

Holding all the Cards

The State and the Allocation of Risk under Pakistani law

by

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Introduction

This paper must necessarily begin with some clichéd truths. Firstly, it is no longer open to doubt that economic growth requires a healthy and vibrant private sector. Secondly, private sector investment in any investment opportunity is directly proportional to the risk associated with that investment opportunity: the higher the risk, the less likely the investment. In a country with levels of investment risk, investors will only participate in a business opportunity if the offsetting reward is enough to compensate for the additional risk. Economically rational investors will buy sovereign debt at 6% rather than junk bonds at 12% because there is less risk (hopefully) associated with sovereign debt. Similarly, economically rational international investors would rather invest in Singapore and make 10%, rather than try for a 20% rate of return in Pakistan. For Pakistan to compete with less risky economies, the rates of return it offers have to be much higher. This in turn means that Pakistani projects which do not offer very high rates of return are starved of funds, both from international investors and from local investors.

The point here is very simple: high levels of risk hurt Pakistan. Pakistani governments should therefore try to reduce endemic risk within the legal system. Reducing risk will result in increased investment both by international investors as well as by local investors. An analysis of the legal system, however, reveals that there have been minimal reform efforts by any government to reduce the levels of endemic risk. Risk levels for

businessmen therefore remain extremely high within the legal system with the result that investment suffers. Finally, risk levels for private parties remain high because the State concentrates all discretionary powers in its own hands. Legal structures in Pakistan have been deliberately rendered weak and porous by successive government so as to ensure that no evildoers can hide behind them. The end result however is to weaken the utility of these structures for well-wishers and evildoers alike.

This paper therefore examines various areas of law so as to see where there are risk levels which actually threaten economic investment. Due to time and space constraints, these areas of law have been limited to the following:

1. The law of real property
2. The corporate form
3. Economic policy, incentives and exemptions
4. Public and private dispute resolution

The Law of Real Property

Simply defined, capitalism consists of the belief that the most efficient use of capital arises when individuals are given the maximum freedom to decide how to use their capital. If that is assumed (repeat, assumed) to be true, it follows that the state has a vested interest in ensuring that transfers of capital are made as secure, as quick and as efficient as possible. More specifically, since the primary form of wealth in Pakistan consists of real property, the state of Pakistan has a vested interest in ensuring that property transactions are as secure, as quick and as efficient as possible.

Given this objective, it can be readily seen that the legal system of Pakistan is a miserable failure: every single possible transaction regarding real property in Pakistan is highly insecure, is grossly inefficient and so unnecessarily encumbered by litigation and the threat of litigation as to be completely dysfunctional.

Transfers of property can be divided into various categories such as sales, leases, mortgages and transfers through operation of law (i.e. inheritance laws). However, it can easily be appreciated that prior to any transfer, there must first be a system which allows title to be definitively recorded so that prospective buyers of property can have some degree of satisfaction as to what they are buying. Unfortunately, our legal system falters at this very first hurdle because there is no centralized and authentic system of recorded title in Pakistan.

Let me be very clear as to what I am saying: there are multiple systems in Pakistan which record evidence of title: there no systems which record title itself. For example, the land revenue records under the guardianship of the ubiquitous patwari are just that: land revenue records or a record of who is liable to pay tax with respect to a particular patch of land. They are not definitive proof of title, merely evidence of title. Where land has been allotted within a housing scheme or by a government entity, the original letter of allotment constitutes title but subsequently, the records of the housing scheme or the government entity are again only evidence of title, not proof of title. The difference between “evidence of title” and “title” itself is that evidence of title requires proof to be made definitive whereas a title record, for example, through a centralized land registry system, can be taken as definitive proof of title without any further investigation.

The consequence of this is that nobody knows for sure as to who owns what. Considering that England has had a written record of title since the commissioning of the Domesday Book in 1086, it is probably time for Pakistan to consider the same. The consequences of not having a centralized title registry are not only serious, but obvious.

The simplest and most obvious consequence of not having a definitive record of title is that all transactions based upon real property automatically become insecure. This has a drastic effect in the case of secured transactions because the quantum of the loan which will be offered by a financial institution is directly related to the degree to which it can realize its security which in turn is affected by the security of title of the borrower (or guarantor, as the case may be). On a purely anecdotal level, it can be ascertained that

banks in Pakistan will not normally give a loan for more than 50% of the assessed value of a property in Pakistan. Banks in the United States will however, regularly allow loans for up to 90% of the assessed value of property. That difference between 90% and 50% is dead capital and is directly attributable to the fact that a US bank has no exposure to title risk whereas Pakistan banks have a substantial risk to title risk whenever loans are secured by real property.

Another obvious consequence of not having a definitive record of title is that this uncertainty in the system supports a vast army of lawyers who do nothing but litigate title disputes. According to one ADB survey, roughly 90% of civil disputes in Pakistan relate to land. So long as the title of property is disputed, the economic value of that property is minimal, which in turn means that the economic base of Pakistani society is being diminished to that degree. Disputed property is dead property, good for nothing except feeding disputes.

A record of title for real property is one of the primary foundational factors for all economic activity in a country. This is particularly true in a country where wealth is still kept more in real property rather than in stocks and bonds. The extent to which Pakistan's economic growth would benefit from a comprehensive revaluation of its property laws must necessarily remain speculative. However, to paraphrase a famous saying by Lord Reid, just because something is not capable of being defined with mathematical exactitude is no basis for claiming that it does not exist.

Even if the fundamental problem of a lack of a centralized and definitive record of title is laid aside, Pakistan's laws are still economically asinine. Take for example, the simple concept of a sale of real property. Since 1604 when the statute of Elisabeth was passed by the Parliament of England, every transfer of real property in England has required a written document. In Pakistan, we can still have oral gifts of property. More importantly, it is still possible to enter into a binding but unregistered agreement for the sale of property in Pakistan. Pakistani law thus recognizes the concept of an unregistered "Agreement to Sell" which can subsequently be enforced through court action. The civil

courts are therefore full of lawyers brandishing random bits of paper as proof of the fact that their client has entered into a binding agreement to sell with the defendant. Those bits of paper may or may not be authentic but by the time that issue is decided, decades have passed and the property has remained fallow and economically unproductive during that entire time.

Let us aside the problem of unverified sales and come now to a peculiarly Pakistani problem: the law of pre-emption. Under the law of pre-emption, various relatives and neighbours have a superior right of purchase to outsiders. A neighbour whose land adjoins the land being sold can therefore “pre-empt” the sale and purchase the land at the offer price. The neighbour’s right of pre-emption is, however, dependent on a complex series of “talbs” or demands, each of which must be made at different times and in different ways. All of this must be necessarily proven through a court process in which an additional complicating factor is added by the fact that the land being sold will most likely have been declared at less than the actual value in the agreement to sell. The net result is more litigation, more business for lawyers and more dead capital.

It is also important to realize that not only is litigation a potent deal-breaker but that the threat of litigation is an even bigger deal-breaker. Buyers will obviously not be interested in property which is enmeshed in dispute. However, it is perfectly possible for litigation to exist with respect to a particular piece of property without anybody knowing about it except the litigant and his lawyer. To clarify, the law applicable in Pakistan (with the exception of Karachi) does not require notice of litigation to be registered. In order to be sure that a property is not under litigation, a prospective purchaser would face the impossible task of having to check all litigation in all courts with jurisdiction over the property in question.

And it gets worse. Pakistani law also recognizes the concept of an unregistered mortgage, i.e. a mortgage created through the possession of title documents. In order to be sure that a person claiming to have title actually is the owner, a prospective buyer must examine not only the title documents of the seller but the title documents of all the seller’s

predecessor's in interest. And if any one of them had lost his title deed, the possibility will certainly exist that there is a bank out there which has the title deed in its possession as a security for a loan.

A similar complication is added by the various rent control laws prevalent throughout Pakistan. The result of these laws is that there is no such as a limited term lease in Pakistan. In other words, once you rent property to a tenant in Pakistan, that tenant has the right to stay there for ever, subject only to two considerations. The first consideration is default in payment of rent by the tenant. The second is the bona fide personal need of the landlord. Both considerations are questions of fact which must be decided by a court of law if disputed by the parties. The end result is litigation: it is normal for eviction proceedings to stretch for decades and go up to the Supreme Court. Indeed, one survey found that approximately 6% of reported Supreme Court decisions over the period 2000-05 dealt with rent matters.

To examine the issue of rent laws from an economic perspective, the laws of Pakistan force a landlord to take the risk that he will not be able to evict his tenant even if his tenant is paying rent at a rate considerably below market rates. Many landlords will rent only to foreigners or multinational companies so as to minimize the risk of a recalcitrant tenant. Many landlords prefer not to take that risk as is evident from the number of houses which are kept empty. And those who do rent, often ask for massive upfront security deposits equivalent to one or even two years rental value in order to provide themselves with some security. The end result is that rental values are being made higher by a legal system ostensibly geared to protecting the economic interests of the lower classes.

The final straw, and this is by no means, an exhaustive survey comes courtesy of the Islamic law of inheritance. Under the law of inheritance, all property owned by a person vests automatically in all heirs of that person to the extent of their Quranic shares on the death of that person. Thus, if a person owns six different properties and has six different children, each of those children will have a share in each of those six properties. Each

death therefore results in major confusion as to who owns what which confusion is normally followed by litigation. Since Pakistani men have the regrettable habit of trying to cheat their sisters and other female relatives out of their Quranic share of property, litigation is the normal consequence of death. Furthermore, since the Supreme Court has held that there is no statute of limitations applicable to *purdanashin* ladies, the passage of even fifty or sixty years is no deterrent to litigation. The further consequence of this is that fathers often try to gift their properties to their children in their lifetimes. However, since Pakistani law also recognizes the concept of benami ownership of property, it is open to the disgruntled females (if any) to allege after the death of the gift-giver that the property was being held benami and that they have been illegally deprived of their share in the family estate.

To summarise the above, the laws of Pakistan are not just inefficient when it comes to real property but economically asinine. Indeed, Pakistani property law invites and rewards litigation. It is a dysfunctional and idiotic system which exists for no other reason but due to inertia and the vested interests of the hordes of lawyers who cling parasitically to the system's flanks.

It is often stated in response to observations such as the above that India has the same system and yet seems to be progressing just fine. I find this reasoning entirely unacceptable. In the first instance, India's progress is despite its legal system, not because of it. Secondly, there are many things which the world has figured out which have yet to be adopted in India. It is now not open to debate that a functional, efficient and definitive system of property law is helpful for economic growth. India is progressing without such a system: Pakistan does not have that luxury. We do not have that luxury because our risk factors are in any event much higher than India's risk factors. A foreign investor examining the risk matrix in India may decide to ignore its system of property law because of other factors such as the size of the market and the fact that India is a stable democracy. We do not have similar compensating factors. In any event, there is no harm in being better and more economically savvy than India. For once, let us lead and not follow.

All of the problems noted above have very simple legal solutions. Those solutions have been worked out in the West (not to mention countries like Singapore) and are functioning perfectly well there. Those solutions can be applied in Pakistan without any cultural constraints. Pakistan's refusal to modernize its property laws is equivalent to treating diseases with the conscientious application of leeches rather the usage of antibiotics. Not surprisingly, people are dying but the wonder is that we continue to be surprised.

II. The Corporate Form

The worldwide popularity of the limited liability company and its overwhelming usage as a vehicle of choice for investments is due to the very simple fact that it limits liability, i.e. it minimizes risk. The joint stock company allows investors to limit their liability to the extent of the value of their shareholding. By comparison, a partner of a partnership firm is personally liable for all of the debts of the firm and can face personal ruin as the result of an unwise decision by one of his partners.

From the perspective of the state, the corporate form has both benefits and costs. The benefit of the corporate form is that the company allows people who would not otherwise take any risk to invest their savings productively. Joint stock companies are a wonderful tool for capital mobilization and thus for economic growth. On the other hand, the limited liability of companies can be used to shield malefactors from personal liability. A bank which lends to a company may be left with nothing if the company goes into liquidation. More importantly, who is to be held liable if a company commits a crime?

Unfortunately, the Pakistani state has till date focused only on the negative aspects of corporatisation. Pakistan therefore has a number of laws which effectively destroy the corporate shield so much so that there is now little advantage to be gained from corporatisation. For example, the Income Tax Ordinance 2001 specifies that directors of a company are personally liable for all arrears of income tax owed by a company. More

importantly, the State Bank of Pakistan requires all loans of a company to be backed by the personal guarantee of all the directors of a company. Most importantly, General Musharraf's regime introduced the NAB Ordinance in 1999 which provides that any default on any loan or liability owed to a state entity is a criminal offense for which the directors and controlling shareholders of a company can be punished with a jail sentence of up to 14 years in jail.

The end result of all these provisions is a massive increase in the risk profile of the investor. If I invest in General Motors today, I do so secure in the comfort that the bankruptcy of GM tomorrow will not land me in jail. I cannot make the same statement with respect to a Pakistani company. Self-evidently, the number of people who are willing to take on this level of risk is limited as compared to the number of people who will invest if not faced with the prospect of a 14 year jail sentence.

The final point to note is that the NAB Ordinance is not only economically undesirable but otherwise unnecessary. The precise crime defined by the NAB Ordinance which creates problems is the crime of "willful default." Willful default did not need to be criminalized through the NAB Ordinance because a deliberate default is already punishable as fraud. However, the NAB Ordinance defines "willful default" as all default of more than 30 days. In short, the term "willful" has no additional meaning under the NAB Ordinance: what has been criminalised is default simpliciter.

It should further be noted that this point has already been brought home to the government. As a result of protests from the business community, the NAB Ordinance was amended in 2002 to provide that cases of willful default would only be open to prosecution if the State Bank of Pakistan certified that the default in question was indeed, willful. The SBP has subsequently clamped down on the NAB law with the result that there are very few instances of defaults being characterized as willful defaults by the SBP for the purposes of the NAB Ordinance. An additional hurdle has also been thrown into the path of the NAB Ordinance by the Sindh High Court which held in the Kaloodi case (reported at 2003 P Cr LJ 626) that no case of default could be prosecuted as willful

default unless the amount in question had become finally settled as “due” by a court of civil jurisdiction. The end result is that we are now left with the worst of both worlds, i.e. the criminal liability remains on the books to scare the wits out of all prospective investors but in actual terms, the willful default provision has been comprehensively defanged.

III. Economic policy, incentives and exemptions

The Pakistani government, like all governments, tries to drum up investment by promising tax exemptions of all sorts to prospective investors. These normally include exemptions to various degrees from sales tax and customs duties, as is the case in other countries. The only different is that in the case of Pakistan, an investor does not have the right to rely on the statements being made by functionaries of the Pakistani government. To put it bluntly, the Pakistani government may or may not be laying to investors but it certainly has reserved to itself, the right to lie to investors. Any investors who relies on a commitment by the government of Pakistan to provide a certain exemption is a fool.

To understand the above point requires taking a step back into the taxation methodology under Pakistani law. In countries like the United States, rates of taxation are determined by the legislature and can only be changed by the legislature. Under Pakistani law, the rates of taxation are nominally determined by the legislature but in actual fact, the rates are determined through the levels of exemptions provided, which exemptions are determined by the CBR (i.e. the executive). The classic example of this reverse taxation methodology was the Central Excise Act of 1944 which taxed all goods and all services at a very high rate, which goods and services (barring two or three) were then promptly exempted by the CBR. In any event, the normal method of providing tariff or tax relief to any person or industry is through a notification issued by the CBR which will contain either a partial or complete exemption subject to whatever conditions may be specified.

In 1986, the Supreme Court of Pakistan decided the Al Samrez case in which it was held that when the Government withdrew an exemption relating to customs duty, that

exemption would not affect such goods with respect to which the importer had already made an irrevocable commitment of payment. The rationale of the judgment was that the importer had relied to his detriment on the notification of exemption while opening his L/C and under the doctrine of promissory estoppel, the Government could not change its position so as to affect those goods which were already paid for under the L/c.

In 1988, the Government of Pakistan promptly amended the Customs Act, ____ via the insertion of §31-A which provided that no matter what the Government might have said earlier, the rate of taxation would be the rate applicable on the day the goods landed in Pakistan. In short, if the exemption was withdrawn while the goods were in transit, that was the importer's risk. The importer could therefore no longer rely on the exemption notification of the Government to be applicable at the time of import.

It is important to understand that this provision of law only allows the Government to realize the additional customs duty for goods which would be imported within the normal period for which a letter of credit is opened, i.e. about three to four months. By contrast, the change in risk profile for an importer is massive. Now, when the government announces a customs exemption, the importer or the intended beneficiary has to factor in the risk that the exemption will be withdrawn after the goods have been paid for but before they have landed. If that risk is unacceptable, the exemption will be useless.

One would have imagined that the economic lunacy of such a provision would long since have become evident to the Ministry of Finance. However, rather than repealing the offending provision, §31-A of the Customs Act has been made applicable to the sales Tax Act, 1991 so that sales tax exemptions are similarly prejudiced.

The economic devastation which can be caused by the misuse of this provision can be seen most clearly in the cases arising out of the Gadoon Amazai economic zone. As noted in the Supreme Court case reported as M.Y. Electronics v. Government of Pakistan, 1998 PTD 2728 the Federal Government decided to support the creation of a special economic zone at Gadoon Amazai in the expectation that the development of local

industries would allow the elimination of poppy cultivation in the area. A number of industrialists were then cajoled into setting up shop in the wilds of Swabi with the promise that they would be given exemptions from customs duties and other taxes. However, shortly after the new plants came into operation, the Federal Government withdrew its exemptions on the basis that they were being misused by some parties. When the case went up to the Supreme Court, the Federal Government completely disowned the industrialists and in fact denied that it had ever asked them to invest in the area. In its judgment, the Supreme Court clearly disapproved of the actions of the Federal Government but held that §31-A allowed the Government to withdraw any exemption at any time, without notice, and that the industrialists were not entitled to rely on the exemption notifications.

The relevance of §31-A to today's investment climate is fairly simple: investors, and particularly local investors, are not fools. They also tend to have long memories. As the saying goes, "Fool me once, shame on you. Fool me twice, shame on me." Local investors have no intention of getting fooled again.

More generally, the question arises as to why the Government of Pakistan needs the assistance of a legal provision which allows it to wriggle out of its commitments. If the Government wants to be taken seriously, it needs to be capable of making a promise which the courts will regard as binding. At this moment, that capability is lacking. The result is that investors who rely upon exemptions or incentives given by the government are perpetually nervous because they know that those incentives can be withdrawn at any time. More importantly, how can the Government ask investors to invest in an underdeveloped area on the basis of a promise that the Government will provide incentives? As the record of Pakistan's economic policy shows, the good sense of the Ministry of Finance is certainly not adequate assurance.

IV. Dispute Resolution

One of the most obvious risk factors with regard to any transaction is the method of

dispute resolution or alternatively, the method for enforcement of contractual rights. In Pakistan, dispute resolution can be accomplished either through the public dispute resolution system, i.e. the judiciary, or through private dispute resolution systems, i.e. arbitration. In both cases, the system fails.

This paper is not the appropriate occasion for a comprehensive look at the multiple failings of the judiciary in Pakistan. Suffice it to say that from the perspective of the average businessman, the judiciary is so slow in its delivery of justice, so inefficient and so corrupt that its utility is nil. The result is that local businessmen do not rely upon the possibility of judicial action when calculating whether or not to enter into a transaction. Instead, they prefer to enter into transactions with people whom they know, either through *biraderi* based networks or through professional groups, in which the ultimate method of enforcement is not the coercive arm of the law but rather the social opprobrium of being a defaulter. As studies of the yarn market in Faisalabad have shown, these unofficial networks can work very efficiently. However, the problem is that these networks are limited to those who are members of that network and to those who have sufficient social capital. The whole point of an independent judicial system is that it should reduce the risk of dealing with a total stranger. In that sense, the judicial system of Pakistan is a complete failure.

The failure of the public dispute resolution system is further exaggerated by the failure of the private dispute resolution system, i.e. the law relating to arbitration. For many international investors, trusting indigenous judicial systems is not an option when investments worth millions of dollars or more are at stake. In such cases, investors prefer to have their disputes adjudicated through international arbitrators. However, international arbitration has been hamstrung in Pakistan through a number of questionable decisions. In the case of Uzin Exports vs M. Iftikhar, 1993 SCMR 866 the Supreme Court allowed a local party to evade international arbitration on the grounds that the witnesses and documents were all in Pakistan. More recently, in the Hubco case, reported at PLD 2000 SC 841, the Supreme Court allowed the Government of Pakistan to avoid arbitration on the ground that the allegations of fraud were non-arbitrable, a finding

which flies in the face of international practice and which has lead the international investment community to look at Pakistan's judiciary with grave suspicion. In yet another dubious case, reported at 1998 SCMR 1618, the Supreme Court declared that an international arbitration proceeding in London under ICC rules could, under certain circumstances, be subject to orders made by a civil judge in Sheikhpura merely because the cause of action had arisen there.

The consequence of all these decisions is that they again raise the level of risk that an international investor faces. Once the international investor takes that heightened level of risk into account, he will only be prepared to invest if and only if his return on investment is commensurately high. However, high rates of return (as in the case of the 1994 Power Policy) only lead to further suspicion amongst the local population which eventually leads to judicial blowback in some form or another, thereby worsening the problem. Meanwhile, Pakistan's economy continues to suffer.

IV. Conclusion

The above narrative is not intended to be a comprehensive list of issues relating to the allocation of risk under Pakistani law. Instead, there are two fundamental points being made. The first point is that levels of risk in Pakistan are unacceptably high. The second point being made is that the Government of Pakistan sees itself as not just a participant but as a contestant in the economic fray. Within that contest, the Government does not like to lose. Thus, the Government consistently modifies and changes laws so that all discretionary powers vests in its own hands. That approach is flawed. The Government must stop thinking of itself as a competitor to private corporations and must instead embrace a role as facilitator in which it provides the necessary infrastructure for commerce in return for a transactional fee (i.e. taxation). Until and unless that paradigm shift occurs, the Government will still want to hold all the cards to make sure that it does not lose. What the Government forgets is that when you hold all the cards, nobody wants to play with you.