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Abstract

It has been argued in this article that endeavours to improve corporate governance should be diverted to change the perception of corporate law. Managerial unethical practices are dealt with corporate governance strategies; rather, they should be addressed by empowering shareholders to initiate proceedings against errant directors, who are primarily accountable to shareholders. Derivative litigation is not only a useful tool to recover losses caused by the directors to companies, but it may also serve as a deterrent against managerial wrongdoings. However, derivative ligation may lead to abusive proceedings in some circumstances where some opportunistic shareholders may use this very kind of private enforcement mechanism to achieve their bad motives and private gains. This issue can be addressed by allowing only merit-based litigation through screening and filtration of valuable litigation, which could serve the larger interest of the corporations.

Key Words: Derivative Litigation, Corporate Governance, Abusive Proceedings, Unethical Practices

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Title

Derivative Litigation and Corporate Governance: A Problem of Abusive Proceedings

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Contents

Abstract

It has been argued in this article that endeavours to improve corporate governance should be diverted to change the perception of corporate law. Managerial unethical practices are dealt with corporate governance strategies; rather, they should be addressed by empowering shareholders to initiate proceedings against errant directors, who are primarily accountable to shareholders. Derivative litigation is not only a useful tool to recover losses caused by the directors to companies, but it may also serve as a deterrent against managerial wrongdoings. However, derivative ligation may lead to abusive proceedings in some circumstances where some opportunistic shareholders may use this very kind of private enforcement mechanism to achieve their bad motives and private gains. This issue can be addressed by allowing only merit-based litigation through screening and filtration of valuable litigation, which could serve the larger interest of the corporations.

Keywords: Derivative Litigation, Corporate Governance, Abusive Proceedings, Unethical Practices

Introduction:

Derivative Proceedings and Their Role in Improving Good Corporate Governance

Shareholder litigation is widely recognised. The usefulness of derivative litigation is twofold, as it not only helps in recovering damages for the losses caused by the wrongdoing of directors to companies, but it is also of vital importance for deterrence purposes. Moreover, it is important to reduce agency costs, which corporations inherently face due to the separation of ownership and managerial positions in companies. Litigation against wrongdoing managers, in fact, diminishes the reputation of the corporate professionals as

well as attendant recoveries from the managers. Therefore, both compensatory and deterrence purposes of derivative litigation are useful and vital for aligning the interests of corporations with those of the investors. It is argued that recovery from successful litigation is insignificant and the utility of derivative litigation is more glorified because of its deterrent impacts (Dignam & Lowry, 2009) The recovery benefits of derivative litigation are criticised on grounds that the outgoing shareholders, who sells shares before derivative suits, are deprived of the recovery after successful litigation and thus the incoming shareholders enjoys such recoveries after the suits. Secondly, it is also argued that minorities in the corporations are not significantly benefited from this litigation, as the recovery is distributed proportionately to the number of shares in corporations; since they are minorities in the companies, they get an insignificant amount of the successful litigation (Arad, 2007, 2003).

In fact, the importance of derivative litigation is beyond the compensatory benefits and serves more of a deterrence purpose than recovery of lost assets. The deterrence impacts may help investors trust corporate management and diversify their investments, which would ultimately help solve liquidity problems in corporations. Thus, where directors are found violating their fiduciary duties, shareholders should be possessed with the power to initiate litigation against them, as Reisburg opines that directors' duties and the enforcement power of shareholders are concomitant in enforcing directors' fiduciary duties (Arad, 2010)

In Pakistan, the situation calls for more need for derivative litigation as the corporate ownership structure is concentrated, where minority shareholders have been found showing no interest in disciplining management by use of their insignificant voting power. In multinational corporations, minority shareholders are even unaware of any governance problems and unethical decisions, which provides a justification to empower shareholders to initiate legal actions against such wrongdoer directors (Vgts, 2004). Other remedies available to shareholders are more specific to their return of personal losses, but in derivative litigation, added value is contributed to the well-being of the company. For example, if a shareholder files a suit to buy his shares as being disgruntled by the wrongdoing of the managers, and suppose the company is suffering some nine million pounds loss, if the loss is recovered by a successful derivative action, it would definitely add value to the company and the aggrieved shareholder. As such, if the shareholder presented a suit in court by way of an unfair prejudice remedy, it would not have been apt to choose this course because he would have lost the added value and increase in share price which is possible only through a successful derivative action. This was recognised by an Australian court to prefer derivative proceedings over initiating proceedings for personal recovery, as derivative suits bring forth added value and collective recovery. Moreover, the no reflective loss principle also necessitates derivative proceedings instead of the unfair prejudice remedy because this principle stipulates that shareholders are barred from bringing suits for themselves where the loss is attendant upon the loss to the company. Thus, a recovery by the successful derivative litigation against the company would automatically benefit aggrieved shareholders as well (Aralidou, 2009; Bebchuk, 2005).

Theoretical Underpinning of Private Legal Proceedings

Private legal proceedings are important in order to provide shareholders with an accountability check on managerial abuses against the interests of corporations. As such, cause of action in these proceedings should be available to shareholders to take actions where they find managerial abuses in the form of exploitation of corporate assets, bribery, and other dubious payments made by the corporations to get business deals. These business deals might be advantageous to the corporations, but such unethical business deals made by the managers are subject to legal actions by the shareholders, as the directors of companies are under fiduciary duties to act in accordance with the law of the companies (Robert & Ronald, 2004).

As such, such a violation of fiduciary duties by the directors is punishable in the UK, as the court recognised the private right of shareholders to take action against management's involvement in unethical payments and bribery in the Auerbach v Bennet case (Auerbach & Bennet, 1979). The court held in the case that where management is found in matters of corrupt payments and bribery, shareholders are justified in taking action against such managerial malpractices. As such, a significant

development in this regard was made in (Konamaneni and others v.Rolls Royce Industrial Power (India) Ltd and others, 2002), which recognised private proceedings to make wrongs good in corporations by accepting an exception to the Foss v Harbottle rule, which provides that the company itself is only the entity to take action against wrongdoer managers. In this case, minority shareholders of an Indian company, namely Spectrum Power Generation Ltd, levelled allegations of bribery against British enterprises for bribing the managing director of the Indian company in return for getting business contracts relating to the installation of a power station in Indian (Foss v Harbottle, 1843).

International corruption is also a subject of consideration in Pakistan. Scams such as Karkey, Reko Diq offer ample testimony to such a kind of corruption that the situation calls for the attention of the policy makers to consider matters of illegal payment and bribery as actionable through private proceedings by the shareholders. In Karky, management of the Private Power & Infrastructure Board, Lakhra Power Generation Company, in connivance with officials of the government, received kickbacks and illegal payments to award contracts in favour of Karkey (Dawn, 2016).

The Reko Diq case is a striking example of international bribery and kickbacks received by the government to extend a business deal to a multinational company. The irony of the fate is that a hundred billion dollar asset was converted into an eleven billion dollar liability for the government of Pakistan due to the unethical practice of a multinational corporation. In 1993, an Australian company named BHP was involved in extracting gold and copper from the Reko Diq Mine. In 2000, an Australian company named Mincor Resources took over BHP shares, and with this arrangement, Reko Diq was jointly owned by Antofagasta with 37 percent shares, Barrick Gold also sharing 37 percent shares, and the Government of Balochistan with 25 percent shares The Tethyan Copper Company, a subsidiary of Minor Resources, owned all rights and liabilities of BHP in this arrangement. In 2011, TCC applied for the second time for the lease of mining as they claimed that they could not pay twice for the same favour from the Government, which was refused. (Dawn N , 2017)

The Supreme Court of Pakistan turned down the application of TCC. Upon the rejection of the application of TCC, TCC moved to the International Centre for Settlement of Investment Disputes, a World Bank body, which awarded damages to TCC of 6 billion dollars and dismissed the allegation of Pakistan regarding corruption, and held that the agreement between Pakistan and TCC was a valid agreement and nullified the jurisdiction of Pakistan. Finally, with the intervention of the military establishment in Pakistan, an out-of-court settlement was reached between Barrick Gold and the Government of Pakistan, whereby the fine awarded by ICSID became ineffective, and the production from the project started with new arrangements and agreements with the Government of Pakistan.

This case serves as an vivid testimony to the fact that multinational companies exploit weak governing systems in developing states to gain business deals by exercising unethical means, in these business deals personal interests and individual greed are prioritised over the national interests and as the case shows, a hundred billion dollars asset was converted into an eleven billion dollars liability which left multiple negative impacts on judicial and economic system of Pakistan.

Problem of Abusive Proceedings in Derivative Suits

Derivative proceedings, as discussed earlier, are considered a useful tool for disciplining bad practices in corporate governance, yet the problem of abusive proceedings in such suits is a problem to be addressed to get the optimal results of derivative claims. As such, some opportunist shareholders may exercise this power to frustrate or, in some way, to get a bad motive in these proceedings. The managers might be dragged and involved in unfounded and meritless litigations, which ultimately diminishes the efficiency and dedication of managers (Haroon, 2022). Another problem that may crop up in such proceedings is that of voluntary settlements and withdrawal of suits for private gains. For instance, shareholders may, in connivance with managers, settle disputes of vital importance for the interests of the company at the cost of the reputation and losses to the company, which would otherwise be useful for the corporation if such litigation succeeds. Managers may also lure the litigants to repurchase their shares at a price higher than the market price of the shares in order to compensate the shareholders for withdrawing

litigation in favour of the wrongdoing managers. As such, these types of managerial tactics might undermine the utility of derivative suits, as a successful derivative suit brings forth all direct and indirect gains to the company and its shareholders, which, under such dubious deals and settlements with management, are lost to the indirect interests of shareholders (Henry W B, 1949, Cheema, A., et al. (n.d.).

Despite all such risks of unfounded litigation, it holds no justification to discard the utility of derivative proceedings, as such settlements and winding-up judicial proceedings are subject to the scrutiny and approval of courts. The courts are supposed to protect the interests of the companies by properly scrutinising such settlements and discontinuations by ensuring that such deals are not disadvantageous to the interests of the company. Furthermore, a filtration mechanism in law is required to allow only genuine and merit-based litigation to proceed (Kaey, 2014, 2015). This can be addressed by a preliminary proceeding mechanism by which the usefulness of the suit would be assessed for its further proceeding in the next phase (Mulheron, 2022). It may be contended here that such proceedings would discourage managers from taking risky decisions which are otherwise useful for market capitalisation, as some daring and quick decisions are required in such business deals. Moreover, it may also be argued that allowing such proceedings would lead to an opening of Pandora's box of litigation, which would affect the decision-making capacity of managers, and they would be busy defending proceedings instead of focusing on their professional work. The argument of excessive derivative proceedings is not validated by the experience of jurisdictions such as the UK, the US, Australia, and some other countries, where derivative proceedings are flexibly approved by courts, and there is no deluge of proceedings in such countries. This exemplifies that if proper rules and safeguards are in place, the problem of abusive proceedings can be settled. (Thompon & Thomas, 2004).

In juxtaposition of both sides' arguments, it is submitted that derivative proceedings are a necessary tool for effective accountability in corporations. The significance and importance of such litigation becomes of paramount importance, particularly in a jurisdiction like Pakistan, where majority shareholdings are held by a few in corporations which, by their majority holdings' strength, control decision making, and thus, leave other minor communities in corporations at the mercy of the decisions of these majority shareholders. This is for obvious reasons that litigation against managers would be frustrated or might be suppressed by the majority shareholders, who are also virtually the managers as well. This is the reason the derivative proceedings provide the disgruntled communities in corporations with a tool to discipline and safeguard themselves against tyrannical decisions of the management.

It may also be argued that, since shareholders are at their free will to leave a public company when dissatisfied with the decision of the management, that situation requires more justification and grounds for allowing derivative proceedings where they have the option of quitting the company. There are a number of reasons that this argument does not hold ground to be relied on. As such, denying this very right of initiating legal proceedings against wrongdoing managers would otherwise mean giving go-ahead to them to continue unethical practices and running corporations for their personal gains by ignoring the deterrent role of derivative proceedings. The wrongdoing managers, without any fear of being subjected to litigation, would continue prioritising their interests over the interests of corporations. It is pertinent to mention here that the scope of derivative litigation starts where management denies or otherwise fails to take action against any kind of wrongdoing in the managerial affairs of the company (Bebchuk, 2005). As such, this remedy is available to shareholders who are premised at deterring management from malpractices in corporations and choose to remain in the company which the situation is very encouraging for solving liquidity problems in the corporate sector of Pakistan because, being disgruntled with the decision of management, leaving the company is not a solution to the managerial abuses. Moreover, even though it is believed that the outgoing shareholder of the company would be bereft of the benefits of the successful proceedings, it is argued that he might not get a fair price for his shares when selling because it is quite probable that managerial wrongdoing may lead to a decrease in the share price of the company. In the US, it was found that in public companies, derivative proceedings proved more useful than those in the

private ones; therefore, it is submitted that a jurisdiction like Pakistan where majority shareholdings are held by a few, derivative litigation is of vital importance to counterbalance the controlling role of majority shareholders in the corporate sector of Pakistan (Chen et al., 2009)

It may also be argued that since minority communities in family-owned companies possess very low shareholding, the need for derivative litigation is not required in Pakistan for the different purposes of these proceedings. It is submitted in this regard that this aspect of criticism also does not hold ground for disallowing derivative proceedings because emphasis on derivative litigation is made on a case-by-case basis. As such, the emphasis on derivative litigation is made because a minor shareholder in a family-owned company may need more protection and safeguards against the tyrannical behaviour of the majority or controlling shareholders in the company. It is submitted here that this situation is supported by data available in the courts of Pakistan on abuses and wrongdoings of managers in the interests of minority shareholders. The total number of 22 cases of managerial abuses filed in the courts of Pakistan shows that out of the total number of cases, 12 cases were initiated by the shareholder who possessed shareholding between 20 and 50 percent (Cheffins, 2008).

In the upshot, the significance and importance of derivative proceedings are even more emphasised for matters of unethical managerial decisions in closely held corporations (Reed, 2000). This is necessary because managerial wrongdoings in public companies are, by other means, punished and disciplined by market forces, which is not the case in closely held companies, and the aggrieved shareholders are left at the mercy of such directors to redress their grievances if they are bereft of any legal remedy. Minorities are more vulnerable to directorial abuses in closely held corporations, which necessitates legal remedy in the form of derivative proceedings to make wrongdoers accountable. This is validated by a study regarding the utility of derivation proceedings in private companies in Canada and Australia in order to make wrongs good done to the companies.

Conclusion

International corruption in the form of bribery and kickbacks, and the use of derivative proceedings, has been closely examined in this article. Moreover, an apprehension that derivative proceedings would suffer at the hands of a risk of abusive and opportunistic proceedings has been allayed in this article by giving some suggestions to make necessary arrangements in the law. Derivative litigation as a mandatory check on unethical business practices can serve as an important tool for maintaining public trust through ethical and responsible corporate governance. This is important in the sense that private enforcement mechanisms are more informed and effective because an aggrieved party who initiates proceedings against wrongdoers is possessed with more information about malpractices than a public enforcement mechanism, which is relatively unconcerned and lacks relevant information about the wrongdoings in corporations. Unethical practices in corporations, such as the case of Reko Diq, can showcase a lesson of ethical business practices for the world, integrating this case in business ethics courses in universities, and the role of derivative litigation to curb such malpractices can help the readers and policymakers to better understand the implications of unethical business practices at the national level. It is, thus, recommended that the extension of the cause of action in derivative proceedings to international corruption should be considered by the policy makers, and the legislators are required to incorporate an effective filtration mechanism to disallow unfounded and vexatious litigation in the company law in Pakistan.

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