

Palestine Economic Policy Research Institute

# **Impact of the Draft Company Law On the Performance of the Private Sector in Palestine**

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**2008**

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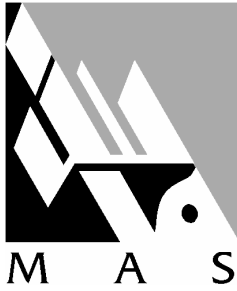
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## **Foreword**

The draft company law prepared by the Ministry of National Economy at the beginning of 2008 caught the attention of many lawmakers, researches, businessmen, and policy makers in public and private sectors. The draft law is of great importance since it acts as an umbrella for other economic laws, enhances the investment environment, and enforces competitiveness in the Palestinian economy. This draft follows several attempts to issue a modern company law that unifies the current company laws in the West Bank and Gaza Strip and takes into consideration the political and economic developments in the local, regional, global environment.

The aim of this study is to analyze the draft company law and assess its impact on conduct, performance and competitiveness of Palestinian companies. It uses economic analysis to review the performance of the private sector, whilst taking into account the unique nature of the Palestinian economy and the prevailing political-economic conditions in Palestine. The study is of special importance at this particular time as it may contribute to the development of the draft law and help achieve the law's desired objective of promoting domestic and foreign investment, and enhancing the competitiveness of the private sector in Palestine.

This study is undertaken by the Palestine Economic Research Institute (MAS) under the fourth and final phase of "enhancing the competitiveness of private sector" program, which is funded generously by the International Development Research Centre (IDRC), Canada. I would like to sincerely thank IDRC for funding this series of studies. I would also like to thank all those who cooperated with us in this study, especially the Ministry of National Economy who provided us with the draft law, the experts whom we interviewed, the participants at the workshop during which the study was presented and discussed, and the reviewers of the first draft of the study, whose input was hugely beneficial. Finally, I would also like to thank the research team for their efforts to produce such a valuable paper.

**Dr. Mohamed Nasr**  
**Director General**



## **Executive Summary**

1. The study aims to analyze the draft Company law prepared by the Ministry of the National Economy to conduct an assessment of its impact on the performance of companies operating in Palestine and on their competitiveness in both local and international markets. It also aims to measure the role of the draft law in attracting foreign investment. The study aims to identify the strengths and weaknesses of the draft law in order to formulate specific recommendations about the required amendments and to obtain a modern law for companies in Palestine.
2. To achieve the objectives of this study, the theoretical background of potential impact of economic laws in general and company law in particular on the economy. The provisions of this draft law were compared with other applicable company laws and company laws in other countries, the other laws applicable in Palestine, taking into consideration modern developments, mainly globalization, information technology, e-trade, and global opening. A group of stakeholders were interviewed to consult their opinions on the potential impact of the law. A specialized workshop was organized with a number of researchers and law professionals and businessmen and other stakeholders to discuss the topic.
3. The theoretical framework of the impact of laws in general, and company law in particular, on the business sector can be explained through a basic well-known model in industrial economy, namely: “structure – behavior – performance”. According to this model, the behavior of industrial establishments defines their performance; however this behavior is affected by and defined by the structure of the industry in which these establishments work. According to this model, we can say that the Company law usually affects the structure of the market and the behavior of institutions operating therein, which is directly reflected on the performance of these companies.
4. The number of establishments in the Palestinian Territory in 2007 amounted to 130,000, mostly owned by the private sector (above 91% of the total number of establishments). These establishments are mostly service providers (commerce, transportation, tourism, etc.) on the expense of other productive sectors (agriculture, industry and construction), which barely represent 18% of the total number of establishments in 2007. Most of these are small sized enterprises; the percentage of establishments employing four or less employees

reached 90% of the total number of enterprises operating in the West Bank and Gaza Strip. Data also show that most of these establishments are sole-enterprises that account for 88% of the total number of establishments operating in Palestine in 2007). The number of public shareholding companies accounted for a mere one per thousand and private shareholdings represented 1.3%.

5. Data provided by the Company registrar of the Ministry of National Economy showed that the number of companies registered in the West Bank since the establishment of the Palestinian National Authority in 1994 until the first quarter of 2008 is 10,605 out of which 98% are either private shareholdings or ordinary companies. That is, most of our companies are either sole or family enterprises. Data for the Gaza Strip lack but we notice a small number of companies was registered in the period from 2004 to 2007 and with small capital as a result of the siege and closure imposed upon the Gaza Strip. Data show that the number of companies registered in the Gaza Strip in 2007 attained 225 companies.
6. The laws applicable to companies in both parts of the Palestinian Territory are different. The law in force in the West Bank is the Jordanian Company law No (12) for the year 1964 while the Palestinian Company law No (19) for the year 1929 is applicable in the Gaza Strip in addition to the Palestinian Ordinary Company law No (19) in the year 1930.
7. Company laws applicable in the West Bank and Gaza Strip have many problems, mainly that they are outdated and are no longer fit for the major political and economic developments. The obsolete nature of these laws weakens governance in Palestine in addition to the lack of necessary systems and enforcement regulations leading to improper interpretation of their provisions. The difference in the company laws applicable led to different oversight mechanisms and different mandate of the controllers between the West Bank and Gaza. It also entailed different types of companies in compliance with the different laws in force.
8. Company laws from neighboring and advanced countries were reviewed to benefit from their experience, mainly Jordan, Egypt, Lebanon, United Arab Emirates, Morocco, Israel and Singapore. The study shows that the provisions in the draft law resemble many of the provisions of the company laws applicable in these countries, which shows an attempt to develop a modern law that matches the modern legislations existing in the region.
9. The study attempted to analyze the provisions of the draft law from an economic perspective to assess the impacts that may result from the



application thereof in case of enactment on the private sector, mainly on its competitiveness in local and foreign markets. The study also reviews the suitability of such provisions for the Palestinian economy. It concluded the following findings and recommendations:

10. Findings and recommendations:

- ✧ There is a dire need to enact a modern company law as it is important to improve the investment environment and motivate local and foreign investors, especially that the company laws, in most cases, is considered as the umbrella and framework of many economic laws and legislations.
- ✧ The draft law attempted to unify the types and tags (names) of different companies covered by the laws applicable in the West Bank and Gaza Strip and added new types of companies that have not been regulated by existing laws, including civil companies, recipient companies but it neglected other types that are spread out in the Palestinian Territories.
- ✧ Allowing the establishment of governmental companies without any legal regulations raises fears and risk of competition with the private sector establishments. This could have negative repercussion on the economy at large and on the investment environment in particular. It also contradicts with the philosophy of free economy adopted by the PNA and with its privatization strategy.
- ✧ A sole enterprise contradicts with the concept of a company, especially if the owner of all shares is a natural person. This leads to concentration of economic power in the hands of a limited group of persons, hence increasing risks, especially in the small Palestinian economy and the current political and economic instability in Palestine. This could be acceptable if the sole shareholder is a person-at-law, like a company owning all of the shares of another company. We notice that recipient companies are allowed to conduct this kind of business by law because the owners of the (person-at-law) company are in this case the shareholders in the parent company.
- ✧ The draft law did not define the minimum number of shareholders in a public shareholding company although it stipulated that the minimum number of founders must be seven. This may enable public shareholding companies be established with a limited number of shareholders, which contradicts with the advantages of public shareholding companies that aim to expand community/grassroots participation and avoid concentration of

economic power in the hands of a small number of persons, and attraction of personal savings of small investors and carrying out large projects.

- ✧ The draft law defined the minimum capital of shareholdings (private and public) but the sums set in the draft law, in addition to being small, could lose in value as a result of the increasing rates of inflation on the one hand and the devaluation of currencies on the other. This will require continuous updating of the law.
- ✧ The draft law requires that the capital be fully covered upon subscription, which shows non valuation of the time value of money and of the cost of the alternative opportunity of this money collected as such and frozen without acceptable reason or justification. This will entail higher cost of investment in these projects and will make many investors hesitate prior to subscribing to such companies.
- ✧ The draft law allows public shareholding companies to purchase their shares (treasury bonds), which implies high risks as a result of the possibility of abusing of this option in fluctuation, especially in the absence of any assurance of transparency in many companies as a result of lack of oversight legislations and bodies. This may also harm small investors and weaken the production base of the Palestinian economy.
- ✧ The draft law requires public shareholding companies to allocate no less than (1%) of their net annual profit to spend on scientific research and professional training. Such a requirement enhances investment in human capital and contributes to building institutions. This concords with the requirements of sustainable development and with the other legislations, mainly the banks law and the decree with a status of a law amending the Income Tax Law.
- ✧ The most important achievement of the draft law is its being in concordance with recent developments, mainly in the area of governance. It adopted the principles of governance as part of the provisions of the law. This will no doubt contribute to improving companies' performance and enhancing the competitiveness of the Palestinian economy. This appears in many examples including taking into consideration the rights of small investors in electing one or more representatives thereof to the Board of Directors and the right of the general assembly in public shareholding companies to elect an independent member to the board of directors, the prohibition of combining the position of the chair of the board and

director general of the company or any other waged labor therein among others.

- ✧ Nonetheless some of the provisions in this draft law contradict with the principles of corporate governance: allowing for convening regular (and irregular) public assembly meetings outside of Palestine, which entails risks of non participation of small investors. It also does not make reference to the question of rotation of accounts' auditor.
- ✧ The draft law presents incentives to encourage merging of companies by exempting companies and shareholders from payment of merging fees and taxes; this may reinforce competitiveness of companies by benefiting from the economy of scale and cutting down on the costs of production, promotion and distribution and can help indebted firms. However, merging carries the risk of increased monopolies, especially if it is an amalgamation with a competing large company.
- ✧ The draft law attempts to regulate foreign companies and provide them with incentives to attract external investment. By doing so, it completes a package of legislations offered by the PNA to encourage such investments, namely: the Investment Promotion Law, the Income Tax Law and the Industrial Estate Law and others.
- ✧ The draft law attempts to concord with other laws and legislations in force in Palestine including the income tax law, the insurance law, and the banks law but at times it failed to remove the contradiction between its provisions and the provisions of such laws, causing a lot of confusion in terms of enforcement of such regulations.
- ✧ The law allows any person to review the information related to the company, which is a positive point as it increases transparency. However, it did not prescribe publication of financial and administrative data through the companies' web site especially that the existence of such a company web site and a perquisite of corporate governance.
- ✧ The draft law grants huge mandate to the companies controller. Notwithstanding some cases that require so, many of the authorities are not justifiable and leave a lot of room for persona discretion of the controller.

#### 11. Recommendations:

- ✧ Accelerate the issuance of instructions and regulations that regulate the provisions of this law to enact them in parallel to the

promulgation of the law, especially the regulations and instructions that govern and specify the authorities of the companies' controller.

- ✧ The draft law must include all of the main types of companies operating and spread out in the Palestinian Territory, especially particular partnership. The operations of not-for-profit companies must also be regulated and the procedures of the registration thereof must be clarified as well as oversight mechanisms.
- ✧ The sectors and areas in which government companies work must be specified and justified on socioeconomic or political basis. In this case, a special law needs to be enacted to regulate these companies to ensure they are efficient and they don't compete with the private sector.
- ✧ The minimum number of shareholders in public shareholding companies must be specified (50 persons at least)
- ✧ Prescribe that a company be owned by a sole person-at-law and not a sole enterprise owned by one natural person.
- ✧ Need not specify the capital of a shareholding company (private or public) in the body of the law and ensure it is specified in the enforcement regulations or prescribe for the updating thereof under the authority of a special committee.
- ✧ Need not require covering all shares allotted for subscription at once and request payment of capital as per the needs of the project with specification of a time ceiling (two years for instance) for full recovery of capital.
- ✧ Need not allow private shareholding companies issue all different kinds of shares.
- ✧ Need not allow public shareholding companies purchase its own shares prior to the completion of the legislations and oversight institutions and enactment of clear conditions. The number of shares that can be purchased by a sister or subsidiary company must also be specified.
- ✧ Coordinate with other laws to remove the contradiction or redundancy with other provisions in other laws. Refer to the necessity of approval of other entities in some provisions. Exclude financial leasing companies, mortgage companies, securities market, non-banking financial institutions from the oversight of the Minister of National Economy and entrust such oversight to the Capital Market Authority similar to insurance companies.
- ✧ Not allow holding general assembly meetings outside Palestine without ensuring a mechanism that guarantees participation of all shareholders especially small investors (like using

videoconference), and allowing for notification and voting via email.

- ✧ Request from public shareholding companies to include a chapter in their annual reports on corporate governance.
- ✧ Referring to the question of rotation of accounts auditor in matching with the principles of corporate governance.
- ✧ Establish specialized commercial courts that can litigate in trade related cases in an expedited manner and prepare specialized judges knowledgeable in economic theories and trade customs.
- ✧ Provide a clear and specific mechanism to coordinate between the different oversight institutions to ensure effectiveness of these institutions in overseeing companies and to protect rights of the company's shareholders and clients.
- ✧ Accelerate the ratification of the law on encouragement of competition and prohibition of monopolies to avoid the abuse of any monopoly power resulting from merging and to reinforce competitiveness of Palestinian companies.
- ✧ Employ serious and sufficient effort to ensure participation of the Gaza Strip in the formulation and amendment of the provisions of the draft law.
- ✧ Develop the electronic system of the Ministry of National Economy so that necessary and detailed data on companies operating in the Palestinian Territory can be made available. It is also necessary to coordinate between the companies' registration department and the Palestinian central Bureau of Statistics to avoid contradictions in data related to companies.