GLOBAL FORUM ON LAW, JUSTICE AND DEVELOPMENT (GFLJD)

COMMUNITY OF PRACTICE

REPLY TO QUESTIONNAIRE ON INSOLVENCY LAW AND COMPANY LAW

Jurisdiction: Nepal

An Introductory Note:

Response to the following questionnaire is based on our understanding of the provision made in Insolvency Act 2006 dealing with Insolvency proceeding of insolvent company.

Insolvency Act 2006 (Insolvency Act) of Nepal is general law on corporate insolvency. It primarily applies to companies incorporated under Company Act 2006 (Company Act) with limited liability. However, the government has authority to issue an order to make this law applicable to other corporate bodies with limited liability (i.e. statuary corporations with limited liability). No such order has been issued so far.

We find that the questionnaires are well designed to analyse the interrelation between the insolvency law and the company law. This analysis is especially important in Nepal's context because existing Insolvency Act has, for the first time, segregated the insolvency proceeding from the ambit of company law. So long as the insolvency law remains as part of Company Law, there may be fewer chances of conflicts, contradictions and jurisdictional issues in the insolvency proceedings.

Though, there is no specific superseding provision in the Insolvency Act, our understanding is that the Company Act provisions dealing with shareholders right are subjected to provisions made under the Insolvency Act. So in case of conflict the later will prevail. Our replies to the following questions are based on this premise. Questions on this may be raised in future on this matter and courts may have different view. But so far, there are no court rulings on this matter.

There are many grey areas. In view of this, it is right time for Nepal government to take appropriate legislative actions to harmonise these two laws for the purpose of better clarity and to avoid conflicts in future.
I. Introductory questions on the insolvency procedures available in the relevant jurisdiction.

1. What insolvency procedures – either liquidation or reorganization procedures – are available for distressed or insolvent companies?

   Insolvency Act, 2006 (the "Insolvency Act") is one law with two systems. It contains separate chapters dealing with re-organization of financially distressed or insolvent company. Chapters 3 and 4 of the said Act deal with re-organization. Rest of the provision are applicable to liquidation and its procedure.

2. Are there special insolvency procedures available for financial institutions or for other special classes of companies?

   Existing Insolvency Act is a general law on insolvency. However, it requires the prior approval of regulators of companies carrying out regulated business such as banking and insurance to initiate insolvency process.

   Nepal Rastra Bank (the Central Bank) has submitted draft bill to the Ministry of Finance to replace the existing Banks and Financial Institutions Act and to amend a few provisions of the Central Bank Act. Each of these draft bills contain special provisions to deal with financially distressed banks and financial institutions. If the Bill is passed by the parliament it will provide special legal regime for the resolution of insolvent banks and financial institutions replacing some of the provisions of the Insolvency Act, 2006.

3. Are there specific provisions for out-of-court restructurings?

   Existing Insolvency Act does not contain any express provisions dealing with out-of-court restructuring. However, there are few provision in the Central Bank Act, 2002 (i.e. Nepal Rastra Bank Act, 2058) dealing with out of court restructuring of financially distressed or insolvent banks and financial institutions. This comes as a part of regulatory action of Central Bank.

4. What are the commencement criteria for insolvency procedures?

   The process is commenced either on the balance sheet test or cash flow test of insolvency.

5. Who can propose a restructuring plan? (e.g. corporate bodies, insolvency representatives, creditors)

   The insolvency practitioner (investigating officer) appointed by the Court to investigate into the possibility of re-organization of insolvent company can propose re-organization plan. Creditors have authority to approve or disapprove
the plan. Insolvent or financially distressed company can also propose re-organization plan under Section 13 (2) and 22 (1) of the Insolvency Act. But, the re-organization plan must be approved by the Court under Section 24 (9) of the said Act.

6. Please describe whether and to what extent shareholders’ rights can be affected by a situation of distress/insolvency of a company before and/or irrespective of the opening of a formal insolvency proceeding (e.g., are there any fiduciary duties of the shareholders to approve corrective measures/plans proposed by the board?)

The opening of formal insolvency proceeding substantially affects the Shareholder’s right. There is no express law on the fiduciary duty of the shareholder to approve corrective measures. However, provisions made under Section 60 of the Company Act, 2006 requires the Board of Directors of a financially distressed company (i.e. the Company with negative net worth) to prepare an appropriate plan/corrective measures required for the protection of the interest of the Company and its shareholders. If the plan requires the approval of shareholders, the board of directors should call a special general meeting of the shareholders for its approval.

Failure on the part of the directors to propose appropriate plan to correct the situation is punishable under the Company Act. Therefore, if the majority shareholders reject the plan proposed by the directors without any logical or convincing reasons, the shareholders in favour of the plan (i.e. minority shareholders) may apply for the Court for appropriate relief.

II. Shareholders’ Rights in Companies Subject to Insolvency Proceedings

7. Are shareholders notified of the initiation of an insolvency process? If notification is individualized, what are the mechanisms used to identify shareholders?

Shareholders are notified about it at different stages. Please refer reply to item no. 11 for further information. However, if the insolvency process has been initiated by the Board of directors, they should inform the shareholders in the forthcoming general meeting. This is required under Section 60 of the Company Act.

There is no legal requirement to send the individual notice to shareholders.

8. Are shareholders required to file claims in the insolvency proceeding? What are the consequences of not filing a claim?

Shareholders are not required to file claim in insolvency proceeding. But, if a
shareholder is also a creditor, it has the right to file claim as creditor but not in the capacity of shareholder.

9. Can shareholders continue to trade and transfer shares after the initiation of an insolvency proceeding affecting the company?

Section 11 of the Insolvency Act authorizes the Court to issue interim order prohibiting the transfer of the ownership of the shares in a company during the preliminary hearing of the insolvency application.

But, once the court orders to initiate the insolvency proceeding, there would be an automatic stay on the sale and transfer of ownership of company's shares in any manner that would affect the ownership status. However, the court may issue an order to relax the automatic stay at the request of shareholder if it is satisfied that the interest of the company and its creditors shall not be adversely affected due to the transfer of such shares. Section 19 (2) of the said Act requires the shareholder seeking the relaxation to prove that the automatic stay on sale or transfer of shares shall cause him the loss.

10. Do shareholders have the right to request that a shareholders' meeting is held, even if the company is insolvent? (If there are separate reorganization and liquidation procedures, does this affect the response?)

Shareholders will have the right to call meeting even if the company is insolvent. But they cannot pass any resolution to bind the liquidator or the re-organization manager appointed by the Court.

Section 40 (1-d) of the Insolvency Act authorizes the liquidators to make all the required decision and sign document on behalf of the company and use of company seal, the law does not give any role to the shareholders during the liquidation process. Similar authority has been given to re-organization manager under Section 31 of the said Act.

11. Do shareholders have the right of requesting information in an insolvent company? Do they have information rights as to the progress of a reorganization procedure? Can they exercise that right vis-à-vis the directors of the company, if they remain in charge of the company or vis-à-vis the insolvency representative?

Insolvency Act does not recognize the right of the shareholders to request information in an insolvent company. However, there are several provisions in the said Act requiring the insolvency representative to provide copy of the report to the company after it has been submitted to the Court. The company should make appropriate arrangement to enable shareholders to inspect the report. Provisions made under Sections 18 (4), 21 (2) and 24 (1) are important on this matter.
12. Can shareholders make proposals for nomination of directors, if the directors continue managing the company?

This matter shall be governed under the Company Law rather than insolvency law. So long the Company is managed by its directors, shareholder can exercise all the corporate right to appoint and to terminate the service of the director on grounds defined under Company Act, 2006.

13. If special categories of shares exist whose holders are granted additional governance rights, are these additional rights affected by the opening of an insolvency procedure? (If there are separate reorganization and liquidation procedures, does this affect the response?)

The law does not recognize and grant special treatment to shareholders having special additional governance right after the Court has appointed re-organization manager or liquidator (insolvency representative). In both the situation, the insolvency representative takes charge of the management of the insolvent company.

14. Can shareholders challenge the decisions of the shareholder meeting, if it is still active? Do they retain the possibility of taking action against the acts of the directors? And against the acts of an insolvency representative? Is any authorization by a judicial or administrative body required to do so or, more generally, to exercise corporate rights? (If there are separate reorganization and liquidation procedures, does this affect the response?)

The right of the shareholders to challenge the decisions of the shareholders meeting depends upon the type of company (i.e. public or private) and the subject matter and the effect of the decision of shareholders' meeting. For example, the decision of shareholders meetings of a public company to change its objective clause provided in its memorandum of association can be challenged by shareholders only on the following conditions:

i. They have not voted for or consented to the decision;

ii. They represent at least 5 percent of the total paid up shares;

iii. They have filed the petition to the Court to challenge the decision within 21 days of the shareholders’ decision.

The decision of the shareholders’ meeting to increase or decrease the share capital cannot be challenged by the dissenting shareholders unless they can prove that the decision is against their interest or they are discriminated. This right has been granted under Section 21 (4) and Chapter 12 of the Company Act, 2006.

The Company Law does not apply in case of action taken by insolvency
representative. But a shareholder may apply to the Court to remove a liquidator or re-organization manager (insolvency representative) on the ground prescribed under Section 70 of the Insolvency Act.

Chapter 12 of the Company Act grants severed right to the shareholders to challenge the decision of the director. If the Court is satisfied that director's decision, action or inaction are against the interest of the Company or its shareholder, the law grants appropriate remedy.

15. Do shareholders have the right to call a special investigation of the affairs of the insolvent company?

Section 121 of the Company Act grants such power to shareholders. They should apply to the office of the Company Registrar who can order investigation into the company's affair and appoint an investigation officer. This can also be done in case of an insolvent company. But the authority of the office of the Company Registrar may not be operative once the Court has ordered the initiation of the insolvency procedure and appointed an investigation officer/ re-organization manager/ liquidator. After the Court has appointed the investigation officer to investigate into the affair of the insolvent Company, this matter should be informed to the Office of the Company Registrar as required under the Section 11 (2) of the Insolvency Act. Similarly the liquidator has the authority to investigate into the possible fraud, cheating or misrepresentation by the directors, shareholders, employees of the company. Thus, it is very unlikely that the Registrar will exercise its authority to investigate the affair of insolvent company at the request of Shareholder, once the matter has been taken over by the insolvency practitioner as per the Court order, the Insolvency Act prevails.

16. Does the law provide for the establishment of a shareholders’ committee (or several committees, in case of different share classes)? What are their powers? Who bears the related costs?

The law is silent on this issue. The Insolvency Act does not envisage shareholders committee.

17. Can shareholders voluntarily transfer shares of the company undergoing insolvency proceedings against any provisions in the articles/bylaws restricting transfers of shares?

It may not be possible. Please refer our response to item no. 9 above.

18. Can outstanding shares of the company undergoing insolvency proceedings be assigned to third parties without the consent of the relevant shareholders? If yes, under what conditions? Are existing shareholders entitled to compensation? What other safeguards
are provided? (e.g., does the law include a principle according to which the affected shareholders should not receive less than in a liquidation procedure?)

**Insolvency Act does not give such authority to Court or insolvency practitioner. But in case of an insolvent bank, the Central Bank can order a particular shareholder to sell its share to a third party. But even in such case, the shareholders should be paid the compensation.**

19. Can outstanding shares of the company undergoing insolvency proceedings be cancelled to third parties without the consent of the relevant shareholders? If yes, under what conditions? Are existing shareholders entitled to compensation? What other safeguards are provided? (e.g. does the law include a principle according to which the affected shareholders should not receive less than in a liquidation procedure?)

**The law is silent on this matter so, it is not possible.**

20. Do shareholders of the company undergoing insolvency proceedings have pre-emption rights over new issues of shares? (2) Are there special conditions for the suppression of pre-emption rights if the company is insolvent (if there are separate reorganization and liquidation procedures, does this affect the response?).

**Yes. Section 56 (8) of the Company Act deals with this matter. This pre-emptive right to new shares is suppressed if such shares are issued or sold to third parties as a part of the execution of re-organization program of an insolvent company under the Insolvency Act. This has been prescribed under Section 56 (9-f) of the Company Act.**

21. Can shareholders retain a participation in the company undergoing an insolvency process even if the company is insolvent according to a balance-sheet test? (i.e., where the value of its liabilities exceeds the value of its assets) If yes, under what conditions? (If there are separate reorganization and liquidation procedures, does this affect the response?)

**For the purpose of initiating insolvency process, the law, treats both balance sheet test and cash flow test equally.**

22. Are the ranking of classes of shares and the preferential rights of classes of shares affected (and if yes, to what extent) by the fact that the company is undergoing an insolvency process? (If there are separate reorganization and liquidation procedures, does this affect the response?)

**There would be no such effect. But at the time of the distribution residual assets by the liquidator, the preference shareholder will get the priority on payment, if such preference shares are participatory. Insolvency law is silent on this matter but Company Act protects such right.**
23. Can shareholders, in the course of an insolvency procedure, supply goods, services or financial resources to the company? If yes, under what conditions (e.g., judicial authorization)? What would their ranking position be towards other creditors?

Shareholders as suppliers are not treated separately. Section 20 of the Insolvency Act requires the provider of essential services such as electricity, water, telecommunication to continue such services till the insolvency process is completed, and this can be discontinued with the permission of the Court. But the law does not require the continuation of the supply of other goods, services or financial resources.

24. Can shareholders, in their capacity as counterparties, be under a duty to continue a contractual relationship with the insolvent company during an insolvency procedure? (If there are separate reorganization and liquidation procedures, does this affect the response?).

This matter will be governed under the terms and conditions of the relevant contract. The law does not impose special obligation simply because the shareholder is the counterparty.

25. Can shareholders (or companies of the same group) holding credit claims against the company under insolvency procedure participate in the creditors’ meeting and vote on the insolvency plan without restrictions? (If there are separate reorganization and liquidation procedures, does this affect the response?)

Shareholders including companies of the same group holding claim against the insolvent company can participate in creditors meeting on the same basis as non-shareholder creditors. But if they are secured creditors, they cannot vote. This restriction applies to all secured creditors, but shareholders who have not paid any amount payable in respect of the value of share held by them, their claim against the credit is reduced by such unpaid amount on resources.

26. If shareholders (or companies of the same group) do not hold credit claims against the company under insolvency procedure, must/can they participate in the creditors’ meeting? If that is the case, what rights or duties do they have in that meeting? (If there are separate reorganization and liquidation procedures, does this affect the response?)

Shareholders cannot participate in creditors meeting as a matter of right. So, if they do not have credit claim, they cannot participate in such meeting. But the liquidator or the reorganisation manager can invite such Director and Shareholder. However, such invitee cannot vote. If a Shareholder is also director, he/she have the duty to provide information required by the Investigation Officer appointed by the Court.
27. Do shareholders in an individual company have information rights as to the filing of insolvency proceedings by the parent or other related companies?

Law is silent on this matter.

III. The Role of the Shareholders’ Meeting

28. Does the shareholders’ meeting continue to exist in insolvency proceedings? (If there are separate reorganization and liquidation procedures, does this affect the response?)

Insolvency Law is silent on this matter.

29. Does the shareholders’ meeting preserve all of its competences, generally? (If there are separate reorganization and liquidation procedures, does this affect the response?)

Insolvency Law does not envisage any type of shareholders meeting. Company Law is also not clear on this matter. However, once the management of the insolvent company has been taken over by the re-organization manager or liquidator, they are authorized to exercise all the company's authorities as corporate agent. Thus, there would be no business left for shareholders meeting.

30. Does the shareholders’ meeting need to approve the accounts of the distressed/insolvent company?

In view of the provisions made under Section 69 of the Insolvency Act, shareholder will not have any authority to approve the accounts of the Insolvent Company.

The re-organisation manager or the liquidator should maintain independent books and account of the insolvent company after the re-organisation manager has assumed the management of the insolvent company or the liquidator has assumed his duty under Chapter 5 of the Insolvency Act. The books, account and the financial statement so maintained and prepared should be audited and certified as per the prevailing law. This audited report should be submitted to the Insolvency Administration Office. The law leaves no room for the account to be submitted to the shareholder meeting and seek their approval.

31. Does the shareholders’ meeting have the power to dismiss directors – if directors are still in charge of the insolvent company? Can the shareholders’ meeting request the removal of the insolvency representative? (If there are separate reorganization and liquidation procedures, does this affect the response?)

Yes. The Court can remove the Insolvency Representative on ground of proven fault defined under Section 70 of the Insolvency Act.
32. Is a shareholders’ meeting authorization required to start an insolvency procedure? (If there are separate reorganization and liquidation procedures, does this affect the response?)

No. It can be initiated by shareholders, creditors, liquidators, regulators etc who are qualified under Section 4 of the Insolvency Act.

33. Does the shareholders’ meeting need to approve an insolvency or reorganization plan? Can shareholders challenge an insolvency or reorganization plan?

It will be approved by the Court. Insolvency Act does not give any space to the shareholder to challenge the insolvency or re-organisation plan. Only the creditor has such right.

34. Can an insolvency/reorganization plan affect the structure of the corporate entity (e.g., by merger, spin-off, or change of the legal form)? Is a shareholders’ authorization required for this?

Yes. Shareholders authorisation is not required under the law. Please refer our response to item no. 35

35. Is a shareholders’ meeting decision required to issue new shares of the company undergoing insolvency proceeding? Can a new share issue be decided by the board or the insolvency representative? If a capital increase has to take place through the conversion of claims into new shares, does this affect the response?

The question of the issue of new shares of the company undergoing insolvency proceedings arises only as a part of re-organization plan approved by the Court under Section 24 (9) of the Insolvency Act and thus becomes the part of the Court order. Once such plan has become part of the Court order, it binds the company, its directors, shareholders and creditors except the secured creditors. This has been expressly provided under Section 26 of the Insolvency Act. So, if the issue of new shares of the company is the part of re-organization plan approved by the Court, the company must implement it and approval of shareholders meeting may not be required. But as a matter of convenience, the re-organization manager may call such meeting but it would simply be a formality because shareholders cannot disapprove the issue of new shares.

The decision to issue new shares being the part of re-organization plan, the re-organization manager can issue new shares as per the scheme approved by the Court. This becomes the part of the execution of the re-organization plan. Since, the re-organization manager will exercise all the corporate powers of the company as its legal agent under Section 31(4) of the Insolvency Act, the Board of Directors shall have no authority to exercise.

If the debt claim has to be converted into new share even as a part of re-organization plan, the re-organization manager (the insolvency practitioner) has
the power to take appropriate corporate decision.

36. On what conditions can the company carry on business during an insolvency procedure? (If there are separate reorganization and liquidation procedures, does this affect the response?). Is a shareholders’ meeting authorisation required?

The Company shall not have such power. During the re-organization period, the business of the company shall be carried out by the re-organization manager. The liquidator shall manage the business of the company during the period of liquidation. All the corporate authority of directors will be exercised by the liquidators. Shareholder has no legal role to play. Their authorization is not required.

37. In the course of an insolvency procedure, what provisions apply to the sale of specific assets out of the ordinary course of business and to the sale of the entire business operation of the company? Is a shareholders’ meeting authorisation required? (If there are separate reorganization and liquidation procedures, does this affect the response?)

The authority to sell all types of company assets vests in the insolvency practitioner (i.e. re-organization manager or the liquidator). The liquidator has the authority to sell the entire assets. The provisions made under Section 31, 38, 39 and 40 of the Insolvency Act are clear on this matter.

38. Does the shareholders’ meeting have any power in relation to a decision of the board or the insolvency representative to continue or reject any favourable, unfavourable or essential contract during an insolvency procedure? (If there are separate reorganization and liquidation procedures, does this affect the response?).

Insolvency Act does not give any such power to shareholders.

39. If an insolvency plan can be presented for a whole corporate group, must that plan be approved by the shareholders’ meetings of each company of the group, including of those that are balance-sheet insolvent? How are the different meetings’ decisions coordinated? Are there specific safeguards (e.g., any veto power or other remedy) for minority shareholders of the companies that are not insolvent?

Existing Insolvency Act treats one Company as a separate and individual entity. It does not envisage the insolvency of the whole corporate group.

40. If companies belonging to the same group file separate insolvency proceedings, are there specific requirements/mechanisms to provide for coordination of those proceedings? Are shareholders of the relevant companies involved in the coordination
mechanisms, if any?

Please refer response to item no. 39.

IV. Other Obstacles for Insolvency Procedures Found in Company Law

41. Please list any other legal provision in company law that, in your opinion or in your experience, may interfere with the insolvency procedure of a company in your jurisdiction.

Insolvency Act, 2006 is still in the preliminary stage of its operation. Instances of interference of the company law provisions during the insolvency procedure have not been noticed in practice.

The blacklisting directive issued by Nepal Rastra Bank (i.e the Central Bank) has been a major stumbling block to insolvency process. As provided in the said Directives, an Insolvent or financially distressed company is automatically blacklisted if it applies to the Court to initiate insolvency process either to re-organize or liquidate it. Once a company is blacklisted its directors are blacklisted too. A blacklisted company or its directors cannot take loan and other facilities from banks and financial institutions. The Blacklisting Directives issued by the Central Bank has frustrated the whole objective of the insolvency law.