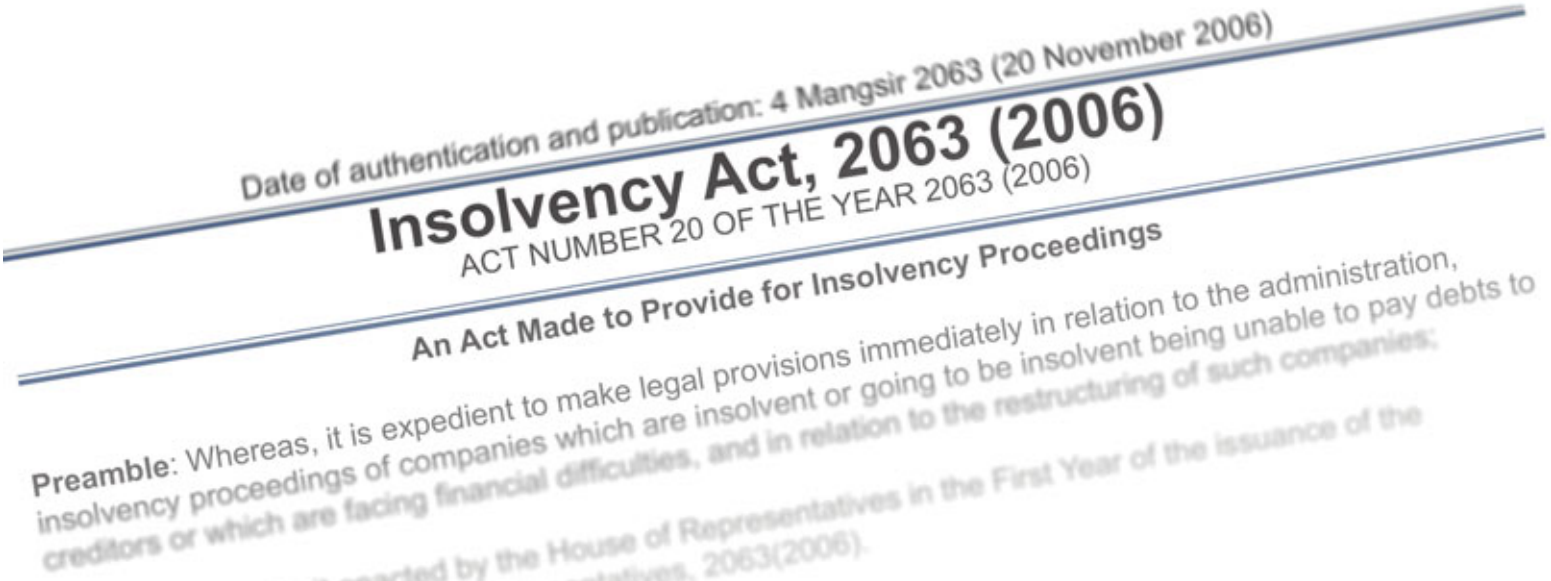
NEPAL ECONOMIC FORUM

nefsearch

September 2012 Issue 3

INSOLVENCY IN NEPALI CONTEXT


Date of authentication and publication: 4 Mangsir 2063 (20 November 2006)

Insolvency Act, 2063 (2006)

ACT NUMBER 20 OF THE YEAR 2063 (2006)

An Act Made to Provide for Insolvency Proceedings

Preamble: Whereas, it is expedient to make legal provisions immediately in relation to the administration, insolvency proceedings of companies which are insolvent or going to be insolvent being unable to pay debts to creditors or which are facing financial difficulties, and in relation to the restructuring of such companies;

INSOLVENCY IN NEPALI CONTEXT

Nepal's first codified law, the Muluki Ain, was put into practice in 1853[1]. It took the country a good 150 years after this to establish and enact the Insolvency Act in 2006, a step that is now considered to be a milestone in the process of modernizing commercial law in Nepal. Previously, bits and pieces of the laws that make up the Insolvency Act were scattered throughout various items of legislation.

History

The concept for the Insolvency Act originally began in 1853 with the establishment of the Personal Bankruptcy Law that stemmed from the Muluki Ain. However, due to flaws present in the act, the process for the new Insolvency Act started in 2002 with the aid of a technical assistance grant from the Asian Development Bank. A major shortcoming in the old regime was that it did not have any provisions for the reorganization of insolvent companies. As a result, companies facing financial difficulties had no alternative to liquidation. Furthermore, the old law provided no qualifications for liquidators and there was no regulatory authority to supervise the insolvency proceedings. Apart from these major flaws in the old Act, the Judiciary also lacked an Insolvency Administrative Office. The need for a unit devoted specifically to insolvency matters was soon seen as a major necessity. Today, the Act is based on the principle of "one law, two systems" and it covers laws for both liquidation and rescue and restructuring.

Situation Report

Since the inception of the Insolvency Act in 2063 (2006), very few companies have been willing to step forward and begin official insolvency proceedings. It is important to note that the Insolvency Act and its regulations were introduced at different times. The lack of synergy during this process has not helped the current predicament of companies that should be (but aren't) pursuing insolvency proceedings. Without sufficient data on

INSOLVENCY & LIQUIDATION – What's the Difference?

When a company enters **liquidation**, it enters a process of termination in which the company's assets are used to discharge it from its liabilities.

Insolvency occurs when an individual or company is unable to meet its financial obligations to its creditors or when a company's liabilities exceed its assets. Insolvency can lead to legal insolvency proceedings, the outcome of which can be restructuring, or liquidation. **Insolvency proceedings do not necessitate liquidation.**

insolvency proceedings, it is difficult for experts and lawmakers to accurately discern solutions to persisting problems.

The most prominent company to have begun proceedings is Nepal Development Bank. The implementation of the Act in this case shows that the Act unsatisfactory. Even if companies do begin insolvency proceedings, their respective situations are bound to be complicated due to different legislations that clearly contradict each other, such as the contradictions between the Insolvency Act and the Banks and Financial Institutions Act (BAFIA). Clearly, conflicts such as these have created hurdles for all parties involved and require a court hearing to clarify which Act supersedes the other.

Another major problem in insolvency proceedings is the belief that insolvency is the result of criminal acts by individuals or companies. However, the fact is that filing for insolvency is not necessarily the result of a criminal act. Because insolvency is perceived as a crime in Nepal, many companies that in principle should file for insolvency do not.

Another significant problem lies in the inadequate monitoring of companies by Company Registrar's Office (CRO) as a result many companies that should file for insolvency go unnoticed. These companies prefer to abandon operate rather than file for insolvency.

Even though a few companies have filed for insolvency and are undergoing liquidation, the current situation, with respect to insolvency procedures is not ideal. A careful and thorough analysis of the shortcomings in the Insolvency Act is necessary so that a viable solution is found and applied effectively. The key question we must ask is this: why are insolvent Nepali companies not coming forward to begin insolvency proceedings?

Current Challenges

The Insolvency Act needs to be refined before it reaches a standard that proves to be both efficient and effective. The push to reform the Act must come from the Nepali business community; unfortunately discussions on insolvency laws are avoided.

Insolvency Practioners believe that there are three factors that lead to the insolvency of banks and financial institutions in Nepal - bad management, bad policy and bad luck, with bad management being the primary culprit. In the case of Nepal Development Bank insolvency resulted from an asset-liability mismatch. The main reason for this mismatch is "related party lending", where the borrower is connected to the management, leading to fraudulent transactions. Data from liquidated companies show that 26% suffered from poor supervision and the lack of a regulatory body, 20% had defective bank management, 11% were victims of political influence, and 15% fell to lending and fraud.ii

A major shortcoming in the Insolvency Act is the number of contradictions it holds with other acts. There are contradictory

three factors that lead to the insolvency of banks and financial institutions in Nepal - bad management, bad policy and bad luck, with bad management being the primary culprit.

clauses in the Banks and Financial Institutions Act (BAFIA) and the Insolvency Act. While BAFIA states that individual depositors will be the first recipients of any payout, the Insolvency Act states that employees and other liabilities will be the first.[2] As there is no supremacy of laws, it results in obvious conflicts partiesand confusion between parties before a court hearing to determine the procedure to be followed. One of the reasons behind such gaps is the fact that the Act is based on the Insolvency Acts of other countries; it lacks flexibility and practicality required for the Nepali context.

Since insolvency is not a readily accepted practice, it is very difficult to point out flaws. The lack of practice also reveals other problems with the legal document and legal officials who deal with the process of insolvency. Due to a lack of practice, there is a shortage of both liquidators and judges who are trained and equipped to handle insolvency related cases. Commercial laws are still a budding concept in Nepal and not all the judges in the Judicial System are educated on issues like insolvency and liquidation. Further aggravating this problem is a rule that reshuffles judges in a trial meaning

that one insolvency trial can have several judges. This has led to even further confusion and conflict.

The success of the Insolvency Act will largely be dependent on how it is implemented. There are certain positive steps being taken to ensure smoother insolvency procedures; – lawyers and judges are being trained and a separate commercial bench has been created too. Still, there are very few companies that have filed for insolvency. This raises the question whether insolvency is unpopular due the stigma attached to it or because the process in itself is a hassle. The legal provision for insolvency is not discretionary and the measure of one-size fits all is creating problems with the liquidation of different types of companies.

Another problem is the lack of public awareness. Misinformation creates major misunderstandings and gaps in knowledge. For example, the general public presumes that a bank audit is always bad news and in anticipation, can lead to unnecessary mass bank runs. What a lot of people do not understand is that an unscheduled bank audit is completely normal and not always a cause for alarm. Additionally, companies fear being blacklisted when they are declared insolvent.

Government and Regulator's Perspective

Insolvency practitioners in Nepal have been expressing the need to smoothen the process of restructuring of insolvent companies. Government officials and regulators have expressed similar views, urging that reforms be made to the current Insolvency Act to avoid future problems. Although the provision for blacklisted is meant to identify frauds and those associated with it, regulators are willing to consider waiving the provision of being blacklisted if companies willingly declare themselves insolvent. Nepal Rastra Bank (NRB) could also encourage troubled financial institutions to merge or be acquired by a stronger one instead of directly liquidating them.

Table 1: Country Profile

	India[3]	Sri Lanka[4]	Bangladesh[5]	South Asia[6]
Average time taken to resolve insolvency (yrs)	7	1.7	4	3.4
Cost (% of estate)	9	5	8	9
Recovery Rate (cents on the dollar)	20.1	48.3	25.8	29

Country Profiles

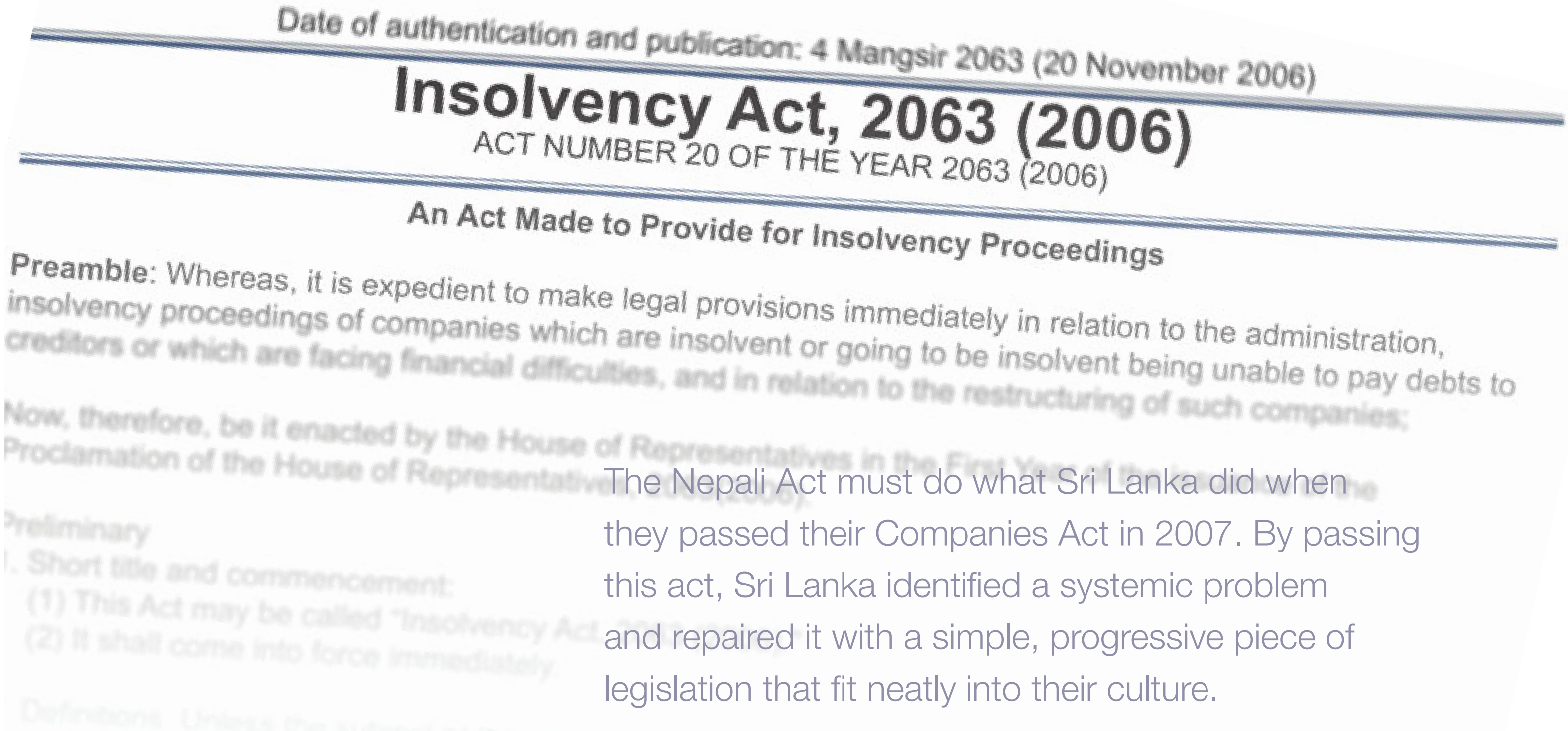
Nepal has shown significant improvement in regards to its procedures for insolvencies in the nation, but how exactly does Nepal fare in terms of the South Asian community? The three following country profiles provide a summary of the different procedures used by the respective countries. Furthermore, there are flaws in their system that the Nepali Act must try to avoid as well as identify beneficial aspects of their laws that the Nepali Act should emulate.

Sri Lanka

The Sri Lankan procedures for insolvencies are largely similar to that of Nepal. The same issues recur with respect to financial transparency and bad accounting practices. However, there are a few notable exceptions that could be responsible for explaining Sri Lanka's above average performance in this particular area (in relation to South Asia). Sri Lanka currently ranks 42nd in the world in terms of resolving insolvencies, the time taken to resolve insolvencies is much less than the rest of South Asia, and the recovery rate (cents on the dollar) is much higher. Through reforms in 2007, the Sri Lankan government has sought to introduce a 'rescue culture' into the business environment. They have done this by taking the model of British financial legislation.[7] Under Sri Lankan law, debtors that file for insolvency can go into 'administration'.[8] Administration is a process in which the Board of Directors of the company can appoint an administrator to bring the company's head above water again. This reform has been said to give incentives to rescue companies rather than liquidate them, fostering the aforementioned 'rescue culture'.

India

Amongst South Asian countries, India


Date of authentication and publication: 4 Mangsir 2063 (20 November 2006)

Insolvency Act, 2063 (2006)

ACT NUMBER 20 OF THE YEAR 2063 (2006)

An Act Made to Provide for Insolvency Proceedings

Preamble: Whereas, it is expedient to make legal provisions immediately in relation to the administration, insolvency proceedings of companies which are insolvent or going to be insolvent being unable to pay debts to creditors or which are facing financial difficulties, and in relation to the restructuring of such companies;

Now, therefore, be it enacted by the House of Representatives in the First Year of the

Proclamation of the House of Representatives, 2063(2006).

Preliminary

1. Short title and commencement:

(1) This Act may be called "Insolvency Act,

(2) It shall come into force immediately.

> The Nepali Act must do what Sri Lanka did when they passed their Companies Act in 2007. By passing this act, Sri Lanka identified a systemic problem and repaired it with a simple, progressive piece of legislation that fit neatly into their culture.

and Nepal are the two exceptions where insolvency law reforms have not received the required attention and priority.[9] However, the Indian act has some laws that would benefit the Nepali act. The Indian insolvency act, more commonly known as the Provincial Insolvency Act, has provisions where the court can set aside some property to the insolvent so that he is able to support himself and his family. This means that if a person were to become insolvent, their assets would only be seized insofar that they could still house their family. Also, in order to avoid fraudulent behavior, the Indian court has the power to charge the creditor a fine of INR 1000 (NPR 1600 or USD 19.4) if the court feels that the charged petition was frivolous and false.[10] This fine is made to the debtor as a compensation for the injury caused to him and his company during the trial. In order to maintain the debtor's security, the act also has a protection order. This is when the debtor, to keep himself clear of chances of imprisonment during the case, can file for a protection order. However, any creditor of his is entitled to appear and oppose the grant for a protection order without sufficient evidence as to why.

Bangladesh

Compared to the rest of South Asia, Bangladesh has not done well in terms of resolving insolvencies. Data given by the World Bank illustrates that Bangladesh is lagging behind in regional averages in almost every single category. However, the Bangladeshi government has made attempts at reforms. The Artha Rin Adalat Act of 2003 sought to create separate courts for the speedy recovery of loans, but no mention has been made as to whether the Bangladeshi business culture seeks to rescue ailing companies or whether it favors asset recovery through liquidation. Furthermore, it appears that the creation of separate courts for dealing with insolvency has neither made the process particularly speedy (in relation to the rest of South Asia), nor has it helped the recovery rate.

Conclusion

Given the three country profiles, Nepal must ask the question: What can we learn from our neighbors? It is clear that the insolvency laws in India, Bangladesh and Sri Lanka are not perfect, but Nepal must learn what it can from them and adopt it in a framework that will suit the Nepali context. Perhaps the Nepali laws may need provisions, similar to that of the Bangladeshi laws for the creation of separate bankruptcy courts in order to speed up the entire insolvency process. An in-depth analysis should be done with regards to Sri Lanka and why they are faring so much better in this area than all other South Asian countries. The Nepali Act must do what Sri Lanka did when they passed their Companies Act in 2007 where Sri Lanka identified a systemic problem and repaired it with a simple, progressive piece of legislation that fit neatly into their culture. In the process of amending the Nepali system, some thought should be given to adopting some of the better provisions found in Indian insolvencies laws as these two respective national cultures are fairly similar. In order to find out what provisions can be adopted from these respective neighbors, more research is needed to ascertain the positive aspects found in each country's insolvency practices. We must also be vigilant in researching the areas in which their insolvency laws have failed, so that we do not repeat their mistakes. On the other hand, the principal goal must be failings make the process of insolvency more efficient and molding laws to fit Nepali culture.

OUTLOOK

The immediate future, with respect to the process of insolvency, in Nepal seems to be full of hurdles and confusions. Reforms have previously been either excruciatingly slow or non-existent. This has been further exacerbated by the CA's recent failure to ratify a constitution, thus throwing Nepal's political future up in the air. With such political volatility, it is not a great surprise that reforms have not been passed. Owing to these conditions, the legislation (and its implementation and regulation) is inconsistent as well.

In order to combat these failings, swift actions must be taken by the private and public sectors. The process of insolvency can only be made more efficient through progressive reforms of the existing Insolvency Act. In order to make progressive reforms, one must review and update laws constantly; an update once every decade will not suffice. Reforms must be made in legislation and in the Nepali business culture. The following points are aspects of legislation and business culture that must be reformed:

- The public and corporate awareness level on insolvency needs to be raised in order to help all parties understand the existing legal framework and overcome misunderstandings.
- The unification of corporate laws under one act would remove the many ambiguities that are currently present.
- The training of legal officials, judges and liscensed insolvency practioners in matters of insolvency are paramount to the success of any insolvency laws.
- Any single case of insolvency should require the same judge to be present at all times. This will help keep rulings on the case consistent and it should also make the process smoother for all parties involved.
- Internal management should review the operations of a company on a routine basis to prevent fraudulent actions and behavior. Furthermore, internal management should also be subjected to random audits.
- CRO must take increase their monitoring and evaluation process so as to identify companies that need to file for insolvency.
- Restructuring should be an alternatives for companies facing insolvency.
- The provision for blacklisting , unless where absolutely necessary to identify frauds, should be removed with regards to voluntary declarations of insolvency. It may be a step in the right direction to break the stigma regarding insolvency proceedings.
- The judicial system needs to be vigilant. It must keep updating insolvency laws to fit the contemporary climate of the country. Laws need to be progressive; if they are static, they will simply be ineffective.

Even though it has only been tested a few times and there are some positive steps being taken to make the implementation more efficient, the Insolvency Act Nepalmust be progressively updated. A 'rescue culture', much like the one fostered in a rapidly growing Sri Lanka, must be encouraged. This may help preserve failing businesses and institutions. The rescue of companies can be beneficial for all parties:- the creditors may, in the long-term, regain the value of the amount they lent and debtors could have another shot at prospering. A solid, progressive and contemporary legal framework for insolvency proceedings is in the best interest of every Nepali, should they land on either side of the procedure.

ENDNOTES

1. Bharat Raj Upreti, "Latest Trends and Developments in the insolvency law in Nepal" (paper presented at the Fifth Forum for Asian Insolvency Reform (FAIR), Beijing, China, April 27-28, 2006).

2. Ministry of Commerce and Supplies, Government of Nepal, "Insolvency Act," 2063 (4th November 2006), http://www.mocs.gov.np/uploads/Act%20list%20English/insolvency-act.pdf.

3. "Ease of Doing Business in India," last modified 2012, http://www.doingbusiness.org/data/exploreeconomies/india#resolving-insolvency.

4. "Ease of Doing Business in Sri Lanka," last modified 2012, http://www.doingbusiness.org/data/exploreeconomies/sri-lanka?topic=resolving-insolvency.

5. "Ease of Doing Business in Bangladesh," last modified 2012, http://www.doingbusiness.org/data/exploreeconomies/bangladesh#resolving-insolvency.

6. "Resolving Insolvency," last modified 2012, http://www.doingbusiness.org/data/exploretopics/resolving-insolvency.

7. Kandiah Neelakandan, "Restructuring Companies in Sri Lanka" (paper presented at the LAWAISA Conference, New Delhi, India, November 12-14, 2010). http://finder2000.lk/mnlaw/pages/CompRestruct.pdf

8. The Department of the Registrar of Companies, Government of Sri Lanka, Companies Act, 2007. http://www.drc.gov.lk/App/comreg.nsf/200392d5acdb66c246256b76001be7d8/$FILE/Act%207%20of%202007%20(English).pdf

9. Sumant Batra, "Insolvency laws in South Asia: Recent Trends and Developments" (paper presented at the Fifth Forum for Asian Insolvency Reform (FAIR), Beijing, China, April 27-28, 2006).

10. Ministry of Corporate Affairs, Government of India, "Provincial Insolvency Act," 1920.

This nefsearch is based on the research and analysis carried out by the nefsearch team. It also incorporates the proceedings of the neftalk "Insolvency in Nepali Context", a talk program jointly organized by Nepal Insolvency Practitioners Association (NIPA) and Nepal Economic Forum (NEF) on 02 May 2012. NIPA is an association of professionals committed to creating awareness in the field of insolvency. The keynote speakers at the neftalk were Justice Bharat Upreti, Judge, Supreme Court, Bhesh Raj Sharma, Secretary, Ministry of Law and Justice, Maha Prasad Adhikary, Deputy Governor, Nepal Rastra Bank and Narayan Bajaj, Liquidator, Nepal Development Bank and Member, NIPA.

NEPAL ECONOMIC FORUM

Issue 4, September 2012 I Publisher: Nepal Economic Forum I www.nepaleconomicforum.org
P. O. box 7025, Krishna Galli, Lalitpur-3, Nepal I Phone: +977-1-5548400
email: info@nepaleconomicforum.org
nefsearch team: Akrit Sharma, Shayasta Tuladhar, Shreyansh Malla, Shristi Singh
Design: Big Stone Medium, contact@bigstonemedium.com

NEPAL INSOLVENCY PRACTITIONERS' ASSOCIATION