INSOLVENCY LAWS IN PAKISTAN: A COMPARATIVE PERSPECTIVE

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(Corporate Law)

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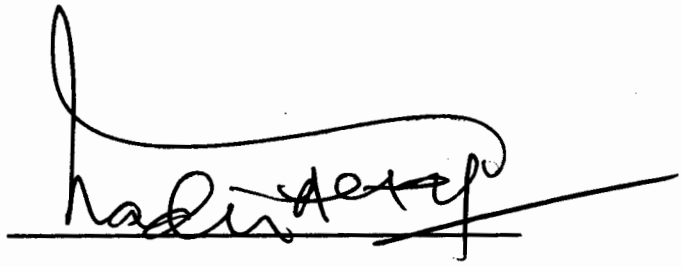

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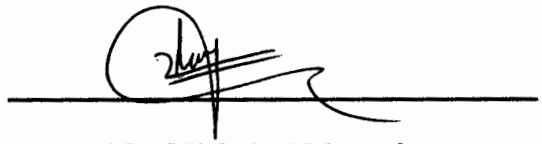

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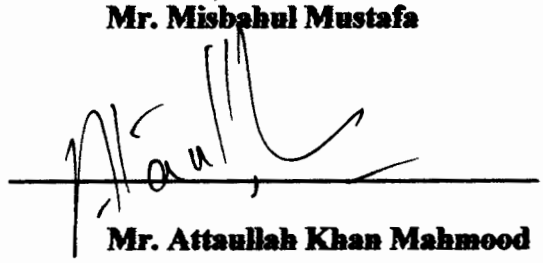

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DEDICATION

"Dedicated to my Parents"

"And your Rubb has decreed that you worship none but Him. And that you be dutiful to your parents. If one of them or both of them attain old age in your life, say not to them a word of disrespect, nor shout at them but address them in terms of honor. And lower unto them the wing of submission and humility through mercy, and say: `My Rubb! Bestow on them Your Mercy as they did bring me up when I was young". (31:14)

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for providing all possible support and guidance".

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ABSTRACT

For the last several years we have noticed that the bankruptcy laws in Pakistan have been unsuccessful in establishing the required proportion between the creditors and the debtors' rights. A concerted effort is required to achieve a balance and harmony with the insolvency legislative frame works proposed or in place in various jurisdictions around the globe to ensure interoperatability without compromising national requirements and policies.

The development of Insolvency Laws in Pakistan is deficient and needs to be revamped thoroughly to protect creditors/lenders of the insolvent companies by giving them an equitable allocation with regards to the company's assets.

The concept of insolvency and bankruptcy are inherently different and thus need to be defined individually enabling the effective implementation of the provisions of insolvency and bankruptcy laws.

Insolvency laws and practices cannot operate in a vacuum there is a need to ensure that standards are set and applied if the insolvency laws are to have any prospect of producing positive results.

As there is no comprehensive Insolvency law available in Pakistan, all the relevant provisions dealing with insolvency in different laws i.e. Companies Ordinance 1984, Banking Companies Act 1962, and The Code of Civil Procedure 1908 etc. need to be studied in depth and critically analyzed in juxtaposition with the Insolvency Laws effective in United Kingdom and United States of America in order to make a comparison of the same with the laws of our country. The result of this in-depth study recommends for the reformation of the insolvency laws in Pakistan that would be able to

cater to the fast growing economic scenario as it is not practically functional for any government to run the day-to-day transactions and affairs without making the economic law flexible, which is also supportive of all the concerned stakeholders.

My research work is a qualitative research work coupled with comparative methodology, it involves massive literature survey of literature comprising of books, reports, conferences proceedings, statutes.

The development of a vibrant private sector in respect of financial market is the basis for the promotion, growth and expansion in terms of prospects for individual entities. It is an established fact that the encouragement of business entities and individuals to follow the proper measure of insolvency as well as bankruptcy laws can not be achieved until and unless a conducive environment pertaining to the legal and regulatory frame work is provided-which in any case should include the safeguarding of property rights, easy availability of credit, and a system of justice which is not only efficient but is also devoid of procedural complications.

INTRODUCTION

Insolvency and bankruptcy result in loss of jobs, homes, savings and investments. They are a traumatic experience for many. With the establishment of Pakistan as an independent sovereign state on August 1947, it was decided to derive the prevalent legal system of British Colony of India. During that period of time two laws were available namely the Bankruptcy law and the Companies Consolidation Act 1913, repealed by Companies Ordinance 1984. The Bankruptcy Laws were applied to the insolvency of individuals only. The Provincial Insolvency Act of 1920 and the Insolvency (Karachi Division) Act of 1909 were the operative laws. Whereas the Companies Ordinance of 1984 deals with winding up or liquidation of companies and is applied to companies only. It also covers the aspects of corporate rescue i.e. restructuring or receivership. Later on a new legislation was promulgated in 1997 with the purpose of recovery of corporate debts especially in the case of banks and financial institutions. Debt recovery could also be initiated under the provisions of the Civil Procedure Code, 1908[1].

The term insolvency cannot be applied to governments. Any government's ability to service its debts is judged by the levying of taxes and as such same is not dependent upon its assets. If the above said is not the case then every government would have to maintain assets which are equivalent, at least to the sum of the debts owed by them. Whenever a government is unable to pay the interest factor of its debts, it is said to be in default, if the said observation is made on a purely technical basis. It is a known fact that the assets of any government can not be taken over by the creditors of that government and as such the

[1] Al Moudooa A Khan & Aly Shah, Orr Dignam & Co; *Insolvency Law Regime*, 2007

government so affected resorts to further financing or monetization (issuance of currency)[2].

Insolvency laws affect a variety of constituents, including banks, employees and governments. Ultimately, however, the users or 'clients' of insolvency laws can be divided into two broad groups: debtors and creditors. Consequently, proceedings under most insolvency laws can be commenced by one of these two groups. Although each group is affected by the actions of the other, the party commencing the proceeding often dictates, at least at the outset, what type of proceedings will be taken.

Thus the insolvency law regime needs to be measured both in instances where a creditor commences liquidation or terminal proceedings and those where a debtor commences reorganization proceedings.

Briefly, the aforesaid United Kingdom system was adopted by Pakistan. However, this attempt was made in an erratic manner which made the applicable legal regime more complex creating imbalances between creditor and debtor rights.

I shall discuss this in more detail in later chapters.

[2] http://en.wikipedia.org/wiki/Insolvency retrieved on 02/22/2008

Chapter (I)

1.1 Early History of Insolvency:-

The roots of Bankruptcy can be traced to biblical time. It is recorded history that somewhere between the 9th and the 14th Century, if a person was unable to pay his debts, his creditors would forcefully enter his workplace and demolish his "workbench". The words "banca rotta" in the Italian language mean a bench which is broken, thus the term "Insolvency" in the English language is the derivative of the same[1].

During the 16th Century the First "bankruptcy" laws were implemented in England, wherein bankruptcy was treated as an offence of criminal nature. The laws of bankruptcy in England do not favor the debtors in the present times also.

The beginning of the 19th century saw the implementation of the laws of bankruptcy in the United States of America, which was the result of the then down trend in the economy of America. Several laws on bankruptcy came into existence and later repealed during the 19th and the 20th century in the USA in order to adjust the bankruptcy laws to the changes being experienced by the economy of the country. In the USA the laws of, bankruptcy were established under Civil Code of United States. The Bankruptcy Reform Act was implemented in the year 1978[2]. By virtue of the said Act, which resulted in ease for the businesses or individuals to reorganize their debts to dissolve the same. It is thus

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[1] Anuradha Sen, '*The Bankruptcy Laws: Comparing Russia, USA.Canada and UK*'. Text also available on online http://papers.ssrn.com/so13/papers.cfm?abstract_id=912931 retrieved on 18/09/06

[2] http://www.legalhelpers.com/legal_helpers/brc_articles_bankruptcy_history.html retrieved on 02/10/2006

considered that the economic superiority of the US is the consequence of their laws of bankruptcy. [3]

Bankruptcy law is designed to provide a "fresh start" for debtors through either liquidation or reorganization.

Some writer use the term 'Bankruptcy' and 'Insolvency' interchangeably but both have different connotations. Oxford Law Dictionary explains the term 'Bankruptcy' as "where the company has been declared insolvent". Bankruptcy is the financial failure of an individual or a company. If the company or individual gets behind on payments, it is essential to catch up. This is done by increasing income or using savings or by reducing spending. If none of these solutions can be achieved, the unavoidable resolution would be a bankruptcy.

1.2 Definitions from dictionaries:-

- **Oxford Law Dictionary**

Oxford Law Dictionary in its 7th edition defines Insolvency as a state of not having enough money to pay what you owe.[4]

- **Black's Law Dictionary**

Black's Law Dictionary in its 7th edition defines insolvency as the condition of being unable to pay debts as they fall due or in the usual course of business. The second

[3] Bankruptcy Reform Act 1978

[4] Oxford Advanced Learner's Dictionary 7th edition, (Oxford University Press, 2005)

definition of Black's Law Dictionary is the inability to pay debts as they mature. Also termed failure to meet obligations.[5]

- **The Business Dictionary**

"In legal terminology, it is the situation where the liabilities of a person or firm exceed its assets. In practice, however, insolvency is the situation where an entity cannot raise enough cash to meet its obligations, or to pay debts as they become due for payment. Properly called technical insolvency, it may occur even when the value of an entity's total assets exceeds its total liabilities."[6]

- **The American Heritage Dictionary**

"According to the American Heritage Dictionary Insolvency is the condition of one who is unable to pay his debts as they fall due or in the usual course of trade and business as a merchant's insolvency".

- **Banking Dictionary** says;

"Inability to pay debts as they mature, or as abligations become due and payable. A person may still have an excess of assets over liabilities, but be insolvent if unable to convert assets into cash to meet financial obligations"[7].

It further says that;

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[5] Black's Law Dictionary 7th edition, (West Groups: ST. Paul, Minn; 1999) 799.

[6] The Business Dictionary,(London: Profile Books, 2004)

[7] Banking Dictionary, (Karachi: Royal Book Company, 2000)

"A financial institution, such as bank, generally is considered to be insolvent if its ratio of capital to assets is at or close to zero, or if its capital assets, including common assets, are of such poor quality that its continued existence is uncertain."

- **Investment Dictionary**

Describes insolvency as;

"when a company no longer meet its debt oblogations with another firm or institution"[8].

From the above observation it can be concluded that insolvency is the inability of an individucal or a comnpnay to cope up with debt payments with current liquid assets.

1.3 Definitions from encyclopedias:-

- **Britannica Concise Encyclopedia**

Defines insolvency as;

"Condition in which liabilities exceed assets so that creditors can not be paid. It is a financial condition that often preceeds bankruptcy, in the context of equity insolvency is the inability to pay debts as they become due; insolvency under the balance-sheet approach means that total liabilities exceed total assets." [9]

[8] Investment Dictionary, Charles J.Woelfel,(Chicago: Toppan, 1994)

[9] Britannica Concise Encyclopedia, (Chicago: Encyclopedia Britannica, INC. 2003), 952.

- **Law Encyclopedia** says;

"Incapacity to pay debts upon the date when they become due in the ordinary course of business; the condition of being an individual whose property and assets are inadequate to discharge the person's debts". [10]

- In **Thesaurus** insolvency is

"The condition of being financially insolvent: bankruptcy, bust, failure.[11]"

1.4 Definitions in Corporate Laws:-

Companies Ordinance 1984;

S.305. of Companies Ordinance 1984 of Pakistan defines winding up wherein clause (e)of the said section throws light on the scenario of insolvency in the terms of inability to cope up with debt obligations owed by a company as: [12]

(e) "if the company is unable to pay its debts."

S.306. Company when deemed unable to pay its debts is reproduced below:-

(1) A company shall be deemed to be unable to pay its debts:-

(a) If a creditor, by assignment or otherwise, to whom the company is indebted in a sum exceeding one per cent of its paid-up capital or fifty thousand rupees, whichever is less, than due, has served on the company, by causing the same to be delivered by registered post or otherwise, at its registered office, a demand under his hand requiring the company to pay the sum so due and the company has for

[10] Law Encyclopedia, (Lahore: Shah Book Corporation), n.d.

[11] http://www.answers.com/topic/insolvency?cat?=biz-fin retrieved on 07/02/2008

[12] Companies Ordinance 1984

thirty days thereafter neglected to pay the sum, or to secure or compound for it to the reasonable satisfaction of the creditor; or

(b) If execution or other process issued on a decree or order of any Court or any other competent authority in favour of a creditor of the company is returned unsatisfied in whole or in part; or

(c) If it is proved to the satisfaction of the court that the company is unable to pay its debts, and, in determining whether a company is unable to pay its debts, the Court shall take into account the contingent and prospective liabilities of the company.

The demand referred to in clause (a) of sub-section (1) shall be deemed to have been duly given under the hand of the creditor if it is signed by an agent or legal adviser duly authorized on his behalf, or in the case of a firm if it is signed by such agent or legal adviser or by any member of the firm on behalf of the firm.

With reference to section 305 and 306 of the Companies Ordinance 1984 it has been declare by Rana Bhagwan Das in one of his landmark judgments titled as "Habib Credit and Exchange Bank Ltd. Karachi v M/s Tariq Cotton Mills Ltd. Karachi";

> "Notwithstanding the circumstances that Ordinance XIX of 1979 was repealed by Banking Companies(Recovery of Loans, Advances, Credits and Finances) Act, 1997 vide section 28 learned counsel vainly contended that on the date of filing the present proceedings Ordinance, 1979 was in the field. I see no merit in the argument because the present winding up petition is quite clearly maintainable under the provisions of section 305 of the Ordinance on the ground that the respondent company is unable to pay the debt. Bar of jurisdiction if any would arise in a suit exclusively

triable by the Special Banking Court and not in the present proceedings which are quite evidently maintainable and within jurisdiction. At any rate with the repeal of 1979 Ordinance the argument is no longer helpful to the counsel & is completely misconceived on the face of it. To my mind neither the new Act of 1997 nor the Ordinance, 1979 bars the maintainability of the present petition. Obviously winding up proceedings are not a substitute for recovery of loan amount and indeed the prayer before this court is not for recovery of the loan amount. The argument being hyper-technical and without any substance must be repealed.

As the respondent company appears to have lost its sub stratum and is no longer in a position to pay the heavy debt due against it despite the lapse of a long period, it is only just and equitable to direct winding up of the company which was ordered by a short order at the conclusion of the hearing on 16-12-1997. These are the reasons for the conclusion.

Petition accepted."[13]

From the above case it is clear that if company is not in a position to payoff the heavy debt due against it, it would be just and equitable to wind up such a company.

The term bankruptcy is very well defined in perspective of Islamic business transactions under Islamic law[14],very well written by Dr. Muhammad Tahir Mansuri, wherein he refers the term bankruptcy to individuals and not to a business entity, according to him when debts of a person exceed his assets, he is considered as bankrupt.

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[13] Habib Credit and Exchange Bank Ltd. Karachi v M/s Tariq Cotton Mills Ltd. Karachi, PLJ 1998,454

[14] Dr. Muhammad Tahir Mansuri, *Islamic Law of Contract and Business Transactions* 3rd edition, (Islamabad: Shariah Academy International Islamic University Islamabad, 2005)58.

Under UK Insolvency Act 1986;

Section 123;

A company is deemed unable to pay its debts where a creditor has served a written demand on the company (in the prescribed form), for a debt then due, and which exceeds 750 pounds, and the company fails either to pay the debts or to secure or compound it to the reasonable satisfaction of the creditor, within 21 days of the demand.

"A company is also deemed to be unable to pay its debts if it is proved to the satisfaction of the court that the value of the company's assets to less than the amount of its liabilities, taking into account its contingent and prospective liabilities"[15].

(1) "A company is deemed unable to pay its debts—

(e) if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due.

(2) A company is also deemed unable to pay its debts if it is proved to the satisfaction of the court that the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities".

It is pertinent to mention here that this definition is also known as the 'assets test'. Whilst this example of the asset test applies to the corporate debtor, a similar provision is found in the UK Insolvency Act 1986 **s.341 (3),** which states:

[15] Insolvency Act 1986

An individual is insolvent if:

> "He is unable to pay his debts as they fall due, or the value of his assets is less than the amount of his liabilities, taking into account his contingent and prospective liabilities"[16].

Corporate Act of 2001 - Section 95A provides the definition of the term solvency and insolvency, it states that:[17]

(1) A person is solvent if, and only if, the person is able to pay all the person's debts, as and when they become due and payable.

(2) A person who is not solvent is insolvent.

It further defines that the "insolvent under administration" means a person

1.5 Insolvency Laws of Pakistan in Prevailing Scenario

In many of Asia's developing countries, systemic problems with legal frameworks continue to undermine the efficiency, and ultimately, the legitimacy of legal, judicial and law enforcement institutions; and to undermine the ability of governments to implement their development policies, particularly those governments who look upon the entrepreneurs in the private sector as providing the main impetus for the economic growth of their country.

Debt recovery has always been a problem in Pakistan, despite the presence of a well-defined legal framework for it. This epitomized the 'implementation gap' that

[16] Ibid

[17] Corporate Act 2001

underscores, that basic preconditions must exist for the proper functioning of any law, including insolvency laws[18].

Insolvency law must be placed in context. It is but a part of the commercial law system and financial infrastructure of any economy. Ultimately this implies that insolvency systems and processes cannot be divorced from the broader challenges of law and development. They are a subset of the rule of law. As such, insolvency and restructuring must be considered in the context of prevailing economic, political, social, cultural and governance conditions.

It is important to recognize that recent insolvency reforms will not be fully implemented in Pakistan until governments strengthen the four key components of governance, accountability, transparency, predictability and participation. Without these, the implementation of insolvency laws in a country is likely to remain poor.

South Asia is a multiracial region, and the economic and legal systems of its countries reflect the customs of its various communities. The legal and financial systems in the region have undergone significant transformation over the last two decades. Various reforms have been initiated aimed at promoting an efficient, well-diversified and competitive financial system with the ultimate objective of improving the allocative efficiency of resources so as to accelerate economic development[19].

In Pakistan, the legal environment is uniquely complex owing to the imbalance between creditor and debtor rights. The creditor-friendly laws have impacted the financial landscape, particularly the investment climate in Pakistan. Some laws are regarded as being overly punitive to debtors and as having frustrated attempts at restructuring. The

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[18] Sumant Batra, *Insolvency Laws in South Asia: Recent trends and developments*,(Beijin:27-28 April2006)

[19] Ibid

National Accountability Ordinance of 1999 lead to the creation of the National Accountability Bureau, permitted the presumption of guilt, and shifted the burden of proof to the accused. The target of this law was corruption in all its forms including non-seriously flawed[20].

For borrowers, a new legal term/concept was introduced whereby any default to any government institution (even on a utility bill) of more than 30 days was defined as "willful default". Willful defaulters were exposed to imprisonment, barred from holding any public office and put on the Exit Control List that barred them from foreign travel.

Despite problems and difficulties, it is fair to state that a lot of progress has been made to improve the health and soundness of the financial sector in Pakistan in recent years.

Pakistan is much stronger today compared to nine years ago. There has been a strict monitoring and reduction of non-performing loans through the active involvement of the Corporate Industrial Restructuring Corporation and the Committee of Revival of Sick Units.

The Insolvency laws of Pakistan are not effective with regards to corporations. For this reason, insolvent companies are wound-up under the Companies Ordinance 1984. However, the insolvency rules set out in the insolvency laws are applicable in the case of winding-up of insolvent companies as regards, rights of secured and unsecured creditors and to provable debts etc[21].

The Companies Ordinance 1984 provides for several methods by which an insolvent company may be dealt with.[22] These are as follows: (a) Winding up of the company; (b)

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[20] http://www.oecd.org/dataoecd/42/14/38184124.pdf retrieved on 07/10/2008

[21] Ibid

[22] Companies Ordinance 1984

Compromises, Arrangements and Reconstruction; (c) Management by Administrator; and Rehabilitation of companies owning sick industrial units. The Provincial Insolvency Act, 1920 ("Provincial Insolvency Act")[23] and the Insolvency (Karachi Division) Act, 1909 ("Insolvency Act")[24]. The Provincial Insolvency Act 1920 relates to the law of insolvency as administered by the courts of Pakistan having jurisdiction outside the Karachi Division, whilst, the Insolvency Act 1909 relates to insolvency for the Karachi Division. These statutes become relevant under the insolvency procedure of winding up, at the stage of proof of debts in respect of insolvent companies.

Globalization and the opening of trade have led countries to consider adopting model laws and laws that come from fundamentally different legal jurisdictions. Today, the influence of a number of legal systems is visible in the region. The legal framework for corporate insolvency is provided under the company law, which deals with the winding up of companies. The absence of effective tools and instruments to supervise and manage the insolvency process renders the liquidation process an insignificant part of market dynamics. A company can be wound up for several reasons. These include failure to deliver statutory reports to the registrar, holding a statutory meeting, or commencing business within a year of the company's incorporation. Other reasons include: suspension of business for one year; reduction of the number of members below the statutory requirement; when the court views it just and equitable to wind up a company; non payment of debt; inability to satisfy a judgment[25], and so on and so forth.

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[23] The Provincial Insolvency Act 1920

[24] The Insolvency (Karachi Division Act 1909

[25] http://www.oecd.org/dataoecd/42/14/38184124.pdf retrieved on 07/10/2008

Chapter (II)

2.1 Operative Insolvency Laws in Pakistan

2.1.1 Overview

The Civil Laws, Commercial Laws, Banking Laws and Insurance Laws primarily effect the realm of insolvency in Pakistan and the same were directed towards the distribution of assets in all cases of insolvency.

Two principal statutes govern Pakistan's insolvency laws[1].

- Insolvency of companies by Companies Ordinance, 1984 (companies)
- Insolvency of individuals by Provincial Insolvency Act, 1920 (individuals).

The purposes of the above said laws are;

- The settlement of claims of the debtor, and the transfer to a trustee for the purposes of liquidation of the entire assets of the insolvent.
- That all classes of creditors are the beneficiaries of the distribution between them on an equitable basis.
- To restrict any such transaction on the part of the insolvent which may be referred to as preference which was not due to the creditor to whom it was given in negation of the rights of other creditors,
- To keep a cheque on the insolvent or his managers, especially with regards to the manner in which the affairs of the insolvent are being carried out.

[1] Amna Piracha, Khan & Piracha, *Insolvency Law Reforms*, Report on Pakistan, 2007

2.1.2 Insolvency regime in Pakistan

With the establishment of Pakistan as an independent sovereign state in August 1947, the issue regarding the legal system to be enacted in the newly born state arose. As Pakistan was part of British Colony of India, it was decided to adopt the prevalent legal system of British Colony of India[2]. As a result of the said adoption the Insolvency (Karachi Division) Act of 1909 and the Provincial Insolvency Act of 1920 became operative and were applicable to insolvent individuals only. Whereas the Companies Ordinance of 1984[3] dealing with the winding up or liquidation law, applied to companies only, it also covers corporate rescue i.e. restructuring or receivership. Later on new legislation came in to being in 1997 carrying the main purpose of recovery of corporate debt specifically by banks and development finance institutions, that is the Banking Companies (Recovery of Loans, Advances, Credits and Finances) Act of 1997[4], whereas the same was repealed, modified and reenacted in the form of the Financial Institutions (Recovery of Finances) Ordinance 2001. Another platform for the recovery of debts was also available under the Civil Procedure Code, 1908.

2.1.3 Introduction

Insolvency i.e., When an individual is not able to service his debts upon their becoming due in Pakistan is dealt with under the provisions of Insolvency (Karachi Division) Act, 1909 and the Provincial Insolvency Act of 1920. Where as the winding up of corporate entities is the subject matter of the Companies Ordinance 1984. The law of personal

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[2] Ibid

[3] Companies Ordinance of 1984.

[4] Financial Institutions (Recovery of Finances) Ordinance 2001

insolvency is almost an antique law as it dates back to 1920. Insolvency proceedings against individuals are rarely filed, as the proceedings are slow and burdensome.

2.2 Parties involved;

A liquidation petition may be submitted before a court of competent jurisdiction by[5]:

a. The creditors of the company

b. The shareholders of the company

c. The company in its capacity as a legal person

d. The Registrar of Companies in his capacity as the regulator of companies

e. The Security & Exchange Commission of Pakistan in its capacity as the watch dog of the affairs of companies

f. An individual or a person whom SECP so authorises.

However, Section 318 of the Companies Ordinance 1984 lays down that an order for winding up shall operate in favour of all creditors and shareholders of the company as if it had been made on their joint petition. Therefore, in practice, any creditor or shareholder may join the winding up proceedings. Section 312 of the Companies Ordinance 1984 states that a winding up of a company by a court shall be deemed to commence at the time of presentation of the petition for the winding up ordinarily orders for winding up of a company would only be passed after hearing in the case has taken place. Whereas, in practice the order of winding up is always passed subsequent to presentation of the

[5] Franks, Julian R. Nyborg, Kjell G. Torou. "A comparison of US, UK, and German insolvency codes.(Special Issue: European Corporate Finance)", Financial Management, Autumn 1996 Issue

petition. However, once an order has been passed it operates retrospectively and the liquidation is deemed to have commenced at the time of the presentation of the petition.[6]

2.3 Administering departments

The Court of the District and Sessions Judge of every district is vested with the jurisdiction to take cognizance of insolvency matters. The creditor or the debtor himself brings a petition to the court when insolvency occurs where after the court may pass an order of adjudging the debtor as an insolvent such order is called an "order of adjudication." A wide variety of acts constitute acts of insolvency and include a fraudulent preference, disappearance of the debtor who so disappears with the intent of avoiding or delaying payments due from him to his creditors, in cases where the process of execution has come into motion, with regards to either the sale of the assets of the insolvent or his imprisonment till the payment of the debts due from him. Pending adjudication the insolvency court has the power to detain the debtor in a civil prison and order the attachment of his property[7].

There are three different laws effective in Pakistan dealing with the insolvency laws. High Court and Banking Tribunals are empowered to exercise jurisdiction designated to them in the matters relevant to insolvency, these competent authorities, with competent jurisdiction in this country, are subject to the supervisory control of the respective High Courts, Courts of District and Session Judges and the Civil Courts. Whereas the Banking

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[6] Companies Ordinance 1984

[7] "Harneys Corporate Recovery Services Guides to The Insolvency Act 2003 - Part 1.", Mondaq Business Briefing, August 4 2004 Issue

Tribunal's jurisdiction is not without limitation but are governed by limitation to the extent of those cases, which are by and against banks.

Courts

The Companies' Ordinance 1984 by virtue of section 7 empowers the High Court to administer liquidation. Other courts besides the High Court can also be vested with the jurisdiction of the administration of the process of liquidation by the Federal Government Pakistan but no such initiative has yet been taken.

The High Courts are vested with powers to control the process of liquidation of companies who have become insolvent. When the winding up of a company is on a voluntary basis and has been initiated either by the creditors or the shareholders, the directions of the High Court are sought on issues resulting from the said process of winding up.

On the other hand the liquidation of financial institutions like insurance companies or banks can only be initiated by the respective agency regulating their affairs[8].

State Bank of Pakistan

The State Bank of Pakistan is the regulator of the banking institutions in this country for matters of insolvency. The Banking Companies Ordinance, 1962 takes a very hard stance with regards to any kind of arrangements or compromises proposed to be made between

[8] http://www.paksearch.com/Government/SBP/FOREX/Secp/Law%20Insurance%20Ord.html retrieved on 14/06/2009

the bank and the creditors or shareholder of the company. Section 46 (1) of the Banking Companies Ordinance 1962, makes it incumbent upon the High Court to not allow any such arrangement or compromise until the same has been certified by the State Bank of Pakistan that it is;

a. A workable solution, And

b. Not against the interests of the account holders of the bank in question[9].

SECP

Before embarking up on an effort to look at the role which the Security and Exchange Commission of Pakistan plays in matters of insolvency we have to keep in mind the SECP is the successor of Corporate Law Authority[10]. The Securities and Exchange Commission of Pakistan was established by virtue of section 3 of Security and Exchange Commission of Pakistan Act 1997, whereas the Securities and Exchange Commission of Pakistan Policy Board is composed of 9 members which are appointed by the Federal Government of Pakistan, as provided by section 12 of Securities and Exchange Commission of Pakistan Act 1997.

The powers and functions of this commission are enumerated in the clauses 1 to 7 of **sub-section (4) of section 20** of Securities and Exchange Commission of Pakistan Act 1997[11].

Section 20; "Powers and functions of commission;

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[9] http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/LAWANDJUSTICE/GILD/GILDCOUNTRIES/GILDPAKISTAN/0,,contentMDK:20114599~menuPK:262759~pagePK:157658~piPK:157731~theSitePK:262753,00.html retrieved on 18/04/2009

[10] "SEC notifies draft Employees Provident Fund (Investment in Listed Companies) Rules, 2005.", (PPI - Pakistan Press International), Sept 29 2005 Issue

[11] Securities and Exchange Commission of Pakistan Act 1997

(4) The Commission shall be responsible for the performance of the following functions:

1. regulating the issue of securities ;
2. regulating the business in Stock Exchange and any other securities market;
3. supervising and monitoring the activities of any central depository and Stock;
4. registering and regulating the working of stock brokers, sub-brokers, share transfer agents, bankers to an issue, trustee of trust deduct registrars to an issue, underwriters, portfolio managers, investment advisers, and such other intermediaries who may be associated with the securities markers in any manner;
5. proposing regulations for the registration and regulating the working of collective investment schemes, including unit trust schemes;
6. promoting and regulating self-regulatory organizations including securities industry and related organizations such as Stock Exchanges and an associations of mutual funds, leasing companies and other NBFIs;
7. Prohibiting fraudulent and unfair trade practices relating to securities markets".

As we have seen above the Federal Government appoints Securities and Exchange Policy Board consisting of 9 members the functions of which are the subject matter of clause (a) sub-section 1 of section 21 of the Securities and Exchange Commission of Pakistan Act 1997 and are stated therein as follows:[12]

Sec.21. Functions and Powers of the Board;

(1) Subject to the provisions of this Act, the Board shall:

(a) when so asked to do and after consultation with the Commission, advise the Federal Government on all matters relating to;

(i) The securities industry [and insurance industry];

(ii) Regulation of companies sector and protection of the interests of investors;

[(iia) regulation of the insurance sector and protection of the interests of insurance policy holders;]

(iii) Measures to encourage self-regulation by the Stock [insurer, insurance intermarries, insurance surveyors] and NBFIS by specifying h standards for such self-regulatory organization;

(iv) Measures to promotes the development of and to regulate the securities market [and the insurance market]; and

(v) Other related matters.

[12] Ibid

Securities and Exchange Commission of Pakistan (previously CLA) , under section 265 of the Companies Ordinance 1984, has the power to investigate into the affairs of companies and if, after a consideration of the investigation report, it is of the opinion that the company or its management have acted fraudulently or have misconducted its affairs, or the members of the company are being deprived of reasonable returns on their investment or the financial position of the company has endangered its solvency, the Securities and Exchange Commission of Pakistan or the Registrar of Companies, may present a petition to the court for winding up of the company. Investigation into affairs of the company may be ordered by the SEC on its own motion, consequent to orders of the court, resolution of its members, consequent to an adverse report made by the Registrar of Companies after inspection of the accounts and papers of the company carried out by him under section 231 of the Companies Ordinance 1984 or on the basis of information or explanation obtained by him under Section 261(6) of the Companies Ordinance 1984 from the management and officers of the company. Any scheme of arrangement or compromise becomes effective only after a certified copy of the order sanctioning the scheme has been filed with the Registrar of Companies within 30 days from the date of the orders, as required by section 284(3) of the Ordinance.[13]

In number of cases it is seen that, before beginning any formal proceedings a lender is the one who efforts to negotiate an informal administration, although such attempts remain unsuccessful in cases which are before the courts for the purposes of winding up. When a complaint is made by such creditors whose claims are at least twenty percent (20%) of the capital that is paid up under Sec.305 of the Companies Ordinance 1984 by the

[13] Companies Ordinance 1984

company, any creditor or it could be any contributory as well (Sec.309). In such cases an application to the Registrar of Companies is required as per section 290 of the Companies Ordinance 1984[14].

The appointment of receivers or managers can be made by an individual under any powers comprising in any instrument. Section 16 of Financial Institutions (Recovery of Finances) Ordinance 2001 also provides the appointment of receivership by the court itself, providing that the plaint must relate to the recovery of any amount through a sale of charged property.

An administrator can also be appointed by the representation through those creditors having equivalent to sixty percent (60%) of the capital of the company which is not left unpaid[15].

It may be a case where, a company is declared as sick unit and in such a case Federal Government has the authority to pass the order for its rehabilitation. The Banking Company, Creditors, secured or unsecured, or customer can file recovery suit under the Financial Institutions (Recovery of Finances) Ordinance 2001. Recovery suits can also be filed by any creditors secured or unsecured through the courts.

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[14] http://www.adb.org/documents/others/insolvency/local_study_pak_piracha.pdf retrieved on 06/07/2009

[15] Ibid

2.4 Legal procedure in insolvency:

In view of the several Acts, Ordinances, Rules etc. applicable to the process of insolvency in Pakistan we would now attempt to present the various sections, sub-sections, and clauses in which they are applicable to the procedure adopted for the purposes of winding up of a company.

Winding up of the Companies Ordinance 1984 commences under Sec.290 pursuant to an order which is passed on the complaint made by the creditors who have equivalent in amount up to at least twenty percent (20%) of the company's paid up capital or under Sec.305 if company is indebted to a creditor in a sum exceeding one percent of its paid up capital or Rs. 50,000, whichever is less, and demand made by effected creditor is not met by the company for a period of one month starting from the day when such demand was first made, or if any order of a court of law is against the interests of the creditor or if the court is satisfied that the business concern has become incapable of servicing its debts. Voluntary winding up can be commenced when the company through special resolution makes a decision that the company be wound up (Sec.358) of the Companies Ordinance 1984, but in the case where a declaration to the effect that the company has become insolvent; has not been filed can not be said to be a procedure of insolvency in the strict sense of the term[16].

The procedure to be followed in case of compromise, arrangements and reconstruction in the subject matter of section 284 of the Companies Ordinance 1984 which states;

Sec.284. "Power to compromise with creditors and members:

[16] Ibid

1. Where a compromise or arrangement is proposed between a company and its creditors or any class of them, or between the company and its members or any class of them, the Court may, on the application in a summary way of the company or of any creditors or member of the company or, in the case of a company being wound up, of the liquidator, order a meeting of the creditors, or class of creditors or of the members of the company or class of members, as the case may be, to be called, held and conducted in such manner as the Court directs.
2. If a majority in number representing three-fourth in value of the creditors or class of creditors, or members, as the case may be, present or voting either in person or, where proxies are allowed, by proxy at the meeting, agree to any compromise or arrangement shall, if sanctioned by Court be binding on all the creditors or the class of creditors or on all the members, or class of members, as the case may be, and also on the company, or, in the case of a company in the course of being wound up, on the liquidator and contributories of the company.

Provided that no order sanctioning any compromise or arrangement shall be made by the Court unless the Court is satisfied that the company or any other person by whom an application has been made under sub-section (1) has disclosed to the Court, by affidavit or otherwise, all material facts relating to the company, such as the latest financial

position of the company, the latest auditor's report on the accounts of the company, the tendency of any investigation proceedings in relation to the company and the alike.

3. An order made under sub-section (2) shall have no effect until a certified copy of the order has been filed with the registrar within thirty days and a copy of every such order shall be annexed to every copy of the memorandum of the company issued after the order has been made and filed as aforesaid, or in the case of a company not having a memorandum to every copy so issued of the instrument constituting or defining the constitution of the company.
4. If a company makes default in complying with sub-section (3), the company and every officer of the company who is knowingly and willfully in default shall be liable to a fine which may extend to five hundred rupees for each copy in respect of which default is made.
5. The Court may, at any time after an application has been made to it under this section, stay the commencement or continuation of any suit or proceeding against the company on such terms as it thinks fit and proper until the application is finally disposed of.
6. In this section the expression " company" means any company liable to be wound up under this Ordinance and the expression "arrangement" includes a re-organization of the share-capital of the company by the consolidation of shares of different classes or by

the division of shares into shares of different classes or by both those methods, and for the purposes of this section unsecured creditors who may have filed suits or obtained decrees shall be deemed to be of the same class as other unsecured creditors."

Whereas these compromises and arrangements are enforced by the Court in accordance with the powers vested in the court by section 285 of the Companies Ordinance 1984, which is as under;

Sec. 285 "Power of Court to enforce compromises and arrangements;

(1) Where the Court makes an order under section 284 sanctioning a compromise or an arrangement in respect of a company, it may, at the time of making such order or at any time thereafter, give such directions in regard to any matter or make such modifications in the compromise or arrangement as it may consider necessary for the proper working of the compromises or arrangement.

(2) If the Court is satisfied that a compromise or arrangement sanctioned under section 284 can not be worked satisfactorily with or without modification, it may, either of its own motion or on the application of the registrar or any person interested in the affairs of the company, make an order winding up the company, and such an order shall be deemed to be an order made under section 305.

(3) The provisions of this section shall, so far as may be, also apply to a company in respect of which an order has been made before the commencement of this Ordinance sanctioning a compromise or an arrangement.

The appointment of a receiver or manager can be brought about by a debenture holder by requesting and getting an order for the same from a court of competent jurisdiction or by virtue of the provisions with regards to insolvency/liquidation in any instrument of law or in accordance with Sec. 16 of the Financial Institutions (Recovery of Finances) Ordinance 2001[17] or under Order XL of the Civil Procedure Code.[18]

Share holders or Creditors of a business concern whose shares or debts are atleast sixty percent (60%) of the company's paid up capital may make a representation for the appointment of an administrator to take care of the affairs of the company, if they can prove mismanagement or a depleted financial position of the company.

Federal Government can declare a company as sick unit and such a company may be subjected to rehabilitation in a case where a company is bearing financial problems.

When a company makes default in respect of its payment to the banks a banking company can initiate recovery proceedings under the Financial Institutions (Recovery of Finances) Ordinance 2001.[19]In cases where the corporate debtor is not been able to service his debts or the obligations thereto or some major conditions of the agreements of finance have not been fulfilled resulting in non-payment to the lenders, the creditors can file recovery proceedings before the court.

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[17] Financial Institutions (Recovery of Finances) Ordinance 2001

[18] Civil Procedure Code 1908

[19] Financial Institutions (Recovery of Finances) Ordinance 2001

2.5 Commencement:

The winding up proceedings may be initiated by filling a petition in accordance with section 309. In case of reconstruction, arrangement or compromise, the requirement is an application to the court as per section 284 the Companies Ordinance 1984 as already stated above.

If an agreement grants power in respect of appointment of receiver or manager then in such a case appointment can be obtained directly and without the intervention of court. On the other hand if the said appointment is required to be by an order to the court then an application for the said purpose has to be submitted before the requisite court.

Section 295 of the Companies Ordinance 1984 deals with the appointment of an administrator and requires that a representation be made for the said purpose to the Securities and Exchange Commission of Pakistan[20].

Federal Government has the power to declare a company as sick unit suo moto (Sec.296). Upon the filling of suit before the Banking Court recovery under the Financial Institutions (Recover and Finances) Ordinance 2001 can be obtained. Similarly recovery through court can also be attained if a suit is filed for the same before the Civil Courts[21].

2.6 Time limitation

The Companies Ordinance 1984 lays down the period of time from the formal initiation of insolvency proceedings and the formal appointment of an administrator to administer the affairs of the corporate debtor, whereas in winding up proceedings or appointment of

[20] http://www.adb.org/documents/others/insolvency/local_study_pak_khan.pdf retrieved on 06/20/2009

[21] http://www.adb.org/documents/others/insolvency/local_study_pak_piracha.pdf retrieved on 06/07/2009

liquidator the Companies Ordinance 1984 stipulates the period of about three and a half months[22].

In case of recovery suit under the Financial Institutions (Recovery of Finances) Ordinance 2001, leave to defend is stipulated to be decided within twenty one days (21) of an application for leave to appear and the suit to be settled within ninety days (90) after leave to defend has been allowed. When a judgment is passed by the Banking Court a period of thirty days (30) is allowed for the preference of an appeal against such a decree. Moreover if such an appeal is filed, the Financial Institution (Recovery of Finances) Ordinance 2001 requires that the same be decided within three months from the date of admittance of the same.

In case recovery proceedings are filed by way of civil suit the prescribed time period is up to three years in the first instance. It is pertinent to mention here that in theory law lays down the time limits, although this fact can not be ignored that in practice there are delays and time limits are not adhered to.

2.7 Consequences of insolvency procedure

Not only the corporate debtors but the company's constituent parts and business relationships are also, with no doubts, affected by the initiation of the legal procedure of insolvency. Here I would like to cote some examples as to how the commencement of the insolvency procedure affects, such as:

- The debtor's governing powers;
- The shareholders/owners interests;

[22] Ibid

- The contracts wherein the debtors are a parties;
- Any suits or other legal proceedings wherein the company has been arrayed as a party;
- The remedies available to individuals/companies who are in contract with the debtor although the said contracts are not based upon debts[23].

2.8 Judicial non-judicial division

Judicial Proceeding

All property of the company is to be in the custody of the court as from the date of the order for winding up of a company. The Official Liquidator is required to take into his custody or control all property, which belong to the company. The management of the company is required to hand over all properties to the liquidator including , the books and papers of the company. The liquidator has to maintain proper accounts regarding receipts and payments and furnish them to the court at least twice a year.

The liquidators also have the power to ask any shareholder, trustee, receiver, banker, officer, agent or employees of the company to surrender to the official liquidator any money, property or papers of the company[24].

The liquidator may also summon any persons suspected of having in possession of property of the company. Under Section 406 of the Companies Ordinance 1984, unless the court orders otherwise, any transfer of property or delivery of goods made by the

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[23] Ibid

[24] http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/LAWANDJUSTICE/GILD/GILDCOUNTRIES/GILDPAKISTAN/0,,contentMDK:20114599~menuPK:262759~pagePK:157658~piPK:157731~theSitePK:262753,00.html retrieved on 04/16/2009

company (except made in the ordinary course of business or in favour of the acquirer in good faith and for valuable consideration) shall be void against the liquidator if made within one year prior to commencement of winding up. Once a liquidator has been appointed, the management of the company stands removed, and is substituted by the liquidator. The liquidator is the main person incharge of the liquidation. When a liquidator has been appointed the Chief Executive and the board of directors of the Company ceases to hold office. Unless he requires them for continuation of business of the company, the liquidator would terminate the employment of all officers. The liquidator may, under section 407 of the Companies Ordinance 1984, disclaim, with leave of the court, any land burdened with onerous covenants, shares and unprofitable contracts or property not readily saleable, within twelve months after the commencement of winding up or an extended period allowed by the court. The liquidator has the power to sell all properties whether tangible or intangible belonging to the company by public auction or by private contract, by sanction of the court. In the legal sense all properties of the company continue to remain to vest in the company, unlike vesting in the receiver in case of personal insolvency, but the custody, as mentioned earlier, is deemed to be with the court.

Under Section 412 of the Companies Ordinance 1984, officers or directors of the company may be compelled to pay or restore any money or property of the company that might have been misapplied or retained by them or regarding which they might have been guilty of misfeasance or guilty of breach of trust. If intend to defraud creditors of the company or any other person or for a fraudulent purpose has been discovered during the

course of winding up, every person who was a party to such transactions may be prosecuted.

Non-judicial proceedings

Non-Judicial liquidation takes place by voluntary winding-up, which can be brought about by the members.

a) Voluntary winding up by a company:

Section 358 of the Companies Ordinance 1984 lays down that a company may be wound up voluntarily when the period, if any, fixed for its duration by its articles expires, or the articles provide that the company shall be dissolved if a specified event takes place, and on occurrence of such event the company, in a general meeting passes a resolution of winding up. [25]

The company may also, by a special resolution, decide that it should be wound up voluntarily. In case of voluntary winding up, the directors are required to make a declaration that the company has no debts or that it shall be able to pay its debts within a period not exceeding twelve months from the date of commencement of winding up. The voluntary winding up is deemed to commence from the time of passing of the resolution for voluntary winding up. A liquidator appointed in a general meeting carries it out and such liquidator is deemed to be an officer of the company.

[25] Companies Ordinance 1984

b) Creditors voluntary winding up

Where a company has some creditors and it has been proposed by the company that it shall be wound up voluntarily then it is required that a meeting of the creditors be summoned for a day, or the immediately following day, on which a general meeting of the company is held for passing of a resolution for voluntary winding up.

Although a voluntary winding up is not a winding up being carried out by the court, an application may be moved to the court under section 396 of the Companies Ordinance 1984 for determination of any questions arising out of the winding up of the company and for other appropriate orders.

Rehabilitation process

It is visualized that if agreements proposed by creditors is approved in the prescribed manner by the requisite majority of the creditors and also by the court, becomes binding on all creditors, subject to adjustments are made by the High Court. Main parts of the Companies Ordinance 1984 dealing with rehabilitation are parts IX and X, wherein the appointment of a receiver or manager as per section 137, reconstruction and the arrangement cosequencing from the same as per section 284, an administrator when appointed according to section 295 or when the borrower company is declared to be a sick unit as per section 296, are the major aspects effecting such proposed agreements[26].

[26] http://www.adb.org/documents/others/insolvency/local_study_pak_piracha.pdf retrieved on 04/07/2009

Reorganization process

The court may be approached in form of an application either by the company itself or any of its creditors praying for an order for a meeting to obtain the consent of a group of creditors or all of them on a proposed agreement of reorganization/rehabilitation or compromise. In such a meeting if 75% of a group of creditor or creditors attending the meeting by proxy or inperson agree with the terms of the arrangement or compromise, the said arrangement or compromise would be given legal sanctity by the orders of the court and the same would bind the company and the creditors to the arrangement or compromise[27].

2.9 Bankruptcy treaties and conventions

Pakistan has yet not become a signatory to any convention or bankruptcy treaty on the international scenario.

2.10 Rationale of insolvency law

The background and purpose of these insolvency laws fall under 3 major categories, which include Distributive, Rehabilitative and Penal. Where as the Concerned provisions of law are discussed below[28]:

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[27] http://www.oecd.org/dataoecd/42/14/38184124.pdf retrieved on 04/07/2009

[28] Amna Piracha, Khan & Piracha, *Insolvency Law Reforms*, Report on Pakistan, 2007

Distributive:

The insolvency regime covering the corporate sector of Pakistan lays the major stress on distribution, with a purpose that such concept is to apportion the liabilities and resolve much of the debts as possible (Sec.349). Recovery of debt and distribution has been the main focus of the all the laws. i.e. Companies Ordinance 1984,Banking Companies Ordinance 1962 etc.

Rehabilitative:

In these times of accelerated economic growth the running of the every day affairs of a country in terms of commercial transactions and affairs without making the respective laws accommodative of the needs of producers and the consumers both. Rehabilitation of sick unit is one of the major purposes for which law is being modified in the recent decades. This policy will precipitate the rehabilitation of the sick units and make them more participative for the economic growth, as it would result in a winning situation for both the government and the industry in distress. The Companies Ordinance 1984 deals with rehabilitation in parts IX and X, wherein the appointment of a receiver or manager as per section 137, reconstruction and the arrangement cosequencing from the same as per section 284, an administrator when appointed according to section 295 or when the borrower company is declared to be a sick unit as per section 296, are the major aspects effecting such proposed agreements.

Penal:

The legal status of an undischarged insolvent carries with it certain disabilities that prevent him from conducting certain businesses. For instance, if an undischarged insolvent receives a credit of Rs.50 or more without disclosing his legal status to his creditor he shall be punishable on conviction for a term of up to six months, while a fine can also be imposed. Under the Insolvency Act an insolvent stands disqualified from being appointed or acting as a magistrate; or being elected to any office of any local authority where the appointment to such office is by election or holding any such office to which no salary is attached; and being elected or sitting or voting as a member of any local authority. These disqualifications are removed if the order of adjudication is annulled on the basis of the fact that the total sum of the debts due has been cleared or on the declaration by the court that the order passed by for these disqualifications was misconceived and thus of no legal effect. In addition, the company law, too, prescribes a two years imprisonment and fine for an undischarged insolvent in case he acts as a director, chief executive or a managing agent of a company. Some other laws too prescribe similar disabilities for undischarged insolvents.

Where there are fraudulent acts the element of penal action is always there by way of applicable penal sanctions in respect of such cases entailing imprisonment and fines. The penal sections which outline these imprisonments and fines are[29]:

Sec.412 power of court to asses damages against delinquent directors.

Sec.413 liability for fraudulent conduct of business

Sec.415 fraud by officers of company in liquidation

Sec.416 liability where proper accounts not kept

[29] Ibid

Sec.417 penalty for falsification of books

Sec.418 prosecution of delinquent directors

Sec.419 penalty for false evidence

In the Financial Institutions (Recovery of Finances) Ordinance 2001 offences are dealt under **section 20** which states:[30]

1. Whoever;

(a) dishonestly commits a breach of the terms of a letter of hypothecation, trust receipt or any other instrument or document executed by him whereby possession of the assets or property offered as security for re-payment of finance or fulfillment of any obligation are not with the financial institution but are retained by or entrusted to him for the purposes of dealing with the same in the ordinary course of business subject to the terms of the letter of hypothecation or trust receipt or other instrument or document or for the purpose of effecting their sale and depositing the sale proceeds with the financial institution; or

(b) makes fraudulent mis-representation or commits a breach of an obligation or representation made to a financial institution on the basis of which the financial institution has granted a finance; or

[30] Financial Institutions (Recovery of Finances) Ordinance 2001

(c) subsequent to the creation of a mortgage in favour of a financial institution, dishonestly alienates or parts with the possession of the mortgage property whether by creation of a lease or otherwise contrary to the terms thereof, without the written permission of the financial institution; or

(d) subsequent to the passing of a decree under section 10 or 11, sells, transfers or otherwise alienates, or parts with possession of his assets on properties acquired after the grant of finance by the financial institution, including assets or properties acquired benami in the name of an ostensible owner shall, without prejudice to any other action which may be taken against him under this Ordinance or any other law for the time being in force, be punishable with imprisonment of either description for a term which may extend to three years and shall also be liable to a fine which may extend to the value of the property or security as decreed or the market value whichever is higher and shall be ordered by the Banking Court trying the offence to deliver up or refund to the financial institution, within a time to be fixed by the Banking Court, the property or the value of the property or security.

Explanation: - Dishonesty may be presumed where a customer has not deposited the sale proceeds of the property with the financial institution. In violation of the terms of the agreement between the financial institution and the customer.

2. Whoever knowingly makes a statement which is false in material respects in an application for finance and obtains a finance on the basis thereof, or applies the amount of the finance towards purpose other than that for which the finance was obtained by him, or furnishes a false statement of stocks in violation of the terms of the agreement with the financial institution or falsely denies his signatures on any banking document before the Banking Court, shall be guilty of an offence punishable with imprisonment of either description for a term which may extend to three years, or with fine or with both.
3. Whoever resists or obstructs, either by himself or on behalf of the judgment-debtor, through the use of force, the execution of a decree, shall be punishable with imprisonment which may extend to one year, or with fine, or with both.
4. Whoever dishonestly issues a cheque towards re-payment of a finance or fulfillment of an obligation which is dishonoured on presentation, shall be

punishable with imprisonment which may extend to one year, or with fine or with both, unless he can establish, for which the burden of proof shall rest on him, that he had made arrangements with his bank to ensure that the cheque would be honoured and that the bank was at fault in not honouring the cheque.

5. Where the person guilty of an offence under this Ordinance is a company or other body corporate, the chief executive by whatever name called, and any director or officer involved shall be deemed to be guilty of the offence and shall be liable to be persecuted against and punished accordingly.
6. All offences under this Ordinance shall be liable, non-cognizable and compoundable.

2.11 Insolvency laws

Whenever there are financial difficulties faced by the corporate debtors the following insolvency procedures are applicable in the legal system of our country besides the ones already discussed in the previous sections of this chapter.

Insolvency Act 1920

Acts of Insolvency (Section 6)

A debtor commits an act of insolvency in each of the following cases, namely[31]:--

(a) If, in India or elsewhere, he makes a transfer of all or substantially all his property to a third person for the benefit of his creditors generally;

(b) If, in India or elsewhere, he makes a transfer of his property or of any part thereof with intent to defeat or delay his creditors;

(c) If, in India or elsewhere, he makes any transfer of his property, or of any part thereof, which would, under this or any other enactment for the time being in force, be void as a fraudulent preference if he were adjudged an insolvent; if, with intent to defeat or delay his creditors,--

(i) He departs or remains out of the territories to which this Act extends,

(ii) He departs from his dwelling-house or usual place of business or otherwise absents himself,

(iii) He secludes himself so as to deprive his creditors of the means of communicating with him;

(e) If any of his property has been sold in execution of the decree of any Court for the payment of money;

[31] http://www.helplinelaw.com/bareact/bact.php?no=03&dsp=prov-insolvency& retrieved on 12/07/2009

(f) If he petitions to be adjudged an insolvent under the provisions of this Act;

(g) If he gives notice to any of his creditors that he has suspended, or that he is about to suspend, payment of his debts; or

(h) If he is imprisoned in execution of the decree of any Court for the payment of money.

Under the Ordinance:

The company law imports into the winding-up of insolvent companies the "rules" "as are in force for the time being under the law of insolvency[32]."

Under the Companies Ordinance, the companies can be wound up either "voluntarily" or "under the supervision of the court" if they are unable to pay their debts 30 days from the time they become due. The amount of the debt should be either 1 per cent of the paid-up capital of the company or Rs.50, 000.00 whichever is less. Winding up under the court orders is only available to unsecured creditors; secured creditors are expected to rely on their security for the repayment of their debts. If the security proves insufficient, they can contact the court for the deficient amount as unsecured creditors. The courts are generally found sympathetic to the debtors and willing to allow them time to pay the debt. A winding up proceeding in a court can take up to three to four years. [33]

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[32] http://www.pcp.org.pk/PDF/Comp_Ord1984.pdf retrieved on 03/03/2009

[33] www.khanassociates.com retrieved on 15-12-2008 retrieved on 03/03/2009

Individual insolvency

Proceedings in cases of individual insolvencies the following options are available:

In the case of creditors who are secured, they have the option of having their securities realized[34].

a) In such cases if the creditor has a mortgage on a property, then the same would operate in a manner, wherein the property so mortgaged would be transferred to the name of the person secured but the debtor would still have the right to redeem his property upon the clearance of the entire debt due to such a creditor.

b) A charge is also a security in the form of a promise personally given by the obligor that a specified piece of property would stand realizable at the option of the creditor to fulfill the obligation. The only set back which a creditor who is secured by a charge is that in the case of a bonafide purchaser on due payment of value for the same, in effect results in a transfer of the said property to the bonafide purchasers name without any recourse being available to the creditor who had held a charge to the same.

c) Pledge, a floating charge or hypothecation are the major ways in which personal property may be use as a security. In the case of a pledge as the same can be enforced by the pledgee of his own accord as the property so pledged is already in his possession and the same can be sold after the fulfillment of a few formalities of legal nature. Whereas in the case of hypothecation of an

[34]http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/LAWANDJUSTICE/GILD/GILDCOUNTRIES/GILDPAKISTAN/0,,contentMDK:20114599~menuPK:262759~pagePK:157658~piPK:157731~theSitePK:262753,00.html retrieved on 17/08/2009

asset/goods the obligor retains the possession of the same as such requiring the creditor to have his rights enforced through a court of proper jurisdiction. The same can only be avoided if the obligor agrees to sell the hypothecated assets/goods on a voluntary basis.

Personal property may be secured by way of creation of a floating charge of the same. Whenever there is a floating charge on a property the obligor retains the right to deal with the said property for the purposes of routine business but the transferee's right to acquire such property without any charge remains effective.

The enforcement of a security may only be achieved by virtue of an order of a court until and unless both the creditors and the debtors are in agreement for a sale of the assets voluntarily. When we look at the same aspect in cases where companies are involved any interest of security being held on the assets of a company, the same needs to be made a part of the record held with the registrar of the companies. If any such interest does not stand recorded in the requisite register of the registrar of the companies, the liquidator or the creditors would not be able to enforce the same.[35]

Under Section 47 of the Insolvency Act, 1920 the secured creditor may realize his security and prove his debt, for the balance due to him after adjusting the amount realized. He may also relinquish the security for general benefit of the creditors. If he does neither of these then his debt would not be admissible to proof unless he places value on the security. Where he values the security, he can receive the debt only in respect of the balance after taking into account the specified value. In other cases the

[35] Ibid

court may, before the secured creditor realizes the security, redeem it by payment of the assessed value. Where a secured creditor realizes the security, after having valued it, the actual amount realized would be substituted for the previous amount of valuation made by the creditor. The secured creditor, who does not comply with this provision of law, is to be excluded from any share in the dividends. However, in practice, in order to facilitate the liquidation process, a secured creditor may allow the liquidator to sell the security with the secured creditor having the same rights in the proceeds of the sale of the secured property as in the property itself. In ordinary practice, the liquidator, on the above understanding, sells all assets and then distributes them between the creditors, after satisfying the claim of the secured creditors. A debtor may propose rehabilitation in case of individual's insolvency a composition and arrangement after he had been adjudged as an insolvent under the Act. After the scheme has been approved, the court may grant a discharge to the debtor with the result that pre-petition debts are paid according to the scheme and thereafter the discharged bankrupt may start a new life, subject to such conditions, if any, as might be imposed by the scheme[36].

In the case of the creditors who are not secured the only repayment which these unsecured creditors can expect is by way of sharing out of the sale proceeds of the insolvent assets on a ratable distribution basis and that also after the satisfaction of the claims of the "preferential creditors". It has to be kept in mind that the unsecured creditors of any company can attain the enforcement of their claims through the process of court. For the said purpose it is incumbent upon them to prove that the debtor was in the process of the disposal of his property with the malafide intention to avoid the

[36] Ibid

execution of an expected decree resulting out of a matter pending adjudication before the said court and if the court is satisfied with their contention then it may in its discretion attach the debtor's property so that a decree, if the same is in the favour of the creditors can be satisfied. The finalization of such matters before a court of law ordinarily consumes a few years and all such decisions are also appealable.[37]

Once the estate of the insolvent has been distributed as above, the insolvent has the opportunity of making a new start in life as a fully discharged insolvent. Individual insolvency is under the control of the Insolvency Court and the bankrupt estate is administered by appointment of a receiver by the court.

After an individual has been declared insolvent by the insolvency court, his estate declared bankrupt, a receiver appointed for the administration of the same and his entire estate is distributed in the manner stated in the paras above, such an insolvent stands fully discharged and may take a new start in life.

Company's insolvency

When we look at the procedure of insolvency in the frame work of companies, we find that to have a company declared as insolvent company there is a requirement for the filling of a petition before the requisite court of law, which after satisfying its judicial mind may declare the initiation of the process of liquidation of the insolvent company by appointing a liquidator for the purposes of realization and the consequent sale of the assets of the business concern under liquidation and distribute the proceeds thereof

[37] Ibid

amongst the creditors of the company. The above procedure may only be avoided in certain cases where voluntary winding up is adopted by a company.

The provisions of the Companies Ordinance 1984 when dealing with companies which have become insolvent, may only take up the matter when the same is presented before them by either the secured or unsecured creditors or the debtors themselves. Normally the courts appoint a liquidator to manage the affairs and assets of the insolvent company, till a decision is reached. As soon as the court passes he order for the winding up of a company no further legal proceedings can be initiated against the said company.[38]

A process termed as the reorganization of the business concern, which is now a days being relied upon by both the creditors and the insolvent companies is a result of the consent of the creditors and company itself by way of certain arrangements which are then solidified in the form of agreements.

Whenever a company is declared as insolvent and the creditors and the company itself agrees to follow the process of corporate rehabilitation, the same falls under the purview of the Securities and Exchange Commission of Pakistan, under whose umbrella the creditors, the company's administration and the liquidators should contain their relevant actions. The rehabilitation process popularly known as corporate rehabilitation is to be proceeded with under judicial monitoring and the same falls under the jurisdiction of the High Court in accordance with the provisions of the Companies Ordinance 1984.

In view of the fact that corporate rehabilitation is judicially monitored, it has to be kept in mind that during the process of reorganization the appointment of any person in a fiduciary capacity is normally not allowed. However, in cases where a liquidator has

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[38] Ibid

already been appointed because the process of liquidation is in process as a consequence of winding up proceedings which are in turn due to the fact that the reorganization of the business concern has already been initiated, the fiduciary capacity of the liquidator would continue. Where there has been a private agreement on a voluntary basis between the creditors and the company to reorganize the business concern without going in to bankruptcy proceedings, the same would be enforceable.[39]

The insolvency of Companies is principally governed by the provisions of the Companies Ordinance 1984 in Pakistan and whenever an insolvent company is in the process of being wound up the rules applicable to the matter remain the same with regards to the secured as well as unsecured creditors.

The various sections of the Companies Ordinance1984 applicable to winding up due to different causes are;

(1) Winding up by the Court (Sec.275 and 305 (e)]

- **a.** Winding up by the Court, (Sec.275).
- **b.** Complaint for fraud or mismanagement (Sec.290).
- **c.** Winding up by Court, (Sec.305).

(2) Reconstruction (Sec.284),

(3) Appointment of a receiver of manager (Sec.137),

(4) Appointment of an administrator (Sec.295),

(5) Declaration of a company as a sick unit and order for rehabilitation (Sec.296).

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[39] Ibid

Banking Companies Ordinance 1962

The salient features of the Banking Companies Ordinance, 1962 and the Insurance Ordinance (XXXIX of 2000) are as follows:

There are certain provisions laid down in the Banking Companies Ordinance 1962, which affect insolvency procedures, especially the banking companies and these provision are contained in part III of the said Ordinance.

These are:[40]

a) The grant by the High Court of a stay of proceeding against a banking company accompanied by a report of the SBP showing that in the opinion of the SBP the banking company will be able to pay its debts if the stay is granted. (Sec.45 of Banking Companies Ordinance 1962)[41].

b) Restrictions on compromise or arrangement between banking companies and their creditors unless the same is certified by the SBP as being workable and not detrimental to the interest of the depositors. (Sec.46 of the Banking Companies Ordinance 1962).

c) Application by the SBP under section 47 of the 1962 Ordinance to the Federal Government for an order of moratorium in respect of the banking company and order

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[40] Banking Companies Ordinance1962,
-http://www.adb.org/documents/others/insolvency/local_study_pak_piracha.pdf retrieved on 19-08-2009.

[41] http://www.insolvencyasia.com/insolvency_law_regimes/Pakistan/section_i.html retrieved on 19-08-2009

for moratorium by the Federal Government staying the commencement or continuance of all actions against the banking company for a fixed period of time, not to exceed six months. (Sec.47 (2) of 1962 Ordinance)

d) During the period of Moratorium the State Bank of Pakistan may in the interest of debtors, public interest, better management of the banking company prepare a scheme for the reconstruction of the banking company or for the amalgamation of the banking company with another banking company. (Sec.47 (4) of the Banking Companies Ordinance 1962).

e) The Procedure for amalgamation is outlined in (Sec. 48)

f) Winding up by High Court, where the banking company is unable to pay its debts or an application for winding up is filed by State Bank of Pakistan (Sec.49).

g) Appointment of Court Liquidator (Sec.50)

h) Notice to preferential claimants (Sec.55)

i) Preferential payments to depositors (Sec.58)

Insurance Ordinance (XXXIX 2000)

The insolvency procedure against the insurance companies were affected by the provisions of Insurance Act 1938 which has been repealed and a new ordinance promulgated which is called the Insurance Ordinance (XXXIX 2000). It may be noted here that the repealed act was made applicable "to certain insurers seizing to enter in to new contracts before commencement of this ordinance". And relevant sections are from143 to155, which are as follows:[42]

Sec.143 This section states that winding up may be ordered by the court in accordance with the Companies Ordinance 1984, on the additional grounds mentioned below:

(b) If with the sanction of the court previously obtained a petition in this behalf is presented by shareholders not less than in number than one-tenth of the whole body of shareholders and holding not less than one-tenth of the whole share capital or by not less than fifty policy- holders holding participating policies of life insurance other than paid-up policies, that have in force for not less than three years and have a total sum insured, including bonuses added to the sum assured of not less than fifty million rupees; or

(c) If the Commission, who is hereby authorized to do so, applies in this behalf to the Court on any of the following grounds:-

i. That the company having failed to comply with any requirement of this Ordinance has continued such failure or having contravened

[42] Insurance Ordinance (XXXIX 2000)

any provisions of this Ordinance has continued such contravention for a period of three months after notice of such failure or contravention has been conveyed to the company by the Commission;

ii. That it appears from the returns furnished under the provisions of this Ordinance, or from the results of any investigation made thereunder, or from a report made by any Administrator appointed thereunder that the company is insolvent; or

iii. That the continuance of the company is prejudicial to the interests of the policy holders.

Sec.144 Deals with the voluntary winding up under certain circumstances.

Sec.148 Deals with the powers of Court to reduce contracts of life insurance.

Sec. 152 Deals with determination of insurance liabilities.

Sec.153 Deals with the application of statutory fund assets.

Sec.154 Deals with the winding up of secondary companies.

Sec.155 Deals with the return of deposits.

2.12 Main characteristics of the types of insolvency procedures with regards to corporate debtors:

1. Winding up proceedings may be commenced by a creditor either as per the provisions of section 305 of the Companies Ordinance1984 or through the Authority as stipulated in section 275 of the Companies Ordinances 1984, consequencing from an order given as per section 290 of the same Ordinance. The initiation of the process of winding up is also possible if a special resolution is passed by the company in accordance with the requirements of the section 358 (b) of the Companies Ordinance 1984 but the same can not be categorized as a procedure of insolvency.[43]

   The administration of the procedure of insolvency is either handled by a liquidator or as his own or with an Inspection Committee. The discretion of the court is very wide in these matters. If the court finds that the making of winding up order, although justified by the facts of the matter, would be unfair and cause prejudice to the creditors, the court has the discretion to regulate the affairs of the company, for the purposes of fair play and dispensation of justice and may even go to the extent of ordering the change of management.

   This exercise is under taken for the purposes of liquidation and distribution of the assets of the company amongst the creditors in a manner wherein, the interest of the creditors, employees and the tax authorities are equitably taken care of.

[43] http://www.adb.org/documents/others/insolvency/local_study_pak_piracha.pdf retrieved on 18-08-2009

2. The commencement of reconstruction is provided for under Section 284 of the Companies Ordinance 1984, which requires an application to be made to the court either by creditor or the company or member, where a company is being wound up by the liquidator.
3. Reorganization of the company and protection of the interests of the creditors, are the main tasks of this procedure.
4. The appointment of a manager or receiver is possible by virtue of an application submitted before the court supported by a financing document which support such an appointment, for the purposes of securing the company's assets and debt settlement[44]. On the other hand court has the power to appoint receiver on its own under Section16 of the Financial Institutions (Recover and Finances) Ordinance 2001, in respect of a case where plaint is related to recovery through sale of a charged asset.
5. In case of appointment of an administrator by the creditor by way of a separation to the Securities and Exchange Commission of Pakistan, but in this case the interest of the creditor or creditors should be atleast sixty percent (60%) of the company's paid-up capital. (Sec. 295)[45].
6. Where there is a company owning an industrial unit and said unit is bearing severe financial losses, the Federal Government possesses the power to declare such a company as a sick company and consequently to issue directions to the effect that a rehabilitation plan for the said company be formulated under (Sec.296), with the purpose of the corporate rehabilitation of such a sick unit.

[44] Ibid

[45] Ibid

7. The Banking Courts have been established under Sec.9, of the Financial Institution (Recovery of Loans and Advances) Act 2001 for the recovery of loans and recovery proceedings may be initiated by filling a suit for the said purpose before a Banking Court of a relevant jurisdiction[46].

2.13 Types of insolvency procedure available for corporate debtors:

Corporate debtors have the advantage of being equipped with insolvency procedures, in the form of various legislations, according to which the debtors of the corporate sector have the choice of availing different procedures for the purposes of insolvency. The said legislations are;

(a) The Companies Ordinance 1984 dealing with winding up, arrangement or management, appointment of receiver/administrators, and rehabilitation.

(b) Financial Institutions (Recover of Finances) Ordinance, 2001.

(c) The Code of Civil Procedure, 1908 enacted for recover of loans.

Insolvency under the Financial Institutions (Recovery of Finances) Ordinance 2001

Where recovery proceedings have been commenced under the Financial Institutions (Recovery of Finances) Ordinance 2001 the management and the routine procedures of such a company are not effective. Similarly the recovery proceedings have no impact up on any remedies or contracts which are within the rights of persons who have had contracts with the company, any vested rights of the owners and shareholders or any

[46] Ibid

proceedings of a legal nature which are subjudice before any court of law, till the time that a decision is announced by the said banking court.[47]

Insolvency under the Civil Law

When we look at the proceedings for recovery filed before a Civil Courts, the effects of the same would be almost the same as I have already stated under the previous heading. It is pertinent to mention here that the only difference between the recovery proceedings under the Financial Institutions (Recovery of Finances) Ordinance 2001 and under the Civil Law, is the difference of Courts, as under the Financial Institutions (Recover of Finances) Ordinance 2001 recovery proceeding are filed before the Banking Court on the other hand the Civil Courts deal with the matter in accordance with the procedures prescribed in the Code of Civil Procedure 1908.[48]

I would like to dwell upon the issue of second insolvency proceedings with regards to a corporate debtor in the case where previously a procedure of insolvency is already subjudice. In this regard as already discussed above the fate of such proceedings would be directly dependent upon the decision of the court of the first instance. Moreover any new proceedings for the purpose of insolvency are required to be consolidated before the court of relevant jurisdiction so that multiplicity of litigation and conflicting judgments can be avoided.

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[47] http://www.adb.org/documents/others/insolvency/local_study_pak_piracha.pdf retrieved on 18/08/2009

[48] "Law Commission- (Cheque bouncing punishment up to three years term, LJC).", PPI – (Pakistan Press International), August 24 2003 Issue

Chapter (III)

Comparative Analysis of different insolvency regimes

3.1 Comparison of UK Insolvency Laws with that of US and Pakistan.

3.1.1 Comparative Analysis of different insolvency regimes

A report on an international comparison of insolvency laws was presented on 27-28 April 2006 in Beijing, China, wherein it was stated that, "Relatively talking, the standards used for considering an enterprise bankrupt and the precedence of labour creditors are the two core problems in respect of insolvency law.

The first refer to the requirement for the implementation of insolvency law. The second manipulates the execution of insolvency law; it launched creditor's rights as well as interests, and also expands effectual economic array".[1]

In another report was found covering the relative issue titled as "comparative overview of Asian insolvency reforms in the last decade" by Mr. Soogeon Oh, This report was also produced in the seminar held on the same dates i.e. on 27-28 April 2006 in Beijing, China, wherein It is was stated that, insolvency laws were urbanized accompanied by economic disorder because the extent of the insolvent debtor's unpaid debts operated as the stress on the development of the insolvency law. People realized due to economic disaster that insolvency law is essential in addition to normal creditor debtor relationship laws. The US insolvency law progressed during the economic collapse of the 1800's. Many economies in conversion in Central and Eastern Europe have developed insolvency

[1] Wang Huaiyu, *An international comparison of insolvency laws* (Beijin:27-28 April 2006)

laws in the 1980's when for the very first time they had firms which were insolvent which, were insolvent which were never before in a planned economy , were never seen before. Latin American countries also renewed their insolvency laws at the time when sovereign states were on the verge of bankruptcy in the early 1990's.

East Asian countries history is a result of similar conditions. When Asia was going through financial calamity in the region in the late 1990's, the insolvency system inplace then was held liable for standing in the way of eradicating doubtful and insolvent firms from the market and held no promise with regard to rather insolvent firms. Hence, insolvency reforms pursued as a result of said economic disaster. In order to advance insolvency law and practice, efforts were made by way of revising outdated insolvency laws, launching reorganization proceedings, introducing insolvency courts and encouraging out-of-court- settlements. In the region nearly all of the countries modified their existing laws or introduce new legislation. In the opinion of Lampros Vassilleu, insolvency reforms paid attention to corporate reorganization tagged with a "restructuring revolution".

East Asian countries had dissimilar tempo in respect of insolvency reforms throughout the last decade for the reason that every country has diverse economic as well as judicial environment. Furthermore, economic development and judicial constancy in the region, widely differed.

In the course of legislative reforms, states preferred to achieve the following changes: increased creditor confidence in implementation of their claims; increased entrepreneurship and fresh start; decreased insolvency cases; and easier out-of-court debt rescheduling. Progresses were noted only in limited areas. Now is the time to assess those

insolvency reforms, discover what ever was attained, and illustrate instructions for future responsibilities.[2]

There is another report which gives the comparison between the insolvency codes of the different countries: The United Kindom, The United States and Germany, titled as "A comparison of US, UK, and Greman Insolvency Codes" prepared by Jullian R. Franks, Kjell G. Nyborg, and Walter N. Torous, all professors of law at the London Business School, comparing the efficiency of these codes against a number of bench marks for the reason that these codes cover a broad variety of debtor and creditor- oriented insolvency procedures. The paper was arranged under funding for the World Bank research project "Optimal Bankruptcy Policy" and published by Blackwell Publishing on behalf of the Financial Management Association International.

We will focus only on the US and UK Insolvency Codes as the emphasis of our study is on the comparison between US, UK, and the Laws of Pakistan.

This paper highlights that the significant difference between the above said codes is the allocation of control rights._For instance, the United States Bankruptcy Code Chapter 11 allows the debtor to retain control of the firm to the debtor alongwith the exclusive right at least for a limited period of time for suggesting plan with regard to the reorganization of the firm.[3]

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[2] Soogeon Oh, *Comparative overview of Asian Insolvency Reforms in the last decade* (Beijin: 27-28 April 2006).

[3] The Bankruptcy Reform Act of 1978 as codified in Title 11 of the United States Code.

Whereas, in UK, control rights to a particular group of secured creditors are provided by receivership, with no responsibilities to embrace the interests of other additional junior creditors.

The US and UK Codes have gone through severe criticism resulted in the form of the latest legislation. The UK code expresses concern in respect of giving confidence to the creditors to rashly liquidate the firm when its worth is more as a going concern. The 1986 Insolvency Act was designed with the purpose to use it as a key to resolve the more evident weaknesses.[4] On the other hand, the new procedures have been applied in a comparatively little number of cases, and, in 1994 the UK government issued a Consultation Document_wherein it was a requirement from those who were interested, while looking forward to further legislation.

In the year 1994, a new legislation was approved in United States which enlarged the safety for some creditors as well as achieving the aim of speeding up the bankruptcy process. Additionally, use of reorganization was rapidly increasing out side the realm of formal bankruptcy process, what Jansen (1989) described as the "Privatization of the bankruptcy process".

The comparison of the under discussion codes on an international basis has been provided in this paper, wherein, it is stated that in the bankruptcy processes there are three aspects i.e. ex-ante, interim, and ex-post, by which the efficiency of any Bankruptcy process may be evaluated.

[4] Insolvency Act 1986

As defined by Holmstrom and Myerson(1983), "the ex-ante stage is the time before individuals are in receipt of any private information; the interim stage is when private information is received but not shared; and, finally, the ex-post stage is when all private information has become common knowledge."[5]

3.2 The Insolvency Code of United Kingdom

To have an access to formal reorganization three achievable methods were available earlier than the 1986 Insolvency Act, such as[6]:

1. Liquidation
2. Receivership
3. Company Voluntary Arrangement

The 1986 Insolvency Act introduced an additional route towards the formal reorganization of a firm termed as " Administration" out of the above stated three routes for the formal reorganization of a firm, liquidation was the most popular and effective mode and was used for more than 75% of all such formal reorganization, in the year 1990. The remaining formal reorganizations were achieved through the process of receivership.

Keeping in view the purpose of this thesis, I think that one should develop a clear understanding of the concepts of liquidation and receivership. When we look at the aims of a liquidator as a layman we find that a liquidator endeavours to re-pay the creditors by

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[5] Julian R. Franks, Kjell G. Nyborg, Walter N. Torour, A Comparisn of US, UK, and German Insolvency Codes,Vol. 25, No. 3(Blackwell Publishing, 1996)which interalia extensively discusses the work of; Holmstrom and Myerson , 1983. Material is also available on net, Stable URL: http://www.jstor.org/stable/3665810

[6] Ibid

the sale of firm's assets. The liquidator may arrange the sale of company under liquidation either as a going concern or in a state of non-operation. It is pertinent to mention here that the liquidator is refrained from utilizing the funds of the creditors for the purpose of delaying the sale of the company. Non-compliance on the part of liquidator with the above condition may result in a dismissal or the initiation of legal proceedings against him.

On the other hand a receiver may be appointed by a creditor of the company having a floating charge on the movable assets of the such company e.g. stocks in hand and the work in progress The appointment of a receiver by a creditor who holds a special kind of lien on the firm's movable assets is a clear indication of the fact that receivership can only become operative with regards to the movable assets of a firm/company.

The receiver has an overriding control of the firm as he does not need any permission either from the court or from the other creditors of the same company. By virtue of the fact that a particular creditor with a floating charge has appointed him and as such he watches the interest of that particular creditor only. His appointment as a receiver casts no obligation on him to care for the interest of other creditors. The receiver although having significant control of the company as already stated, can not claim unabated powers, as the staying of the claims of the firm such as he can not stay the claims of the company, such as the delaying of the payment of interest or the postponement of the capital repayments are beyond the scope of his powers[7]. Whereas, the termination of any of the contracts of the company with parties like suppliers and contractors is within the purview of his powers and on the other hand the receiver may raise finances for the

[7] Ibid

upkeep of the company in the form of a going concern and all such borrowings will be subservient to the existing loans of the firm. We now need to focus our attention on another fetter on the unbridled powers of the receiver which the UK Insolvency Code imposes upon him, is the right of the creditors holding fix charges on assets such as plants, equipments and buildings to repossess such assets even if the said assets are a life line for the maintenance of the firm as a going concern. At such a juncture the receiver is forced into negotiation with such creditors. To avoid such complications the receivers normally work towards the attainment of liens on the fixed assets of the companies.

The 1986 Insolvency Act of the UK does not provide for the appointment of a receiver for a company none of whose creditors holds a floating charge. When confronted with such a situation the only option open is to fall back upon the process of liquidation, wherein an evidence administrator was appointed to fill the said lacunae[8]. The appointment of an administrator is the discretion of the court only as against the appointment of a receiver. The practice of courts in UK has been to allow the appointment of an administrator only in cases where they are convinced that the firm would be able to run as a going concern. The administrator is required to present a proposal for the reorganization of the firm and have it approved by the majority of all the creditors, if they do not allow him an extension for the same.

[8] http://www.hkreform.gov.hk/reports/rrescue-e.rtf retrieved on 07/16/2006

3.3 The Bankruptcy Code of United States

The Bankruptcy procedures applicable to the corporations in United States are the subject matter of chapter 7 and chapter 11 of the Bankruptcy Code of the United States of America[9].

1. Chapter 7
2. Chapter 11

The provisions for the process of liquidation have been dwelt upon in chapter 7 of the said code. It requires that a trustee be appointed by the court to oversee the process of liquidation of the firm. In all probabilities the assets of the company are auctioned after it has been closed down.

On the other hand the working out of a plan with the creditors of the firm for its reorganization is dealt with in chapter 11 of the US Bankruptcy Code. The concept of the debtor-in-possession arrangement the directors of all such corporations remain incharge along with substantial rights being retained by their firms/corporations, the idea behind the same is that the prevailing management of the corporation while representing equity holders would be looking forward to greater incentives if they are able to maintain the corporation as a going concern so that they can withhold the value for the claims of the equity holders.

The situations of bankruptcy arising in the United States are dealt with in three different manners. More than half of the bankruptcies in the United States are dealt with

1. by the existing management remaining in control, whereas most of the rest of such cases

[9] Anuradha Sen, '*The Bankruptcy Laws: Comparing Russia, USA.Canada and UK*'. Text also available on online http://papers.ssrn.com/so13/papers.cfm?abstract_id=912931 retrieved on 18/09/06

2. A new management is applied.
3. Thirdly in a few cases a trustee is appointed by the court as an interim arrangement till the appointment of a new management.

The above stated manner of dealing with bankruptcies as incorporated in chapter 11 of US Bankruptcy Code is adopted by most of the firms after their failed attempts for an informal reorganization. In most cases this takes the form of [10]:

- An offer for exchange of outstanding debts
- Bond Covenants renegotiation
- Negotiations with regard to reduction in interest payments and extensions of loan maturities.

The trend of the firms towards informal reorganization instead of following the provisions of the chapter 11 of United States Bankruptcy Code is followed because of lesser time frame involved for the same. The informal reorganization involves lesser time period as only a limited set of liabilities are usually involved therein, whereas all liabilities have to be taken in account as per the provisions of chapter 11 of the United States Bankruptcy Code. Moreover when am informal reorganization is being worked out the said process is not supervised by the court, whereas chapter 11 of the United States Bankruptcy Code requires the scrutiny of the affairs of the company by its creditors and the court itself.

We find that the major chunks of the bankruptcies in the United States of America are dealt with in accordance with chapter 7 of the US Bankruptcy Code.

[10] Ibid

This is a reflection of the fact that cash deficiency is one of the major aspects which is a cause of the same. Most of the managements prefer to liquidate their companies in accordance with the chapter 11 of the Bankruptcy Code of the United States of America, rather than as per the provisions of chapter 7 of the same code for the sole reason that their retention of control of their businesses results in continued income for them.

3.4 Differences of UK and US Codes:

We will now discuss the UK and US Codes as the focus of our study is on the comparison of the insolvency law regimes of countries namely Pakistan, UK, and US, having completed the same we would then discuss the insolvency laws and processes of Pakistan and compare the same with those of the United Kingdom and the United States. We would now focus our attention on nine characteristics of the insolvency process in United Kingdom and United States of America which are[11]:

1. Who should have the rights to control an insolvent firm?
2. Requirements for initiating the process of insolvency;
3. Stay effective upon the filling of bankruptcy petition;
4. Liability management;
5. Forced sale value compared with the cost of running the business;
6. Funding for the maintenance of a firm as a going-concern;
7. Non-compliance of the said priorities;
8. Cost effect of both the systems;
9. Interests of stakeholders.

[11] Ibid

Now we will discuss each of these nine characteristics in detail:

1. Who should have the rights to control an insolvent firm?

Prespecified rights over the assets of the firm that is going to enter the insolvency process are provided to the creditors and debtors by way of the control rights. These control rights repeatedly becomes one of the cause to generate tensions between different creditors.

For instance, in receivership only secured creditor in UK has absolute control over the assets, against which his debt has a lien. By the use of such a lien a receiver is prevented from utilizing those assets which are used to uphold the business as a going concern. Consequently, the control rights of the creditor possibly strictly limited by secured creditors in case he or she desires to carry on running business, inspite the fact that the creditor who appoints the receiver can supervise the firm without having any interference from the court. Comparatively the debtor possesses hardly any control rights in insolvency, particularly in a receivership; for instance, when receiver is selected board of directors instantly removed from their designated job[12].

This becomes clear when we look at the position of a secured creditor in receivership within the United Kingdom and find that such a creditor has exercise absolute control on the assets which have been marked with a lien to serve, as a security for the repayment of his debts. The secured creditor in such cases by virtue of the lien over the assets would be in a position to restrain a receiver from utilizing the said asset for the maintenance of the company as a going-concern. In other words we can say that the creditors who appoints the receiver may be able to manage the firm without the court getting involved into the

[12] Ibid

same but his or her ability to control the affairs of the firm is restricted when he or she attempts to keep the firm in the form of a going-concern by virtue of the rights and the consequencing intervention on the part of the secured creditors. When we look at insolvency in a receivership we find that the debtor's rights to control are limited, the stepping down of the board of directors upon the appointment of a receiver is one of the instances depicting such restrictions.

The scenario in the United States of America is in accordance with chapter 11 of Bankruptcy Code of the United States of America according to which normally the business continues to be in the control of the debtor-in-possession, till the process of reorganization of the financial portfolio continues. Resultantly the equity does not loose its value completely even after the firm has become insolvent. The management of the company however remains under the supervisory control of the court, thus curtailing the decisive powers of the management in respect of securing fresh advances, the sale of the assets and also to the extent of the monthly remunerations of the managers.

In United States Chapter 7 of the Bankruptcy Code of the United States of America functioning in a different way from that of Chapter 11 of the same code. The procedures as laid down in chapter 7 of the Bankruptcy Code of United States of America one similar in nature, to that of the Liquidation Code in United Kingdom. Whereas, the bankruptcy court appoints the trustee for the purposes of the liquidation of the firm, and as a consequence of the same the management has to relinquish their control of the company.[13]

[13] Bankruptcy Reform Act of 1978 as codified in Title 11 of the United States Code.

2. Requirements for initiating the process of insolvency:

In case default arises on the contracts in respect of trust deed of the loan, the creditor has the right to employ a receiver in the United Kingdom. While, receiver may make use of his control right with no involvement of the court, the authorization of the court is needed in order to attain an administration order, which can only be approved if it is shown that;

a) The company is not in a position to pay its debt or will not be in a position to release the debts when due

b) The entire company or a part of it may stay alive as a going concern or to ensure that there could be additional realizations of the assets of the company which are more beneficial in contrast to liquidation.

It is also provided that the company itself or its directors or any of the creditors may apply for the appointment of a receiver.

Under the same circumstances in the case of United States of America the control rights of the creditors are restricted as per the provisions of Chapter 11 of the United States Code where as the management is kept in control of the company. Consequently, the debtor firm rushes towards the courts in bulk of cases by voluntarily submitting an application for its protection by the courts.

3. Stay effective upon the filing of bankruptcy petition:

The Receivership Code of United Kingdom does not provide any provisions in respect of automatic stay. In reality, there is variety of cases wherein, secured creditors frequently rushed liquidation by way of taking back their assets even when their assets are very much necessary to keep their business a fine running position.

In UK administration the administrator is the right authority who represents all creditors, and while administrator is not selected or appointed, some of the possible disagreements that occur in receivership are diminished. The administrator is awarded with tough command so that he can hang about or holdup the claims of the creditors. For instance, since the administration order is not passed the interest and any repayments on the loans are stayed, similarly the owner would be prevented from taking in to his possession the assets that are leased even if the asset is compulsory for smooth running of the company.

When we compare the provisions of Bankruptcy Code of the United States of America with the ones operative in United Kingdom we find that in absolute contrast of the procedures being followed in the United Kingdom chapter 11 of Bankruptcy Code of the United States of America provide for the most effective provisions of stay.

Meaning thereby that almost all the interest and principal amount payments are effectively brought to a stand still as soon as the firm falls into the ambit of chapter 11 of Bankruptcy Code of the United States of America. Another aspect which has been observed is that the accrual of interest continues only in the case of fully secured debts, whereas the debts which are under secured or un-secured do not stand on the same ground. An another obvious distinction between the insolvency/receivership codes of the United Kingdom and United States of America is that according to chapter 11 of Bankruptcy Code of United States of America all creditors are restrained automatically upon the filling of bankruptcy petition from the initiation of any proceedings of any kind against the debtor for the receipt of their claims or for the enforcement of their liens.

4. Liability management:

The powers of the receiver with regards to the renegotiation of the liabilities of a company which is facing the dilemma of financial distress are limited to a great extent. We find that as the receiver has the interest of only one creditor to watch, he is thus hindered from the further issuance of debt until and unless the other creditors are in agreement of the same and also only if the proposed debt is junior to all other existing claims. The most obvious consequential disadvantage of this restriction upon the discretion of the receiver is that he may not be able to secure the most wanted financial in flows in the shape of fresh facilities in order to maintain the status of the company as a going-concern.

The management of liabilities can be better taken care of by an administrator appointed by a court when looked upon in juxtaposition with a receiver. In the case of an administrator although the approval of the court is necessary, the time consuming aspect of making all the creditor agree with a new shape of debt portfolio, is not a hindrance at all in the process of liability management because the agreement of the creditors consequences from the process of the court itself.

5. Forced sale value compared with the cost of running the business:

In the United States of America the management or the court is not duty bound as per the requirements of chapter 11 of Bankruptcy Code to initiate the liquidation of the firm even if the value so attained is more than the value of the going concern. The rationale behind this course of action is that the business should be kept running, although the worth of the same may be lesser for the creditors upon liquidation then it would be as a going concern.

In other words even if it is obvious that the creditors may receive substantial repayment as a result of liquidation of the firm and the selling of the assets rather than maintaining it as a going-concern, the latter course of action is adopted. In view of the above we can thus safely state that chapter 11 of Bankruptcy Code of the United States of America is structures in a manner which is supportive of the trend of firms being kept going as running-concerns. The provisions of the said chapter are designed in a manner which ensures control rights to the company under debt instead of the creditors of the said company.

On the comparison of the situation in the United States of America as outlined in the above paragraph with that of the United Kingdom we find that the process of liquidation can be forcefully initiated by the creditor which is virtually opposite the state of affairs in the realm of bankruptcy in the United States of America.

6. Funding for maintenance of a firm as a going-concern:

In order to ensure that a firm under financial distress continues its operations even during bankruptcy, funding would be required to maintain the said firm as a going-concern. The fund so required in the perspective of United Kingdom are within the inherent powers of the receiver to arrange, with the condition that the same would be treated as inferior to the loans already in place.[14] This criteria explains why a very small number of companies appoint receivers when additional funds are required to be generated.

Large companies in the United Kingdom make all possible efforts to keep themselves away from the process of bankruptcy which is administered by court, for the simple

[14] Olsen 1996

reason of the hindrances in the way of the availability of further financing and also the non-availability of the provisions for staying interest and repayments on loans. One of the most prominent examples of such means being adopted by large firms is that of M/S Eurotunnel and same has been described in a report "A comparison of US. UK and Germany Insolvency Codes",[15] wherein it is stated that;

> "Eurotunnel, the financially distressed firm that operates the channel tunnel, has recently carried out a major restructuring of its debts, which saw its total debts of £ 9.1 billion reduced to £ 7.1 billion. The restructuring involved a £ 1 billion debt-for-equity swap, the issuance of convertibles and warrants, a reduction in the interest rate on remaining debt, and further facilities for raising new financing should there be shortfalls in revenues. This agreement was made outside the formal bankruptcy process and was negotiated by the company and a small group of banks with large loans outstanding to Eurotunnel".[16]

Looking at the bankruptcy regime of the United States of America we find that as per the provisions of chapter 11 of Bankruptcy Code of the Unites States of America, which by its very nature is oriented towards the debtor, a clear cut reorganization of the debt portfolio, by way of additional financing wherein provisions for financing by way of the debtor remaining in possession is banked upon. This means of financing is referred to as "Supra priority financing" by virtue of the fact that the said financing is given priority

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[15] Julian R. Franks, Kjell G. Nyborg, Walter N. Torous, *A comparison of US. UK and Germany Insolvency Codes*, Vol.25, No.3, (Blackwell Publishing, 1996). Which inter alia extensively discusses the work of Olsen 1996

[16] Winslow, Lance, 'Euro *Tunnel Now Bankrupt'*, Euro Tunnel EnzineArticles.com retrieved on 06-17-2009

over and above many other outstanding liabilities. Here again, I would like to cote the example of Eastern Airlines as given in a report "A comparison of US. UK and Germany Insolvency Codes", wherein;

> "Eastern Airlines was able to raise large amounts of funds to finance the continuous operation of the airline; such financing took priority over existing debt. Such financing provides strong incentives for the debtor company to over invest since the equity holder benefits in the unlikely event that the project pays off does not contribute to the costs".[17]

7. Non-Compliance of the said priorities:

The operation of the code of receivership of the United Kingdom ensures the settlement of claims at a very quick pace alongwith the assurance that the priority of claims is adhered to. These achievements are a direct result of a fact that as soon as the company enters the formal process of insolvency the creditors gain the control of the company. The confirmation of the absolute non-deviation from the priority in receivership was confirmed by Olsen's (1996) empirical analysis of financially distressed UK public companies. [18]On the other hand by virtue of the same analysis it has been found that the process of renegotiating has resulted in noticeable deviations from absolute priority, by way of creditors giving up a percentage of their claims.

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[17] http://www.nytimes.com/1990/07/26/business/eastern-airlines-indicted-in-scheme-ove-maintenance.html retrieved on 08-17-2009

[18] Jullian R.Franks, Kjell G. Nyborg, Walter N. Torour, *A Comparison of US. UK, and German Insolvency Codes*, Vol 25, No.3(London: Blackwell Publishing, 1996) Which inter alia extensively discusses the works of; Olsen, 1996;

It has been noted that in United States of America whenever the process of reorganization of debts is carried out in accordance with chapter 11 of Bankruptcy Code of the United States of America, there always have been noticeable deviations for the benefit of share holders and certain creditors from absolute priority.[19] Some studies have reached the result that substantial deviations of equity have been noted in voluntary reorganizations of the debt portfolio of financially distressed companies which are much greater than the ones entailing as a result of workouts under the provisions of chapter 11 of Bankruptcy Code of the United States of America.[20]

8. Cost effects of both the systems:

There is no cavil to the fact that whichever system of bankruptcy is followed in whichever country, the said process entails costs and as such the effect of such costs is one of the major factors affecting the decision as to which course of action has to be affected. As such the cost which need to be incurred when chapter 11 of Bankruptcy Code of the United States of America is invoked a definitely hire in comparison to the initiation of the process of receivership in the case of United Kingdom. It is so because in case of the receiver and also to a lesser degree when an administrator is appointed, they have liberty of action wherein the aspect of reporting on a daily basis either to the creditor or the court is not involved. This becomes clear when we refers to the case of Wickes, the debt portfolio of which firm was reorganized within the framework of chapter 11 of Bankruptcy Code of United States of America. The time consumed in the process was about three years and an amount of about $ 135 million out of a total of

[19] Frank and Torous, 1989,

[20] Gessner er al, 1978,

approximately $2.50 million was spent as a result of chapter 11 of Bankruptcy Code of the United States of America.[21]

The receiver after his appointment by a certain creditor neither has any noticeable amount of communication with the other creditors nor is he required to communicate with them, except for with the creditor who has appointed him as such.

We thus find that the process of receivership is concluded in a competitively much shorter time frame, as a matter of fact in weeks or months. On the other hand the process of administration in the United Kingdom requires the consent of all the creditors in case of a reorganization plan of the outstanding debts of a firm under financial distress and therefore the time consumed is one of the major factors involved therein.

Another aspect which enables us to compare the cost effects resulting from the reorganization process is the writing-off the creditors claims. Scrutiny of the write-offs of a firm can lead us towards a comparison of the;

(a) value of the company before it entered financially troubled waters

(b) the costs resulting from the above

(c) the costs involved the process of restructuring of the debts of the company.

Our comparison of the circumstances faced by the creditors in the United Kingdom and United States of America has led us to conclude that the write offs are much greater in the numbers and volumes in the case of receiverships in the United Kingdom than the workouts carried out in the United States of America.

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[21] Jullian R.Franks, Kjell G. Nyborg, Walter N. Torour, *A Comparison of US. UK, and German Insolvency Codes*, Vol 25, No.3(London: Blackwell Publishing, 1996) Which inter alia extensively discusses the work of; Wickes,1985and Gessner er al 1978

9. Interest of Stakeholders:

In the interest of a all stake-holders which include the benefit of the creditors and all other stake-holders of a financially non-viable firm carry a noticeable amount of importance in the system of bankruptcy of the United States of America. This is achieved by offering various incentives to all the stake holders of the distressed firm so as to keep it running in the form of a going-concern. The possibility of the stake holders not being able to enjoy the fruits of the above said interests can not be ruled out because of the imposition of costs on these stakeholders in other bankrupt companies. In the United States of America the process of chapter 11 of the Bankruptcy Code is being noticeably used by companies to gain competitive advantage in their respective industries. This is observed when most of the firms in an industry are facing financial downtrend as a result of which the firms of the said industry are generally resorting to the frame work of chapter 11 of Bankruptcy Code of the United States of America and are thus able to attain and renew financial facilities at lower interest rates, resultantly acquiring a marked competitive advantage in comparison to the firms who are facing the down word trend financially but are still out of the realm of bankruptcy.

The US Airlines industry is an example of the above said competitive advantage and the solvent firms of the same industry have been increasingly complaining about such situations.

The circumstances in the United Kingdom arising out of the process of bankruptcy do not cater for the interests of the stake holders but infact the entire focus is on the repayments to the creditors of the company.

3.5 Insolvency laws in Pakistan vis a vis US and UK:

In comparison to the UK and US laws as detailed above now the existing law of Pakistan as already discussed in detail in chapter two, I would now endeavour to base my discussion on the effectiveness of the insolvency law regime in Pakistan as the same becomes practically applicable to the insolvency scenario in our country. Due to inequity between creditor and debtor rights legal environment in Pakistan is composite. The investment climate has crashed the creditor-friendly laws in Pakistan. The National Accountability Bureau was created by the promulgation of the National Accountability Ordinance of 1999. The purpose of the said Ordinance was to root out corruption from society in all forms and aspects like non-payments as well as delayed payments of the debt to be made to the bank. Moreover any delays exceeding thirty days or non-payment utility bills or government dues were also declared as willful defaults. The said Ordinance further stipulates that any such willful defaulter would have to face penalties which include imprisonment, disqualification from being appointed to any public office and replacement of the name of such a defaulter on the Exit Control List. In recent years regardless of difficulties in respect of development, the financial sector in Pakistan has made a strong progress in this regard. Corporate Industrial Restructuring Corporation and Committee of Revival of Sick Units both have played a major role in field of monitoring and the reduction of non-performing loans[22].

The provisions of the Company law formulate a legal frame work for corporate insolvency dealing with the winding up of companies whereas; liquidation is performed by government liquidators.

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[22] http://www.oecd.org/dataoecd/42/14/38184124.pdf retrieved 06/30/2009

Law provides no provisions for reorganization either of business or companies; legal frame work provides liquidation for commercial insolvency only. Only an informal rehabilitation process is provided in Pakistan, which does not complete the recognized principles of informal out-of-court workouts.

Section 305 of the Companies Ordinance 1984 enunciates the factors which may lead to winding up of a business concern which include non-filing of reports of statutory nature before the registrar of the companies, where a company does not have itself incorporated within twelve calendar months of the initiation of its business, does not hold its annual meetings in time, does not continue the operations of its business exceeding the period of one year and if the number of the members reduces below the statutory requirement.[23]

In all such cases, amongst others, the court would be justified in ordering the winding up of such a company.

The date on which a court makes the final order with regards to the winding up of such a company, the aggregate assets and property of such a business concern are deemed to be under the direct supervision of the court making such an order and an official liquidator is appointed, who is considered to be official representative of the government, in which capacity he then controls the entire assets and the property of the insolvent company. On the appointment of a liquidator all ledgers, account books, property and other documents and the entire assets of such a company are given in the possession of the official liquidator by all members of the management whether present or past, as well as agents and officers of the company concerned, furthermore, official aid is afforded to the liquidators for the purposes of taking over the control of the above stated documents and

[23] Companies Ordinance 1984

properties. It is the duty of the said liquidator to maintain authentic accounts of all financial matters, especially payments and receipts, and he is required to submit the detailed report before the court on six monthly bases.

Company in not entitled to transfer property or make delivery of goods without the orders of the court, if a company has done so, then any such transfer or delivery which was made within a period of twelve months prior to the commencements of winding up proceedings shall be considered as invalid. The liquidator so appointed if he so feels, with the permission of the court and within a year of the initiation of winding up proceedings or if an extension in the said period is allowed by the court may reject any immovable property burdened with contracts of onerous nature, shares, contracts which may not be beneficial or property having no market value.

The liquidator is empowered to make sale of all tangible plus intangible properties of the company in the following three manners;

- public auction,
- by private contract, or
- by permission of the court.

The claims against the company being wound up can be categorized as superior payments and residuary payments have been declared as permissible as evidence.

In Pakistan secured creditors can insist on their security only if they join the proceedings of winding up and their claims would be satisfied to the extent of the proceeds collected by the sale of the said security. For the said purpose they are required to place their

respective claims before the liquidator without which they would lose their right to approach a court of law in the matter.[24]

The board of directors and all officers of the company cease to hold office as soon as a liquidator is appointed. Such terminations do not absolve the directors and officers of the company from their duty of providing all the account statements, list of assets, statements of liabilities and debts, a comprehensive list of the assets of the company and all other documents with regards to the affairs of the said business concern.

The initiation of any proceedings of a legal nature is not allowed either by the company or against the company after the order of winding up has been passed by the court. The only possibility of filing any suit by or against such a company is when permission for the same is granted by the court concerned.

Voluntary winding up proceedings of a company may also be started by the debtor company itself by presenting a petition for the said purpose before the court of requisite jurisdiction. A debtor may file a petition for voluntary winding up under the following circumstances:

a) When a resolution is passed in a general body meeting of the company for the said purpose;

b) When especial resolution is passed by the company for voluntary winding up;

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[24]http://web.wprldbank.org/WBSITE/EXTERNAL/TOPICS/LAWANDJUSTICE/GILD/GILDCOUNTRIES/GILDPAKISTAN/O,,ContentMDK:20114599~menuePK:262759~pagePK:157658~piPK:157731~theSitePK:262753,00.html (retrieved on 19-08-2009

c) When an extraordinary resolution is passed by the company to the effect that the said company is unable to proceed with its business due to excessive liabilities and as such has to be wound up.

The process of seizure of the subjected property is burdensome, sale takes place by way of public auction and generally gives very low values in comparison to the sale where the company is presented for sale in a running condition.

The Companies Act contains very few provisions in respect of compromise and scheme of arrangement, which does not facilitate the rehabilitation of companies.

For settling the dues and restructuring debts creditors normally do not make use of these provisions. A proposal for a compromise arrangement is discussed between the creditors and the company and if agreed upon the same may take the form of an agreement between them. The compromise or arrangement arrived at in such a manner, will become binding upon the creditors, the members, and the liquidator, in the case where the creditors who represent at least 75% of the total creditors or members agree to the same and the court passes an order to the same effect. Any such order passed by the court is required to be registered, with the Registrar of Companies, in order to become effective[25].

The process of rehabilitation with regards to the companies in Pakistan has been dealt with in the Companies Ordinance 1984 and is the subject matter of Part IX of the said Ordinance. On the approval of scheme of compromise in accordance with the approved method anticipated by creditors it binds all the creditors at once. The majority as required of the creditors should have approved the compromise and should have consequently obtained an order for its implementation by the court. Any amendments in the same

[25] Ibid

would strictly fall under the jurisdiction of the High Court. Debt payments in such cases may take the form of extending the time of payment, debt restructuring or if the recovery does not seem possible the debt could be written off. The aim of the scheme is to keep the operations of the business in running position in order to make the company capable in order to come up its commitments and work within the parameters outlined by the arrangement agreed upon. Whereas, if an individual is pronounced as an insolvent, a composition or scheme of arrangement would be anticipated by a debtor. Court may award release to the debtor on the approval of the scheme but the same would be with a condition that the debts which have become due prior to the filing of the petition would be paid as per the approved arrangement.[26]

In those cases wherein compromise or rehabilitation/reorganization scheme is planned between the company or creditors, or any class of them it is provided that an application, containing the request to the court to pass an order for meeting of all the creditors or class of creditors in order to obtain their approval, may be moved by the company or any creditor. Furthermore, any such compromise or arrangement shall be binding on all the creditors or class of creditors including the company itself as the case may be, with a condition that if mainstream of members presenting three-fourths in value of the creditors or class of creditors which are present and voting in person or by proxy at the meeting give their approval to such compromise or arrangement and the same will also be approved by the court as well.

The liquidator can also move petition in case company was going through the process of being wound up.

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[26] Ibid

For the management of the assets of the company the Corporate Industrial Restructuring Corporation (CIRC) was established in September 2000 considered to be a public sector corporation mandated by its permitting law "to make provisions for the acquisitions, restructuring, rehabilitation, management, disposition and realization of non-performing loans" [27]

In case of banks operating in the public sector including other financial institutions are required to report all their non-performing loans to Corporate Industrial Restructuring Corporation (CIRC). In May 2000 by the notification of Ministry of Finance the Committee of Revival of Sick Units (CIRSU) came into existence and the same comprised of members representing the industrial sector and financial institutions of the public sector, carrying the objective to explore the basic reasons of industrial sickness and give way out for sustainable growth in major industrial bunch and fragments.

As liquidators are considered to be officials of government there are some standard service regulations, which define the function s of the employees of the government only, such liquidators are also coordinated by these standard service regulations. The court has to play an administrative role in the process of liquidation of such companies. A limited supervisory role is also given to the registrar of the companies to monitor the activities of the liquidators.

In Pakistan liquidation is administered by the High Court provided that such court has jurisdiction where the company is registered. Since Pakistan has four provinces therefore four provincial High Courts have been established therein, though all of these High

[27] Corporate Industrial Restructuring Corporation 2000

Courts are proficient in their standards but still come across criticism as regards their independence in a few cases.

As regards the courts containing jurisdiction above insolvency or bankruptcy no performance standards are provided that could be applied to such courts. In respect of bankruptcy cases general standards are followed that are practical to court trials, in order to grip the cases. It may be said that the judges may not be having specialize knowledge and experience to enable them to adjudicate upon such matters. In the law of Pakistan committee of inspections function in respect of liquidation. The laws applicable to the matters of insolvency in Pakistan do not cater for the attainment of the services of experts or professionals in matters of insolvency.[28]

[28] http://www.oecd.org/dataoecd/42/14/38184124.pdf retrieved on 06/30/2009

Chapter (IV)

Conclusion and Recommendations

In the last section of my thesis titled "Insolvency Laws in Pakistan: A comparative perspective" I would attempt to conclude my opinions in the form of critical appraisal and suggestions based upon the contents including the observations and suggestions contained in the previous chapters/sections of my dissertation.

Allah Ta'ala has been very kind to me that after a hectic endeavor of several months I have had the chance of taking a look at almost all legislation on the subject of my thesis and have found that one thing is certain today that we cannot abandon the existing legal frame work. There is a need of more clarity concerning the interpretation and observance of the existing laws, relevant to the subject of my thesis and of course a new set of legislation of the same is inevitable and thus most necessary. At international and regional levels, we basically need an elaborated and stable structure while fighting against economic crises in the financial environment.

The preceding three chapters of this thesis have helped to develop an understanding of factual and legal position with regards to insolvency law in Pakistan. The same has been possible by our having in the first chapter, made the efforts of comprehending the definition of insolvency in the background of the history and development of insolvency laws. We have further endeavored to define insolvency and bankruptcy laws.

We have attempted to survey insolvency and bankruptcy laws in detail in the second chapter. Herein we have also undertaken to form a relatively comprehensive understanding of various laws, legislative structures and frameworks.

The next chapter was an attempt to identify the areas of concern with regards to Pakistan wherein the key insolvency laws and procedures have been identified and compared with the law regimes of the US and UK.

The resultant effect of the areas of concern referred to in the previous paragraph have been dwelt upon, thus bringing us to this final chapter, wherein we would endeavour to critically overview the insolvency laws in Pakistan in comparison with the legal regimes operative in the above said countries

As a result the required legal frame work i.e. of insolvency law would be critically appraised and recommendations/changes with regard to the same would be attempted and after a legal frame work most appropriate to the environment and requirements of Pakistan, as per the understanding of the author have been suggested in this chapter, the thesis would be concluded.

To be able to approach the matter as stated above we would have to dwell upon the historical aspect of the same, despite the fact that it has been already made a part of chapter one of my thesis.

The roots of Bankruptcy can be traced to biblical times. It is recorded history that somewhere between the 9th and the 14th Century, if a person was unable to pay his debts, his creditors would forcefully enter his workplace and demolish his "workbench". The words "banca rotta" in the Italian language mean a bench which is broken, thus the term "Insolvency" in the English language is the derivative of the same. Therefore the financial condition of an individual or a business concern where the assets have depleted and have become lesser than the liabilities is termed as balance-sheet insolvency and on the other hand cash flow insolvency is a result of non-servicing of the obligations of debt

of the said business concern. Any of the two financial situations referred to in the previous lines result in the declaration of a legal bankruptcy. However, as most people avoid the expense to be incurred on court fees, it is most often observed that although a person or entity may be insolvent only because of the reason that the said person or entity has not been declared to be bankrupt in the legal sense of the term.

Once the company becomes insolvent or continues to pay some creditors over the other, in most jurisdictions under bankruptcy laws it is an offence for the company to continue in business. It can lead to grounds for civil action.

As we have already noted in the previous chapter that an individual becomes insolvent when he is not paying his debts as required by the routine operation of the business or when the said debts become payable and in such situations as per the provisions of the Bankruptcy Code of the United States of America and the said individual is said to have become insolvent. It has to be kept in mind that under the said code the creditors may invoke some important rights against the insolvent individual or business concern.

If the company or individual gets behind on payments, it is essential to catch up. This is done by increasing income or using savings (selling assets, renting etc.) or by reducing spending (closing accounts, canceling services, reducing staff, etc.). If none of these solutions can be achieved, the unavoidable resolution would be a bankruptcy.

Bankruptcy is the financial failure of an individual or company. Under bankruptcy, selling the debtor's assets and transferring the amounts produced with those sales to the creditors proportionally against the amounts owed discharge debts.

Insolvency is the inability of an individual or company to cope with debt payments with current liquid assets. This can be solved by selling non-liquid assets, by borrowing

money, by negotiating new terms with creditors, etc. If no solution is achieved, insolvency will probably lead to bankruptcy. Insolvency is commonly applied to businesses and seldom to individuals.

The Civil Laws, Commercial Laws, Banking Laws and Insurance Laws primarily effect the realm of insolvency in Pakistan and the same were directed towards the distribution of assets in all cases of insolvency.

Two principal statutes govern Pakistan's insolvency laws.

- Insolvency of companies by Companies Ordinance, 1984 (companies)
- Insolvency of individuals by Provincial Insolvency Act, 1920 (individuals).

The purposes of the above said laws are;

- The settlement of claims of the debtor, and the transfer to a trustee for the purposes of liquidation of the entire assets of the insolvent.
- That all classes of creditors are the beneficiaries of the distribution between them on an equitable basis.
- To restrict any such transaction on the part of the insolvent which may be referred to as preference which was not due to the creditor to whom it was given in negation of the rights of other creditors,
- To keep a cheque on the insolvent or his managers, especially with regards to the manner in which the affairs of the insolvent are being carried out.

Companies, like people, are undisputedly considered legal persons. But it is also a fact that the only cure for a sick company is execution. During the recent past, we have witnessed random mood swings on a national basis between the desire for "recovery" of bank debt and the aspiration to "revive" sick industry. The debtors rights and the creditors

rights are no properly balanced and this can only be redressed through the adoption of a modern insolvency legislative regime.

The total assets of a company do not project the actual value of the company itself. As such the continuation of businesses in a functional form, although the same could be hard on certain creditors.

A consequence of the above said policy, if the same is stretched too far, would be the unwillingness of banks and financial institutions to lend to such a business concern and even if they decide to do so the same would be at rates of interest higher than the normal. It is thus an essential requirement of a comprehensive law of bankruptcy, that the same should be able to ensure that all the above said aspects are catered for, the betterment of the society .

And it is from this angle, of balancing the competing demands of creditors and debtors, that the consistent failure of the existing insolvency and recovery laws in Pakistan is most clearly visible. Out of frustration, we have had to adopt ad hoc (administrative) insolvency solutions like the H.U. Beg Committee (of the early 1980's), "cosmetic" rescheduling of project financing loans in the 1990's, State Bank of Pakistan's debt amnesty scheme of 1997 and State Bank of Pakistan's BPD Circular No 29 of 2002. Periodic recourse to these "one-time" incentive schemes is effectively a public admission that in the areas of insolvency and corporate rescue, the legal system has failed.

Insolvency Laws in Pakistan: The Current Structure:

The Companies Ordinance 1984 thus contains two distinct provisions relating to the rehabilitation of companies. The first option, under Section 284, allows a company to present a scheme and make it binding on all the creditors that if the scheme is approved by the creditors whose claims constitute either 75% or greater than the worth of the liabilities of the company. In addition, Section 296 creates a special committee to deal with sick industrial units.[1]

Both of these provisions have comprehensively failed to deal with corporate insolvency. Since 1984, there are only 12 reported cases in which insolvent companies have used the provisions of Section 284 to deal with their creditors.

So far as Section 296 is concerned, the Federal Government did not even establish this committee until 2000 (i.e. 16 years after the promulgation of the Companies Ordinance1984!). Subsequently, the committee has dealt with a grand total of 388 sick units out of which it claims to have revived 196. According to a World Bank report, this committee has chosen to act as an "arbitration window", and has not developed any capacity to undertake deep (i.e., operational) restructuring.

The government of General Musharraf introduced the National Accountability Bureau Ordinance on November 16, 1999, wherein, the failure to pay back a bank loan was defined as a criminal act punishable by up to 14 years in jail.

This was then followed in 2000 by a new law, the Corporate and Industrial Restructuring Corporation Ordinance, 2000 consequenced the creation of the Corporate and Industrial

[1] Companies Ordinance 1984

Restructuring Corporation (CIRC), a new state entity with wide-ranging powers to deal with insolvent companies and their debts.[2]

The Situation Today:

The situation today is once again that Pakistan is faced with a situation in which levels of corporate debt are increasing rapidly (at 10% - 12% p.a.) while liquidation values have been declining at the same rate for the past several years.

The Situation in USA:

For us to be able to gauge the ground position in insolvency matter as it stands in the United States of America, so as to be able to analyze the insolvency scenario in Pakistan. I would like to refer to the case of Manpac Industries Pty Ltd v Ceccattini [2002] NSWSC 330. In the said case Young CJ in Eq said;

> [40] Solvency and insolvency are defined in **s.95A** of **the Corporation Act** as meaning a company which is unable to pay all its debts as and when they become due and payable. This, as Lindgren J pointed out in **Melbase Corp Pty Ltd v Segenhoe Ltd (1995) 17 ACSR 187,** requires a cash flow test rather than a balance sheet test. Again, as His Honor said in that case, when one is applying the cash flow test, it is relevant to take in to consideration the relationships between creditor and debtor, any agreement

[2] Corporate and Industrial Restructuring Corporation Ordinance 2000

and course of conduct. **In Hamilton [v BHP Steel (JLA) (1995) ACLC 1548]** I indicated that that course of conduct may mean that despite what is written on the invoices etc as to time for payment, industry practice or dealings between the parties demonstrate that everyone accepts that debtors will often not pay creditors within normal trading terms. In business circumstances sometimes it is quite necessary in an industry which is experiencing recession because otherwise creditors may not be able to sell their product at all. Even though they would prefer people to stick to their 30 day terms it is better to have recalcitrant debtors than sell no product at all.

[41] What I said in Hamilton seems to have been developed in to a much stronger statement by counsel in **Emwest Products Pty Ltd v Olifent (1996) 22 ACSR 202, 209-210 and in Southern Cross [Interiors Pty Ltd v Deputy Commissioner of Taxation (2001) 39 ACSR 305] at 315.** However, if what is said in Hamilton is properly examined, it will be seen that the proposition expounded is not only quite in accordance with the authority, but is also good commercial and legal common sense."

Matters of insolvency are dealt with in a very professional, commercially/ legal responsible manner in the United States of America. On studying various cases of

insolvency decided by the United States Court of law one finds that not only the commercial/traders community, businesses and corporations, the respective departments but also the relevant judicial forums themselves operate an act in a very responsible manner and while doing so they ensure that all the relevant aspects of the maters subjective before them are taken care of.

My above observation has found strength by my study of various cases dealing with the subject matter of my thesis. Keeping in mind the restrictions as to the length of my dissertation, I would restrict myself to the case of Hussein v Good, wherein the concepts of debt simpliciter and a contingent debt have been dwelt upon and the difference between the same that has been clarified, although the relevant section applicable to the situation, that is section 592, does not clarify the said difference.

In an article entitled "Insolvent Trading" by a Herzberg, [77] the author says in relation Hussein v Good:

> "A distinction was drawn between a contingent debt and a debt simpliciter. Section 592 does not state expressly whether "debt" includes a contingent debt. Given the aim of the section, such a distinction focuses on the wrong issue. Directors should bear responsibility in both situations.
>
> It is arguable that the Hussein v Good distinction between contingent and non-contingent debts places directors in an unfair position. They may order goods for their company at a time when it is solvent yet nevertheless bear personal

liability if it becomes insolvent by the date of delivery, even though this could be a considerable time later. Directors in order to avoid personal liability will cause their insolvent company to breach the contract for the supply of goods by refusing to take delivery of them and thus detrimentally affect the supply. However, a supplier will be in a better position if goods ordered are not delivered to the insolvent company than would be the case if the company accepted delivery without payment. The very purpose of an effective insolvent trading provision should be to encourage directors of insolvent companies to cease trading and invoke some form of insolvency administration."

The English Model:

Comparatively the English model has not only been successful within England but has been adopted by a large number of other common law corporate jurisdictions such as Australia, Singapore and Hong Kong. Given that the laws of Pakistan have traditionally drawn upon English laws for inspiration, and also given the relative familiarity of the Pakistani legal community with English statutes and case law, the English model would appear to be the logical choice. However, any assumption to that effect would be incorrect.

After observing the above mentioned areas of concern it can be concluded that some ground rules would be helpful in profit making insolvency and bankruptcy:

- Private investor should bear both, profit and loss whereas; government should not be involved in this regard.
- Profit incurred should be paid to the government partly by means of tax.
- All those profits which are country's generated ones by utilizing resources within the country should be reinvested in the country.
- There should be no discrimination amongst the parties of government. Professionalism should be kept in mind in order to carry out business as a result these should be a level competition.

Deep study and keen observation suggests that there should be supporting infrastructures so as to enable laws to act as restraint and institutions to become more effective, there are six ingredients which are considered essential to compose this environment such as:

- The defaulters fall in to two categories one is known as willful defaulters and other as circumstantial defaulters, to make distinction between the two, the banks need specialists in respect of remedial assets management; furthermore the circumstantial defaulters should be accommodated with ample relief whereas willful defaulters should be sent to NAB for accountability.
- There is need to improve pre-existing standard of auditing.
- Expertise in the field of forensic accounting should be made available in order to introduce forensic accounting and concerned department should be provided proper training in this regard.
- One of the essential ingredients to compose above mentioned environment is the need of training to the judges in commercial, corporate and tax laws.

- Prevailing court system in Pakistan results in unwanted delays in the court procedures regarding the concerned cases, therefore Pakistan needs informal alternative mechanism in order to avoid loss of production, unbearable burden on the borrowers and piling up of unrecoverable assets by the banks, time wastage as well as financial resources.
- For the execution of court decrees and judgments specialized set of skills is required by official receivership system in Pakistan.

From the above observation and study it can be very well concluded that private companies should also participate in order to improve their corporate governance, only then these laws, institutions supporting infrastructure will make sense.

I am sure that of the above observations and suggestions are adhered to with regard to the "Insolvency Laws in Pakistan" by way of amendments, the concerned legislation would be able to cater for the ever increasing legal regulatory requirements of the subject of my thesis.

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