



International Corruption and Shareholder Litigation: A Perspective of CSR in Pakistan

Aamir Abbas¹, Atika Lohani², and Muhammad Mumtaz Ali Khan^{3*}

¹College of Law , Government College University Faisalabad, Pakistan

²College of Law, University of Sargodha, Pakistan

³Research &Development, Punjab Higher Education Commission, Lahore, Pakistan

*Corresponding Author: mumtaz.ali@punjabhec.gov.pk

Abstract

The significance and importance of corporate social responsibility requires that companies must take into consideration the multi-stakeholder interests ranging from environment, economic and other social impacts of corporate actions. The profiteering of corporations has made business actions questionable which is particularly evident in developing states. This article encompasses issues of corruption and bribery in commercial transactions as a corporate social responsibility aspect and sheds light on shareholders' derivative right of actions for the implementation of CSR issues. It also looks into mandatory bars on derivative claims and relationship of CSR to derivative claims considering the social responsibilities of shareholders in corporations. This potentially establishes that breach of duties on the part of directors and other corporate wrongs damaging society at large are required to be taken to courts and need to be remedied.

Introduction

Derivative litigation has an important role to play in fighting against bribery, corrupt payments and wastage of corporate assets. The cause of action in derivative proceeding is required to be extended to matters of questionable payments made by the companies. Such corrupt payments might be used in furtherance of the interests of the companies; however, shareholders are entitled to challenge such payments on grounds of the wastage of corporate assets and breach of fiduciary duty which the directors owe to the shareholders. This element of cause of action in derivative proceedings is recognised worldwide. For example, in the case of *Auerbach v Bennet* (1979), corrupt payments and kickbacks paid by the corporation were challenged by a shareholder through a derivative action. The court permitted the action to be continued on the cause of action involving acts of bribery and illegal payments. Action against acts of bribery and

other illegal payments brought this aspect of CSR enforceable by derivative right of shareholders.

International corruption was first time recognised in the judgment of Konamaneni and others. Rolls Royce Industrial Power Ltd (India, 2002) and others case in the context of derivative proceedings. By this recognition, international corruption became cause of action in derivative litigation as an exception to the Foss v Harbottle rule (1843). In this case, minority shareholders of an Indian company namely Spectrum Power Generation Ltd levelled allegations of bribery against British enterprises for bribing managing director of the Indian company in return of getting business contracts relating to installation of power station in Indian. Required by corporate regulations, directors of the companies are bound to exercise their duties in order to protect the interests of the companies. However, when the directors of the companies go errant and perform their duties and functions disadvantageous to the interests of the shareholders, the shareholders can take action against them on majority basis. Majority rule is not always remedial to wrongs committed by the management because concentrated corporate ownership like in Pakistan, might allow controlling shareholders to take self interested decisions, by using the means of exploitation of corporate assets and related party transactions. As an alternative option, law provides two types of remedies to the shareholders; unfair prejudice remedy and derivative claims in to correct wrongs done by the management of the companies.

Before broaching the discussion of relationship of derivative claims to CSR issues, it is necessary to explain the grounds for these legal remedies in Companies Act 2017. Unfair prejudice remedy is available to shareholder under the law. Unfair prejudice remedy is available to shareholder where their individual rights are infringed and they may seek remedy by invoking this very kind of remedy. Although this remedy is available to shareholders in the company law of Pakistan, however, the threshold to initiate legal proceedings against the wrongdoing directors is to hold minimum 10 percent of the shareholdings of the company. This threshold must be reduced in order to make every shareholder of company to avail this remedy because it is the minority shareholders of the company who deservingly need protection against the wrongdoings of directors. Ten percent shareholdings are possessed with a significant pressure to safeguard their interests; it is these individual shareholders of the company who really deserve legal protection without any bar to protect themselves from the misconduct of directors. This high threshold stipulated by the company law of Pakistan needs to be reduced following the remedy available to each shareholder of the companies under UK companies Act 2006.

Right of shareholders to derivative litigation is not codified in Pakistan which leaves multiple ambiguities and complexities for this very useful remedy to shareholders. The same is recognised worldwide as a useful remedy to discipline the wrongdoing of directors. For example, derivative proceedings can be initiated in the UK on CSR issues such as acts of bribery and corruption under section 260 of the Companies Act 2006. Section 260 (3) permits actions against management where it is found involved in negligence, breach of duty or trust and default. Primarily, it is duty of company to ensure that company's affairs are being run responsibly and in

accordance with the interests of the shareholders. However, when the corporate management fails to perform its functions as to the protection of interests of shareholders and pays no attention to interests of other stakeholders, it is the shareholders who step into the shoes of company's right of action against the wrongdoer. This right of action is legitimate in the circumstances where the corporate management is not called to account by the shareholders owing to their low shareholdings or otherwise.

As such, the proper plaintiff rule which means that it is company which is possessed with the right of action against any misdoing, not the individual shareholders to initiate litigation against the corporate management. Secondly, the majority rule is recognised as an accountability mechanism in corporation. Both these rules exclude courts' interference and shareholders' right to initiate suit against management. Without the courts' interference and involvement, management transgresses its fiduciary duty and takes decision detrimental to the interests of shareholders which the situation requires and justifies shareholders' right of action against wrongdoing managers. This is why; the right of shareholders' action is recognised in most of jurisdictions.

Derivative proceedings and their impacts on corporate governance in Pakistan

The corporate ownership structure in Pakistan is concentrated which allows controlling shareholders to rule over managerial decisions and also helps them exploit corporate resources by prioritizing their interests over the interests of corporations. There are corporate mechanisms to discipline wrongdoing corporate management such as, market for corporate control, independent directors and other minority shareholders' protective tools but these mechanisms are limited and allow corporate management in concentrated corporate ownership structures to perpetuate their control.

A significant effective corporate disciplinary mechanism lies in the hands of the regulators of the financial institutions who exercise supervisory powers to make wrongdoers in corporations accountable. However, politicization of the governance actions of these institutions makes them incomplete as an enforcement mechanism. The impact of corporate proceedings on the corporate board, improving corporate governance and maintain investor confidence has a significant role to play given the facilitation mechanism in derivative actions.

Since directors and wrongdoers in corporations are made liable personally in successful derivative actions. Financial liability concerns make managerial decisions disciplined if taken under the apprehensions of derivative claims where these go wrong or taken in self interests. The monetary benefits of derivative actions ensue that company may recover looted money or damages from the errant directors. Apart from the personal liability concerns of the management, the risk of directors' reputation is heavily affected by the threat of derivative proceedings. In Pakistan, like in most of the world, directors of corporations' hail from professional services structures. These professionals are very sensitive and conscious of their reputation which might be affected in the course of litigations. Thus, derivative proceedings if facilitated by law and

encouraged by the corporations can help corporate management to consider and implement corporate social responsibility issues while making decisions.

In order to increase the utility of derivative proceedings, two types of reforms are necessary to be taken into consideration in Pakistan, (a) reforms in the requirements of laws and removal of procedural hurdles in common law derivative action system, (b) reforming professional services mechanism which would help improve derivative claims utility. Further added to this that derivative proceedings can be facilitated if Pakistani lawyers reduce their retainers and secondly their dependence on contingency fees mechanism is expanded. Codified derivative action framework is direly needed in order to allow more wide range and aspects of suits to be initiated more easily than is presently the condition in common law remedy of derivative claims in Pakistan. By the application of derivative action system, the acts of bribery and corruption would be dealt on counts of compensation and deterrence aspects of derivative proceedings.

Anti -Bribery Framework in Pakistan

There is no single anti-bribery or legal framework pertaining to corruption in Pakistan but this menace is dealt by various enactments. Acts of bribery and receiving kickbacks by the domestic government officials is prohibited by law but acts of bribery of foreign officials are not properly regulated as no law fixes criminal liability on corporate entities which are involved in paying or receiving bribes in Pakistan. It is significant to mention here that foreign corporations are required to follow local laws of the state in which they are operating their businesses.

Some legislations such as US Foreign Corrupt Practises Act and UK Bribery Act have extraterritorial application on their corporate entities involved in corrupt practises anywhere in the world. Both these legislations introduced the concept of derivative liability of their suppliers and agents. Theoretical underpinning of the utility of derivative litigation depends on the ability and efficacy of the judicial system of Pakistan. After judicial activism in the backdrop of the lawyers' movement for the restoration of illegally ousted chief justice Iftikhar Muhammad chaudry, judicial policy 2012 came to fore where significant measures have been taken to strengthen the judicial system in Pakistan. Moreover, commercial courts in Pakistan have begun to function which would ultimately help achieving the optimal usefulness of derivative proceedings in CSR issues particularly encouraging shareholders to play their role in upholding integrity and honesty in businesses.

Anti – corruption as a CSR issue

Corporations are contracted by legal and public policy arrangements, corruption, as a CSR issue; the focus of this paper, has not been viewed through the lens of corporate governance rather it was dealt by laws and regulations , However , in the recent times, wrongdoings in corporations have been addressed through CSR which has brought the phenomenon of international corruption within the discourse of CSR. Smerdon has provided a theoretical basis for companies to foster relationship with its stakeholders as means of improving shareholder value. He relied on

pluralist theory of corporate governance which requires corporation to take into considerations of interests of employees, customers, creditors, environment and society. In corporate governance literature, two camps are being viewed in running corporations, i.e. business oriented objectives and value based perspective of corporate governance. Business oriented objectives are aimed to increase shareholder value, while the value based perspective of corporate governance focuses on integrity, honesty and transparency in managerial actions.

The OECD principles on corporate governance are limited in terms of addressing corporate actions on environment, anti bribery and other ethical concerns. In today's world, corporate operations are international where CSR issues are significant to be addressed. CSR issues particularly the one which involves bribery of public officials is not effectively dealt by corporate governance. It is because that the outsiders have little scope to participate in the internal affairs of corporate governance.

In International commercial transactions, allegations of payments made to foreign public official in order to get business deals at less than market price are numerous which the matter requires the attention of policy makers to deal with this menace by employing various means. This phenomenon put the allegations of bribery within the CSR and attracts derivative suits to fall within the literature of corporate governance. Since CSR was a voluntary guidelines for companies to adhere in order to appear as responsible businesses. Laws pertaining to anti-corruption provide an ample testimony to the notion that laws have major role to play in ensuring CSR standards. Critically, the soft law mechanism for corporations to shun corruption and bribery appears ineffective, though remain a source of regulations in this regard.

Allegations of bribery and kickbacks measure on the circumstances which underpin necessity and significance of shareholder litigation in CSR discourse in Pakistan. International corruption is also a subject of consideration in Pakistan. Scams such as Karkey and RekoDiq and allegations of bribery and kickbacks in China –Pakistan Economic Corridor offer ample testimony to such kind of corruption which the situation calls for the attention of legislators to extend cause of action in international corruption and illegal payment to derivative proceedings so as to strengthen the enforcement powers of shareholders to punish the wrongdoers involved in acts of bribery and receiving kickbacks in return of transacting business deals on less than the markets rates. A close estimation shows that kickbacks in procurement processes alone make up to the level of 15 percent of Pakistan's total development budget. Shareholders' concerns and actions towards anti corruption can be better echoed in large or multinational corporations who are better placed to reject demands of bribery and collusive contacts than in the small sized corporations in Pakistan.

In Karky scam, the managing director of Private Power and Infrastructure Board (PPIB) and three chief executive directors of Lakhra Power Generation Company alongwith other government official were found involved in award of contracts for Karkey in return of receiving kickbacks and other illegal payments. Reference was filed against Karkyby National

Accountability Bureau, where the Turkish company requested for plea bargain accepting the allegation of bribes and kickbacks. Their request to settle dispute locally was struck down by the Supreme court of Pakistan. The Turkish company, as a result, moved ICSID for claiming damages for damage done to its vessels at Karachi port.

Reko dick is another example of this unfortunate phenomenon to quote. In 2006, a foreign consortium of Chilean and Canadian was granted the rights of mining exploration in the province of Baluchistan. This was the largest foreign direct investment ever made in the history of Pakistan. In 2012, the then government of Baluchistan cancelled the agreement and instead granted it to locally collaborated Chinese company with little experience background of mining. As a result, the matter was brought at multiple forums, the Supreme Court of Pakistan, International Centre for settlement of Investment Disputes (ICSID) and at International Criminal Court (ICC). The Supreme Court of Pakistan declared the original agreement null and void on grounds of violation of public policy aspect of the contract. The ICSID and ICC opined otherwise and resultantly dismissed the application of government of Pakistan leading her to face damages of over 11 billion US dollars.

Moreover, the Textile sector of Pakistan which accounts for about 50 percent of Pakistan's total exports is also marred with examples of violation CSR issues. It is claimed that the sector is characterised by subcontracting in order to avoid labour laws enforcement. This practise estimates that bribes and kickbacks in government inspection of corporate sector accounts for over 47 percent violation of labour regulations. Moreover, it was disclosed in 2007 that some national and multinational extorted about 134 billion Pak Rupees during last decade in obtaining oil and gas contracts but with no exploration of oil and gas.

The above mentioned cases of bribery and corruption have provided an analysis to showcase the impact of derivative suits on CSR issues, particularly on anti corruption standards. It is, thus, recommended that the extension of cause of action in derivative proceeding to international corruption should be considered by the policy makers and legislators in Pakistan.

Conclusion

Corporate Social Responsibility has been viewed and discussed increasingly in corporate governance. However, the closer examination of the role of corporate governance in dealing with the external CSR issues finds it limited and incapable without the involvement of shareholders in enforcing CSR through litigation. This paper examined an important role which corporate governance can play in checking bribery and corrupt practises. By derivative litigation, being a significant aspect of corporate governance, shareholders take control of corporate actions. Shareholders' right of derivative litigation analysed in this paper shows the empowerment of shareholders to discipline corporate decisions pertaining to the social and ethical obligations in corporate operations. This is more significant in the context of Pakistan where multinational corporations take advantage of relatively weak administration to get business deals by bribing public officials. Derivative claims, can, therefore, provide as useful tool by which corporate

governance deal with issues of bribery and corruption. However, the utility and significance of derivative proceedings depend on the increased application of derivative claims by facilitating the benevolent shareholders and easing the procedural routes in legal framework. Law and economic method has been employed in this paper in order to assess the impact of derivative claims on economic growth and on the protection of the interests of all stakeholders.

References

- Argandona , A . (2004). Corruption and Companies: The Case of Facilitating payments .*IESE Business School Working paper No. 539*
- Bhutta, Z, (2017). RekoDiq Gold Mine Project :Pakistan May Face 11.5 Billion US Dollar Penalty’ *The Express Tribune*
- DEtlev F. Vagts, (2005). The governance of the Multinational, *Wis. Int’l Lj* 525,532
- J. Sabapathy .(2005).*In the dark all cats are grey :corporate responsibility and legal responsibility*.JOUR 2005
- Paul Lydon Davies, Gower and Davies. (2008). *Principles of Modern Company Law*. Smith & Maxwell
- Reisberg. (2008). *Derivative actions and Corporate Governance*.Oxford University Press 1st edition
- Richard Smerdon. (2010).*A practical guide to corporate governance*, 4thedition.Sweet & Maxwell

Legislations &Cases

- Auerbach v Bennet. (1979). 419 NYS 2d 920
- Konamaneni and others v .Rolls Royce Industrial Power (India) Ltd and others. (2002). 1 ALL ER 979
- Foss v Harbottle. (1843) . 67 ER 189
- Prudential Assurance Co Ltd v Newman Industries Ltd and others(No.2) . 1982 .1 All ER 354
- Principles on Corporate Governance2010*.(OECD)www.oecd.org/dataoecd/32/18/31557724.pdf
- Collusion and Corruption in Public Procurement 2010* (Policy Roundtables). (OECD.)
- Sarbanes- Oxley Act , 2002*
- Companies Act 2006*(UK.)

Foreign Corrupt Practice Act 1977(USA.)

Bribery Act 2010(UK)

Companies Act 2017, (Pak.)