

Title

Bypassing Corporate Personality by the Financial Institutions

Thesis Statement

The law has assigned legal personality to the company for enhancing the financial enterprise, but in practice this personality is not always respected --- in fact, the banks usually violate it.



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A dissertation submitted in partial fulfillment of the
requirements for the degree of MASTER OF LAW

(Faculty of Shariah and Law)

INTERNATIONAL ISLAMIC UNIVERSITY, ISLAMABAD



Accession No TH-9669

MS
340
HAB

- 1- Law and ethics
- 2- Civil rights legal theory

DATA ENTERED

A 23/05/13



Final Approval

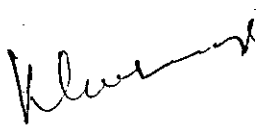
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We have evaluated the dissertation and found it up to the requirements in its scope and quality for the award of degree.

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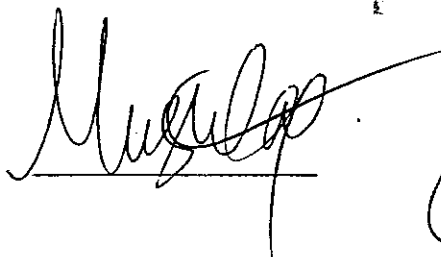
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It is not a sixth or a tenth of a man's devotion which is acceptable to God, but only such portions thereof as he offereth with understanding and true devotional spirit.

(Prophet (PBUH))

Dedication

I humbly thank *Allah Almighty*, the *Merciful* and the *Beneficent*, who gave me health, thoughts and co-operative people to enable me achieve this goal.

I wish to dedicate this work to Holy Prophet Muhammad (Peace be on him) and his companions who laid the foundations of Modern civilization and paved the way for legal, social, moral, political, and economic revolution.

Acknowledgment

I am delighted to thanks my parents, especially my father for his never ending support and prayers which always acted as a catalyst in my academic life. I also like to thanks my teachers and husband for there moral support to achieve this goal, And, I especially want to thanks my supervisor for his exceptional guidance and support for completion of this thesis.

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AIR (1963) SC 1811
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Abstract

Bypassing the corporate personality by the financial institutions

by

Hafsa sarfraz

Corporate personality is one of the mile stone concepts of the corporate law. The law intends to provide the distinct entity to the company to enhance the corporate activity; therefore, the companies enjoy all attributes of a legal person. This thesis is basically an effort that has been made not just to gather the information regarding the topic rather to trace the existing conflict between the two laws and suggest the possible solutions.

It begins with the detailed discussion on the separate legal entity concept, its development, and the intension of law behind such an enormously advantageous concept. This is followed by the concept of financial institutions especially the banks, there different kinds of loan transaction with the companies, there lending policies, and there documentary requisite for lending loans. The thesis then deals with the discussion regarding liabilities of the company and its directors. Thereafter comes the point of shifting the liabilities regarding the unpaid loans of the company to its directors.

Here, begins the conflict between the application of two laws, that is to say the general law of separate legal entity and the special law of prudential regulations of state bank of pakistan. the next chapter deals with the comparative study of the same system of different countries, like British, America and India, so that we can have an idea of what is going on throughout the world. A final chapter deals with some possible solutions for avoiding any such conflict and for the smooth running of the financial affairs of corporate sector. The related documents are also provided in the annexure for the better understanding of the issue.

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pIntroduction

The corporate law endows an enormously advantageous doctrine to the companies; the 'doctrine of separate legal entity'. This is one of the most significant creations of legal fiction, and it effects efficiently for the benefits of natural persons.

The separate legal personality of a company connotes that it has a different legal existence from its members. A company may sue and be sued in its own name and own property separately. As such the shareholders do not own the assets of the company, and are not liable for its debts: they are the assets and liabilities of the company. this concept of separate legal personality makes companies an attractive vehicle for commercial ventures, as the liability rests with the company...this separate legal personality has the consequence that a company has perpetual succession too.

The most imperative feature that flows from the separate legal personality concept is that of limited liability. It is intended at giving investors maximum protection for their private lives, so that they can participate in the business ventures under the strong shelter of limited liability towards the company.

The law has assigned the status of separate legal entity to the company. When a company registers itself at law, it becomes a legal person having powers and liabilities like an individual.

The House of Lords held in *Saloman v. A Saloman & Co. Ltd*, that "The incorporation process made Saloman and his company two separate persons. Even if the business was the same as before, and it was still managed by Salmon himself, the company was not an agent or trustee for the members. Although Salmon beneficially owned all the issued shares of the company, the court also recognized him as a separate person who can be secured creditor with enforceable rights against the company".¹

¹ *Saloman v. A Saloman & Co. Ltd*, [1897]

As, a company is a separate legal person; it has its own rights and liabilities. The legal personality grants freedom to the company to enter into transactions. Therefore, it uses to transact with the banks to borrow the loans to flourish its business. The law has assigned legal personality to the company for a purpose, but in practice this personality is not always respected --- In fact, the banks usually violate it.

The banks use to lend the loans by observing the principles of lending². As the legal person the company is to bear its on liabilities, that is to say the company is liable to pay back the loans it borrows from the bank. The company cannot make the directors liable for repayment of its loans, because company is a separate legal person.

The honorable court execute this notion by giving the judgment, in the case of *Ehtesham Ghazi v. Izharuddin*, the court held: "... company is a separate and distinct legal entity from its shareholders and directors ... Any liability against the company cannot be transferred or shifted to its shareholders or directors except to the extent of their individual shares in the company."³

However, the banks use to take personal guarantee of the directors for the recovery of the loans, which the company borrows. The banks shift the company's liability to its directors just to ensure the recovery of the loan. Although banks try to be on safe side and the law allows them so, but here begins the conflict of the general law with the special law.

As the doctrine of separate legal entity provide that company should bear its liabilities on its own, while The Prudential Regulations for small & medium enterprises financing and The Prudential Regulations for Corporate/commercial banking, provides that directors should sign a personal guarantee to repay the loans in case of default of the company.

This conflict of laws⁴ is in practice and the question arose that, why such conflict exists? Why the banks are bypassing the corporate personality of the company, duly assigned by law? These questions are to be answered. This research is designed to trace out the logics behind this

² Asrar H. Siddiqi. *Practice and law of banking in Pakistan*, 6th ed. (Karachi: Laureate packages, 1998), 249

³ *Ehtesham Ghazi v. Izharuddin*, 2001 YLR 526(a)

⁴ The general law (Doctrine of separate legal entity), and the special law (Prudential Regulations for small & medium enterprises Financing and Prudential Regulations for Corporate/commercial banking)

practice and to suggest any system out to avoid such conflict. In this situation of conflict of law between the general, and special law, the regulatory bodies have to go through there rules and there application so that the conflict of law should be evaded. And the system of providing financial services to the companies can smoothly run.

Therefore, this research is designed to indulge into the matter and to mark out the reason of this bypassing of corporate personality by the banks as well as to chalk in a mode to avoid the existing conflict of laws.

Chapter # 1: Concept of Separate Legal Entity

The Concept of Separate Legal Entity:

Laws are made to harmonize the affairs of life and to mark a road map for the up coming days. An average human being can work out properly if following the laws, related to the specific field of life. The laws are drafted to facilitate the life, and in this attempt the concept of legal fiction is very significant. It helps for smooth running of affairs. The fundamental legal fiction ever created is the legal person.⁵ It is the magnificent philosophy of corporate law. As in the eye of law the expression 'person' theoretically means a subject of rights and duties.⁶ So, is the legal person, (also identified to be the juristic (legal) person).⁷

The legal personality is the characteristic of non-human entity regarded by law to have the status of a person. The legal person has a legal name, rights, liabilities, privileges under law, in fact the whole status like the natural person. It can own property of its own, can sue and be sued, and can borrow or lend.

The commercial activities increase by the factors like globalization and industrialization. The single person's activities turned to the group activities. With the development of law these activities are governed by the enacted laws. The groups involved in such activities are named by the law as companies, and certain features like limited or unlimited, share capital, number of shareholders etc are designed for them. With the passage of time these activities turned to be the back bone of corporate law, and the basic principle remains the same: "major advantage of incorporation is the separate legal entity of the company and from this principal benefit all other benefits follow."⁸ The company is fundamentally an artificial legal person made up of natural persons.⁹

⁵ Chris Shepherd, "Company Law", 8th ed., (London: HLT Publications, 1996), 3

⁶ Len Sealy and Sarah Worthington, "Cases and Material in Company Law", 8th ed., (Oxford University press, 2007), 31

⁷ "Legal person" www.worldlingo.com (accessed on: August 11, 2010)

⁸ "Corporate liability sharing" www.peerpapers.com (accessed on :February 10, 2010)

⁹ Jhon.H. Farrar, company law, (London: Butterworths, 1985), 66

The term company is defined by the court as “in (Whartons’ ‘Law Lexicon).’ ‘Company’ is described as a body of persons associated for the purpose of business.”¹⁰

So it is to say that a company is a number united or assembled group of persons to get incorporated for joint actions especially for business. Section 2(7) of the Companies Ordinance 1984, defines the term ‘company’ as a company formed and incorporated under this Ordinance or an existing corporation.¹¹ Here, an existing company is defined in Section 2(15) as a company formed under any preceding Companies Act. The preceding Companies Act consists of the Indian companies Act, 1866 and the Act in force previous to it or repealed by it, the Indian Companies Act, 1882 and the Indian Companies Act, 1913 as it subsisted in India and later implemented in Pakistan.¹² Customarily, the phrase company means an association of a number of persons structured for some common purpose. It entails two ideas:

- i. It has several members, and;
- ii. A member may transmit his interest without the approval of others.

If such an organization is incorporated according to law, it becomes a legal person, an entity distinct and separate from its members. “A company is nothing but a group of persons who have come together or who have contributed money for some common purpose and who have incorporated themselves into a distinct legal entity in the form of a company for that purpose.

Under Halsbury’s Laws of England, the term “company” has been defined as a collection of many individuals united in one body under special domination, having perpetual succession under an artificial form and vested by the policies of law with the capacity of acting in several respects as an individual, particularly for taking and granting of property, for contracting obligation and for suing and being sued, for enjoying privileges and immunities in common.”¹³

Therefore law enables a company to enter into contracts, to own property in its own name and to sue and be sued. The company enjoys a perpetual succession too. All these are the attributes of a

¹⁰ PLD 1958, Lah. 887

¹¹ Section 2(7), Companies Ordinance 1984

¹² A.G.Chowdhry, “*Company Law in Pakistan*”, (Lahore: Khyber Law Publishers, 1994), 1

¹³ Rana Aneel Arshad, “*Brief History of Company Law*”, (Corporate Law Decisions, 2004)

'legal entity'; hence the doctrine of separate legal entity becomes operative when a company gets itself registered at law, so that the aforementioned attributes can be provided to that company. The doctrine of separate legal entity states; that every legal entity whether natural or artificial, carries its own rights and duties and along with that it would be an altogether separate entity from the other ones in the eye of law.

By focusing the practical aspect of the matter, that how the company functions; we can see that its corporate will is manifested, acts done and, the decisions made by the natural persons who are its members and officers.

It is also ascertained by the Honorable court in the judgment of *Feedai Agency Ltd. v. Pakistan*, as "Company registered under Companies Act, 1913, is a legal entity separate from its shareholders and it can acts through its directors and other officers."¹⁴

The companies when entered in any contract that give rise to some rights along with some liabilities to it. The doctrine of separate legal entity do not allow the legal person to shift its liabilities to any of its members or the officers, because it enjoy the rights it self and is responsible for the duties as well.

The courts implement this concept by there decisions, as in the case of *Ehtesham Ghazi v. Izharuddin*, the court held: "... company is a separate and distinct legal entity from its shareholders and directors ... Any liability against the company cannot be transferred or shifted to its shareholders or directors except to the extent of their individual shares in the company."¹⁵ "Since a company is a separate legal entity it has rights and obligations of its own."¹⁶

The corporate law develops this doctrine for the ease of the natural persons (the investors) and to flourish the field of corporation. The doctrine of separate legal entity is not developed in a couple of days; rather it took years to develop. In the present era this doctrine is the strongest pillar of corporate law. As today a large number of investors are engaged in the business because of this shelter provided by law. The investors feel secured as the application of the said doctrine results

¹⁴ *Feedai Agency Ltd. v. Pakistan* (1984 CLC 2761)

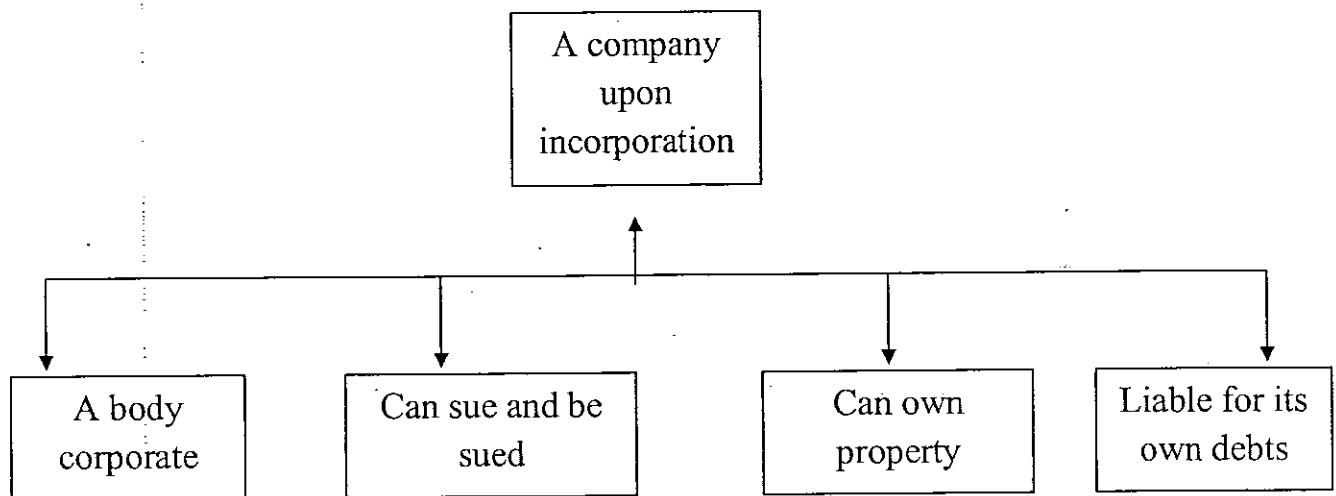
¹⁵ *Ehtesham Ghazi v. Izharuddin* (2001 YLR 526(a))

¹⁶ Chris Shepherd, "Company Law", 8th ed., (London: HLT Publications, 1996), 3

in the idea of limited liability. And the concept of limited liability secures the investors and, they will just be liable for the extent of their share in the company but not more than that.

This means to say that stakeholders or directors are under no responsibility to the company or its creditors ahead of their commitments on per value of their shares.¹⁷ The concept of separate legal entity and limited liability goes hand in hand and, provide the maximum protection to the investor as well as facilitate the commercial ventures.

As aforementioned a company when gets incorporated becomes a separate legal person, it can enter into transactions with its own name, can own property which do not belong to its members rather of the company and, it can sue and be sued.



Thus the effects of incorporation are:-

- a. A body corporate;
- b. It can sue and be sued;
- c. It can own property;
- d. It is liable for its debts.

When a company registers itself at law, it becomes a legal person having powers and liabilities like an individual. A company is considered in law as a person separate and dissimilar from its

¹⁷ Jhon.H, Farrar, Company law, (London: Butterworths, 1985), 80

members.¹⁸ In the renowned case of *Saloman v. A Saloman & Co. Ltd*, for the first time court accepts the company as a separate legal entity, having a separate existence.

As, "The House of Lords held that the incorporation process made Saloman and his company two separate persons. Even if the business was the same as before, and it was still managed by Salmon himself, the company was not an agent or trustee for the members. Although Salmon beneficially owned all the issued shares of the company, the court also recognized him as a separate person who can be secured creditor with enforceable rights against the company".¹⁹

The doctrine of separate legal entity enables a company to sue and to be sued in its own name. The members of the company can not use this right on behalf of the company, only the corporation itself can inflict this right. As is decided in the case of *Foss v. Harbottle*, The court decided that as the damage complained of was damage to the corporation and not to the members. As such the members can not take action; rather just the company has the right to sue.²⁰

The company is empowered by law to hold property in its own name. The members have nothing to do with that property. Even if any of them is holding majority shares or almost all shares of that company. The proprietary rights belong to the company alone.

This principle is decided in the famous case of *Macaura v. Northern Assurance Co. Ltd*. "The House of Lords found that the timber belonged to the company and not to Mr. Macaura. Even though he owned all the shares in the company, Mr. Macaura had no insurable interest in the property of it. Just as corporate personality facilitates limited liability by making the debts belong to the corporation, it also means that the company's asset belong to it and not to the shareholders".²¹

When a company is incorporated, it becomes liable for its debts and all other liabilities. The members or officers are not liable for those liabilities. Where the company is limited by shares,

¹⁸ L S Sealy, "Cases and Materials in Company Law", 5th ed., (Butterworths, London, 1992), 29

¹⁹ "Separate legal entity" www.graguraman1.blogspot.com (accessed on: October 23, 2010).

²⁰ Ibid.

²¹ Clement, Chigbo, "Corporate Personality and Limited Liability" The Bahama Journal, March 3, 2006, www.jonesbahamas.com (accessed on: February 2nd, 2010).

the members are liable to the extent of their shares. And where the company is limited by guarantee the members are liable to the extent they have guaranteed the capital but not more than that. The creditors of the company cannot clutch the members or officers liable in any case. The said principle is applied by the courts so many times.

As, in the case of *Ayaz durrani and others v. Chairman, WAPDA and others*, The court held: "It needs no gainsaying that a company incorporated under the Companies Ordinance, 1984 is a separate and distinct juristic person quite apart from its chief executive, director or the shareholders. The liability of such a company cannot fall upon the directors or the shareholders who have no personal responsibility for the same".²²

The Historical Development of Separate Legal Entity Concept:

The laws are developed with the passage of time and, enacted when is required by the society. They are always drafted to ensure the ease of the people of the society. So is the concept of separate legal entity. Like the other concepts of law it also takes time to develop and that is not just years but centuries.

As in the early Middle Ages, the whole set up of the society was different than that of today. Like wise the concept of corporations was not the same as is today, rather it was totally different. One of the first explanations of the legal personality were that the legal personality exists in the concepts only, but not in corporeal, and therefore do not have its will. It cannot even act on its own but through its members.

The most familiar intimate of the modern company do not emerge till the second millennium. The first identifiable corporate association was medieval guilds, where the members decided to follow the rules, but did not contribute in endeavor the profits. In the earlier 19th century the corporations were formed for the restricted order in Europe. However, by the end of 19th century and the beginning of 20th century a strong perceptive of the phenomena of legal entity developed.

In mid 19th century, the foremost systematic study of the concept of legal entity named as "theory of fiction" by FK Savigny states as follows; "if the Roman idea of the opportunity

²² *Ayaz durrani and others v. Chairman, WAPDA and others* (PLD 2000 Lah.414)

clearly presented itself a combination of individuals, specific capacity of a person, it is as easy and severed the relationship, relegating people to the category of things or giving possession of a personal nature where the individual, as owner, can not be called".²³

The discussion about the concept of legal entity revolves around the concept of its being the factual focus of real community relations. As another theory named "organic theory" argued that a legal person- is a special bodily and spiritual organism, which affects the state, but does not call for life. This theory was also criticized and was not considered as the right answer to the matter under discussion.

While criticism another theory come to existence known to be the "realist theory" and it states that "human community into an impendent entity, distinct from the sum of the individual, its components are needed: a) the existence of a permanent group that is distinct from the individual interests of its members, and b) the organization concerned, able to identify the collective will, to represent and protect the general interest c) the inclusive of staff in the legal environment".²⁴

The developed version of the legal entity concept, generally, based on either of the above mentioned theories, and hardly put anything new in that. The popularity of these theories does not have any negative impact on the practical implication of the concept.

On the other hand, practically in the medieval times the legal entity was considered as a group of individuals who are granted the charter by the state, and accumulate private funds for a particular purpose. That particular purpose is mostly the public service. The state kept a strict check on the activities of that group, and cancels the charter if the purpose is not fulfilled properly.

The most primitive form of the commercial ventures was partnership. By the time trade ventures increased, therefore the royal charters were also granted more rapidly, especially in England and Holland. The corporate personality enjoyed more privileges under the charters issued to them. Formally, the owners trade the stocks in the companies on their own, but, later the share holders

²³ "The notion of legal entity: the history and modern interpretation" <http://yqyq.net/> (accessed on: 16 May, 2011)

²⁴ Ibid.

step forward for joint account and stocks. That was the time when Joint Stock Company comes into being.

It was later realized that, the early companies were purely cost-effective projects, as the stocks of the joint stock company can not be detained for the debt recovery of any share holder. The corporate activity was growing fast at that period. The corporate activity was hampered by the Bubble Act, 1720²⁵, but, it was overcome by the traders and investors. This Act was triumph over by the investors as they stop trading with the unincorporated companies. And finally, the said Act was revoked in 1825. Nevertheless, the amplified demands of the trade activity were not meet by the charter system, and it requires a great change in the whole corporate sector. With the passage of time the corporate activities grow larger, and so were the requirements to run that system. So, that requisite was fulfilled by the launch of registration system for the counter part of the modern company under the provisions of "Joint Stock Companies Act, 1844".

The progressive wave of legislation for the betterment and development of the corporate sector continues by enacting another very valuable law, and that was "Limited Liability Act, 1855". This brings the concept of limited liability in the form of enacted law, and indeed more effectively applicable. The idea of limited liability was that the share holders were not be liable in case of insolvency for more than their share in the capital.

As the development of company law was keep going by the codification of the above mentioned enactments together as, "Joint Stock Companies Act, 1856". The theory of the Act was to allow the maximum freedom both in the structure and functioning of a Limited Liability company.²⁶ Here begins the modern company law, and the corporate activity twist towards the road of progress.

"In the later nineteenth century depression took hold, and just as company numbers had boomed, many began to implode and fall into insolvency. Much strong academic, legislative and judicial opinion was opposed to the notion that businessmen could escape accountability for their role in the failing businesses. The significant development in the history of companies was the decision of the House of Lords in *Salomon v. Salomon & Co.* where the

²⁵ Rana Aneel Arshad, " *Brief History of Company Law*", (Corporate Law Decisions, 2004)

²⁶ *Infra*, reference no 22

House of Lords confirmed the separate legal personality of the company, and that the liabilities of the company were separate and distinct from those of its owners".²⁷

The decision of House of Lords was an excellent one, and was considered as a universal authority on the doctrine of corporate personality.

As Lord Macnaughten observed "The company is at law a different person altogether from the subscribers to the memorandum; and, though it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the sub-scriber or trustee for them."²⁸

The case decisively launches the concept that the company upon incorporation becomes a distinct entity from those who are its members, and directors. It pursues the idea that the rights and duties of the company are its own, and not of any other. This acknowledgment of legal personality was the establishment of the modern company law.

The company law kept on changing with the enhanced needs of time. So, another Act was introduced with some more changes and improvements, and was titled as the "Companies Act, 1985". Some years later the legislation again drafts another Act for the better regulation of corporate activity, and it was the "Companies Act, 1989".

"CA 2006 is the product of the most extensive revision of company law since 1856. it arises from a consultation carried out over seven years, from 1998 to 2005, by the Company Law Review (CLR), which was set up by the Department of Trade and Industry (DTI)".²⁹

So, the latest enacted company law is the CA 2006. It brought the remarkable changes and updates in the field of company law. The corporations are now growing towards the new horizons:

²⁷ "Corporate law", <http://en.wikipedia.org> (accessed on: May 16, 2011)

²⁸ Robert R Pennington, "Company Law", 8th ed., (Butterworths, UK, 2001), 39

²⁹ Len Sealy and Sarah Worthington, Cases and Material in Company Law, 8th ed., (n.l.: Oxford University press, 2007), 4

In Pakistan usually the British patron of laws is followed. As, the sub continent was the British colony, all laws were enacted and enforced by the royal government before the independence of Pakistan. Even after the independence those British laws were followed after making some minor alterations in them. But, with the passage of time the needs of our society changed to the extent that our system requires the new legislation to run the setups. Same is the case in corporate sector. The foremost company law in Pakistan was the Companies Act, 1913, with some alterations in it. After an extensive period the new law for the companies was drafted in the name of 'Companies Ordinance, 1984'. Since then 17 amendments were designed and approved by the government in the aforesaid Ordinance. These amendments were framed to bring comprehensive development in the corporate sector, so as to catch up with the industrial world.

While talking about the historical development of companies' law in Pakistan, "the Commissioner (Enforcement) of SECP said "originally the Companies Act 1913 governed the companies. It was replaced by Companies Ordinance, 1984. Amendments, however, continued to be effected in it from time to time. The Ordinance was reviewed twice comprehensively, that is, in April 1991 and 1999."³⁰

The recent amendments were designed by a committee appointed by the SEC in October 2001, after detailed sessions with the, corporate associations, stock exchanges, expert accounting groups, and legal professionals for upgrading the Ordinance. The new law presents the latest corporate developments, so as to walk with the pace of time, and to ensure to maintain the up dated level of measures. SECP plays a great role in the development of corporate sector in Pakistan, and keep on suggesting the new phenomena's as are followed in the developed world.

The Intension/purpose of law behind the Concept of Separate Legal Entity:

As discussed earlier the laws are always enacted for ease of the society, to enhance the living standards of the people by drafting the rules to run the affairs in a smooth way. So is the concept of legal entity. The basic intension of law behind creating this fiction of separate personality was to grow the corporate sector to the new horizons, and to flourish the economic activity of the society. By providing this concept of legal personality, law provides machinery to the investors

³⁰ Muhammad Ilyas, *Amendments to make corporate operation easier: Companies Ordinance '84*, DAWN, October 9, 2002, www.dawn.com (accessed on: May 21, 2011)

and the rich persons to invest the money in the risky trade ventures. As the investors interest is fully protected by the shelter of legal personality. One of the crucial and central beliefs which give our industrial feudalism rational proportion is the embodiment of great industrial enterprise.³¹

The decision of the court in the case of *Ayaz durrani and others v. Chairman, WAPDA and others*, shows the intension of law. As, the court held: "... In the present case, the consumer was the incorporated company namely, Ayyaz Textile Mills limited and the petitioner has no personal liability even though he may be chief executive of the company., ... It needs no gainsaying that a company incorporated under the Companies Ordinance, 1984 is a separate and distinct juristic person quite apart from its chief executive, director or the shareholders. The liability of such a company cannot fall upon the directors or the shareholders who have no personal responsibility for the same".³²

Therefore, the law attains a very consistent and functional mechanism by creating this segregation between the company, its members and the management. Now, the interests of all of them would more safe and they can put there maximum efforts to improve and grow to the new heights. This separation of power among the three provides a transparent and most proficient way of managing the corporate affairs. As aforesaid, all the stake holders would be on safe side and things would be smoother. This doctrine affirms that assets of the stakeholders are separate and distinct from the assets of the company.³³

The legal entity concept endow with a fabulous protection to the investor in the form of limited liability. Automatically the economic activity rise to a large extent. The investor feels secure and can even put the money to the risky ventures, and as a result of that, the purpose of law is fulfilled by the enhancement of economic sector.

³¹ Gonzalo Villalta Puig, "A Two-Edged Sword: Salmon and the Separate Legal Entity Doctrine" *Murdoch University Electronic Journal of Law*, Volume 7, Number 3 (September 2000), www.murdoch.edu.au/elaw (accessed on: February 10, 2010)

³² *Ayaz durrani and others v. Chairman, WAPDA and others* (PLD 2000 Lah.414)

³³ Muhammad, Khalid Malik, "International Aspects of Corporate Law and Governance" *University of Warwick, UK* (2006), 3, <http://www.jstor.org> (accessed August 4, 2011)

The law intends to deal the company as a separate legal person because it is awarded with all the rights-like a natural person, so, it should also bear the responsibilities on its own. 'Every one is equal in the eye of law' and, every right is accompanied with some duty. So, the principles are the same for every one. While the company is enjoying the status of separate legal entity, distinct from its owners, members and officers it is be liable for its duties as well. As the company is a legal person.³⁴

So in the eye of law the company is a right-and-duty-bearing entity.³⁵ It cannot pass on its liabilities to some one else like its owners, members or officers, because they are distinct persons at law, and they have their own rights and duties as well.

If this severance of interest do not lie there and the company and its share holders and officers are the same. How the custom of the transfer of shares would work? The transfer of shares is a usual trade activity and if the concept of legal personality is not observed this deed of transferring the shares is not possible. Indeed the corporate system would turn to be seized.

Moreover, in the absence of limited liability his opportunities to transfer would in practice be much restricted. With a registered company freedom to transfer, both legally and virtually, can be eagerly achieved.³⁶ Here, again the purpose of law is successive by applying the legal entity concept. And the benefit of considering the company as a distinct entity is that the corporations are running swiftly with a day by day increasing interest of investors.

The purpose behind the said concept also includes another significant feature, and that is the company after getting the status of legal person also got a perpetual succession. This characteristic of the company enables the factor of certainty in its existence. Because if any of the member or director of the company died, it would not cease to work rather, it can always have the new member or director by the prescribed process because, it enjoys the perpetual succession.³⁷

³⁴ Len Sealy and Sarah Worthington, *Cases and Material in Company Law*, 8th ed., (n.l.: Oxford University press, 2007), 31

³⁵ John, Dewey, "The Historic Background of Corporate Legal Personality" *The Yale Law Journal*, Vol. 35, (Apr., 1926), 655-673, <http://www.jstor.org> (accessed August 4, 2010)

³⁶ Paul Davies, *Principles of Modern Company Law*, 7th ed. (London: Sweet & Maxwell Ltd, 2005), 37

³⁷ Jhon.H, Farrar, *Company Law*, (London: Butterworths, 1985), 79

But if we did not apply the concept of legal personality here then the company would end with the death of its members or officers, and the factor of uncertainty would always be there with its existence. So this noteworthy advantage is the part of intension of law.

Howsoever, above all the profit generating idea was behind the concept of legal entity, because this concept provides the shelter of limited liability to the investors. The share holders and officers also get themselves secured from any unseen liability of the company. Industrialists typically look at monetary and economical incentives in various trade policies of the Government.³⁸

This risk insured environment creates the investors interest to invest in the business ventures. And the participation of investors took the corporate village to the new directions of development growth. It is evident that the notion behind the concept of separate legal entity is fulfilled, because the outcomes of the concept show the positive results in the corporate operations. It effects more positively in the developing world, and the economies of the said world achieve a better place in the corporate world.

The supportive features of the concept and the basic intension of law working at the rear of the legal entity concept hit the right goal, by encouraging the investors to invest. As the increased interest of wealthy investors open up the new wave of development, and as a result of that the corporate activity accelerate.

The law provides such suitable conditions for the corporate activities, which brought the remarkable achievements. Thus, the concept of separate legal entity is fully successful as well as it turned to be the mile stone in the development of the corporate world.

The Natural offshoot of Separate Legal Entity Concept:

The doctrine of separate legal entity is accompanied with another concept. That is the limited liability concept, which is a natural offshoot of legal entity. In fact, limited liability is the most important component of the doctrine of separate legal entity. The idea of limited liability is that,

³⁸ Dr. Tariq Hassan, *Legal framework for economic development in Pakistan & Gulf economist*, (December 11, 2000) (No. 50) 31, 4

as the share holders and the officers are the separate entities, and the company is a separate entity, there assets are evidently separate from each other. And so are the responsibilities, they are liable to there own extents. As the members and officers are not liable for the company's debts, rather to the specific extent of there own liabilities. A solid protection is created by law between the company and its share holders, which is known as 'corporate veil'.

This is because of this veil that the company and its members are considered to be distinct in interests, assets and liabilities from one another. "the liability of the company's members is limited 'by shares' or 'by guarantee', then the company's creditors cannot seek satisfaction from the members, even if the company has insufficient funds to pay its own liabilities in full"³⁹

The fundamental intention of the limited liability concept is to provide the maximum protection to the investor against any liability of the company. So that the members and the management should just be liable for there own responsibilities and not of the company. Thus, the creditors of the company should look towards the company and not any one else for the satisfaction of there claims. Therefore, the limited liability concept provides the shelter to the stake holders, and on the other hand risk is all for creditors, because in case of insolvency they will be left with the corporate assets only. They cannot claim against the private property of the stake holders and the officers.

The limited liability concept emerges in England in 17th century, through the Limited Liability Act, 1855. Prior to this Act, there was no concept of limited liability, rather any of the partners could be held liable for all the debts of the corporation. Large investments were required to get involved in the risk taking of the large business projects, and the investors keep on hesitating form taking such risks. At that time such a solution to this problem was required in corporate sector, which can develop the interest as well as the confidence of the investors. Hence, that the investor can invest the large amounts in the risky business ventures. At that stage, law provides an excellent solution to the problem in the shape of 'limited liability concept'.

³⁹ Len Sealy and Sarah Worthington, *Cases and Material in Company Law*, 8th ed., (n.l.: Oxford University press, 2007), 51.

“The aim of limited liability therefore, was to free up the wealth and “to enable a number of capitalists to embark upon risky adventures without shouldering the burden of personal liability”.⁴⁰

As, the basic goal of limited liability, was to gather the wealth by developing the investors confidence, so, that the trade activity can be enhance and the economy can grow. Consequently, The Limited Liability Act, 1855 was a total success.

The law of limited liability was also established by the renowned case of “*Salomon v. A Salomon & Co Ltd*”. The court draws a line of distinction between the company and its' shareholders, and provides the advantage of limited liability to the shareholders. The court determinedly emphasize on the liability of the shareholders, as they are only liable to the extent of their share in the company. And the company cannot hold the shareholders as well as the officers liable for its liabilities.

So the investors enjoy the incentive of limited liability which plays the role of a shield for any extra liability. In case of any odd circumstances in the company, the only thing on stake of the shareholders is the investment in the shares, and not there personal property. As due to the protection of limited liability the inexperienced investors also shows the nerve to invest, because they are sure that they would not be involved in the management, and they would be getting the profits as well. Thus, it can be said that limited liability is a capital raising medium. The company can elevate its capital by the said vehicle.

The limited liability concept creates segregation between the stakeholders and the management of a company and it brings the uniformity in the business planning of the company. This concept put the real burden on the creditors, as in case of any thing wrong they would be left with just the company's assets to satisfy there claims. They cannot look to the stake holders or the officers for recovery of there debts. Therefore, the creditors are not the one who gets the benefits of limited liability; rather they have to bear the whole risk involved.

The other side of the picture is that the concept of limited liability is having some shortcomings as well. As the stakeholders enjoy the unlimited benefits in the company, but tolerate the limited

⁴⁰ Aiden, Small, “Limited Liability- A Necessary Consequence of Incorporation?”, (accessed on: April 14, 2011)

liabilities. This means that when the company is in good days, the shareholders fully enjoy being a part of that company, but in the tough times they bear only a limited pain of the company.

Another shortfall of the limited liability is that some times the business activities are designed to defraud the creditors. This kind of activities brought in question the trust of the creditors, and may create some tough time for the whole sector. So, these weaknesses should have to be overcome by the laws. However, the limited liability may have some deficiencies and flaws, but there is no practical alternative having even equivalent benefits.⁴¹ Thus, it is the need of time to keep on working with this remarkable invention of mankind.

Application of the concept:

The majority of laws are drafted by the legislature, as it is the primary function of legislature to create the laws, for the state. At the same time the other sources of law also goes hand in hand with the prime source, so that the pace of law would remain with the velocity of time. The judiciary is a strong limb of the law making. And it always plays an imperative role in law making process.

In the corporate zone the courts plays an enormous role in the development and growth of the new concepts. Those concepts play the role of landmarks in the progress of the corporate laws. Among those concept is the well established concept of separate legal entity.

Along with the secondary function of law making, the primary objective of the courts is to make laws applicable by there decisions. And, this function is beautifully performed by the courts in context of the concept of separate legal entity. Where, in the case of "*Salomon v. A Salomon & Co Ltd*", the decision of the House of Lords was a mile stone of the modern company law.

"The case firmly established that upon incorporation, a new separate artificial entity comes into existence. At law, a corporation is a distinct person with its own personality separate

⁴¹ Aiden, Small, "Limited Liability- A Necessary Consequence of Incorporation?", (accessed on: April 14, 2011)

from and independent of the persons who formed it, who invest money in it, and who direct and manage its operations.”⁴²

This was for the first time when a court establishes the principle of separate legal entity by its decision. As it is evident by the decision that once incorporated a company becomes a separate legal entity, entirely distinct from the stake holders as well as the officers.

According to the decision of House of Lords, “... the incorporation process made Salomon and his company two persons. Even if the business were the same as before, and it was still managed by Salomon himself, the company was not an agent or trustee for the members.

Although Salomon beneficially owned all the issued shares of the company, the court also recognized him as a separate person who can be a secured creditor with enforceable rights against the company.”⁴³

At this point, it is observable that the court emphasized on the idea of distinct entity of the company. And rigorously follow this concept of law while giving the judgment. The court determine that the interests of the company and its stake holders are not the same, and the segregation between all entities was the practical need of the corporate ventures. Corporate personality becomes a trait of a company, after it was executed by the court, and so is the isolation of interests between the company and its members and officers.

It is very notable in the words of, Lord Halsbury: “Either the limited company was a legal entity or it was not. If it was, the business belonged to it and not to Mr Salomon. If it was not, there was no person and no thing to be an agent at all; and it is impossible to say at the same time there is a company and there is not.”⁴⁴

The Honorable Lord emphasis on the legal entity of the company, because once it's declared by law to be a separate legal entity there left no reason to unjustified the rule. Therefore, the company possesses all features of a legal entity. As “The realist theory of law by Dicey provides

⁴² Gonzalo Villalta Puig, “A Two-Edged Sword: Salmon and the Separate Legal Entity Doctrine” *Murdoch University Electronic Journal of Law*, Volume 7, Number 3 (September 2000), www.murdoch.edu.au/elaw (accessed on: February 10, 2011)

⁴³ Raguraman ,Gurusamy, “Separate Legal Entity (Law 346)” (July 13, 2010), <http://graguraman1.blogspot.com> (accessed on: October 23,2010)

⁴⁴ Paul Davies, *principles of Modern Company Law*, 7th ed. (London: Sweet & Maxwell Ltd, 2005), 28

that the artificial person created by law, has a real personality, a real mind, will and power of action." This means to say that the company owes all attributes of legal personality like the natural person.

The aforesaid discussion is re-established in the words of Lord Macnaghten: "The company is at law a different person altogether from the subscribers ...; and, though it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscriber or trustee for them. Nor are the subscribers, as members, liable in any shape or form, except to the extent and in the manner provided by the Act."⁴⁵

The concept of separate legal entity was firmly recognized by the courts in the case of Salomon. The implication of the concept by the decision of the court was very significant. As the primary function of the court is to implicate the principles of law by there decisions.

Particularly, in the case of Pakistani laws, the courts play a significant role in the implementation of the laws, with the help of law enforcing bodies. The Pakistani courts also follow the decisions of UK courts as the precedents. While, the developments in the British company law are followed in our corporate sector too.

As, the company is considered as a distinct legal entity by the law, and it owes all the features of a natural person; it also owes all the liabilities on its own. This factious person is created by the law to facilitate the trade activities.

And, to provide a secure manner to the natural person to earn enormous profits. The concept of separate legal entity enables the investors to invest in the risky business ventures, as it develop the confidence of the investor, and provide a excellent business environment.

The Pakistani courts also implement the Salomon's principle in there decisions. As, in the case of "*THE STATE v. Aizas Ahmad and another*", the Honorable Ghazanfar Ali Gondal, J Held: "In Companies Act, 1913, Section 2(2) defines company to means a company formed and registered under the Act ... the company shall be a body corporate by the name

⁴⁵ Infra, reference no, 41

contained in the memorandum, capable forthwith of exercising all the functions of an incorporated company, and having perpetual succession and a common seal ... the basic feature of a company in the context of Section 2(a) (iv) of the Ordinance is that it should have independent existence and should have the power to govern its affairs by itself. Seen in this light, the words institution or body which succeed the word company in this clause mean institution or body which is an entity by itself and can act independently of any other entity or organization".⁴⁶

In the above mentioned case, the Honorable court decides that the company once registered under the company law is considered as a separate legal entity in the eye of law, which has a common seal and enjoy the perpetual succession.

The company has the benefit of its independent existence, and it governs its affairs by itself. The principle of separate juristic person is also affirmed in another case that is in the case of "*Messrs Franksons & Co. v. Mian Muhammad Hussain*" the Honorable Zakiuddin Pal, J Held:

"... According to law a company is a separate juristic person, distinct and different from its shareholders. It is not a mere alias for its share-holders nor merely an agent for them. Any individual share holder cannot indemnify the company against debts which it incurred except to the extent of his share in the capital. His liability is limited to that extent and he can only be called upon to contribute in the event of a winding up of the company to the extent of his own share.

(Reliance in this respect can be place upon *A Salaman & company limited v. Aron Salaman* (1897 AC 22), *Aveline Scott Ditcham v. James J Miller* (AIR 1913 PC 203), *E.B.N. company Ltd. V. Dominion Bank* (AIR 1937 PC 279) and *Ikram Bus Service and others v. Board of Revenue, West Pakistan etc* (PLD 1963 SC 564) ...) ...the status and interest of the company is quite distinct from its shareholders. Though shareholders has close identity with interest of company and their interests are interlinked with each other but company is a separate juristic person, and interests of company and its shareholders are separate".⁴⁷

⁴⁶ *THE STATE v. Aizas Ahmad and another*, 1986 Pcr.LJ 561

⁴⁷ *Messrs Franksons & Co. v. Mian Muhammad Hussain*, 1983 CLC 1042, [Lahore]

The court again establish the rule of juristic person along with the concept that the shareholders are not liable for cannot pay the debts of the company, rather they are liable for there own liabilities. The law creates this segregation between the company and its members.

Another ruling states the same principle as in the case of "*Macaura v. Northern Assurance Co*" it was held that: "... this appeal relates to an insurance on goods against loss by fire. It is clear that the appellant had no insurable interest in the timber described. It was not his. It belongs to Irish Canadian Sawmills Ltd, ... He owned almost all the shares in the company, and the company owed him a good deal of money, but, neither as creditor nor as shareholder, could he insure the company's assets. The debt was not exposed to fire nor were the shares, and the fact that he was virtually the company's only creditor, while the timber was its only asset, seems to me to make no difference. He stood in no 'legal or equitable relation to' the timber at all. He had no 'concern in' the subject insured. His relation was to the company, and not to its goods, and after the fire he was directly prejudiced by the paucity of the company's assets, not by the fire ..."⁴⁸

The law allows the company to be considered as a separate legal entity so that it can bear it liabilities on its own. The members or directors are not liable for any liability of the company.

The court utters the same rule in the case of "*A. Rehman v. Tehsildar Lahore and another*", the Honorable Malik Muhammad Qayyum, J Held: "... That M/s. Progressive Journalist Ltd. From whom the money is-allegedly due is a company incorporated under the Companies Act, 1913 and the petitioner even though its Managing Director has no personal liability ... it needs no gainsaying that in law a company is a distinct entity separate from its shareholders and directors and the liability of the company cannot be passed on to its directors personally".⁴⁹

The company cannot put its liability on the director's shoulders. The law does not allow the company to do so. Even the share holders cannot be held liable for the debts of the company. The

⁴⁸ Len Sealy and Sarah Worthington, *Cases and Material in Company Law*, 8th ed., (n.l.: Oxford University press, 2007), 39.

⁴⁹ *A. Rehman v. Tehsildar Lahore and another*, 1993 CLC 1222 [Lahore]

court again establishes the rule of law in the case of "*Union Council, Ali Wahan, Sukkur v. Associated Cement (Pvt.) Limited*", the Honorable Ajmal Mian, Sajjad Ali Shah and Saleem Akhtar, JJ Held:

"... It appears to be an admitted position that the respondent is a company incorporated under the Companies Act having an independent and legal personality distinct from the government which own its shares ..."⁵⁰

Privy Council re-enforce the concept of distinct entity in the case of "*Lee v. Lee's Air Farming*", the Privy Council of London held that: "the company and Mr Lee were distinct entities and therefore capable of entering into legal relations with one another as such they had entered into a contractual relationship for him to be employed as the chief pilot of the company he could in his role of Governing Director give himself order as chief pilot. It was therefore a master servant relationship and as such he fitted the definition of 'worker' under the Act. The widow was therefore entitled to compensation."⁵¹

The courts perform a remarkable role in the implementation of the said doctrine. This is due to the implementation of the doctrine that the fruitful results are achieved by the corporate sector, and the company law grows to the present profile.

Impact of the Concept of Separate Legal Entity:

The concept of separate legal entity is the landmark in the growth of the corporate world. Now a day, it is the most significant doctrine in the company law; rather it's not wrong to say it is the back bone of company law. It brought about a number of positive impacts on the corporate law as well as to the society as a whole.

Since the very earlier ages, the economic position of the society had an effective contribution in the overall status of life. And trade activity plays a vital role in the improvement of economy. So

⁵⁰ *Union Council, Ali Wahan, Sukkur v. Associated Cement (Pvt.) Limited*, 1993 SCMR 468 [Supreme Court of Pakistan]

⁵¹ Vijay, "The Doctrine of Separate Personality" (September 26, 2010) <http://vijayhighcourt1.blogspot.com> (accessed on: April 16, 2010)

the fundamental objective of the separate legal entity concept is to focus the enhancement of the trade activity, which is achieved in an incredible way. The appliance of the said concept along with the natural offshoot of limited liability works excellently.

By, the application of both the concepts the wealth is cast out from the investor's pocket, to be invested in the risky business projects. This is due to these concepts that the investors' interest is established in the present day commercial developments. Now it is assured to the investor that he would not be held liable for any veiled liability of the company. The investor's confidence boost the trade activity and the business world prosper with every passing day.

Especially in the modern world of globalization and technology, the strong limbs of an industrial economy are required to walk with the pace of time. Therefore, the application of these principles brought the marvelous impact on the corporate sector. The business friendly mechanisms like the aforesaid concepts enable the growth of the commercial world.

As discussed earlier the company law is not developed in a couple of days rather it took centuries to achieve the status which it has today. The companies are developed to the extent that they are the backbone of the economy of the world. Hence, by creating such useful impact on the society and humanity the corporate principles fully satisfied the objective or intention of law for their creation.

In fact, it can be said the invention of legal entity concept is among some extra ordinary inventions of man. The advanced business environment is entirely changed and now it enables the public to invest and receive the profit without being caught up in the supervision. It facilitates the investors to get into the joint ventures, sole traders or small partnerships.

The other side of the picture is not satisfactory as the relaxation provided by the law in the shape of the separate legal entity and limited liability, is being used for the negative gains too.

They also facilitate the way to fraud, or the company some times is just a shame. The misuse of this facility of law is also a factor of concern. But, the law enforcing institutions and the courts

are there to keep a check on the wrong doers. However, in brief, the separate legal entity brought an extraordinary change in the commercial region. By introducing such valuable concepts law provides a way out to the whole new world of progress for the corporate sector.

As the law grant legal personality to the company and endow it with all rights as well as duties too. The company itself is responsible for its liabilities, and it can enjoy its rights on it own. The members and officers have nothing to do with its rights or duties; they stood in the status of distinct entities. The law allows the company to enjoy the same status as the natural person. It can own property, it can sue and be sued, and it can enter into transactions, have a common seal, and enjoys the perpetual succession.

Being a separate legal entity a company can enter into transactions. Those transactions could be of any type (lawful), including those for the loan. Wherever, the company entered into any transaction for loan from a financial institution, it would be liable itself for the recovery of that loan. The companies most likely entered into loan transactions with the banks. The banks also provide the loans, and enter into such transactions because the company is having the status of separate legal entity. To sum up the idea of separate legal entity it can be said that as an ordinary person, this factious person created by law is also enjoying the same status. The law provides all attributes of a natural person to this artificial legal person.

Chapter # 2: Transactions of the Company with the financial institution (banks)

Transactions of the company:

The company is a separate legal entity and the law provides all attributes of a person to it. In those attributes comes the one that the company can enter into transactions in its own name.

Therefore, a “company” has been defined as a collection of many individuals united in one body under special domination, having perpetual succession under an artificial form and vested by the policies of law with the capacity of acting in several respects as an individual, particularly for taking and granting of property, for contracting obligation and for suing and being sued, for enjoying privileges and immunities in common”⁵²

This is the reason why a company can transact on its own. As a company enjoys the status of a legal person it can compose a valid and efficient contract⁵³ like in the famous case of Lee v. Lee’s Air Farming the court declares the contract of service as a valid and enforceable contract.⁵⁴ The company after incorporation attains the status of a legal person and all the rights of a legal person comes its way. Moreover ‘common seal’ is one of the elements of a legal person. The company enters into transactions because of this common seal, and all the rights and liabilities coming out of this attribute would belong to the company, and no one else.

The Honorable court in the case of “*THE STATE v. Aizas Ahmad and another*” upheld the same principle as “... The company shall be a body corporate by the name contained in the memorandum, capable forthwith of exercising all the functions of an incorporated company, and having perpetual succession and a common seal ...”⁵⁵

⁵² Rana Aneel Arshad, “*Brief History of Company Law*”, (Corporate Law Decisions, 2004), 49

⁵³ Len Sealy and Sarah Worthington, “*Cases and Material in Company Law*”, 8th ed., (Oxford University press, 2007), 39

⁵⁴ Vijay, “*The Doctrine of Separate Personality*” (September 26, 2008)
<http://vijayhighcourt1.blogspot.com> (accessed on: April 16, 2010)

⁵⁵ *THE STATE v. Aizas Ahmad and another*, 1986 Pcr.LJ 561

The company cannot live its own all the time, but sometimes it needs to borrow from an outsider. The limits of borrowing should be specified in the memorandum or articles of association of the company. In case of, no particular declaration for the borrowing power in the memorandum or articles, the company is assumed to have oblique power to borrow.⁵⁶

The company engages itself in different types of transactions as is authenticated by the shareholders in the memorandum and articles of association of the company.⁵⁷ Although some companies enjoys a wider range of transactions then others. But, the law allows all the companies to enter into transactions in the same manner as natural persons⁵⁸, and impose the same liabilities too. The company can transact for any lawful object, as it usually transact for the business, or for buying and selling of property, to sell or buy the shares, and also to borrow and lend, etc. Generally, the company borrows loans to elevate investment⁵⁹ for the commercial activities, which are the object of the company. The financial organizations⁶⁰ are the most reliable source of borrowing for any company as they are the most organized lenders.

Since The Company is fundamentally a factious legal person consists of natural persons.⁶¹ So it habitually works through those natural persons. Same is the case in getting into the transactions; the company bound itself in any legal obligation through the natural persons.

In the case of "*National Engineering Services Pakistan (pvt) Ltd. v. Steel Mill Corporation*" this principle was upheld that: "A Corporate body acts through its directors and persons duly authorized under the Articles of Association ... third party dealing with a corporate entity is justified to assume that all the matters of internal affairs have been duly complied with and persons who have proximate relationship with the corporate entity is either authorized under the charter of the company or has been delegated such authority thereunder."⁶²

As a rule the company is required to observe substantial formalities in context with execution of any transaction in writing under its common seal. The least requirement of law to transact was; to affix the common seal on the document of transaction, along with the signatures of a director

⁵⁶ H.K.Saharay, "*Company Law*", 5th ed., (New Delhi: Universal Law Publishing Co.,2008) , 253

⁵⁷ Richard Smerdon, "*Palmer's Company Law Manual*", 1st ed., (London : Sweet & Maxwell,2000), 286

⁵⁸ Robert R Pennington, "*Company Law*", 8th ed., (UK: Butterworths,2001), 121

⁵⁹ Infra, reference no,6, 287

⁶⁰ The Financial Institutions (Recovery of Finances) Ordinance, 2001, Sec 2 (a)

⁶¹ Jhon.H, Farrar, *Company Law*, (London: Butterworths, 1985), 66

⁶² *National Engineering Services Pakistan (pvt) Ltd. v. Steel Mill Corporation*, 2003 YLR 1696

and secretary of the company, or of two directors. Here the directors and the secretary of the company are the authorized person in regard to transact for the company. Any contract or transaction needs to be in proper form and should be in accordance with law, for being acknowledged and enforced by law.

But, at present the formalities are somewhat changed, as the company is not bound to affix the common seal along with the signatures of the authorized person. Rather, only the signatures of the authorized person are sufficient to enforce the transaction deed, which should later be approved by the board of directors. Or even if the deed is composed in a manner that it is articulated in any form of expressions to be implemented by the company also has the same effect as a document executed under the common seal.⁶³ The law obliges the parties to a contract to create legal obligations by a written deed, so the company is also bound to reduce all transactions to writing.

In the case of "*National Engineering Services Pakistan (pvt) Ltd. v. Steel Mill Corporation*" it was held that: "any contract which, if made between private persons, would be by law required to be in writing, signed by the parties to be charged therewith, may be made on behalf of the company in writing signed by any person acting under its authority, express or implied, and may be in the same manner be varied or discharged;"⁶⁴

The rule of making the deed remains the same no matter it is required to be or not. So, it is understood that whatever transaction the company is getting in should be in written form. Because one of the renowned principal of law is that 'it helps the vigilant'. And the company is presumed to get the benefit of this shelter of law. In Pakistan, Section 212 and 213 of the Companies Ordinance, 1984 stipulate the way to create legal responsibilities for the company.⁶⁵

Now, there are some limitations imposed on the borrowing powers of the company. As aforesaid the memorandum of association should set out the borrowing powers of the company, so are the limitations. The limitation on the borrowing power may be provided in the memorandum. First,

⁶³ Robert R Pennington, "*Company Law*", 8th ed., (UK: Butterworths, 2001), 120

⁶⁴ *National Engineering Services Pakistan (pvt) Ltd. v. Steel Mill Corporation*, 2003 YLR 1696

⁶⁵ A.G. Chowdhry, "*Company Law in Pakistan*", (Lahore: Khyber Law Publishers, 1994), 156

it may specify that the company shall not borrow more than the particular figure. Secondly, it may affirm that the company shall not borrow beyond the paid-up capital.⁶⁶

However, if no such restriction is imposed by the memorandum, there are no statutory limits imposed besides the legal formalities. In Pakistan, the companies generally borrow in the form of:

- a. Cash finance;
- b. Overdraft and;
- c. Loans.

a. Cash finance:

This is a very common form of borrowing by the commercial and industrial concerns, and is made available either against pledge or hypothecation of merchandise, produce or commodities.⁶⁷

b. Overdraft

This is another very common form of borrowing by the companies. This kind of accommodation is allowed against collateral guarantees.⁶⁸

c. Loans

When a company borrows a fixed amount from a bank, which is repayable either in an intermittent payment⁶⁹ or a lump sum at a fixed future time that is called loan.⁷⁰

These are the common kinds of transactions through which a company use to borrow from the financial institutions. The law requires the company to pass a special resolution⁷¹ in the Annual General Meeting for the approval of transactions of loan by the stakeholders.

⁶⁶ H.K.Saharay, "Company Law", 5th ed., (New Delhi: Universal Law Publishing Co.,2008) ,253

⁶⁷ Asrar H. Siddiqi, "Practice and law of banking in Pakistan", 6th ed.(Karachi: Royal Book Company, 1998), 254

⁶⁸ Sidney Mandell, "Laws Governing Banks And Their Customers", (America: Oceana Publication, Inc, 1975),79

⁶⁹ Fitzgerald Demond, *Elements of banking 1&2*, (London: Financial training pubhcations limited, 1983), 177

⁷⁰ Ibid, 176

⁷¹ A.G.Chowdhry, "Company Law in Pakistan", (Lahore : Khyber Law Publishers,1994), 143

Financial Institutions:

The financial institutions are those which provide the financial services to its clients. The term 'Financial institution' is defined in Section 2(a) of 'The Financial Institutions (Recovery of Finances) Ordinance, 2001, as;

"Financial Institution" means and includes;

(i) Any company whether incorporated within or outside Pakistan which transacts the business of banking or any associated or ancillary business in Pakistan through its branches within or outside Pakistan and includes a government savings bank, but excludes the State Bank of Pakistan;

(ii) A Moradabad or Moradabad management company, leasing company, investment bank, venture capital company, financing company, unit trust or mutual fund of any kind and credit or investment institution, corporation or company; and

(iii) Any company authorised by law to carry on any similar business, as the Federal Government may by notification in the official Gazette, specify."⁷²

The financial institutions play an imperative role in the financial system of any country, and so they are performing a vital task in the financial sector of Pakistan. These institutions are mostly regulated by the government agencies. The fundamental influence of the financial institution is the proficient allotments of funds.⁷³

The financial institutions need to identify the business needs as well as their own profitability to allocate the resources. The financial institutions provide the most important service to the corporate sector by being the financial mediators.⁷⁴ As they brought borrowers and lenders together in one place. The corporate sector takes the real advantage as the loans are easily manageable from these institutions.

⁷² The Financial Institutions (Recovery of Finances) Ordinance, 2001, Sec 2 (a)

⁷³ Wjeeha Tahir, "Managing Risk in Financial Sector", 2nd ed., (Pakistan: The Institute of Bankers, 2008), 1

⁷⁴ Nasser Arshadi and Gordon V. Karels, "Modern Financial Intermediaries and Markets", (New Jersey: A Simon & Schuster Company, Upper Saddle River, 1997), 27

The Section 2(15A) of Companies Ordinance, 1984 defines the term 'financial institution' as "financial institution" includes,—

(a) a company or an institution whether established under any special enactment and operating within or outside Pakistan which transacts the business of banking or any associated or ancillary business through its branches;

(b) A modaraba, leasing company, investment bank, venture capital company, financing company, housing finance company, a nonbanking finance company; and

(c) Such other institution or companies authorised by law to undertake any similar business, as the Federal Government may, by notification in the official Gazette, specify for the purpose.”⁷⁵

While providing the financial services, risk and profits go parallel.⁷⁶ The increasing level and complications of financial institutions and in the pace of their financial transactions require that they make use of refined risk management tools. As they have to meet their specific goals by systematizing and managing the human and monetary resources. These institutions are expected to handle the risk tactfully while granting the loans to the companies. They make all considerable inquiries before entering into any legal transactions and make sure that they are lending to the reliable parties who can meet the liabilities in time and manner prescribed.

“Financial institutions need to increase their role as risk managers to corporate and other entities by offering a variety of derivative products. Financial institutions are also expected to employ processes and practices, which could help them to become more cost effective and efficient.”⁷⁷

With every passing day the role of these institutions is going to be tougher, because of the rapid changes in the field of corporate sector and the loan transactions. The financial institutions have to utilize the new techniques and technology for keeping the pass with the time. So, that

⁷⁵ Companies Ordinance, 1984, Section 2(15 A)

⁷⁶ Irfan Karim, “*Managing Risk in Financial Sector*”, 2nd ed., (Pakistan: The Institute of Bankers, 2008), 29

⁷⁷ Dr. Shamshad Akhtar, “*Inaugural Address at the Dawn Asia Finance Conference*”, May 13, 2006, Karachi, www.google.com.pk (accessed on: June 18, 2011)

eventually the finance sector can enhance economic escalation to advantageous levels.⁷⁸ The strongly established financial institutions are the back bone of any economy, as they can save the economy against any crisis or upset.

Banks --- as Financial Institution:

The most reliable financial institution is the 'banks'. Banks play very significant role in the economy of a country and Pakistan is no exception. Banks are curator to the assets of the general public. The banking sector plays a considerable role in a modern-day world of money and economy.⁷⁹ As the bank is the most structured type of financial institution. The bank evaluates creditworthiness and observes loan performance. Also, by guaranteeing their depositors a sure return, they tolerate the monetary risk of the loans they provide to the corporations.⁸⁰

The banks have a proper setup, and regulations to lend the loans. The companies mostly rely on the banks for the loan, as they are the safest and organized lenders.

The Banking Act, 2006 defines the term 'bank' as follows; Section 2(1)(f) says: "bank" means a company (whether incorporated in Pakistan or outside Pakistan) which is licensed to carry on banking business in Pakistan under Section 14."⁸¹

Here the term banking business means the financial services which are provided by the banks to its customers. The fundamental function performed by the banks, namely 'banking' is defined by The Banking Companies Ordinance, 1962 as; Section 5(b) articulates:

(b) "Banking" means the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise;"⁸² And the term 'banking company' is defined in Section 5(c) as:

⁷⁸ Muhammad Shahbaz, Muhammad Nasir Malik, "Does Financial Instability Weaken the Finance-Growth Nexus? A Case for Pakistan", (February 05, 2011), <http://mpira.ub.uni-muenchen.de/28666/>, (accessed on: June 20, 2011)

⁷⁹ "Pakistan's Banking Sector Industry Analysis", <http://www.oppapers.com>, (accessed on: January 18, 2011)

⁸⁰ Meir Kohn, "Money, Banking, and Financial Markets", 2nd ed. (n.l.: The Dryden Press Series In Economics, 1992), 44

⁸¹ The Banking Act, 2006, Sec 2(1)(f)

⁸² The Banking Companies Ordinance, 1962, Sec 5(b)

(c) "Banking company" means any company which transacts the business of banking in Pakistan and includes their branches and subsidiaries functioning outside Pakistan of banking companies incorporated in Pakistan;"⁸³

So a banking company is that which renders the financial services (deposit, lending and transactions of investment of money) to the public. Therefore, banks are financially sound and declining their links firmly with the real world for endorsement of savings, investment and development. As the prosperity of banking sector and business succession is significant in order to evaluate the soundness and steadiness of the banking sector.⁸⁴

The banks play the vital role in the financial sector of Pakistan as well, in fact it not gainsaying that the banks governs the financial system.⁸⁵ A strongly established financial sector can provide an economic boost to the economy. And the fact that Banks form the strength of any economy⁸⁶ cannot be overlooked.

Here it is mentionable that mostly the financial sector is governed by some highly organized body which is mostly a governmental institution. So in case of Pakistan's financial sector the governing body is 'The State Bank of Pakistan'. It is the central bank of the state and also assists the government in governing matters of financial sector.

As the preamble of State Bank of Pakistan Act, 1956 puts the responsibility to governs the financial and credit system of Pakistan and to promote its growth in the best national interests with a view to securing monetary stability and comprehensive utilization of country's productive resources⁸⁷ to SBP. It drafts the rules and regulations accordingly for the day to day affairs of the banks, as it tries to cut short the benefits of depositors and borrowers.⁸⁸

⁸³ The Banking Companies Ordinance, 1962, Sec 5(c)

⁸⁴ Khizer Ali, Muhammad Farhan Akhtar, and Prof. Hafiz Zafar Ahmed, "Bank-Specific and Macroeconomic Indicators of Profitability – Empirical Evidence from the Commercial Banks of Pakistan", (*International Journal of Business and Social Science*, Vol. 2 No. 6; April 2011), 235

⁸⁵ Abhay Gupta, "Comparing Bank Lending Channel in India and Pakistan", <http://mpira.ub.uni-muenchen.de>, (accessed on: June 20, 2011), 8

⁸⁶ Economic Updates - Exclusive Articles, "Bank lending needs refocusing", (*Business Recorder*, Tuesday, 26 April 2011), www.forexpk.com (accessed on: 30 April, 2011)

⁸⁷ Dr. Asrar H. Siddiqi. "Practice and law of banking in Pakistan", 8th ed. (Karachi: Royal Book Company, 2007),

32.

⁸⁸ Ishrat Husain, "Banking sector reforms in Pakistan", (*Blue Chip - The Business People's Magazine*, January 2005.), 7

The SBP brought inevitable reforms to the banking sector with the passage of time, which puts positive impacts on the system. As the banks are the backbones of any economy, so SBP is trying hard to keep the pass with the time, by providing the updated rules and regulations along with a check on the implications of those rules.

Therefore “The State Bank of Pakistan while keeping in view the strategic positioning of the banking sector in the country, has introduced a number of reforms, restructuring regulations and policies aiming at brining refinement in this important organ of economy.”⁸⁹

The economic growth increased by the increasing rate of trade activity. And the banks play the vital role by providing financial assistance to the corporate sector. The banks are the most reliable and organized source of lending, for the companies to invest in the enhanced business ventures. The companies get into the long term risky projects because of the financial assistance of the banks. So the government and the regulatory agencies should provide the environment of the kind that the standards of banking system should be consistent with the global practical evidence.⁹⁰ Hence, the policy makers should ensure the fiscal and economical incentives⁹¹ for the businesspersons along with the good returns to the financial institutions, so that the economy can grow to the new echelons. .

Loan Transactions of the Companies with the Banks:

As discussed earlier, leasing is a contractual agreement among two parties.⁹² The companies use to take lease from the creditors, and the banks are the most reliable creditor. So in the usual practice of corporate sector the banks are considered as the priority for the financial assistance. There is a proper process of lending which includes all the legal requirements to be followed.

⁸⁹ Syed Umar Farooq, Sajjad Ahmad Afridi, and Waqar Alam, “Banking Reforms in Pakistan-Impacts & Implications”, (*International Bulletin of Business Administration, Issue 7, 2010*), 57

⁹⁰ Abhay Gupta, “Comparing Bank Lending Channel in India and Pakistan”, <http://mpira.ub.uni-muenchen.de> , (accessed on: June 20, 2011), 49

⁹¹ Dr. Tariq Hassan, “Legal framework for economic development in Pakistan”, (*Pakistan & Gulf economist, December 11, 2000*) (No. 50) 31, 4

⁹² Mark Havers, “Microenterprise and small business leasing – lessons from Pakistan”, (*Small Enterprise Development Journal, Vol. 10 No. 3*), www.google.com.pk (accessed on: June 24, 2011)

The loan transactions are of different kinds, according to the requirement of the borrower. And the bank also needs to check out the borrowers' details, to be on the safe side in context of the repayment of those loans, that is why banks require comprehensive documentation.⁹³ Although there is a great demand of credit from the banks and the bank use to lend by the specialized loan transactions. Those transactions usually include; Overdraft, Cash finance, and Loans.

a. Overdraft

“This is a short term facility which is granted to the borrower to enable him meeting his day to day funding needs; like payment of salaries, utilities and purchases of inventories etc. An agreed limit is sanctioned by the bank and the borrower is allowed to draw that amount through his current account.”⁹⁴

Thus the most common form of bank finance⁹⁵ is overdraft. When a borrower requires provisional adjustments⁹⁶, his bank allows withdrawal on his account in excess of the balance which the borrowing customer has in credit, and an overdraft thus occurs. This kind of accommodation is allowed against parallel securities.⁹⁷

Where the borrower cannot give any collateral security except his personal security, such accommodation is called clean overdraft.⁹⁸ But when the borrower offers collateral security, such accommodation is termed as secured overdraft.⁹⁹ The facility of overdraft is also known as ‘Running Finance’ in the modern banking system.

The banks use to charge a noticeable fee for granting any overdraft to the borrowers, even sometimes the overdraft services, including outsized fees for small debit card transactions.¹⁰⁰

⁹³ Kashif Hamid, Abaidullah, “Financing the Small and Medium Scale Enterprises in Faisalabad (Pakistan)” (*Journal of Agriculture & Social Sciences*, 2006), 107

⁹⁴ Mansoor Hassan Siddiqui, Allauddin Achakzai, and Farzand Ali, “SME Financing Products”, (Pakistan: State Bank of Pakistan, 2011), 5

⁹⁵ Sidney Mandell, *Laws Governing Banks And Their Customers*, (America: Oceana Publication, Inc, 1975), 74.

⁹⁶ Asrar H. Siddiqi, “Practice and law of banking in Pakistan”, 6th ed. (Karachi: Royal Book Company, 1998), 259

⁹⁷ “Bank Loans for Small Businesses”, <http://smallbusiness.dnb.com/> (accessed on: June 24, 2011)

⁹⁸ Fitzgerald Demond, *Elements of banking 1&2*, (London: Financial training publications limited, 1983), 167.

⁹⁹ Ibid.

¹⁰⁰ “Overdraft loans overview”, www.responsiblelending.org (accessed on: June 25, 2011)

Anyhow this kind of transaction is very useful for the companies to fulfill their urgent financial requirements.

“Generally a current account holder is allowed to withdraw money in excess of his own credit balance, upto a certain limit sanctioned by the bank.”¹⁰¹

The banks usually allow this kind of loans to those customers who have a stable source of income so that the repayment can be ensured. Since, it is a short term loan so the banks deduct the amount as soon as it is deposited in the account. The overdraft is a flexible facility provided to the companies, and it can be an enormous financial support for handling the day to day monetary matters.

b. Cash finance

The foremost segments of bank operations are involved in borrowing and lending¹⁰², and the corporate sector is one of the main borrowers of the banks. Usually the extensive business ventures need the services of financial lending by the banks.¹⁰³ In this context, another very frequent form of lending is Cash Finance.¹⁰⁴

This is a very widespread form of borrowing by the commercial and industrial concerns, and is made available either against pledge or hypothecation of commodities, produce or goods.¹⁰⁵ In cash finance, a borrower is allowed to borrow money from the bank up to a certain limit, either at once or as and when required. The borrower prefers this form of lending due to the facility of paying markup charges only on the amount he actually utilizes.

“Under this type of financial accommodation the facility amount is disbursed in specially opened account for the purpose. The pledged goods are released to the borrower against cash

¹⁰¹ Mohammed Julfeekar Haider, “Types of Loans provided by banks; Methods of lending money by bank”, www.indiastudychannel.com (accessed on: June 25, 2011)

¹⁰² Khizer Ali, Muhammad Farhan Akhtar, and Prof. Hafiz Zafar Ahmed, “Bank-Specific and Macroeconomic Indicators of Profitability – Empirical Evidence from the Commercial Banks of Pakistan”, (*International Journal of Business and Social Science*, Vol. 2 No. 6; April 2011), 238

¹⁰³ Ishrat Husain, “Banking sector reforms in Pakistan”, (*Blue Chip - The Business People's Magazine*, January 2005.), 7

¹⁰⁴ Ikram Rahim, “Evolution of Banks in Pakistan”, (Final Internship Report on NBP, June 27, 2011), 33, www.google.com (accessed on: June 25, 2011)

¹⁰⁵ Asrar H. Siddiqi, *Practice and law of banking in Pakistan*, 6th ed. (Karachi: Laureate packages, 1998), 254.

payment only. In case the goods pledged are seasonal in nature, the customer would be required to adjust the facility before the season ends. Rollover shall not be allowed.”¹⁰⁶

Usually the transaction of Cash Finance is for a longer term and a larger amount than that of Overdraft, as the latter can be issued of even days. Therefore, this loan is given for an outsized amount and for a longer interlude. Interest is charged on the amount truly withdrawn by the borrower.¹⁰⁷ If the borrower does not consume the entire cash allotted, the banker has to lose return on the “un-utilized”¹⁰⁸ amount. In order to counterbalance this loss, the bank may provide for a suitable stipulation in the agreement of cash finance.¹⁰⁹

The major divergence between a ‘cash finance’ and ‘overdraft’ is that cash finance is a bank funding used for long term by corporate concerns, whereas an overdraft is a transitory adjustment.

However, “For short-term loans, the asset conversion cycle, rather than long-term profitability of the business and cash generation, is more critical to an assessment of the probability of loan repayment.”¹¹⁰

c. Loans

“The primary purpose of a bank is to provide loans to trading companies. Banks provided funds to allow businesses to purchase inventory, and collected those funds back with interest.”¹¹¹

When a consumer borrows from a banker a predetermined amount repayable either in periodic repayments or in lump sum at a fixed future time, it is called a loan.¹¹² When the banks allocate loans to their customers aligned with collateral securities these are termed as ‘secured loans’ and

¹⁰⁶ “Cash Finance”, <http://www.bop.com.pk> (accessed on: June 24, 2011)

¹⁰⁷ Mohammed Julfekar Haider, “Types of Loans provided by banks; Methods of lending money by bank”, www.indiastudychannel.com (accessed on: June 25, 2011)

¹⁰⁸ Asrar H. Siddiqi, *Practice and law of banking in Pakistan*, 6th ed. (Karachi: Laureate packages, 1998), 254.

¹⁰⁹ Ibid, 256

¹¹⁰ Joselito Gallardo, “Leasing to Support Micro and Small Enterprises”, (*Financial Sector Development Department, The World Bank, October 1997*), 4

¹¹¹ Modassir, “Role of Commercial Banks Lecture # 15”, www.google.com.pk (accessed on: June 24, 2011) slide#8

¹¹² Ikram Rahim, “Evolution of Banks in Pakistan”, (Final Internship Report on NBP, June 27, 2011), 46, www.google.com (accessed on: June 25, 2011)

where no collateral security is provided those are labeled 'clean loans'. The bank puts the amount of loan at the borrower's access in a separate account for the fixed period agreed upon, and the interest is allocated on the complete loan amount as determined by the bank.¹¹³

Therefore, the bank provides a fixed amount for the borrower, whereas the banks are satisfied for such lending of loans of a fixed term against an appropriate security. These loans include 'short term loans' which are provided for the day to day needs of the business and for a term up to one year.

While, the 'medium term loans' are provided by the banks for the directorial expenses of the business and are lend for a term up to five years. And, lastly the 'long term loans' which are granted for the investment purposes and the term of these loans is six to ten years. This facility of loans is for the long period of time as compared to the other ones as discussed earlier, so the banks demand an evenhanded security as well.

Most likely that can be any immovable property. The bank prefers to first make sure the repayment of the loans, and the mode of repayment is decided prior to the grant of such loan. In normal practice such loans are re-paid in standard installments or fractional repayments. Otherwise the loans can be paid back to the bank in lump sum by the due date as decided in the loan transaction.

There is a thick line of distinction between the 'Cash Finance' and 'Loans'. Normally, the cash finance is offered for short term, adjacent to moveable property, and banks also indicts markup on the used amount of the account.¹¹⁴ Fixed loans are generally allotted for long term, against the immovable property, and the bank charge interest on the total amount of loan whether consumed or not.¹¹⁵

¹¹³ Mohammed Julfekar Haider, "*Types of Loans provided by banks; Methods of lending money by bank*", www.indiastudychannel.com (accessed on: June 25, 2011)

¹¹⁴ Qazi Shahzad Ehtesham, "*Principles of Banking*", 2nd ed., (Lahore: Azeem Academy Publisher & Book Seller, 2008), 156

¹¹⁵ Ibid, 157

Securities --- banks take while lending:

Banks lend clean financial advances¹¹⁶ as well as guaranteed advances¹¹⁷ against promissory notes, and tangible and marketable securities respectively. Some common securities for the bank advances are as follows:

- a. **Banker's lien:** lien is the right of the bank as long as the claim on the property is paid¹¹⁸;
- b. **Pledge:** pledge is defined in Section 172 of the Contract Act, 1872 as the bailment of goods as sanctuary for repayment of a debt or performance of a undertaking is called pledge¹¹⁹
- c. **Hypothecation:** where the property in the goods is charged as security for a loan from the bank but the ownership remains with the borrower, the goods are said to be 'hypothecated' the possession of property is not transferred in hypothecation.¹²⁰
- d. **Guarantees:** Guarantee is an undertaking to perform the promise, or release the liability, of a third person, in case of his default.¹²¹
- e. **Indemnity:** Indemnity is a contract, by which one party agrees to save the other from loss caused to him by the behavior of the promisor himself or by any other person, is called a 'contract of indemnity'.¹²²
- f. **Charge:** Section 100 of the Transfer of property Act, defines 'charge' in the following terms: "where immovable property of one person is by the act of parties, or operation of law, made security for payment of money to another, and the transaction does not amount to a mortgage, the latter person is said to have a charge on the

¹¹⁶ Asrar H. Siddiqi, *Practice and law of banking in Pakistan*, 6th ed. (Karachi: Laureate packages, 1998), 259

¹¹⁷ Ibid.

¹¹⁸ Sidney Mandell, *Laws Governing Banks And Their Customers*, 75.

¹¹⁹ See Also, Sir Jhon Paget, *Law of banking* 6th ed. 451. "Where the security is professedly handed over for the purpose of security an overdraft or an advance, the transaction is strictly of the nature of a pledge or an equitable mortgage";

¹²⁰ See Also, Dr. Hart, in his book *The Law of Banking*. Defines hypothecation as "a legal transaction whereby goods may be made available as security for a debt without transferring either the property or the possession to the lender

¹²¹ The Contract Act, 1872, Sec.126

¹²² The Contract Act, 1872, Sec.124

property; and all provisions herein before contained which apply to a simple mortgage shall, so far as may be, apply to such charge".¹²³

Lending policies of the banks:

The most credible financial institution in the corporate world is the banks. They provide the financial assistance to the corporate sector, and they are the most reliable creditors of companies. Therefore, the banks have to follow some specific lending process¹²⁴ for granting loans to the companies.

As lending is the foremost task of the banks, they collect the finance from the public and put them into some reasonably profitable business. The banks are bound to be very vigilant while lending as they not only have to select the suitable borrowers but also have to keep in line with the overall national development plans.

The banks as creditors have to perform their functions in conformity with the current national credit policy chalked down by the State Bank of Pakistan. The SBP drafts a set of prudential regulations for the banks to follow while rendering their financial services. So the banks follow the standard principles of lending¹²⁵ in process of granting any financial assistance¹²⁶ to their borrowers.

There is absolutely no doubt that methodical perception as well as accurate application of lending principles is of supreme importance for managing risk in financial sector. The company's borrowing capacity and legal status must be examined before sanctioning loan to it. The usual lending policies of the banks are:

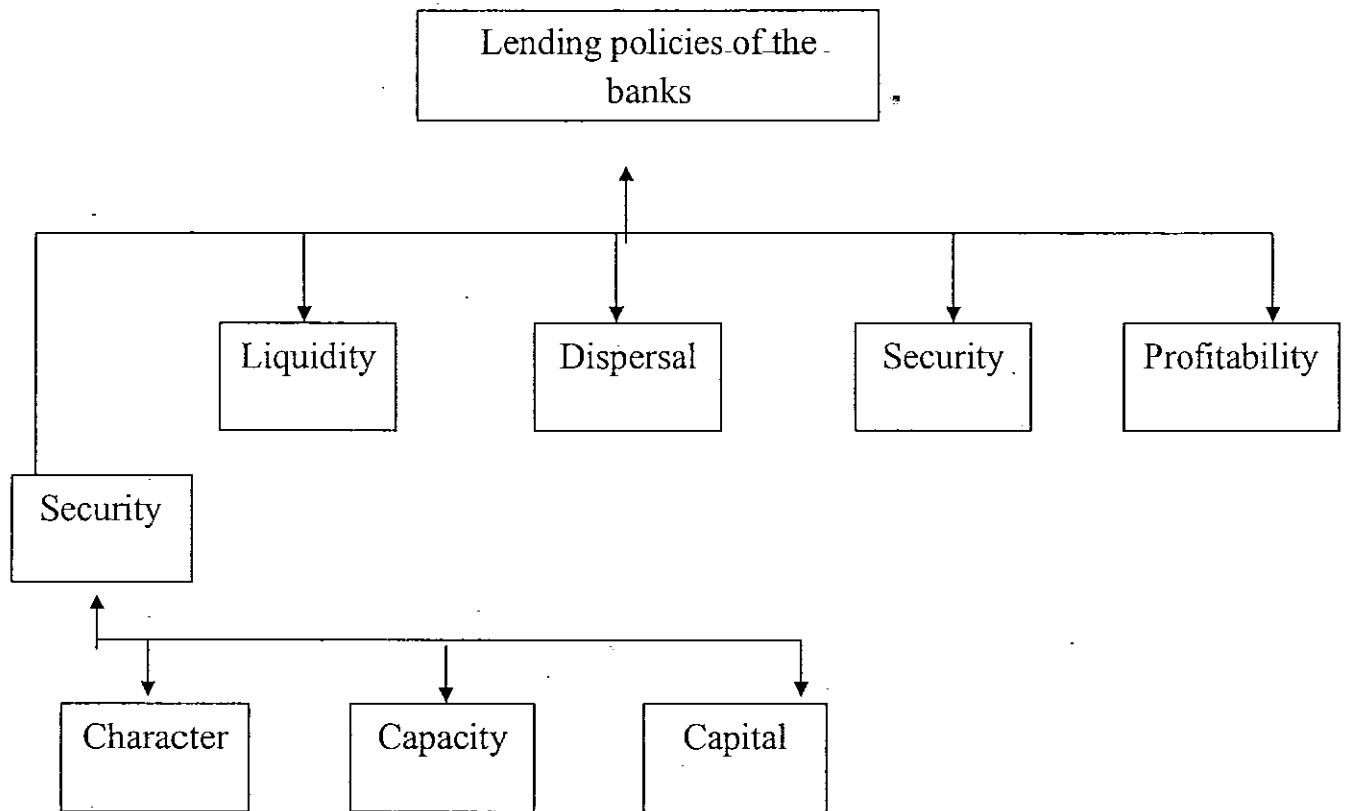
¹²³ The Transfer of Property Act, 1882, Sec.100

¹²⁴ Nadeem Hussain, "Successes and Challenges in Microfinance Banking", (Karachi: Dawn, May 13, 2006)

¹²⁵ Dr. Asrar H. Siddiqi, *Practice and law of banking in Pakistan*, 8th ed. (Karachi: Royal Book Company, 2007),

267

¹²⁶ Mansoor Hassan Siddiqui, Allauddin Achakzai, and Farzand Ali, *"SME Financing Products"*, (Pakistan: State Bank of Pakistan, 2011), 6



Therefore, the bank follows a set of lending policies which are the key “principles of lending. They are as follows:

a. Safety

“Banker’s funds comprise mainly of money borrowed from numerous customers on various accounts ... It indicates that whatever money the banker holds is that of his customers who have entrusted the banker with it only because they have full confidence in the expert handling of money by their banker. Therefore, the banker must be very careful and ensure that his depositor’s money is advanced to safe hands where the risk of loss does not exist. The elements of character, capacity and capital can help a banker in arriving at a conclusion regarding the safety of advances allowed by him.”¹²⁷

¹²⁷ Ikram Rahim, “Evolution of Banks in Pakistan”, (Final Internship Report on NBP, June 27, 2011), 43, www.google.com (accessed on: June 25, 2011)

Character: The most significant factor in the outlining of the safety of finance is the character of the borrower. As a borrower's character can specify his plan to repay the loans. If the borrower's past record shows that his reliability has been doubtful, the bank should not lend any loan to such borrower, especially when the securities presented by him are insufficient for the repayment of the loans.

Capacity: The term capacity here means 'the management ability factor', it indicates the past performance and future possibilities of a business. The specific business sense along with the capabilities to manage the business can make it a profitable venture beside the nominal financial status. And if the situation is reverse then the one aforementioned then there are more chances for the banks loose of the funds, so here again the banks needs to be vigilant.

Capital: This factor can be said as a monetary check, because the capital of any business is a prima facie evidence of the success. The banks usually provide short term capital to the corporate concerns, yet at times the companies require the large amounts as the capital from the banks. Here the bank needs to focus the core issue that the investment is safe and profitable, otherwise should avoid any such situation.

b. Liquidity

Here the term 'liquidity' means the immediate repayment of loan, as the bank should be able to recover the payment in case of urgency. A banker will lend loan to a customer only if he has complete confidence in the customer's willingness and ability to pay back the loan in terms of regular interest payments and to repay the amount on the due date.¹²⁸ Hence this principle of landing is to be strictly followed by the banks so that the loan amount should be safely returned.

c. Dispersal

The dispersal of the amount of finance should be generality based so that the larger number of customer can get the financial assistance from the banker's funds.

"The banker must ensure that his funds are not invested in specific sectors like textile industry, heavy engineering or agriculture. He must see that from his available funds he

¹²⁸ D.G.Hanson, "Service Banking, The arrival of all-purpose Bank", 2nd ed., (England: Staples printers Rochester limited, 1983), 62

advances them to a wide range of sector like commerce, industry, farming, agriculture, small business, housing projects and various other financial concerns in order of priorities.”¹²⁹

Distribution of finance is very crucial from the security point of view as well, because it increases the risk of loss when a particular sector grabs the major share of the funds.

d. Security

While granting any credit facility, principle of security is of crucial importance. As the banks have to take all precautionary measures for any kind of loan default. The most appropriate time to ask for the reasonable security is at the drafting of the loan transaction.

The security against the bank lending is required “to cover the bank against loss in the event of unforeseen circumstances which prevent the borrower repaying the loan ... to emphasise to the borrower that they share the risk undertaken by the banks. This is a form of insurance for the lending bankers and will make the borrowers act in a prudent manner if the borrower’s own assets are at risk.”¹³⁰

e. Profitability

The bank has to be certain at the time of lending any credit facility that the sound rate of interest should be agreed with the borrower which can provide a suitable profit to the bank. The core purpose of commercial bank is to earn profit. So, the granted loan should provide a realistic profit.¹³¹ The banks must make every effort of improving there legitimate interest under the legal cover and process. As “the main desirability in extending financial services to the passive consumer segment is for the view of earning better interest rate spread ...”¹³²

As aforesaid the banks are the most reliable and organized creditors of the corporate sector. And the companies mostly relay on the banks for the financial assistance. The banks have to tolerate

¹²⁹ Dr. Asrar H. Siddiqi, *Practice and law of banking in Pakistan*, 8th ed. (Karachi: Royal Book Company, 2007), 267

¹³⁰ Fitzgerald Demond, *Elements of banking 1&2*, (London: Financial training publications limited, 1983), 173

¹³¹ Qazi Shahzad Ehtesham, “*Principles of Banking*”, 2nd ed., (Lahore: Azeem Academy Publisher & Book Seller, 2008), 158

¹³² “*Bank Lending: the new challenges*”, (Pakistan: A publication of The Institute of Bankers, 2004), 35

the credit risk of the finance they lend,¹³³ with the nominal interest rate. The SBP regulates the financial institutions and have drafted the regulations to harmonize the borrower and lender relationships, along with keeping the interests of both. While, the continuing rise in the interest rates has the probability of affecting the credit reimbursement capacity of borrowers,¹³⁴ but at the same time the companies are also taking benefits of the financial services of their own choice and manner.

Documentary requirements of the bank

“There is a system of documentation(s) existing in respect of financing(s), which starts after the grant and /or approval of the application of the customer(s)/borrower(s) by the financial institution(s), in shape of the issuance of the sanction letter/advice.”¹³⁵

Being the government regulated institution; the banks follow the prescribed pattern of transactions for advancing any financial facility. SBP designed the prudential regulations for the financing of the corporate sector. Those regulations require the banks to obligate the company to submit the following documents¹³⁶ while applying for a loan:

- a. Application of finance;
- b. Borrower's basic fact sheet;
- c. Financial audit report;
- d. Memorandum of association of the company;
- e. Articles of association of the company;
- f. Form-29;
- g. Credit information (borrower's report);
- h. Search report;
- i. Copy of the special resolution passed in the AGM;
- j. Certificate of incorporation;

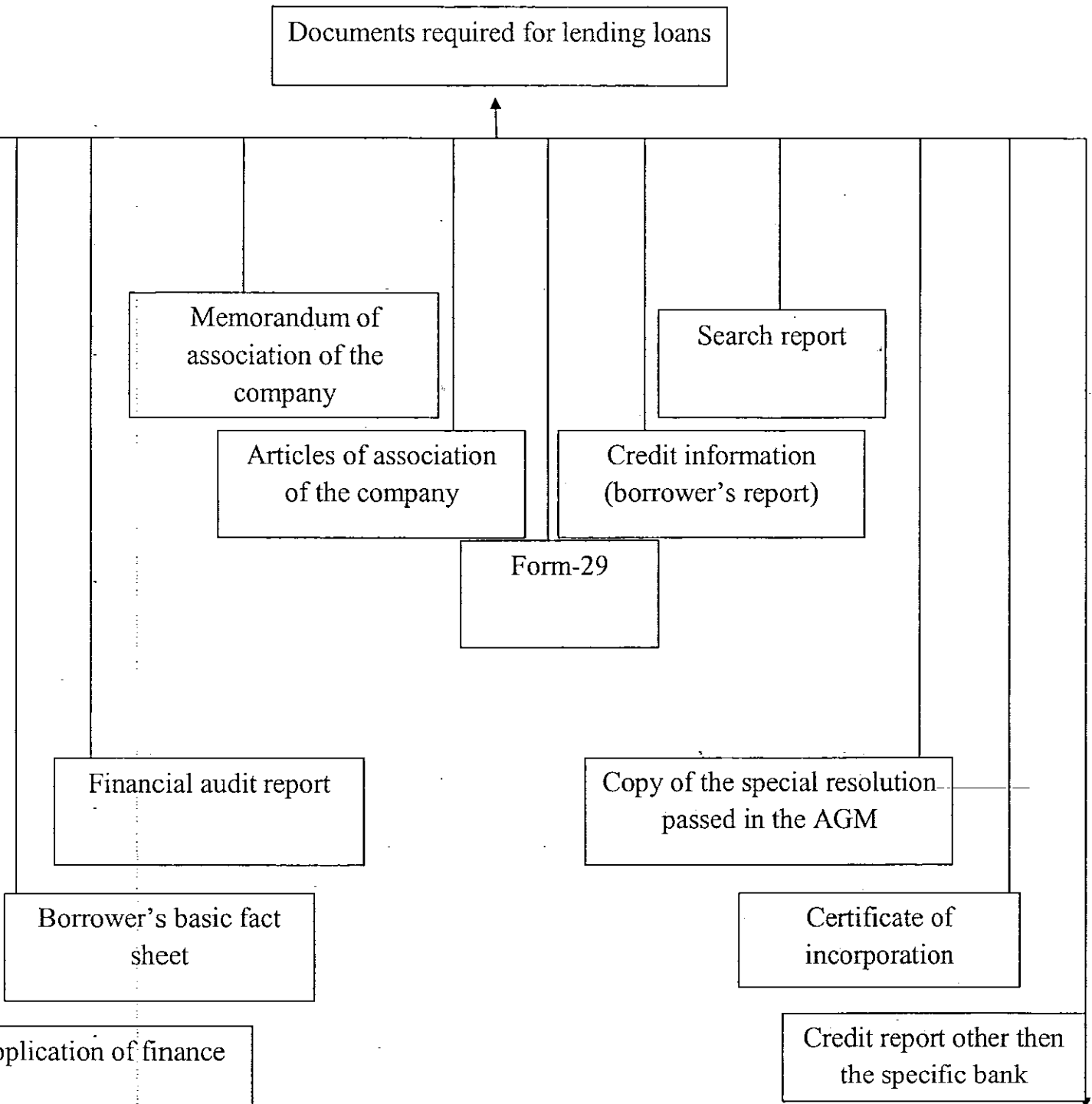
¹³³ Meir Kohn, *Money, Banking, AND Financial Markets*, 2nd ed. (n.l.: The Dryden Press Series In Economics, 1992), 44

¹³⁴ Syed Umar Farooq, Sajjad Ahmad Afridi, and Waqar Alam, “Banking Reforms in Pakistan-Impacts & Implications”, (*International Bulletin of Business Administration, Issue 7, 2010*), 55

¹³⁵ Saalim Salam Ansari, “*Documentation(s) in Respect of Financing(s) and/or Mortgage(s)*”, (*Corporate Law Decisions*, 2006), 22

¹³⁶ “Prudential Regulations for Corporate/Commercial Banking”, www.sbp.org.pk (accessed on: July 25, 2010)

k. Credit report other than the specific bank.



These documents¹³⁷ are required by the banks to ensure that the company borrowing the loan can payback it by the specified time.¹³⁸ These documents are required just to ensure the safety of the finance advanced to the company. The detail of the above mentioned documents is as follows;

a. Application of finance

The financial services are provided by the banks to the companies through a proper process, and the borrowers file an application of finance for initiating the process to borrow. The application of finance is the first document which carries the summarized data of all required information from the borrower.

“The application for finance provides an overview of the individuals involved, the proposed business venture and the financial structures, together with some background of records. The application should be submitted with a comprehensive business plan.”¹³⁹ The application of finance is to be accompanied with the followings.

b. Borrower's basic fact sheet

The borrower's basic fact sheet¹⁴⁰ is the document which contains all the factual information about the borrower. As the prescribed Performa¹⁴¹ of basic fact sheet is drafted to be filled and submitted by the borrower. Basically this document is the summarized facts about the details of the borrower, which normally includes borrowers' profile, details of directors, corporate status, and nature of business, along with the detail history of the past loans, and the securities etc. It also includes the details of director's personal guarantees in case of company's default.

c. Financial audit report

The financial audit report is a recognized opinion, or repudiation, drafted by the internal or external auditor as a result of an internal or external financial audit done for a legal entity. The

¹³⁷ See also, diagram, 46

¹³⁸ “Interview Excerpts”, Ammara, Adnan. Credit analyst, MCB regional branch, Islamabad (August 5, 2008)

¹³⁹ “Application of Finance”, www.standardbank.co.za (accessed on: July 3, 2011)

¹⁴⁰ “Prudential Regulations for small and Medium Enterprises Financing”, Annexure I, (Banking Policy & Regulations Department, State Bank of Pakistan: January, 2009)15

¹⁴¹ See Also, Annexure I, 96

financial audit report is required by the banks for lending loans on the bases of the results of that financial audit report, as that report shows the actual financial position of the business concern.

An auditor's report is considered an essential tool when reporting financial information to users, particularly in business. Since many third-party users prefer, or even require financial information to be certified by an independent external auditor, many auditors rely on auditor reports to certify their information in order to attract investors, obtain loans, and improve public appearance.¹⁴²

So this audit report brings the clear picture of the financial status of the borrower, and the decision making for the bank becomes easier.

d. Memorandum of association of the company

The memorandum of association is also said to be the constitution of the company and it administrates the business operations by marking the clauses of what a company can do and what it cannot.¹⁴³ The bank requires the borrowing company to submit a copy of it along with other documents. In fact, it is crucial documents of the company, which set out the relation of the company with the outsiders.

"It is a document which sets out the constitution of a company and, as such, it is the foundation on which the structure of the company is based. It defines its relations with the outside world and the scope of its activities."¹⁴⁴

e. Articles of association of the company

The article of association is another very crucial document relating to a company as it provides the complete internal structure and working of the corporate entity. Therefore, the articles are the regulations made by the company for the internal management of its affairs and for implementation the objects of the company.¹⁴⁵ The bank obliges the borrower to submit a copy of articles of association to the bank while applying for the loan.

¹⁴² "Auditor's Report", <http://en.wikipedia.org/wiki> (accessed on: July 3, 2011)

¹⁴³ "Memorandum of Association", <http://www.secp.gov.pk> (accessed on: March 20, 2011)

¹⁴⁴ *Egyptian Salt and Soda Ltd. v. Port Said Salt Association Ltd. (1931) A.C. 677*

¹⁴⁵ A.G. Chowdhry, "Company Law in Pakistan", (Lahore : Khyber Law Publishers, 1994), 25

f. Form-29

The bank requires the borrowing company to provide a filled copy of Form-29¹⁴⁶ along with the other documents. That form would give the detail information about the particulars of the directors and other officers, including the company secretary, the chief executive, the accountants and auditors, and the legal advisor too. The Section 205 of the Companies Ordinance, 1984 provides requirement for the form- 29.¹⁴⁷ So the borrowing company has to furnish the details about its officers in the form of form-29.

g. Credit information (borrower's report)

Another mandatory condition for the borrowing company is to endow a credit report which should state the detailed information about the credits of the company. This report should also mention the complete details about the credit borrowed in the past and at the present. The bank requires this information so as to have a clear picture of the credit history along with the repayment issues of the borrower.

h. Copy of the special resolution passed in the AGM

In addition to the above mentioned documents, the company also has to submit a copy of the special resolution passed in the AGM of the company¹⁴⁸. The law requires passing a special resolution in the AGM to borrow from the bank. The special resolution is drafted in a prescribed form.¹⁴⁹ The intension of law behind this requisition is that all the stakeholders of a company should have the knowledge of any such borrowing, and there consent should be taken before taking such step.

i. Certificate of incorporation

The certificate of incorporation¹⁵⁰ is the documentary proof of the existence of a corporate entity. The certificate of incorporation declares a company to be registered with its name, kind and date of registration as well. So it is to be accompanied with the other documents as well. The bank

¹⁴⁶ See Also, Annexure III, 100

¹⁴⁷ Section 205, Companies Ordinance, 1984

¹⁴⁸ Section 172, Companies Ordinance, 1984

¹⁴⁹ See Also, Annexure IV, 101

¹⁵⁰ See Also, Annexure II, 99

tries hard to avoid any problematic situation that is why it requires all possible proofs from the borrowing company.

j. Credit report other than the specific bank

The banks determine the credibility of the borrowing company with the help of the credit report. It is crucial to note that the credit report is required by another institution rather than the specific lender of that borrower. These measures are taken for the safety of the finance.

So, the required "Credit report is Personal file that contains factual records of consumer's credit activities which are used by potential lenders to evaluate credit reliability. Credit report reflects variety of information about credit history like open and closed loan accounts, credit balances, and history of payments."¹⁵¹

The abovementioned documents are the least required list for the bank lending. As there is a incredible requirement of bank credit¹⁵², the banks need to be extremely vigilant while granting finance to any corporate entity.

"Lending is one of the primary services of the Bank and involves issuing credit to a customer where the customer does not immediately repay the Bank. With any type of lending, lending documents are used to create a legal agreement and collect and verify information concerning the borrower."¹⁵³ The banks can "effectively manage their resources and risks with the help of all these documents specially the financial information"¹⁵⁴

Being the most regulates and systemized lender, the banks are ought to provide financial assistance to the borrowers, but at the same time they need to use all the means and ways to avoid any possible malpractice with regard to the financing.

In this regard the banks are entitled to apply the doctrine of strict compliance, as "the legal principle that the bank is entitled to reject documents which do not strictly conform to the terms of the credit is conveniently referred to as doctrine of strict compliance. It means that,

¹⁵¹ "Credit Report", <http://forumpkonline.com/?p=3366> (accessed on: July 5, 2011)

¹⁵² Ishrat Husain, "SME Financing - Issue and Prospects", Key note address at the SMEDA-IBP seminar on "Issue of SME financing" held at Lahore on October 24, 2003

¹⁵³ "Corporate Lending Documents", www.bankersacademy.com (accessed on: July 3, 2011)

¹⁵⁴ Muhammad Bashir Chaudhry, "Prudential regulations for SMEs", (Karachi: DAWN – Business, August 18, 2003)

upon presentation of document by the seller, the bank must examine the document to ensure that they comply on their face, with the terms of the credit and decide whether to accept or reject the documents.”¹⁵⁵

Now, the most crucial requisition of the bank for lending loan to a limited company is, obtaining the personal guarantee¹⁵⁶ of its directors.

Personal guarantee of the directors is required

The banks require the company to provide personal guarantee of its directors for the repayment of the loans of the company in case of its default.

Under the regulation R-2 of the Prudential Regulations for Small and Medium Enterprises Financing¹⁵⁷ provided by the State Bank of Pakistan the companies are required to submit personal guarantee of all directors other than nominee directors¹⁵⁸, while applying for the loan. Along with this the regulation R-10 Prudential Regulations for Corporate/Commercial Banking also provides as banks shall originate a policy, duly approved by their board of directors, about acquiring personal guarantees of directors of private limited companies.¹⁵⁹

This requirement is allowed by the regulations of the State Bank of Pakistan, because SBP is the authorized institution for drafting the regulations for the banks of Pakistan.

As the same instructions are given as; “refer to clause (D) of BCD Circular No. 7, of 31st May 1972 reproduced as under:- “No banking company shall, make advances to a private limited company without obtaining personal guarantee of the directors of such company, in addition to the normal security which the banking company may require.”¹⁶⁰

¹⁵⁵ Malik Muhammad Hafeez, “Importance of Letter of Credit in International Trade”, (Pakistan Law Journal, March 2006)

¹⁵⁶ The Institute of Bankers, “Questions on banking practice”, 11th ed. (London: published by The Institution of Bankers, 1978), 22

¹⁵⁷ Prudential Regulations for Small and Medium Enterprises Financing, www.sbp.org.pk (accessed on: July 25, 2010)

¹⁵⁸ Muhammad Naseem Chaudhri, *Complete banking laws in Pakistan*, (Lahore: Lahore law time publication, 2005), 1483

¹⁵⁹ Dr. Asrar H. Siddiqi, *Practice and law of banking in Pakistan*, 8th ed. (Karachi: Royal Book Company, 2007), 423, Appendix - X

¹⁶⁰ “BSD Circular Letter No. 22”, “BSD Circular Letter No. 21” and “BSD Circular Letter No. 6”, www.sbp.org.pk (accessed on: July 3, 2011)

It is the usual practice of the banks to obtain personal guarantee of the directors in addition to the other securities. Such personal guarantee would be more significant if the resources owned by these owners/directors.¹⁶¹ But, here comes a point of divergence and that is the company is a separate legal person who is responsible for its legal obligations on its own. And no one else can be held liable for its liabilities, even if he is the director or any other officer or stake holder of the company.

The directors are required to give the personal guarantee without the seal of the company.¹⁶² This shows the intension of the bank to bind the directors in case of default by the company.¹⁶³

“Since long the banks and public financial institutions (hereinafter collectively referred to as ‘the Banks’) have unilaterally and arbitrarily developed a practice, without authority of law, to execute personal guarantee agreements with the directors of a company to secure the debts of the company. This view is supported by the following latest judgment of the Supreme Court.

Recently, the Supreme Court in the case of *Karnataka State Financial Corporation vs. N. Narasimahaiah & Ors.* (2008 AIOL 348 Civil Appeal No. 610-612 of 2004 Decided on 13/03/2008) has observed as follows (in para 18):

“18. Banking practice may enable a financial corporation to ask for a collateral security. Such security, we would assume, may be furnished by the Directors of a Company but furnishing of such security or guarantee is not confined to the Directors or employees or their close relatives. They may be outsiders also. The rights and liabilities of a surety and the principal borrower are different and distinct.” (emphasis supplied) Therefore, it stands concluded, without any doubt, that the banks have developed the practice to execute personal guarantee agreements with the directors of a company to secure the debts of the company without the authority of law ... This practice is against the principle of limited liability of the shareholders as well as directors of the company as provided in the

¹⁶¹ Muhammad Bashir Chaudhry, “Prudential regulations for SMEs”, (Karachi: DAWN – Business, August 18, 2003)

¹⁶² “Interview Excerpts”, Ammara, Adnan. Credit analyst, MCB regional branch, Islamabad (August 5, 2008)

¹⁶³ Ibid.

Companies Act, 1956. Accordingly, it is clear against the letter and spirit of the Companies —Act and therefore unlawful.”¹⁶⁴

The same practice is followed in Pakistan as well. Although, the courts up held the principle of ‘separate legal entity’ in almost 99% cases, even then at the same time the same principle is being ignored by allowing the personal guarantee of the directors.

As in the case of “*Tariq Saeed Saigol v. District Excise and Taxation Officer, Rawalpindi* [1982 CLC 2387]” the honorable court held that: “the company being a corporate body, cannot be identified with its directors. Its liability to pay the cess is personal in nature, and unless a provision for vicarious liability, is provided in the Ordinance it self, the recovery cannot be made from the petitioner (director), as arrears of land revenue and thus the order to recover the cess by attachment of his personal properties, arrest or other coercive means is utterly without lawful authority... the company is the owner of the factory building, machinery and other assets, far more excess in value, than its outstanding liability, and that the respondent, at the most could recover the amount in question, by attachment and sale of such property... in the first instance recovery has got to be made from the assets of the company.”¹⁶⁵

So, it is evident that the company is it self liable for any kind of debt payable on its name, and it cannot hold any director responsible for the same. This is to say that in case of evasion the directors are not liable, if there is no implementation or existence of personal guarantee.¹⁶⁶

¹⁶⁴ N.K. Sharma, “Director’s Personal Guarantee – A Void Agreement”, <http://www.drtsolutions.com> (accessed on: July 3, 2011)

¹⁶⁵ *Tariq Saeed Saigol v. District Excise and Taxation Officer, Rawalpindi* [1982 CLC 2387]

¹⁶⁶ Saalim Salam Ansari, “Documentation(s) in Respect of Financing(s) and/or Mortgage(s)”, (Corporate Law Decisions, 2006), 28

Chapter # 3: Liabilities Regarding the Recovery of Loans

The Recovery of Loans:

The financial assistance provided by the banks to the corporate entities is funded by the public money, so the reimbursement of that finance is assured by the banks while offering such assistance. The special laws were drafted for the recovery of bank loans.¹⁶⁷ The regulating authorities strive their best to provide the practical method¹⁶⁸ for the speedy recovery of the loans along with the satisfaction of both the ends.

The banks enter into an 'agreement of financing' with the borrowing company, which states all other details along with the "nature of finance and the re-purchase price, if any and / or the schedule of installments, terms and conditions of finance ... further in case of default of any installment(s), the conditions/consequences should be endorsed"¹⁶⁹ after the approval of the application of finance. Because, the bank's much developed "financial management is also protecting its own longer-term interest."¹⁷⁰

The laws for the recovery of loans unfold through enormous modifications in the recent years in Pakistan. Most of these modifications have been designed at providing for precise and efficient recovery of finance owned to banks. There have been modifications in legislation on the matter numerous times to make it more inflexible, efficient and widespread each time. This special law for immediate recovery of loans is titled against the bank debtors.¹⁷¹ The most recent law drafted for this concern is 'The Financial Institutions (recovery of finance) Ordinance, 2001. This law is designed to safeguard the interests of the financial institutions. This Ordinance provides a summarized procedure to recover the defaulted loans from the borrowing company. In fact, this

¹⁶⁷ M.M. Malik, "Banking Courts and Recovery of Loans", (Corporate Law Decisions, 2003), 15

¹⁶⁸ Shahid Jamal Tubrazy, "An Elucidation of Section 15 of the financial Institutions (Recovery of Finances) Ordinance, 2001", (Corporate Law Decisions, 2006), 71

¹⁶⁹ Saalim Salam Ansari, "Documentation(s) in Respect of Financing(s) and/or Mortgage(s)", (Corporate Law Decisions, 2006), 26

¹⁷⁰ Sayyed Adil Latif, "Economic priorities & money management", <http://www.paperarticles.com> (Lahore: Thursday, 23 April, 2009), (accessed on: December 20, 2010)

¹⁷¹ Infra, reference no 1

law enables a bank to take proceedings to collect defaulted debt¹⁷² along with the removal of official difficulties and time hindrances in recovery of evaded loans.¹⁷³

It is the moral and legal obligation of a customer to accomplish his liabilities to the financial institution.¹⁷⁴ Here, the intension of law is that the borrowing companies should fulfill their obligations regarding the repayments of the loans in the specific manner and time as is decided in the agreement of financing. The borrowing company is bound by law to pay back its debts. As according to the principle of 'separate legal entity', a company is a distinct entity and is liable for its obligations itself. Therefore no one else can be held liable including the directors of the company.

The court establishes this rule in so many cases as in the case of "*A. Rehman v. Tehsildar Lahore and another*", the Honorable Malik Muhammad Qayyum, J Held: "...That M/s. Progressive Journalist Ltd. From whom the money is allegedly due is a company incorporated under the Companies Act, 1913 and the petitioner even though its Managing Director has no personal liability ... it needs no gainsaying that in law a company is a distinct entity separate from its shareholders and directors and the liability of the company cannot be passed on to its directors personally".¹⁷⁵

In case of "default" by a company to discharge its liability the law provides a suitable procedure for the recovery of the defaulted loan, and especially 'The Financial Institutions (Recovery of Finances) Ordinance, 2001' provides a summarized process to recover the bad debts. The Section 8 of the said Ordinance allows the financial institutions to file a suit for the recovery of loan against the defaulter. As in the words of the Ordinance, 2001;

"(1) a financial institution may, ... file a suit for the recovery of any amount written off, released or adjusted under any agreement, contract, or consent, including a compromise or

¹⁷² Abhay Gupta, "Comparing Bank Lending Channel in India and Pakistan", <http://mpira.ub.uni-muenchen.de>, (accessed on: June 20, 2011), 7

¹⁷³ Ishrat Husain, "Banking sector reforms in Pakistan", (*Blue Chip - The Business People's Magazine*, January 2005.), 3

¹⁷⁴ The Financial Institutions (Recovery of Finances) Ordinance, 2001, Sec 3(1)

¹⁷⁵ *A. Rehman v. Tehsildar Lahore and another*, 1993 CLC 1222 [Lahore]

withdrawal of any suit or legal proceedings or adjustment of a decree between a financial institution and a customer ...”¹⁷⁶

These provisions of law are applied by the courts while giving any decision. And the courts grant the remedy accordingly. As in the case of “*Federation of Pakistan v. Standard Insurance company Ltd. Karachi*” the court decides to wind up the company for the reason of its inability to pay back the due debts.¹⁷⁷ Similarly the courts use to wound up the companies for there inability to pay there debts. But, it’s not always the same; in fact the court has to decide according to the facts of each case.

As in the case of “*Smith Klin and French of Pakistan Ltd. v. Spencer & Co. (Pakistan) Limited*” the court decide that “the company deliberately failed to pay amount for which they were not only liable to pay legally but which they had admitted as their liability ... and the company being a public limited company and having sufficient assts to meet its liability, it was willing to deposit the required amount ...winding up of company to the effect that company would be wound up and official assignee would be appointed as official liquidator subject to the condition that order of winding up of company would not be given effect to for a period of two months.”¹⁷⁸ This is how the courts grant the remedy accordingly.

Although the banks enjoys the status of secured creditors and they are preferred to be paid in case of winding up of the company. And the same is upheld and appreciated in the case of “*Muhammad Iqbal and others v. Messrs Sampak paper and board mills*” that;

“the amount was distributed amongst secured creditors i.e. PICIC and Pak Libya Holding company, who were the first charge holders as well as the first secured creditors... the company was finally dissolved and official liquidator was directed to distribute the amount to the secured creditors.”¹⁷⁹

Beside all these, the latest remedy for the speedy recovery of the defaulted loan is the concept of sale of mortgaged property without the intervention of court. The Section 15 of the Financial

¹⁷⁶ Infra, reference no 8, Sec 8(1)

¹⁷⁷ *Federation of Pakistan v. Standard Insurance company Ltd. Karachi*, PLD 1986 Kar 409

¹⁷⁸ *Smith Klin and French of Pakistan Ltd. v. Spencer & Co. (Pakistan) Limited*, 1989 MLD 38

¹⁷⁹ *Muhammad Iqbal and others v. Messrs Sampak paper and board mills*, 2009 SCMR 585

Institutions (Recovery of Finances) Ordinance, 2001 provides the process through which Banks can sale out the mortgaged property without involvement of the courts.¹⁸⁰

This remedy is provided to précis the long procedure of filing the suit for the recovery of defaulted amount. The law provides this way out that the Financial Institutions can dispose of the mortgaged property by the public auction in case of evasion.¹⁸¹ This is for the first time that the financial institutions are given the authority to act in this manner without intervention of court.

Although the proper notice is to be issued to the borrower and all formalities to be meet before the application of this remedy. Basically the intension of law behind this provision is to secure and facilitates the smooth recovery outstanding dues owed to the bank.

Company's Liability Regarding Repayment:

The company borrows the loan from a bank as a person¹⁸² and no doubt it is a legal person. The legal personality is the characteristic of non-human entity regarded by law to have the status of a legal person. The legal person has a legal name, rights, liabilities, privileges under law, in fact the whole status like the natural person. It can own property of its own, can sue and be sued, and can borrow or lend.

In the case of application for 'Re Yee Yut Ee', "Yee was the secretary of a company that was a wholly-owned subsidiary of an American corporation. The company had retrenched their staff and dispute arose as to the retrenchment benefits. The matter was brought to the Industrial Arbitration Court where an award was made in the company's absence. As the company did not comply with the award, the Arbitration Court ordered that Yee be personally liable as he had been appointed director by then. The High court held that a director is nor liable for the company's debts."¹⁸³

The same principle is laid down in another judgment of "*Tariq Saeed Saigol v. District Excise and Taxation Officer*" the honorable court held that: "the company being a corporate

¹⁸⁰ M.M. Malik, "*Banking Courts and Recovery of Loans*", (Corporate Law Decisions, 2003), 16

¹⁸¹ Shahid Jamal Tubrazy, "*An Elucidation of Section 15 of the financial Institutions (Recovery of Finances) Ordinance, 2001*", (Corporate Law Decisions, 2006), 71

¹⁸² Len Sealy and Sarah Worthington, "*Cases and Material in Company Law*", 8th ed., (n.l.: Oxford University press, 2007), 31

¹⁸³ *Re Yee Yut Ee*, (978)2 MLJ 142

body cannot be identified with its directors. Its liability to pay the cess is personal in nature, and unless a provision for vicarious liability, is provided in the Ordinance it self, the recovery cannot be made from the petitioner (director), as arrears of land revenue and thus the order to recover the cess by attachment of his personal properties, arrest or other coercive means is utterly without lawful authority... the company is the owner of the factory building, machinery and other assets, far more excess in value, than its outstanding liability, and that the respondent, at the most could recover the amount in question, by attachment and sale of such property... in the first instance recovery has got to be made from the assets of the company.”¹⁸⁴

The law obliges every person to be answerable for the liabilities it own. Same is the case with the company, it borrow the loan so it is the liability of the company to payback the same. This is to say that stakeholders or officers are under no commitment to the company or its creditors beyond their obligations on per value of their shares.¹⁸⁵ And, the company being the legal person is liable to pay its debts and it cannot pass on its liability to anyone else including the directors and all other stakeholders.

As aforesaid, the company is bound to pay back its debts, and the court allows different ways to fulfill its liability towards the creditors. Therefore in the case of “*Muhammad Anwar Khan Tiwana v. Mst. Sadeeqa Begum and 4 others*”, the court held that “the company is at law a different person altogether from the subscriber to the memorandum ... only that property would be liable to be attached in execution of the decree which is shown to be belonging to the company.”¹⁸⁶ This is to say that the company should dispose off its own assets to accomplish its liability.

The court also allows the company to issue new shares in lieu of the debts payable by the company in errand of the creditor. As in the case of “*Metro Management (pvt.) Ltd. v. Privatization Commission of Pakistan and 5 others*” the court held that the Section 86 of the Companies Ordinance, 1984 does allows the company to issue the new shares without issuance of right shares subject to certain conditions. Likewise Section 87 of the Companies Ordinance,

¹⁸⁴ *Tariq Saeed Saigol v. District Excise and Taxation Officer, Rawalpindi*, 1982 CLC 2387

¹⁸⁵ Jhon.H. Farrar, *Company law*, (London: Butterworths, 1985), 80

¹⁸⁶ *Muhammad Anwar Khan Tiwana v. Mst. Sadeeqa Begum and 4 others*, PLD 1984 Lahore 411

1984 also permits issuance of shares for the adjustment of the outstanding debts.¹⁸⁷ Thus, the company can issue shares in context with the fulfillment of its obligations regarding the due debts.

The bank takes many precautionary measures to ensure the repayment of its granted loans. Many documentary requirements are applied by the banks to safeguard its money. The banks use to verify that the loan is used appropriately for the reason it was borrowed,¹⁸⁸ along with the borrower's keenness and capability to pay back a loan in time.¹⁸⁹ The company has to repay the debts so that it can fulfill its liability, and to gain the bankers trust¹⁹⁰ for future loans as well as to get benefit from the bank in the form of financial and economical incentives.¹⁹¹

Director's Liability Regarding Repayment:

The company once incorporated attained the status of a legal person, but it cannot do anything by its own rather it worked through its directors (natural persons). And the directors being the management of the company stands in some crucial duties towards the company. The 'fiduciary' as well as 'skill and care' are the duties which are the most concerning ones with regard to our discussion.

The director stands in a fiduciary duty to the company as he is the one who take the financial decisions and should act in good faith in the interest of the company. So, 'fiduciary' equals; reliability, liberty, no undisclosed profits, no conflict of interest, and justice.¹⁹² Therefore, the directors are liable to perform there duties of allegiance and due care to the company.¹⁹³

As in the case of "*Muhammad Baksh and sons Ltd. v. Azhar Wali Muhammad*" the court held that "the nature of relationship being a fiduciary between a director and company, such

¹⁸⁷ *Metro Management (pvt.) Ltd. v. Privatization Commission of Pakistan and 5 others*, 2003 CLD1393

¹⁸⁸ B.R.Sharma, "*Bank Frauds, including Computer and Credit Cards Crimes Prevention and Detection*", 2nd ed. (Delhi: Universal Law Publishing CO.Pvt.Ltd, 2001), 12

¹⁸⁹ Ishrat Husain, "*SME Financing - Issue and Prospects*", Key note address at the SMEDA-IBP seminar on "Issue of SME financing" held at Lahore on October 24, 2003

¹⁹⁰ D.G. Hanson, "*Service banking, The arrival of all-purpose bank*", 2nd ed. (England: The Institute of Bankers, 1983), 63

¹⁹¹ Dr. Tariq Hassan, "Legal framework for economic development in Pakistan", (*Pakistan & Gulf economist*, December 11, 2000) (No. 50) 31, 4

¹⁹² Richard Smerdon, "*Palmer's Company Law Manual*", 1st ed., (London : Sweet & Maxwell, 2000), 202

¹⁹³ Patrick R. Delaney and Irvin N. Gleim, "*CPA Examination Review Business Law*", (Canada: Jhon Wiley and Sons, Inc, 1984), 341

director should always to act in good faith.”¹⁹⁴ Hence, the rule is basically that “the fiduciary duty is owned by the directors to the company as a separate entity, and not to individual members (*Percival v Wright [1902] 2 ch 421*), nor to creditors (*Multinational Gas & petrochemical Co. v Multinational Gas & petrochemical Services Ltd [1983] ch 258, CA*).”¹⁹⁵

The specification of the fiduciary duty of the director is very clearly mentioned above as they are liable to the company in regard of due care and diligence, but not to the others. The law drafted the duties of the directors with a view to make sure everybody’s wellbeing is shielded.¹⁹⁶

However, in practice beside all other liabilities of the directors, they also held legally responsible for company debts and required to sale their own assets to cover this.¹⁹⁷ As the directors are bound to furnish personal guarantee¹⁹⁸ in case of company’s default to pay back its loans. The banks as creditors requires the personal guarantee of the directors of the company, as under the regulation R-2 of the Prudential Regulations for Small and Medium Enterprises Financing¹⁹⁹ provided by the State Bank of Pakistan the limited companies are required to submit personal guarantee of all directors with an exception of the nominee directors²⁰⁰, while applying for the loan.

Along with this the regulation R-10 ‘Prudential Regulations for Corporate/Commercial Banking’ also provides as “banks shall formulate a policy, duly approved by their board of directors, about obtaining personal guarantees of directors of private limited companies.”²⁰¹ Therefore, “the directors of the company are jointly and severally liable to

¹⁹⁴ *Muhammad Baksh and sons Ltd. v. Azhar Wali Muhammad*, 1986 MLD 1870

¹⁹⁵ Stephen W. Mayson, Derek French. “*A practical approach to company law*”, 2nd ed. (Shrewsbury: Livesey limited, 1985), 335

¹⁹⁶ “Is a director liable for company debt?” www.google.com (accessed on: April 21, 2010)

¹⁹⁷ “Company directors risking personal bankruptcy over company law”, <http://www.bytestart.co.uk> (accessed on: April 21, 2010)

¹⁹⁸ The Institute of Bankers, “*Questions on banking practice*”, 11th ed. (London: published by The Institution of Bankers, 1978), 22

¹⁹⁹ Prudential Regulations for Small and Medium Enterprises Financing, www.sbp.org.pk (accessed on: July 25, 2010s)

²⁰⁰ Muhammad Naseem Chaudhri, *Complete banking laws in Pakistan*, (Lahore: Lahore law time publication, 2005), 1483

²⁰¹ Dr. Asrar H. Siddiqi, *Practice and law of banking in Pakistan*, 8th ed. (Karachi: Royal Book Company, 2007), 423, Appendix - X

indemnify the lender in respect of his loss resulting from the company's failure to meet its obligations."²⁰²

The directors have no personal guarantee according to the general law (Doctrine of separate legal entity), but the same is imposed on the directors by the special law (Prudential Regulations of the State bank of Pakistan). This practice is the same around the world, although two contradictory principles cannot be applicable in the same time. However, the corporate personality of the company prevents the directors from being personally liable for the obligations of the company. Hence, the directors are responsible for governing the affairs of the company along with the correlation between the administration and shareholders of a company²⁰³, and not to personally incur the liabilities of the company.

As in the case of "*Shamim-ud-din v. Federal Government of Pakistan and 4 others*" the honorable court held that "the managing directors of a limited liability company cannot be made personally liable for arrears etc, of the company, and the individuals constituting the company cannot be held responsible for the default of certain payments. There can, therefore be no personal obligation on the shareholders or even the directors in respect of the debts or even the taxes, revenue etc, due from the company. It is further contended that it is only the assets of the company that can be proceeded against."²⁰⁴

So, it is evident that the company is itself liable for any kind of debt payable on its name, and it cannot hold any director responsible for the same. This is to say that in case of non-payment the directors are not liable, if there is no implementation or subsistence of personal guarantee.²⁰⁵

The directors are expected to show the level of vigilance which should be foreseeable in the person being the director of a company. He should perform his duties with honesty and without any underhanded motives. The directors are usually answerable for the management of the company,²⁰⁶ in fact they are responsible to the extent of acting in good faith and take due care

²⁰² Denis Keenan, Josephine R Bisacre, "*Smith & Keenan's Company Law for students*", 11th ed., (London: Financial Times Pitman Publishing, 1999), 101

²⁰³ M. Iqbal Patel, "*Directors-Corporate Governors*", (Corporate Law Decisions, 2006), 94

²⁰⁴ *Shamim-ud-din v. Federal Government of Pakistan and 4 others*, 1995 CLC 299

²⁰⁵ Saalim Salam Ansari, "*Documentation(s) in Respect of Financing(s) and/or Mortgage(s)*", (Corporate Law Decisions, 2006), 28

²⁰⁶ "The duties, responsibilities and liabilities of directors", www.iod.com (accessed on: April 15, 2011)

while performing their duties, and to show the carefulness in regard to the financial decision making for the company. They are responsible to take precautionary measures to safeguard the interests of all the stakeholders, including the creditors as well. But they do not have personal liability for the company's debts.

"In another recent decision of the Supreme Court, *Sita Ram Gupta vs Punjab National Bank*, the guarantor was not so lucky. He had cancelled his guarantee in a letter to the bank which had extended a loan to the principal debtor. He argued that the guarantee stood revoked under Section 130 of the Contract Act even before the loan was taken. The Delhi high court and the Supreme Court rejected his contention. The agreement of guarantee clearly provided that the guarantee shall be a continuing one and shall not be considered as cancelled by intervening factors. The courts gave prominence to the terms of the agreement over the statutory provision."²⁰⁷

Practice of Shifting the Liability:

As is already discussed that the directors are not personally liable to the debts of the company, rather it's the company itself whose liability is to repay the loans borrowed. The company passes an ordinary resolution²⁰⁸ in AGM to borrow loans from the bank by the directors up to that specifically decided amount, and the directors are held liable to give personal guarantee for the repayment of that loan.²⁰⁹

Under the *regulation R-2* of the "Prudential Regulations for Small and Medium Enterprises Financing" provided by the State Bank of Pakistan the companies are required to submit personal guarantee of all directors other than nominee directors, while applying for loan.²¹⁰

The directors are required to give the personal guarantee without the seal of the company.²¹¹ This shows the intension of the bank to bind the directors in case of default by the company. This

²⁰⁷ M.J. Antony, "Director as Guarantor", (*Business Standard*, April 2008), 10

²⁰⁸ The Institute of Bankers, "*Questions on banking practice*", 11th ed. (London: The Institution of Bankers, 1978), 26

²⁰⁹ Ibid.

²¹⁰ Muhammad Naseem Chaudhri, "*Complete banking laws in Pakistan*", (Lahore: Lahore law time publication, 2005), 1483

²¹¹ "Interview Excerpts", Ammara, Adnan. Credit analyst, MCB regional branch, Islamabad (August 5, 2008)

requirement is allowed by the law as the State Bank of Pakistan is authorized to draw the regulations for the banks of Pakistan.²¹²

Whereas, in the case of "*Ehtesham Ghazi v. Izharuddin*" the court held: "... company is a separate and distinct legal entity from its shareholders and directors ... Any liability against the company cannot be transferred or shifted to its shareholders or directors except to the extent of their individual shares in the company."²¹³

However, the banks and the other financial institutions have developed an independent and random practice, without lawful authority, to execute personal guarantee contracts with the directors of a company to secure the debts of the company.²¹⁴

The court utters the same rule in the case of "*A. Rehman v. Tehsildar Lahore and another*", the Honorable Malik Muhammad Qayyum, J Held: "... That M/s. Progressive Journalist Ltd. From whom the money is allegedly due is a company incorporated under the Companies Act, 1913 and the petitioner even though its Managing Director has no personal liability ... it needs no gainsaying that in law a company is a distinct entity separate from its shareholders and directors and the liability of the company cannot be passed on to its directors personally".²¹⁵

²¹² www.sbp.org.pk (accessed on: July 28, 2008)

²¹³ *Ehtesham Ghazi v. Izharuddin*, 2001 YLR 526(a)

²¹⁴ N.K. Sharma, "Director's Personal Guarantee – A Void Agreement", <http://www.drtsolutions.com> (accessed on: July 3, 2011)

²¹⁵ *A. Rehman v. Tehsildar Lahore and another*, 1993 CLC 1222 [Lahore]

The compassionate features of the concept and the basic intension of law working at the nurture of the legal entity concept hit the right goal, by encouraging the investors to invest their financial resources. As the amplified interest of affluent investors open up the new ways of development, which results in the acceleration of the corporate activity.

The law provides such appropriate conditions for the corporate activities, which brought the significant attainments. Thus, the concept of separate legal entity is fully successful as well as it turned to be the mile stone in the development of the corporate world.

The law provides the status of separate legal entity to the company so that the business activities can flourish, and the concept of separate legal personality was developed to facilitate the trade gratifying commercial needs of time.²²² Limited liability is natural offshoot of corporate personality and this means the law creates segregation between the company and its members as well as officers, so that the company being a separate person should be responsible to pay its debts.

The special law (Prudential Regulations of State Bank of Pakistan):

The special laws are the Prudential Regulations of State Bank of Pakistan. They provide the rules to govern the financial affairs of the banks including the lending processes.

As, according to the regulation R-2 of the "Prudential Regulations for Small and Medium Enterprises Financing"²²³ the companies are required to submit personal guarantee of "all directors other then nominee directors"²²⁴, for getting the financial assistance from the bank. In conjunction with this the regulation R-10 "Prudential Regulations for Corporate/Commercial Banking" also states as "banks shall formulate a policy, duly

²²² Muhammad, Khalid Malik, "International Aspects of Corporate Law and Governance" *University of Warwick, UK* (2006), 2, <http://www.jstor.org> (accessed August 4, 2010)

²²³ Prudential Regulations for Small and Medium Enterprises Financing, www.sbp.org.pk (accessed on: July 25, 2010)

²²⁴ Muhammad Naseem Chaudhri, *Complete banking laws in Pakistan*, (Lahore: Lahore law time publication, 2005), 1483

approved by their board of directors, about obtaining personal guarantees of directors of private limited companies.”²²⁵

The regulations of the State Bank of Pakistan require these formalities to be met with. SBP is the certified institution given the responsibility to draft the regulations for the banks of Pakistan. The banks are guided to observe the similar directions as; “refer to clause (D) of BCD Circular No. 7, of 31st May 1972 reproduced as under:-

“No banking company shall, make advances to a private limited company without obtaining personal guarantee of the directors of such company, in addition to the normal security which the banking company may require.”²²⁶

It is the customary practice of the banks to acquire personal guarantee of the directors in addition to the other securities from the borrowing company. Such personal guarantee would be more significant if the owners/directors owned the resources themselves.²²⁷

Nevertheless, this is the point of deviation that the company is a separate legal person who is answerable for its legal obligations on its own. And no one else can be held legally responsible for its liabilities, even if he is the director or any other officer or stake holder of the company.

The matter of conflict among the two laws:

The matter of conflict arose regarding the two laws under discussion where the application of the parallel practice begins. The general laws are the universally accepted principles and are the backbone of the system of law.

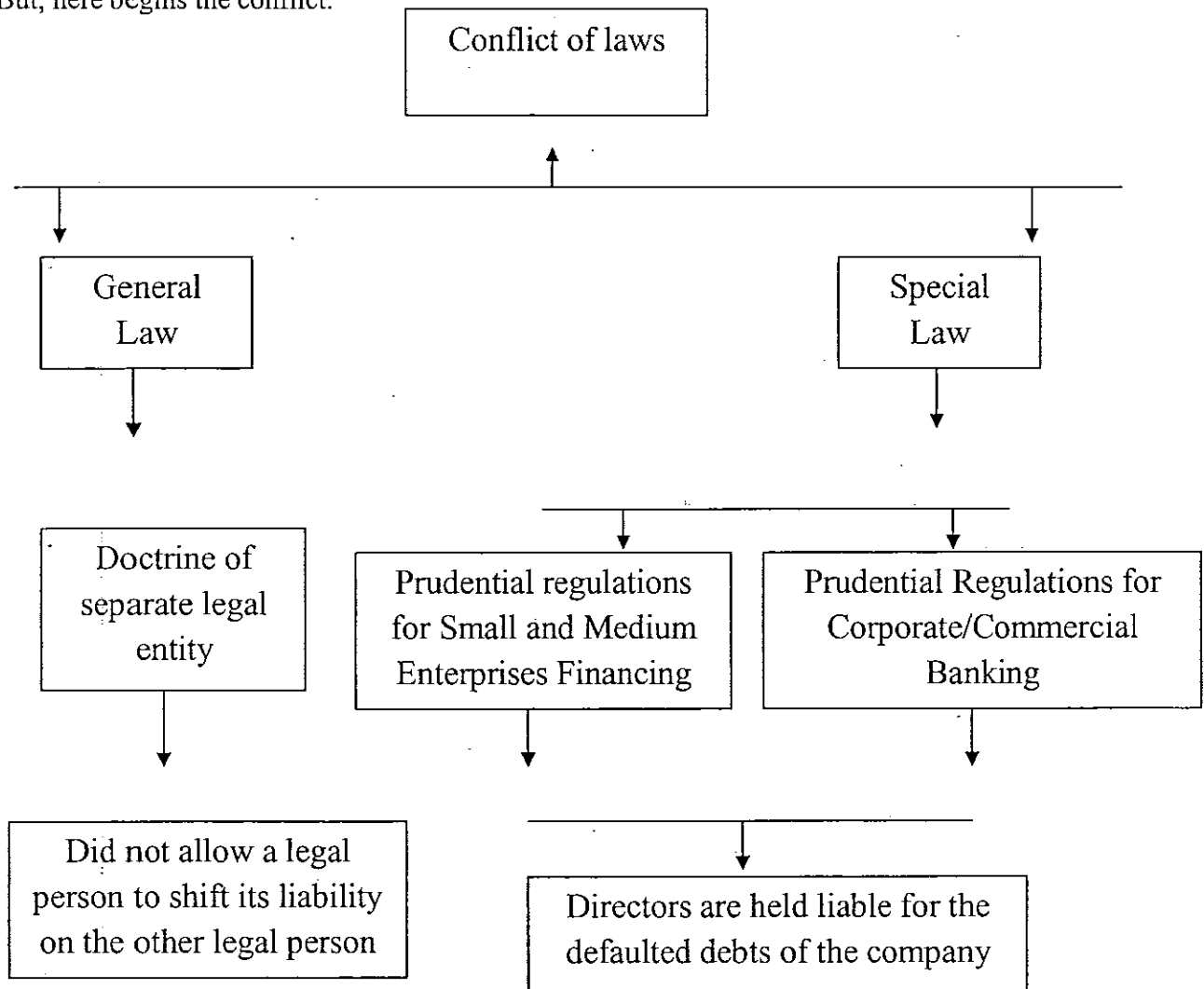
They are equally applicable everywhere, as well as equally beneficial for everyone. At the same time the special laws are drafted to settle down some specific issues, as in the present case the banks are justified to secure the recovery of their finance.

²²⁵ Dr. Asrar H. Siddiqi, *Practice and law of banking in Pakistan*, 8th ed. (Karachi: Royal Book Company, 2007), 423, Appendix - X

²²⁶ “BSD Circular Letter No. 22”, “BSD Circular Letter No. 21” and “BSD Circular Letter No. 6”, www.sbp.org.pk (accessed on: July 3, 2011)

²²⁷ Muhammad Bashir Chaudhry, “Prudential regulations for SMEs”, (Karachi: DAWN – Business, August 18, 2003)

But, here begins the conflict.



The matter of conflict between the two laws is that the common Law²²⁸ did not allow the company to shift the burden of its own liabilities²²⁹ to the directors. As far as the general law is concerned, directors stand in a fiduciary position towards the company, but not to its creditors (including banks).²³⁰

²²⁸ Len Sealy and Sarah Worthington, *Cases and Material in Company Law*, 8th ed., (n.l.: Oxford University press, 2007), 31

²²⁹ Ibid, 33

²³⁰ "Directors and Officers Liability" <http://www.trafalgar.intl.com> (accessed on: July 25, 2011)

While, the particular law²³¹ allow the shifting of burden from the company to the directors. The logic behind this special law is that in most cases the directors are the owners of the company. In case the director is not the owner, even then he is responsible to practice ordinary care²³² and appropriate carefulness²³³ while deciding the financial matters related to the company (including the borrowing of debts).

The conflict begins with the application of both laws, as they are exactly opposite to each other in there intensions and goals. The general law obliges the legal person to bear its responsibilities by its own and the special law is providing an open way out to shift the responsibilities of the artificial legal person to the natural person. Here, one special law is contravening the applicability of a generally accepted and implemented law.

The matter of conflict here is that how the system is running while two laws are in contradiction with each other, and this gave rise to the statement that 'The law has assigned legal personality to the company for a purpose, but in practice this personality is not always respected --- in fact, the banks usually violate it'.

²³¹ Prudential Regulations For Small And Medium Enterprises Financing and Prudential Regulations for Corporate/Commercial Banking, www.sbp.org.pk (accessed on: July 25,2010)

²³² Patrick R.Delaney and Irvin N. Gleim, *CPA Examination Review Business Law*, (Canada: Jhon Wiley and Sons, Inc, 1984), 341

²³³ Ibid.

Chapter # 5: comparative study of the British, American and Indian system

The company law is one of the most capricious fields of law, because of the swiftly changing necessities of time, along with the rapid development in the financial sector of the economy of the world. Therefore, the law making agencies kept on performing their duties by updating the required legislation. And the regulatory bodies also keep the pace with them by continuous up gradation of the rules and regulations for the financial institutions and banks.

Although the financial systems through out the world are somewhat alike but, still there is a huge difference between the systems of the developed countries in comparison with the systems of the developing countries. Hence, the intension of the comparative study of different systems is to have a broaden view of the issue and to draw a better outline for the future practices of our own system. We will be discussing the British, American and Indian systems for this study.

The British system:

The British system of law is the most idyllic one, as the most developing countries are keeping their path in line with this system. And especially in the field of corporate laws, the new ideas or additions are keenly observed, and followed by the developing countries including Pakistan and India. The corporate laws in UK have attained the new heights of development and success, with the excellent trends and practices, which no doubts set the new standards of the corporate world.

The doctrine of separate legal entity:

The company laws like the other laws are not developed in a couple of years rather it took centuries to develop it to the present day standards. The concept of legal fiction is highly significant and this fact is beyond any doubt that the outstanding legal fiction ever created is the 'artificial legal personality', which is the basis for the doctrine of separate legal entity.

Along with the other extraordinary ideas and concepts, the 'doctrine of separate legal entity' is the one exceptional achievement of British corporate laws.

The concept of legal entity was firstly established by the House of Lords, in the judgment of the renowned case of '*Saloman v. A Saloman & Co. Ltd*'. This was the first time that a company was given the status of a distinct person, altogether separate from its members and officers.

According to the decision of House of Lords, "... the incorporation process made Salomon and his company two persons. Even if the business was the same as before, and it was still managed by Salomon himself, the company was not an agent or trustee for the members. Although Salomon beneficially owned all the issued shares of the company, the court also recognized him as a separate person who can be a secured creditor with enforceable rights against the company."²³⁴

Therefore, the company once get incorporated becomes a legal entity, and enjoy all the attributes of a natural person. It acquires all the rights of a person and at the same time it is liable for any of the liabilities created on its own name.

According to the Halsbury's Laws of England, the term "company" has been defined as a collection of many individuals united in one body under special domination, having perpetual succession under an artificial form and vested by the policies of law with the capacity of acting in several respects as an individual, particularly for taking and granting of property, for contracting obligation and for suing and being sued, for enjoying privileges and immunities in common."²³⁵

The separate legal entity of a company signifies that it is a diverse legal subsistence to the shareholders and directors. Section 16 of Companies Act 2006, states the effect of registration as;

"(1) the registration of a company has the following effects as from the date of incorporation.

²³⁴ Raguraman ,Gurusamy, "Separate Legal Entity (Law 346)" (July 13, 2010), <http://graguraman1.blogspot.com> (accessed on: October 23,2010)

²³⁵ Rana Aneel Arshad, "*Brief History of Company Law*", (Corporate Law Decisions, 2004)

(2) The subscribers to the memorandum, together with such other persons as may from time to time become members of the company, are a body corporate by the name stated in the certificate of incorporation.

(3) That body corporate is capable of exercising all the functions of an incorporated company.”²³⁶

A company may sue and be sued in its own name and own property independently. Therefore, the shareholders do not own the resources of the company, and are not liable for its debts. This concept of separate legal entity makes companies an attractive medium for business ventures, as the liability remains with the company...this concept has the consequence that a company enjoys the perpetual succession.

Evolution and development of the doctrine:

The laws gets mature with the course of time and, are drafted with the needs of the society, so is the concept of separate legal entity. Like the other concepts of law it also takes time to develop and that is not just years but centuries. As in the early Middle Ages, the whole system of the society was unlike that of today. Like wise the concept of corporations was not the same as is today, rather it was totally different.

The most recognizable intimate of the modern company do not appear till the second millennium. In the earlier 19th century the corporations were formed for the restricted order in Europe. Nevertheless, by the end of 19th century and the beginning of 20th century a strong perceptive of the phenomena of legal entity developed.

However, in the medieval times the legal entity was considered as a group of individuals who are provided the charter by the state, and collect private funds for a particular purpose. That particular purpose is mostly the public service. The government kept a strict check on the activities of that group, and cancels the charter if the rationale is not fulfilled properly.

The most primordial form of the business ventures was partnership. By the time when trade ventures increased, the royal charters were also granted more rapidly, especially in England and Holland.

²³⁶ Companies Act 2006, Section 16

It was later realized that, the early companies were purely gainful projects, as the stocks of the joint stock company can not be held for the debt recovery of any share holder. The corporate activity was growing fast at that period.

The corporate activity was vulnerable by the Bubble Act, 1720. With the passage of time the corporate activities developed, and so were the requirements to run that system. So, that requisite was fulfilled by the launch of registration system for the equivalent of the modern company under the provisions of "Joint Stock Companies Act, 1844".

The progressive wave of legislation for the improvement and development of the corporate sector persists by enacting another very precious law, and that was "Limited Liability Act, 1855". This brings the concept of limited liability in the form of enacted law, and indeed more effectively applicable. And the progress of company law was keep going by the codification of the above mentioned enactments together as, "Joint Stock Companies Act, 1856".

"The significant development in the history of companies was the decision of the House of Lords in *Salomon v. Salomon & Co.* where the House of Lords confirmed the separate legal personality of the company, and that the liabilities of the company were separate and distinct from those of its owners".²³⁷

The decision of House of Lords was an exceptional one, and was considered as a universal authority on the doctrine of corporate personality.

As Lord Macnaughten observed "The company is at law a different person altogether from the subscribers to the memorandum; and, though it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the sub-scriber or trustee for them."²³⁸

²³⁷ "Corporate law", <http://en.wikipedia.org> (accessed on: May 16, 2011)

²³⁸ Robert R Pennington, "Company Law", 8th ed., (Butterworths, UK, 2001), 39

The company law keeps on changing with the increased needs of time. So, another Act was introduced with some more changes and improvements, and was titled as the “Companies Act, 1985”. Some years later the legislation again drafts another Act for the better regulation of corporate activity, and it was the “Companies Act, 1989”.

“CA 2006 is the product of the most extensive revision of company law since 1856. it arises from a consultation carried out over seven years, from 1998 to 2005, by the Company Law Review (CLR), which was set up by the Department of Trade and Industry (DTI)”.²³⁹

Therefore, the latest enacted company law is the CA 2006 in Britain. It brought the remarkable changes and updates in the field of company law. The corporations are now growing towards the new horizons.

Applicability of separate legal entity:

As aforesaid the doctrine of separate legal entity was first applied by the court in the decision of the House of Lords, and it was a mile stone of the modern company law. The court applied this principle to a number of other cases too.

But “This case firmly established that upon incorporation, a new separate artificial entity comes into existence. At law, a corporation is a distinct person with its own personality separate from and independent of the persons who formed it, who invest money in it, and who direct and manage its operations.”²⁴⁰

As it is evident by the decision that once incorporated a company becomes a separate legal entity, entirely distinct from the stake holders as well as the officers. The decision of House of Lords states, that upon incorporation Salomon and his company becomes two persons distinct from each other. Even if the business was the same as it was before, and was still administered

²³⁹ Len Sealy and Sarah Worthington, *Cases and Material in Company Law*, 8th ed., (n.l.: Oxford University press, 2007), 4

²⁴⁰ Gonzalo Villalta Puig, “A Two-Edged Sword: Salmon and the Separate Legal Entity Doctrine” *Murdoch University Electronic Journal of Law*, Volume 7, Number 3 (September 2000), www.murdoch.edu.au/elaw (accessed on: February 10, 2010)

by Salomon ... The court also recognized Salomon as distinct person who can be a secured creditor with inflict able rights against the company.²⁴¹

It is very notable in the words of, Lord Halsbury: "Either the limited company was a legal entity or it was not. If it was, the business belonged to it and not to Mr Salomon. If it was not, there was no person and no thing to be an agent at all; and it is impossible to say at the same time there is a company and there is not."²⁴²

The Honorable court emphasis on the legal entity of the company, as once it's acknowledged by law to be a separate legal entity there left no reason to unjustified the rule. Therefore, the company possesses all features of a legal entity. As the realist theory of law by Dicey provides that the artificial person created by law, has a real personality, a real mind, will and power of action.

This means to say that the company owes all attributes of legal personality like the natural person. The implication of the concept by the decision of the court was very significant. As the primary function of the court is to implicate the principles of law by there decisions. Another decision states the same principle as;

In the case of "*Macaura v. Northern Assurance Co*" it was held that: "... this appeal relates to an insurance on goods against loss by fire. It is clear that the appellant had no insurable interest in the timber described. It was not his. It belongs to Irish Canadian Sawmills Ltd, ... He owned almost all the shares in the company, and the company owed him a good deal of money, but, neither as creditor nor as shareholder, could he insure the company's assets. The debt was not exposed to fire nor were the shares, and the fact that he was virtually the company's only creditor, while the timber was its only asset, seems to me to make no difference. He stood in no 'legal or equitable relation to' the timber at all. He had no 'concern in' the subject insured. His relation was to the company, and not to its goods, and

²⁴¹ Raguraman ,Gurusamy, "Separate Legal Entity (Law 346)" (July 13, 2010), <http://raguraman1.blogspot.com> (accessed on: October 23,2010)

²⁴² Paul Davies, *principles of Modern Company Law*, 7th ed. (London: Sweet & Maxwell Ltd, 2005), 28

after the fire he was directly prejudiced by the paucity of the company's assets, not by the fire ...”²⁴³

The concept of separate legal entity is applied by the Privy Council in the case of “*Lee v. Lee's Air Farming*”; the Privy Council of London held that:

“The company and Mr Lee were distinct entities and therefore capable of entering into legal relations with one another as such they had entered into a contractual relationship for him to be employed as the chief pilot of the company he could in his role of Governing Director give himself order as chief pilot. It was therefore a master servant relationship and as such he fitted the definition of ‘worker’ under the Act. The widow was therefore entitled to compensation.”²⁴⁴

The courts perform a remarkable role in the implementation of the said doctrine. This is due to the implementation of the doctrine that the fruitful results are achieved by the corporate sector, and the company law grows to the present profile.

Loan transactions between the company and the bank:

The company indulges itself in diverse types of transactions as is permitted by the shareholders in the memorandum and articles of association of the company.²⁴⁵ Even though, some companies enjoy a wider range of transactions than others. But, the law allows all the companies to enter into transactions in the same manner as natural person²⁴⁶ and impose the same liabilities to them. The financial organizations²⁴⁷ are the most reliable source of borrowing for any company as they are the most organized lenders. The transactions need to be drafted in accordance with the prescribed manner and form. Section 43 of the Companies Act 2006, provides ‘Company contracts’ as;

“(1) under the law of England and Wales or Northern Ireland a contract may be made—

²⁴³ Len Sealy and Sarah Worthington, *Cases and Material in Company Law*, 8th ed., (n.l.: Oxford University press, 2007), 39.

²⁴⁴ Vijay, “The Doctrine of Separate Personality” (September 26, 2008)
<http://vijayhighcourt1.blogspot.com> (accessed on: April 16, 2009)

²⁴⁵ Richard Smerdon, “*Palmer's Company Law Manual*”, 1st ed., (London : Sweet & Maxwell, 2000), 286

²⁴⁶ Robert R Pennington, “*Company Law*”, 8th ed., (UK: Butterworths, 2001), 121

²⁴⁷ The Financial Institutions (Recovery of Finances) Ordinance, 2001, Sec 2 (a)

(a) By a company, by writing under its common seal, or

(b) On behalf of a company, by a person acting under its authority, express or implied.

(2) Any formalities required by law in the case of a contract made by an individual also apply; unless a contrary intention appears, to a contract made by or on behalf of a company.”²⁴⁸

The major service a bank provides to a company is the financial assistance. The main forms of loan transactions are: overdraft; loans and venture capital. Overdraft is the most usual form of loan transaction of the company as it is a short term facility which is provided to the company so that the urgent needs can be fulfilled. It is operated through the current account of the borrower. The borrower can withdraw the agreed amount in excess of the current balance of the account. This kind of accommodation is allowed against parallel securities.²⁴⁹

The ‘loans’ “are approved where the borrowing is expected to be less variable than an overdraft. When a customer borrows a fixed amount from the bank, which is payable by a pre-decided time, and the repayment is to be made either in installments or in lump sum, such facility is called as ‘loan’. This kind of financial assistance can be with or without the collateral securities.

In case of venture capital, “the banks now have schemes for financing businesses ... businesses, whether sole trader, partnership or limited companies, which require funds for the acquisition of fixed assets can negotiate either a sale of part of the equity stake in the business or borrow in the form of convertible loans.”²⁵⁰

Lending policies of the banks:

Lending money is one significant task a bank performs; it is a very significant element of a bank’s financial services. Banks have rigorous business financing criteria which are strictly followed. In general, banks need to see the business plans for future which can enable the bank to forecasts the future cash flows of the company.

²⁴⁸ Companies Act 2006, Section 43

²⁴⁹ “Bank Loans for Small Businesses”, <http://smallbusiness.dnb.com/> (accessed on: June 24, 2011)

²⁵⁰ Fitzgerald Demond, *Elements of banking 1&2*, (London: Financial training publications limited, 1983), 168,169

This enables the banker to assess company's ability to repay the loan, and they can better decide to offer what kind of facility to that customer. The bank offers both the secured and unsecured loans, and the secured loans reduce the bank's risk, as the borrower would be bearing a chance of losing his collateral security in case he fails to repay the loan.

Credit history is another key factor as it facilitates the bank to make a decision for lending loan to that customer or not. Credit report and financial history needs to be good enough to win the bankers confidence. Usually banks are requiring the crippling personal guarantees of the directors too.

“However, the standard policies of lending are followed by the banks while lending loans to the companies. These are given below;

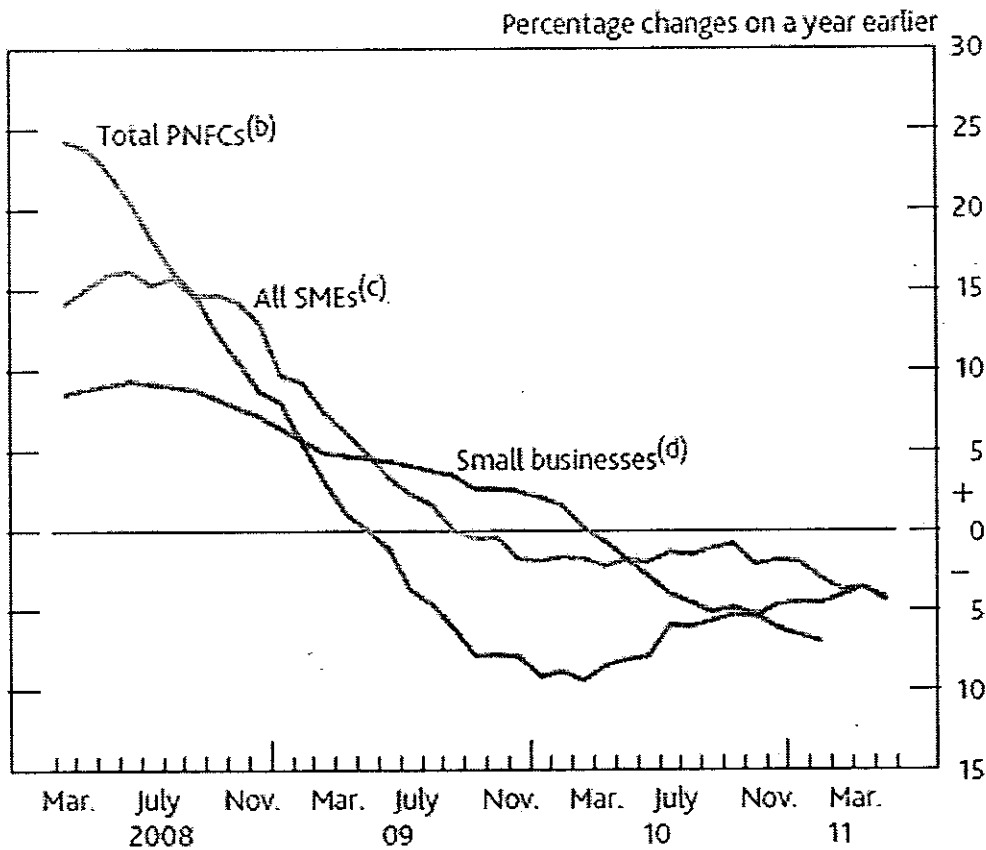
- a) Character
- b) Competence
- c) Capital
- d) Connection
- e) Security”²⁵¹

The latest development regarding the lending and repayment of the loans is very satisfactory. The banks are lending the financial services, and the companies are repaying the same in the decided time, as per schedule.

The continued contraction in the stock of lending to businesses overall has also been reflected in the stock of lending to small and medium-sized enterprises (SMEs) (Chart 1.1). In recent discussions, some major UK lenders indicated that smaller businesses were deleveraging and continuing to repay bank debt.

²⁵¹ Infra; reference no 17, p 172

Chart 1.1 Lending to small and medium-sized enterprises^(a)



Sources: BBA, BIS, Bank of England and Bank calculations.

- (a) Rate of growth in the stock of lending. Non seasonally adjusted.
- (b) Data cover lending in both sterling and foreign currency, expressed in sterling terms.
- (c) Source: monthly BIS survey. Lending by four UK lenders to enterprises with annual bank account debit turnover less than £25 million. Data cover lending in both sterling and foreign currency, expressed in sterling terms.
- (d) Source: BBA. Lending by seven UK lenders to commercial businesses with an annual bank account debit turnover of up to £1 million. Sterling only. Available at www.bba.org.uk/statistics/small-business.

The effective rate on new borrowing for businesses overall, which may include new lending on facilities arranged earlier at low pre-crisis rates²⁵²

²⁵² In courtesy with Bank of England, "Trends in Lending", www.bankofengland.co.uk, (July 2011, Bank of England), (accessed on: August 10, 2011)

The rule of personal guarantee:

Now, the most crucial requisition of the bank for lending loan to a limited company is, obtaining the personal guarantee²⁵³ of its directors. The bank regulations allow the bank to require the personal guarantee of the directors of the company. The director stands in a fiduciary duty to the company as he is the one who take the financial decisions and should act in good faith in the interest of the company. So, 'fiduciary' equals; reliability, liberty, no undisclosed profits, no conflict of interest, and justice.²⁵⁴ Therefore, the directors are liable to perform there duties of allegiance and due care to the company.²⁵⁵ Bank loans, overdrafts and mortgages all these are to be covered by personal guarantee of the directors.

"The current practice (for all banks) is that their debt recovery units request (and obtain by any means possible) a signed asset/expenditure form or personal financial statement. This is now requested by banks immediately at or after demand has been made on a Personal Guarantee. That's because a signed form of that nature will provide the bank with their first 'counter' to any possible defence/s to their claim. Signing any financial disclosure or providing the bank with such personal information will prejudice and often destroy any later attempt by the customer (or indeed anyone else) to negotiate the debt itself or defend the debt at all."²⁵⁶

However, in practice beside all other liabilities of the directors, they also held legally responsible for company debts and required to sale their own assets to cover this.²⁵⁷ As the directors are bound to furnish personal guarantee²⁵⁸ in case of company's default to pay back its loans.

"The enforcement of director's personal guarantees (offered to support a borrower's covenant) is now widespread - the use of bankruptcy proceedings can be a fast and direct

²⁵³ The Institute of Bankers, "*Questions on banking practice*", 11th ed. (London: published by The Institution of Bankers, 1978), 22

²⁵⁴ Richard Smerdon, "*Palmer's Company Law Manual*", 1st ed., (London : Sweet & Maxwell, 2000), 202

²⁵⁵ Patrick R. Delaney and Irvin N. Gleim, "*CPA Examination Review Business Law*", (Canada: Jhon Wiley and Sons, Inc, 1984), 341

²⁵⁶ "Personal Guarantee, Personal Guarantee and Indemnity", www.ibas.co.uk (accessed on: August 10, 2011)

²⁵⁷ "Company directors risking personal bankruptcy over company law", <http://www.bytestart.co.uk> (accessed on: April 21, 2010)

²⁵⁸ The Institute of Bankers, "*Questions on banking practice*", 11th ed. (London: published by The Institution of Bankers, 1978), 22

method of enforcement if a guarantor refuses to pay. This avenue is likely to be followed more often as lenders seek to recover debt from failed businesses by enforcing personal guarantees and taking personal guarantor's assets."²⁵⁹

The American system:

The American system of laws is another developed and well established system, with its well settled principles and patterns of work. The doctrine of separate legal entity is one of the mile stones of corporate laws in the United States. The system of America is of a kind that both the federal laws and the state laws are enforced according to the requirements of the society. So, the worthy fact to note here is that this kind of system can be said a fool proof system.

The doctrine of separate legal entity:

Corporate personality is a fiction; the entity which is embodied is not a fiction. The amalgamation of the members is no fiction. The pretension as if they were one person is no mere allegory. In a word, even though corporate personality is a fiction, yet it is a fiction established upon fact. It is as normal to personify a body of men unified in a structure like that of the regular company as it is to personify a ship.²⁶⁰

In the case of "*Cedric Kushner Promotions, LTD. v. King et al. (A.D. 2001)*" the court held that: ... And the corporations are different "persons," even where the employee is the corporation's sole owner. Incorporation's basic purpose is to create a legal entity distinct from those natural individuals who created the corporation, who own it, or whom it employs. See, e.g., *United States v. Bestfoods*, 524 ... are different "persons," even where the employee is the corporation's sole owner. After all, incorporation's basic purpose is to create a distinct legal entity, with legal rights, obligations, powers, and privileges different from those of the natural individuals who created it, who own it, or whom it ..."²⁶¹

The perception of the corporation as a distinct legal entity is, as Farrar portrays basically a figurative use of language, clothing the recognized group with a single separate legal entity by

²⁵⁹ "Personal Guarantee Demand for Payment", www.ibas.co.uk (accessed on: August 10, 2011)

²⁶⁰ Arthur w. Machen, Jr, "Corporate Personality", (*Harvard Law Review*, vol. 24, no.4, feb, 1911), 266

²⁶¹ "Legal Entities", www.Findlaw.com (accessed on: August 11, 2011)

resemblance with a natural person. whereas evidently a fiction, the choice of r analogy is not entirely subjective, and must retort to organizational realities of the corporation as well as complying with and making intelligible the dealing of organizations as legal actors. In this sense the notion of a corporation is systematic and ideological, descriptive and prescriptive.

The separate legal entity provides the characteristics of a natural person to the company, and this is the reason being that creditors of the company have only the assets of the company to satisfy there debts, and not the stakeholders or officers of the company.

In the decision of "*Walker v Winborne*", states; "The creditor of a company whether it be a member of a group of companies in the accepted sense of that term or not must look to that company for payment. His interest may be prejudiced by the movements of funds between companies in the event that they will become insolvent."²⁶²

"In particular the concept is a useful way of describing a number of these aspects (for example: limited liability, perpetual succession, the ability to sue and be sued etc). These fights, however, can be conceptually understood independently and do not 'logically' or necessarily constitute 'separate legal personality'. As Thomas Ross writes 'we cannot translate our metaphors because the particular reality seen through the metaphor is a new reality.'²⁶³

Loan transactions between the company and the bank:

The different kinds of loan transactions between the company and the bank are:

Secured loan:

A secured loan is a loan in which the borrower pledges some asset movable or immovable, as a security for the loan, which then becomes a secured debt payable to the creditor who gives the loan.

Mortgage loan:

Mortgage is a very common form of debt, utilized to purchase landed property. Under this financial facility, the money is used to purchase the property. However, security is given to the

²⁶² *Walker v Winborne* [1976]137 CLR 1

²⁶³ James, Nicholas (1993) "Separate Legal Personality: Legal Reality and Metaphor," *Bond Law Review*: Vol. 5: Issue. 2, Article 6, p 12

commercial banks - a lien on the title to the property – unless the mortgage is paid in full. If the borrower defaults on the loan, the bank would have the legal right to recapture the property and auction it, to recover the finance outstanding to it.

Unsecured loan:

Unsecured loans are financial loans that are not protected against the borrowers assets i.e., no security is involved. The banks use to lend loans in some other kids as well, which includes the followings;

“These may be available from financial institutions under many different guises or marketing packages:

- ✓ bank overdrafts
- ✓ corporate bonds
- ✓ credit card debt
- ✓ credit facilities or lines of credit
- ✓ personal loans”²⁶⁴

In addition to consumer loans and mortgages, the other familiar forms of loans given by banks to establish and rising small businesses are:

- ✓ “working capital lines of credit for the ongoing cash needs of the business
- ✓ credit cards higher-interest, unsecured revolving credit
- ✓ short-term commercial loans for one to three years
- ✓ longer-term commercial loans: generally secured by real estate or other major assets
- ✓ equipment leasing for assets you don't want to buy outright
- ✓ letters of credit for businesses engaged in international trade”²⁶⁵

²⁶⁴ “commercial bank”, <http://en.wikipedia.org>, (accessed on: June 28, 2011)

²⁶⁵ “Common Types of Bank Loans”, www.uschambersmallbusinessnation.com , (accessed on: June 28, 2011)

Lending policies of the banks:

“The Equal Credit Opportunity Act (ECOA) of 1974 obliges the creditors which regularly provide credit to consumers—including banks, they are supposed to evaluate applicants on creditworthiness alone, rather than other aspects such as race, color, religion, and national origin. Favoritism is not justified for any specific customer.

Bank regulation in the United States is highly split as compare with other countries, where nearly everyone is having only one bank regulator. In the U.S., banking is synchronized at both the federal and state level.²⁶⁶

“In the United States there are regulatory laws that cannot be contravened. These laws enacted by federal and state are inviolable and the rights of the debtors is clearly spelt out. All debtors must be aware of these laws ... The Fair Debt Collection Practices Act (FDCPA) is the watch dog as far as recovery of debt is concerned. This was enacted by the Federal Government in 1977 for the entire United States and is a federal law. It is a comprehensive law and covers the rights of the debtor in detail. Debtors must be made aware that the FDCPA expressly debar a collection agency from contacting a debtor by making threats of imprisonment or causing bodily harm. In addition the collection agents are debarred from calling at odd hours or in the middle of the night ... Debt collection is a vast and lucrative field and more and more companies are entering this field. In fact in the USA it is good business to start a debt collection agency and try and reap in the profit. But debt collection agencies should be aware that consumer laws in the USA are strict and no harassment will be tolerated.”²⁶⁷

The rule of personal guarantee:

In the current environment, many banks are working on small business loans. In numerous cases, the companies directors will have been essentially require to undertake a Guarantee when the

²⁶⁶ “Bank regulations in united states”, www.wikipedia.com (accessed on: August 04, 2011)

²⁶⁷ Madan, “Basics of Debt Collection in USA”, www.wikinut.com (accessed on: July 10, 2011)

loan was taken. When the company is incapable to pay the Bank, it will otherwise look to recover the money from the directors personally.²⁶⁸

“A Personal Guarantee is generally given by a director as security for money borrowed by a company in which they are also a shareholder. If down the line the business is unable to repay the bank it then looks to the director personally under the guarantee ... The bank usually limits the Personal Guarantee to a fixed amount but in reality the eventual amount owed can be double after interest and costs have been added ... For a director the consequences can be dramatic –involving, for example, selling the family home in order to pay back the bank and/or bankruptcy.”²⁶⁹

The directors of a limited company are bound to sign the personal guarantee for the defaulted bank debt of the company.

The directors of a company assigned personal guarantees to achieve the needs of the company and to fulfill them. If the company cannot bear to pay these off in full, the creditors can uphold against the directors personally for the underperformance. So, the director is in a fiduciary obligation to the company as he is the one who take the financial decisions and should act in good faith in the benefit of the company. So, ‘fiduciary’ means; reliability, liberty, no conflict of interest, no undisclosed profits, and justice.²⁷⁰ Consequently, the directors are liable to perform there duties of allegiance and due care to the company.²⁷¹

Therefore, the directors have to furnish the personal guarantee for the loan of the company, in case of non compliance of the same by the company itself.

²⁶⁸ “Personal guarantee review”, www.business-lawfirm.co.uk (accessed on: July 20, 2011)

²⁶⁹ “Tips for avoiding difficulties with personal guarantees”, www.business-lawfirm.co.uk (accessed on: July 20, 2011)

²⁷⁰ Richard Smerdon, “*Palmer's Company Law Manual*”, 1st ed., (London : Sweet & Maxwell, 2000), 202

²⁷¹ Patrick R. Delaney and Irvin N. Gleim, “*CPA Examination Review Business Law*”, (Canada: Jhon Wiley and Sons, Inc, 1984), 341

The Indian system:

The legal system of India is the one which is struggling very hard to keep the pace with the developing world, and is counted as a developing system like Pakistan. As, both these countries adopt the British laws after getting independence. So, there is a noticeable part of British laws included in the Indian laws too. Especially, in the corporate sector the Indian laws are keeping in line with the British pattern, and kept an eye on the developments in British laws, so that they can be followed. In fact, the sub-continent was the colony of British that is why there pattern of laws suits our system as well as the Indian system.

The doctrine of separate legal entity, its evolution and development:

The doctrine of separate legal entity is applied in the same sense as is applied throughout the world. Hence, upon incorporation the company constitutes to be a distinct and independent person. And this person is endowing with special rights and privileges, in fact the whole status of a natural person.

“The political, economic and social conditions throughout the history of Ancient India reveal a number of things of importance to understanding the development of the *sreni* and organizational forms in India... the corporate form would grow when the demand for it increased, induced by increasing trade and technology developments, and when the supply of the conditions necessary for the corporate form’s development were present. These conditions include the monitoring methodologies necessary for reducing agency costs and creditor information costs. In Ancient India the *sreni* appears to have developed when these conditions were present (good monitoring of *sreni* members plus good accounting rules) along with rapidly growing trade ... Second, the number, size and complexity of the *sreni* increased with the growth of trade in India. As the *sreni* became more numerous and occupied more important roles in society it is not surprising that more attention would be paid to it and that it’s internal governance would become a matter for further discussion... Third, when examining the factors leading to the growth of trade in Ancient India one notices that it grew under a variety of different government and political structures ... India is a country of considerable historical antiquity with a long and successful history of trade.

For the researcher, this makes it an enviable environment in which to study the development of business organizations ... Overall the ability of the sreni to survive and develop in a predictable fashion through so many centuries and such differing environments in Ancient India attests to its resilience and adaptability. Moreover, the Ancient Indian sreni forces us to revise our conceptions of when corporations developed to a much earlier time period. Indeed, much can be learned about the corporation from the Ancient Indian sreni.”²⁷²

The major function of the evolution of the company is the large scale procedure and production, which is not possible for handful persons or even it, is not manageable with the supply of finance for such operations. Massive investments and large scale productions are just being possible by the creation of the company, as there is someone responsible for the completion of great tasks in time.²⁷³

Applicability of separate legal entity concept by the courts:

The concept of separate legal entity is applied in the different decisions of the courts. As, the honorable court, in the case of, *State Trading Corporation of India Ltd.* states as;

“As soon as citizens form a company, the rights guaranteed to them by article 19(1)c has been exercised and no restraint has been placed on the right and no infringement of that right is made. Once a company or corporation is formed, the business which is carried on by the such company or corporation is the business of that company or corporation and is not the business of the citizens who get the company or corporation incorporated and the rights of the incorporated body must be judges on that footing and cannot be judged on the assumption that they are the rights attributed to the business of individual citizens.”²⁷⁴

In, another case of *C.I.T. v. Meenakshi Mills Ltd.* the court apprehended that the income-tax establishment was entitled to lift the veil of incorporation and to look at the reality of the contract to scrutinize whether the corporate entity was being used for tax evasion. In this case, a distinct

²⁷² Vikramaditya S. Khanna, “The Economic History of the Corporate Form in Ancient India”, S.J.D. Harvard Law School 1997, www.google.com, (accessed on: July 23, 2010)

²⁷³ Rahul Kumar singh, “Origin and Evolution of the Modern Company law”, www.legalservicesindia.com (accessed on: June 28, 2011)

²⁷⁴ AIR (1963) SC 1811

legal entity was brought into being outside the taxable area with the mysterious motives of evading the tax liability by the assessee mills.

But, the Supreme Court held: "It is true that from the juristic point of view, the company is a legal personality entirely distinct from its members and the company is capable of enjoying rights and being subjected to duties which are not the same as those enjoyed or borne by its members."²⁷⁵

But in some extraordinary cases the Court is unrestricted to lift the veil of incorporation and to pay regard to the monetary realities behind the legal fascia. For instance, the Court has power to disrespect the corporate entity if it is used for tax avoidance or to circumvent tax responsibility.²⁷⁶

Lending policies of the banks:

The chief business of banking company is to provide loans and financial assistance to traders as well as commercial and trade establishments. The most significant use of banks money is lending. However, there are risks in lending. While lending the financial services the banks usually keep such collaterals and assets so as the lending may be safe and secured. In fact, the banks follow certain principles to minimize the risk.

"Following are the important areas to be taken care while lending:

1. Safety
2. Liquidity
3. Profitability
4. Purpose of loan
5. Principle of diversification of risks"²⁷⁷

²⁷⁵ AIR 1967 SC 819

²⁷⁶ "Case study on separate legal entity of a company", www.lexvidhi.com, (accessed on: July 22, 2011)

²⁷⁷ "Principles of Bank Lending Policies", www.indianmoney.com (accessed on: July 10, 2011)

Safety

Generally the bank uses the funds of depositors in providing loans and advances. That is the reason, while granting loans the bank should consider about the safety of depositor's finance. The rationale behind the safety is to see the fiscal position of the borrower, whether he can pay back the amount with the interest or not.

Liquidity

The bankers are legally bound to pay the total deposited amount to the depositor on demand. So the banker has to keep definite cash in hand. Furthermore the bank grants the short term loan, because this kind of lending is recovered on demand.

Profitability

Profit earning is the main emphasis of Commercial banks. They should have arrangement of deposits in a profitable way to pay further interest to the depositors. Before intriguing any decision the banker should be confident that it is profitable.

Purpose of loan

Banks never finance for any kind of function that will lead to loose of money. The banks provide loans and advances for the protection of its wealth, and assertion of recovery of loan and the bank lends only for industrious purposes. Before granting a loan the bank has to be certain that whether the rationale for which the loan has given is productive or not.

Principle of diversification of risks

A bank should be very cautious while letting loans because if the bank lends to a non creditable consumer, it will influence the endurance of the bank. To diversify the lending risk they should grant loans to clients from diverse sectors such as agriculture, housing, educational, etc. focused on a specific set of customers will negatively affect the bank.

The rule of personal guarantee:

The banks have developed an unlawful practice of requiring the personal guarantee of the directors of the company in case of lending loan to the company. Although this practice is backed by the banking rules and regulations, but even then it is repugnant with the provisions of law.

“This view is supported by the recent judgment of hon’ble Supreme Court in *Karnataka State Financial Corporation vs N. Narasimahaiah & Ors.* {2008 AIR 1797, 2008 (5) SCC 176, 2008 (4) JT 183; Date of Judgment: 13/03/2008}, wherein the court has observed as follows (in para 18):

“18. *Banking practice* may enable a financial corporation to ask for a collateral security. Such security, we would assume, may be furnished by the Directors of a Company but furnishing of such security or guarantee is not confined to the Directors or employees or their close relatives. They may be outsiders also. The rights and liabilities of a surety and the principal borrower are different and distinct.”²⁷⁸ “(Emphasis supplied) Therefore, it stands concluded, without any doubt, that the banks have developed the practice to execute personal guarantee agreements with the directors of a company to secure the debts of the company without the authority of law ... This practice is against the principle of limited liability of the shareholders as well as directors of the company as provided in the Companies Act, 1956. Accordingly, it is clear against the letter and spirit of the Companies Act and therefore unlawful.”²⁷⁹

“A Case Study– Dena Bank (Letter of Guarantee)

Extracts of Paragraph nos. 1, 3, 4, 5, 6, 10 and 15 of Letter of Guarantee of Dena Bank are reproduced below for ready reference –

Paragraph no. 5 “The Bank may recover against me/us to the extent herein before mentioned notwithstanding that the Principal or his agents, partners, directors or officers

²⁷⁸ Narendra Sharma, “Personal Guarantee-A Void Agreement”, www.lawyersclubindia.com 13 February 2011 (accessed on: June 25, 2011)

²⁷⁹ N.K. Sharma, “Director’s Personal Guarantee – A Void Agreement”, <http://www.drtsolutions.com> (accessed on: July 3, 2011)

may have exceeded his or their powers or that the arrangements with the Bank may have been ultra vires and without being bound to enforce its claim against the borrower or any other person or other security held by the Bank. *The Bank shall not be bound to inquire into powers of the Principal or his agents or partners, directors or officers purporting to act on behalf of the borrowers and all moneys dues or liabilities incurred shall be deemed to form part of the present guarantee notwithstanding that the Principal or his agents, partners, directors and officers may have exceeded his or their powers or the arrangement with the Bank may have been ultra vires*²⁸⁰

The directors are required to give the personal guarantee without the seal of the company.²⁸¹ This shows the intension of the bank to bind the directors in case of default by the company.

²⁸⁰ Infra, reference no45.

²⁸¹ "Interview Excerpts", Ammara, Adnan. Credit analyst, MCB regional branch, Islamabad (August 5, 2008)

Chapter # 6: Recommendations to avoid the conflict of laws

The laws are drafted for being respected and not to be overlooked or bypassed by any flaw in the process of its application. From the above discussion we know that the doctrine of separate legal entity is the backbone of corporate law. Along with that the prudential regulations of the state bank of Pakistan are also the key rules to run the lending affairs of the banks. Both the laws should be implemented in harmony with each other and not in conflict of the same. So regarding the whole discussion it seems that the process of lending needs to be re-considered, and the flaws should be overcome by the authorities as well as the process of lending loans by the banks should be drafted in an infallible way, so that any conflict of law can be evaded.

The present conflict of laws arose because of the reason of insecurity to the financial institutions for the repayment of its loans. Therefore the process of granting loans needs to be upgraded to the international standards. Hence, the banks need to be granted the status of secured creditors, so that they can be certain about the repayment of loans granted.

The status of secured creditor for the banks

One of the solutions to the conflict of laws seems to be that the banks should be given the status of secured creditors.²⁸² If we closely observe the problem it became evident that banks want to be ensured for the repayments of the debts because the money they lend to the company comes from different customers, and the customers trust them to handle with their money properly. So it seems highly significant that the banks should hold the status of a secured creditor. By observing this way out the banks would not need to elevate the veil of incorporation²⁸³, by demanding any personal guarantee of the directors and the doctrine of separate legal personality would be respected.

The same practice is being observed in the developed countries successfully. Therefore, I am of the opinion that it can work in our system as well. Along with the status of a secured creditor the

²⁸² T.H. Donaldson, *How to handle problem loans*, (Britain: Macmillan Publishers Ltd, 1986), 7

²⁸³ Paul Davies, *Company Law*, 7th ed. (London: Sweet & Maxwell Ltd, 2005), 181

banks need to work on some other matters as well. It's a worth saying that 'Prevention is better than cure'.

Applicability of strict documentary requirements by the banks

Although the banks are already observing very stringent rule while lending loans to the corporations. But the need of time is that the banks should re consider those rules. The banks usually require a list of documents before lending the loans.²⁸⁴ But in practice it is not strictly followed, so there must be a counter check that the documentary requirement should be followed up to the mark. The banks should keep an eye watch on the companies, and should take regular update information about the performance of the company as well as of the object or purpose for which the loan was granted.

Banks own inquiry system to issue clearance report regarding financial position of business of borrowers

Another worthy opinion is that, if the banks formulate a setup to inquire and to draw a report regarding the financial position of the company, before granting the loan. The banks need to work on the lending operations as well, which is highly important for the ensured recovery of the loans. The regulatory authorities should ensure to setup a system of investigation in each bank. There must be a department of investigation which should work on the applications for financing, and go through the past financial transactions of the borrowing company as well as its business history, so that the facts about the repayment capability of the company should be known. And it should issue a clearance report of that company which can ensure that the specific borrower is capable of repayment of that loan. The report should be based on the financial position of the company including the value of its assets too.

The bank itself draw the inquiry report about the borrower so that it can be fully trustworthy, and company's capability should be known accurately before granting any loan to that company. Such a report can help avoiding problems regarding loan recovery.

²⁸⁴ See, chapter 2,

Conclusion

Doctrine of separate legal entity provides a great mechanism to boost the financial activities of the economy. Practically, a number of investors are being involved in the trade ventures because of the shelter of limited liability, provided by the said doctrine. The economic activity increased with the investments in the risky business ventures, to the remarkable levels.

Law creates the fiction of distinct legal personality for the development and growth of the corporate sector. In fact, this is the intension of law to assign the status of separate legal entity to the company. The law intends to deal the company as a 'person', so that the natural person can get the maximum benefit of it by enhancing the corporate activity.

The distinct corporate entity provides all the attributes of a natural person to the company, and as a result of that a company can enter into transactions, and creates legal rights and duties therewith. The company use to borrow loans from the creditors, by practicing the right to transact. Banks are the main creditors of the companies, as they are the most reliable and organized lenders. So, it expects the recovery of that finance from the company itself. The banks provide the financial assistance to the company with a view of its being distinct personality from those of its shareholders and the directors. It means to say that the company itself is responsible for the liabilities created by the loan transactions.

But, the practical aspect is quite different, as the banks lift this veil of incorporation while recovering loans from the company, because the bank wants to ensure the repayment of there finance and not to hook into any fraud. Therefore, they held the directors personally liable for the bad debts of the company, in case of default by the same.

The banks are authorized under the banking regulations to do so, and they are justified to recover there finance. But, at the same time bypassing the corporate personality is not justified, because it is duly assigned to the company. There should be a mediate way to solve the issue, and the recommended solutions are very cost effective.

In fact, the problem is of a kind that urgently needs to be resolved, and it's the die need of time to ponder upon this issue. The laws are meant to run the affairs smoothly, and not to create conflicts. So, the present conflict of law is to be settled so that the banks feel their money secured, and can help the corporations to flourish and to boost the economy in a peaceful, and legally strong structured way. Eternal vigilance and abiding the rules are the basic preventive measures. Knowledge of the possible paths can keep the banker informed and consequently fore-armed against frauds, along with giving the due respect to the corporate personality.

**BORROWER'S BASIC FACT SHEET- FOR SMEs OTHER THAN INDIVIDUALS
PRESCRIBED UNDER REGULATION R-8**

Date of Request. _____

(TO BE COMPLETED IN CAPITAL LETTERS OR TYPEWRITTEN)

1. BORROWER'S PROFILE:

Name										Address									
Phone #										Fax #					E-mail Address				
Office					Res.														
Computerized National Identity Card #										National Tax #					Sales Tax #				
Import Registration #					Export Registration #					Date of Establishment					Date of opening of A/c.				

2. DETAILS OF DIRECTORS/OWNERS/PARTNERS:

Name										Address									
Phone #										Fax #					E-mail Address				
Office					Res.														
Computerized National Identity Card #										National Tax #									
Share-holding					Amount					% of Share-holding									

3. MANAGEMENT:

A) EXECUTIVE DIRECTORS/PARTNERS:																			
Name					Address					CNIC #					Phone #				
1.																			
2.																			
B) NON-EXECUTIVE DIRECTORS/PARTNERS:																			
Name					Address					CNIC #					Phone #				
1.																			
2.																			

4. CORPORATE STATUS:

Sole Proprietorship			Partnership			Public / Private Limited Company		

5. NATURE OF BUSINESS:

Industrial	Commercial	Agricultural	Services	Any other

6. REQUESTED LIMITS:

	Amount	Tenor
Fund Based		
Non-Fund Based		

7. BUSINESS HANDLED/EFFECTED WITH ALL FINANCIAL INSTITUTIONS DURING THE LAST ACCOUNTING YEAR:

Imports	Exports	Remittances effected (if any)

8. EXISTING LIMITS AND STATUS:

	Amount	Expiry Date	Status	
			Regular	Amount Overdue (if any)
Fund Based				
Non-Fund Based				

9. ANY WRITE-OFF, RESCHEDULING/ RESTRUCTURING
AVALIED DURING THE LAST THREE YEARS:

Name of Financial Institution	Amount during 1 st Year		Amount during 2 nd Year		Amount during 3 rd Year	
	Write-off	Rescheduled/ Restructured	Write-off	Rescheduled/ Restructured	Write-off	Rescheduled/ Restructured

10. DETAILS OF PRIME SECURITIES MORTGAGED/ PLEDGED:

A) AGAINST EXISTING FACILITIES:				
Name of Financial Institution	Nature of Security	Total Amount	Rank of Charge	Net Realizable Value
1.				
2.				
B) AGAINST REQUESTED/ FRESH/ ADDITIONAL FACILITIES:				
Name of Financial Institution	Nature of Security	Total Amount		Net Realizable Value
1.				
2.				

11. DETAILS OF SECONDARY COLLATERAL MORTGAGED/ PLEDGED:

A) AGAINST EXISTING FACILITIES:				
Name of Financial Institution	Nature of Security	Total Amount	Rank of Charge	Net Realizable Value
1.				
2.				
B) AGAINST REQUESTED/ FRESH/ ADDITIONAL FACILITIES:				
Name of Financial Institution	Nature of Security	Total Amount		Net Realizable Value
1.				
2.				

12. CREDIT RATING (WHERE APPLICABLE):

Name of Rating Agency	Rating

13. DETAILS OF ASSOCIATED CONCERNS
(AS DEFINED IN COMPANIES ORDINANCE, 1984):

Name of Concern	Name of Directors	Share-holding	% of Total Share Capital

14. FACILITIES TO ASSOCIATED CONCERNS BY THE CONCERNED FI:

Name of Concern	Nature & Amount of Limit	Outstanding as on—	Nature & Value of Securities	Overdues	Defaults

15. DETAILS OF PERSONAL GUARANTEES PROVIDED BY THE DIRECTORS / PARTNERS ETC. TO FIs TO SECURE CREDIT:

Names of the Guarantors	Institutions/persons to whom Guarantee given	Amount of Guarantee	Validity Period	NIC #	NTN	Net-worth

16. DIVIDEND DECLARED (AMOUNT) DURING THE LAST THREE YEARS:

During 1 st Year	During 2 nd Year	During 3 rd Year

17. SHARE PRICES OF THE BORROWING ENTITY:

Listed Company		Break-up Value of the Shares in case of Private Limited Company
Current Price	Preceding 12 Months Average	

18. NET-WORTH (PARTICULARS OF ASSETS OWNED IN THEIR OWN NAMES BY THE DIRECTORS/PARTNERS/PROPRIETORS):

Owner's Name	Particulars of Assets	Market value	Particulars of Liabilities

19. DETAILS OF ALL OVERDUES (IF OVER 90 DAYS):

Name of Financial Institution	Amount

20. Details of payment schedule if term loan sought.

21. Latest Audited Financial Statements as per requirements of Regulation R-8 to be submitted with the LAF (Loan Application Form).

22. Memorandum and Articles of Association, By-laws etc. to be submitted by the borrower alongwith the request

I certify and undertake that the information furnished above is true to the best of my knowledge.

CHIEF EXECUTIVE/S/ BORROWER'S
SIGNATURE & STAMP

COUNTER SIGNED BY:

AUTHORISED SIGNATURE & STAMP
(BANK / DFI OFFICIAL)



SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN
COMPANY REGISTRATION OFFICE

COMPANY REGISTRATION OFFICE

Karachi

CERTIFICATE OF INCORPORATION

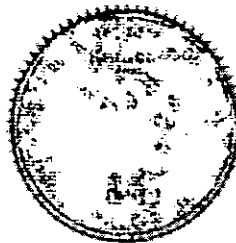
[Under section 32 of Companies Ordinance, 1984 (XLVII of 1984)]

Company Registration No. [REDACTED]

I hereby certify that ~~XXXXXXXXXXXXXXXXXXXX~~ is this day incorporated under the Companies Ordinance, 1984 (XLVII of 1984) and that the company is limited by Guarantee without having Share Capital Under Section-42 of the Companies Ordinance, 1984.

Given under my hand at ██████ this ████ day of ██████ two thousand and seven.

Fee Rs. 25,000/- (Twenty Five Thousand Only)



(Muhammad Naeem Khan)
Joint Registrar of Companies

Joint Registrar of Companies

ANNEXURE III

FORM 29

THE COMPANIES ORDINANCE, 1984 (Section 205)

PARTICULARS OF DIRECTORS AND OFFICERS, INCLUDING THE CHIEF EXECUTIVE, MANAGING AGENT, SECRETARY, CHIEF ACCOUNTANT, AUDITORS AND LEGAL ADVISER, OR OF ANY CHANGE THEREIN

Please complete in typescript or in bold black capitals.

1. Incorporation Number											
2. Name of the Company											
3. Fee Paid (Rs.)	<table border="1"> <tr> <td></td><td></td><td></td><td></td><td></td> </tr> </table>										
	Name & Branch of The Bank <table border="1"> <tr> <td></td><td></td><td></td><td></td><td></td> </tr> </table>										
4. Receipt No.	<table border="1"> <tr> <td></td><td></td><td></td><td></td><td></td><td></td><td></td><td></td><td></td><td></td> </tr> </table>										
5. Mode of payment (Indicate)	Date <table border="1"> <tr> <td></td><td></td><td></td><td></td><td></td><td></td><td></td><td></td><td></td><td></td> </tr> </table>										

6. Particulars*

Present Name in Full	NIC No or passport No. in case of Foreign National	Father's/ Husband's Name	Usual residential address	Designation	Nationality**	Business Occupation*** (if any)	Date of present appointment or change	Mode of appointment/ change/ any other Remarks
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)
6.1 New appointment/election:								
Ceasing of office/Retirement/Resignation:								
6.3 Any other change in particulars relating to columns (a) to (g) above:								

7. Name of Signatory		8. Designation											
9. Signatures of Chief Executive/ Secretary		10. Date	<table border="1"> <tr> <td></td><td></td><td></td><td></td><td></td><td></td><td></td><td></td><td></td><td></td> </tr> </table>										

* In the case of a firm, the full name, address and above mentioned particulars of each partner, and the date on which each became a partner.

** In case the nationality is not the nationality of origin, provide the nationality of origin as well.

*** Also provide particulars of other directorships or offices held, if any.

FORM 26

THE COMPANIES ORDINANCE, 1984

[Section 172]

SPECIAL RESOLUTION

Please complete in typescript or in bold block capitals.

1. CUIN (Incorporation Number

--	--	--	--	--	--	--	--

2. Name of the Company

--

3. Fee Paid (Rs.)

--	--	--	--

Name & Branch of The
Bank

--

4. Receipt No.

--

Date

--	--

--	--

--	--	--	--

Day Month Year

(Bank challan to be attached in original)

5. Date of Dispatch of notice

--	--

--	--

--	--	--	--

Day Month Year

6. Specify the intention to propose
the resolution as Special

--

Resolution

Day Month Year

7. Date of passing of Special Resolution

8. Total Number of Members

Representing Each	shares of Rs.
-------------------	---------------

9. Members present in person and/or through proxy in the meeting

Representing Each	shares of Rs.
-------------------	---------------

10. Members voted for

Representing Each	shares of Rs.
-------------------	---------------

11. Members voted against

Representing Each	shares of Rs.
-------------------	---------------

12. At a general meeting of the members of the said company,

duly convened and held at

(Mention the address)

13. Place (city)

14. Text of special resolution

(attach copy, if space is
insufficient to reproduce it)

Resolved that,

--

15. Signature of Chief Executive/ Secretary

--

16. Name of Signatory

--

17. Designation

--

18. NIC Number

--	--	--	--	--	--	--	--	--	--	--	--	--	--	--

19. Date

--	--

--	--

--	--	--	--



STATE BANK OF PAKISTAN
BANKING SUPERVISION DEPARTMENT

Corporate Credit Information Report

Report Ref No: _____

Report date: _____

Customer's Profile

Code	Name
Present Address	
Previous Address (If Any)	

Consolidated Credit Exposure as on

Outstanding Liabilities	Amount under Litigation
Fund Based	Write-offs (During last five years)
Non Fund Based	Date and amount of Recovery against written off loans.
Over Due	No of times Rescheduling/Restructuring
Past Due 90 Days	(During last five years)
Past Due 365 Days	

Group Entities of the Borrower

Code #	Name of Entity	Code #	Name of Entity

Credit Enquiries

Enquiring Financial Institution	Enquiry date

Remarks

<ul style="list-style-type: none"> • • • •
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