

**IN/ADEQUACY OF NEPAL'S LAW ON SECURITY INTERESTS\* IN LIGHT OF UNCITRAL  
LEGISLATIVE GUIDE ON PRIVATELY FINANCED INFRASTRUCTURE PROJECTS**

by

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## **ABSTRACT**

Private participation in infrastructure development is a necessity and this is usually done through complex project financing. Project securities are one of the primary legal concerns of the lenders in such transactions. Nepal though has adopted a separate law on security interest, it has some inadequacies in addressing the security concerns of lenders in infrastructure financing. Consequently, this thesis is focused on the review and analysis of the Secured Transaction Act and other relevant laws of Nepal in terms of its adequacy to effectively regulate project securities in reference to two legislative guides of UNCITRAL on privately financed infrastructure projects and secured transactions. The thesis discusses some positive aspects and inadequacies of the regulation in context of securing obligations in project finance transactions. Though the Secured Transactions Act provides comprehensive scope for creation of security, it has some inconsistencies with requirements of project security. Requirement of possession for maturing security in goods, ambiguity as to the possibility of creating security over contractual non-monetary claims and concession agreement, and uncertainty in possibility of exercising step in right are some of the problems in existing secured transaction laws of Nepal.

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## INTRODUCTION

### *i. Importance of Private Sector in Infrastructure Financing*

Infrastructure development is key to overall development in both developing and developed nations. It is evident that a huge amount of investment is required and expected in infrastructure sector in developing nations. Data from great number of sources suggests that an average of \$3.3 trillion annual investment is needed to just support the currently expected rates of growth of which developing economies account for about 60%.<sup>1</sup> Because of the public goods and positive externalities generated by infrastructure projects, traditionally these were primarily financed by public funds<sup>2</sup>. However, due to requirement of huge capital in this sector and inability of public sector to make sufficient spending characterized by small sized budget of developing countries led to reduction in infrastructure investment at government level.<sup>3</sup> The participation of private sector in infrastructure development has increased by reason of significant technological innovations, increased debt and limited budget of public sector, and expansion of domestic and international capital markets at one end and better access to private funding and records of higher success in private participation on the other

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\* The phrase "law on security interests" has been used to refer in general to the rules of law governing security rights in movable property. The phrase is intended to have same meaning as what it is called "secured transaction law" in U.S. and "personal property security law" in U.K and its former colonies. The legislative guides and model laws prepared by UNCITRAL and EBRD also uses the term "law on secured transaction". The phrases "law on security interests", "law on secured transactions" or "secured transactions law" wherever used on this thesis have the same meaning referring to laws concerning charge/pledge or creation of security rights in movable property. The use of term "security" or "security right" shall mean property right in a movable property that is created by agreement that secures payment or other performance of an obligation.

<sup>1</sup> Jonathan Woetzel and others, '*Bridging Global Infrastructure Gaps* | McKinsey & Company' <<https://www.mckinsey.com/industries/capital-projects-and-infrastructure/our-insights/bridging-global-infrastructure-gaps>>; accessed 3 December 2017.

<sup>2</sup> OECD '*Private Financing and Government Support to Promote Long-Term Investments in Infrastructure*' <<https://www.oecd.org/daf/fin/private-pensions/Private-financing-and-government-support-to-promote-LTI-in-infrastructure.pdf>> accessed 3 December 2017.

<sup>3</sup> Ibid.

end.<sup>4</sup> Indeed nowadays, the major source of infrastructure investment in both developed and developing nation is private sector.<sup>5</sup>

*ii. Forms of Private Sector's Involvement in Infrastructure Projects*

Private sectors' investment in infrastructure can be in various forms like Private Public Partnership (PPP Model), fully owned private enterprise with Build Operate and Transfer Model (BOT Model), or fully financed private enterprise with long term operation under concession agreement. UNCITRAL Legislative Guide on Privately Financed Infrastructure Project (hereinafter "Legislative Guide on PFIP") classifies forms of private participation in two categories viz. "public ownership with private operation" and "private ownership with private operation"<sup>6</sup>.

Irrespective of the form of investment, the most popular and efficient method for structuring financing by private sector in infrastructural sector is project financing. In project financing the new investment is financed by structuring finance based on the operating cash flow and assets of the project itself without requirement of additional sponsor guarantees<sup>7</sup>. Among various forms of investments commercial lending represents the majority of investment in project finance whose return is highly dependent on successful completion and operation of the project.

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<sup>4</sup> United Nations Commission on International Trade Law, *UNCITRAL Legislative Guide on Privately Financed Infrastructure Projects* (United Nations 2001).

<sup>5</sup> Jordan-Tank Matthew, 'Why Infrastructure Development Needs More from the Private Sector' <<http://www.ebrd.com/news/2017/why-infrastructure-development-needs-more-from-the-private-sector.html>> accessed 3 December 2017.

<sup>6</sup> Legislative Guide on PFIP (n 4), p 13.

<sup>7</sup> IFC, '7 Lessons of Experience: Project Finance in Developing Countries, 1999' <<http://documents.worldbank.org/curated/en/952731468331147256/pdf/multi0page.pdf>> accessed 2 December 2017.

### *iii. Importance of Effective Secured Transaction Laws in Infrastructure Financing*

Securing loans against assets and receivables of the project is an important legal concern in project finance. Scope for creating the security and options of enforcement available under host state laws are important factors influencing investment decisions. Securities have an important role to play in project financing. Studies suggests that reformed efficient secured transaction law promotes flow of credit.<sup>8</sup> It is not necessary that only a particular model of secured transaction law be efficient and effect, any reformed law should provide sufficient scope for creating security inexpensively and effectively, defined methods of enforcement, and should be framed in a way that it fits within the framework of other laws<sup>9</sup>. Further, structuring of a project finance depends on problems encountered in perfecting security. It often necessitates changes in how a project is to be restructured.<sup>10</sup> Therefore, it is important to have a modern reformed secured transaction law to attract private investment in infrastructure development. Unlike in general secured transactions, security concerns in project finance are unique and specific, which the reformed law should address.

Various studies have been made on the importance and form of reforming secured transactions law and also in respect to reforming laws to promote private participation in infrastructure projects. Legislative Guide on PFIP provides general legislative recommendations in respect to reforming laws on privately financed infrastructure project. Reforming secured transactions law is one of the important issues recommended by the

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<sup>8</sup> Gerard McCormack, *'Secured Credit and the Harmonization of Law: the UNCITRAL Experience'* (Edward Elgar Publishing, 2011); United Nations Commission on International Trade Law, *'UNCITRAL Legislative Guide on Secured Transactions'* (United Nations, 2007); Heywood Fleisig, Mehnaz Safavian and Nuria de la Pena, *Reforming Collateral Laws to Expand Access to Finance* (The World Bank 2006) <<http://elibrary.worldbank.org/doi/book/10.1596/978-0-8213-6490-1>> accessed 7 February 2018.

<sup>9</sup> Ibid.

<sup>10</sup> Dentons, 'A Guide to Project Finance' <<http://www.dentons.com/~media/6a199894417f4877adea73a76caac1a5.ashx>> accessed 2 December 2017.

guide. Further, UNCITRAL Legislative Guide on Secured Transactions (hereinafter "Legislative Guide on Secured Transaction") provides detailed requisites of modern secured transaction laws.

#### *iv. Research Aim and Methodology*

Nepal is a under developed country with massive infrastructure gap<sup>11</sup>. Nepal has a very small budget of around 12.79 billion USD of which almost 2.9 billion USD has source on foreign loans<sup>12</sup>. Under this situation the primary hope for infrastructure development lies on private involvement of private sectors, usually foreign. As discussed above secured transaction laws are one of the primary legal concern of the private investors. Nepal adopted a Secured Transaction Act in 2007 but it has not yet been fully implemented because of various reasons including the failure to establish of security registration office. Though this Act is one of the most important legal instrument in credit enhancing, most importantly in project financing transaction, scholars and lawyers in Nepal have barely discussed or reviewed the provisions of this Act. There are no scholarly articles analysing the provisions of this Act and no reported cases till date interpreting the issues raised in reference to this Act. With the growth of attraction of foreign lenders in making investment in Nepal, it is hereby important to review the adequacy and effectiveness of this Act in securing the interests of lenders. It is important to review and examine the provisions of this Act in light of international best practices and reforms suggested by studies of expert institutions like UNCITRAL to analyse whether provisions adequately regulate concerns regarding security rights in foreign lending

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<sup>11</sup> Ashutosh Mani Dixit and Bishal K Chalise, '*Strengthening infrastructure governance in Nepal*' <<http://eprints.lse.ac.uk/75548/1/blogs.lse.ac.uk-Strengthening%20infrastructure%20governance%20in%20Nepal.pdf>> accessed 25 March 2018. "World bank estimate that Nepal needs to invest at least 12 percent of GDP in infrastructure to maintain its current GDP growth".

<sup>12</sup> Ministry of Finance of Government of Nepal, Budget Summary for fiscal year 2017/2018, <[http://www.mof.gov.np/uploads/document/file/Budget\\_Speech\\_207475\\_20170530011441.pdf](http://www.mof.gov.np/uploads/document/file/Budget_Speech_207475_20170530011441.pdf)>.



primarily in project finance transactions. Therefore, this thesis hereby attempts to identify important security concerns in project finance transactions and review Nepalese laws governing secured transaction to analyse its adequacy in regulating these security concerns. While doing so, the thesis analyses the relevant provisions of Secured Transaction Act and other related laws in reference to legislative guides prepared by UNCITRAL on privately financed infrastructure project and secured transactions. The thesis, however, is limited to matters relating to security concerns in project finance transactions. In lack of reported cases dealing with these matters and scholarly writings in Nepal, the thesis will basically make references to recommendations of UNCITRAL and literatures relating to project finance and secured transaction in general.

#### *v. Structure of the Thesis*

Chapter I briefly discusses the role of security in project finance in general with recommendations made by Legislative Guides. It explains the basic features of project finance and function of taking security in project finance focusing on positive and defensive function. It also identifies basic requisites of secured transaction law that is desirable in project finance transactions. Chapter II discusses the issues relating to creation of security. It basically focuses on possibility of creating security over overall project assets, in receivables and shares of project company. The Nepalese legal provisions have been briefly analysed in reference to recommended standards. This chapter will highlight lacunas of laws viz. lack of clarity as to creation of security in contractual non-monetary claim like right in concession agreement and requirement of possession for maturing security in goods. The final chapter deals with the issue of publicity and enforcement of security interest. Publicity is a concern since it is important for effective working of priority system and hence the secured transaction law. The chapter highlights the serious problem of delay in establishing a secured transaction registry office in Nepal, thus hampering on the effective implementation of

secured transaction law itself. Realizing the role of security in project finance primarily as defensive but not to sale collateral, this chapter analyses requirements for step in right and its possibility in Nepal. The chapter then briefly discusses other methods of enforcing security against collateral.

## CHAPTER I

### 1. SECURITY IN FINANCING OF INFRASTRUCTURE PROJECTS

#### 1.1. PROJECT FINANCE AND THE ROLE OF SECURITY

Project finance is used to collect finance for the development of large capital-intensive infrastructures where a special purpose vehicle established for a particular project act as a borrower. This is different to corporate finance where lending is made against balance sheet of the company and projected cash flows estimated from the past profits and cash flows of the borrower<sup>13</sup>. Corporate finance is made based on a company's past records that it will remain in business and continue to generate profits.<sup>14</sup> Contrary to this, project finance involves one-time large financing with an expectation of greater return upon completion of the project. Repayment of investment in such project is dependent on internally generated cash flows of the project.<sup>15</sup> Unlike general loan investment, lending decision of any investor is based on the ability of the project to repay its debt from its own earnings. Creditworthiness of the participating sponsors and the value of collateral granted by sponsors as security are of secondary concern for investors financing in project finance<sup>16</sup>. Unlike traditional role of security to secure payment of debt and recover from collateral in case of debt, security in project finance has role of preventing others from creating priority security over project assets and providing lenders the opportunity to step in and operate in case of default.

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<sup>13</sup> Stefano Gatti, *Project Finance in Theory and Practice: Designing, Structuring, and Financing Private and Public Projects* (2nd ed, Elsevier/AP, Academic Press 2013).

<sup>14</sup> Edward R Yescombe, *'Principles of Project Finance'* (Academy Press 2009).

<sup>15</sup> David Gardner and James Wright, *'Project Finance'*, (HSBC)

<<https://www.hsbcnet.com/gbm/attachments/products-services/financing/project-finance.pdf>> accessed 2 December 2017.

<sup>16</sup> Stefano Gatti (n 13).

### 1.1.1. Characteristic Features of Project Finance

Project finance is characterized by some features which differentiate it from general corporate financing. Jan-Hendrick Rover stresses that project finance is basically characterized by five features. These are<sup>17</sup>, *first* the purpose of financing is clearly defined and specific to a project. *Second*, borrower is a special purpose vehicle established for the purpose of a project and is legally and economically independent from its sponsors. *Third*, the loan of borrower is repaid from the future cash flows of the project. *Fourth*, there is no or very limited recourse to the sponsors. *Finally*, the risk is comprehensively allocated between various parties through complex contractual arrangements. Hoffman comprehensively defines 'project finance' as "a nonrecourse or limited recourse financing structure...*in which lenders base credit appraisals on the projected revenues from the operation of the facility, rather than the general assets or the credit of the sponsor of the facility, and rely on the assets of the facility, including any revenue-producing contracts and other cash flow generated by the facility, as collateral for the debt*"<sup>18</sup> [emphasis added].

In project financing a financially and legally independent ad hoc company also called as special purpose vehicle (hereinafter "SPV") is established solely for the purpose of the project which acts as a borrower.<sup>19</sup> Since borrower is an independently established company it should be self-sufficient for its operation. After completion of the project, cash flow generated by the company is utilized in its operating cost and to make payments of debts. Creditors have priority claim on revenues/cash flows of the company. Any balance remaining

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<sup>17</sup> Jan-Hendrik Rover, 'Security in project finance and PPP and the implications for secured transactions law: "Security is a shield, not a sword"', in Frederique Dahan, *Research Handbook on Secured Financing in Commercial Transactions* (Edward Elgar Publishing 2015).

<sup>18</sup> Scott L Hoffman, *The Law and Business of International Project Finance: A Resource for Governments, Sponsors, Lenders, Lawyers, and Project Participants* (2<sup>nd</sup> ed., Transnational Publishers [u.a] 2001).

<sup>19</sup> Ibid; Stefano Gatti (n 13).

after allocation of operating cost and servicing of debt, can be distributed as dividends between sponsors.<sup>20</sup>

Borrower being legally independent entity, lenders do not have recourse against the shareholder-sponsors after the project is completed. Sponsors' liability is limited and their involvement in the project deal is limited in terms of time, amount and quality<sup>21</sup>. Basically, the return of investment of lenders is dependent on the success of the project and if project is unsuccessful, the lenders will have no or very limited right to claim their payments from the assets or cash flows of promoters and equity participants (sponsors). Such a structuring protects the sponsors from unbearable loss and allocate risks among lenders and other project participants. Lenders assume the part of risk on consideration of higher interest rate and projection of consistent cash flow on successful completion of the project.

Project documents and financial documents like charter of the borrower, shareholders agreement, sponsor support agreement, facility agreements, and inter-creditor agreements allocate risk equitably among parties involved in the transaction. Practical allocation of risk is a key in well-designed project finance and therefore the risks are assigned to parties who are best able to control and manage the particular risk. In addition to the equity contribution of sponsors, they may give other collateral or guarantees to the benefit of lenders. Beside equity sponsors and lenders, other parties including construction contractor, operation contractor, input supply contractor, off-taker, and host government are major members on project structure. The level and quality of risk allocation among these self-interested members through networks of agreements among themselves and with borrower determines the bankability of the project.

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<sup>20</sup> Ibid.

<sup>21</sup> Ibid.

Lenders have concern on bankability of the project. Bankability of a project is assessed by making comprehensive study on the project's overall documents, identification of potential risks, and determination of how these risks have been allocated among the parties<sup>22</sup>. For a project to be bankable it should be ensured that project risks are not concentrated in the project company but are appropriately and practically allocated among parties or mitigated in other ways.<sup>23</sup> Lenders also make evaluation of construction, operation and other contracts of the project to determine construction cost and operating cash flows. Lenders also monitor and control the activities of the project company so as to ensure that the basis on which they determined bankability and assessed project risks are not undermined. There might be various factors the lender may consider while determining the bankability of the project including, performance of the physical plant, cost and availability of input and value of revenue to be generated, social and environmental impact of the project, adequacy of the project's insurance programme, integrity of the financial models, scope of concession provided by the government and many other.

Beside bankability of the project, lender's decision to extend long term credit to a project company depends on the level of confidence and comfort they have on the overall security package.<sup>24</sup> One of the major concerns of the Lender is the scope for taking security over the present physical assets, account receivables, contract obligations and all other forms of present and future asset of the project company. For this a detailed due diligence is made on the local laws dealing with secured transactions law and legal environment on project finance in general to determine the scope of creating the security and ease of enforcing such security interest available under the laws.

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<sup>22</sup> John Dewar (ed.), *International Project Finance: Law and Practice* (Oxford University Press 2011).

<sup>23</sup> Yescombe (n 14).

<sup>24</sup> Dewar (n 22).

### 1.1.2. Role of Security

Philip R Wood claims that the purpose of security in project finance is often primarily defensive, i.e. it is a shield but not a sword<sup>25</sup>. Defensive in the sense that senior security created by lender protects it from actions by unsecured or junior creditors<sup>26</sup>. This is true in the sense that assets of the project are usually non-marketable, and their value is not comparable to existing debt liability. The security therefore is a shield against third parties or unsecured creditors who may claim priority claim over the project assets<sup>27</sup>.

Another purpose of security is to maintain control of lenders on the project company.<sup>28</sup> By taking security over all assets of the company, including receivables and shares, company can simply step in, take over management and operate the project to generate revenue to reimburse its debt. Security can also serve its traditional offensive function of enforcing the security to dispose assets and repay debt in case of failure of project. This is relevant when previous options are not practically possible due to some reasons like restriction of laws<sup>29</sup>. In essence, project security is both defensive and offensive.

The defensive function relates to protecting the project and its property from the claims of third parties<sup>30</sup>. The major purpose of the security package, therefore, would be to eliminate the control of borrower on secured assets in case of default and to provide the lender with priority claims over the assets against other creditors of the borrower, who may seek to

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<sup>25</sup> Philip R Wood, *'Project Finance and Subordinated Debt and State Loans'* (Sweet & Maxwell, 1996), p 30.

<sup>26</sup> Jeffrey Delmon, *Private sector investment in infrastructure: project finance, PPP projects and risk*" (Kluwer Law International, 2009), p 52.

<sup>27</sup> Jan-Hendrik Rover (n 17).

<sup>28</sup> Philip R Wood (n 25).

<sup>29</sup> Jan-Hendrik Rover (n 17).

<sup>30</sup> Stefano Gatti (n 13), p 267.

enforce their own interest over the property<sup>31</sup>. It prevents other creditors from creating conflicting security and from initiating enforcement action against the assets to the detriment of lenders<sup>32</sup>. The lenders require that project assets should not be sold or disposed without its consent, ensuring that important assets are available to operate the project or sold for a price that allows replacement<sup>33</sup>. Whether a security serves this purpose depends upon the host state laws, since the validity of the security package and the priority of the lender over other creditors and scope of enforcement depends primarily upon the laws of host country.

Further the security helps lender to control the destiny of project in case of any default. Through security interest lenders hope to maintain their control over the project company and determine how the project should proceed. Lenders reserve the step-in option, in case of default by borrower, whereby they have option to take project in their own control to complete the remaining work and operate it by appointing receiver to generate revenue in order to payback their investment<sup>34</sup>. Appointment of receiver would be possible only if there is a floating charge over all present and future assets of the company. Therefore, exercising control by appointing receiver would be a valid purpose if host state laws recognizes possibility of creating floating charge. Control can also be achieved by taking security over shares of the company so that it can transfer ownership in case of default<sup>35</sup>. This is not possible if there are restriction under national laws to pledge shares of project company which received concessions from the government.

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<sup>31</sup> Dewar (n 22).

<sup>32</sup> Guide to Project Finance (n 10). Appointment of reliever is, however, possible only under English law which recognizes floating charge.

<sup>33</sup> Scott L Hoffman (n 18), p 364.

<sup>34</sup> Guide to Project Finance (n 10).

<sup>35</sup> Stefano Gatti (n 13).



Offensive or positive of project security relates to traditional function of security i.e. to make it possible to repay loan in case default<sup>36</sup>. Project financing could be perceived also as a complex secured transaction lending scheme. Lenders usually do not have recourse to any other property other than asset of the project and cash flows. If the project is not successfully completed the lender has no option except to enforce the security interest over the collateral package. Therefore, lender takes security over all all present and future asset and cash flows as a collateral package.

In jurisdictions where secured transactions laws are not comprehensive or where subordination of security interest is not recognized or is not effective, existence of security interest of more than one person over the same assets can create problems. This particular concern of whether other creditors can attach competing security interest over the already pledged project assets depends also on the nature of the security device, nature of the assets and approach of secured transaction law of concerned jurisdiction.

In respect to taking security over project documents, lenders primarily have two concerns in<sup>37</sup>. First, lenders have concern if effective security can be taken over project contracts. Contracts over which the lenders wish to create security interest should be chargeable and assignable by way of security.<sup>38</sup> Second, it is important that all key contracts exist and remain valid at the time of enforcement of security by lenders. The lenders, therefore, pay special attention to termination clauses in key contracts.

Therefore, for investors to be motivated for making investment in project in a particular host state, it should be ensured that laws of that state dealing with securities should fulfil

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<sup>36</sup> Ibid.

<sup>37</sup> David Lee, Gareth Price and Graham D Vinter, *Project Finance* (4 ed, Sweet & Maxwell 2013).

<sup>38</sup> Ibid.

minimum characteristics based on international best practices. By making a reference to English law as project finance friendly law, Dentons, an international law firm, in its guide to project finance, highlights the basic requirements of laws on secured transactions<sup>39</sup>. Among them the first is that the laws should provide scope to create security over virtually all types of assets of project including future receivables. Since receivables are the major source for payment of debt, lenders wish to maintain control over the utilization of the receivables<sup>40</sup>. Second, since the assets of the borrower are fluctuating in nature and borrower may acquire additional valuable property over time, the law should provide scope for creating floating charge over all property of the company without identifying or listing such property<sup>41</sup>. Creating floating charge without identifying particular property, at one end, ensures security of lender on all existing property of the borrower and on the other hand provide scope for the borrower to seek additional loan in case of necessity. Third, as valuable assets of the company like plants machineries, equipment upon which the lenders have major interest are to be used for day to day operation of the project for generation of revenue, the law should provide scope for creation of security without necessity of taking control by possession (non-possessory security interest)<sup>42</sup>.

Further, the law should incorporate comprehensive rules on ranking and priority of conflicting interest. Lenders may be subjected to lengthy and uncertain court proceedings if the priority are not defined under laws. In addition, for efficient realization of creditors' interest over collateral, the laws should provide scope for out of court enforcement and should allow the lenders to dispose or utilize the assets for realization of debt under

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<sup>39</sup> Guide to Project Finance (n 10).

<sup>40</sup> Stefano Gatti (n 13).

<sup>41</sup> Guide to Project Finance (n 10).

<sup>42</sup> Ibid.

commercially reasonable terms<sup>43</sup>. Secured creditor should have capacity to take the assets in its control and operate by appointing receiverships to generate revenues. Finally, the laws should identify an efficient system for registration of the securities with centrally administered database.

These issues have been further discussed and analysed in reference to Legislative guide and laws of Nepal in the chapters following.

## **1.2. RECOMMENDATIONS OF UNCITRAL LEGISLATIVE GUIDES**

The Legislative Guide on Privately Financed Infrastructure Projects prepared by UNCITRAL (Legislative Guide)<sup>44</sup> provides legislative recommendations intended to assist in the establishment of a legislative framework favourable to privately financed infrastructure projects. It deals with matters that are important to address in legislation specifically concerned with privately financed infrastructure projects. It provides recommendations ranging from general constitutional provisions and institutional reforms to specific legislative provisions on issues like power of concessionaire, selection of bidder, procedure of accepting bid, provisions of project agreement. It is supplemented by Model Legislative Provisions (Model Law) on Privately Financed Infrastructure Projects<sup>45</sup>. Section IV(E) of the Legislative Guide and the Model Provision 35 of Model Law provides for basic requirements concerning security interest.

The Guide acknowledges that project security has both defensive and protective function and security provides creditors the right to reposes the property or third-party reposes or sell it,

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<sup>43</sup> Ibid.

<sup>44</sup> Legislative Guide on PFIP (n 4).

<sup>45</sup> United Nations Commission on Trade law, *Model Legislative Provisions on Privately Financed Infrastructure Projects* (United Nations 2004).

and priority right to receive payment from the proceeds in case of default<sup>46</sup>. The recommendations made under the legislative guide are basic and focus on the scope of creation of security over particular type of assets. The major recommendation made by the Legislative Guide is to provide scope for concessionaire to create security interests over any of its assets, rights or interests, including those relating to the infrastructure project, as required to secure any financing needed for the project. The guide particularly suggests that there must be sufficient scope to create security interest over at least three specific categories of assets<sup>47</sup>. First all movable and immovable property owned by the projects company, second, the proceeds of use of facility or services of the company and receivables owed to the project company, and finally over shareholder's shares in the project company<sup>48</sup>. The Guide further clarifies that it is desirable to have a reformed secured transaction law for effective and efficient working of security. These matters have been discussed in detail and Nepal's law has been analysed with these recommendations in chapters following.

### **Essential Requirements of Reformed Secured Transaction Laws**

Reformed secured transaction law that is based on comprehensive functional approach should cover all voluntary security devices creating charge over almost all forms of movable property having value.<sup>49</sup> According to UNCITRAL Legislative Guide on Secured Transactions, though the states may adopt secured transaction laws in their own idiosyncratic way, legal rules of modern reformed secured transaction laws are based on some fundamental

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<sup>46</sup> Legislative Guide on PFIP (n 4), p 118.

<sup>47</sup> Model Provisions on PFIP (n 45), Model Provision 35.

<sup>48</sup> Ibid.

<sup>49</sup> Fleisig, Safavian and de la Pena (n 8).

legal policies<sup>50</sup>. First fundamental policy is that the law should be comprehensive in scope that covers all forms of secured transactions, all categories of security giver and secured creditors, and all types of movable assets and secured obligation<sup>51</sup>. Second, the guide suggests that the modern law should adopt integrated and functional approach, meaning that all transactions that create right in any type of movable assets to secure performance of an obligation should be characterized as secured transaction<sup>52</sup>. Third, law should permit the possibility of creating security rights in future assets<sup>53</sup>. Fourth, the law should recognize the extension of security right into whatever proceeds received upon the disposition of charged asset<sup>54</sup>. Fifth, the law should be clear enough to distinguish between creation of security interest and effectiveness against third parties<sup>55</sup>. The security interest should be effective against third parties after fulfilment of some minimal additional steps like notice filing. Sixth, law should permit possibility of granting more than one security interest in the same assets<sup>56</sup>. Seventh, the state should have a single registry for registration of security interest that records notices relating to existing or potential security rights which are accessible by third parties<sup>57</sup>. This will enhance efficiency by providing publicity for different kind of assets, borrower and secured creditor<sup>58</sup>. Eighth, the law should provide clear rules for determining priority among

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<sup>50</sup> Spiros V. Bazinas, 'The Work of UNCITRAL on Secured Interest' (Unif. L. Rev. 15 (2010), <[http://heinonline.org/hol-cgi-bin/get\\_pdf.cgi?handle=hein.journals/droit2010&section=20](http://heinonline.org/hol-cgi-bin/get_pdf.cgi?handle=hein.journals/droit2010&section=20)> accessed 25 March 2018.

<sup>51</sup> Legislative Guide on Secured Transactions (n 8), p 23.

<sup>52</sup> Ibid.

<sup>53</sup> Ibid.

<sup>54</sup> Ibid.

<sup>55</sup> Ibid, p 24.

<sup>56</sup> Ibid.

<sup>57</sup> Ibid.

<sup>58</sup> Hugh Beale, 'An Outline of Typical PPSA Scheme', in Louise Gullifer and Orkun Akseli (ed), 'Secured transactions law reform: principles, policies and practice' (Hart Publishing, 2016), p 7-19.

competing security interest over same asset and priority with other rights conflicting with security right over the asset. Further the guide suggests that the law should be facilitative in nature and parties should be permitted to design their own security agreement<sup>59</sup>. Ninth, the law should not set any limitations on secured creditors' right to enforce the security out of court<sup>60</sup>. Finally, the law should ensure that it treats all secured creditors in equitable manner<sup>61</sup>. Reformed secured transaction law in general is desirable for project finance, but some features of the secured transaction law are more important and pressing for project finance including scope of creating security, and enforcements. These matters are discussed in chapter II and III below.

### 1.3. GENERAL FRAMEWORK OF NEPALESE LAWS

The modern legal era of Nepal begins from the codification of the Country Code <sup>62</sup>for the first time in 1854 A.D.<sup>63</sup> It covered major sectors of regulation including civil, criminal and commercial that are not otherwise governed by other specific laws. The code was subsequently revised to form Country Code 1963<sup>64</sup>. Special laws passed by parliament supersedes the provisions of the Code<sup>65</sup>. In respect to other matters where there are no separate laws enacted by the parliament general provisions of the country code governs both

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<sup>59</sup> Legislative Guide on Secured Transactions (n 8), p 25.

<sup>60</sup> Ibid.

<sup>61</sup> Ibid, p 26.

<sup>62</sup> Country Code (Muluki Ain) was the first formal codified law of Nepal prepared in command of Junga Bahadur Rana, the then autocratic Rana prime minister of Nepal and was enacted by King Mahendra Bir Bikram Shah. It was a single comprehensive code including substantive provisions on civil, criminal matters and rules of procedures.

<sup>63</sup> Dipakraj Joshi and Rajesh Kumar Katuwal, '*Nepalese Legal and Judicial System: An overview*' <<http://nkcs.org.np/nja/elibrary/pages/download.php?ref=98&size=&ext=pdf&k=&alternative=-1&usage=-1&usagecomment=>> accessed 31 March 2018.

<sup>64</sup> मुलुकी ऐन २०२०.

<sup>65</sup> Chapter on Preliminary Affairs, Country Code 2020, s 4.

in terms of substance and procedures. Further Nepal recognize the common law principle of binding precedent and therefore the ratios of the judgements of higher court constitute part of binding laws<sup>66</sup>. Lately Nepal has passed various sector specific commercial laws like Insolvency Act, Secured Transaction Act, Bank and Financial Institution Act, Banking Fraud and Offence Act, whose provisions are too some extent based on international best practices. For example, secured transaction act seems highly influenced by UCC Article 9 of the United States<sup>67</sup>.

Government of Nepal passed Secured Transaction Act 2063 (2006) ("ST Act") on 16 November 2006<sup>68</sup>. The primary objective of the consolidated act, as stated in its preamble, is to secure obligations with movable and intangible property in order to ensure maximum promotion of economic activities<sup>69</sup>. The ST Act is influenced by functional approach of Article 9 of the Uniform Commercial Code of USA<sup>70</sup> and in general is in compliance with principles of international best practices in secured transaction law<sup>71</sup>.

Before the Secured Transaction Act came into effect, matters regarding creation and enforcement of charge over movable property were governed by scattered provisions under Country Code (Muluki Ain),<sup>72</sup> sectoral laws like the Banking and Financial Institutions Act

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<sup>66</sup> Constitution of Nepal, art 128(4).

<sup>67</sup> James D. Hekel, The UCC Comes to Nepal, Part II <<http://jameshekel.com/index.php/tag/secured-transactions>> accessed 5 February 2018.

<sup>68</sup> सुरक्षित कारोबार ऐन २०६३.

<sup>69</sup> Secured Transaction Act 2006, preamble.

<sup>70</sup> James D. Hekel (n 67).

<sup>71</sup> The World Bank, 'Nepal - Feasibility Study on Establishment of Secured Transactions Registry' (The World Bank 2008) 43679 <<http://documents.worldbank.org/curated/en/296121468323683883/Nepal-Feasibility-study-on-establishment-of-secured-transactions-registry>> accessed 6 February 2018.

<sup>72</sup> The General Code of Nepal is going to be replaced by separate civil code, civil procedural code, criminal code, and criminal procedural code from the next year. New codes are based on and give continuity to the major provisions of the Muluki Ain.

(applicable only to licensed banks), and general and specific provisions of the Contract Act 2056 (2000). The mortgages and other forms of charge over immovable property is still governed by the provisions of the Country Code. The provisions of civil code only recognized the traditional form of pledge through possession and control. Lending and taking security in commercial manner is still limited to licensed banks which has defined rules for enforcing security. The lenders other than licensed banks, should follow court administered auction for recovery of loan by disposing the security if not covered by Secured Transaction Act. Specific order of the court was required to administer auction of the collateral. General legal provision contained on country code (Muluki Ain) relating to general transactions<sup>73</sup> or contract act should be relied upon as the substantive law.

The Secured Transaction Act is divided into seven chapters and deals with four substantial aspects of secured transaction law viz. (i) establishment and operation of Secured Transactions Registration Office (hereinafter "**STRO**")<sup>74</sup>, (ii) creation and attachment of security interest<sup>75</sup>, (iii) maturity and priority of security interest<sup>76</sup>, and (iv) enforcement of the security interest<sup>77</sup>. Beside this the Secured Transaction Act makes provisions for offences and punishment relating to matters governed by the Act<sup>78</sup>, and transitional provisions dealing with

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<sup>73</sup> See, Chapter on General Transaction (लेनदेन ब्यवहारको महल) of Muluki Ain 2020 (1963). Deeds in the format specified under Muluki Ain should be presented to base claim under this chapter and are less attractive in case of commercial transaction. The chapter is intended to regulate non-commercial transactions between individuals.

<sup>74</sup> Ibid, chapter 2.

<sup>75</sup> Ibid, chapter 3.

<sup>76</sup> Ibid, chapter 4.

<sup>77</sup> Ibid, chapter 5.

<sup>78</sup> Ibid, chapter 6. For example, under section 55: an act of knowingly making false statements in a notice submitted to registration office or interfering with exercise of right to use, possess, execute or give security in property is punishable offense and person committing the offense can be punished with fine ranging from NRS. 50,000 to NRS 500,000 or with imprisonment up to six months or both, to be determined based on the gravity of the offence.



transactions executed prior to implementation of this Act<sup>79</sup>. Though section 1(2) of the Act provides for immediate effect, the Act has not yet come in real application due to government's failure to operate STRO for filing notices. Almost a decade after enactment of ST Act, Government of Nepal established a STRO<sup>80</sup> by passing Secured Transaction Regulation 2073 (2010) on 30 January 2017. STRO, however, has not yet started accepting notices but is expected to operate soon.

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<sup>79</sup> Ibid, chapter 7.

<sup>80</sup> See Official website of secured transaction registry office of Nepal, <<https://www.stro.org.np/public>>.

## CHAPTER II

### 2. CREATION OF SECURITY INTEREST IN PROJECT ASSETS

In project finance transactions, since the scope and nature of securities provided by the project company is largely determined by the host state laws, it is desirable that secured transaction laws of host state fulfil fundamental policies of reformed secured transaction laws. However, as the purpose of security in project finance is primarily defensive in nature and is intended to confer control of the project in case of default<sup>81</sup>, parties are primarily concerned with some specific features of secured transaction law. In terms of creation of security interest, parties wish that host state laws provide comprehensive scope for creation of security over whole of the assets of project company, both present and future<sup>82</sup> assets of a tangible or intangible nature<sup>83</sup>. Since infrastructure financing are long term in nature, parties should be able to define assets given for security specifically or generally<sup>84</sup>. It must be possible to attach security without necessarily taking control of the asset i.e. the project company should be able to create non-possessory security interest<sup>85</sup>. Further, since lending in infrastructure is based on expected cash flows of the project company but not the present assets, the host state law should recognize possibility for assignment of proceeds from contracts with customers and other trade receivables to lenders<sup>86</sup>. Finally, lender should be able obtain security over the shares of the project company<sup>87</sup>, in order to ensure that lenders

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<sup>81</sup> Philip R Wood (n 25), p 30.

<sup>82</sup> Andrew McKnight, 'The law of international finance' (Oxford University Press, 2008), p 752.

<sup>83</sup> Legislative Guide on PFIP (n 4), p 120.

<sup>84</sup> Ibid, p 192.

<sup>85</sup> Stefano Gatti (n 13).

<sup>86</sup> Ibid.

<sup>87</sup> Jeffrey Delmon (n 26), p 245.

can exercise control over project company in case of default. UNCITRAL Legislative Guide on PFIP also suggests that the financing documents for privately financed infrastructure projects typically include both security over physical assets related to project and security over intangible assets held by concessionaire<sup>88</sup>. The Guide then specifically recommends that project company should be capable of creating security interest over all physical assets including public property that becomes the part of project asset, the concession agreement itself, trade receivables and shares of the company<sup>89</sup>. Some of these important considerations relating creation of security in project financing has been briefly discussed and been analysed in reference to the existing laws of Nepal in the sub chapters following.

## **2.1. COMPREHENSIVE SECURITY IN PHYSICAL AND INTANGIBLE ASSETS**

In a typical project finance, the lender obtains blanket lien covering all assets of the project company which means that all assets of the company either real or personal, tangible or intangible is pledged in name of lender<sup>90</sup>. The security package therefore includes all physical and intangible assets necessary for ownership, development, construction, start-up, and operation of the project<sup>91</sup>. It is ensured that all these assets necessary for the project is owned (or leased) by the project company to efficiently formulate a comprehensive collateral package. These assets forming the part of collateral package include personal property like equipment, plants and fixtures, computers, vehicles, pipelines, transmission lines, and similar physical assets; project cash flows; and intangible assets like intellectual property (trademarks, technology rights, patents), permits licenses and concessions, all significant

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<sup>88</sup> Legislative Guide on PFIP, p 118.

<sup>89</sup> Ibid, p 119-121.

<sup>90</sup> Scott L Hoffman (n 18), p 365.

<sup>91</sup> Ibid.

contracts, insurance proceeds, bank accounts, lease.<sup>92</sup> Secured transaction law of the host state should recognize the possibility of creating security interest over all these forms of assets.

The model provision 35 of UNCITRAL Model Legislative Provision on Privately Financed Infrastructure Project provides that the project company should have right to create security over any of its assets, rights or interest including in security over movable and immovable assets owned by the project company<sup>93</sup>. Further the Legislative Guide on secured transactions recommends that all types of assets should be capable of being object to security right and the secured transaction law should apply to security rights in all forms of movable assets, either tangible or intangible, present or future<sup>94</sup>. The guide also focuses on creating security over inventory, equipment, contractual rights, contractual non-monitory claims, etc. which are of prime importance in project finance.

### **Status under Secured Transaction Act of Nepal**

Secured Transaction Act of Nepal recognises possibility of creating all forms of security over all forms of assets by incorporating a broad definition of 'security interest' and 'collateral'. The Act, under section 2(r), has defined 'security interest' as a property right in collateral that secures performance of an obligation. This broad definition of security interest covers all form of proprietary interest in collateral that is intended to secure an obligation, either monetary or non-monetary<sup>95</sup>. The Act defines 'collateral' as 'any intangible property, fixtures, and movable property including such collateral arising in future, collateral located in or outside Nepal, sold accounts or secured sales contracts, leased goods and proceeds of

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<sup>92</sup> Stefano Gatti (n 13); Scott L Hoffman (n 18).

<sup>93</sup> Model Provision on PFIP (n 45), Model Provision 35.

<sup>94</sup> Legislative Guide on Secured Transactions (n 8), p 32.

<sup>95</sup> Secured Transaction Act, s 21(2).

collateral<sup>96</sup>. This definition includes almost all forms of tangible and intangible assets including inventory, fixtures and future assets. Section 22 of the Act further clarifies that description of collateral will be sufficient if it reasonably identifies the collateral and the description can be expressed in general terms like "all assets" or "all movable property"<sup>97</sup>. The Act further assumes the possibility for creation of multiple security interest over a collateral<sup>98</sup> or a security interest securing multiple obligations<sup>99</sup>. Such security interest may also secure future and pre-existing obligations<sup>100</sup>.

### **2.1.1. Securing Against Contractual Non-Monetary Claims (Concession Agreement)**

The Secured Transaction Act does not provide any specific rule in respect to security over contractual non-monetary claims like rights of project company under concession agreement, lease of public property, EPC Contract or O&M Contract. Lenders are particularly concerned in taking security over concession agreement so that lender could effectively exercise step-in right in case of default<sup>101</sup>. The Legislative Guide in PFIP particularly suggests that lenders in project company should be able to take assignment of concession agreement and leasehold rights over public property<sup>102</sup>. Project company cannot encumber property in which it does

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<sup>96</sup> Ibid, s 2(p).

<sup>97</sup> Ibid, s 22.

<sup>98</sup> Ibid, s 20(1).

<sup>99</sup> Ibid, s 21(1).

<sup>100</sup> Ibid.

<sup>101</sup> EBRD, "EBRD Core Principles for a Modern Concessions Law", principle 10 < <http://www.ebrd.com/documents/comms-and-bis/ebrd-core-principles-for-a-modern-concessions-law-selection-and-justification-of-principles.pdf>> accessed 25 March 2016; Legislative Guide on PFIP (n 4), Recommendation 49.

<sup>102</sup> Legislative Guide on PFIP (n 4), p 119.

not have title. Therefore, lenders in project finance can only obtain control over leased public lands or property only by taking security over the leasehold right<sup>103</sup>.

The Secured Transaction Act covers broad definition of "intangible property" as all movable property which creates legal right, other than goods, accounts, secured sales contract, deed, instruments and cash<sup>104</sup>. The broad application of the Act to all form of security over all forms of assets including intangible should, therefore, cover security over concession and leasehold rights. However, Act lacks any description about assignment of contractual non-monetary claims. Section 42 of the Act mentions that any person can assign any or all of its right on intangible property. But the definition of 'assignment' under section 2(jj) of the Act limits it to 'transfer of right to payment' thus excluding non-monetary claims. Further, in lack of special provision dealing with these contractual non-monetary claims, importantly concession agreement, it is uncertain if project company require consent of obligor to create security on these contracts. It would be better, for the shake of clarity, to specifically include 'rights to performance of obligation' within the definition of "intangible assets" and 'contractual non-monetary claims' as specific category of asset being covered within the scope of Secured Transaction Act, as done on UNICTRAL Model Legislation on Infrastructure Project.

Lack of separate law dealing with concession in infrastructure projects, makes the issue more uncertain. Principally, a concession agreement must specifically allow assignment or pledge of concession agreement and should be regulated by a concession law<sup>105</sup>. Legislative Guide on PFIP suggests that legislation should provide under which conditions transfer of

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<sup>103</sup> Ibid.

<sup>104</sup> Secured Transaction Act, s 2(c).

<sup>105</sup> Glenn S. Kolleeny, '*RF Law on Concessions and prospects for private-public partnership infrastructure projects in Russia*' (OECD Seminar on Russia's Investment Environment and Policy, 2007) <<https://www.oecd.org/investment/investmentfordevelopment/38664137.pdf>>, accessed 25 March 2018.

concession can be made<sup>106</sup>. Nepal has not adopted separate law regulating concession and private financing in infrastructure projects. However, the proposed draft of Model Project Development Agreement prepared by Government of Nepal for Hydropower Project (Model PDA) at clause 23.1 provides that project company can assign or otherwise transfer all or part of the rights under the PDA to any Lender for the purpose of arranging or rearranging finance for the project subject to prior written consent of Government of Nepal<sup>107</sup>. It further clarifies that the consent shall not be unreasonably withheld<sup>108</sup>. Model PDA further provides that project company may mortgage or otherwise give security over its assets and undertakings including lease, license or other interest granted by Government of Nepal to any lender providing finance for the project<sup>109</sup>. Although the Model PDA is non-binding reference document prepared by government which is subject to further negotiation with project company and sponsors, the provisions included in the Model PDA suggests flexible approach taken by government in terms of assignment of concession and creation of security. Since these clauses are in favour of project company, they are less likely to be changed by negotiations. It should however be noted that this Model PDA is targeted for hydropower project and one can reasonably expect but cannot rely that government will adopt same approach in other sectors of infrastructure financing. It is, therefore, necessary for government to adopt a law dealing with concession on private financing in infrastructure projects, providing rules regarding assignment of concession, lease and licenses, among others.

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<sup>106</sup> Legislative Guide on PFIP (n 4), p 122.

<sup>107</sup> Ministry of Energy of Government of Nepal, *'Proposed Draft of Model Project Development Agreement for Hydropower project with installed capacity less than 500 MW'*, s 23.1.1

< [http://www.moen.gov.np/pdf\\_files/Proposed-Draft-PDA.pdf](http://www.moen.gov.np/pdf_files/Proposed-Draft-PDA.pdf)>.

<sup>108</sup> Ibid.

<sup>109</sup> Ibid, s 23.1.4.

### 2.1.2. Possessory Requirement for Maturity of Security in Goods

Popular and traditional method of creating security over tangible goods is pledge which typically involve relinquishment of possession by grantor of security to secured creditor. In terms of effect and notice to third party traditional form of pledge is more efficient instrument for encumbering physical movable assets. However, considering the special nature of project finance which involve financing on collateralization of assets used in construction and operation of the project, possessory security is impracticable<sup>110</sup>. Therefore, the host state law should provide scope for creation of non-possessory security. Denton, an international law firm, in its guide to project finance suggests that under English law security can be taken over virtually all classes of asset without taking possession of that assets, which makes the English law project finance friendly<sup>111</sup>. Some instruments to achieve this can be non-possessory pledge, registered pledge, floating charge, whose definition and scope off course varies according to nations adopting them. In laws based on functional approach, substance should be more important than form<sup>112</sup>.

Contrary to the above principle, under section 26(4) of the Secured Transaction Act of Nepal, security interest in goods, instruments, documents or secured sales contract is matured only when security holder takes possession of such collateral. Although, the security holder may file notice to the secured transaction registry during or after the possession, taking possession is compulsory for perfecting security interest<sup>113</sup>. The term 'goods' under the Act has been defined as all kinds of things that are movable including fixtures, timbers to be cut and

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<sup>110</sup> Legislative Guide on Secured Transactions (n 8).

<sup>111</sup> Legislative Guide on PFIP (n 4), p 45.

<sup>112</sup> Legislative Guide on Secured Transactions (n 8), p 56.

<sup>113</sup> Secured Transaction Act, s 26(4).



removed for sale and farm products<sup>114</sup>. Therefore, the provision applies to all tangible property including fixtures and farm products. Security interest attaches and is enforceable against security giver to a collateral where security agreement is entered with description of the collateral and security holder has given value to the security giver<sup>115</sup>. Attachment would make security enforceable against the security giver but for security to be effective against third party to ensure priority in case of conflict, it should be perfected (matured) according to the prevailing laws<sup>116</sup>. The priority among security interest in collateral is determined according to the time when the initial notice is filed, or security interest is first matured<sup>117</sup>. Therefore, the security interest over goods will not get priority until it is matured by taking possession. The Act does not infer any possibility of considering constructive possession as sufficient for maturing the security in goods.

The concept of possession for maturity of pledge over goods is a method adopted by German law to combat secret-lien<sup>118</sup>. Although the requirement of possession addresses the problem of secret lien, it is ill suited to modern times<sup>119</sup>. UNCITRAL Legislative Guide on Secured Transaction argues that traditional form of possessory pledge over tangible assets have two limitations on modern economies. First, the security giver requires possession of its business assets in order to carry out its business operation<sup>120</sup>. Second, possessory pledge cannot cover future assets because it is practically impossible to transfer possession of future assets at the

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<sup>114</sup> *ibid*, s 2(y).

<sup>115</sup> *Ibid*, s 25.

<sup>116</sup> Russel A. Hakes, 'The ABC of the UCC: (Revised) Article 9 Secured Transactions' (American Bar Association, 2000), p 33.

<sup>117</sup> Secured Transaction Act, s 28(2).

<sup>118</sup> Tibor Tajti, '*Comparative Secured Transaction Law*' (Akadémiai Kiadó, 2002), p 348.

<sup>119</sup> *Ibid*.

<sup>120</sup> Legislative Guide on Secured Transactions (n 8), p 107.

time of creation of security<sup>121</sup>. Additionally, the modern secured transaction law cover fixtures and equipment as movable goods for purpose of dealing with security. Requirement of possession would simply make it impossible to create security over fixtures and equipment that are affixed to project site and used regularly. The problem is not solved fully even if law recognizes constructive possession<sup>122</sup>. Therefore, the guide suggests that party's agreement should constitute security, notice filing with registry should perfect it for achieving third party effectiveness and taking possession should only be available as alternative method to registration or filing<sup>123</sup>. The Guide further acknowledges that perfection by possession is not an efficient option since it may create problem of ostensible ownership meaning it may lead third parties to falsely believe that creditor holds an unencumbered asset over which it may grant a security right<sup>124</sup>. It also requires third party to verify on whose possession the asset is and when the physical transfer of property happened<sup>125</sup>. At the present age, registration or notice filing is the most suitable notice giving method from the point of view of business needs<sup>126</sup>.

For the above reason, requirement of possession of goods for maturity under the laws of Nepal, therefore, is impracticable specifically in context of project finance. Further, the provision requiring possession for maturity is inconsistent with concept of security in fixtures and inventory. Section 37(5), provides where notice has been filed before interest of owner or mortgage of immovable property is registered, matured security interest in fixture has priority over interest of owner or mortgage. For security to be perfected by possession the property

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<sup>121</sup> Ibid.

<sup>122</sup> Ibid, p 108.

<sup>123</sup> Legislative Guide on Secured Transactions (n 8), p 24.

<sup>124</sup> Ibid.

<sup>125</sup> Ibid.

<sup>126</sup> Tibor Tajti (n 118), p 349.

must be capable of actual or constructive delivery<sup>127</sup>. The requirement of possession for maturity for goods which includes fixtures in section 26 makes these provisions inconsistent with each other. Also contrary to section 26, section 20(3) further provides that security interest will not be invalid by reason that security giver retains the right to use, possesses, sell, exchange, commingle, or otherwise transfer the title to, the collateral. It is not sure how the court will interpret these clause in case of conflict. The plain meaning suggests that by reason of retention of possession of goods by security giver creditor will not obtain priority against conflicting security interest, but security will still be enforceable against the security giver.

Therefore, it is important, for the sake of efficiency that, secured transaction law of Nepal repeal the provision requiring compulsory possession and recognize notice filing as sufficient to mature security in goods. Maturity by notice filing, however, should be supplemented by other rules providing debtors and third parties the sufficient opportunity to obtain information regarding exiting security over the goods and assets in possession of security giver. UCC Article 9 for example provide debtor the right to request document verifying the existence of security or list of collateral over which the secured party has created security<sup>128</sup>.

## **2.2. SECURITY OVER RECEIVABLES**

Cash flows generated from the operation of the project is the major source that provides fund for project company to repay its debt.<sup>129</sup>Physical assets of the project company developing infrastructure projects are not sufficient to secure large amount of debt required. Project

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<sup>127</sup> P.A.U. Ali, 'The Law of Secured Finance: An international survey of security interests over personal property' (Oxford University Press, 2002), p 99.

<sup>128</sup> For example, *see* § 9-210 of UCC Article 9 which provides to debtor the right to request information regarding list and type of collateral. Statutory damages are prescribed to secured creditors under § 9-625(f) for non-compliance of such request to list of collaterals.

<sup>129</sup> Stefano Gatti (n 13), p 270.

financing is therefore a popular model in infrastructure projects whereby debt can be secured by the future cash flows of the project. All present and future receivables of the company should be charged in favour of lender. These include receivables deriving from contracts entered by the project company, more importantly, the contracts for payment from sales of goods or provision of services.<sup>130</sup> Typically and most importantly the lenders take security over cash flows generated from long terms off take agreement<sup>131</sup>, for example, power purchase agreement in hydropower projects. Security can also be given in proceeds of large number of individual transactions that may include tariffs charged to public for use of infrastructure, for example, monthly payment of water bills, electricity supply, road tolls<sup>132</sup> Future and contingent receivables for reimbursement, restitution, compensation, indemnities, or credits arising from guarantees like performance bonds, or payments from insurance providers can also be part of security package<sup>133</sup>. Further, since receivables arising from offtake agreements are revolving credit<sup>134</sup>, and they are usually deposited in a cash collateral account<sup>135</sup>, it is important to create security over such bank accounts. The funds deposited on the account is applied for repayment of the debt after operating expense of the project are paid<sup>136</sup> and hence security over the fund is essential to ensure that such amount is not utilized otherwise.

The security over such receivables or proceeds of a contract can be created by way of pledge or assignment in favour of lender. In some legal systems distinction is made between legal

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<sup>130</sup> Ibid.

<sup>131</sup> Scott L Hoffman (n 18), p 365.

<sup>132</sup> Legislative Guide on PFIP (n 4), p 121.

<sup>133</sup> Stefano Gatti (n 13), p 270.

<sup>134</sup> Ibid.

<sup>135</sup> Scott L Hoffman (n 18), p 365.

<sup>136</sup> Ibid.

effect of pledge and assignment of receivables and sometimes also between outright assignment of receivables or assignment for the purpose of security<sup>137</sup>. UNCITRAL Legislative Guide on Secured Transaction however suggest that reformed law should subject any form of assignment or pledge of receivables to same set of rules defining security right and priority<sup>138</sup>. The possibility of assignment can be problematic sometime by inclusion of anti-assignment clause in the contracts. Under UCC Article 9, section 9-318(4), any anti assignment restriction in a contract consisting right to payment is ineffective if such clause would have prevented creation of security in contract (general intangible)<sup>139</sup>. Legislative Guide on Secured Transactions suggests that generally no effect should be given to contractual restriction on assignment of receivables except for defined circumstances<sup>140</sup>. Mostly receivables in project finance are assigned in form of bulk assignment since it would not be practical to specific each receivable<sup>141</sup>. The host laws should recognize possibility for creating such security over receivables.

Further, it should be noted that creating security over future receivables, more broadly future assets in generally (e.g. bulk assignments) may sometime require the possibility to create floating lien. Where this is available, the project lender may take security in all of the project assets then existing or thereafter acquired without need for new documentation<sup>142</sup>. It should be however possible for the company to deal with these future assets in ordinary course of business. Therefore, UCC Article 9 in United States, for example, recognizes the rule that

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<sup>137</sup> Legislative Guide on Secured Transactions (n 8), p 92.

<sup>138</sup> Ibid.

<sup>139</sup> Scott L Hoffman (n 18), p 372.

<sup>140</sup> Legislative Guide on Secured Transactions (n 8), p 92.

<sup>141</sup> Legislative Guide on PFIP (n 4), p 121.

<sup>142</sup> Scott L Hoffman (n 18), p 369.

purchase money security interest in receivables has priority over floating lien<sup>143</sup>. A different concept of floating charge adopted in common law states like United Kingdom can also be relevant in creating charge over future assets. Floating charge is an equitable charge created over all existing and future assets of the borrower that crystallizes into fixed charge when the debtor enters into liquidation proceedings or upon enforcement of security interest by creditor following default<sup>144</sup>. Until the charge crystallizes the borrower can sell, or deal with the asset in any other form<sup>145</sup>.

### **2.2.1. Receivable Financing under Secured Transaction Act**

Secured Transactions Act of Nepal by incorporating broad definition of collateral including intangible property and future assets, provide scope for creating security interest over trade receivables and proceeds of the contract<sup>146</sup>. Since the definition of "intangible property" covers all movable creating legal rights other than goods, account, deeds, instruments and secured sales contract<sup>147</sup> receivables under contract including payment under off take agreement and individual contracts having schedule payment falls under the categories of collateral covered under the definition of the Act. Also, by incorporating accounts as collateral, the Act ensures that project company can encumber bank accounts operated for the purpose of depositing receivables. Further the Section 22 provides scope for creating security over future receivables by providing that the description of collateral can be made in general terms like 'all movable assets'. This makes clear that valid security can be created over contract receivables and cash flows.

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<sup>143</sup> P.A.U. Ali (n 127).

<sup>144</sup> Scott L Hoffman (n 18), p. 370.

<sup>145</sup> P.A.U. Ali (n 127), p 113.

<sup>146</sup> See Secured Transaction Act, s 2(p), s 2(r), s 3, s 20(1), s 20(3).

<sup>147</sup> Ibid, s 2(c).

Section 42, further, clarifies that person can assign any or all of the person's rights in accounts...and other intangible property. It is not required to obtain the consent of the obligor or give any information for the attachment, maturity or enforcement of security arising from such assignment<sup>148</sup>. By virtue of section 26 of the Act, the security in assignment should be matured on notice filing with registration office. In respect to priority, the Act adopts the principle that information notified first, or security matured first has priority over another<sup>149</sup>. However, the Act is silent about priority of security in assignment over other interest in receivables. The Secured Transaction Act is also silent about floating lien making it uncertain if lender requires additional documents to secure future receivables that are not presently identified. Though, it recognises the possibility of describing collateral in general terms, it is also not sure if blanket security can be created over all present and future receivables. Some projects operating in Nepal has provided such bulk assignment of all present and future receivables, but it is yet to be seen how this matter would be interpreted by court in case of dispute. The Act also is silent about creation of floating charge. By virtue of a provision providing that security interest validly attaches to a collateral only when security agreement has been entered into providing 'description of the collateral'<sup>150</sup>, it is clear that Act does not adopt the concept of floating charge unlike some common law jurisdictions. Silence of the Act in respect to treatment of bulk assignment and future receivable and their priority, it creates uncertainty and unpredictability in dealing with contract receivables.

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<sup>148</sup> Secured Transaction Act, s 42(3).

<sup>149</sup> *See Ibid*, s 28(1-2).

<sup>150</sup> *Ibid*, s 25(1)(a).

### 2.3. PLEDGING SHARES OF PROJECT COMPANY

Legislative Guide on PFIP suggests that the law should not impose restriction on creating security over the shares of project company to ensure that project company's ability to raise funding for the project is not limited<sup>151</sup>. In project finance the only practical method to safeguard the interest of lender in case of default by project company or its failure to operate efficiently is to take over the project and management<sup>152</sup>. Security interest basically serves this purpose in project finance. Since project and project company in essence are same in case of project finance, taking security over project company's capital provides security over entire project<sup>153</sup>. Due to non-recourse or limited recourse nature of the project finance, only practical way for lender to receive repayment of its debt is to operate the project<sup>154</sup>. Pledge of shares of project company gives lender the right to step-in or carry out sales of these shares<sup>155</sup>. Though enforcing security over shares of defaulting project would not be an effective option, the lenders could foreclose and take over the management of the company to yield proceeds and apply for recovery of their investment. Further, taking in consideration the offensive purpose of security in shares, it is the most efficient and easy security to enforce against all assets of the project company<sup>156</sup>. It is easier to take control of ownership interest of sponsors than foreclosing on the project assets<sup>157</sup>. Further, project loan agreement typically includes act of expropriation as event of default and hence the lender can use pledge in

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<sup>151</sup> Legislative Guide on PFIP (n 4).

<sup>152</sup> Stefano Gatti (n 13), p 269.

<sup>153</sup> Ibid.

<sup>154</sup> Scott L Hoffman (n 18), p 367.

<sup>155</sup> Stefano Gatti (n 13), p 269.

<sup>156</sup> Ibid.

<sup>157</sup> Scott L Hoffman (n 18), p 367.



ownership interest to negotiate compensation payable for expropriatory act<sup>158</sup>. Although this pledge of shares is one of the most efficient security, security over other project assets is required since enforcing pledge in security is not always practical, for example in case of bankruptcy<sup>159</sup>.

UNCITRAL Legislative Guide on PFIP acknowledges the fact that contracting authority providing concession for infrastructure project might be concerned that the original members of the bidding consortium maintain their commitment to the project and it is not transferred to unknown parties since biddings are granted on the basis of the experience and capabilities of sponsors<sup>160</sup>. Contracting authority may not like to see the unknown party taking control over the project. However, the Guide highlights that since a separate project company is established to limit the recourse of contracting authority, if project defaults contracting authorities' claim against sponsors for performance guarantees is very limited<sup>161</sup>. In such circumstances, it would be in best interest of the contracting authority that project is operated and hence taking over of control by lender to operate the project may prove beneficial to contracting authority as well. Therefore, the Guide recommends that host state laws should not in general impose restrictions on pledge of ownership interest of the project company though it may specify restriction for limited period under public policy<sup>162</sup>.

### **2.3.1. Pledging Shares under the Laws of Nepal**

Shares representing the ownership interest in the company are form of intangible property and hence is covered within the definition of collateral under Secured Transaction Act of

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<sup>158</sup> Ibid.

<sup>159</sup> Stefano Gatti (n 13), p 269.

<sup>160</sup> Legislative Guide on PFIP (n 4), p 122.

<sup>161</sup> Ibid, p 123.

<sup>162</sup> Ibid.

Nepal<sup>163</sup>. Therefore, a person holding shares can give security over its ownership interest pursuant to this Act<sup>164</sup>. Further Company Act of Nepal clarifies that share of a company are movable property and hence can be sold and pledged as goods subject to the articles and memorandum of the company<sup>165</sup>. Pledge on shares is effective with approval of board meeting or shareholder's meeting (subjects to articles of the company) of the project company and is recorded by filing of resolutions with office of company registrar<sup>166</sup>. There are no laws in Nepal restricting, in general, the transfer or pledge of ownership interest by sponsors of project companies having concession from government or other authorities. However, proposed draft of Model PDA prepared for hydropower project provides that 'project company should ensure that its sponsors do not assign, sell or transfer their interest in the company or project until five (5) years from commercial operation date<sup>167</sup>. After the specified period, the sponsors can transfer the ownership interest with prior consent of the government<sup>168</sup>. The government however has reserved the right of first refusal<sup>169</sup>. It should again be noted that this Model PDA is not binding and is subject to further negotiation and also applies only to hydropower projects. In a recently agreed hydropower project, sponsors have pledged their full ownership interest and assigned shareholder's advances to Lender.

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<sup>163</sup> See Secured Transaction Act, s 2(p)

<sup>164</sup> Ibid, s 20.

<sup>165</sup> Companies Act 2006 of Nepal, s 42(1).

<sup>166</sup> See Companies Act 2006 and Companies Directive 2015.

<sup>167</sup> Model PDA (n 107), s 24.1.1.

<sup>168</sup> Ibid, 24.1.2.

<sup>169</sup> Ibid, 24.1.4.

## CHAPTER III

### 3. PUBLICITY AND ENFORCEMENT OF SECURITY INTEREST

#### 3.1. PUBLICITY AND NOTICE FILING

##### 3.1.1. Importance of Publicity

A publically accessible place for filing notices and making security interest is a pre-requisite for effective working of priority system. Lenders in project company are primarily concerned in protecting the project assets from third party claim. By taking comprehensive security over all of the project assets, lender wish to ensure its priority claim. Philip R Wood claims that 'the main objects of project security is to act as a defence against unsecured creditors, and to confer control of the project on default'<sup>170</sup>. For this, effective secured transaction law having clear rule on priority is important. Clear rules on priority is also helpful to determine which form of security device to use. Practical and efficient rule of priority is core for successful working of secured transaction regime<sup>171</sup> and publicity through notice filing or registration is essential for efficient working of priority system.<sup>172</sup>

Traditionally actual possession and control was prime method for creating security over movable property<sup>173</sup>. However, this has certain shortcomings like entities obtaining security has interest in retaining the possession of goods for daily businesses and it may be difficult to create security over intangibles. Therefore, modern laws on secured transaction use the concept of public filing or registration for perfection and thus for determining the priority of

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<sup>170</sup> Philip R Wood (n 25), p 30.

<sup>171</sup> Legislative Guide on Secured Transactions (n 8), 185.

<sup>172</sup> Fleisig, Safavian and de la Pena (n 8), p 38.

<sup>173</sup> Legislative Guide on Secured Transactions (n 8), p 149.

security interest<sup>174</sup>. Guide on Secured Transactions argue that registration of information about security over movable asset serves three purposes<sup>175</sup>. First it provides general method for acquiring effectiveness against third party thus eliminating the requirement of taking possession or control. Second, it provides reliable information to third parties about whether a particular asset has to any priority charge. Third, it helps for fair and efficient ordering of priority system.

In Nepal, except some specifically identified assets like goods, instrument, secured sales contract in which security can be matured only by possession, notice filing is the primary way of perfecting security over movable<sup>176</sup>. In assets where maturity is achieved by notice filing, date of registration is the primary basis for determining priority among conflicting security<sup>177</sup> with few exceptions based on the nature of security<sup>178</sup>.

### **3.1.2. Requirements of a Standard Public Filing System**

In a filing-based security system, a dedicated private or public office should have a public database for recording securities so that the lender would have a practical basis to determine whether a prior security exist over a property before advancing credit secured against that property<sup>179</sup>. Notice filing, and registration system are few popular methods of publicity. Where registration system requires registration of security agreement or details of security, notice filing system requires just a notification of existence which primarily includes identity

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<sup>174</sup> Legislative Guide on PFIP (n 4), p 149.

<sup>175</sup> Ibid.

<sup>176</sup> See Secured Transaction Act, s 26.

<sup>177</sup> Ibid, s 28.

<sup>178</sup> For example, purchase money security interest.

<sup>179</sup> Fleisig, Safavian and de la Pena (n 8).

of collateral, security giver and receiver and is generally internet based<sup>180</sup>. Notice filing system is considered to be effective and practical system. Under notice filing system a registry is established whose main purpose is to maintain a database where lenders can register their notices and retrieve information about other security interests in particular collateral<sup>181</sup>.

Notice filing system recommended under the Legislative Guide on Secured Transaction have some basic features. The state establishes a single central registry where all security over all types of movable assets can be registered<sup>182</sup>. It is not required to file evidence of existence of security or underlying security agreement but a simple notice with details of the parties and collateral.<sup>183</sup> Registry's function is to keep the database of the securities filed by the parties but not to verify the validity of the security. Validity of security would be determined according to rules on attachment pursuant to applicable law. The database of registration should be publicly accessible so that third parties including future creditor and buyers can find about existence of prior security on the property<sup>184</sup>.

### **3.1.3. Secured Transaction Registry Office in Nepal**

Secured Transaction Act of Nepal has adopted the notice filing system and provides for establishment of Secured Transaction Registry Office ("**STRO**"). STRO defined under Secured Transaction Act is a single national level public body to be established by Government of Nepal by notification in public gazette to perform functions defined under the

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<sup>180</sup> Ibid.

<sup>181</sup> The World Bank (n 71).

<sup>182</sup> Legislative Guide on PFIP (n 4), p 150.

<sup>183</sup> Ibid.

<sup>184</sup> Ibid, p 155.

Act<sup>185</sup>. Secured transaction Act and Secured Transaction Regulation 2017 assumes that any public or private entity can be contracted to perform the function of the Registry<sup>186</sup>. Secured Transaction Regulation, enacted by Ministry of Finance with the purpose of establishing STRO, clarifies that the notice filing shall be online<sup>187</sup>.

The functions and power of STRO defined under the Act, are consistent to international best practices of registries adopting notice filing system<sup>188</sup>. The major functions include establishing, operating and maintaining electronic registry for filing, amendment, continuation or termination of notices, and delivering information from the record when requested<sup>189</sup>. Name and address of security giver and holder (or agent of the holder) and details of the collateral is the minimum requirement of the notice<sup>190</sup>. All liability in respect to correctness and sufficiency of the information of the notice lies on the notice giver<sup>191</sup>. A notice filed with STRO has a validity for five years with option for renewal and continuation.

A feasibility study conducted by a team of World Bank, International Finance Corporation (IFC), South Asia Enterprise Development Facility (SEDF) and Foreign Investment Advisory Services (FIAS) upon request of Government of Nepal (hereinafter "GON") on March 2008 recommended Credit Information Bureau (CIB) as a viable organization for performing the task of STRO under a contract with GON<sup>192</sup>. The study further recommended for adopting online filing system and identified English language as the practical medium of notice filing

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<sup>185</sup> Secured Transaction Act, s 4.

<sup>186</sup> Ibid, s 5(2).

<sup>187</sup> Secured Transaction Regulation, rule 6.

<sup>188</sup> The World Bank (n 71).

<sup>189</sup> Secured Transaction Act, s 5(1); Secured Transaction Regulation, rule 5.

<sup>190</sup> Secured Transaction Act, s 7(1).

<sup>191</sup> Secured Transaction Regulation, rule 6.

<sup>192</sup> See The World Bank (n 71).

and maintaining record<sup>193</sup>. Based on the recommendation of the study, GON passed Secured Transaction Regulation for clarifying functions and operations of STRO and established STRO by contracting with CIB. STRO has already launched its official website with the system for filing and requesting records<sup>194</sup>. However, it has not still obtained notices. It is expected to obtain notice and come in operation in a very short time.

Failure of government of Nepal to operate STRO until a very long time limited the application of secured transaction registry. Since maturity of most of the securities is based on notice filing, provisions of Secured Transaction Act are not applicable to these security devices. Even though a reformed secured transaction law has been adopted almost 12 years before, investors are still subjected to uncertain priority regimes leading to unpredictable legal disputes. By reason of this infrastructure projects financing through project finance are left with uncertainties in choice of security devices and documentation of security package. It should, however, be noted that, even though non-establishment of STRO creates problem in determining third party effectiveness and priority, the security created over collateral pursuant to the Act are valid and enforceable against security giver by virtue of section 25 (provision on attachment).

### **3.2. RIGHT TO STEP IN AS ALTERNATIVE TO ENFORCEMENT**

Role of security in project finance is primarily defensive and hence the normal enforcement mechanisms are unrealistic<sup>195</sup>As project company does not own assets that have value comparable to the loan under project finance<sup>196</sup>, sale of encumbered assets is not a primary

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<sup>193</sup> Ibid.

<sup>194</sup> See <https://www.stro.org.np/public>.

<sup>195</sup> Philip R Wood (n 25), p 30.

<sup>196</sup> Stefano Gatti (n 13), p 266.

choice of enforcement. Project company does not have valuable assets at the outset and assets are purchased from the amount of loan itself<sup>197</sup>. Assets of project company are usually non-marketable<sup>198</sup>. It's difficult to find a buyer and even if someone is found assets does not get value sufficient to pay back the loan. Revenues obtained after operation of the project is applied for the operation of project as working capital and remaining for reimbursement of loan to lenders<sup>199</sup>. Lenders rely on cash flows of the project company for realization of debt. So, in case the project fails to operate or becomes subject to enforcement claims against its assets, chances of paying back loan is threatened<sup>200</sup>. The project has value only if it is operating and generates revenue<sup>201</sup>. For the same reasons acceleration of loan is not a viable option unlike in corporate finance<sup>202</sup>. Therefore, the security in project finance are designed in a way to make lenders capable of taking control<sup>203</sup> over the project company and then operate to generate revenue. Therefore, in project finance the most practical form of enforcement is exercise of step in right thereby taking control of the project company. In rare circumstances where there are no other possible solutions, lenders might enforce security interest in traditional sense<sup>204</sup>.

### **3.2.1. Exercising Right to Step-In**

For various reasons stated above, the most practical choice for lender, in case of default, is to step into the management of project company, operate it and generate revenue to reimburse

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<sup>197</sup> Ibid.

<sup>198</sup> Phi Philip R Wood (n 25).

<sup>199</sup> Ibid, 273.

<sup>200</sup> Ibid.

<sup>201</sup> Stefano Gatti (n 13), p 273.

<sup>202</sup> Ibid.

<sup>203</sup> Ibid.

<sup>204</sup> Ibid, p 274.



the loan. This can be achieved by enforcing step in right under security agreement and direct agreements<sup>205</sup>. In essence exercise of step in rights enable the representative of lenders or receiver nominated by them to take over the position of the project company under the project contract<sup>206</sup>. The possible ways to step in to the project can be enforcement of security over shares to obtain ownership of the project company itself, or appointment of receiver to manage the project company. Where receivership is possible it can be achieved by foreclosure of all the secured assets including concessions and licensees and followed by appointment of receiver to operate the project.

### **Enforcing Security Over Shares**

Lenders can enforce their security over the shares of the sponsors pledged under the comprehensive security package. By taking ownership the lenders could appoint new directors for operation<sup>207</sup>. This might be difficult for project companies operating infrastructure project under concession received from government if local laws have restrictions to make assignment of shares of sponsor entirely or at least until some period<sup>208</sup>. Further it raises issues regarding duty of directors towards company, meaning directors appointed by lenders would have to serve their duty towards company not only to creditors<sup>209</sup>. Nepal does not have specific laws restricting transfer or pledge of shares of sponsors in project company, as discussed in chapter 2.6 above. Although as seen in Model PDA for hydropower project <sup>210</sup>, the government can impose restriction for certain period in a

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<sup>205</sup> Ibid, p 274.

<sup>206</sup> Andrew McKnight (n 82), p 753.

<sup>207</sup> Philip R Wood (n 25).

<sup>208</sup> Stefano Gatti (n 13).

<sup>209</sup> Philip R Wood (n 25).

<sup>210</sup> See Model PDA (n 107), s 24.

concession agreement itself. Therefore, in lack of outright restriction, taking security over entire shares can be one of the viable option for lenders to take control of project company in Nepal.

### **Appointing Receiver**

Another option to step into the project is by appointing a receiver to take control of the secured property<sup>211</sup>. This is a characteristic feature of English security law on personal property where secured party can appoint a receiver to take control of the secured property, and collect the income generated by the property<sup>212</sup>. However, taking complete control of project by appointment of receiver to manage the business is only possible when there is floating charge<sup>213</sup> covering all of the security provider's business<sup>214</sup> including the concession agreement. It is not possible, for example, under the UCC Article 9 of US since it does not have the concept of floating charge in one hand and on the other hand it has codified enforcement right that does not include receivership.<sup>215</sup> Under English law, secured party is entitled to make extra judicial appointment<sup>216</sup> of a receiver if the security agreement grants such right or there is a statutory right.<sup>217</sup>

As discussed in chapter 2.5 above, the concept of floating charge does not exist in Nepal. Though security agreement can describe collateral in general term including phrases like "all

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<sup>211</sup> P.A.U. Ali (n 127), p 259.

<sup>212</sup> Ibid, p 259.

<sup>213</sup> Philip R Wood (n 25). Alternative terminology of universal business charge in law of secured transaction.

<sup>214</sup> P.A.U. Ali (n 127), p 259.

<sup>215</sup> Nick Segal, 'The Effect of Reorganization Proceedings on Security Interests: The Position under English and U.S. Law' (Brooklyn Journal of Int'l Law, vol. 32, No. 3, 2007), p 945.

<sup>216</sup> Without requiring order of a court.

<sup>217</sup> P.A.U. Ali (n 127), p 259.

movable property"<sup>218</sup> the Secured Transaction Act does not provide scope for creating security over all present and future assets that crystalizes after event of default. Pursuant to section 25 and 26(1) of the Secured Transaction Act, the security over collateral crystalizes right after valid security agreement is entered. Though taking possession is one of the method of enforcement of security over collateral under the Act<sup>219</sup> if does not deal with any matters relating to appointment of receiver and its procedures. Further Act acknowledges that security holder has right to exercise any remedies as provided in the security agreement<sup>220</sup>. This provision can be interpreted to define right of security holder to appoint receiver over specific property in case it has been specifically agreed in the security agreement. However, in lack of any provision dealing with procedures of appointment and other, the scope is uncertain. Further the assumption of availability of remedy of receivership as contractual remedy would be wrong in lack of concept of floating charge.

Foreclosure can be another option which involves transfer of ownership interest of the secured asset to secured creditor thereby extinguishing the right of redemption<sup>221</sup>. The right of foreclosure is available in most of the modern secured transaction law. For example, under English law foreclosure is available to legal and equitable mortgages subject to order of the court<sup>222</sup>. In project finance, where the lender has floating charge over all assets, it can foreclose the mortgage, take control over all the assets of the project company and operate the project through different vehicle. Taking control by foreclosure of assets will be successful only where concession agreements, licenses and permits of the project could also

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<sup>218</sup> Secured Transaction Act, s 22

<sup>219</sup> Secured transaction Act, s 48

<sup>220</sup> Secured Transaction Act, s 47(2)(d).

<sup>221</sup> P.A.U. Ali (n 127), p 266.

<sup>222</sup> Ibid.

be assigned to new company including rights and obligations under the contracts entered into by the project company<sup>223</sup>. Though the secured holder has right to buy the collateral in any public or private sale<sup>224</sup> during enforcement, exercise of step in right by foreclosure is not relevant in Nepal in lack of possibility of creating floating charge.

### **3.2.2. Importance of Direct Agreement**

Exercise of step in right is possible in pursuance of direct agreement or tripartite agreement<sup>225</sup> with host government and key contractors like EPC contractor, O&M contractor, and off taker<sup>226</sup>. Direct agreement is one of the fundamental part of the project finance security package<sup>227</sup> and are listed as condition precedent to financing documents. The direct agreements freeze the exercise of right of cancellation by project contractors on default of project company under the event of defaults like non-compliance, non-payment, insolvency, and security enforcement<sup>228</sup>. Generally, contractor agrees to notify default to the lenders, cancellation freezes until the observation period and contractors agree not to cancel if lender agrees to pay the obligations and operate on behalf of project company<sup>229</sup>. This is important for exercising step in right because the default of loan agreements, or any initiation of enforcement proceedings by lenders may lead to cancellation of concession agreement and key contracts leaving nothing of value for lenders to operate or generate revenue<sup>230</sup>.

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<sup>223</sup> Scott L Hoffman (n 18).

<sup>224</sup> Secured transaction Act, s 50(5).

<sup>225</sup> Entered into between the lender, project vehicle and contractor freezing the right of termination or at least providing the right to step in to the lender in case of any default of the main contract.

<sup>226</sup> Andrew McKnight (n 82), p 754.

<sup>227</sup> Stefano Gatti (n 13), p 27.

<sup>228</sup> Philip R Wood (n 25), p 32.

<sup>229</sup> Ibid.

<sup>230</sup> Stefano Gatti (n 13).

### 3.3. ENFORCEMENT AGAINST COLLATERAL

In project finance security can be enforced against collateral for reimbursement of the loan from the amount received from selling every single asset for the highest possible value<sup>231</sup>. It's true that security in project finance is not just to serve defensive function but also has positive function, i.e. security provides possibility for repayment of debt by appropriating the amount by selling the property encumbered<sup>232</sup>. Contrary to Philip R Wood who claims that security in project finance primarily is a shield not a sword<sup>233</sup>, security also serves the primary function of risk reduction with respect to non-performance of debt service of the project loan<sup>234</sup>. Out of court enforcement of right to transfer and assignment right of security will be more relevant in later period of operation of the project when project assets get more value<sup>235</sup>. This traditional function of security is the ultimate remedy available for lender in case step-in-right could not be exercised due to technical restrictions of the law or is economically not feasible due to regressive status of the project.

This traditional function of security can be enforced by taking possession of collateral, selling it to the highest possible value, or foreclosing the security interest and apply the collateral for one's own purpose<sup>236</sup>. As a rule of thumb, receivership is available in countries where the concept of floating charge is recognized<sup>237</sup>. It would be possible and practical to appoint receiver and to manage the assets where lender has security over all present and future assets of the company and this is possible only if there is a floating charge. In general, the

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<sup>231</sup> Ibid.

<sup>232</sup> Ibid.

<sup>233</sup> Philip R Wood (n 25), p 30.

<sup>234</sup> Jan-Hendrick Rover (n 16), p 243.

<sup>235</sup> Ibid.

<sup>236</sup> P.A.U. Ali (n 127), p 249.

<sup>237</sup> Ibid.

enforcement process involves taking possession followed by private or public sale of the collateral<sup>238</sup>.

UNCITRAL Legislative Guide on Secured Transactions recommends that, 'when enforcing, security holder should have the option for proceeding either judicially or extra-judicially the security right in order to maximize flexibility in enforcement and to obtain highest possible price upon disposition'<sup>239</sup>. Self-help repossession and privately administered sales are considered to be efficient and effective modes of enforcement<sup>240</sup> compared to court enforcement and court administered sales. Possibility of out of court enforcement is important and is more pressing in project finance since court proceedings are usually slow and costly<sup>241</sup>. Court enforcement are generally lengthy which may lead to diminished return since value of movable property depreciate over time<sup>242</sup>. Where extra judicial enforcement is available, security grantor and third party having right in the secured assets should have sufficient scope to make legitimate claim and defences before the court<sup>243</sup>. Further such extra judicial enforcement should comply some mandatory rules like requirement to send notice of default and intended disposition, obligation to act in good faith and commercially reasonable manner, and account to the security giver for proceeds of disposition<sup>244</sup>. This is important to ensure fairness and that private collectors or creditor does not unreasonably exploit the debtor or security giver<sup>245</sup>.

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<sup>238</sup> Hugh Beale (n 58).

<sup>239</sup> Legislative Guide on Secured Transactions (n 8), p 283.

<sup>240</sup> Fleisig, Safavian and de la Pena (n 8).

<sup>241</sup> Legislative Guide on Secured Transactions (n 8), p 283.

<sup>242</sup> Fleisig, Safavian and de la Pena (n 8).

<sup>243</sup> Legislative Guide on Secured Transactions (n 8), p 284.

<sup>244</sup> Ibid, p 283.

<sup>245</sup> Fleisig, Safavian and de la Pena (n 8).

### 3.3.1. Possibility of Extra Judicial Enforcement in Nepal

Secured Transaction Act of Nepal recognize the party autonomy in choice of remedies<sup>246</sup> by providing scope to exercise remedies agreed in security agreement<sup>247</sup> including the right to take possession<sup>248</sup> and to sell and dispose<sup>249</sup> the collateral. Such enforcement procedures, however, requires prior court order unless the borrower voluntarily agrees such enforcement procedures. Exercise of any of these remedies requires fair procedures. Pursuant to Section 46(2) sub sections (c) and (e), security holder can also exercise other remedies available under the Act or other prevailing laws. However, in lack of any mention about further remedies under the Act or any other prevailing laws, it is not sure what else is available.

In respect to taking possession, the Secured Transaction Act provides that, in case of event of default, the security holder can take possession or control of the collateral without legal proceedings if security giver has consented in writing<sup>250</sup>. The plain meaning of the section 48(1) suggest that taking control without court order is possible only when security giver voluntarily agrees to transfer possession to the creditor after event of default has occurred. Otherwise court order is required to take possession or control<sup>251</sup>. Further, section 49 of the Act ensures protection against any interference in enforcement by providing right to claim for restraining orders and preliminary relief against any interferences. On the other hand, the grantor has right to appeal to the supreme court against the court order providing possession to creditor<sup>252</sup>.

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<sup>246</sup> Secured Transaction Act, s 46.

<sup>247</sup> Ibid, s 46(2)(d).

<sup>248</sup> Ibid, s 46(2)(a).

<sup>249</sup> Ibid, s 46(2)(b).

<sup>250</sup> Ibid, s 48(1).

<sup>251</sup> Ibid, s 48(2).

<sup>252</sup> Ibid, s 48(3).

Secured Transaction Act guarantees the right of security holder to sell, lease, permit or dispose collateral in the event of default<sup>253</sup>. But is not clear if separate court order is required disposal. Though it does not expressly state anywhere, general observation of the provisions suggests that Act assumes sell or disposal of the assets follows taking of possession. Therefore, the preliminary court order granting possession is the basis for subsequent sale and further order is not required<sup>254</sup>. The sale can be done privately or publicly<sup>255</sup> either in unit or in package at any time or place<sup>256</sup>. Notice of proposed time and place of sale (only time in case of private sale) is mandatory except where it is impracticable due to perishable nature of collateral<sup>257</sup>.

The Act secures the right to defence of security grantor and provides discretion to the court to specify terms and conditions of disposal or simply restrain disposal of collateral if security holder fails to comply with rules of enforcement<sup>258</sup>. Any sale or disposal should be made in commercially reasonable manner<sup>259</sup>. Pursuant to section 54(4) of the Act, price or method of sale is not the basis for determining commercial reasonableness. It is deemed to be commercially reasonable if it is sold in conformity with prevailing commercial practice<sup>260</sup>. Right of security giver to redeem collateral by paying expenses incurred in enforcement procedure is ensured<sup>261</sup>.

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<sup>253</sup> Ibid, s 50(1).

<sup>254</sup> It can be inferred from requirement to provide notice to security giver under section 40(4).

<sup>255</sup> Ibid, s 49(2).

<sup>256</sup> Ibid, s 49(3).

<sup>257</sup> Ibid, s 49(4).

<sup>258</sup> Ibid, s 54(1).

<sup>259</sup> Ibid, s 54(2).

<sup>260</sup> Ibid, s (54(5).

<sup>261</sup> Ibid, s 53.



In case of enforcement against receivables, due to the nature of receivables normal enforcement rules of taking possession and sale or disposal is not relevant. The effective remedy in default of obligation secured by assignment of receivable would be to require the debtor of receivable to directly pay to the assignee<sup>262</sup>. Guide on Secured Transactions recommends that in case of receivable financing secured creditor should be provided right to recover payments from debtor of receivable after default by providing such notice to the debtor and without being required to take further steps to achieve enforcement<sup>263</sup>. Secured Transaction Act of Nepal recognize that security holder can directly proceed against the accounts or intangible in respect to exercise of right relating to assignment or collection<sup>264</sup>. Section 47 further elaborates that security holder can notify a debtor who owes payment to make payment to security holder and also to take control of any subsequent proceeds. Therefore, the Act sufficiently guarantee the possibility of out of court enforcement of security against receivable.

Although the Secured Transaction Act recognizes the possibility of extra judicial enforcement in respect to assignment of accounts and receivables, judicial order is mandatory to take possession and dispose other secured assets in case of default. It is necessary to add rules providing scope for enforcing security out of the court by using self-help measures like taking possession and sale of the asset without necessarily requiring court order or at least its functional equivalents<sup>265</sup>. However, the introduction of self-help measures in the law must be

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<sup>262</sup> Legislative Guide on Secured Transactions (n 8), p 305.

<sup>263</sup> Ibid.

<sup>264</sup> Secured Transaction Act, s 46(4).

<sup>265</sup> Those devices that could be used for prompt and ex parte protection of secured creditor's interest. Very little is known about such functional equivalents of self-help. *See* Tibor Tajti, 'Could Continental Europe Adopt a Uniform Commercial Code Article 9-Type Secured Transactions System? The Effects of The Differing Legal Platforms' (Adelaide Law Review 35, 2014)

supplemented by the debtor protection laws<sup>266</sup> like injunctive relief, damages for breach of peace, requirement of notice, and right to challenge enforcement action<sup>267</sup>.

### **3.4. OTHER LAWS INFLUENCING ENFORCEMENT OF SECURITY**

Beside provisions relating to enforcement in Secured Transaction Act, other prevailing regulations have some direct or indirect connection with enforcement of security by foreign lenders in Nepal. For example, Consortium Lending Directive of Central Bank<sup>268</sup>, Bank and Financial Institutions Act (hereinafter "**BAFIA**"), Foreign Exchange (Regulation) Act, Contract Act, Arbitration Act. Some of the issue relevant under other laws beside Secured Transaction Act has been briefly discussed in this sub chapter.

#### **3.4.1. Consortium Lending Directive and BAFIA**

It is more convenient and efficient to enforce security if it has been arranged in consortium financing model involving local licensed bank acting also as a security agent. Project financing generally involve syndicated or consortium lending in which a group of investors form a pool to jointly finance a borrower and enter into a contract delegating responsibilities among themselves<sup>269</sup>. Such an arrangement helps to generate higher amount of finance and distributes risk among the participating lenders. Since a local bank acting as lead bank and security agent can enforce loan and security agreements for and on behalf of all participating

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<[http://heinonline.org/HOL/Page?handle=hein.journals/adelrev35&div=14&g\\_sent=1&casa\\_token=&collection=journals](http://heinonline.org/HOL/Page?handle=hein.journals/adelrev35&div=14&g_sent=1&casa_token=&collection=journals)> accessed 4 April 2018.

<sup>266</sup> Tibor Tajti (n 118), p 358.

<sup>267</sup> Ibid. The reference should be made to US, Canadian and English laws in respect to such self-help measures and accompanying debtor protection rules.

<sup>268</sup> Consortium Financing Provisions (Directive No. 2074/11) of Unified Directives issued by Nepal Rastra Bank (the central bank of Nepal) to licensed banks of Class A, B and C.

<sup>269</sup> See, Sean Ross, 'What Is the Difference between Loan Syndication and a Consortium?' (*Investopedia*, 28 November 2014) <<https://www.investopedia.com/ask/answers/112814/what-difference-between-loan-syndication-and-consortium.asp>> accessed 8 February 2018.

lenders, consortium financing model is preferred and recommended in project financing involving foreign lender. Further since a lead bank acting on behalf of consortium members would be a licensed bank from Nepal, it can exercise self-help remedies and special enforcement rights available for licensed bank for recovery of loan pursuant to Bank and Financial Institutions Act (2073).

Consortium lending is regulated by a Consortium Lending Directive<sup>270</sup> issued by Nepal Rastra Bank<sup>271</sup>. The Directive applies to 'consortium'<sup>272</sup> and to 'loose consortium'<sup>273</sup>. Section 3(2) of the Directive enables forming a consortium with non-licensed institutions (including foreign lenders)<sup>274</sup>, provided that it is notified to Nepal Rastra Bank, the central bank of Nepal (hereinafter "**NRB**"). According to section 7 of the Directive, the lenders are free to determine their internal procedures among themselves provided they comply with the mandatory requirement of the directive. The consortium has to be led by a bank or financial institution licensed by the NRB.<sup>275</sup> Therefore, a local bank will have to be nominated as a lead bank for the purposes of the transaction and will also have to take the role of the security agent. Therefore, in consortium arrangement lead bank acting as a security agent will hold all securities on project assets including receivables and shares of the company and will initiate

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<sup>270</sup> Consortium Financing Provisions (Directive No. 2074/11) of Unified Directives issued by NRB.

<sup>271</sup> Nepal Rastra Bank (NRB) is a central bank of Nepal established under Nepal Rastra Bank Act. It is licensing authority for Bank and Financial Institutions and has power to issue binding directives and circulars in order to regulate, monitor and supervise bank and financial Institutions licensed by NRB.

<sup>272</sup> Defined as arrangement of providing loans and facilities to customer, company, firm or project on the basis of mutual agreement between two or more banks and financial institutions licensed by NRB. Directive No. 11/2074, Unified Directive issued by Nepal Rastra Bank to licensed bank and financial institutions of class A, B and C, s 1

<sup>273</sup> Lending to a project by sharing security in a *pari-pasu* basis without forming a consortium (e.g. through independent facilities), Consortium Lending directive, s 2.

<sup>274</sup> For example, foreign lenders recently entered into a consortium financing arrangement with local banks and HIDCL to finance a first privately financed hydropower project in Nepal.

<sup>275</sup> Nepal Rastra Bank, Unified Directive for Class A, B, and C, Consortium Lending Directive, s 8.

enforcement on behalf of each and all members of the consortium in case of default of obligations under financing documents.

Lead bank, being a bank licensed by NRB<sup>276</sup>, can exercise powers of loan recovery available under Bank and Financial Institution Act 2074 (2017) ("**BAFIA**"). BAFIA provides the most efficient out of court fast track enforcement procedures. Enforcement or recovery methods available under the Act gets priority over other general enforcement options<sup>277</sup>. Pursuant to section 57(1) of BAFIA, licensed bank can recover its principal and interest by auctioning or otherwise disposing of any property pledged to it, or any collateral or security deposited with it by the borrower (without a court order). Section 57(2) further guarantees statutory right of recourse to licensed bank whereby it can ask borrower to provide additional collateral if the existing security is not sufficient to recover the loan.<sup>278</sup> Relevant offices and registrar are obliged to transfer the auctioned property to the name of selected bidder upon a notice of the bank<sup>279</sup>.

Nepal government has also established a specialized administrative tribunal for sole function of hearing disputes concerning recovery of loans by licensed banks<sup>280</sup>. In case of failure to recover loan through self-help recovery option the bank can file a petition for recovery with Debt Recovery Tribunal (hereinafter "**DRT**") established under the provisions of Recovery of Debt of Banks and Financial Institution Act 2058 (2002). DRT is a three-member specialized judicial body composed of a legal expert, a banking expert and an account expert<sup>281</sup>. It is

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<sup>276</sup> Provisions of BAFIA applies to bank and financial institutions licensed by NRB.

<sup>277</sup> Bank and Financial Institution Act, s 129.

<sup>278</sup> Ibid, s 57(3).

<sup>279</sup> Ibid, s 57(5-6).

<sup>280</sup> *see* Official website of Debt Recovery Tribunal <<http://drtribunal.gov.np/en/>>. The monthly report for month of Shrawan, 2074 (Jul/Aug 2017 A.D.), there are 281 cases regarding recovery of loan pending in the tribunal.

<sup>281</sup> Recovery of Debts of Banks and Financial Institution Act 2058, s 4(3).

authorized to decide cases on debt recovery, and also to enforce its verdict.<sup>282</sup> The tribunal has a separate committee for enforcement of final decision that provides service for enforcement of judgement credit from property of the debtor. Lead bank acting also as a security agent in project finance can exercise these recovery measures on behalf of consortium members including foreign lenders.

### **3.4.2. Conflict of Law Issues in Enforcement**

In lack of municipal private international law, it is difficult to enforce contracts governed by foreign law in Nepal. There are higher chances for courts denying jurisdictions. It is therefore desirable that all security agreements are governed by local laws and security documents including instrument of deeds are prepared according to formalities of local law. Further, it is difficult to recognize and enforce foreign decisions in lack of codified private international rules. However, foreign arbitral awards are enforceable pursuant to Arbitration Act of Nepal. Arbitration Act of Nepal is based on UNCITRAL Model Law on Arbitration and provides that foreign awards undertaken as per the laws of Nepal or laws of contracting party to the New York Convention can be enforced under Arbitration Act.<sup>283</sup> Since no prevailing laws deny the arbitrability of loan agreement and security agreements, security documents providing for dispute settlement by arbitration can be enforced through arbitration. Arbitration is desirable when the agreements provide for foreign governing law.

### **3.4.3. Foreign Investment and Foreign Exchange Regulation**

Foreign investment regulation and foreign exchange regulations of Nepal subject creation and enforcement of security to unnecessarily lengthy procedures. The Foreign Investment and Technology Transfer Act 2049 (1992) (hereinafter "**Foreign Investment Act**") and the

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<sup>282</sup> Ibid, s 14(1).

<sup>283</sup> Arbitration Act 2055 (1999) of Nepal 1, s 34.

Foreign Exchange (Regulation) Act 2019 (1962) (hereinafter "**Foreign Exchange Act**") regulates borrowing from foreigners and borrowing in foreign currency by Nepal incorporated entities or persons and thus creating security in favour of foreigner. Prior approval of Department of Industries (hereinafter "**DOI**")<sup>284</sup> is required to undertake investment as loans or loan facilities by foreigners in Nepalese entity<sup>285</sup>. All loan and security documents including facility agreement and security agreements should therefore be approved by Department of Industries<sup>286</sup>. Loan agreements, security documents or any other documents and agreement entered into as a part of loan transaction involving foreign lender not registered with or not approved by Department of Industries would be invalid and unenforceable by application of section 88 of the Contract Act that provides for formal requirement to be fulfilled by certain types of contract.

Foreign Exchange Act 1962 and Notices of NRB issued pursuant to the Act requires another approval from NRB for introducing foreign investment in Nepal including loan and repatriating proceeds or making payments to foreign party<sup>287</sup>. The NRB requires all set of loan documents and security documents to be presented for the approval. The loan amount and proceeds of the loan including award of enforcement can be transferred through proper banking channels once NRB provides approval based on the documents presented. National commercial banks can suspend withdrawal of money accepted from foreign lender until the approval of NRB is presented.

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<sup>284</sup> Department of Industries is a body operating under Ministry of Industry which has been designated by Ministry of Industry as a regulatory body for foreign investment.

<sup>285</sup> Foreign Investment and Technology Transfer Act 2049 (1992), s 3(1).

<sup>286</sup> See, Department of Industry, 'Procedural Manual for Foreign Investment in Nepal (Ministry of Industry 2016) < <http://doind.gov.np/images/fdi/PManual-016.pdf>>.

<sup>287</sup> Foreign Exchange (Regulation) Act, s 10 B and 10C; Notice of Nepal Rastra Bank dated 22 January 2013.

By application of these procedures creation of security in favour of foreign lenders or process for repatriating amount received after enforcement becomes lengthy and burdensome. Foreign lending in general is affected by these regulations. Further, exercise of step in right is subjected to additional procedures by application of this Act. For instance, transfer of ownership of shares to foreign lender by enforcing security against shares of sponsors will require approval of Department of Industries and NRB.

## CONCLUSION

It was a progressive step for Nepal to adopt the Secured Transaction Act based on international best practices. Reforming secured transaction laws was actually important to enhance the credit market and effectively regulate secured transactions including in the sector of infrastructure financing. Foreign lending being one of the most potential sources of funding for infrastructure projects and project securities being one of the most important legal consideration for foreign lenders to make investment in infrastructure sector, reformed secured transaction law was important for promoting foreign private investment in infrastructure sector. Secured Transaction Act of Nepal provides defined rules regarding secured transactions most of which are in conformity with international best practices. However, when analysed in context of project securities and concerns in project finance transactions, the rules provided by Act has some inconsistencies and inadequacies.

There are some important features of the Act that are project finance friendly. For example, the comprehensive definition of 'collateral' and granting possibility of creating any form of security over the collateral, makes it possible for lenders to charge all important assets of the project company including intangibles, receivables and proceeds of the company. By introducing the notice filing system for maturity of security and providing for the establishment of a central registry, the Act ensures effective publicity of any existing security over assets and efficient basis for determining priority. Since protecting project assets from claim of third parties is a primary purpose of project security, notice filing system serves important benefit for lenders in project finance transactions. Further, by recognizing the possibility of enforcing security by taking possession of the collateral and by sale or disposition of collateral, the law sufficiently preserve the protective function of project security.



However, there are still some lacunas and inconsistencies in the legal regime of secured transactions of Nepal which are not project finance friendly. First, the requirement of possession for maturing security in goods is contrary to concept of project security. Project security are created over assets that are used in daily business and operation of the project and actually bought from the proceeds of the loan itself which makes it simply impossible and impractical for lender to take possession. By requiring possession for maturity, the Act limits application of all benefits of secured transactions law like protection against conflicting security on the particular asset, defined priority, and most importantly charging assets also leaving possibility for using assets for generating revenue. By reason of this particular provision, lenders in project finance transaction cannot fully rely on secured transaction law and have to rely on complex contractual arrangements and bulky project documents. This possessory requirement is conflicting with the concept of taking charge over fixtures, inventories and proceeds of the project company. Further, the Act is not clear whether judicial order is required to sell or foreclose the collateral matured by taking possession. It is therefore recommended that, the mandatory requirement of possession for maturity should be repealed and maturity by notice filing should be recognized also in case of goods. However, law should provide supplementary rules providing sufficient opportunity for third parties and debtor to obtain information regarding existing security over the goods.

Second, Secured Transaction Act is ambiguous about possibility of creating security over contractual non-monetary claims like rights over leasehold property, rights in concession agreement, claims on EPC and O&M Contracts, and other non-monetary claims of project company arising from contracts. Although, the wording of the Act is pretty clear as to possibility of securing rights to payment to be received from contracts, it is not clear if the provisions of this Act will apply also in respect to non-monetary claims. This is particularly important in project finance since lenders are interested to take control of the company by

taking assignment over substantial contracts of the project. It is therefore recommended that, the definition of intangible property should refer, among others, the non-monetary claims in contract, so that it will come within the broad coverage of the Act. Further the provision on assignment provided in section 42 of the Act should be extended to cover non-monetary claims and rules should be provided to regulate their priority and enforcement.

Third, because of lack of separate laws dealing with rules regarding private participation in infrastructure projects, it is not clear if consent of the government is required for assigning concessions, licenses or shares of the project company and if yes what would be the requirements and procedures. It is not clear if the rules of Secured Transaction Act apply without any qualification also in respect to charges in concession agreement, licenses and shares. If assumed in affirmative, it would be unpredictable whether government will interfere in any attempts of secured creditors to transfer ownership from project company and take over the concessions in case of default. Though a Model PDA prepared by government of Nepal for hydropower project below 500 MW has provided some rules regarding this issue, it cannot be assumed with certainty that same rules will apply in respect to other projects. It is therefore recommended that Nepal should adopt a law regulating private investment in infrastructure project thereby specifically defining the requirements and procedures for creating and enforcing security over concession, project assets, licenses and shares of the project company. The specific model and contents of the law should however be decided after further studies and policy considerations.

Fourth, the enforcement methods provided by the Secured Transitions Act have some inconsistencies. The Act requires court order to take possession of the assets but is silent about if another court order is required for sale or disposition of the collateral. The drafting seems to assume that sales or disposition follows after taking the possession. This raises question in respect to assets secured by taking possession at first place. In such cases, can

lender sell or dispose without taking judicial order or a separate order is required. Further, the Act does not recognize the possibility of utilizing the assets to generate revenue after taking possession for reimbursement without necessarily selling or foreclosing the assets. For the sake of efficiency, it is recommended that the law should not mandatorily require court order for taking possession or selling or disposing collateral provided it requires sufficient notice and provide sufficient rights to the owner or the debtor to challenge extra judicial possession or sales of the collateral.

Lastly, the power of licensed bank to self-recovery by auctioning the collateral (without judicial order) available under Bank and Financial Institution Act is very progressive in terms of speed in enforcement procedures. Specialized debt recovery tribunal ensures more efficient recovery of loan and enforcement of security. This regime will be applicable to lenders in project finance only if the financing is made through consortium model and licensed bank is appointed as lead bank and security agent. It would be a progressive step at least to extend the jurisdiction of debt recovery tribunal to all cases involving recovery of loan where loan has been secured pursuant to Secured Transaction Act. The viability of this option is actually subject to further studies and discourses.

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