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Derivative Action Remedy and the Protection of Minority Shareholders' Interests: An Analysis

Alisha Abbas,[1] & Sayyeda Fatima[2]

Abstract:

This article undertakes a comprehensive analysis of Pakistan's corporate structure, with a specific emphasis on the safeguards for minority shareholders outlined in the Companies Act 2017. Within the corporate sphere, instances of directors with substantial control or major shareholders exploiting their capital for personal gain are regrettably prevalent. This exploitative conduct disproportionately affects minority shareholders, rendering them prone to undue coercion by the majority. The consequences of such exploitation are multifaceted, ranging from disruptions in the normal course of corporate activities to the initiation of litigation and the stimulating of tensions among shareholders, culminating in substantial financial burdens. Existing remedial measures, while well-intentioned, are beset by limitations that contribute to worsening the situation. Recognizing this imperative, the article posits that the recourse of derivative action stands as a pivotal and hitherto underutilized remedy, offering a more robust shield for shareholders. Significantly, the current form of the Companies Act of 2017 fails to acknowledge derivative action as a viable remedy for safeguarding the rights of minority shareholders. In light of this deficiency, the article advocates for legislative amendments to strengthen company law, thereby supplementing shareholders' enforcement capabilities and establishing a framework for enhanced corporate accountability within the Pakistani context.

Keywords: Companies Act 2017, majority-shareholders, derivative action, minority-shareholders, corporate accountability, directors

INTRODUCTION

A well-organized corporate governance system ensures the smooth operation of the company, protects shareholders' rights, and provides diligent oversight of the company's affairs. Various

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[1] Visiting Lecturer, Department of Law (Female Campus), International Islamic University, Islamabad, Pakistan. Email: alisha.abbas.vt5490@iiu.edu.pk

[2] Assistant Professor, Department of Law (Female Campus), International Islamic University, Islamabad. Email: sayyeda.fatima@iiu.edu.pk

initiatives have been undertaken to establish an organized and equitable corporate governance system, which includes the introduction of practices like derivative action to promote fairness and hold wrongdoers accountable. This framework ensures equal representation for all shareholders and helps prevent malpractices such as stock pyramids and cross-ownership in family firms.

This article underscores the necessity of a robust legal framework to facilitate effective company operations in Pakistan. Frequently, the central challenges within companies arise from conflicts between majority and minority shareholders rather than issues related to owners and managers. Majority shareholders may develop policies that primarily serve their interests, exerting pressure on minority shareholders to conform to their methods or to sell their shares at reduced market prices due to the absence of proper litigation systems. This underscores the importance of establishing a system that safeguards the rights of minority shareholders, enabling them to participate in a company without fear of infringement.

Derivative action serves as a safeguard against managerial or directorial oppression. The abuse of power is common in Pakistan, and the country's company law is insufficient in providing protection due to the absence of a proper, accessible, and clear litigation system.

Many countries, including Australia, New Zealand, the United Kingdom, and the United States of America have adopted the system of derivative action and incorporated it into their corporate laws. However, Pakistan, despite being a common law country, has yet to adopt the derivative action system, which is common in most other common law jurisdictions. This statutory framework is expected to play a crucial role in promoting effective corporate governance. Derivative action is a key tool for holding managerial authorities accountable in cases involving minority shareholders.

In the Companies Act of 2017, a significant change is the inclusion of directors' duties to ensure good corporate governance. This law outlines specific duties and responsibilities for directors, compelling them to consistently prioritize the best interests of the company. It mandates that directors discharge their obligations with a due measure of care and diligence while exercising their judgment independently. The inclusion of these affirmative duties significantly heightens the potential liability faced by directors should they fail to diligently fulfill their responsibilities or act in contravention of applicable laws. Independent directors, in particular, are widely recognized for their pivotal role in promoting good governance and ensuring the effective operation of the board. Furthermore, the Act has introduced safeguards for shareholders who hold a substantial 10% of the company's share capital. These provisions empower such shareholders with the right to petition the court for relief in cases of directorial misconduct. In instances of minority oppression, the court is vested with the authority to order the winding up of the company. Moreover, these shareholders are granted the privilege of nominating the company's auditor during the annual general meeting. In the event of irregularities, they maintain the option to approach the court and challenge the validity of directorial elections. Additionally, should there be any material defect, they possess the prerogative to initiate legal proceedings, seeking the declaration of a general meeting's proceedings as invalid and calling for the convening of a fresh meeting.

However, the codification of all the aforementioned protections applies only to shareholders who hold at least 10% of the share capital. Unfortunately, this leaves shareholders with less than 10% of the share capital without a remedy, which is inherently unfair and unjust. The judicial process for

corporate matters also leaves much to be desired. The complex systems available to minority shareholders are either inaccessible or excessively time-consuming, leading shareholders to hesitate when considering these methods. There is a pressing need to establish commercial courts in Pakistan and to introduce derivative actions within these courts.

In the modern day, in an increasingly litigious society, enabling commercial courts to handle derivative litigation would be a significant achievement. This article aims to contribute to this endeavor, to protect the rights of minority shareholders and eliminate malpractices by both majority shareholders and the managerial authorities.

The basic objective of this article is to examine insider misuse of authority and its impact on companies and small investors. It intends to address challenges that affect the effectiveness of derivative litigation in Pakistan and explore mechanisms that empower minority shareholders and safeguard their interests within Pakistan's legal framework.

The article intends to address the following research questions: How extensively do insiders (majority and controlling shareholders) exploit their authority when making business decisions, disregarding the interests of companies and small investors? How does the implementation of derivative actions contribute to safeguarding minority shareholders? In the context of Pakistan, what measures can be taken to reform, streamline, and modernize company law, thereby strengthening the ability of shareholders to enforce their rights and protect their interests?

LITERATURE REVIEW

To establish the foundation for addressing the primary concerns of this article, an exploration of the literature is essential. Scholars widely acknowledge ownership structures as a pivotal component within the governance framework. This recognition is based on the profound influence that ownership structures exert over governance challenges and the development of corresponding policies (Shleifer & Vishny, 1997). In cases of concentrated ownership structures, shareholders employ various strategies to gain control over a company. One notably common strategy is the “block-holding strategy,” which involves the ownership of substantial share blocks, granting the ability to exert control over corporations (Cheffins, 2008).

The issuance of shares with augmented voting rights presents an avenue through which shareholders can wield control over a company. Additionally, control can be established through the utilization of pyramid ownership structures. These structures empower majority shareholders not only to govern the company in which they possess the majority of shares but also to extend their influence over subsidiary entities, even when their equity stakes in these subsidiaries are comparatively smaller.

Minority shareholders, often holding relatively modest stakes, may exhibit limited engagement in corporate affairs, given the perceived minimal impact of their actions. Such passive shareholder behavior affords management a degree of flexibility to exercise discretionary control and manipulate the decision-making processes within the company. Consequently, management gains the ability to influence the composition of meeting agendas, further eroding shareholders' control over corporate proceedings (Cubbin & Leech, 1983).

Jensen and Meckling introduced the agency theory, which posits that controlling shareholders, owing to their influential positions, may exploit opportunities at the expense of minority interests, potentially resulting in the misappropriation of corporate assets. Consequently, the mitigation of agency costs becomes imperative as a means to bolster shareholders' trust and enhance managerial performance. The agency theory provides insights into the divergence between ownership and control, illuminating the inherent conflict of interest within this agency relationship. Research by Jensen and Meckling validates that a higher ownership percentage corresponds to a reduction in agency costs borne by shareholders (Jensen & Meckling, 1976).

This finding garners further support from Deakin and Hughes's study, which suggests that scenarios in which the board holds over 50 percent of shares are less susceptible to agency problems. However, dispersed ownership structures are not widely prevalent, except in the United Kingdom and the United States. Instead, concentrated corporate ownership structures tend to predominate, often influenced by business groups and governmental entities (Deakin & Hughes, 1999).

In Pakistan, shareholder concentration is prevalent, with families and business groups assuming dominant roles in both family-owned enterprises and listed companies. Cheema et al. examined the factors contributing to the progress of the corporate sector in Pakistan. Their findings underscore the pivotal role of the private sector in driving industrialization post-independence. A select few families emerged as the primary beneficiaries of the Government of Pakistan's (GOP) financial policies. These families secured fiscal incentives, access to subsidized credit, and favorable imports of capital goods, collectively facilitating their ascent to dominance within the Pakistani corporate sector (Ali et al., 2003).

The separation of ownership and control serves several crucial purposes; however, it can also give rise to conflicts of interest, commonly referred to as 'agency problems' among economists. These conflicts emerge when management prioritizes personal interests over those of shareholders, particularly when their interests diverge. Management is entrusted to act as the agent of shareholders, safeguarding the well-being of both the company and its shareholders. Paradoxically, the presence of agency problems is unsurprising in the absence of legal and extra-legal mechanisms designed to mitigate them. Notably, management typically enjoys privileged access to corporate information compared to shareholders, making it challenging for shareholders to ensure that managerial decisions are aligned with the company's best interests.

Consequently, this situation has the potential to foster managerial opportunism, leading management to prioritize personal gains over the welfare of the company and its shareholders. This misuse of authority has adverse implications for managerial performance and, subsequently, undermines shareholders' trust in making investments in the company. This issue of conflicting interests results in monitoring expenses for shareholders who seek to oversee managerial conduct, as well as bonding expenses for management to establish trust among shareholders that their actions align with the goal of maximizing shareholder value. Berle and Means (1932) proposed that using the law is a method to regulate and govern managerial conduct.

In Pakistan, horizontal agency problems emerge due to the absence of a distinct separation between control and ownership. In family-owned enterprises, controlling shareholders often

appoint family members and individuals they trust to managerial and directorial roles. Similarly, political affiliations and personal connections to the government influence the selection of managers in state-owned enterprises. According to Eisenhardt, agency theory is applicable in three circumstances: (a) situations involving conflicting interests that lead to managerial opportunism, (b) scenarios characterized by inherent uncertainty, and (c) situations where effective monitoring is challenging. These circumstances are particularly relevant for addressing managerial opportunism and safeguarding shareholder interests. Consequently, the reduction of agency problems remains a central focus within the discourse on agency theory (Eisenhardt, 2007).

Research conducted by Rafael La Porta et al. has reinforced the significance of legal intervention in safeguarding shareholder interests. Their empirical study carried out across various jurisdictions, underscores the critical role of legal protection for shareholders in determining the effectiveness of capital markets (La Porta et al, 2000). Their findings indicate that jurisdictions offering robust shareholder protection mechanisms are more likely to attract investors and stimulate the initiation of Initial Public Offerings (IPOs). These IPOs, in turn, inject liquidity into corporations, thereby contributing to the expansion and development of capital markets.

Conversely, in jurisdictions where legal safeguards for minority shareholders are insufficient, the functionality of capital markets tends to be compromised. In well-protected nations, external investors, including minority shareholders, feel a sense of security and assurance. Consequently, they are more inclined to provide financial support to corporations. This infusion of funds, in turn, contributes to the advancement of capital markets.

Rafael La Porta et al. proposed that enhancing shareholder protection holds the promise of mitigating misinformation that can harm contractual agreements and curbing the improper appropriation of corporate assets. They advocate for legal intervention to safeguard minority shareholders within block-holding ownership structures as a means of alleviating managerial opportunism (La Porta et al, 2000).

Dam shares the perspective that a link exists between legal protection for shareholders and economic growth, emphasizing that robust legal safeguards are essential for promoting economic expansion. Judge Stephen further asserts that law plays a pivotal role in driving economic development, particularly in jurisdictions lacking shareholder protection (Dam, 2006).

Coffee and Schwartz emphasize the importance of holding managers accountable for corporate misconduct. They argue that allowing shareholders to take legal action against those responsible would yield public benefits and serve as a deterrent. This is why derivative litigation has the potential to offer valuable deterrence, enhancing both societal and economic values to instill greater confidence among shareholders (Coffee & Schwartz, 1981).

Ramsay and Saunders further argue that, beyond the economic benefits of shareholder protection, reliance on the law is essential, driven primarily by the principles of equity and justice. This is crucial for addressing instances of corporate wrongdoing attributed to directors and managers (Ramsay & Saunders, 2006).

Abugu shares this perspective on the law's interventionist role, highlighting that justice and equity principles necessitate equal treatment of shareholders through the safeguarding of their rights

(Abugu, 2007). Reisberg argues that derivative litigation plays a pivotal role in advancing sound corporate governance practices and safeguarding corporate assets. This form of litigation has the potential to curtail agency costs by introducing the prospect of liability for potential managerial misconduct. Consequently, it compels directors to act in the company's utmost interest. Directors are entrusted to fulfill their obligations in alignment with the company's objectives, effectively representing the shareholders who have entrusted them to safeguard their investments. In this context, derivative proceedings assume a significant role in enforcing directors' fiduciary duties (Reisberg, 2007).

Adnan analyzed Pakistan's regulatory framework, delving into the legal architecture governing the country's corporate sector. He identified shortcomings within the existing minority protection mechanisms and advocated for the necessary safeguarding of minority shareholders' interests. Adnan asserts that contrary to the ownership model proposed by Berle and Means, which delineates a separation between owners and controllers, addressing these concerns is crucial to ensure effective protection for minority shareholders (Adnan, 2006).

RESEARCH METHODOLOGY

This article adopts an analytical approach. Qualitative methods are used to conduct the study. The research is carried out using resources from libraries, case studies, different research articles related to the topic, and relevant textbooks. Drawing from both primary and secondary data sources, an interpretive framework is constructed. The article relied on official documents, primary sources, legal periodicals, scholarly publications, decisions from apex courts, other materials accessible on the web, and electronic journals.

SIGNIFICANCE AND SCOPE OF THE DERIVATIVE ACTION REMEDY

The derivative action remedy plays a pivotal role in addressing injustices experienced by both companies and their minority shareholders (Deakin et. al. 1997). This remedy empowers minority shareholders to protect their interests by initiating legal actions against wayward directors in privately held companies (Ramsay and Saunders, 2006). In its implementation, the concept of derivative action not only acts as a deterrent against potential managerial misconduct within the company on whose behalf shareholders initiate the action but also serves as a cautionary measure against future transgressions by directors in other companies (Coffee, 1993). The deterrent impact of derivative actions provides a universal and public advantage because shareholders often diversify their investments across various avenues, effectively conveying a message of deterrence to potential wrongdoers in different companies.

In Pakistan, the inadequacy of legal safeguards for minority shareholders compounds the conflict-of-interest dilemma between minority and majority shareholders. The implementation of a well-structured statutory protection mechanism, such as a derivative action system, carries the potential to bolster the safeguarding of both minority and company interests, simultaneously reducing the opportunities for controlling managers to inappropriately appropriate corporate assets. This article seeks to extend Reisberg's argument regarding the significance of derivative litigation in the regulation of corporate management and the preservation of corporate assets within the specific context of Pakistan (Reisberg, 2007).

Furthermore, this perspective aligns with the findings of Jensen and Meckling, underscoring the imperative need for an effective mechanism that empowers shareholders to initiate derivative proceedings against managerial misconduct. Considering the existing limitations and deficiencies within the current managerial disciplinary framework, the establishment of a robust derivative action system holds the potential to play a pivotal role in proactively addressing potential misconduct by corporate management in Pakistan.

In Pakistan, many malpractices in the directorial and administrative sectors occur due to the neglect of derivative litigation, which allows diffuse or majority shareholders to infringe upon the rights of minority shareholders. In diffuse or family ownership structures, derivative litigation serves as a safeguard against the abuse of power by managerial authorities. The drawbacks of diffuse ownership can be mitigated by offering the remedy of derivative action to the shareholders (Allen, et al., 2009).

In Pakistan, ownership is largely concentrated, making the implementation of derivative action a pressing need to counteract, or at the very least, reduce the wrongdoings of majority shareholders. An important step taken by the Government of Pakistan is the privatization of 26% of shareholdings in state-owned enterprises through Initial Public Offerings (IPOs). Some listed companies in Pakistan are required to make at least 25 percent of their shareholdings available to the public (SECP Report, 2016).

The remedy of derivative litigation provides a platform for minority and majority shareholders to collaborate effectively. Derivative action is essential in both diffuse and concentrated majority shareholding companies. Another remedy for disciplining undisciplined directors is the direct lawsuit, which may be presented as the most suitable option in this context (Panijpan, 2014). However, it is not appealing for several reasons. In derivative suits, if the wrongdoing is committed by the company, it covers the legal costs for the lawsuit. In contrast, in direct suits, shareholders themselves bear these costs, making it less favorable for shareholders to pursue direct action (Wrbka et al., 2012).

The benefit of legal cost exemption for minority shareholders is referred to as a collective action problem. Another approach to address the collective action problem is to pursue aggregation. However, this has the drawback of minority shareholders' incapability, resulting in the company bearing the costs rather than the shareholders themselves. Majority shareholders and corporate suit lawyers are more inclined toward direct suits, as it may spare the company from legal costs, and for lawyers, it offers the advantage of a contingency fee. It is worth noting that contingency fees are not allowed in Pakistan, which gives derivative suits an advantage in preventing legal malpractices. To strengthen Pakistan's corporate sector through derivative action, it is essential to consider the court procedures. The judicial system in Pakistan, due to numerous flaws, often fails to deliver timely justice. These delays in case proceedings result in significant losses for companies and the corporate sector as a whole in the country (Muhammad, 2015).

An efficient stock market also aids in legal suits by providing precise figures. For instance, if the stock market functions effectively, a shareholder can sell their shares before the judgment, after determining the cost of the lawsuit. However, in our country, this approach may not work owing to the volatile nature of the stock market. It often fails to provide shareholders with accurate prices

and figures, making it difficult for shareholders to assess their losses or interests. This, in turn, leads to a lack of trust in the judicial system, discouraging shareholders from pursuing this method. The derivative action system can help overcome this problem, as it favors minority shareholders against wrongdoers in the corporate sector (Thompson & Thomas, 2004).

Therefore, the increase in real investment, the absence of contingency fees with the loser bearing the suit's cost, the volatile nature of the stock market, and the delays in court proceedings create a strong case for the implementation of the derivative action system. Establishing a relevant judicial forum with proper jurisdiction in this regard can also be beneficial, as it would enhance shareholders' trust in the judicial system. In Pakistan, there have been observed gaps in bringing suits against wrongdoers. Providing the public with a proper system of checks and balances in corporations through a derivative action remedy would be well-received by the masses.

There are different viewpoints regarding derivative litigation. Some scholars are against this system, considering it to have a negative impact on good corporate governance. In contrast, others hold the opposite view, describing derivative litigation as indispensable in the corporate sector for curbing malpractices by majority shareholders and wrongdoers. In cases where a company experiences wrongdoing, the traditional perspective dictates that the company itself is the party responsible for initiating legal proceedings against the wrongdoers. This doctrine finds its embodiment in the words of "Lord Davey" within the landmark "*Burland v Earle*" case, where it is stated that the "proper plaintiff" in such circumstances is unequivocally the company that has endured harm due to the actions of its directors (Burland Case, 1902). The core premise of the "proper plaintiff' rule" is firmly rooted in the fundamental principle that a party, represented as 'A,' cannot pursue damages from another party, 'B,' for losses incurred by a third party, 'C' (Prudential Assurance Co Ltd v Newman Industries Ltd, 1982).

Moreover, similar to the "proper plaintiff rule", two parallel concepts, the "majority rule" and the "internal management principle", dictate that determinations pertaining to a company's internal affairs must be based on the "majority rule". Consequently, the courts traditionally exercise restraint in intervening in the civil petitions of individual shareholders concerning a company's decision-making processes. It is important to note that shareholders are generally bound by the collective decisions of the majority, barring instances where such decisions contravene legal statutes (Sammel v President Gold Mining Co Ltd, 1969).

Collectively, the "majority rule" and the "proper plaintiff' rule" are referred to as the "*Foss v Harbottle* rule". The "*Foss v Hartbottle*" case holds particular significance as it introduced exceptions when the company is under the control of wrongdoers perpetrating fraud that detrimentally affects minority shareholders. In such scenarios, aggrieved shareholders have the opportunity to initiate a derivative claim concerning breaches, limitations, or losses of individual rights, or illegal acts that the company cannot rectify (Foss v Hartbottle, 1843).

Minority Shareholders Protection in Companies Act 2017

There are various types of shareholders in Pakistan, ranging from families to business groups, as well as the state as dominant shareholders. Furthermore, companies can be both public and private in nature. These majority shareholders employ multiple methods to maintain control over companies, which include holding the majority of equities and using complex ownership structures

such as interlocking pyramid ownership, and cross-shareholder structures. It is important to note that this complex shareholder structure is often not understood by external investors. Consequently, majority shareholders take advantage of this situation to appoint their trusted individuals as board members and in other crucial positions, such as non-executive directors. When appointing their trusted persons to the board, majority shareholders often overlook factors like relevant qualifications, knowledge of the corporate sector, and professional experience.

In both private and public enterprises, the majority of decisions are made by board members without due consideration for the rights and shares of minority shareholders. Regrettably, in Pakistan, most private enterprises are governed by majority shareholders who control the companies through interlocking dictatorships and cross-holding structures, consequently undermining minority interests. When the interests of minority shareholders are undermined, common allegations against board members include mismanagement of the business, expulsion of petitioners from management, and share dilution, among others.

After corporate groups, the majority of shareholders in business entities are the State, known as State-Owned Enterprises (SOE). SOEs are owned and controlled by the government, and the management of these enterprises aims to protect the interests of minority shareholders, the government often appoints board members without due consideration of qualifications and corporate experience, instead relying on political affiliations.

While it is commonly believed that SOEs have their interests aligned with minority shareholders and other constituencies, this concept is not universally true. There are scenarios in which board members are appointed based on political affiliations, and the government may have overarching objectives that lead SOEs to pursue their political goals. Within the context of SOEs, it is evident that minority shareholders are susceptible to exploitation as controlling entities often prioritize their interests at the expense of the minority shareholders. This dilemma has been notably exemplified in recent corporate scandals involving SOEs such as Pakistan Steel Mills, Pakistan Railway, Pakistan Telecommunications Company Limited, National Insurance Company Limited, and others.

The vulnerability of minority shareholders to exploitation stems from various factors, including the relentless pursuit of absolute power by majority shareholders, interpersonal conflicts among shareholders, and notably in family-run businesses. A key concern remains the conflicting interests between active and non-active shareholders, with a substantial number of the latter belonging to the minority group. For instance, active shareholders often advocate for high executive remuneration and minimal dividends, while non-active shareholders typically favor the opposite scenario due to their lack of involvement in high-level executive positions.

To delve deeper into this issue, it is crucial to understand the framework within which shareholders and directors function. In numerous companies, the directors also serve as majority shareholders, wielding significant power that allows them to exploit their position and potentially neglect their fiduciary duties. While directors owe their primary duties to the company itself rather than to other shareholders or clients, the convergence of roles as both shareholders and directors poses a challenge in enforcing these obligations. Furthermore, family ownership and management of companies further complicate the prospect of taking legal action against directors.

This situation aligns with neo-classical economic theory, emphasizing the importance of establishing clear standards for directors' duties to prevent self-interested behavior. In large companies, numerous dispersed shareholders worldwide often lack the incentive to actively monitor managerial conduct and hold them accountable for any misconduct.

However, there is an exception to this scenario when the company faces insolvency. During insolvency, directors' duties shift towards creditors, preventing them from externalizing the cost of their debts during financial crises. This shift reflects the idea that when a company is on the brink of insolvency or undertaking a venture heavily reliant on creditor funds, the interests of the company primarily align with the interests of existing creditors.

Minority shareholders also grapple with the challenge of liquidity, primarily due to the limited strength of the public market for minority shares. Attempts by minority shareholders to sell their shares can often be met with difficulties in finding a buyer, resulting in their investment becoming illiquid. This limitation can result in a loss of control over their investments, diminished influence, and an inability to reallocate funds to more profitable ventures. The vulnerability of minority shareholders in such scenarios opens the door to potential exploitation by majority shareholders through reduced dividends, share purchases at lower prices, or even 'squeeze out' tactics.

The “squeeze out” process can lead to disputes and create problems for minority shareholders, especially when it involves merging with another organization or selling the company's assets. Statutory or company requirements may necessitate the consent of some or all minority shareholders, and when they are unwilling to sell their shares, disputes can arise. Minority shareholders may resist, feeling that their shares are undervalued, and suspect that the majority shareholders seek to benefit at their expense. To facilitate a 'squeeze out,' dividends may be withheld, affecting minority shareholders who may still incur taxes on income they are not receiving. Furthermore, removing minority shareholders from employment positions can be another tactic to 'squeeze them out,' especially when they are kept in the dark about the company's operations by withholding information. To mitigate these issues, regulations mandating the public disclosure of specific records become imperative.

Numerous experts argue for the necessity of robust legal frameworks to protect minority shareholders from potential misconduct by managers and directors. Scholars like La Porta emphasizes the significance of minority protection instruments, such as laws, in fostering capital market growth, enhancing corporate governance, and ensuring shareholder protection (La Porta et al, 1999).

Directors have frequently deviated from their designated roles, as evidenced in prominent cases like “*Dewan Sugar Mills Limited*” (Dewan Sugar Mills Ltd. vs. SECP, 2009) and “*Fazal Textile Mills Limited*” (Muhammad Sohail Tabba vs. Director Enforcement, SECP, 2016). These instances reveal directors' shortcomings in four critical areas. They engaged in the practice of providing unauthorized inter-corporate financing and soft loans to associate enterprises, diverting resources that should be in the company's best interest. They neglected minority shareholders' participation in annual meetings, which were either infrequent or exclusive, limiting transparency and inclusivity in corporate decision-making processes. They misinterpreted facts and figures for minority shareholders, obscuring the true financial status of the company and hindering shareholders'

ability to make informed decisions. They abused their power by maintaining parallel books of accounts and misappropriating corporate assets for personal gain, breaching their fiduciary duties and compromising the integrity of the company.

The Companies Act 2017 has introduced a series of protections aimed at safeguarding the rights of minority shareholders. These protections apply to members who hold not less than ten percent of the issued share capital, a reduction from the previous threshold of twenty percent under the old Companies Ordinance. This reduction in the threshold signifies a more accessible way for minority shareholders to exercise their rights in cases of oppression and mismanagement within a company. These provisions grant shareholders holding ten percent of the company's shares specific rights and remedies. They can petition the court in cases of oppression and mismanagement. In cases of oppression, the court may order the company's winding up. Shareholders meeting this threshold can propose the company's auditor during the annual general meeting, enhancing transparency and accountability. They can also apply to the court to invalidate the election of directors in cases of material irregularity. Shareholders with the stipulated shareholding percentage have the right to petition the court to declare general meeting proceedings invalid if there is a material defect or omission in the notice or if irregularities hinder members from exercising their rights effectively. This may result in the organization of a new meeting, upholding fairness and transparency.

Several new provisions have been incorporated into Pakistan's Companies Act 2017 with the objective of enhancing the mechanisms for enforcing directors' responsibilities. These enhancements encompass heightened disclosure mandates, the establishment of a dedicated tribunal to address corporate governance concerns, and the imposition of more stringent penalties on directors who breach their obligations (Adil, 2018).

The enforcement of specific measures by the regulatory body has expanded directors' obligations concerning their duties. As per Section 205 of the Companies Act 2017, the director of a company is required to disclose any personal interests in a transaction. Section 5 of the Companies Act of 2017 specifies that "the court" refers to the “High Court Rules 1997” establishes both the High Court and District Court and provides a definition for the term "Judge." According to Section 479 of the Companies Act 2017, the SECP, an official from the Enforcement Commission, and the Registrar of Companies. Sections 397 to 405 of the Companies Act 2017 encompass offenses related to company winding up and use the term "court." This raises a crucial ambiguity: determining which forum has the authority to adjudicate offences listed in the Companies Act 2017 in Sections 397 to 405. Section 476 of the Companies Act 2017 aims to empower the SECP to conduct investigations into offenses carrying penalties involving imprisonment. An aggrieved party has the option to simultaneously seek both criminal and civil remedies, or they may choose to forgo either of them. According to Section 398 of the Companies Act 2017 mandates a mandatory penalty, but the final decision rests with “the court”, which may also entail additional criminal liability.

In the case of “*Nadeem Kiani v American Lycetuff (Pvt.) Limited*”, Justice “Jawad Hassan” examined the implications of Section 286 of the Companies Act 2017. The case centered on parties who had previously been in a matrimonial relationship, which had now ended, leading to a contentious dispute over the company's goodwill. The plaintiff initiated legal proceedings as per Section 286 of the Companies Act 2017, alleging oppression by the respondent. Justice Jawad Hassan, in his discussion, emphasized that the Section's primary aim is to regulate and prevent the oppression of

minority shareholders' rights and to curb mismanagement by majority shareholders. The Court, in essence, interpreted oppression as the unjust treatment of minority shareholders. However, it was also underscored that not every form of illegality falls within the purview of 'oppression' as defined by the law (Nadeem Kiani v American Lycetuff, 2021).

CONCLUSION

Minority shareholders require protection due to the potential for exploitation by majority shareholders and directors. Holding directors accountable to shareholders is crucial to ensure the company operates in a way that maximizes firm value. Key findings include the presence of self-serving behavior among corporate management in Pakistan. It has been confirmed that directors often deviate from their designated roles in four critical areas, including unauthorized inter-corporate financing and providing soft loans to associate enterprises; neglecting the participation of minority shareholders in infrequent or exclusive annual meetings; misinterpreting facts and figures to minority shareholders; and abusing power, such as maintaining parallel books of accounts and misappropriating corporate assets for personal gain (Hussain, 2022).

Derivative litigation has the potential to significantly reinforce shareholder enforcement powers and plays a vital role in safeguarding the rights of minority shareholders against the actions of majority shareholders. Neither voting mechanisms nor capital and corporate control mechanisms are as effective as derivative litigation in holding managers accountable for misconduct. In publicly-owned companies, appointments are often politicized, and managers may lack corporate experience. In such cases, derivative litigation becomes the last resort for minority shareholders.

Four key problems have been highlighted in analyzing minority protection mechanisms: there are insufficient rights allocated to minority shareholders, including voting, dividend, and preemptive rights; the lack of rights for minority shareholders regarding unfair prejudice; absence of a mechanism for derivative litigation on behalf of minority shareholders; and the common challenge of litigation costs when pursuing suits against directors and managerial misconduct.

There is no denying that a robust derivative action mechanism has the potential to deter managers from misconduct and wrongdoings. It is high time for the corporate sector in Pakistan, especially the Companies Act, to revamp the existing derivative litigation mechanism and enhance the overall functioning of the system.

Recommendations

One of the proposed solutions is to introduce derivative actions in Pakistan through an amendment to the Companies Act, 2017. This would empower individual or minority shareholders, even those without sufficient voting rights, to bring claims against directors and majority shareholders for accountability. Such a change would lead to the development of director duties under Section 204 of the Companies Act 2017, which is currently lacking in Pakistan. Additionally, reducing or abolishing voting requirements in Sections 256 and 286 of the Companies Act 2017 could offer further protection for minority shareholders. The Securities and Exchange Commission Pakistan (SECP) should establish a comprehensive regulatory framework that clearly defines the rules governing the responsibilities of directors, as outlined in Section 204(9) of the Companies Act. The limited number of legal cases filed within the seven-year timeframe indicates a lack of established

legal precedents concerning the interpretation of statutory obligations. Consequently, there exists a state of uncertainty regarding the extent to which these obligations have been formalized and realized. To address legal ambiguities, the SECP needs to formulate comprehensive regulations that delineate the scope of a director's duties.

Furthermore, the mechanisms detailed in Sections 286 of the Companies Act 2017 (Application to the Court) and 256 of the Companies Act 2017 (Report to SECP) for the enforcement of minority shareholders' rights display certain shortcomings. The requirement for commencing legal action against a director is set at a threshold of 10%, which poses a significant challenge in effectively asserting their entitlements. The legal framework does not grant individuals the authority to initiate legal proceedings in a private capacity. It is advisable to remove the voting requirement pertaining to shareholders through an amendment, thereby empowering shareholders to individually pursue claims and seek personal remedies.

The incorporation of the derivative action remedy into the legal framework is proposed, as it aligns with the codification of directors' obligations. Legally, shareholders may initiate a "derivative action" on behalf of the company when the board of directors fails to fulfill its responsibilities. This would serve two main purposes: firstly, it would simplify the process for minority shareholders to seek redress, even if they do not meet the voting requirements outlined in Sections 254 and 286 of the Companies Act 2017. The implementation of the derivative action would positively impact the enforcement of director responsibilities and the evolution of legal concepts related to these obligations. Encouraging legal action against directors is essential for this purpose.

In summary, Pakistan's corporate governance framework aimed at safeguarding minority shareholders and investors primarily relies on Section 286 of the Companies Act 2017 (Application to the Court) and Section 254 of the Companies Act 2017 (Investigation into affairs of the company by the SECP. Firstly, it is important to note that shareholders holding less than 10% of voting rights are unable to directly initiate legal action in court or request the Commission to investigate a matter, as evident from case law. Secondly, the SECP's enforcement of the minority shareholder protection regime, as demonstrated by the aforementioned case law effectively shields minority shareholders from both directors and majority shareholders. It is recommended that derivative actions should be introduced through statutory amendments to the Companies Act 2017.

While this article argues for a comprehensive reform of the Companies Act 2017, it is imperative to recognize that the effectiveness of derivative litigation is intrinsically linked to the efficiency of the country's judicial system. Consequently, the successful implementation of derivative litigation requires an active role from the judiciary.

To mitigate conflicts between minority and majority shareholders, it is advisable to implement measures aimed at improving the transparency, timeliness, and accuracy of corporate disclosures. These disclosures must furnish all stakeholders, including minority shareholders, investors, and directors, with comprehensive information to minimize the risk of exploitation. Stock exchanges should establish minimum reporting standards and enforce accountability for those who breach these standards.

As this article advocates for enhancements in Pakistan's derivative litigation mechanism, it is crucial to acknowledge that the process can be time-consuming, cost-inefficient, and potentially

detrimental to a company's reputation. Therefore, it is advisable that, before resorting to derivative litigation, the corporate sector and the judicial system promote alternative dispute resolution methods, such as arbitration, negotiation, and mediation.

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