

# DOING BUSINESS (2018) – PAKISTAN

## Lahore and Karachi

### Getting Credit

#### Introduction

1. This briefing paper considers the current position of the DB topic of ‘Getting Credit-Strength of Legal Rights’ in Pakistan.
2. The laws regulating the field of credit are primarily federal laws including Companies Ordinance 1984, Financial Institution (Recovery of Finances) Ordinance, 2001 and Financial Institutions (Secured Transactions) Act, 2016 (hereinafter referred to as the ST Law). The ST Law was assented by the president on June 28, 2016 and published in the Official Gazette on July 1, 2016. The ST Law shall come into force on such date notified by the federal government for establishment of the Secured Transactions Registry.
3. Due to federal laws and regulation of this field, there is no difference between the scores of Lahore and Karachi for this index.
4. The DB Survey 2018 has been conducted on the basis that ST Law is in field without the Secured Transactions Registry. This preliminary briefing paper also assumes that ST Law is in force and therefore, Getting Credit - Strength of Legal Rights score is seven out of 12.<sup>1</sup>
5. Due to ST Law, Pakistan can improve its index score. However, there is opportunity for performing better. It is imperative to first identify the reasons for Pakistan’s low performance on this index, which are listed below:
  - i. lack of unified collateral register for all immovable assets
  - ii. preferential taxation and employee claims compared to the claim of a secured creditor
  - iii. inapplicability of rules of preference/priority of secured creditors in case of insolvency of debtor
  - iv. recourse to stay/injunctive relief against the enforcement action initiated by a secured creditor
  - v. Non-availability of out of court enforcement mechanisms for secured creditors
6. Pakistan’s performance can be improved within a year if concerted efforts of reform are made on all fronts. For most of these indicators, policy and legislative reform is required albeit the importance of up to date infrastructure development cannot be underestimated at any cost.

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<sup>1</sup> Data provided by the State Bank of Pakistan and the Doing Business team.

7. The following table identifies the indicators in need of reform and accordingly lays out a reform plan for it, requiring intervention in following three areas: Policy and Legislative (PL), Technical Assistance (TA) or Infrastructure Investment (II).

<u>Indicator</u>	<u>Measures</u> (Policy and Legislative – <b>PL</b> , Technical Assistance – <b>TA</b> , Infrastructure Investment – <b>II</b> )
Does an integrated or unified legal framework for secured transactions that extends to the creation, publicity and enforcement of functional equivalents to security interests in movable assets exist in the economy?	<b>II &amp;TA-</b> From experience, the unified electronic collateral register for movable assets is a key to the financial reforms agenda. <sup>2</sup> Presently, in Pakistan the collateral registries are organized according to the type of the owner of asset instead of the type of the asset itself. For example, the charges on all types of assets (moveable or immovable) of a company are registered with the Securities and Exchange Commission of Pakistan (SECP). On the other hand, the ST Law contemplates a collateral register only for the immovable assets of non-corporate entity. There should be one unified collateral registry for immovable assets, regardless of the type of entity (corporate and non-corporate).
Are secured creditors paid first (i.e. before tax claims and employee claims) when a business is liquidated?	<b>PL-</b> The insolvency law should provide for an order of priority where creditors of an entity are paid off in case of liquidation. The companies' law should be amended to clearly stipulate the order of priority and in this order, the priority defined in the ST Law should be followed as a matter of principle in insolvency proceedings. Unfortunately, the priority or preference rules are not applicable in case of insolvency proceedings. Presently, in case of insolvency, if the assets are less than the liabilities, the creditors are proportionately paid off from proceeds of the assets. The law should be modified to stipulate the priority of creditors in liquidation/or insolvency proceedings and the claim of secured creditors should be satisfied in full before any other creditors are paid off.
Are secured creditors paid first (i.e. before tax claims and employee claims) when a debtor defaults outside an insolvency procedure?	<b>PL-</b> Although the ST Law provides that secured creditors can claim outside insolvency proceedings and would have priority over any preferential claim, it does not define the expression 'preferential claims'. The expression 'preferential payments' is defined in the Companies Ordinance 1984 (Section 405) and includes taxes and employees' salaries. The ST Law should be amended to include the definition of the expression 'preferential claims' to avoid unnecessary litigation for the secured creditors.

<sup>2</sup> The Ghana's experience of establishment of collateral register is indicative of that.

<p>Are secured creditors subject to an automatic stay on enforcement when a debtor enters a court-supervised reorganization procedure?</p> <p>Does the law protect secured creditors' rights by providing clear grounds for relief from the stay and/or sets a time limit for it?</p>	<p><b>PL-</b> Court supervised reorganization procedures are not part of Pakistan law. The only mode for insolvency is liquidation. The ST Law should include provision where enforcement proceedings/action initiated by the secured creditor is not amenable to injunctive proceedings or any other specific relief. Under Pakistan law, there are three grounds recognized for the grant of stay/injunctive relief to an applicant, namely, prima facie case in favor of the applicant, any irreparable harm to the applicant and balance of convenience in favor of grant of injunction. The law can be amended to categorically state that against the claim of enforcement of a secured creditor none of those grounds would be available and hence, no injunctive relief can be granted. In the alternative, the law can prescribe two things. First, if at all an injunctive relief is allowed against the claim of the secured creditor in exceptional cases, the time period of stay would not exceed specific number of days (e.g. 14 days). Second, once the stipulated time period elapses, the stay would not be renewed and there would operate no legal bar against the claim of a secured creditor.</p>
<p>Does the law allow parties to agree on out of court enforcement at the time a security interest is created?</p> <p>Does the law allow the secured creditor to sell the collateral through public auction and private tender, as well as for the secured creditor to keep the asset in satisfaction of debt?</p>	<p><b>PL &amp; TA-</b> The ST Law may include provisions allowing parties to agree on a mode of enforcement of security interest without court intervention. One possibility can be appointment of receiver by agreement of parties. Another option can be public auction by the secured creditor after the default of debtor continues beyond a specific period of time. In any case, the law must set out a procedure for such out of court mechanisms of enforcement. An alternate avenue for disposal of distressed assets exists in the form of Corporate Restructuring Companies and creditors can sell the encumbered assets to such companies. Corporate Restructuring Companies would be established under the new law introduced in 2016 i.e. Corporate Restructuring Companies Act, 2016. In this regard technical training sessions focusing on role and business model of such companies should be organized by the regulators to promote their incorporation.</p>