LATEST TRENDS AND DEVELOPMENTS IN INSOLVENCY LAW IN NEPAL

by
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1) A brief overview of the Nepalese legal system[1]

a) *Introduction*

Nepal did not exist as a single country in a true political sense prior to unification by King Prithivi Narayan Shah Dev in 1768 (1825 Bikram Sambat). Present day Nepal was divided into various small kingdoms. The Kathmandu valley itself consisted of three separate kingdoms. All of the separate kingdoms had their own set of legal systems and ruled mainly on the basis of religion.

Even after the unification of Nepal in 1768, there was no unified set of legal rules, and the laws were scattered in various royal decrees, customs and religious practices. The first codified law that applied to a unified Nepal was the Muluki Ain (the Country Code), which was introduced in 1853. The Muluki Ain of 1853 was repealed by the existing Muluki Ain 1963 (2020). The Muluki Ain contains both substantive and procedural laws, and covers both criminal and civil matters. The Muluki Ain is a general law, the provisions of which are overridden by specific law. Matters dealing with the registration of security for immovable assets, such as land, the enforcement of such security, etc. are governed by various chapters of the Muluki Ain.

The legal system of Nepal is predominately influenced by the common law system, though there are some elements of continental law as well. For example, the Contract Act 2056 does not require consideration to enforce a contract. However, most commercial laws are based on common law.

Commercial laws were mainly introduced in the 1930s. In 1936, the Company Act, and the Patents, Design and Trademark Act were introduced. The legislation dealing with banks was introduced through the enactment of the Banking Law of 1937. Specific contract law legislation was introduced in 1966. Prior to that, contractual relationships were governed by Section 37 of the Muluki Ain entitled Loan Transactions.

b) *Court system*

There are three layers of courts. District courts are the courts of first instance. The Court of Appeal has appellate jurisdiction, and the Supreme Court of Nepal is the highest court. There are 75 district courts and 16 courts of appeal. All the regular courts have

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general jurisdiction. There is no separate commercial court to handle commercial disputes such as the enforcement of contract, or property rights. There are certain specialised courts and tribunals such as, for example, the labour courts, and the Special Court (which is the court of first instance to hear corruption and drug-related cases). Very recently the Debt Recovery Tribunal was also established.

c) *Parliamentary system*

The Constitution of Nepal of 1990 is the supreme law of the land; it contains the principle of constitutional supremacy. The Constitution also calls for a bicameral parliament. The lower house of the Parliament is called the Parthinidhi Shaba and the upper house is called the Rastryia Shaba. Laws are passed by the Parliament, which take force after receiving assent from the King. Unfortunately, the Parliament was dissolved two years ago when the King dismissed the elected prime minister.

2) Insolvency law before 2005

The concept of insolvency law in Nepal began with the personal bankruptcy law, which was introduced in 1853. The existing personal bankruptcy law is governed by the Chapter on Bankruptcy (Damasahi Ko Mahal) of the Muluki Ain. It is interesting to note that there have never been any reported cases of personal bankruptcy.

Before the promulgation of the Insolvency Ordinance, bits of corporate insolvency law were scattered throughout various items of legislation. For example, commercial banks were governed by the Banks and Financial Institution Ordinance 2005. The laws related to the registration of real estate mortgages, the enforcement of securities, and court judgments were dealt with by different chapters of the Muluki Ain. The insolvency of government corporations was governed by their respective acts of incorporation even though, in some cases, the liquidation of some government-owned autonomous business entities was not defined. Liquidation of companies with limited liability was governed by the Companies Act 1997, which lacked detailed provisions, and covered both voluntary and involuntary liquidation in a scant 19 sections. The Partnership Act 2020 dealt with the dissolution and insolvency of partnership firms. Thus, the old insolvency law regime suffered from a wide variety of defects and shortcomings.

Under the old regime, it was extremely difficult for creditors to initiate liquidation proceedings. First, only creditors representing a minimum of 50% of the total outstanding dues could apply and, second, the maturity date of the claim for the purpose of initiating proceedings was very long. If a borrower wished to initiate an insolvency process, the debt had to be outstanding and remain unpaid for more than one year. There was no room for individual shareholders to initiate proceedings, nor was there any legal authority to supervise or regulate the insolvency process.

Another serious shortcoming of the old regime was that it did not have any provisions for re-organisation. As a result, the only option for companies in financial difficulty was liquidation. Furthermore, the old law did not prescribe qualifications for liquidators. Liquidators were appointed without regard to objective criteria, and there was no regulatory authority to supervise the insolvency profession.

There was no separate Insolvency Administrative Office. As a result, all administrative matters related to insolvency were handled by the Office of the Company Registrar, which is not a judicial body. In addition, the Office of the Registrar was over-burdened with matters such as the incorporation of companies, and managing filings and annual returns. Moreover, it had no unit devoted specifically to insolvency matters, and lacked trained manpower.

3) Latest developments in insolvency law : The Insolvency Ordinance of 2005

The government of Nepal promulgated its first corporate Insolvency Ordinance on 23 September 2005. The enactment of this law was a milestone in the process of modernising commercial law in Nepal. The process was started in 2002 with a technical assistance grant from the Asian Development Bank. The ordinance is based on the principle of "one law, two systems" as it covers both the law of liquidation and the law of rescue/restructuring.

4) The salient features of the new Insolvency Ordinance 2005

The Insolvency Ordinance of 2005 covers companies with limited liability. It leaves out personal bankruptcy and statutory corporations fully owned by the government from its ambit. It also covers banks and financial companies, though the prior approval of the central bank is required before initiating an insolvency procedure. Insurance companies are also covered, but require prior approval from Beema Sameti (the insurance regulatory authority). Voluntary liquidation was also excluded from the law, though it remains part of the new Company Ordinance 2005.

The recently introduced Insolvency Ordinance incorporates most of the accepted good principles of insolvency law and overcomes most of the difficulties under the existing Company Act 1977. The ordinance is one of a kind in South Asia and could be a valuable model for other countries in the process of reforming their insolvency law. In fact, no other country in South Asia provides for re-organisation as part of its general law on insolvency. Some of its salient features are discussed below.

a) Access

The ordinance provides for easy access to the insolvency process and is in line with accepted good principles of insolvency law in this respect. Under the ordinance, 5% of the creditors, or 5% of the total shareholders of the company, or 5% of the debenture holders can initiate insolvency proceedings. This should help root out insolvent companies from the market.

b) Supervision

Courts were not entrusted with the duty of supervising the insolvency process under the previous insolvency laws. Under the new law, this supervisory authority is given to the commercial bench of the court as designated by the government. The ordinance introduced the concept of a commercial bench in Nepal for the first time. The government is required to obtain the consent of the Supreme Court of Nepal in designating the bench. However, almost six months have elapsed since the promulgation of the new Insolvency Law and the government has not yet set up the commercial bench, thus stalling the process of reform.

c) Stay orders and avoidance of transaction

The Insolvency Ordinance provides for stay orders by which the court can give orders on the application of the concerned party or *suo motu*[2] for the protection of the assets of the company in the insolvency process. The court can also appoint an interim administrator during the stay period if it deems it appropriate. The ordinance further incorporates a provision for automatic stay whereby the court orders the initiation of the insolvency process of the company.

The Insolvency Ordinance authorises courts to invalidate or void certain transactions. Under the ordinance, preferential transactions and transactions with related parties entered into six months before or after initiating the insolvency procedure are rendered void. But, in cases involving alleged fraudulent transactions, transactions entered into two years before or after initiating the insolvency procedure are rendered void. Such provisions are new in the history of commercial law in Nepal.

d) Re-organisation

The Insolvency Ordinance covers both liquidation and restructuring. In addition, it provides for liquidation subsequent to restructuring if the restructuring fails, or a change from a restructuring procedure to a liquidation procedure if it is found appropriate. The ability to convert from one insolvency process to another is new in South Asia.

The re-organisation proposal prepared by the re-organisation manager requires the approval of the court for its implementation. Once approved by the court, it is binding on all creditors, directors and shareholders. However, it does not bind secured creditors unless they have agreed to the programme. Nor are the lessors and the owners of property used by the company bound by the re-organisation programme ordered by the court. But, the court can issue orders to secured creditors, the lessors and owners of the property used by the company, if it is proved that the re-organisation programme will fail if the secured creditors or lessors of the property enforce their security or take back the leased property. However, the court shall require an assurance that the rights of secured creditors and lessors are properly protected under the re-organisation scheme.

e) Recognition of private sector insolvency professionals

The previous law dealing with the insolvency of limited companies never provided for the qualification of liquidators or insolvency practitioners. In fact, the old law never envisaged insolvency practitioners at all. The new insolvency law relies heavily on the efficiency and integrity of private sector insolvency practitioners.

In view of this, the new law sets out minimum qualifications. The minimum age criterion is 35 years. Amongst other requirements, qualified insolvency practitioners should be a member of the prescribed professional body, and should have degrees in commercial law, business studies, management or any other prescribed subjects from a recognised university. Furthermore, no one can practice in the insolvency profession without obtaining a license from the Insolvency Administration Office. The licensing requirement is equally applicable to liquidators appointed to conduct the voluntary liquidation of a solvent company under the new Company Ordinance 2005.

f) The Insolvency Administrative Office

The Insolvency Ordinance also deals with establishment of the Insolvency Administrative Office. This office functions as a regulator of the insolvency profession as well as the custodian of the files and documents generated by insolvency professionals. The liquidator or the re-organisation manager should file periodical progress reports to the Insolvency Administration Office. After an insolvency process has been completed, the documents and records should be delivered to the office for recording and custody. Some other functions of this office are as follows:

1) To administer the insolvency profession;
2) To issue licenses to insolvency professionals;
3) General supervision of the management of insolvent companies;
4) To formulate codes of conduct for insolvency professionals;
5) To keep records on all insolvent companies; and
6) To perform any other prescribed functions.

g) Creditors' meetings and creditors' committees

The new Insolvency Ordinance requires material consultation with creditors in the insolvency process. The investigation officers appointed by the court should call a creditors' meeting before the finalised report is submitted to the court. Similarly, the re-organisation manager should call a creditors' meeting to seek their input on and approval of the re-organisation programme prepared by him. The liquidator should also call a creditors' meeting for the purpose of preparing the liquidation report to be submitted to the court. Creditors can also form a committee (not exceeding five members) to assist the liquidator in the liquidation process.

h) Payment priority

The new law has made significant changes in the matter of priority of payment. Employees and workers get priority after the costs of liquidation or re-organisation are settled. Outstanding payments to workers and employees have been classified into two categories for the purpose of priority; wages and remuneration have priority. There is no ceiling on the payment, but working directors do not get priority in the payment of their remuneration. Another departure from the past is that the government is no longer a preferred creditor. Governmental claims on items such as taxes are treated as unsecured debt, just as any other unsecured debt payable to a non-governmental debtor.

i) The implication of liquidation orders

The new law also deals with the implication of liquidation orders. The liquidators assumes all the powers and authorities of the board of directors, and takes control of all the assets and property of the company in liquidation. The services of all employees of the company are terminated on the date of the assumption of office of the liquidator, unless otherwise ordered by him. The standstill arrangement continues with the exception of the right of secured creditors to enforce their security, and the return of leased property to its owner.

5) Implementation problems

In spite of its utility in addressing the problems of insolvent companies, the new Insolvency Ordinance remains inoperative. The new law is already more than six months old, but the government has not created the basic infrastructure required for its implementation and operation. The licensing of insolvency practitioners and the creation of a commercial bench are two basic pre-requisites. Nor has the government established the Insolvency Administration Office, which issues licenses to insolvency practitioners.

6) Prospects for further reform

The new law has yet to see the day of its operation. Its defects and lacunae might be revealed after its implementation. Even so, four broad areas that require further improvement are already visible: i) cross-border insolvency; ii) protection of the interests of providers of essential services to insolvent companies during the insolvency process; iii) the insolvency of government corporations with unlimited liability; iv) personal insolvency; and v) the framework for informal workouts.

7) Difficulties and challenges ahead

The Insolvency Ordinance of 2005 represents a much needed reform of Nepal's insolvency regime. However, the difficulties do not end with its passage. The effectiveness of the Insolvency Ordinance is yet to be tested in practice, and more challenges lie ahead.

The major challenge at this stage is the lack of political commitment to its implementation. The availability of trained manpower is also a major concern. The insolvency profession is yet to be developed as an independent profession and more people need to be attracted to the field. Moreover, there is an urgent need for capacity building among regulatory bodies. Regulatory institutions have not yet been set up and, when they are, they will first need to gather experience. At present, there is virtually no one, either in the private or the government sector in Nepal, who has any kind of experience in regulating insolvency matters. The commercial bench of the court is yet to be established to hear matters of insolvency. Furthermore, the constitution of a commercial bench is of little help if judges are appointed without any specific training on the technicalities of insolvency matters. Training of all those involved in the insolvency process is, therefore, the need of the hour.

Notes

1. For a more detailed discussion of Nepalese legal history, refer to Anup Upreti (2003), "An Overview of Nepalese Legal History", Business and Law in Nepal, Centre for Development and Governance and Focal Point for Financial Sector Reform, pp. 139-146.
2. Suo moto, means "on its own motion". It is a legal term, approximately equivalent to the English term sua sponte.

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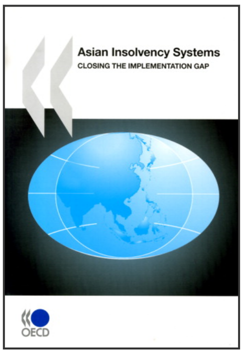

Asian Insolvency Systems: Closing the Implementation Gap

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