The Bloom Is Off the Rose: Deprofessionalization in Public Accounting in Steven Mintz (ed), *Accounting for the Public Interest: Perspectives on Accountability, Professionalism and Role in Society* (Springer, Online 2014) 63-4.

[58] Lilian Miles and Simon Goulding, 'Corporate Governance in Western (Anglo-America) and Islamic Communities: Prospects for Convergence?' (2010) 2 *Journal of Business Law* 126-149 and Jeyapalan Kasipillai, Janine Pascoe and Shanthy Rachgan, ' Shareholder Protection in Public Listed Companies: Issues in an Emerging Market' (2011) 22 (11) *International Company and Commercial Law Review* 363-381.

[59] These sources have been discussed at 6.4 of Chapter Six.

Muslim jurists have also defined the purposes of Islamic law in order to interpret the primary sources of Islamic law. This provides a guideline to future jurists in pursuit of their interpretation of primary sources for finding a solution in present times. As discussed earlier, preservation of religion, life, progeny, intellect and wealth are basic purposes of Islamic law. These purposes have priority in the same order in which these are stated. Therefore, a purpose ranked high will have priority over the purpose ranked below. These purposes have also objective of pursuing public interest. For example, life has priority over progeny but the death sentence is prescribed under certain circumstances to a person who has unlawful sexual intercourse. In this case, progeny has been given priority over life due to prevalence of public interest over private interest. In this case, preservation of life of culprit is private interest whereas preservation of society from evil effect of unlawful sexual intercourse is a public interest. Islamic law, therefore, not only defines the nature of public interest but also gives priority to it over private interest.

Before exploring the extent to which public interest under Islamic law acts as a barrier to convergence to western model of corporate governance it is important to see the Islamic view point about core issues of corporate governance discussed in this study: Agency Cost, Minority Shareholder Rights and Enforcement Mechanism. These three core corporate governance issues have the common objective that is investor protection and especially the minority shareholders protection. As discussed earlier, preservation of wealth is one of purposes of Islamic law. The preservation of wealth has two aspects: positive and negative. The positive aspect of preservation of wealth means that it is the duty of the state to provide such facilities to the individuals which are conducive for the growth of wealth. On the other hand, the negative impact is to provide protection to the wealth of the individuals. Islam provides punishment for stealing the wealth of others.[60]Therefore, investor protection is one of the basic objectives of the Islamic law.

There are many instances in the primary sources of Islam which provides protection to the investors especially the minority stakeholders.[61] Here only few are narrated to explain the objective of the *Shariah* to explain the investor protection. *Qur'ān* says:

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[60] Imran Ahsan Khan Nyazee, *Theories of Islamic law* (Islamic Research Institute, Islamabad 1994) 238-47.

[61] Mahmoud Almadani, ' The Role of Sharia Law in Protecting Minority Shareholders in Private Companies' (2010) 21 (12) *International Company and Commercial Law Review* 397.

‘And do not swallow up your property among yourselves by false means, neither seek to gain access thereby to the judges, so that you may swallow up a part of the property of men wrongfully while you know’[62]

This verse clearly provides protection to the property rights of the others. Similarly, the *Sunnah* also provides protection to the property of the others:

‘…A Muslim …does not oppress his brother nor abandon or humiliate…every Muslim is protected, his blood, his wealth, and honour’.[63]

Holy Prophet (peace be upon him) has also been quoted as saying that God says:

‘*I am a third partner of those who form partnership; unless one of them betrays the other, I leave them alone’*[64]

This *Sunnah* indicates that one, who betrays the other partner, will lose blessings of God. It is also part of religious duty to be faithful to other partners in business. These references clearly provide that protection to the property is given high importance in the religion of Islam. In entrepreneurship, the weaker party is mostly at risk of being dealt unfairly, exploited and expropriated by the stronger party. Therefore, the focus of the *Shariah* is to provide protection to the weaker party in commercial dealings.[65]

Investor protection has been considered as a key factor in recent research on corporate governance. It creates an environment which is conducive for investment and which encourages business activities. The whole society gets benefits in the form of better quality products. This also provides to the society an environment which is conducive for investment and provides opportunities to increase their wealth through legal business means. In the context of corporate governance, the protection of the investors is a public interest because this provides a sense of protection to the investors and they can invest without any fear of expropriation by the dominant party and management. This public

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[62] Al-Baqarah 2:188 (a verse from the Holy *Qur’ān).*

[63] Narrated by Imam Muslim (May Allah be pleased with him) (A well-known Muslim scholar and collector of *Sunnahs*).

[64] Narrated by Abu Dawood (May Allah be pleased with him) (A well-known Muslim scholar and collector of *Sunnahs*).

[65] Dr Lu’ayy 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* 228.

interest has been given high priority in Islamic law. Therefore, an individual is prohibited to pursue his / her private interest which is harmful to the society as a whole. Islamic law also protects the minority shareholders in entrepreneurships. These two principles clearly refer to the good corporate governance concept which is understood in west. Therefore, as to form of protection to the investors, the public interest is not in any way a barrier to convergence to western model of corporate governance. However, the problem is the mechanism to achieve this objective. As discussed earlier, Islamic law puts certain restrictions on the way in which businesses are to be run by the managers. Islam prohibits certain kind of business activities which it considered against the *Shariah*. The basic difference between the Islamic law and western law of capitalism is the way in which business is to be run. As far investor protection through reducing agency cost, minority shareholders protections and enforcement mechanism is concerned both have same objectives. Therefore, convergence in corporate governance to western model is possible subject to the condition that it is not against the fundamental principles of Islam.

As to way the convergence to western model of corporate governance may take place, there are three principles of Islamic law which can facilitate convergence to western model of corporate governance. Firstly, western corporate governance features can be adopted that are not against the *Shariah* under the principle of 'presumption of continuity'. Under this principle, all those features which are not against the *Shariah*, can be adopted under Islamic law even if there is no evidence under the *Shariah*. This will allow adopting any feature even if it is taken from the western system. Secondly, the features that have some kind of defect may be restructured in a way that they are made compatible with Islamic finance. The Islamic method of 'ruses' (*hila*) may help to remove this defect. Under this principle, if there is any defect in any feature which makes it against the *Shariah*, then this can be restructured by removing defect and can be made compatible with *Shariah*. For example, conventional Insurance and Bonds have been reconstructed in a way to made compatible with Islamic law. *Takaful* (Islamic Insurance) and *Sukum* (Islamic bonds) have been developed by the Muslim scholars to provide alternatives to conventional Insurance and Bonds.[66] Thirdly, the features that have minor defects may be adopted under the principle of 'necessity' (*darurah*). Muslim jurists apply these three principles for providing relief to the people when there is no evidence in the primary sources of Islamic law. They used public interest as a basic feature in these principles for

[66] Zafar Iqbal and Mervyn K. Lewis, *An Islamic Perspective on Governance* (Edward Elgar Publishing Limited, Cheltenham 2009) 223-8.

the welfare of society as a whole. Therefore, public interest is not a barrier to convergence to western system of corporate governance rather it will facilitate convergence which might otherwise cause divergence in some cases.

6.7 Precepts of Islamic finance

Islamic finance is based on certain fundamental elements, which are as follows:

6.7.1 Prohibition on *riba* ('interest')

Prohibition on *riba* is a basic precept of Islamic finance. It is the basic principle that differentiates the Western financial system from Islamic finance.[67] *Riba* is considered exploitive in nature and, therefore, causes injustice to one or both the parties.[68]

6.7.2 Avoiding uncertainty (or speculation or chance)[69]

Uncertainty is a wide term which may take different forms such as uncertainty in the contract itself or the subject matter.[70] The objective of this prohibition is fair play, which means all parties to a transaction are well informed before entering into the transaction. In essence, it prohibits conventional insurance, future sales, credit transactions, gambling, and speculative and future trading in the market. However, there are some exceptions to the general rule of prohibition on future trading where the subject matter does not exist or is uncertain, for example, *salam* ('credit sale') and *istisna* ('manufacturing contract') are allowed on the basis of social necessity.[71]

6.7.3 'Profit and loss' sharing or risk sharing

'Profit and loss' sharing is another important aspect of Islamic finance. Islam requires that all parties to a transaction should take part in an activity where the risk is shared. If risk is undertaken by one party, then may it be an injustice to the party who takes the risk.[72]

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[67] Imran Ahsan Khan Nyazee, *Corporations in Islam* (Federal Law House, Rawalpindi 2007) 180.
[68] See text to n 166.
[69] David M. Eisenberg, 'Sources and Principles of Islamic Law' in Craig R. Nethercott and David M. Eisenberg (eds), *Islamic Finance: Law and Practice* (Oxford University Press, Oxford 2012) 45.
[70] Muhammad Tahir Mansuri, *Islamic Law of Contracts and Business Transactions* (3rd edn, *Shariah* Academy IIUI, Islamabad 2005) 95.
[71] Eisenberg (n 69) 48.
[72] See text to n 151, 166.

6.7.4 Asset-backed transactions

Avoiding uncertainty requires that a financial transaction be backed by identified and tangible assets. When financial transactions are backed by assets uncertainty in transactions may be removed and real economic activity may be developed.

6.7.5 Prohibition on certain business activities

Islamic finance is based on ethics. Therefore, it prohibits all business activities that are considered immoral and harmful to society, such as gambling, pornography and alcohol.[73]

6.8 Schools of interpretation in the Muslim world

There are five basic schools of interpretation of legal rules in the Islamic world. They involve different methodologies of interpretation. The basic difference among them is the recognition of sources of Islamic law which affect the rules of interpretation. These schools spread all over the world for local, historical, occupational and political reasons. This gave rise to different faiths, which causes differences among Muslims all over the world and has divided Muslims socially and politically.[74]

6.8.1 Shia School

The Shia school is based on political differences among Muslims. The followers of this school are found in Iraq, Iran, the Gulf States,[75] India and Pakistan.[76] As regards the interpretation of legal rules, they do not consider secondary sources as valid sources of Islamic law.[77]

6.8.2 Hanafi School

The Hanafi School dominates in the Muslim world. The followers of this school comprise almost one third of the total Muslim world. The majority are found in South Asia,

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[73] HM Treasury, *The Development of Islamic Finance in the UK: The Government's Perspective* (HM Treasury, London 2008) 7.
[74] Venardos (n 31) 17.
[75] *Ibid* 18.
[76] The majority of Pakistanis are Hanafi Sunnis but a large minority of Shia live in Pakistan.
[77] Nyazee (n 23) 124.

including Pakistan and India; the Middle East; and Central Asia.[78] Their methodology of interpretation revolves around logic.[79] They prefer analogy over the opinion of companions (*qawl al-sahabi*) as a source of Islamic law.[80]

6.8.3 Maliki School

This school was founded in the city of Medina. The followers of this school are mostly found in Eastern Arabia, and North, Central and West Africa. The distinctive feature of interpretation of this school is that they prefer the practice of the people of Medina (custom found in Medina) over *qiyas* ('analogy'). They also consider *maslahah mursalah* ('extended analogy') and opinions of companions as valid sources of Islamic law.[81]

6.8.4 Shafi School

The founder of this school was a pupil of Imam Malik, a founder of the Maliki School. The followers of this school are considered modernist and have discussed the *Sunnah* more critically than other schools. [82] The reason for such an approach might be to remain within the ambit of the *Qur'ān* as long as possible. They also do not accept *maslahah mursalah* ('extended analogy'), opinion of companions (*qawl al-sahabi*) and *istihsan* ('juristic preference') as valid sources of Islamic law.[83] Followers are mostly found in South East Asia and Saudi Arabia.[84]

6.8.5 Hanbali School

This school is considered traditionalist and has strict views regarding the interpretation of the law. They are mostly found in Saudi Arabia.[85] However, the majority of Saudi Arabians are followers of the Shafi School. The Hanbali School considers analogy (*qiyas*) as a last resort in order to arrive at a conclusion.[86]

[78] *Ibid* 407.
[79] Venardos (n 31) 19.
[80] Nyazee (n 23) 156.
[81] *Ibid* 410.
[82] Venardos (n 31) 19.
[83] Nyazee (n 23) 412-3.
[84] Venardos (n 31) 19; Nyazee (n 23) 414-5.
[85] Venardos (n 31) 19.
[86] Nyazee (n 23) 414-5.

6.9 The nature of Islamic law

Islamic law is developed by jurists and scholars of Islamic law. The role of the state is to enact the laws in the light of jurists' and scholars' interpretation of primary and secondary sources of Islamic law.[87] This is also visible in the context of Pakistan where legislation is subject to scrutiny by the superior courts. As the nature of the Pakistani constitution is Islamic, different bodies have therefore been established to guide the state to check the compatibility of the existing laws as well as new legislation according to the *Shariah*.[88]

Jurists develop Islamic law from its primary sources such as the *Qur'ān and Sunnah.* The *Quean* is unique all over the world. However, it provides only general principles but no detail on each and every matter. The *Sunnah* provides details of the general principles provided in the *Qur'ān*. The problem with the *Sunnah* is its compilation after the death of Prophet Muhammad (peace be upon him). His death led to the creation of many fabricated *Sunnah*s. Early jurists tried to compile the *Sunnah* but ambiguity remained with regard to its authenticity. Therefore, each *Sunnah* has force according to its authenticity.

Political and social factors also divided Muslims soon after the death of the Prophet, which led to the establishment of different schools of interpretation.[89] Different schools were established in different parts of the world at different points in time and have different interpretational rules for deriving Islamic law. As far as acceptance of primary sources of Islamic law is concerned, there is no difference of opinion but for secondary sources there is difference of opinion among the different schools. Acceptance of one source by one school may be rejected by another. Another problem area is giving importance to one source of Islamic law over another. This may lead to differences of opinion in developing Islamic law in general and acceptance of features of Islamic finance in particular. Therefore, divergence may be visible in the existing scenario in the Muslim world.

Some modern jurists have introduced different methodologies to establish consensus among the Muslim world. These methodologies include 'choice and selection' (*iktiyar* and *takhayyur*), 'amalgamation or patching' (*talfiq*), 'necessity' (*darurah*) and 'ruses' (*hila*).[90]

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[87] Ahmed (n 18) 370.
[88] See text to n 9-17.
[89] Baderin (n 22) 188.
[90] Ahmed (n 18) 383-4; Vogel and Hayes (n 20) 42-52.

In the ‘choice and selection’ methodology, a contemporary jurist of one school may refer suitable evidence from another school to arrive at some conclusion. In the ‘amalgamation or patching’ methodology, a jurist may combine different rulings from other schools to arrive at a conclusion. ‘Necessity’ is an important principle of Islamic law which allows otherwise prohibited acts in cases of dire need; for instance, pork and wine are strictly prohibited in Islam but when it is a question of saving a Muslim’s life, then they are allowed to the extent of saving the life only. So, in a similar fashion, ‘necessity’ can also be used in financial matters to allow disapproved acts in cases of dire need; for example, debt may be allowed but in dire need only. ‘Ruses’ is a methodology in which any transaction, which is otherwise prohibited, may be constructed in such a manner so as to avoid prohibition;[91] for example, modern jurists have constructed Islamic insurance.

Istishab or *ibahah* (‘presumption of continuity’) is an important source of Islamic law which may be used to legitimize Western laws transmitted to colonial nations such as Pakistan. The spirit of this principle is that every contract, rule or feature of corporate governance will be considered permissible by default and only explicit prohibition from the *Shariah* will make it void.[92] Nyazee argues that ‘*the principle of Istishab requires that the continuance of a rule is conditional upon the fact that it was originally established by the evidence from the Shariah*’[93] He further argues that an existing law should not be allowed merely on the presumption that it is not against the *Shariah*. This is a very strict approach and may create problems in developing corporate governance. The very spirit of Islamic law is to check conformity with the injunctions of Islam. Habib also acknowledged this fact.[94] Therefore, there seems no reason to accept Western legal rules if they are not against the injunctions of Islam. A strict approach followed by classical and some modern jurists may cause divergence even within the Muslim world.

6.10 *Shariah*-compliant products

Jurists involved in Islamic finance have developed different modes of financing keeping in mind the basic ingredients of Islamic law. Here the discussion is limited to those forms that are directly related to corporate governance.

[91] *Ibid* 384.
[92] *Ibid* 380.
[93] Nyazee (n 23) 153.
[94] Ahmed (n 18) 380.

6.10.1 *Musharakah* ('Partnership')

The word *musharakah* is derived from the Arabic word *shirkah* which means 'sharing'[95] or 'becoming partners'.[96] This may be used as an ideal alternative to interest-bearing debt financing.[97] However, there is disagreement between classical jurists regarding the correct definition of the term *musharakah*. In simple terms, *musharakah* is like a kind of partnership in the Western system of finance.[98] It may also be termed a company subject to the condition that Islamic law recognizes its fictitious legal personality and limited liability, which are main features of the modern form of a company.[99]

The *musharakah* comes into existence by mutual contract between all parties involved. The objective is to conduct business where the parties have certain rights and liabilities.[100] As far as the rights and liabilities of the parties are concerned, there is disagreement between classical jurists. The Maliki and Shafi schools consider the distribution of profit strictly according to the ratio of investment made by the parties. The Hanbali School prefers contractual agreement between parties for the distribution of profit. The Hanafi is school has an intermediate view that relies on the role of the partners in the business.[101] The Maliki and Shafi view does not seem appropriate as this practice may discourage entrepreneurs in business activities who are more active and contribute more in the business by way of their skills, efforts, knowledge and experience. This contractual agreement may be a useful methodology as it may encourage partners with expertise and skills to run the business. Partners who are more active and contribute more in the form of skills, efforts, experience and knowledge may be allocated a higher percentage of the profits compared to those who are not active and skilful.

However, there is no disagreement with regard to sharing in business losses. According to them, every partner will share in a loss strictly according to his or her investment.[102] This view needs some consideration by modern jurists. A point to be considered is that if profit can be contractual, then why not the loss? If some partners get more shares from profit

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[95] Mufti Muhammad Taqi Usmani, *An Introduction to Islamic Finance* (*Maktaba Ma'Ariful Qur'an*, Karachi 2004) 33.
[96] Muhammad Imran Ashraf Usmani, *Meezan Bank's Guide to Islamic Banking* (*Darul-Ishaat*, Karachi 2002) 81.
[97] *Ibid*.
[98] Mansuri (n 70) 241-2.
[99] The concept of company under Islamic law has been discussed separately.
[100] Vogel and Hayes (n 20) 195.
[101] Usmani (n 95) 35-7.
[102] *Ibid* 37.

because they are more active and take business decisions, they should also take more responsibility for losses. The sharing of profit and loss on equal footing may be more helpful for business development.

As far as the nature of capital is concerned, again there is disagreement between classical Muslim jurists. Some favour money and exclude commodities as capital. However, others favour any kind of capital, including exclusively money or commodities or a mixture of both.[103] In modern business forms there seems no reason to exclude commodities as an alternative to capital because it is much easier now to evaluate the market price of any commodity.

As far as the management in *musharakah* is concerned, a general rule of Islamic finance developed by the jurists is that the management in *musharakah* will be shared by all the partners. However, one or more partners may be sleeping partners, in which case their share in profit will not exceed the ratio of their investment.[104]

The termination of *musharakah* may be in the same way in which the modern form of partnership is terminated. As far as the question of the continuity of *musharakah* is concerned, there is no guideline in classical Islamic jurisprudence on excluding those partners who are not willing to carry on the business and want to withdraw their investment. However, modern scholars are of the view that since huge business investment normally calls for continuity of business, this can be done on the basis of the nature of the business conducted in modern times. So, if any partner is not willing to carry on the business, his or her investment and share of profit, if any, accrued until his disinvestment may be returned.[105] This supports the idea of establishing a modern form of a company that can handle huge investment with multiple forms of investments and frequent transfer of investment without liquidating the company.

6.10.2 *Mudarabah* ('Partnership')

Mudarabah is another form of doing business in Islamic finance. In *mudarabah* the capital is invested by one party while the business is conducted by another party. The first party only contributes capital and does not participate in the management, whereas the second

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[103] *Ibid* 38.
[104] Ashraf Usmani (n 96) 86.
[105] Usmani (n 95) 35-44.

party does not invest in, but carries on, the business. The first party is called *rabb ul-mal* ('investor'), whereas the second party is called *mudarib* ('the manager').[106] The ratio of profit is determined in advance by the mutual consent of the parties. Islamic law does not prescribe any fixed profit.[107] If both parties invest money, this will not be a *mudarabah* business it will amount to a *musharakah* business. In a *mudarabah* business, loss of the investor is monitory, whereas the manager loses potential benefits that he or she might have obtained had the business earned profit. The loss of the manager is, therefore, in terms of his or her loss in efforts and skills. The liability of the investor is limited to the extent of his or her share in the business.[108] Therefore, a *mudarabah* business is like a modern form of partnership with limited liability where an investor is a sleeping partner. The only difference between it and a modern form of partnership is that the manager is not an investor. Even in modern forms of partnership, the law of partnership does not prohibit some of the partners from investing. Such partners may contribute their skills, expertise and knowledge, and thereby share in the profit. The only problem will be in sharing in losses. However, this can be resolved through contractual arrangement. Mansoori writes that *mudarabah* may also be equated with the Western form of a company as under Islamic law there is no difference between a partnership and a company.[109] However, again, the question is acceptance of the separate legal personality and limited liability in Islamic law which are the main ingredients of the company under the Western form of a company.

As a general rule, the liability of the investor is limited to the extent of his or her share in the business but if he or she had allowed the manager to incur debts on his or her behalf, then his or her liability will be unlimited. The manager is also supposed to work with the due care and diligence that is normally required for that kind of business. If, however, he or she fails to exercise due care and diligence, then he or she is accountable for his or her misconduct.[110]

It is possible to combine both *mudarabah* and *musharakah* business in one contract. In this scheme, some parties only invest money without the right to take part in management, and some investors and non-investors are involved in the management. In this case a

[106] Ashraf Usmani (n 96) 98.
[107] Usmani (n 95) 50.
[108] Ashraf Usmani (n 96) 100.
[109] Mansuri (n 70) 278.
[110] Usmani (n 95) 43-5.

business will be run as a combination of both *mudarabah* and *musharakah*.[111] This is like a modern, complex form of a company where some investors and some non-investors run the company, whereas others are only investors without taking active part in the management.

6.10.3 *Salam* ('Advance payment')

Islamic law prohibits selling something that does not exist or is possessed by someone or whose delivery is uncertain. This rule is based on the *Sunnah* of Prophet Muhammad (peace be upon him) which says, '*do not sell which you do not possess*'. However, a *salam* contract is an exception to the general principle of Islamic law. This is allowed bearing in mind the social needs of farmers and traders but with certain conditions. In a *salam* contract the seller agrees to sell specified goods to a buyer. The payment must be made in advance in full and on the spot, whereas delivery of the commodity is deferred. To avoid conflict, a *salam* contract is allowed only in those commodities whose quality, quantity and identity can be determined or whose supply is certain. The objective is to avoid uncertainty and conflicts, for example, a *salam* contract can be entered into for the sale of wheat, flour or rice. To some jurists, domestic animals can also be the subject of such a contract provided it is determined by specification and identification. As far as the presence of the commodity is concerned, it must be in existence both at the time of the contract and at the time of delivery. However, some jurists follow a liberal interpretation and say that a commodity that is habitually available at the time of delivery may be a valid subject of a contract.[112] The *Shariah* also prohibits concluding a *salam* contract involving those commodities that it requires to be delivered on the spot, for example, the exchange of currencies.[113] For the exchange of currencies, there is a separate contract of sale regulated by Islamic law as discussed below.

6.10.4 *Sarf* ('Money exchange')

Under Islamic law money can be used as a medium of exchange and measure of value only. It cannot be used as a commodity for business purposes. Money exchange is allowed

[111] *Ibid* 53.
[112] Mansuri (n 70) 203-7.
[113] Usmani (n 95) 185-8.

only with certain conditions to avoid an element of *riba*.[114] As a general rule, money cannot be sold for money but, as an exception, money exchange is allowed under certain conditions. This is like the conventional exchange of money with one basic difference which is the prohibition on an element of *riba*. The exchange of money under Islamic law has to follow two basic conditions prescribed by the *Shariah*. First, if both currencies are the same, then they must be exchanged in equal quantity and on spot. If there is either inequality or delay from one side, it will amount to *riba*, which is not allowed. Second, if the currencies are different, then equality is not required but a spot transaction is necessary. Delay from any side will attract prohibited *riba* which is also not allowed.[115]

6.10.5 *Sukuk* ('Islamic or revenue bonds')

Sukuk or Islamic bonds are new products in Islamic finance. This product seems to have been introduced to provide an alternative to bonds issued by conventional finance. 'Sukuk *are the certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity*'.[116] Bondholders are entitled to claim financial rights attached to these bonds. In conventional finance the bonds are issued representing debt certificates which mature after a certain period, with interest. *Sukuk*, however, are not debt instruments. They are a kind of equity investment. The objective is to avoid the prohibition imposed by the *Shariah* regarding interest. These bonds resemble *mudarabah* business but this is a special kind of *mudarabah* investment in which an existing company raises funds for an economic activity other than its normal running business, for instance, to build a bridge, tunnel or tool plaza or even to invest in securities. Investors (*rabb-ul-mal*) purchase bonds and the company acts as the manager (*mudarib*). After completion of the project, the profit is shared according to the predetermined ratio. It is also sometimes provided in the contract, though non-bindingly, that these bonds may be retired in future before the maturity date at the market price but payment may be made periodically out of the profits of the manager (*mudarib*) in stages.[117]

[114] 'The Text of the Historic Judgement on Interest given by the Supreme Court of Pakistan written by Justice Muhammad Taqi Usmani' at para 138 available at <http://www.albalagh.net/Islamic_economics/riba_judgement.pdf> accessed 05.11.2013.
[115] Mansuri (n 70) 199.
[116] Bilal Rasul, 'Lessons from Pakistan's Model' in Angelo M. Venardos (eds), *Current Issues in Islamic Banking and Finance* (World Scientific Publishing Co. Pte. Ltd., Singapore 2010) 177.
[117] Vogel and Hayes (n 20) 169.

6.10.6 *Takaful* ('Islamic insurance')

Insurance is also a new industry in Islamic finance. It is the fastest-growing sector of the global insurance market. Insurance is an alternative to conventional finance and is based on the *Shariah* concept of 'mutuality and co-operation'.[118] This concept in Islamic law is different from conventional finance for two reasons. First, in conventional finance uncertainty is inherent in the insurance contract, which is strictly prohibited in Islamic law. Second, insurance companies employ funds in interest-bearing investments, which is also not allowed under Islamic law.

Muslim jurists disagree on whether or not insurance is permitted under Islamic law. Some jurists allow this contract for two reasons. First, they state that insurance can be allowed provided it is not composed of a bilateral agreement as this will contain excessive amounts of uncertainty. To avoid this uncertainty, an insurance company can be a multilateral institution in which all members contribute funds in the form of instalments. This charitable collective enterprise helps those who form part of it in case of any casualty or loss to any member. This help will be considered a gift from fellow members. However, uncertainty will remain even in a collective enterprise but it can be tolerated on the basis of gratuitous acts over uncertainty. Second, the funds should be invested only in an Islamic way of financing.[119] This contract is gaining acceptance among jurists, therefore, Islamic financial institutions employ *takaful* contracts in their operations.[120] However, there is still a need for further research and consensus on its operations under Islamic law.

6.11 The concept of a company under Islamic law

Musharakah and *mudarabah* under Islamic law resembles a partnership in conventional finance. However, *musharakah* and *mudarabah* can be equated with the Western form of a company, provided all basic characteristics of a company are also acceptable under Islamic law. The acceptance of the concept of a company under Islamic law is significant because it may resolve many problems involving finance under Islamic law.

Kraakman *et al*. describe five basic characteristics of a company: (1) legal personality, (2) limited liability, (3) transferable shares, (4) centralized management under a board

[118] Peter Hodgins and Caroline Jaffer, 'Takaful' in Craig R. Nethercott and David M. Eisenberg (eds), *Islamic Finance: Law and Practice* (Oxford University Press, Oxford 2012) 272.
[119] Venardos (n 31) 62.
[120] Vogel and Hayes (n 20) 150-4.

structure and (5) investor ownership.[121] These features can be tested with Islamic forms of business organizations.

6.11.1 Legal personality

Legal personality means the existence of an entity that is separate from its members. It can sue and be sued in a court of law. It can own and transfer property in its own name. It can delegate powers to agents and can also enter into contracts in its own name. Though all these functions are performed by the directors on behalf of the company, the company is liable for these acts unless directors act beyond their powers. This legal personality concept is, in fact, entity shielding, which means that it protects the assets of the company from the creditors of the owners.[122] According to classical jurists of Islamic law, there is no concept of a fictitious legal entity. Under Islamic law, the objective of any legal person is to perform duties as well as to worship. Since a fictitious legal entity cannot worship, these jurists did not recognize this entity under Islamic law.[123] Usmani believes that the concept of a fictitious legal personality, as is understood in the West, was not known to classical jurists. Though they did not discuss it, they were aware of the concept. He writes that the classical jurists considered and treated *waqf* ('trust'), *bait-al-mall* ('exchequer of the Islamic state) and the joint stock of different investors as separate entities.[124] Therefore, a fictitious personality concept in the form of a company is not against Islamic law. This can also be rationalized under the Islamic principle of *ibahah* ('presumption of continuity'). Under this principle, as the concept of creating a legal entity is not against the *Shariah*, it may be allowed under Islamic law.[125] Nyazee considers that the only reason for creating a corporation under the Islamic concept may be to provide a social device for the growth of the wealth of the Muslim community as a whole.[126] This may be one ground for creating a company but this is a very restricted approach. The objective of the *Shariah* is not just the growth of wealth. Had the growth of wealth been the basic objective of the *Shariah*, then other sources of creating money, such as interest and debt, might also have been allowed under Islamic law. There may be more appropriate grounds to create a company under Islamic law, other than the growth of the Muslim community's wealth.

[121] R. Kraakman *et al.*, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2nd edn, Oxford University Press, Oxford 2009) 5.
[122] *Ibid* 9-10.
[123] Nyazee (n 23) 102.
[124] Usmani (n 95) 223-8.
[125] Ahmed (n 18) 392.
[126] Nyazee (n 67) 226.

The principle of *darrurah* ('necessity'), such as modern business requirements, the welfare of society, the continuity of big business enterprises, economic growth and the principle of *ibahah* ('presumption of continuity') are more appropriate grounds for creating a company under Islamic law.

6.11.2 Limited liability

Limited liability is an important characteristic of the modern form of a company. Under this concept, the liability of the equity holders is limited to their investment in the company or guarantee given by them to contribute towards the assets of the company at the time of winding up. This is, in fact, owner shielding which protects the assets of the shareholders from the creditors of the company.[127] Acceptance of the limited liability of a fictitious legal personality is important under Islamic law. Usmani writes that the classical jurists were aware of the limited liability but this concept was not associated with a fictitious person. As far as limited liability of a natural person is concerned, Usmani gives the example of a deceased natural person who dies indebted. In this case the creditors of the deceased cannot claim from the family of the deceased more than what was left by the deceased. The creditor can claim only what is left by the deceased. This shows acceptance of the concept of personal liability of a natural person by Islamic law. On the same grounds, this concept can be extended to an artificial legal person.[128]

Modern jurists consider limited liability according to the *Shariah* using the same reasoning as for accepting the concept of a corporation. Therefore, it may be allowed keeping in mind the needs of modern financing. The separation of ownership and management necessitates limited liability of the investors. The liability created by the management, more than what has been invested, may restrict the public from making an equity investment in corporations. Furthermore, the involvement of the general public and freely transferable shares are other reasons for the introduction of limited liability. If Islamic law does not allow limited liability, then big projects that require large-scale public investment may not be feasible. However, as far as creditors' rights are concerned, Usmani writes that this concept needs more *ijtihad* in view of the potential dangers for the creditors.[129] This concern about creditors' interest may not be as strong as it appears. Modern finance, as well as Islamic finance, provides more security to the creditors than

[127] Kraakman *et al*. (n 121) 9-10.
[128] Usmani (n 95) 221-4.
[129] *Ibid* 222.

the shareholders. Islamic law will give the creditors priority over the owners in cases of liquidation of companies. This premise is based on the priority rights of the creditors of the deceased natural person over the heirs in the inheritance at the death of the debtor. Another important point in this regard is that Islamic law allows creditors to take collateral from debtors. Therefore, limited liability cannot be a potential threat to the creditors as far as their security is concerned. Vogel acknowledges this concept of limited liability under Islamic law by providing a solution to the problem. He writes that Islamic finance may limit the ratio of debts to the equity of the company and may also allow vigorous piercing of the corporate veil in cases of excess loans taken by the managers.[130]

There is also disagreement on the extent of the application of limited liability of companies under Islamic finance. Usmani considers that as limited liability is injurious to creditors, it should be allowed only in public companies. He asserts that the public cannot be held responsible for the day-to-day affairs conducted by the management. He further suggests that this should not be allowed in private companies and partnerships. According to him, an exception can be extended to those shareholders or partners who are not involved in the management of companies or partnerships respectively. The rest of the members will be responsible for unlimited liability. He further explains that the objective to restrict limited liability to public companies and sleeping partners is to avoid the cheating of investors and creditors.[131] There does not seem to be any cheating if all the stakeholders, including the creditors, are aware of the fact that the liability of the company is limited. They should also be vigilant about the financial position of the company while advancing loans or credit to a company. Similarly, allowing limited liability only to large public companies vis-à-vis the interests of the creditors is not justifiable as this interest may be more exposed in big public companies than in small companies. Large companies have huge capital investments, and large numbers of shareholders and creditors. This situation may be more dangerous than in small companies where assets and liabilities can be determined more easily than in large public companies. So, public interest and welfare necessitate extending limited liability to small companies and partnerships as well. This concept may not be against the principles of the *Shariah* and may be allowed keeping in mind the welfare of the nation and the principle of *ibahah*. Nyazee also favours extending

[130] Vogel and Hayes (n 20) 169.
[131] Mufti Muhammad Taqi Usmani, 'The Principle of Limited Liability from Shariah Viewpoint' (1992) online, published by New Horizon available at <http://www.newhorizon-islamicbanking.com/index.cfm?section=features&action=view&id=11312> Accessed 05.11.2013.

the concept of limited liability to all forms of business enterprises. [132] He writes that if the concept is beneficial to large-scale investors, then it should be beneficial to sole proprietors, partnerships and companies, including both private and public companies. This will allow small investors an opportunity to do business that includes the benefit of limited liability.

6.11.3 Transferable shares

A transferable share is also a basic characteristic of the modern form of business corporation that distinguishes a company from partnerships and other forms of enterprises. It means an interest in a company is fully transferable without interruption in the business. However, some restrictions may be imposed in private companies, where the transfer of interest remains within the limited group of persons or subject to approval of the board of directors.[133] This concept can also function in Islamic finance if interests in enterprises are securitized. Islamic finance does not prohibit converting interests in business organizations such as *musharakah* and *mudarabah* into small units that represent the ratio of investment in the business.[134] As *musharakah* is a kind of investment where investors may have limited liability and the right of participation in the management, shares in *musharakah* will represent shares with voting rights. Voting rights provide the right to participate in the affairs of the company which is a basic requirement for a *musharakah* form of business. However, securitization in *mudarabah* would be like the shares of a company with limited liability without voting rights. As the nature of *mudarabah* business is such that investors do not have the right to participate in the management, therefore, shares in *mudarabah* will be without voting rights. The rights of management remain with the manager who does not invest. A combination of *musharakah* and *mudarabah* is allowed under Islamic law; a company may issue some shares with voting rights and some shares without voting rights. Therefore, according to Islamic law, there is no harm in securitizing investments in *musharakah* and *mudarabah* or a combination of both into shares that are tradable in the secondary market. The general public can invest through the purchase of shares on the stock market and may get profit and can take part in the decision-making by the right of vote attached to these shares. They can also sell their shares once they want to disinvest from the company. The seller may incur a capital gain or capital loss depending upon the performance of the company. In an ideal market the

[132] Nyazee (n 53) 226.
[133] Kraakman *et al*. (n 121) 11.
[134] Usmani (n 95) 58-61.

price of a share is directly connected to the real value that represents the assets of the company. If the company is earning profit, then this may increase the assets of the company and the share price. However, if it is not performing, then the value of assets may decrease and, consequently, the price of the shares may also decrease. Investors may get profit either in the form of a dividend or capital gain and may also share loss in the form of capital decrease. This will fulfil the *Shariah* requirement of sharing in profits and losses. The market and good governance mechanism will play a major role in this process.

The issuance of preference shares under Islamic law is debatable. Nyazee asserts that the issuance of preference shares is not against Islamic law. He explains that if the preference shareholders are contracted to a 12% dividend and the board decides on a 15% dividend for ordinary shareholders, then the extra 3% can be retained to provide a cushion for payment of dividends to preference shareholders for the next years.[135] This interpretation clearly shows a misunderstanding of the nature of preference shares in the modern form of a company. This presumption does not seem to fulfil the requirements of Islamic law due to the nature of preference shares. Preference shares are normally of four categories. The first category is preference in the profit of the company over ordinary shareholders by inserting a condition in the contract that the preference shareholders will be paid a dividend at a fixed rate. The second category is where preference shareholders may have enhanced voting rights over ordinary shares. The third category is where preference shareholders enjoy preference in the capital return at the time of winding up or reduction of share capital.[136] In the fourth category the nature of some preference shares may also contain a condition that if the profit is not paid out in one particular year, but that the same amount will be accumulated for the next year and so on unless fully paid. These are called *accumulative preference shares*. The question here is whether Islamic law allows fixed return. As far as the fixing of the ratio of profit of any business is concerned, there seems to be no prohibition, for example, suppose A and B start a business with £10,000 and £20,000 respectively and agree on 30:70 profit ratios. A may be a sleeping partner and B an active partner to carry on the business. This may not be problematic for Islamic law as profit ratio is quite legal in Islamic law. However, if the parties stipulate that A will get 30% of his investment, A's investment will amount to a debt to B at 30% interest. In preference shares the stipulation of a condition that the parties will get a fixed rate of

[135] Imran Ahsan Khan Nyazee, *Islamic Law of Business Organisation: Corporations (Islamic Law and Jurisprudence 2* (The International Institute of Islamic Thoughts and Islamic Research Institute, Islamabad 1998) 181-2.
[136] Murray A. Pickering, 'The Problems of the Preference Share' (1963) 26 (5) *The Modern Law Review* 499.

return that is directly related to the ratio of their investment and not to the ratio of profit, amounts to a kind of debt. However, if a condition in the contract stipulates that the preference shareholder will get 30% of the profit of the business, this may be a valid condition. No doubt, a declaration of a dividend is related to the realization of profit but fixing of a profit ratio to the parties' investment is like a debt to the company with interest. Sometimes a company may yield such an amount of profit that could only satisfy the claims of the preference shareholders and the ordinary shareholders get nothing. If a dividend paid to preference shareholders is fixed to some ratio to profit earned by the company, it may be an Islamic mode of financing. As regards the second type of preference shares, namely of giving enhanced voting rights, as discussed earlier, there seems to be no problem under Islamic law. The third kind of preference share, namely of giving preference over capital return vis-à-vis ordinary shareholders at the time of the reduction of capital or winding up resembles preference shares with debt security. This kind of investment through preference shares is a kind of debt to the company. The fourth category of preference shares, namely accumulating profit for subsequent years in cases where company fails to pay dividend resembles preference shares with debt security. Therefore, the issuance of preference shares may not be in accordance with the Islamic mode of financing.

The problem with preference shares is the nature of preference shares themselves. The rights attached to preference shares are based on the contract, regulations of the company and court decisions in common law jurisdictions. Most of the problems of preference shares stem from the absence of clear provisions as regards the rights attached to these shares. No doubt, preference shareholders have certain advantages over ordinary shareholders but it is quite possible that they are at a disadvantage in certain cases. For instance, preference shareholders may be at a disadvantage as compared to ordinary shareholders in cases of surplus profit at the time of winding up or the declaration of more profit to ordinary shareholders than fixed profit paid to preference shareholders. Preference shareholders are also normally at a disadvantage in relation to other debt security holders in the absence of express provisions to the contrary. Debenture holders, for instance, normally have charge over the assets of the company and also priority of capital return at the time of winding up. Therefore, debenture holders have an advantage over preference shareholders. These abnormalities can be resolved only by equating preference shareholders with debenture holders or fixed income securities. The other option may be to clearly define the rights attached to these shares as preferred in respect of dividends or participating shares in respect of voting rights.[137] These problems may limit external finance through preference shares. However, this may be resolved by constructing preference shares in a way that can attract external finance.

Preference shares can also be constructed in Islamic finance within the limits prescribed by the *Shariah.* The *Shariah* does not prohibit variation in the percentage of a share in profit. This could be any proportion of profit, irrespective of the share in the investment, as long as the contract is drafted in accordance with requirements of *Shariah*. One option may be that the preference shareholders are given a higher rate of profit than the ordinary shareholders, for instance, this could be provided in the terms of the preference shares, namely that the holders of these shares will be given 10% more profit than ordinary shareholders. Furthermore, for instance, whenever ordinary shareholders are paid a profit at a rate of 20%, the preference shareholders will get 30% shares in dividends. Another option may be that the terms of the preference shares may be constructed in this way that if preference shareholders and ordinary shareholders have 10: 90 ratios in equity, then the share in profit may be fixed at 20% for preference shareholders and 80% for ordinary shareholders. This will not violate the conditions of the *Shariah*.

However, as the condition of giving preference shareholders priority in liquidation violates a *Shariah* requirement, the preference shareholders must share in the loss of the company according to their investment or contractual rights and duties (if allowed under Islamic law). Preferences shares may, therefore, be issued under Islamic finance provided the above conditions are met. Vogel acknowledges that preference shares that are issued in terms of conventional finance are against Islamic norms. He suggests that preference shareholders may be given more dividend rights as compared to ordinary shareholders subject to their sacrificing rights in the management. According to him, the preference shares can be issued with enhanced dividend rights but without voting rights attached to them.[138] However, there seems no reason to object to the issuance of preference shares that have voting rights with enhanced dividend rights.

As to trading in shares under Islamic finance, there does not seem to be a prohibition under Islamic law. However, this is permissible under certain conditions. Some jurists put

[137] *Ibid* 515-9.
[138] Vogel and Hayes (n 20) 196-7.

a condition on the trading of shares of a company to the general public.[139] They argue that the shares of a public company can be traded among the general public. However, it is necessary that the company owns some non-liquid assets before starting to trade the shares in the market. The OIC Academy has also approved the trading of shares for those companies in which the value of real assets is greater than cash and debts. The reason is that if all the assets of the company are in liquid form, then shares will represent money and, according to Islamic law, money cannot be traded for money except when it is exchanged in equal amount and on the spot.[140] This condition may not be a problem under Islamic law as provision may be made in company law for the shares of the company to be transferable when some of its assets are in non-liquid form.

6.11.4 Delegated management with board structure

In the modern form of corporations, as it is not feasible to invite all the members to make day-to-day business decisions, the power of making decisions is delegated to the board of directors, who are elected periodically, exclusively or primarily by the shareholders.[141] There appears to be no reason why this cannot be done under Islamic finance. Islamic law allows the delegation of management to certain persons nominated by the owners; for example, *mudarabah* allows managers to carry on with the business excluding the investors. Similarly, under *musharakah* business, there may be sleeping partners who are not involved in the business affairs. So, a board structure with delegated management is very much Islamic.

6.11.5 Investor ownership

Investor ownership under conventional finance has two aspects: (1) the right to participate in the management and (2) the right to participate in the net earnings of the corporation. The right to participate in the management means the right to contest the election of a director, the right to exercise voting powers to elect the board of directors and the right to participate in major decisions of the company. The right to participate in the net earnings in the corporation means to share in the profit and claim residual earnings.[142] Both these

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[139] Ashraf Usmani (n 96) 189-190.
[140] Decision 5 (d4/08/88), Fourth Session (1988), *Fiqh Academy Journal* 3:2161, 2163 referred to by Vogel and Hayes (n 20) 173; Brian Kettell, *Introduction to Islamic Banking & Finance* (Brian Kettell, Islamic Banking Training, London 2008) 183.
[141] Kraakman *et al*. (n 121) 13.
[142] *Ibid* 14-5.

rights have exceptions as well, for instance, the right to participate in the management may be restricted when the company issues shares without voting rights. Similarly, the right to participate in the profit may be restricted when the company is formed to carry on a charity or co-operative objects. As discussed earlier, investor ownership is a basic characteristic of business corporations under Islamic law. Therefore, Islamic law does not prohibit the investor ownership requirement of the modern form of a company.

Therefore, the formation of the modern form of a company is not prohibited under Islamic law. However, there may be some restrictions on the activities of the company under Islamic law.

6.12 Functioning of a company under Islamic law

As discussed earlier, the modern form of a company can conduct business with the Islamic mode of financing and its shares can be traded in the market. However, a major difference between the conventional form of a company and Islamic finance is the restriction of the activities under Islamic law. Islamic law does not allow certain kinds of activities that are otherwise allowed under the Western model. These activities include, but are not limited to, businesses involving the production of alcohol, opium and pork; gambling; pornography; and other immoral businesses. Some other business activities, such as interests, uncertainty and future trading in shares, are also not allowed under Islamic finance.

In a system that is not pure Islamic or where two parallel systems are operating, it will hardly be possible for a company, operating under Islamic finance, to keep out of interest-bearing transactions because the company has to deal with financial institutions, banks and other companies involved in interests-bearing transactions. Therefore, companies that operate under Islamic finance may involve some kind of activities based on interest-bearing transactions. Therefore, a part of the profit of the company may also represent interest-baring profit which, under the strict prohibition on interest under Islamic finance, is not allowed. Usmani has proposed a way out to avoid such interest-bearing profit.[143] He writes that suppose a company has declared a dividend but the company has accrued most of its profit through *Shariah*-compliant businesses but some of its profit is earned through

[143] Usmani (n 95) 208.

interest-bearing transaction. The shareholders must segregate such proportion of the dividend that is earned by the company through the interest-bearing transaction. To avoid interest, the amount of profit that represents interest must be given to a charity. This will purify the profit from the interest. However, as regards purification of the capital gain, there is divergence of opinion. Some jurists consider that a portion of the capital gain should also be given to charity as a portion of the company's assets may represent assets obtained through interest-bearing transaction. However, other jurists are of the view that there is no need to purify capital gain as the majority of the assets of the company are composed of legitimate business and only a negligible portion is composed of interest-bearing profit.[144] If this plea is good for the capital gain, then the same may also be applied to the dividend. However, implementing pure faith requires avoiding such kinds of earnings. Therefore, corporate governance requires from the firms operating under Islamic finance to disclose separately the amount and percentage of profit earned through interest-bearing transactions.

Islamic financial institutions use *musharakah* and *mudarabah* as modes of financing which are alternatives to interest-based financing. Islamic financial institutions establish *Shariah* boards to guide them to check whether a particular mode of financing is according to the *Shariah*. The *Sharaih* boards consist of Muslim scholars who synchronized Western forms of financing and the Islamic mode of financing. However, the problem is that there are differences of opinion in their own ranks regarding compliance with these modern modes of financing according to the *Shariah*. The reason is that they belong to different schools of interpretation, which results in the differences of opinion. Members of *Shariah* boards never make uniform or absolute decisions as they sometimes take back their earlier decisions.[145] This causes divergence in Islamic finance within the Muslim world.

As the creation of a company is a relatively new concept in Islamic finance, there is a scarcity of investor protection mechanisms. The kind of protection available to investors that is commensurate with Western forms of rights and protection can encourage an Islamic mode of financing. The Islamic method of interpretation of *ijtihad* can help to provide investors with such protection.[146] The reason for the absence of such investor

[144] Mufti Muhammad Taqi Usmani, 'Principles of *Shariah* Governing Islamic Investment Fund' an online article available at < http://www.albalagh.net/Islamic_economics/finance.shtml> Accessed 05.11.2013.
[145] Vogel and Hayes (n 20) 9-10.
[146] Ahmed (n 18) 391-2.

protection is that Islamic finance has shown its presence quite recently. Most of the Islamic law developed in the early periods of Islam when the modern techniques of financing were not developed. Therefore, classical jurists were not aware of the contemporary techniques of financing which developed during the previous century. The other reason is that Muslim countries remained under the influence of Western powers due to colonization. These countries adopted the Western model of legal, regulatory, financial and governance mechanisms after independence. This might be the main reason for the stagnancy of Islamic finance in the Muslim world in general and Pakistan in particular. However, during the past century the situation was changing. The financial crisis all over the world during the last part of the previous century stimulated the introduction of an alternative model of financing. Islamic finance, which was not practised in modern times, is considered to have the potential to show its presence and to solve problems. Research has also been carried out in the West regarding the scope and potential of Islamic finance. In recent times modern jurists have been giving due attention to Islamic modes of financing.

6.13 Definition of *riba* ('interest')

The literal meaning of the term *riba* is 'excess'.[147] However, it is difficult to define the term in its technical meaning. This difficulty lies in the history of Islamic law and the same is still prominent among Muslim jurists.[148] *Riba* is considered analogous to the modern concept of interest but, technically, it has wider implications.[149] It signifies excess not only in loan and debt transactions, but also in that found in barter trades. The rules of *riba* have been derived from the *Qur'ān* and *Sunnah*. In this context it can be divided into two kinds.

6.13.1 *Riba al-Qur'ān* (*riba al-nasiah* or *riba* by delay)

Nasiah literally means 'delay'. This is found in transactions of loans with interest. A creditor charges extra money for delay in the repayment of a loan.[150] This definition is very similar to the modern concept of interest. There are many verses in the *Qur'ān* that talk about *riba* but here only two are referred to:

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[147] Nyazee (n 67) 181.
[148] Eisenberg (n 69) 41.
[149] Ahmed (n 18) 377.
[150] Nyazee (n 67) 181.

The *Qur'ān* says:

> '*O those who believe do not eat up* riba *doubled and redoubled*'[151]

> '*Those who take interest will not stand but as stands whom the demon has driven crazy by his touch. That is because they have said: trading is like* riba. *And Allah has permitted trading and prohibited* riba . . . *Allah destroys* riba *and nourishes charities* . . . *O those who believe, fear Allah and give up what still remains of the* riba *if you are believers. But if you do not, then listen to the declaration of war from Allah and His Messenger. And if you repent, yours is your principal. Neither you wrong, nor be wronged*'[152]

These verses only talk about exorbitant doubling of money and differentiate between charity and *riba,*[153] sale and *riba*, and declare charging *riba* as the worst kinds of acts. The *Qur'ān* did not explain *riba* in its technical sense as the *Qur'ān* provides only general principles. Another reason may be that this kind of *riba* was very much in practice in Arabs in those days.[154] The *Sunnah* explains *riba* in more detail.

6.13.2 *Riba al-Sunnah* (or *riba al-fadl*)

The rules have been drawn from the famous tradition of Prophet Muhammad (peace be upon him):

> [*G*]*old for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, like for like, same for same, hand to hand. But if these commodities differ, then sell as you like, as long as it is hand to hand.*

Muslim jurists have derived the following rules from tradition:[155]

Firstly, if commodities are of the same genus, they must be exchanged in equal quantity and on the spot, for example, where gold is exchanged for gold.

[151] Al-i-Imran 3:130 (verse from the Holy *Qur'ān*).
[152] Al-Baqarah 2:275-281 (verses from the Holy *Qur'ān*).
[153] Vogel and Hayes (n 20) 72.
[154] *Ibid* 72-3.
[155] Nyazee discusses the rules of *riba* in detail in his book (n 67) ch 10, pp 177-96.

Secondly, if commodities are (different) species of the same genus, then equality is not required but a spot transaction is necessary, for example, where gold is exchanged for silver or wheat is exchanged for rice.

Thirdly, if the genus is different, then both equality and a spot transaction are not necessary, for example, where gold is exchanged for wheat.[156]

To make things easily understandable, *riba* in loans, debts and barter trade can be explained by the following examples:

i) If dollars are exchanged for dollars, and they are exchanged on the spot but are unequal, then this will amount to *riba*

ii) If dollars are exchanged for dollars, and they are equal but delayed from one side, then this will amount to *riba*.

iii) If dollars are exchanged for pounds, equality is irrelevant and the only issue is the spot transaction, and if there is a delay from one side, then this will amount to *riba*.

iv) If wheat is exchanged for wheat, then both equality and a spot transaction are necessary, otherwise this will amount to *riba*.

v) If wheat is exchanged for rice, then equality is not necessary and the only requirement is a spot transaction, otherwise this will amount to *riba*.

vi) If dollars are used to purchase wheat or rice, then both equality and a spot transaction are not necessary. This is so because both are different genera. The payment may be made in advance and delivery of the commodity may be after some time. This is a kind of credit sale or advance payment, which is allowed under Islamic law.[157]

Some rules or situations look absurd and meaningless on the face of it, such as the exchange of dollars for dollars in equal amounts and on-the-spot transactions or exchange of wheat for wheat in equal amounts, and on-the-spot transactions. In the researcher's view, the objective of *Shariah* is to set rules to avoid *riba* and injustice to either party.

[156] The currency value is one genus, such as gold, silver, dollar or pound, while storable food items are other genera such as wheat, barley, rice or salt. The excess may be in terms of weight, measure or counting. Hanafis divide fungible goods into two kinds on the basis of genus: commodities that are weighted are one genus and commodities that are measured are another genus. Other schools divide genera on the basis of currency value and (storable) food value. For this, see Nyazee (n 67)184.
[157] *Ibid* 181.

This can be explained as follows: as no one will exchange dollars for dollars or gold for gold or wheat for wheat in equal amounts and in on-the-spot transactions, *riba* will be avoided. Any violation of these rules will amount to *riba*, for example, if A gives US$100 to B with the condition that B returns US$110 after one year, the extra US$10 amounts to *riba*. Similarly, if A gives US$100 to B and B returns the same amount after one year, this transaction will be called an *interest-free transaction* but, according to Islamic law, this is prohibited because B has taken undue advantage by utilizing the money for one year. As regards doing an injustice against any party, if a creditor charges extra amounts, then he or she will do the debtor an injustice and if the same amount is returned after delay then this will amount to an injustice against the creditor. This does not mean that Islam prohibits any money transaction or giving people loans. In individual cases it discourages taking loans but allows it only in circumstances of dire need. The creditor may give a loan as a *qard hassan* ('charity') and without demanding extra money or other benefits. In commercial transactions, it encourages partnerships and discourages loan but allows loans only in circumstances of dire need and as a last resort. This will also amount to *qard hassan* to save someone from business collapse.[158]

Islamic law also allows demanding security or collateral for debts but the creditor is not allowed to take advantage from that collateral. The reason for such a prohibition is that such advantage will amount to *riba*. However, there is one exception to the general rule. If the collateral is something that requires cost to preserve it or to feed it, as in the case of livestock, then the borrower is allowed to take the cost incurred for its preservation or food. To avoid *riba*, it is necessary to return the excess amount to the debtor or it may be debited to the capital.

Another way to protect commercial loans under the Islamic regime may be the recently developed bail-in mechanism. In this mechanism, when banks are on the verge of insolvency, the regulator, instead of bailing them out using taxpayers' money, uses the mechanism of bail-in. In this mechanism the claims of equity holders and some junior creditors are written off. Similarly, a part of the claims of senior creditors is written off while the remaining part is converted into equity. The objective is to avoid total damage and to provide an opportunity to the senior creditors to save the banks and try to recover as much money as possible. The creditors step into the shoes of the equity holders, and try to

[158] Nyazee (n 53) 188. Imran Ahsan Khan Nyazee, *The Concept of Riba and Islamic Banking* (1st edn, Niazi Publishing House, Islamabad 1995) 28-9.

run the bank and make it a going concern. This technique is hybrid in the sense that initially the contract is made privately while the regulator, a public institution, has the power to write off claims and convert the debts into equity.[159] This technique may be utilized in Islamic finance. It is not clear whether Islamic law will allow the writing-off of some creditors' claims while giving equity rights to others. An appropriate way under Islamic law may be to convert all debts into equity when the company is in distress without writing off the claims of junior creditors. It may not be feasible to convert all debts into equity at the face value of the shares but this can be done by converting debts into equity according to the ratio of debts to the equity capital. This technique may provide a kind of security to the debtors without violation of the *Shariah*.

6.14 Prohibition on *riba*

Islam has a direct effect on the day-to-day life of Muslims and it is considered a divine command to spend one's life according to its orders.[160] Islam is applicable even in Muslims' commercial dealings[161] and provides detailed regulations in this regard.[162] *Riba* is prohibited by Islam in every form in personal or in commercial transactions.

Riba is prohibited irrespective of whether or not it is in manifest or concealed form; manifest in the sense that it is clear from the face of a transaction that it is *riba* but some transactions may also contain an element of *riba* but it does not appear on the face of it. For example, if, A sells his watch to B for US$100 and immediately repurchases the same watch for US$120 on the spot with deferred payment to be made after one year, *prima facie* these are two independent transactions but, in fact, there was only one transaction and that was a transaction of loan. B has advanced a loan of US$100 to A with 20% interest to be paid after one year. These transactions are regarded as being against the spirit of Islamic law as the intention was to bypass the prohibition on *riba* by involving a commodity. A tradition (*Sunnah*) of the Holy Prophet Muhammad (peace be upon him) says 'acts depend on intentions'. Therefore, all those transactions will be prohibited where the intention is to enter into a transaction involving *riba*.

[159] Chris Bates and Simon Gleeson, 'Legal Aspects of Bank Bail-ins' (2011) 5 (4) *Law and Financial Market Review* 264-7.
[160] Usmani (n 95) 16.
[161] Alexander Von Pock, *Strategic Management in Islamic Finance* (Deutscher Universitats-Verlag, Wiebaden 2007) 1.
[162] Eisenberg (n 69) 38.

As to the wisdom or logic behind the prohibition on *riba*, there is dispute among jurists. Nyazee does not agree with the prohibition on *riba* based purely on religious grounds or even injustice as necessary conditions for prohibiting *riba* forwarded by some jurists.[163] He regards distributive justice as the logic behind the prohibition on *riba*. He argues that distributive justice prevents the accumulation of wealth in a few hands. Distributive justice provides social justice and fair distribution of wealth among the masses. However, Usmani does not consider wisdom a necessary condition for the prohibition on *riba*.[164] He observes that *riba* is prohibited irrespective of any wisdom visible in such prohibition. He considers prohibition purely on a religious basis. He writes that there is a difference between wisdom and the basic feature (*illat*) of any order in Islamic law. According to him, the law will apply in the presence of a basic feature (*illat*) irrespective of wisdom. He gives an example of the traffic law that requires stopping at a red traffic light. Here the basic feature or *illat* is the red light and the wisdom is to prevent an accident. He says that this does not mean that when the red light is on and there is no chance of an accident happening, then one may pass through it. One has to stop irrespective of absence of the wisdom of avoiding an accident. He further explains that as far as injustice (*zulm*) as wisdom or philosophy of prohibition is concerned, this is not a basic feature of the prohibition on *riba*. Injustice is a relative term which varies from person to person and system to system, and cannot be termed a basic feature (*illat*) of the prohibition of *riba*. According to him, the basic feature of the prohibition on *riba* is excess claimed over and above the principal in the transaction of a loan, irrespective of the presence of the philosophy of law.[165] However, a more plausible explanation regarding the prohibition on *riba* is forwarded by a renowned Muslim scholar Imam Al-Ghazzali.[166] He believes that *riba* is prohibited as it prevents individuals from undertaking real economic activities. If people are allowed to earn money over money on the basis of interest without undertaking a real economic activity, then this may be harmful to society, and hamper economic growth and development. Islamic law prohibits interest-bearing transactions and encourages equity investment in the form of partnership. It envisages that both parties should participate in profit and loss. One should not free ride on the efforts of others and no one should take more than what he or she deserves.

[163] Nyazee (n 67) 179.
[164] Usmani (n 114) para 119-20, 126.
[165] *Ibid* para 121.
[166] Referred to in 'The Text of the Historic Judgement on Interest given by the Supreme Court of Pakistan written by Justice Muhammad Taqi Usmani' available at <http://www.albalagh.net/Islamic_economics/riba_judgement.pdf> accessed 05.11.2013.

The Constitution of Pakistan imposes a duty on the state to eliminate *riba* as early as possible. Pakistan was the first Muslim country that declared *riba* against the injunctions of Islam. [167] The FSC declared *riba* against the *Shariah* on 14 November 1991. However, this was challenged in the Appellate Bench of the Supreme Court in the form of 67 appeals, including the federal government, banks and financial institutions. The Appellate Bench disposed of all these appeals and upheld the decision of the FSC in 1999. It set 30 June 2001 as the deadline for the elimination of *riba* which was later extended to 30 June 2002. The appellants then filed a review petition to the Appellate Bench who stayed the order on 24 June 2002. It is still pending in the Appellate Bench. [168]

As far as the implementation of the decision of the Supreme Court is concerned, Nidaa is of the opinion that the landmark decision of this court to Islamize the economy could not achieve its objectives because the decision was not based on a democratic process, but rather that it was an outcome of judicial activism only. She further argues that the people of the subcontinent have a quest for a distinct identity in the name of religion and this led to their will to Islamize the economy.[169] Her observation is true to the extent that this wholesale change in the economy requires political, democratic and institutional support. However, the real problem is not the judiciary, but rather political parties who failed to implement decisions despite getting votes from people in the name of Islam. There are public sentiments in Pakistan to Islamize the economy and political parties exploit these sentiments. The constitution makes provision for the Islamization of the economy but the executive failed to take the necessary steps in this regard. Public sentiments may be the driving force behind the implementation of the Islamic economy in Pakistan but this requires the will of the politicians and institutions as well. Similarly, her observation that the people of the subcontinent desire a distinct identity is the reason why they want to Islamize the economy does not seem cogent. Islam is part and parcel of life for Muslims. Therefore, they want to implement Islamic injunctions in their commercial dealings as well. Since *riba* is considered a declaration of war against God and His Prophet by the *Qur'ān*, religious duties, therefore, seem more logical than simply the desire to show a distinct identity.

[167] Art. 38(f) of the Constitution of the Islamic Republic of Pakistan 1973; Usmani (n 114).
[168] See the daily '*Dawn*' an English Newspaper of Pakistan, dated 25.06.2002, available at <http://www.dawn.com/news/44707/fsc-to-decide-riba-case-afresh-supreme-court-sets-aside-earlier-judgment> Accessed 14.01.2014.
[169] Nidaa Masood, 'The Islamization of Pakistan's Financial System: A Legal Analysis' (PhD thesis, University of London 2006) 359-60.

6.15 Nature of the Islamic financial system

Islam is a practical religion that guides its subjects in each and every field, including financial matters.[170] A basic difference between the conventional financial system and Islamic finance is the treatment of interest. The debt is not considered a legal, profitable economic activity under Islamic finance.[171] Conventional finance is based on interest-bearing transactions, whereas Islamic finance prohibits interest from personal as well as commercial loans. There is a misconception with regard to Islamic finance that this system prohibits all modern transactions. In reality, this is only half of the story. Islam provides an alternative to debt and loan financing. It prohibits interest, uncertainty and immoral business activities. As far as interest is concerned, Islam regards it as exploitative and the circulation of money among the rich only. The *Qur'ān* prohibits *riba* by providing a justification for its evil effects: it states that '*it* [wealth] *may not* [merely] *make a circuit between the wealthy among you*'.[172] Interest is, in fact, earning money over money and this may provide opportunities to rich people to enhance their money without getting involved in real economic activities. The Islamic finance system is based on distributive justice, which means the distribution of wealth, goods and resources among the rich and the poor.

In addition to this, it prohibits certain businesses which it considers immoral, unethical or religiously prohibited, for example, gambling; the preparation of alcohol and its related products, and pork products; and pornography. The other difference between conventional finance and Islamic finance is uncertainty. Some financial transactions of conventional finance, such as the futures market, short selling and gambling businesses, are not allowed under Islamic finance on the basis of inherent uncertainty.

The Islamic financial system is characterized as based on ethics and morality. It prohibits risk-free return on finance.[173] The prohibition on *riba* is one manifestation of this characteristic. *Riba* provides one party with an undue advantage over another; for instance, A gives a loan of US$100,000 to B for two years with interest of 10% per year. B starts a business with US$150,000 and suffers a loss of US$50,000. B now has to return US$100,000 to A as the capital return and US$20,000 as interest. B is left with only

[170] Usmani (n 95) 16-7.
[171] Venardos (n 31) 28-31.
[172] *Qur'ān* 59:7.
[173] HM Treasury (n 73) 7, 12.

US$100,000 in business. This means that B has to pay US$20,000 from other sources. In this situation, it will be an injustice against B. However, suppose B earns profit amounting to US$100,000. B will pay US$120,000 (US$100,000 as capital and US$20,000 as interest) to A and will retain US$80,000 as profit for himself. B has earned profit of US$80,000 with only a US$50,000 investment, whereas A has earned US$20,000 with a US$100,000 investment. The profit ratio for B will be 160%, whereas it is only 20% (in the form of interest) for A. In this situation it is injustice against A. This is the main reason for the prohibition on interest (*riba*) as this may cause an injustice to both or one party. Islam prohibits interest as one may have an advantage without taking risk, and sharing in profit and loss. Interest-bearing transaction may encourage the earning of money without taking part in actual economic activity. It, therefore, encourages equity financing. In equity financing there may be less injustice against any one or more parties as all will share in the profit and loss. Islamic finance provides different techniques for carrying on businesses that may be used as alternatives to conventional financing. Modern Muslim and non-Muslim jurists are trying to provide alternatives to the conventional finance system. The provisions of *Shariah*-compliant products as an alternative to conventional financial products are the main features of recent research in Islamic finance. Modern jurists are trying to synchronize Islamic finance with conventional finance. Synthesis is possible between Islamic finance and conventional finance to a certain extent, with the exception of interest, uncertainty and certain businesses, which are not allowed under Islamic law.

6.16 Equity versus debt financing

Islamic finance deals with both equity and debt finance in different ways. Islamic finance encourages equity financing and discourages debt financing. The nature of debt financing is contractual. This is more secured financing in which the creditors receive predetermined amounts in the form of interest and capital irrespective of any profit gained by the debtor in the business. This amount is to be paid within the framework determined in the contract. If a debtor fails to pay interest or return capital, then the creditor has the right to enforce this under the terms of the contract as well as under different laws. As the paying of interest or capital becomes difficult for the debtor in the case of financial difficulty, the nature of debt financing is, therefore, a kind of exploitation in most cases. The creditor has the right of reorganization and liquidation in the case of failure to pay interest or capital. However, the nature of the equity investment is participation in the business. The investor shares in the profit, which is not predetermined. The investor gets a return on investment only when there is a profit in the business. Therefore, there is less of an element of exploitation in the equity investment. The investor has the right to participate in the management, except in those cases where he or she relinquishes this right by acquiring shares without voting rights.

The problem with debt financing is that more debt financing provides the firm with leverage that may be beneficial to it up to a certain level but this leverage may be dangerous when it goes beyond certain limits. This means enhanced leverage is a risky venture.[174] The recent global financial crises are associated with, *inter alia*, bad governance and unbridled debt financing by banks. The debt ratio was increased and debtors were unable to repay their debt. There was not enough equity which could have avoided the crisis. This caused huge financial uncertainty and resulted in a crisis.[175]

Debt financing has structural advantages over equity financing as debt is given more security and the right to recover a loan as per a contract. Equity financing is, however, not secure for individual investors but as far as the corporate structure is concerned, it avoids potential corporate risks. Equity financing requires some assurance to avoid individual risk. This risk can be minimized when there is good governance associated with equity financing. To share the burden of risk, it is necessary that equity holders be given decision-making power and management rights; in other words, the nature of equity financing is to take part in management by contesting the election of directors or voting to elect directors, to make major decisions, and to share in profit and loss. More equity financing in firms will trigger more good corporate governance. As Islamic finance encourages equity, good corporate governance is, therefore, exactly in accordance with the spirit of Islamic finance.

6.17 Evolution of Islamic finance

A presumption about Islamic finance is that it was introduced in the early ages of Islam and that it was not a flexible system that would cater to the needs of modern times. This is an incorrect assumption. Islamic finance is currently still relevant and is ever developing. The role of Muslim scholars is very important in this regard. The new products introduced

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174 Lukas Handschin, 'Risk-based Equity Requirements: How Equity Rules for the Financial Sector can be aApplied to the Real Economy' (2012) 12 (2) *Journal of Corporate Law Studies* 263.

175 S. A. Ross, R. W. Westerfield and B. D. Jordan, *Fundamentals of Corporate Finance* (9th edn, McGraw-Hill, New York 2010) 23.

through conventional finance can be checked in the light of Islamic law due to the flexibility available in Islamic law. Modern scholars have worked on Islamic finance, and have discussed its feasibility according to modern needs and requirements. Islamic finance was central in religious teachings for two reasons. First, religion is integral to the day-to-day life of Muslims and in their financial matters. Second, the Prophet Muhammad (peace be unto him) was himself a merchant; therefore, financial dealings were central to the life of the Prophet. The recent focus on Islamic finance caught the attention of financial experts for two reasons. First, the emphasis on Islamic finance in the Muslim world, which forms a substantial part of the world economy. This phenomenon started in Egypt in 1963 through the introduction of the Mit Ghamr savings project, a social banking initiative[176] and later developments such as the establishment of the first Islamic bank in the mid-1970s. Second, when there was a recession in the world and conventional finance failed to respond appropriately.[177]

In modern times in the Muslim world, Pakistan was the first country that declared that it would Islamize all its banks. It did so in in 1979. Iran and Sudan followed, and in 1983 they declared that they would Islamize their banks. Malaysia, instead, introduced a parallel banking system in 1983.[178] In recent times Islamic finance has been the most dynamic and fastest-developing financial system. Both Muslim and non-Muslim countries have introduced it in their financial system. The focus is on introducing this system parallel to the existing financial system.[179] The introduction of two parallel financial systems may have some legal and regulatory barriers as both conventional and Islamic finance have different natures and, to some extent, are rival systems. This rivalry is based on two important issues: (1) *riba* ('interest') and (2) *gharar* ('uncertainty'). Islam provides an alternative to interest by emphasising profit and the sharing of business activities. It discourages loans but allows them under conditions of necessity and on humanitarian grounds but without interest. It also prohibits uncertain transactions. Both conventional finance and Islamic finance may not be a major problem as both can be synchronized and implemented on the basis of the nature of the products involved. However, this requires the state's commitment to implementing Islamic finance in its true spirit.

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[176] HM Treasury (n 73) 8.
[177] Ibrahim Warde, 'Status of the Global Islamic Finance Industry' in Craig R. Nethercott and David M. Eisenberg (eds), *Islamic Finance: Law and Practice* (Oxford University Press, Oxford 2012) 2, 12-3.
[178] *Ibid* 4.
[179] Pock (n 161) 1.

6.18 Islamic finance as an alternative financial system

The recent financial crisis, which was linked to excessive leveraging, highlighted the importance of an alternative financial system that may respond more appropriately in times of financial distress.[180] Islamic finance prohibits excessive leveraging and focuses on trust building. It focuses more on the ethical realm of business than a sole financial aspect which is dominant in conventional finance.[181] Islamic finance has shown its presence against the backdrop of the recent financial crisis and urges scholars to provide an alternative. One advantage of Islamic finance is that it is an emerging system that has not yet been utilized in modern finance.[182]

The Islamic financial system is different from capitalism and communism. Capitalism is a market-based financial system that provides the freedom of having private ownership, whereas communism provides a controlled economy with the state controlling all economic activities and restricting private ownership by individuals. Capitalism reconfigures existing economic and social arrangements; develops according to market needs; and focuses on individual self-interest and privileged rational utility over traditional ethical norms.[183] Such an ideology was alien to Islam.[184] Islamic finance is based on a different ideology. Its thrust is on ethics and morality. It restricts the free flow of wealth in a few hands,[185] and provides detailed guidelines in the financial matters of its subjects. It prohibits interest-bearing and uncertain transactions. It encourages equity-based financing, sale and leasing contracts.[186] The prohibition on interest-bearing transactions is a major difference between capitalism and Islamic finance.[187] Islamic finance requires real asset-based transactions,[188] and links financial transactions to the real economy, which is governed by the principle of sharing in profit and loss. It prohibits interest (*riba*) and uncertainty (*gharrar*), and encourages equity financing backed by real assets.[189] Capitalism emphasizes individual rights which allow the unbridled accumulation of

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180 Angelo M. Venardos, *Current Issues in Islamic Banking and Finance* (World Scientific Publishing Co. Pte. Ltd., Singapore 2010) 1.
181 Rasul (n 116) 171.
182 Pock (n 161) 2.
183 Patricia Crone, *Pre-Industrial Societies: Anatomy of the Pre-Modern World* (2nd edn, Oneworld, Oxford 2003) 166-8.
184 Timur Kuran, *The Long Divergence: How Islamic Held Back the Middle East* (Princeton University Press, Princeton 2011) 143-66.
185 Nyazee (n 67) 179.
186 Warde (n 177) 4.
187 Venardos (n 31) 28.
188 Usmani (n 114).
189 Warde (n 177) 4.

wealth, whereas Islamic finance focuses on the welfare of the whole of society which does not allow the exploitation of others.[190] Another major difference includes the prohibition on excessive leveraging and imprudent risk taking by Islamic finance. Similarly, paper money is not considered a commodity in Islamic finance. It is considered a medium of exchange and therefore cannot be utilized to increase purchasing power without involving a commodity and a productive activity that is beneficial to society.[191]

The failure of communism in the 1990s and the economic meltdown in last part of the twentieth century and the early part of the twenty-first century has highlighted the importance of an alternate financial system in the world. Islamic finance received attention in the recessions. It has been the most dynamic and fastest-growing economic system in the recent past. There has been extensive academic research on Islamic finance both in the East and West.[192] Products based on Islamic finance are being introduced not only in the Muslim world, but also in non-Islamic countries such as the UK[193] and the US.[194] Islamic finance may not be an ideal financial system for the West as it is not familiar with such a system and it is considered directly related to religion. However, Islamic finance is not restricted to Muslims. It is open to everyone, including non-Muslims. The choice is with the consumers based on pure competition. If Islamic finance provides better options and products to investors and consumers, they will definitely derive an advantage from it. The new economic world scenario is based on pure efficiency and competition, and religion has a very limited role to play, at least in the Western world. Ethics may also be another reason why non-Muslims would be attracted to Islamic products. Ethical finance, such as the prohibition on financing in businesses relating to alcohol, gambling and pornography may also attract non-Muslim who have religious beliefs in this regard.[195]However, Islamic financial transactions may be undertaken on a purely religious basis in the Muslim world

[190] Venardos (n 31) 28-9.
[191] Angelo M. Venardos, 'Resilience and Stability: Socioeconomic Response in Southeast Asia' in Angelo M. Venardos (eds), *Current Issues in Islamic Banking and Finance* (World Scientific Publishing Co. Pte. Ltd. Singapore 2010) 11.
[192] Pock (n 161) 1.
[193] There are 2.74 million Muslim in the UK, which is 4.4% of the total population as on 18 December 2012 reported by the Pew Forum on religion and public life, a US-based organisation. See Pew Forum report 'Database: Religious Composition by Countries in Numbers and Percentage', available at <http://features.pewforum.org/grl/population-number.php> Accessed 05.11.2013.
[194] There are 2.77 million Muslim in the US, which is 0.9% of the total population as on 18 December 2012 reported by the Pew Forum on religion and public life, a US-based organisation. See Pew Forum report on 'Database: Religious Composition by Countries in Numbers and Percentage', available at <http://features.pewforum.org/grl/population-number.php> Accessed 05.11.2013.
[195] HM Treasury (n 73) 3, 7-8.

in general and Pakistan[196] in particular where religion dominates in the social, political and economic life of the masses.

Pakistan is a leading country in the Muslim world when it comes to Islamizing its economy.[197] It was a difficult task for Pakistan as there was no successful model to follow.[198] Nevertheless, it started Islamizing its economy through the introduction of *Shariah*-compliant products in the early 1980s. The first step was to change the banking laws through change in the Banking Companies Ordinance 1962 and introducing profit and sharing accounts. The other major steps included permission to do business through the *mudarabah* form of business. The introduction of the Mudarabah Companies and Mudarabah ('Flotation and Control') Ordinance 1984 allowed the establishment of Islamic financial institutions that allowed the conduct of business through the *mudarabah* form of business. In 1991 the government promulgated the Enforcement of *Shariah* Act, 1991 to Islamize the economy and industry. This paved the way for the introduction of Islamic mutual funds, Islamic insurance (*takaful*), leasing (*ijarah*) and licensing of Islamic commercial banks.[199]

The major breakthrough in this regard was the decision of the *Shariah* Appellate Bench of the Supreme Court in 1991 that declared *riba* against the injunctions of Islam and set June 2001 as the deadline for the elimination of *riba* from the economy. The government filed a review petition. The decision was stayed and is still pending. This shows lack of interest both at government and institutional level to eliminate *riba*, and to Islamize the economy. This is a dilemma for the government. On the one hand, it has shown some kind of efforts to Islamize the economy and, on the other hand, it is not willing to implement a decision prohibiting *riba*, which is a major cause for concern in Islamic finance. There may be three reasons for this decision. First, there have been frequent changes in governments in Pakistan. Sometimes the leftist and sometimes the rightist dominate the political scenario. Pure Islamic parties also have a say in each government. The successive governments may not have the intention to implement pure Islamic finance, rather these parties may have made provision for it in their manifesto to obtain political advantages by

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[196] Pakistan is a Muslim country where Islam is the state religion enshrined in the constitution, which reflects pure public sentiments about Islam. Pakistan has a population of approximately 185 million, with 97% Muslims residing in Pakistan as per the Population Census Organisation, Government of Pakistan website available at <http://www.census.gov.pk/index.php> Accessed 06.11. 2013.
[197] Rasul (n 116) 168.
[198] Masood (n 169) 331-2.
[199] Rasul (n 116) 168.

exploiting the sentiments of the people to get their votes. Second, in the new era of the global economy it may not be feasible to prohibit *riba* unilaterally when countries have debts of billions of dollars brought about by global forces. However, the elimination of *riba* at the domestic level may not be a major problem. This needs some kind of commitment from the government and financial institutions. Third, lack of legal, regulatory and institutional infrastructure may be another cause for the failure in implementing the Supreme Court decision to Islamize the economy.[200] The decision cannot be implemented without proper homework.

In Pakistan *mudarabah* business flourished to some extent but the way in which it was operated was not purely Islamic.[201] This disappointed the people who intended to do business in an Islamic way and for those with an awareness of Islamic finance. Corruption, bad governance, scarcity of a regulatory framework and lack of human resources were the main barriers to the success of Islamic finance in Pakistan. The intentions of most of the entrepreneurs were not to do business in accordance with the *Shariah* but they started businesses just to enjoy the tax incentives provided by the government for *mudarabah* businesses and to exploit general public sentiments. It was an easy way to get finance from the general public in the name of Islam.[202] All this caused the failure of *mudarabah* business in Pakistan and shed doubts on Islamic finance flourishing in Pakistan. Islamic finance can be successful only if a good corporate governance mechanism is established. This would require the government, regulators and other institutions to take a number of steps.

In Pakistan Islamic banking business is not much different from the conventional system. It amounts to a change of nomenclature and most of the transactions conducted by the banks in leasing and *murabahah* were viewed as suspicious by scholars on the grounds that the objective of these transactions was to defeat the Islamic prohibitions of *riba*.[203] In reality, these transactions were more or less like interest-bearing transactions. Islamic finance can be successful only if there are serious efforts and change in mind set at government level as well as entrepreneur level.

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[200] Masood (n 169) 361.
[201] Vogel and Hayes (n 20) 166.
[202] Rasul (n 116) 170.
[203] Mansuri (n 70) 220.

Failure of *mudarabah* business triggered regulator's attention to improve *mudarabah* business in Pakistan. In 2008 the SECP and Mudarabah Association of Pakistan conducted research to obtain the *Shariah* board of *mudarabah*'s approval for the new *Shariah*-compliant products to enhance the scope of *mudarabah* business. They approved 12 products[204] to enhance the scope of *mudarabah* and other *Shariah*-complaint businesses in Pakistan.[205] This is another effort at institutional level to Islamize the economy. The question is whether it will change the existing image of the failed *mudarabah* business introduced in the early 1990s?

The few efforts by the government to Islamize the economy were just the start of a long journey. More needs to be done in this regard. It may not be useful merely to declare something Islamic or un-Islamic. First there is a need to provide an alternative to existing financial products. The existing system cannot be changed overnight. Scholars of Islamic law should try to synchronize texisting financial products with Islamic norms keeping in mind the basic precepts of Islam. Different schools of law in the Muslim community have different interpretations of sources of Islamic law, which may create divergence. This may not be a major problem. Divergence can be converted into convergence but this needs some kind of flexibility in the rules of interpretation to the extent that the interpretation of other schools that is appropriate is adopted and that modern financial products be accepted rather than rejected. Secondly, the scarcity of human resources is another problem in this regard. Some institutions are engaged in Islamic research but they are not enough to cater for the needs of Islamic finance on a larger scale. There is a need to encourage Islamic research at institutional level that can produce scholars who are acquainted with both the modern form of business and the Islamic form of business. Thirdly, corporate governance needs to be strengthened. An inefficient corporate governance system is a major problem in any kind of business. In Pakistan bad governance is a barrier to the healthy growth of the market in general and the economy in particular. As discussed in earlier chapters, there is a need to improve the governance mechanism in Pakistan. Enforcement is a key to good governance. The judiciary, market and regulatory framework need to be improved in order to enhance enforceability in the corporate sector. As far as Islamic finance is concerned, as

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[204] These businesses include leasing (*ijarah*), progress financing (*istisna),* partnership or company (*mudarabah*), *musawamah*, partnership or company (*muharakah*), cost-plus financing (*murabaha*), trade finance (*salam*), diminishing *musharakah*, syndicate *mudarabah*, *syndicate musharakah*, continued funding system (Islamic CFS *murabahah*), Islamic bonds (*sukuk*). Some of these forms are discussed in the section on *Shariah*-compliant products at 6.10.
[205] Rasul (n 116) 173-8.

it encourages equity financing and prohibits interest-bearing transactions, good corporate governance will be a key to its success.

Some efforts have also been made at international level. The establishment of the Islamic Financial Services Board (IFSB) in 2002 was a major step towards this development. It started its operation from 10 March 2003. The board sets standards for regulatory and supervisory agencies involved in Islamic finance, including banking, capital markets and insurance. Its objectives are to promote the development of Islamic industry and to recommend new or adopt existing international standards after adaptation to injunctions of the *Shariah*. The board also guides regulatory agencies for effective supervision and regulations of institutions offering Islamic products. It plays a liaison role among institutions involved in standard setting. So far, the board has issued 19 standards, guiding principles and technical notes for the Islamic financial services industry, including guiding principles on corporate governance for institutions offering only Islamic financial services (excluding Islamic insurance (*takaful*) institutions and Islamic mutual funds). It has issued separate guidelines for insurance and mutual funds.[206] The IFSB takes guidance from other institutions involved in standard setting for banking, finance and governance, for instance, the IFSB has considered standards issued by the Basel Committee on Banking Supervision, and the International Organization for Securities Cooperation for investment and securities markets in order to set its own standards for Islamic banking and finance[207] but subject to the condition that they are not against the *Shariah*. The IFSB issues guiding principles and they are subject to approval at national level. As these principles do not have binding force, the possibility of divergence at international level exists.

The International Islamic Fiqh Academy (IIFA) is a constituent part of the Organization of Islamic Cooperation (OIC). The objective of the academy is to find solutions to contemporary problems according to the *Shariah* and to guide the Muslim community to conduct their life according to the *Shariah* at individual, social and international level. The academy is involved in research in Islamic law and issues Islamic legal opinions (*fatwas*) for guidance to the Muslim community.[208] The scope of research and opinion includes Islamic finance so that the Muslim community could convert their conventional finance to

[206] Website of the IFSB, available at <http://www.ifsb.org/ > Accessed 05.11.2013.
[207] Venardos (n 191) 8.
[208] International Islamic Fiqh Academy website, available at <http://www.oic-oci.org/page_detail.asp?p_id=64#FIQH > Accessed 05.11.2013.

Islamic finance. The rulings of IIFA are guiding principles only and do not have any kind of binding force. This may also lead to divergence in the Muslim world.

The commonly approved *Shariah* products and market can facilitate convergence in Islamic finance at international level in the Muslim world. This could be achieved when there is consensus between Islamic scholars themselves. Once the Islamic form of business is accepted and implemented at national level, some kind of consensus at global level would be required. Consensus in OIC countries that is commensurate, at least to some extent, with EU efforts is also needed.

It is widely accepted that Islamic finance is not immune to financial crises. However, an important question is the extent to which financial crises may impact on Islamic finance. Venardos warns that Islamic finance may be affected indirectly in any turmoil in the world. [209] According to him, the slower economic growth may affect real estate and asset finance. He further warns that reduction in prices of real estate may indirectly affect Islamic financial institutions as their business activities are directly connected to real assets. According to him, this may decrease their assets and affect business. However, this observation should be hedged with other aspects of Islamic finance. Islamic finance is not entirely related to real assets. Islamic finance focuses on ethical business. It prohibits interest-bearing transaction, excessive leveraging and avoiding uncertainty. It encourages sharing in profit and losses, and carry on business based on mutual trust and confidence.

Venardos is also concerned that Islamic financial institutions may pursue aggressive speculative investment strategies with higher risk and higher expected returns in economic stress without adhering to fundamental and sound risk management standards.[210] The IFSB is working towards providing guidelines to avoid such situations. These concerns highlight the importance of good corporate governance strategies to avoid such situations. Another important point in this regard is that Islamic finance does not encourage speculative business strategies. Corporate governance under Islamic finance may not encourage strategies on the part of the managers that are highly speculative irrespective of the quantum of profit they may yield.

[209] Venardos (n 191) 3.
[210] *Ibid*.

Whether Islamic finance will be effective and can provide an alternative financial system at international level in general and Pakistan in particular is a difficult and premature question. However, the principles of Islamic finance cannot be ignored as they focus on ethical business and preach social responsibility.[211] Islamic finance has gained the attention of the world after the recent global financial crisis. The Muslim world has started converting its conventional finance to Islamic finance. Recent research in the Muslim world in general and the Western world in particular shows that Islamic finance has made its presence known and may be considered an alternative financial system. This is a difficult task and requires extensive research in the field. As far as the recent financial crisis is concerned, it is widely accepted that as Islamic finance relies on asset-backed financing, it might have responded more appropriately than capitalism.[212] No doubt, this system is gaining importance in the Muslim world on the basis of religion but it has potential due to its very nature. However, it can be considered in the non-Muslim world only when it is devised beyond the religious aspect and shows its strength as a better financial system than the conventional financial system. It can be introduced in the Islamic world generally and in Pakistan in particular. Once it shows its acceptance and success in the Muslim world, the non-Muslim world may take advantage of it to avoid uncertainty inherent in conventional finance. Globalization has integrated markets and survival of any system depends upon the provision of competitive products.[213] Therefore, Islamic finance can provide an alternative only when gaps in Islamic finance are filled in order to compete in the global economy. This is an uphill task for researchers in general and jurists in particular.

6.19 Islamic finance and stock market indices

Muslim and some non-Muslim countries have introduced stock market indices in their jurisdictions. In non-Muslim countries this may not be on the basis of its success or pure competition, but rather to attract Muslim customers residing in their jurisdiction, for example, the Dow Jones Islamic Market Index in Bahrain, the FTSE Global Islamic Index in the UK[214] and the *Shariah*-compliant index of the KSE in Pakistan.

[211] Rasul (n 116) 185-6.
[212] Warde (n 177) 14.
[213] Vogel and Hayes (n 20) 200.
[214] Pock (n 161) 1.

6.19.1 *Shariah*-compliant index of the Karachi Stock Exchange

In pursuit of government efforts to Islamize the economy, the stock exchanges in Pakistan introduced a stock market index for those companies who are engaged in *Shariah*-compliant products. The KSE introduced the Islamic index with the co-operation of Al-Meezan Investment Management Limited. The Index is called the *KSE–Meezan Index* or *KMI–30 Index* and includes those companies who qualify to be the companies engaged in business according to Islamic norms. For this purpose, 30 companies are selected on the basis of the free float methodology out of those companies who fulfil certain conditions prescribed by scholars with expertise in Islamic law.

The objective of the KMI–30 Index is twofold: (1) the index serves as a gauge for measuring the performance of *Shariah*-compliant equity investment and (2) it provides information to investors about the companies engaged in business according to the *Shariah*. The index provides some relief to those investors who intend to invest in securities of companies operating under Islamic finance.

The conditions prescribed by Islamic scholars for listed companies to be included in *Shariah*-compliant companies or screening filters are as follows:[215]

i) The business of the company must be according to the injunctions of Islam.

ii) Companies must not engage in conventional banking; financial institutions engaged in interest-related activities; conventional insurance; gambling; alcohol; cable networking; entertainment channels; advertising and media, with the exception of business and news dissemination; arms manufacturing; non-*halal* ('impermissible') foods; tobacco; pork production; and pornography.

iii) The debt-to-asset ratio in the company should be less than 37% (the formula is interest-bearing debt to total assets < 37%). Debt includes every interest-bearing investment, including preference shares.

iv) The ratio of non-compliant investment to total assets should be less than 33% (the formula is non-compliant investment to total assets < 33%);

v) The ratio of non-compliant income to total revenue should be less than 5% (the formula is non-compliant income to total revenue < 5%);

[215] The information has been taken from the website of the KSE, available at <http://kse.net.pk/> Accessed 14.01.2014.

vi) The ratio of illiquid assets to total assets should be at least 25% (the formula is illiquid assets to total assets > 25%). The illiquid assets include the assets that the *Shariah* permits to be traded at value other than at par.[216]

vii) The market price per share should be at least equal to or greater than net liquid assets per share calculated as total assets–illiquid assets–total liabilities to number of shares outstanding.[217]

This index provided some relief to those investors who intended to invest in securities of companies operating under Islamic finance. However, this is a liberal interpretation of Islamic finance but as a first step it is encouraging, at least towards the final destination.
At present there are 112 *Shariah*-compliant companies on the KSE.[218] The ratio of these companies to total number of companies is low. This shows that Islamic finance has not gained its footing in Pakistan. Bad governance, accompanied by a lack of legal, regulatory and institutional infrastructure, is a major problem in the flourishing of Islamic finance in Pakistan. Therefore, the improvement of the governance mechanism is essential for the success of companies involved in Islamic finance.

6.20 Convergence to Islamic finance and corporate governance within the Muslim world

The recent phenomenon of utilizing Islamic finance as an alternative or parallel to the conventional financial system in Muslim countries in general and Pakistan in particular has raised different issues. There is a possibility that different countries may have different modes of financing which may conflict with each other as far as their forms and conditions are concerned. This premise is based on the very nature of Islamic law. Though Islamic law provides a degree of flexibility to cope with modern needs and requirements, the problem with Islamic law is that the *Qur'ān* provides general principles only. The book is not composed of detailed rules. These principles were practised and explained by

[216] Gold, silver and paper currencies are not allowed to be traded in value other than at par; see text to n 136-143.
[217] The objective of this provision is that the share value should not wholly represent liquid assets because this will become the trading of currency other than on par which is not allowed; for example, if the value of assets' is £500, illiquid assets are £200 and liabilities are £200 and the company has 10 shares. Putting these values in the formula, one gets (total assets-illiquid assets-total liabilities)/number of shares outstanding = (500-200-200)/10=100/10=10. This £10 is, in fact, value which represents liquid assets. If the value of a share is less than £10, then it means the share represents a liquid asset (e.g., currency, gold or silver) which is not allowed to be traded under Islamic law other than at par. Under Islamic law, £10 cannot be traded for £12 or £9. If the value of the share is greater than £10 then this will represent at least a portion of illiquid assets which is allowed to be traded other than at par.
[218] See website of KSE, available at <http://kse.net.pk/> Accessed 14.01.2014.

the Prophet Muhammad (peace be upon him) and companions. The other problem was the compilation of the *Sunnah* of the Prophet quite a long period after his death which allowed fabrication of the *Sunnah*. This created differences of opinion among Muslim jurists regarding acceptance and the degree of force that such *Sunnah* may exert on the creation of rules.

The other problem is the interpretational rules of different sects of Muslim jurists. Islamic law provides jurists with leverage to explain modern problems in the light of existing principles. The sources of Islamic law other than the *Qur'ān* and *Sunnah* provide this leverage to interpret primary sources. This may lead to different interpretations which, in turn, may lead to different forms of businesses and governance mechanisms that may cause barriers to convergence to a single model in the Muslim world.

Globalization has triggered convergence of different corporate governance norms due to the inter-related interests of the countries, competition and cross-border investment. This phenomenon raised enforcement issues in corporate governance. The Islamic world realizes this difficulty and established the IFSB in order to ensure common *Shariah*-compliant products and regulations. However, a rigid interpretation of the sources of Islamic law by jurists had been the main cause of concern which has led to divergence of *fiqh* within the Muslim world. This may create problem in the development of unique *Shariah*-compliant products, market and corporate governance. Therefore, there is a need for jurists to show some kind of flexibility in interpreting sources of Islamic law. Modern jurists have developed techniques to overcome this difficulty. As discussed earlier, 'choice and selection', 'amalgamation or patching', 'necessity' and 'ruses'[219] may be utilized to redefine the *fiqh* according to modern requirements. This may help to unify different interpretations of Islamic law and converge to unique corporate governance and corporate finance, at least within the Muslim world. This will also help Pakistan to converge to Islamic finance in the Muslim world.

6.21 Convergence to Western corporate governance

There are basic differences between Islamic finance and Western financial systems. Islamic finance emphasizes ethical norms and focuses on the purposes of Islamic law both

[219] Ahmed (n 18) 383-4; Vogel and Hayes (n 20) 42-52.

in the context of corporate law and corporate governance. It does see the interest of investors but looks beyond the sole interest of investors. It wants to achieve the objectives of society as a whole and to safeguard the religion as well. However, the Western model of corporate governance focuses on individual interests and tries to achieve what is demanded by the market. It does focus on society as far as business and corporate governance are concerned but that may not be the primary priority as against the individual interests in the businesses.[220] Managers in the Western form of corporate governance may not be duty-bound to preserve religion which is the basic thrust of Islamic law. This disparity between Islamic finance and the Western financial system may be minimized provided the objectives are clearly defined and some level of flexibility is shown at least by the Muslim jurists in their interpretational rules.

In the context of Pakistan it is important to synchronize existing Western forms of business practices, corporate law, corporate governance objectives and trading in shares with Islamic norms. The basic difference between the Western forms of business practices and Islamic finance is the prohibition on interest. As far as form of business is concerned, most conventional forms of business are very much Islamic but a few are prohibited by *Shariah*, and must be avoided in order to create system that is in accordance with the *Shariah*; for instance, businesses of gambling, preparation of alcohol and pornography may be banned. Trading in stock exchanges is very much Islamic. However, trading in debts, debt securities, forward and future contracts, and short selling must be avoided. As far as corporate governance is concerned, the rights and the protection of investors are as important in Islam as they are in the Western form of corporate governance.

As far as good corporate governance is concerned, it is more important in Pakistan than in any other jurisdiction. Firstly, the prevailing bad governance requires improvement. Secondly, as the thrust of Islamic finance is on equity financing, good corporate governance will be important for Pakistan as the country moves towards Islamic finance. Thirdly, as Islamic finance is new to modern financing techniques, it has not developed investors' rights and their protection.[221] The Western form of corporate governance has developed these rights and protection. As far as Pakistan is concerned, it inherited the British legal and regulatory system, therefore, Pakistani policymakers and legislature may

[220] This discussion excludes corporate social responsibility.
[221] Ahmed (n 18) 391.

benefit from the Western form of corporate governance in general and the UK system of corporate governance in particular.

Islam has to play an important part in the corporate sector of Pakistan. Any future convergence to a Western form of corporate governance may be affected by Islamic injunctions. The barrier of Islamic finance to the Western form of corporate governance may not be as strong as it appears at first sight. Islamic law is also not as rigid as it appears. It has some inherent flexibility in its nature. Some sources and principles of Islamic law such as ‘presumption of continuity’, ‘ruses’ and ‘necessity’ may help to bridge the gaps between Islamic and Western forms of corporate governance. The Western form of corporate governance may be adopted in Pakistan after adaptation in the light of the above-mentioned principles and subject to the objectives of Islam highlighted in this chapter.

6.22 Conclusion

Pakistan is an Islamic republic. The constitution prescribes Islam as the state religion. It is a practical religion which guides its subjects in all spheres of life, including financial matters. Globalization, competition and inter-related financial interests have stimulated convergence from more developed countries to less developed countries all over the world. Pakistan, being a developing county, has been the recipient of foreign governance features. As both conventional and Islamic financial systems have different objectives, convergence to a Western corporate governance feature in Pakistan has to pass the Islamic litmus test.

As far as convergence in corporate governance to international norms in Pakistan is concerned, there are two aspects involved. First is the unique convergence to Islamic finance and corporate governance within the Islamic world. This will also affect Pakistan. The evolution of different schools of thoughts within the Muslim world may lead to divergence in Islamic finance among Muslims. This divergence may be overcome but there is a need to show some kind of flexibility in interpretation by Muslim jurists. There are different techniques in Islamic law that can help to bridge the gap between different interpretational rules and to come to some consensus. Principles such as ‘choice and selection’ (*iktiyar* and *takhayyur*), ‘amalgamation or patching’ (*talfiq*), ‘necessity’ (*darurah*) and ‘ruses’ (*hila*) may be utilized to redefine the *fiqh* according to modern requirements. This may help to unify different interpretations of Islamic law, and converge to unique corporate governance and corporate finance, at least within the Muslim world. This will also help Pakistan to converge to the Muslim world's Islamic finance and corporate governance.

The second aspect is convergence to the Western model of corporate governance in Pakistan. Pakistan is an Islamic country but, being a former British colony, it has adopted the conventional financial system based on the British system. As Pakistan is an Islamic country and people's thrust was towards Islamizing its economy, the government took steps to do so. However, it has not been successful for different reasons such as bad governance; a weak enforcement mechanism; lack of human resources and state commitment; the absence of a legal and regulatory framework; and institutional incapacity. The problem with using Islamic finance in Pakistan is its utility in modern times as the same has not been used before. Furthermore, there is no successful model for Pakistan within the Muslim world. According to classical Muslim jurists, there is a stark difference between the conventional and Islamic financial systems as both have different objectives. Modern jurists are working on Islamic finance to make it an alternative financial system. These efforts of providing an alternative financial system may only be successful when gaps in Islamic finance are filled in order to compete in the global economy.

Globalization has forced convergence of different corporate governance features where survival of any system depends upon the provision of competitive products. In order to improve corporate governance in Pakistan, convergence to Western corporate governance features but within the limits prescribed by the *Shariah* is needed. Firstly, as an abrupt overnight change from the conventional to Islamic financial system is not feasible, the system needs to be changed through a pragmatic approach. Therefore, instead of changing the whole system, the existing system needs to be synchronized with the Islamic financial system. A synthesis is possible to the extent that Western governance features can be adopted that are not against the *Shariah* under the principle of 'presumption of continuity'. Secondly, the features that have some kind of defect may be restructured in a way that they are made compatible with Islamic finance. The Islamic method of 'ruses' (*hila*) may help to remove this defect. Thirdly, the features that have minor defects may be adopted under the principle of 'necessity' (*darurah*).

This whole process needs substantial research and some kind of flexibility on the part of Muslims jurists. The role of Muslim jurists will dominate the process. The conclusion of the discussion is, therefore, that in convergence to Western corporate governance features in Pakistan, Islamic norms may act as a litmus test which may not be as problematic as it appears at first sight.

CHAPTER SEVEN: CONCLUSION AND RECOMMENDATIONS

This thesis discussed adaptation and convergence in corporate governance to international norms in Pakistan. In recent years the features of corporate governance have been transplanted from more developed jurisdictions to less developed jurisdictions. Despite the presence of barriers to convergence such as path dependency forces; and differences in culture, religion, politics, ownership structures, corporate governance norms and institutional structures, the process of convergence is still in progress. Globalization, efficiency and competition are the main stimulants for convergence.

Different governance systems have developed around the world as a result of specific political, cultural, social and religious norms. Different theories have emerged, each claiming the dominance of one system of corporate governance over others. Convergence towards a single model is a remote possibility due to the presence of path dependency forces, and cultural, social and religious norms. Therefore, partial convergence in corporate governance is more likely than unique convergence. In this process, a feature of corporate governance of one system converges on another system, possibly on the presumption that it is the most efficient, but it may be discontinued or abolished, and the old system be reverted to if it is not compatible with existing infrastructure or simply falls into oblivion. Alternatively, the system may again converge on a corporate governance feature of some other system. This process may continue indefinitely. This all depends upon the quality of adaptation and compatibility of the recipient system with a new feature of corporate governance.

Convergence in corporate governance takes place in three basic forms: (1) formal convergence, (2) functional convergence and (3) contractual convergence. Formal convergence occurs where the legal framework is changed according to some other legal framework. Functional convergence occurs where formal legal change is not possible but the system is flexible enough to respond to changed circumstances. In this process, the system starts functioning differently without change in the legal framework. Contractual convergence takes place where firms adopt the regulatory framework of other jurisdictions in order to raise finance from overseas stock exchanges under the terms of a contract. There may be practical difficulties in formal change due to the presence of vested interests that may resist any formal change. Therefore, functional and contractual convergence may dominate the process of convergence. There are some advantages to contractual and functional convergence. Firstly, these forms of convergence can avoid possible resistance to formal change in the legal and regulatory framework. Any change that may be introduced in a formal way may be resisted by vested interests such as families, groups and politicians as the *status quo* may benefit them. Secondly, these forms can be economically efficient as they can reduce the cost of change that may be incurred through formal changes in the rules and regulations. To attract capital, companies can adopt some foreign good practices through alteration in their articles. Once this practice is successful, other companies may follow, which may lead to formal action by the regulator and legislature. This will not be too costly for the regulator to introduce through the legal framework. Thirdly, functional convergence can be used on a trial basis as a test case. If it is successful, then it can be incorporated formally and, if not, the change will not cost too much. This may also provide managers, regulators, policymakers and other corporate actors with opportunities to access the compatibility of the new governance feature and, once this is successful and these corporate actors become familiar with the change, this form of convergence may be formally incorporated. Therefore, functional and contractual convergence may provide a road map for policymakers towards formal convergence. Fourthly, contractual convergence leads to functional convergence which, in turn, leads to formal convergence.

Pakistan is an underdeveloped country but an emerging market. Inefficient legal, regulatory, judicial, institutional and governance norms are basic problems experienced in the country. The regulator, legislature and policymakers have undertaken some reforms due to global forces and competition but a dearth of research has been the main hindrance in developing the system. Therefore, the focus of this thesis was on the application and prospects of convergence in corporate governance in Pakistan. The theory was applied in the context of Pakistan in order to improve corporate governance according to international norms and in accordance with the prevailing circumstances of the country. To this end, the thesis was divided into four core chapters, each discussing one aspect of corporate governance and concluding with recommendations.

Chapter Three discussed the application and prospects of convergence in the context of Pakistan. Path dependency, complementarity institutions, interested families and groups, ideology, politics, and religion may be barriers to convergence in corporate governance in Pakistan. However, global competition, efficiency, international organizations, international investors and foreign listing are all elements that are involved in improving corporate governance in Pakistan.

Convergence in corporate governance in Pakistan gained some momentum in the early 1990s after the economic meltdown in Pakistan in the context of the global recession and nuclear explosion in 1998, and subsequent world sanctions. In order to improve corporate governance, some changes were made to the legal and regulatory framework. Most of these amendments were restrictive in nature to provide rights to investors, especially minority shareholders. A major initiative was the introduction of the Code, but it was not successful due to weak compliance and enforcement. The problem lay in the nature of the Code itself. The Code was implemented through listing regulations, which provided non-listing as the only penalty for non-compliance. The introduction of the Code as a soft law on a self-regulatory basis may be a good idea in the context of Pakistan where the corporate sector is not accustomed to good corporate governance practices, especially foreign corporate governance features. Phased implementation may, therefore, be a good idea. Alternatively, as the Code forms part of listing regulations, the enforcement of listing regulations must be ensured through a penalty that must be commensurate with the quantum of non-compliance. This will ensure compliance with both the listing regulations in general and the code in particular.

Chapter Four is divided into two parts. The first part discussed agency problems in Pakistan. The corporate sector in Pakistan is highly concentrated and controlled by families and the state. Though separation of ownership and control is a problem in dispersed ownership, the agency problem is also visible in the conflict between management and the shareholders in concentrated ownership. The agency problem in Pakistan may be resolved, or at least reduced, by different techniques. Firstly, the separation of control and monitoring through the representation of minority shareholders and institutional investors on the board of directors may reduce the agency problem in the country. Non-executive and independent directors can also play an effective role in this regard. Secondly, the institutional investor industry in Pakistan is underdeveloped due to a lack of proper regulations and the excessive role of the state. Privatization of state-owned funds may foster competition, which may help to develop the industry.

Part two of Chapter Four discussed minority protection in the context of corporate governance in Pakistan. The chapter examines six minority protection mechanisms in the context of Pakistan: (1) pre-emptive rights, (2) cumulative voting rights, (3) the conflict of interest of the fiduciaries, (4) derivative action, (5) the unfair prejudice remedy and (6) winding up on just and equitable grounds. The objective of this part was to explore the possibility and effectiveness of convergence in order to improve minority protection.

Pakistan adopted a legal framework inherited from its former British rulers. The present company law of Pakistan mimics the company law made by the British rulers for the subcontinent. Provision is made for the protection of minority rights in the company law of Pakistan. However, some important minority rights, such as derivative action and the controlling exploitation of corporate opportunities, are not catered for in the corporate law of Pakistan. However, some rights that are provided in company law, such as pre-emptive rights, CVS, RPTs, the unfair prejudice remedy, and winding up on just and equitable grounds, are insufficient, out-dated and redundant, to some extent, in the context of the new corporate scenario. Therefore, there is a need to revamp company law in general and the specific remedies to ensure minority rights, discussed in this thesis, in particular in order to enhance investor protection and to improve the corporate sector in Pakistan.

Chapter Five focused on the improvement of the enforcement mechanism in Pakistan in the light of convergence theory. Investor protection is not merely the provision of rights, but the quality of enforcement as well. The ‘law in books’ is important in the first phase of reforms but ‘law in action’ must be improved in the second phase for better corporate governance and investor protection. This chapter analysed and examined the ‘law in action’ in Pakistan. It recommended different means of improving ‘law in action’ through reforms in Pakistan.

The enforcement mechanism is embedded in the system where the courts and market play an important role in corporate governance. The judiciary has a significant role to play in the ‘law in action’. Therefore, an efficient judiciary is the key to good corporate governance in a given system. The judicial system in Pakistan is inefficient, and fails to provide justice to the general public even in general civil and criminal matters. The situation is worse when it comes to issue relates to corporate matters that are considered technical in nature. Corruption, inordinate delays in disposing of cases, judicial cost, lack of expertise on the part of judges and the inefficiency of the whole judicial system are the main problems. Reforming the whole system is not only lengthy and costly, but may not solve the problem of corporate matters as this will require further special training of judges. The state has established a number of specialized courts and tribunals in many fields that are performing better than the general courts. The phenomenon of creating specialized courts, or establishing agencies, quasi-judicial authorities or tribunals in order to enhance enforcement capacity has already started in a number of jurisdictions in Asia and other parts of the world. Therefore, specialized courts may be established in Pakistan to deal with corporate matters presided over by judges with special knowledge and experience of corporate law, accounting, finance and economics. This may reduce not only the burden on the general judiciary, but may ensure efficiency in corporate matters as well, which may enhance the enforcement mechanism of Pakistan as far as corporate governance is concerned.

The other important aspect of law in action is the capital market of Pakistan which is underdeveloped. This market failed to adhere to compliance and to exercise enforcement. Institutional investors are passive and the takeover market is not performing due to an illiquid market. There is a need to reform this market in Pakistan, bearing in mind the particular circumstances prevailing in the country. Resistance from families and vested interests can be overcome by piecemeal reforms in the market. The market can be divided into two segments, namely (1) the primary market and (2) the secondary market. The primary market may require more disclosure and compliance than the secondary market. International accounting standards, compliance with the Code, controlling related party transactions and other disclosure may be mandatory features of this market. The secondary market may require less disclosure and compliance. International accounting standards, compliance with the Code and related party transactions may be optional. The primary market will be attractive to multinational companies and big public companies. Reputational concerns may attract them to enlist on the primary market. This may be useful to small and dispersed investors who wish to invest in the primary market. Institutional investors may invest in both the primary and secondary market as they have experience in, and knowledge of, where to invest. They can also use their position and voting power to ensure compliance. The secondary market may be attractive to small and new firms, and once they get exposure and know the potential benefits of the primary market, they may enlist on this market. The bonding mechanism will be a stimulant for them to shift to the primary market, which may ensure compliance and enforcement.

Chapter Six dealt with the role of religion in the application of convergence theory. The Constitution of Pakistan prescribes that Islam is the state religion. Islam is a practical religion which guides its subjects in each and every field, including financial matters. Therefore, any convergence to foreign corporate governance features in Pakistan has to pass through the Islamic litmus test.

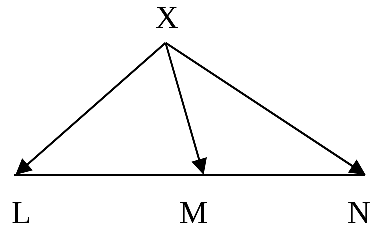
Convergence in corporate governance has two aspects. First, is the convergence to corporate governance in the Islamic world. The evolution of different schools of thoughts in the Muslim world may lead divergence in corporate finance and corporate governance. This is primarily due to the nature of interpretational rules of Islamic law. However, this divergence may be overcome but there is a need to show some kind of flexibility in interpretation by the jurists. There are different techniques in Islamic law that can help to bridge the gap between different interpretational rules and to come to some consensus. Principles such as 'choice and selection' (*iktiyar* and *takhayyur*), 'amalgamation or patching' (*talfiq*), 'necessity' (*darurah*) and 'ruses' (*hila*) may be utilized to redefine Islamic law (*fiqh)* according to modern requirements. This may help to unify different interpretations of Islamic law and converge to unique corporate governance and corporate finance, at least within the Muslim world. This will also help Pakistan to converge to the Muslim world's Islamic finance and corporate governance.

The second aspect is convergence to a Western model of corporate governance in Pakistan. Pakistan is an Islamic country but it has adopted a conventional financial system based on the British system as a former British colony. As Pakistan is an Islamic country and its people were forced to Islamize its economy, the government took some steps to do so. However, these efforts were not successful for different reasons such as a dearth of research; human resources; a legal and regulatory framework; institutional incapacity; and of the state's commitment. The problem with using Islamic finance in Pakistan is its application in modern times. Furthermore, there is no successful model within the Muslim world that may be applied in Pakistan.

In order to improve corporate governance in Pakistan, there is a need to converge to Western corporate governance features but within the limits prescribed by the *Shariah*. As an abrupt overnight change from a conventional financial system to an Islamic system is not feasible, the system needs to be changed through steps. In the first step, instead of changing the whole system, the existing system needs to be synchronized with the Islamic financial system. A synthesis is possible to the extent that Western governance features can be adopted that are not against the *Shariah* under the principle of 'continuity of permissibility'. In the second step, features that have some kind of defect may be reorganized in such a way that they are made compatible with Islamic finance under the methodology of 'ruses'. In the third step, some features that have minor defects may be adopted under the 'principle of necessity'. This whole process requires substantial research and some kind of flexibility on the part of Muslims jurists. Islamic norms may not act as a strong barrier, as it is normally conceived, for convergence to a Western form of corporate governance.

ANNEXURES

Annexure I: Pyramiding structure and its effects on control



Suppose X is a holding company with the following shareholdings:

Shareholders	Percentage in shareholding (%)
X1	51
X2	20
X3	10
X4	10
X5	9

Also, suppose X has three subsidiary companies such as L, M and N with the following shareholdings:

L = subsidiary

Shareholders	Percentage in shareholding (%)
L1=X	75
L2=X1	1
L3	10
L4	10
L5	4

M = Subsidiary

Shareholders	Percentage in shareholding (%)
M1=X	51
M2=X1	24
M3	10
M4	10
M5	5

N = subsidiary

Shareholders	Percentage in shareholding (%)
N1=X	51
N2=X1	1
N3	30
N4	10
N5	8

Explanation:

1. X1 having 51% shareholding in holding company X controls the company and consequently controls all the subsidiary companies L, M and N in the following way:

   a. In subsidiary company L, X1 haves 1% direct control and 75% indirect control through holding company X, which has 75% shareholding in L. As X1 controls X by having 51% shareholding in X, X1 therefore has indirect control in L.

   b. In subsidiary company M, X1 has 24% direct control and 51% indirect control through holding company X, which has 51% shareholding in L. As X1 controls X by having 51% shareholding in X, X1 therefore has indirect control in M.

   c. In subsidiary company N, X1 has 1% direct control and 51% indirect control through holding company X, which has 51% shareholding in L. As X1 controls X by having 51% shareholding in X, X1 therefore has indirect control in N.

Annexure II: Judicial structure in Pakistan

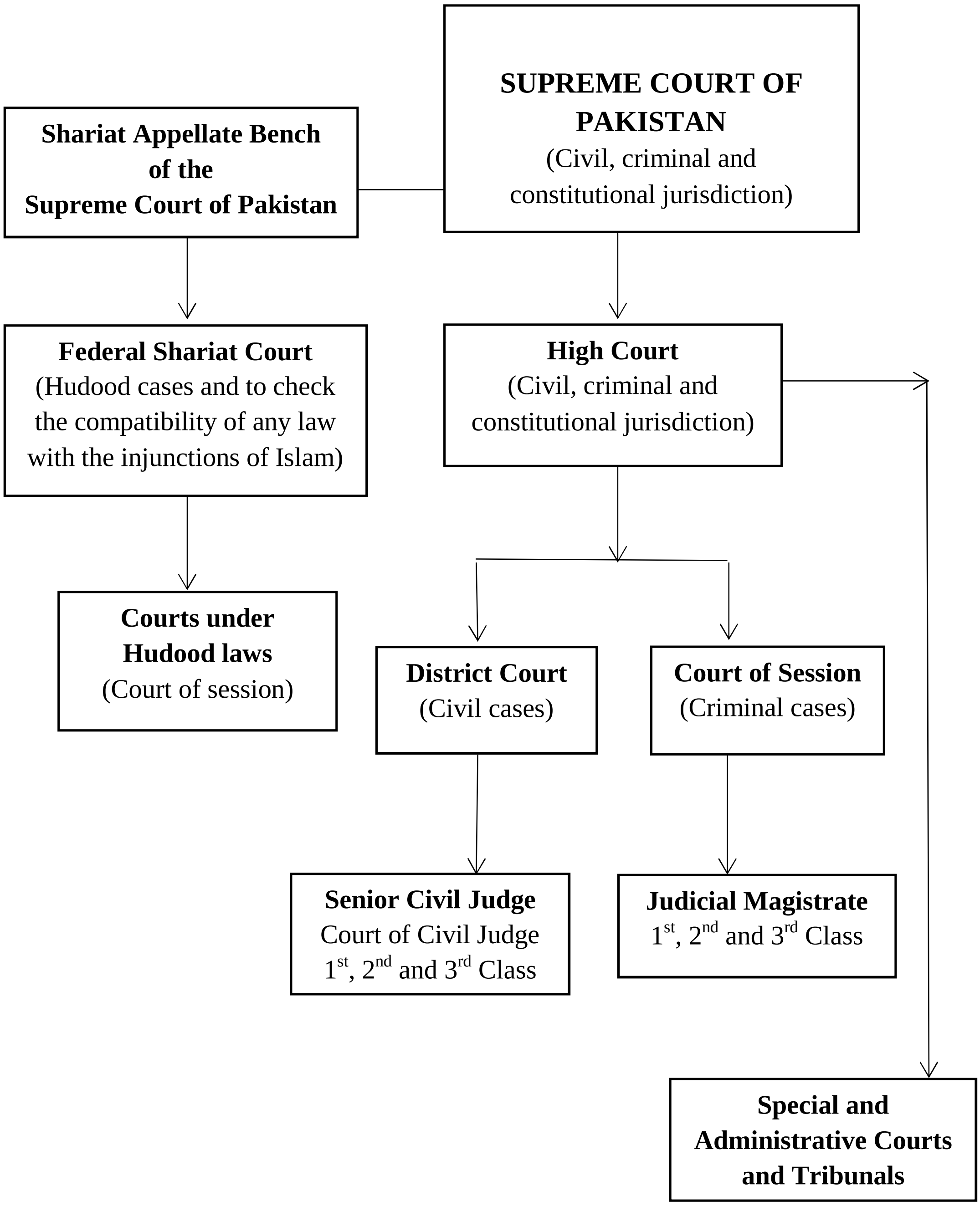


Figure II.1: The judicial structure of Pakistan

Annexure III: Administrative court structure in Pakistan

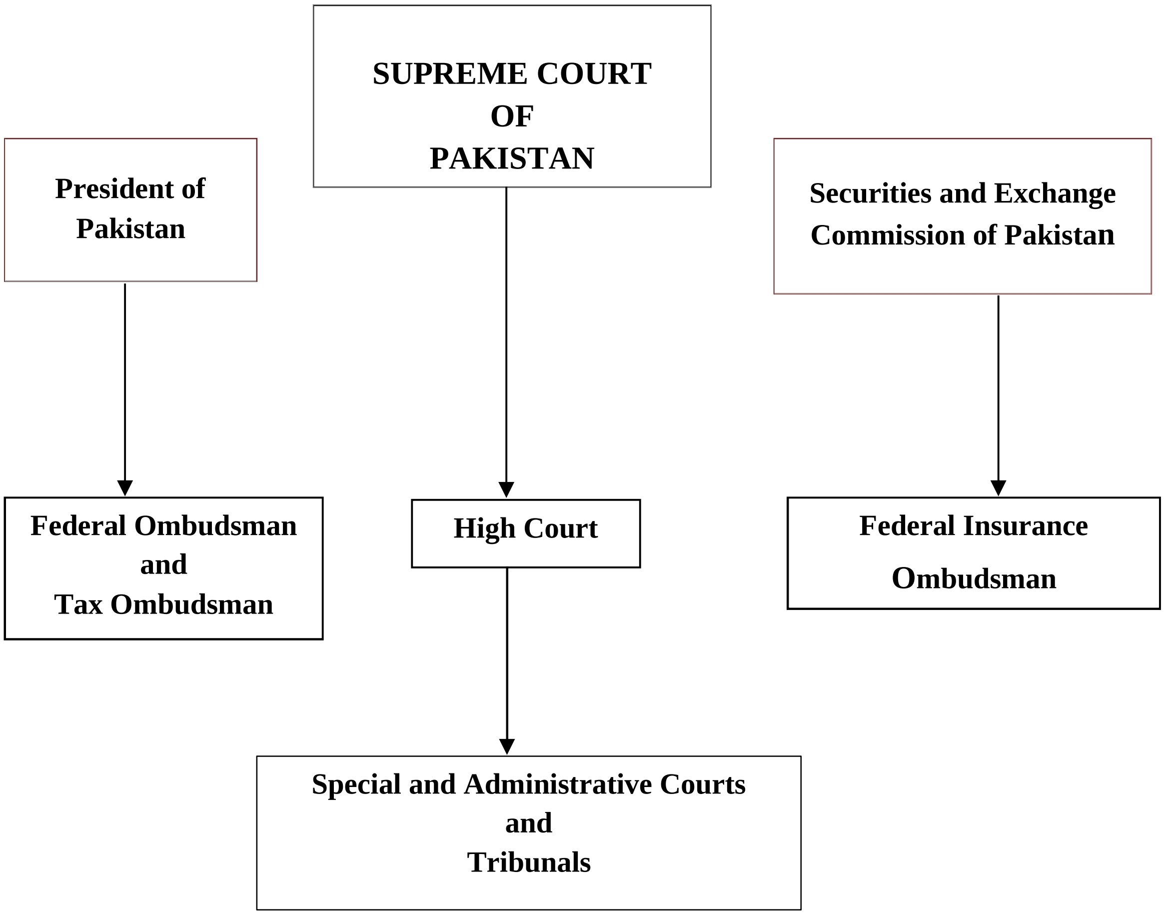


Figure III.1: Administrative court structure in Pakistan

Annexure IV: Federal Administrative Courts and Tribunals in Pakistan

Table AIV.1: Federal Administrative Courts and Tribunals in Pakistan

S. no.	Name of court	Relevant law	Objective and forum for appeal
1	Banking Courts	The Financial Institutions (Recovery of Finances) Ordinance, 2001	To recover loans from defaulters.[1] Appeal against the decision of the Banking Court can be filed with the High Court within 30 days.[2]
2	Special Courts for Banking Offences	The Offences in Respect of Banks (Special Courts) Ordinance, 1984	To conduct a speedy trial of certain offences committed in respect of banks.[3] Appeal against the decision of the Courts can be filed with the respective High Court within 30 days.[4]
3	Anti-Terrorism Courts	The Anti-Terrorism Act, 1997	To provide for the prevention of terrorism, sectarian violence and for a speedy trial of heinous offences and for matters connected therewith and incidental thereto.[5] Appeal against the order of the Court can be filed with the High Court within seven days.[6]
4	Accountability Courts	The National Accountability Bureau Ordinance, 1999	To provide for effective measures for the detection, investigation, prosecution and speedy disposal of cases involving corruption, corrupt practices, misuse? abuse of power, misappropriation of property, kickbacks, commissions and for matters connected and ancillary or incidental thereto.[7] An aggrieved person may file an appeal against the order of the Court with the respective High Court within 10 days.[8]
5	Drug Courts	The Drugs Act, 1976	To regulate the import, export, manufacture, storage, distribution and sale of drugs.[9] Appeal against the

[1] See preamble to the Financial Institution (Recovery of Finance) Ordinance, 2001.
[2] See s. 22 (1) of the Financial Institution (Recovery of Finance) Ordinance, 2001.
[3] See preamble to the Offences in respect of Banks (Special Courts) Ordinance, 1984.
[4] See s. 10 of the Offences in respect of Banks (Special Courts) Ordinance, 1984.
[5] See preamble to the Anti-Terrorism Act, 1997.
[6] See s. 25 of the Anti-Terrorism Act, 1997.
[7] See preamble to the National Accountability Bureau Ordinance, 1999.
[8] See s. 32 of the National Accountability Bureau Ordinance, 1999.
[9] See preamble to the Drugs Act, 1976.

S. no.	Name of court	Relevant law	Objective and forum for appeal
			decision of the Court can be filed with the respective High Court within 30 days.[10]
6	Special Courts for Emigration Offences	The Emigration Ordinance, 1979	To deal with emigration matters. Appeal against the order of the Court can be filed with the respective High Court within 30 days.[11]
7	Labour Courts	The Industrial Relation Ordinance, 2002	To deal with the law that relates to the formation of trade unions, regulation and improvement of relations between employers and workmen, and avoidance and settlement of any differences or disputes arising between them.[12] An aggrieved party may prefer any appeal to the High Court[13] within 30 days.[14]
8	Court of Special Judge (Customs, Taxation and Anti-Smuggling)	The Customs Act, 1969	To levy and collect customs duties, fee and service charges, and other allied matters that may include taxation and anti-smuggling.[15] Appeal against the order of the Special Judge can be filed with the Special Appellate Court within 60 days.[16] Similarly, an appeal against an order of the officer of customs can be filed with the Collector (Appeal) within 30 days[17] and an appeal against the order of the Collector (Appeal) can be filed with Customs Appellate Tribunals.[18] The ag-grieved person or any officer authorized by the Collector may refer a question of law arising from the order of the Tribunal to the respective High Court within 90 days.[19]
9	Income Tax Appellate Tribunals	The Income Tax Ordinance, 2001	To entertain appeals against the orders of the Commissioner of Income Tax. There is limited right of appeal against the order of these tribunals. Any party can ask the

[10] See s. 31 (7) of the Drugs Act, 1976.
[11] See s. 24-A of the Emigration Ordinance, 1979.
[12] See preamble to the Industrial Relation Ordinance, 2002.
[13] See s. 48 of the Industrial Relation Ordinance, 2002.
[14] See s. 47(3) of the Industrial Relation Ordinance, 2002.
[15] See preamble to the Customs Act, 1969.
[16] See s. 185F of the Customs Act, 1969.
[17] See s. 193 (1) of the Customs Act, 1969.
[18] See s. 194-A of the Customs Act, 1969.
[19] See s. 196 of the Customs Act, 1969.

S. no.	Name of court	Relevant law	Objective and forum for appeal
			tribunal to file a reference to the High Court to clear up any question of law.[20] An appeal can also be filed with the Supreme Court against an order of the High Court on such reference.[21]
10	Environment Appellate Tribunals	The Pakistan Environment Protection Act, 1997	The objective of the Act is the protection, conservation, rehabilitation and improvement of the environment; prevention and control of pollution; and the promotion of sustainable development.[22] These tribunals are final fact-finding authorities in cases related to the environment. These tribunals also entertain complains, and appeals against legal action of the Environmental Protection Agency. Private individuals are also eligible to approach the tribunals to seek relief for their grievances against the alleged polluters. Appeals against the order of the Federal Agency or Provincial Agency can be filed with the Environment Tribunals[23] and an appeal against the final order of the tribunal can be filed with the High Court within 30 days.[24]
11	Insurance Appellate Tribunals	The Insurance Ordinance, 2000	Jurisdiction of these tribunals is to judge, adjudicate on/or to determine claims and disputes relating to insurance business. The appeal against the decision of these tribunals are to the High Court only when the claim amount is equal or more than R100,000, otherwise no appeal lies against decisions of these tribunals.[25] Further-more, an appeal is not to Appellate Bench of the SECP as per section 33-34 of the SECP Act 1997.
12	Service Tribunals	Article 212 of the Constitution of the	These tribunals have exclusive jurisdiction with respect to terms and

[20] See s. 133 of the Income Tax Ordinance 2001.
[21] See s. 134 of the Income Tax Ordinance, 2001.
[22] See preamble to the Pakistan Environment Protection Act, 1997.
[23] See s. 22 of the Pakistan Environment Protection Act, 1997.
[24] See s. 23 (1) of the Pakistan Environment Protection Act, 1997.
[25] See s. 124 (2) of the Insurance Ordinance, 2000.

S. no.	Name of court	Relevant law	Objective and forum for appeal
		Islamic Republic of Pakistan through the Services Tribunals Act, 1973	conditions of the service of civil servants.[26]
13	Special Courts (Control of Narcotics Substances)	The Control of Narcotics Substances Act, 1997	To control the production, processing and trafficking of narcotics drugs and psychotropic substance.[27] Appeal against the order of the Special Court comprising a judicial magistrate will be to the Special Court comprising a Session Judge or Additional Session Judge.[28] Appeal against the order of the Special Court comprising Session Judge will be to the High Court.[29]
14	Federal Ombudsman (Wafaqi Mohtasib)	The Establishment of the Office of Wafaqi Mohtasib (Ombudsman) Order, 1983	The objective of the Ombudsman is to diagnose, investigate, redress and rectify any injustice done to a person through maladministration by persons holding public offices.[30] Any party aggrieved by the order or decision of the Mohtasib may prefer representation to the President of Pakistan within 30 days.[31]
15	Federal Tax Ombudsman	The Federal Tax Ombudsman Ordinance, 2000	To entertain complaints against the officer of the Federal Bureau of Revenue (FBR) collecting income tax, sales tax, customs duties and federal excise duty. Any party aggrieved by the order or decision of the Mohtasib may prefer a representation to the President of Pakistan within 30 days.[32]
16	Federal Insurance Ombudsman	The Insurance Ordinance, 2000	This is an autonomous dispute resolution authority that resolves insurance disputes between policyholders and participating companies independently and impartially. The objective of the office of the

[26] See preamble to the Services Tribunals Act, 1973.
[27] See preamble to the Control of Narcotics Substances Act, 1997.
[28] See s. 48 (1) of the Control of Narcotics Substances Act, 1997.
[29] See s. 48 (2) of the Control of Narcotics Substances Act, 1997.
[30] See preamble to the Establishment of the Office of Wafaqi Mohtasib (Ombudsman) Order, 1983.
[31] See s. 32 of the Establishment of the Office of Wafaqi Mohtasib (Ombudsman) Order, 1983.
[32] See s. 32 of the Federal Tax Ombudsman Ordinance, 2000.

S. no.	Name of court	Relevant law	Objective and forum for appeal
			Ombudsman is the quick disposal of the grievances of insurers.[33] Appeal against the order of the Ombudsman can be filed with the Securities and Exchange Commission of Pakistan within 30 days.[34]
17	Commercial Courts	The Import and Export (Control) Act, 1950	The objective of the Act is to control the import into, and export from, Pakistan.[35] Appeal against the decision of the Commercial Court can be filed with the High Court within 30 days.[36]
18	Integrated Utility Courts	Proposal to incorporate through the amendment of the Gas Utility Companies Act, 2010	The purpose of these courts is to deal with defaulters and theft of electricity and gas.[37]

[33] See website of Securities and Exchange Commission of Pakistan available at <http://www.secp.gov.pk/ID/id_complaints.asp> Accessed 04.12.2013.
[34] See s. 130 (2) of the Insurance Ordinance, 2000.
[35] See preamble to the Import and Export (Control) Act, 1950.
[36] See s. 5A (8) of the Import and Export (Control) Act, 1950.
[37]See the daily English newspaper 'Dawn' available at < http://www.dawn.com/news/1033228/cci-approves-national-power-policy-2013> Accessed 04.12.2013.

Annexure V: Provincial Administrative Courts and Tribunals in Pakistan

Table AV.1: Provincial Administrative Courts and Tribunals in Pakistan

S. no.	Name of court	Relevant law	Objective and forum of appeal
1	Revenue Courts	The West Pakistan Land Revenue Act, 1967	The objective of the Act is to create and maintain the record of rights, assessment and collection of land revenue.[1] The courts consist of officers appointed by the government in the revenue department. These include Assistant Collectors, Collectors, Commissioners and the Board of Revenue. The law prescribe their powers and functions.[2]The order of the Assistant Collector is appealable to the Collector and order of the Collector is appealable to the Executive District Officer (EDO) (Revenue) and order of the EDO (Revenue) is appealable to the Board of Revenue. The appeals are subject to conditions that if original appeal is confirmed on first appeal then there will be no further appeal. Similarly, if on appeal, the order of revenue officer (Assistant Collector) is reversed or modified by the Collector, then the order made by EDO (Revenue) shall be final. Appeal to Board of Revenue can only be on point of law.[3]
2	Consumer Courts	These courts are established by provinces under their respective consumer protection Acts. In Punjab there is the Punjab Consumer Protection Act, 2005. In Khyber Pakhtoonkhawa, there is the	The objective of the courts is to provide protection and promotion of the rights and interests of the consumers and speedy redress of consumer complaints.[4] Appeal against the order of the Consumer Court can be filed with the respective High Court within 30 days.[5]

[1] See preamble to the West Pakistan Land Revenue Act 1967.
[2] Faqir Hussain (Registrar of the Supreme Court of Pakistan), 'Judicial System of Pakistan' (2011) available at Supreme Court of Pakistan's website at <http://www.supremecourt.gov.pk/web/page.asp?id=594 > Accessed 20.12.2013.
[3] See s. 161 of the West Pakistan Land Revenue Act, 1967.
[4] See preamble to the Consumer Protection Acts.
[5] See s. 33 of the Punjab Consumer Protection Act, 2005.

S. no.	Name of court	Relevant law	Objective and forum of appeal
		NWFP Consumer Protection Act, 1997. In Islamabad and Baluchistan there is the Islamabad Consumer Protection Act, 1995 and the Baluchistan Consumer Protection Act, 2003 respectively. To date there has been no consumer protection Act in Sindh.	
3	Rent Tribunals	The Punjab Rented Premises Act, 2009	The objective of the Act is to regulate the relationship between a landlord and tenants, and to provide a mechanism for settlement of their disputes in an expeditious and cost-effective manner.[6] An appeal against the order of the Tribunal can be filed with the District Court.[7]
4	Family Courts	The West Pakistan Family Courts Act, 1964	The objective is to provide the expeditious settlement and disposal of disputes relating to marriage and family affairs.[8] Appeal against the order of the Family Court lies with the High Court. In some cases the appeal may be filed with the District Court when the order is passed by any judge below the rank of District Judge.[9]
5	Services Tribunals	The Punjab Service Tribunals Act, 1974	The objective of the establishment of these tribunals is to exercise jurisdiction regarding matters relating to the terms and conditions of services of civil services.[10] Appeal can be filed with the District Judge within 30 days.[11]
6	Anti-	The Anti-	The objective of these courts is to prevent

[6] See preamble to the Punjab Rented Premises Act, 2009.
[7] See s. 29 of the Punjab Rented Premises Act, 2009.
[8] See preamble to the West Pakistan Family Courts Act, 1964.
[9] See s. 14 of the West Pakistan Family Courts Act, 1964.
[10] See preamble to the Punjab Service Tribunals Act, 1974.
[11] See s. 28 of the Punjab Rented Premises Act, 2009.

S. no.	Name of court	Relevant law	Objective and forum of appeal
	Terrorist Courts	Terrorist Courts may also be established by the respective Provincial Governments in addition to the Federal Government under the Anti-Terrorism Act, 1997.[12]	terrorism, sectarian violence and the speedy trial of heinous offences.[13] Appeal against the order of court can be filed with the High Court within seven days.[14]
7	Drug Courts	The Drugs Act, 1976.[15]	The objective of these courts is to regulate the import, export, manufacture, storage, distribution and sale of drugs.[16] Appeal can be filed with the High Court within 30 days.[17]

[12] See s. 13 (1) of the Anti-Terrorism Act, 1997.
[13] See preamble to the Anti-Terrorism Act, 1997.
[14] See s. 25 of the Anti-Terrorism Act, 1997.
[15] See s. 31 of the Drug Act, 1976.
[16] See preamble to the Drug Courts Act, 1976.
[17] See s. 31 (7) of the Drug Courts Act, 1976.

Annexure VI: Penalty structure in corporate law in Pakistan

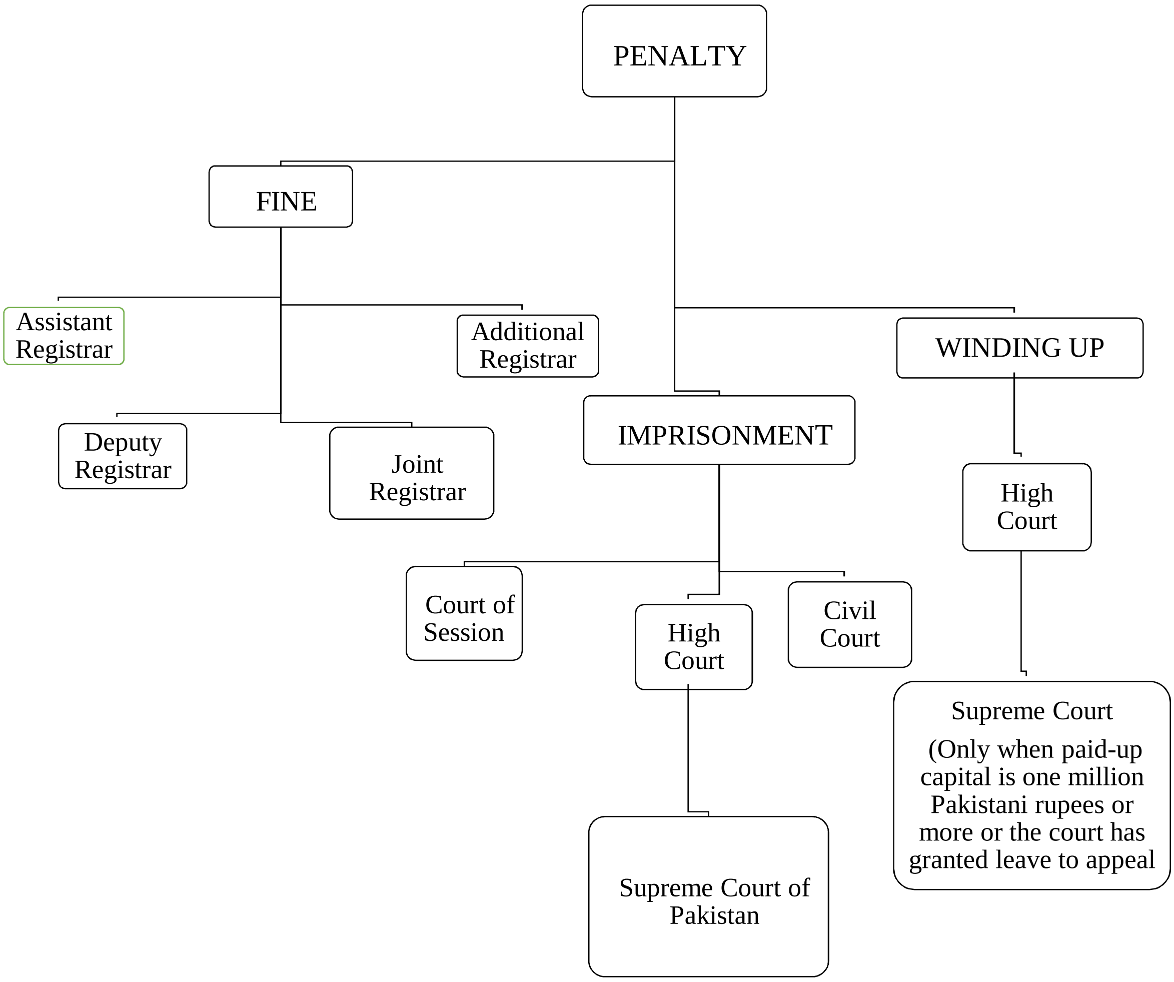


Figure VI.1: Penalty structure in corporate law in Pakistan

Annexure VII: Corporate judicature in Pakistan

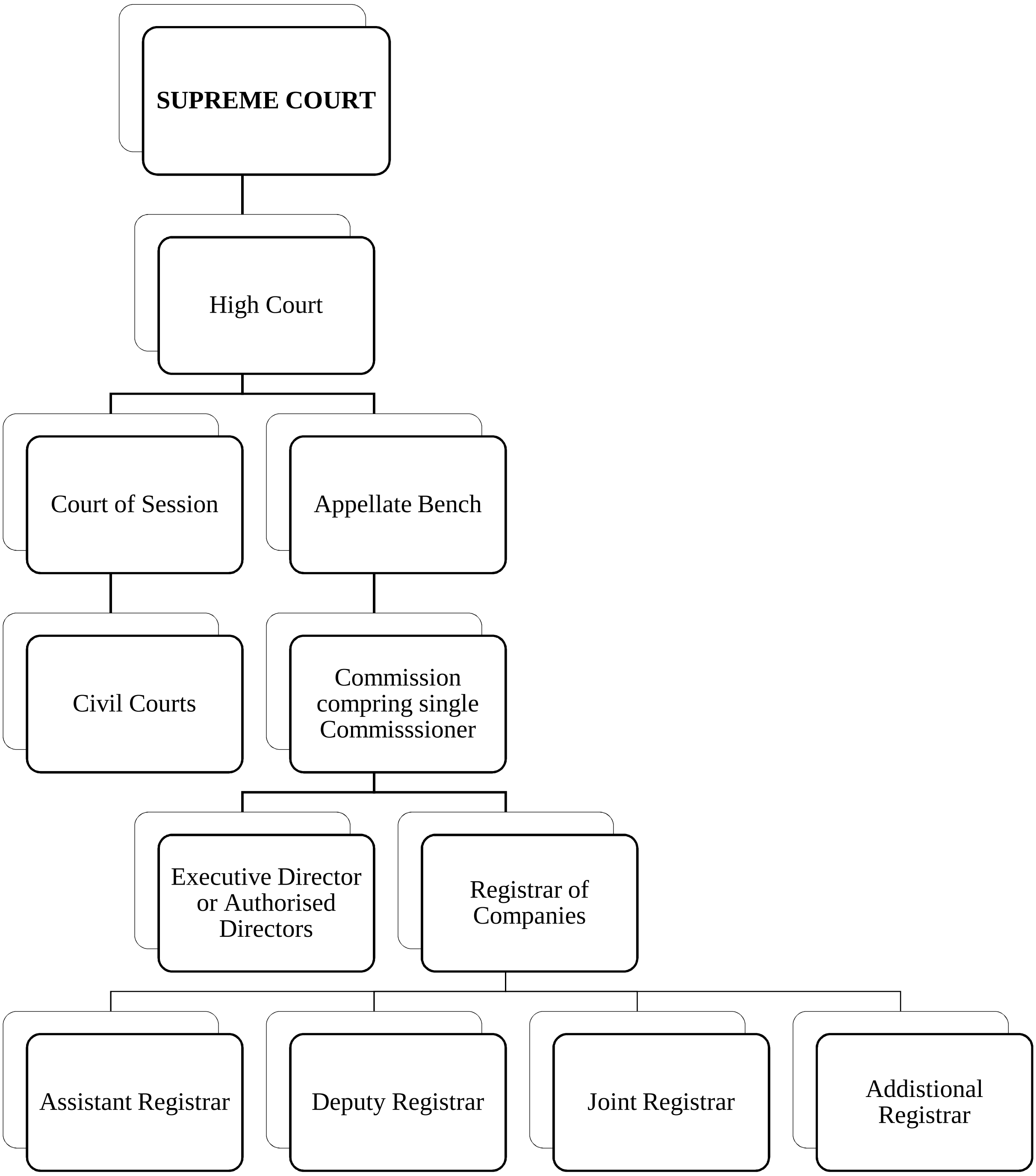


Figure VII.1: Corporate judicature in Pakistan

Annexure VIII: Listing structure in the United Kingdom

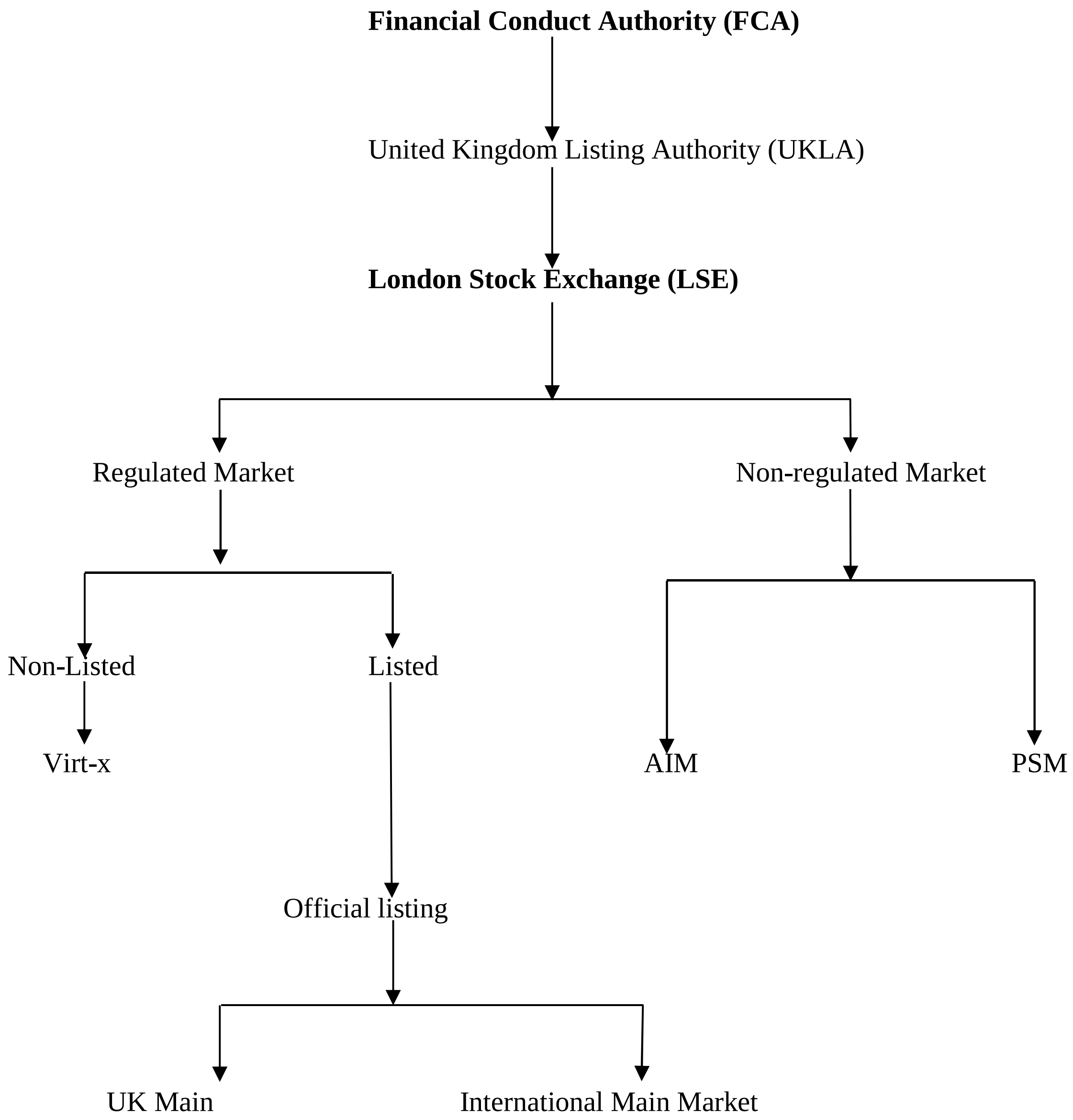


Figure VIII.1: Listing structure in the United Kingdom

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