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# FORUM ON ASIAN INSOLVENCY REFORM 2004

## INSOLVENCY SYSTEMS AND RISK MANAGEMENT IN ASIA

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**RISK MANAGEMENT AND INSOLVENCY REFORMS IN SRI LANKA**

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## **1.0 INTRODUCTION AND OVERVIEW**

### **1. Introduction**

Banks face risks in a variety of situations. The most serious risk is that of the customer-borrower going out of business. A more frequent risk for bankers is default by borrowers. That risk ranges from what is compendiously described as Third World Debt Crisis, home mortgage and credit card default. Having made observations on these lines, Ross Cranston, one of the well-known authorities on banking, says that law and lawyers have a role in responding to such a situation. The Jack Committee in UK (1989) observed that the law has an obvious relevance to the process of bankers confronting risks.

In this Country Paper I propose to deal with the legal provisions in Sri Lanka applicable to lending by banks to its customers, the purpose of which laws is, of course, to minimize risk, and also to deal with the provisions of law in respect of insolvency and winding-up in which (latter) area, I must confess, there has been no sufficient law reforms in the recent past in our country.

Sri Lanka, an island with a modest population of about 19.8 million is a multiracial and multilingual country.

Despite the problems that have beset Sri Lanka for more than two decades there have been encouraging signs of sustainable economic recovery since the declaration of ceasefire in the North-East. Sri Lankans are still optimistic of achieving a political solution to the country's ethnic problem.

In the background of set-backs, the economy of the country has suffered in the recent past. Credit Risk management is of paramount importance to the country.

### **2. Legal System**

2.1 As in other ancient legal systems the conventions, customs, sanctions and the main concepts of law though not concretely formulated, have over the passage of years been established, especially with judicial pronouncements made from time to time. The personal laws that govern the various sections of Sri Lankan community are, Kandyan Law, Thesawalamai and Muslim Law. Various tests are applied to determine whether these personal laws affect those claiming to be governed by them. Persons subject to any of these three personal laws are governed by the Roman Dutch Law, which is the Common Law of the country. However the impact on the Common Law System derived from the English Law has had a much greater influence on the Laws of Sri Lanka than the Roman tradition. Yet, the Roman Dutch law remains the residuary or the Common Law of Sri Lanka. Needless to say, the Common Law has been modified in many directions, both expressly and by necessary implication by Sri Lankan statute law and also by judicial decisions. Criminal Law and Procedure in Sri Lanka is governed by the Penal Code and the Criminal Procedure Code. Civil cases are governed by the Civil Procedure Code which shows the influence of Indian, English and American rules of procedure. The Constitutional and Administrative Law of Sri Lanka is almost wholly based on the principles of English Common Law. The influence of the Roman-Dutch law is to be found in the areas of the law relating to succession, persons, property, and obligations. It is specially noteworthy that the Law of Delict (that is the law governing civil wrong-doing) is predominantly based on the Roman Dutch Law.

2.2 Although the Roman-Dutch Law is the Common Law of the country it has adopted the English Law almost for all the commercial matters.

Sri Lanka which was then known as Ceylon was first occupied by Portuguese from 1505 AD, then the Dutch from 1656 AD and finally by the British from 1796 AD till it became an independent country in 1948.

During the Dutch rule the Roman-Dutch Law was introduced into this country and became firmly enthroned as its Common Law.

By the Civil Law Ordinance (Cap.59, LEC-Revised 1980) the British introduced into this country the Laws of England in respect of Maritime matters and Commercial matters etc., unless there is contrary statutory provision in the country. However, the Ordinance did not introduce English procedure relating to those subjects, matters of procedure being replaced by the Civil Procedure Code. Section 3 of the Civil Law Ordinance reads as follows:-

*“In all questions or issues which may hereafter arise or which may have to be decided in Ceylon with respect to the law of Partnership, Corporations, Banks and Banking, Principals and agents, carriers by land, life and fire insurance, the law to be administered shall be the same as would be administered in England in the like case at the corresponding period, if such question or issue had arisen or had to be decided in England, unless in any case other provision is or shall be made by the enactment now in force in Ceylon or hereafter to be enacted;*

*“Provided that nothing herein contained shall be taken to introduce into Ceylon any part of the law of England relating to the tenure or conveyance or assurance of, or succession to any land or other immovable property, or any estate, right or interest therein.”*

*While in the developing branches of the law, particularly in the commercial field, Sri Lanka has no doubt continued to draw on English statutes and principles, the tacit adoption of English law in matters governed by the common law is now at an ebb, with what may be described as a conscious reaction against this tendency. This trend is most marked in respect of two methods of introduction, viz: (a) judicial decisions and (b) use (in judgments and statutes) of terms peculiar to English law referred to in the preceding sections. (Vide C.G..Weeramanry in his treatise on Contracts).*

In the recent past there have been various statutes enacted by the Parliament of Sri Lanka in commercial areas, of course, most of them based on English models.

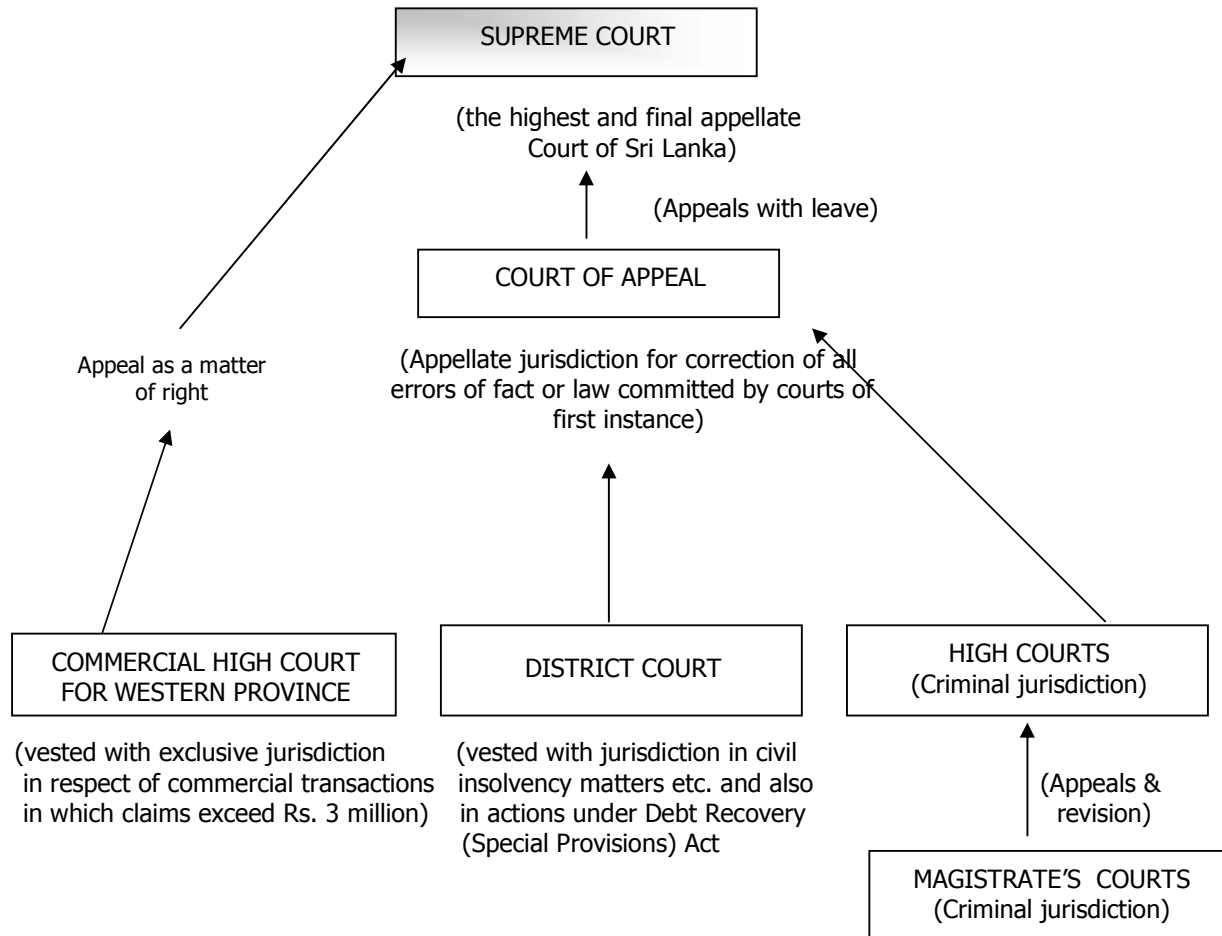
When we assess the Insolvency and Creditor Rights Systems in Sri Lanka we have to be mindful of the fact that although most of the relevant matters are governed by statutes and English Law, the law applicable to properties are the Common Laws (Roman-Dutch) and the Statutory Law. When a property is taken as a mortgage the Roman-Dutch law provisions apply thereto subject to the modifications made by statutes. At the same time the Insolvency Rights and the law applicable to banking is the English Law subject to statutory modification. We shall identify the relevant applicable provisions as we progress.

2.3 The Parliament enacted the Arbitration Act No. 11 of 1995 which came into operation on 1<sup>st</sup> August 1995 as a measure providing for a comprehensive infrastructure for resolving commercial disputes, domestic as well as international, through arbitration. This Law was enacted honouring Sri Lanka’s obligation to give effect to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958. The High Court of Sri Lanka is vested with jurisdiction to enforce foreign arbitral awards as well.

2.4 The law applicable to Corporate Insolvency is found in the provisions contained in the Companies Act No. 17 of 1982 which was enacted on 20<sup>th</sup> May 1982 and came into operation on 7<sup>th</sup> June 1982. The Companies Winding-up Rules 1939 enacted under the Companies Ordinance still continue to apply to the winding-up proceedings under the Companies Act in view of the provisions of Section 450(1) of the Companies Act. There is a separate Insolvency Ordinance which governs the insolvency of individuals which has no relevance to this report.

### 3. Structure of the Courts

The hierarchy of Courts of first instance in Sri Lanka is set out in Section 2 of the Judicature Act No. 2 of 1978. Primary Courts, Magistrate’s Courts, District Courts and High Courts are Courts of first instance. High Courts exercise appellate and review jurisdiction in some matters. The Court of Appeal and the Supreme Court are the Appellate Courts. I give below a diagram setting out briefly our courts system.



### 4. Legal Framework for Creditor Rights

#### 4.1 Creation and enforcement\ of security in r eal property

##### 4.1.1 INTRODUCTION

Mortgage of immovable property is the most popular and acceptable form of security in Sri Lanka and governed by the Roman Dutch Law.

The word ‘land’ when used in a mortgage has a much wider meaning than it has in everyday speech. The general rule of English Law on this matter is summed up by the maxim *quic quid plantatur solo, solo cedit* (whatever is attached to the soil becomes part of it). If, therefore, a building is erected upon land and chattels are attached to the building, the term “land” prima facie includes the soil, the buildings, and the chattels affixed thereto. Similarly, “land” includes growing crops and timber. The Mortgage Act originally defined "land" to include things attached to the earth or permanently fastened to any thing attached to the earth and any estate right or interest in or over land. According to Voet, buildings being annexed to the land are immovables. So also are articles which have been annexed to immovable structures if the manner of their attachment is so secure that separation would involve

substantial injury either to the immovable property or to its accessory. Thus it was held in the case of *Tissera v. Tissera* 42 NLR 10 that machinery in a fibre mill fixed with screws to the floor of the building on a concrete foundation and intended to remain permanently fixed to the building in which it was installed would constitute part of the land on which it stands. Further in another case, *Brodie v. Attorney General* 7 NLR 81. It was decided that fixtures are movables which, by being affixed to or into the ground, or annexed or attached to a building acquire the character of immovables. Thus counters, cooking ranges, water tanks, electric bells, batteries and indicators, baths, lavatory fittings and office equipment fixed in position by bolts screws and in other ways were held to be fixtures and in the absence of special agreement pass upon the sale of the building containing them.

The term 'mortgage' includes any charge on property for securing money or moneys worth. In view of the provisions of Section 46, the mortgagee of any immovable property cannot proceed against any property whatsoever other than the mortgaged property of the mortgagor in satisfaction of his claims. By the Act No. 3 of 1990 Section 46 of the Mortgage Act has been amended and a new Section 47 A introduced. The purpose of the amended Section 46 appears to enlarge the meaning of the mortgaged property. The words "mortgaged property" have been substituted in place of "mortgaged land" so that there will be no doubt as to whether any machineries installed on the land and other properties attached to the land are covered by a mortgage. The purpose of this amendment seems to be only for clarity. The restrictions and the limitations imposed by Section 46 remain subject to new provision added by the new Section 47A.

The amendment brought in by Section 47 A is a significant amendment. The new Section contains provision for execution of a special instrument by the mortgagor renouncing the benefit of Section 46. This renunciation could be obtained in respect of loans where the principal exceeds Rs.150,000.00.

The new section applies only to mortgage bonds in favour of Lending Institutions which are Banks within the meaning of the Banking Act No.30 of 1988 and four State Agencies (The State Mortgage & Investment Bank, The National Development Bank, The National Savings Bank, and The Development Finance Corporation of Ceylon). In terms of the new Section at the time of execution of a mortgage bond in favour of a lending Institution the mortgagor executes a separate instrument containing a special declaration on the part of the mortgagor that he renounces the benefit of Section 46 and that the effect of such renunciation has been explained to him by the Notary. Then in addition to the mortgaged property, any other property belonging to the mortgagor shall be liable to be ordered to be sold under the decree in an action upon the mortgage subject to one restriction, namely, that no process for the seizure and sale of any such other property shall be issued until the mortgaged property is sold and the proceeds thereof applied in satisfaction of the decree. Needless to say a renunciation made under Section 47A will not enable a creditor to issue writ to sell the defendant's residence which is not mortgaged or any other property exempted by Section 218 of the Civil Procedure Code unless the same has been mortgaged.

It appears that a creditor who has obtained mortgage of immovable property and also such renunciation can proceed against the debtor's properties which are not mortgaged only if such creditor obtains a decree in an action upon the mortgage and has not obtained full satisfaction of that decree. Therefore, a creditor who chooses to exercise the right of parate execution may not be able to enjoy the benefit of a renunciation under Section 47A.

Recovery of Loans by Banks (Special Provisions) Act No.4 of 1990 has been enacted to provide for the recovery of loans granted by Banks for the economic development of Sri Lanka. (Please also see paragraph 4.1.5.1 below)

According to Section 69 of the Sri Lankan Mortgage Act the owner of a land may create a mortgage of such land in favour of an approved credit agency by the execution of an instrument in the form set out in the Second Schedule to this Act and by the deposit with that agency of the title deeds of such land. This presupposes the acceptance of the property as security without a proper examination of its title. The lender will therefore have to run the risk that the title of the borrower not having been carefully examined as in ordinary cases, may prove defective. If a mortgage is created by deposit of title deeds of any land under and in terms of Section 69 of the Mortgage Act and attested by an officer of a lending institution then the said special instrument of declaration and renunciation under Section 47A could also be executed before such officer and any reference in the provisions of this new Act to the Notary attesting the mortgage bond is deemed to be a reference to such officer.

Realisation of mortgage of immovable property largely depends on factors like the title of the mortgagor and availability of vacant possession. A prudent banker will not accept an immovable property if the mortgagor's title is defective or if it is occupied by a tenant who is protected by the Rent Act.

If the mortgage of an immovable property has to be realized, the mortgage bond must be put in suit and the procedure described therefor by the Mortgage Act should be strictly followed. All the Banks in Sri Lanka have now been given a right of parate execution. State banks which had this right of parate execution even before the

Debt Recovery legislation of 1990 and the banks which are companies registered in Sri Lanka who have been given the parate execution right under the new Debt Recovery legislation of 1990, can realize the security of mortgaged immovables by the exercise of the right of parate execution, that is, selling the mortgaged immovable properties by auction without recourse to a court of law. In the case of foreign banks which have only branches in Colombo they are also institutions which have been given the power of parate execution, but there is doubt as to whether the Board of Directors who are not Sri Lankan can exercise that right. When exercising the right of parate execution a bank should act carefully by strictly following the procedure particularly in respect of notices required to be published.

#### 4.1.2 **Effective recording and registration procedures**

4.1.2.1 The Mortgage Bond has to be registered at the Land Registry within which the lands are situated, (vide Section 7 of the registration of Documents Ordinance). It only confers priority and no validity. There is no time limit within which it should be registered. In the case of a mortgage of movables executed by the Company, the same should be registered with the Registrar of Companies within 21 days. Failure to do so will result in the mortgagee losing his status as a secured creditor, vide Section 91 of the Companies Act.

##### 4.1.2.2 **Effective priority rules**

The Registration of Documents Ordinance contains the provisions, (Vide Section 30 of the Registration of Documents Ordinance) to register priority notices in respect of registration of documents affecting lands. This will enable a mortgagee to have priority notice registered for execution of the mortgage so that the priority conferred by the mortgage will not be prejudiced. There is no such mechanism available in the case of registration with the Registrar of Companies. Nevertheless, that does not affect the process of registering as once a document is registered it maintains the status of the mortgagee secured creditor which will entitle the mortgagee to claim priority over the unsecured creditors.

#### 4.1.3 **Existence of hidden liens**

Hidden liens are generally the first charges under statutes. It is relevant here to deal with first charges under Statutes vis-à-vis mortgagees as secured creditors. This question arose in the Court of Appeal in the *Development Finance Corporation of Ceylon and others v. Deputy Commissioner of Inland Revenue and others*. C.A. (S.C.) Appeal Nos. 437/75(F), 438/75(F) and 439(F), D.C. Colombo Case No. 77764/M. The 7<sup>th</sup> defendant (the Commissioner of Labour) claimed monies due from the Company (Bonars [Ceylon] Ltd.) under Sec. 2(b) (iii) of the Wages Boards Ordinance, section 38(2) of the Employees' Provident Fund Act and Section 19(1)(b)(iii) of the Shop and Office Employees (Regulation of Employment and Remuneration) Act No. 19 of 1954 as first charges on the sale proceeds of a property of the company which was mortgaged to three banks (the 4<sup>th</sup>, 5<sup>th</sup> and 6<sup>th</sup> defendants). The trial judge held with the Commissioner of Labour but the Court of Appeal set aside that judgment in the appeals preferred by the banks. Having considered the judgments reported in 4 NLR 311, 6 NLR 169, 10 NLR 175 and referred to above. In the case of *Velliappa Chetty v. Pitchai Maula*, 4 NLR 311 it was held that a special mortgagee of movables is entitled to be preferred to all other creditors of the debtor in respect of proceeds of the sale of such movables. In the case of *Raheem v. Yoosuf Lebbe*, 6 NLR 169, it was held that a decree holder was not entitled concurrence with a registered mortgagee and also in *Bapuraj Dajiba v. Narayanan Govindal Kale* A.I.R. (37) 1950 Nagpur and *Wheatley v. Silkstone and Haigh Moor Coal Company* (1885) 29 Ch. D. 715 In the said Development Finance Corporation of Ceylon case, the Court of Appeal of Sri Lanka in its judgment delivered by Ranasinghe J (as he was then) with Vythialingam J held on 15<sup>th</sup> May 1979:

*“On a consideration of all these matters I am of the opinion that the “first charge” imposed by the provisions of the three Acts relied on by the 7<sup>th</sup> defendant, viz. Wages Boards Ordinance, Employees' Provident Fund Act, and the Shop and Office Employees (Regulation of Employment and Remuneration) Act operates, as of the debtor and is not entitled to take precedence over secured creditors who hold securities executed validly and bona fide by the debtor.*

*“I therefore, hold that the claim put forward in this case by the 4<sup>th</sup>, 5<sup>th</sup> and 6<sup>th</sup> defendants all take precedence over the claims put forward by the 7<sup>th</sup> defendant AB regards the 4<sup>th</sup>, 5<sup>th</sup> and the 6<sup>th</sup> defendants, their claims will rank inter se, in order of time that is, according to the dates of registration of their respective bonds.”*

#### 4.1.4 Limitations on foreigners taking security

Sri Lankan Exchange Control laws are still restrictive. Even if a foreigner takes security he will have difficulties in realizing and taking the sale proceeds out of Sri Lanka. Sub-sections 4 to 8 of Section 30 of the Exchange Control Act reads as follows:-

- (4) *“Notwithstanding anything contained in any other law, no transfer of any interest in any business in Sri Lanka made by a person resident outside Sri Lanka to any person also resident outside Sri Lanka shall be valid unless such transfer is confirmed by the bank on an application made to it for such confirmation by the transferor or the transferee. The preceding provisions of this subsection shall not apply to the transfer of any share in a company.*
- (5) *“Except with the general or special permission of the bank, no person resident in Sri Lanka shall transfer any interest in any business in Sri Lanka, or create any interest in any such business, to or in favour of a citizen of a foreign state.*
- (6) *“Except with the general or special permission of the bank, no person resident in Sri Lanka shall give a guarantee in respect of any debt or any other obligation or liability of a person resident outside Sri Lanka.*
- (7) *“Except with the general or special permission of the bank, no person resident in Sri Lanka shall lend any money either to any firm or company (other than a banking company) which is controlled directly or indirectly by persons resident outside Sri Lanka.*
- (8) *“In this section, “foreign company” means a company not incorporated under any law in force in Sri Lanka and in the case of which any of the following conditions is fulfilled:-*
  - (a) *that the company is by any means controlled (directly or indirectly) by any person or persons resident in Sri Lanka; or*
  - (b) *that more than half of the sums which, on a liquidation thereof, would be receivable by holders of share or loan capital, would be receivable directly or indirectly by, or for the benefit of, persons resident in Sri Lanka; or ....*

It may be relevant to quote below Sections 7 and 8 of the Exchange Control Act:-

7. *Except with the permission of the bank, no person shall in Sri Lanka*
  - (a) *make any payment to or for the credit of a person resident outside Sri Lanka, or*
  - (b) *make any payment to or for the credit of a person resident in Sri Lanka by order or on behalf of a person resident outside Sri Lanka, or*
  - (c) *place or hold any sum to the credit of any person resident outside Sri Lanka.*

*Provided that where a person resident outside Sri Lanka has paid a sum in or towards the satisfaction of a debt due from him, paragraph (c) of this section shall not prohibit the acknowledgment or recording of the payment.*
8. (1) *Except with the permission of the bank, no person resident in Sri Lanka, shall, subject to the provisions of this section, make any payment outside Sri Lanka to or for the credit of a person resident outside Sri Lanka.*
  - (2) *Nothing in this section shall prohibit the doing of anything otherwise lawful by any person with any foreign currency obtained by him in accordance with the provisions of Part I of this Act or retained by him with the consent of the bank.*

We also quote below the provisions of Section 35 which deals with legal proceedings:-

- (1) *The provisions of Part II of this Act shall apply to sums required to be paid by any judgment or order of any court or by any award as they apply in relation to other sums, and it shall be implied in any judgment or order of any court in Sri Lanka, and in any award given under the law of Sri Lanka, that any sum required to be paid by the judgment, order or award (whether a debt, as damages or otherwise) to which those provisions apply shall not be paid except with the permission of the bank.*

- (2) *Nothing in this Act shall be construed as preventing the payment by any person of any sum into any court in Sri Lanka, but the provisions of Part II of this Act shall apply to the payment of any sum out of court, whether under an order of the court or otherwise, to or for the credit of any person resident outside Sri Lanka.*
- (3) *In any insolvency proceedings, winding up of a company, or administration of the estate of a deceased person, carried on under the law of Sri Lanka, a claim for a sum not payable without the permission of the bank shall, notwithstanding that the permission has not been given or has been revoked, be admitted to proof as if the permission had been given and had not been revoked.*
- Provided that nothing in the preceding provisions of this subsection shall be construed as affecting the application of the provisions of Part II of this Act to payments by the assignee of the insolvent's estate, or by the liquidator, or by the executor of the last will, or administrator of the estate, of the deceased, or by any other person in such insolvency proceedings, or winding up, or administration.*
- (4) *The provisions of this Act restricting the making of settlements shall not apply to any deed of arrangement made for the benefit of creditors generally, and the provisions of subsection (3) shall apply in relation to proceedings under any deed of arrangement as they apply in relation to insolvency proceedings.*
- (5) *Where the permission of the bank is required under this Act for the payment of a debt the amount of which is sufficient under section 18 of the Insolvency Ordinance, to enable the creditor to petition for the sequestration of the estate of the debtor if the debtor commits an act of insolvency, the debt may, notwithstanding the aforesaid requirement, be allowed to be a good petitioning creditor's debt, if and to the extent that the debt can be satisfied either by a payment into court or by a payment to a blocked account.*

Even if there is a judgment the payment by a resident in Sri Lanka to its creditor has to be with the permission of the Controller of Exchange.

There are Board of Investment of Sri Lanka (BOI) Enterprises which are given certain incentives and benefits by the BOI under the applicable laws and regulations. The BOI can exempt a BOI Enterprise from the Exchange Control Regulations. Then the BOI Enterprise will be able to do certain things free of Exchange Control restrictions. However, the exemption granted by the BOI to the BOI Enterprise cannot be extended to the shareholders or its creditors. The provisions of Section 17 of the BOI Law make it clear that the exemption given to the BOI Enterprises apply only to the Enterprise and not to the shareholders and lenders/creditors.

Section 17 of the Board of Investment of Sri Lanka Law empowers the Board of Investment of Sri Lanka ("BOI") to enter into agreements with any enterprise and to grant exemptions from any law referred to in Schedule B thereto or to modify or vary the application of any such laws, to such enterprise in accordance with such regulations as may be made by the Minister in charge of the subject of the BOI. Every such agreement is reduced to writing and constitutes a valid and binding contract between the BOI and the enterprise upon registration of such agreement with the BOI.

One of the laws referred to in the Schedule B is the Exchange Control Act. The BOI enterprises are entitled to benefits and exemptions under the said Section 17 are generally exempted from the provisions of the exchange Control Act and such exemption is granted by an agreement the BOI enters into with the BOI enterprise concerned.

Such exemption can be given to the enterprise only and not to its Shareholders or Lenders. However, the foreign shareholders have the comfort of the Securities Investment External Rupee Account ("SIERA") scheme through which they are permitted to convert the foreign currency and invest in Sri Lankan Rupees in the companies in which the foreign investment is allowed by way of a general approval to take out of Sri Lanka the dividends and the proceeds of sales of such shares by converting from Sri Lanka rupees to the foreign currency. Nevertheless, the Lenders do not have that comfort. This unsatisfactory state of affairs compel even large foreign Lenders who support big infrastructure projects to seek specific approvals from the Controller of Exchange for matters such as (a) lending in foreign currency and recovering in the same currency (viz: conversion of the recovered debt and interest from Sri Lankan rupees to foreign currency), and (b) obtaining security such as shares of local shareholders and local assets for foreign loans.

Section 2 of the Companies (Special Provisions) Law No. 19 of 1974 which has not been repealed by the Companies Act No. 17 of 1982 (as the provisions of Part XIII of the Companies Act are subject to the provisions of Companies (Special Provisions) Law No. 19 of 1974, vide Section 394 of the Act) contains the following provisions:-

- (1) *On and after the first day of September, 1974, in this Law referred to as the “appointed date” no company –*
  - (a) *shall have an interest in any property in Sri Lanka, whether as owner, co-owner, lessee, mortgagee, or otherwise, or*
  - (b) *shall carry on any undertaking in Sri Lanka unless such company is recognized as an “existing company”, or is incorporated, under the principal enactment, or is an exempted company.*
- (2) *Before the appointed date, the Minister may from time to time, by Order published in the Gazette, alter such date, and thereafter the new date specified in the Order shall be deemed to be the appointed date for the purposes of this Law.*

An “existing company” means a company formed and register under the Joint Stock Companies Ordinance or the Joint Stock Banking Ordinance No. 87 or the Companies Ordinance which were preceding to the Companies act (vide Section 449(1).

An “exempted” company is a company exempted by the Minister in terms of a direction made by him under Section 3 of the Companies (Special Provisions) Law No. 19 of 1974. The list of exempted companies are set out in the direction gazetted in the Gazette Extraordinary No. 142/9 of 18<sup>th</sup> December, 1974 as amended by the direction published in the Gazette Extraordinary No. 612/6 of 29<sup>th</sup> may 1990.

In terms of the provisions of section 83(b) of the Banking Act No. 30 of 1988 as amended by the Act No. 33 of 1995, a company incorporated outside Sri Lanka which has been issued a license under Section 5 of this Act as a Licensed Commercial Bank, is with effect from the date of issue of such licence, deemed to be an exempted company for the purposes of the Companies (Special Provisions) Law No. 19 of 1974.

There was an imposition of 100% tax under the Finance Act No. 11 of 1963 on foreigners acquiring any immovable property, but this levy was removed on the 1st April 2002. However, with a law passed recently the said 100% tax on acquisition by foreigners of immovable properties has been restored by the new Government.

#### **4.1.5 Effectiveness of Enforcement Mechanisms**

##### **4.1.5.1 Applicable laws governing enforcement**

Enforcement of the security has been generally through civil actions and enforced according to the provisions of the Civil Procedure Code.

The Debt Recovery Act No. 4 of 1990 has been enacted to provide for the recovery of loans granted by Banks for the economic development of Sri Lanka. This law was earlier applicable to a loan granted by a Bank (other than the Bank of Ceylon, People’s Bank and Rural Banks), on a mortgage of “property” within the meaning of this Act. “Property” is defined to mean any movable or immovable property and to include the right title and interest of the lease, in any case where a loan is secured by a mortgage of the interest of a lessee under a lease from the State. The statutes creating Bank of Ceylon and People’s Bank had already given the right of parate execution to those banks. By the Amending Act No. 24 of 1995 the definition of the Bank has been amended to include all licensed commercial banks (other than Rural Banks), CCB and National Savings Bank. In other words the right of parate execution has been extended by this Act to commercial banks in respect of those mortgages. This right was earlier exercised only by a few state banks on the basis that they are answerable to Parliament. This new law has extended that power to other commercial banks also, subject to the provisions in respect of the procedure to be followed by those banks. “Parate Execution” means the right of execution whereby a creditor can sell his debtor’s assets mortgage to him without the intervention of the Court and recover the monies due to him.

Before 1990 a few State Banks (namely Bank of Ceylon, People's Bank, National Savings Bank, State Mortgage and Investment Bank and National Development Bank) had parate execution rights to enforce the mortgages without the intervention of Court. The Recovery of Loans by Banks (Special Provisions) Act No. 4 of 1990 changed the position by granting parate execution rights to all the Licensed Commercial Banks. The property, whether immovable or movable mortgaged to a Licensed Commercial Bank can be sold by the Bank by taking necessary steps in compliance with the said Recovery of Loans by Banks (Special Provisions) Act No. 4. If the mortgagor makes default the Bank has the right to enforce the mortgage by its Board of Directors passing a Resolution and authorizing a Licensed Auctioneer to auction the property, but of course complying with the procedural steps in respect of publications. The provisions of this Act have certain defects. They can be summarized as follows:-

- (a) whether a property mortgaged by a third party for the facilities granted to a customer of the bank is subject to parate execution
- (b) whether any one or more of the banks of a syndicate of banks who have obtained a concurrent bond over the properties can seek parate execution
- (c) whether the Board of Directors of a foreign bank can pass a resolution for parate execution.

#### 4.1.5.2 **Amendments to the Debt Recovery Act No. 4 of 1990**

Although the government gazetted a Bill to amend the said Act No. 4 of 1990, the constitutionality of that Bill was challenged in the Supreme Court. Upholding the objections the Supreme Court made order on 26<sup>th</sup> August 2003 that the Bill could be passed only by the special majority required under the provisions of Article 84(2) of the Constitution. We quote below the provisions of Article 84(2) below:-

*“84 (2) Where the Cabinet of Ministers has certified that a Bill is intended to be passed by the special majority required by this Article or where the Supreme Court has determined that a Bill requires to be passed by such special majority, such Bill shall become law only if the number of votes cast in favour thereof amounts to not less than two-thirds of the whole number of Members (including those not present) and a certificate by the President or the Speaker, as the case may be, is endorsed thereon in accordance with the provisions of Article 80 or 79.”*

#### 4.1.5.3 **Constitutionality**

When deciding on the constitutionality of an amendment proposed to be made to the law in August 2003 the Supreme Court of Sri Lanka had given in a nutshell the essence of this law in the following words:-

*“The legislative scheme as contained in the Act empowers the Bank to decide that a default has been made in respect of any loan and to proceed upon such decision to take possession of the mortgaged land and to sell it by public auction without any intervention of a Court of justice. The Bank is also empowered to fix the price below which no person other than the Bank would purchase such property and to issue a certificate of sale to any purchase and which shall be conclusive evidence of the due compliance with the provision of the Act. It also prevents the borrower or any person deriving interest from the borrower from seeking to invalidate such sale in a Court of law.*

*“From the foregoing analysis, it is seen that where a Bank that has lent or advanced money on the security of a mortgage alleges a default on the part of the debtor, the Bank has a choice of resorting to one of two procedures for recovery. The first, is the regular procedure set out in the Mortgage Act which provides for a hypothecary action and if the Court finds that the mortgage ought to be enforced a sale of the property is ordered.*

*“The second is the procedure laid down in the Act No. 4 of 1990, whereby the Bank could at its own option, without recourse to a court, take over the possession and management of the mortgaged property, cause it to be sold and issue a certificate conveying title in the property to the purchaser. From the perspective of the provisions of the Constitution the question that arises for consideration is whether the availability of two such procedures that may be availed of by the Bank is inconsistent with Article 12(1) of the Constitution which guarantees the equal protection of the law to every person.*

As there were conflicting findings by courts of the first instance as to whether such parate execution right is available to a bank against the property mortgaged by a third party for loans granted to a customer, the Government sought to amend the law specifically extending the process of the parate execution to instances where the property has been mortgaged by a person other than the borrower. The proposed amendment further provided

that a resolution of the Board of Directors of a bank to exercise parate execution power cannot be challenged in any court.

The proposed amendment addressed another issue confronted by banks when they syndicate and give loans. The suggested amendment to extend the right of parate execution to a syndicated loan secured by a concurrent mortgage given in favour of several banks. The provision intended to empower any one of such banks to resort to parate execution in respect of the entire outstandings to the Syndicate.

The other proposed amendments were –

- (a) that no enjoining order or interim injunction can be filed to restrain the bank from taking any steps pursuant to a parate execution resolution of its Board after 30 days of the publication or receipt of notice of such resolution.
- (b) Making removal of any movable property or taking steps which would decree the value of an immovable property without the consent of the mortgagee-bank as illegal offences
- (c) Enlarging the definition of the term “Bank” to include Specialised Banks, Finance companies and Housing and Development Finance Corporation.

#### 1.6 **Remedies and process by which a secured creditor realizes on its collateral**

In the case of mortgages on which parate execution is not available to the mortgagee, the mortgagee has to institute action in the appropriate civil court in compliance with the relevant provisions of the Mortgage Act and the Civil Procedure Code. The procedure that will be followed is that the Court will issue summons on the defendants and notice other parties who have interest in the mortgaged property only after *lis pendens* action is registered at the Land Registry and a declaration by an Attorney-at-Law in Court. Thereafter the defendant will have an opportunity of filing answer, raising issues and go through the trial. After the trial the Court will enter judgment and decree. Thereafter the defendant has a right to appeal to the Court of Appeal and from the Court of Appeal to the Supreme Court only on a question of law. Pending an appeal to the Court of Appeal, the judgment creditor (the mortgagee) can apply for and obtain an order to sell the mortgaged property. The Court will permit the same subject to the judgment debtor filing objections and the Court inquiring into the matter. Once the order to sell is issued, whether pending appeal or whether no appeal is made, the auctioneer will be entitled to take steps to sell the property. The properties will be advertised and the title deeds will be offered for examination by prospective purchasers. If there is any defect in the title the realisability of the mortgage may not be possible.

##### 4.1.7 **Ease and Predictability of Enforcement**

Whether by way of parate execution or through Court action, enforcement of a mortgage is not difficult provided (a) the property has a good title, and (b) there is vacant possession available (If the property is tenanted, proceedings have to be taken to eject the tenant. If the Tenant is protected by the Rent Act then the purchaser will need to be able to eject him unless there is a possibility of ejectment of a tenant under any of the provisions permitted by the Rent Act).

##### 4.1.8 **Time frame to obtain judgment to enforce security or to complete execution, foreclosure, public/private auction, including appeals.**

In the case of parate execution the ultimate sale can be reached within a period of about 4 to 5 months unless the mortgagor succeeds in obtaining an injunction or writ to stay the sale. Although our Courts have in the recent past been reluctant to give such injunctions or writs, the mortgagors are still making efforts, raising various technical issues. In the case of a Court action, the time taken to reach the judgment stage is, unfortunately, a long period. The original court proceedings may take about 3 to 5 years if it is a contested case. Appeal to the Court of Appeal takes a longer time and as the appeal to the Supreme Court is only on a question of law, the matter can be generally decided within a period of a few months.

##### 4.1.9 **Costs**

Costs payable in courts proceedings are another unrealistic aspect that encourages the debtors to delay the legal proceedings. Costs are payable according to Costs (Regulations) 1997 made under Section 214 of the Civil Procedure Code. Although it was improvement from the situation which prevailed prior to that the taxed costs are still not sufficiently commensurate with the actual expenses the creditors have to incur in the legal proceedings.

##### 4.1.10 **Credit Information**

One of the difficulties experienced by the Bankers and the other Lenders is the lack of availability of credit information. This issue has been addressed to a limited extent by the creation of the Credit Information Bureau, commonly referred to as “CRIB”

Credit Information Bureau of Sri Lanka was established under the Credit Information Bureau of Sri Lanka Act, No. 18 of 1990 (amended by Act No. 8 of 1995), with the objective of collecting and collating information on borrowers and to furnish such information to shareholding lending institutions. At present, 82 institutions, including all licensed commercial banks, licensed specialised banks, registered finance companies, registered leasing establishments, and the Central Bank, are shareholders of CRIB.

According to the official sources, CRIB currently collects information on regular advances of Rs.500,000 and over, and irregular advances of Rs. 100,000 and over. The number of credit reports issued during the year 2003 increased to 389,171 from 285,269 in 2002, reflecting higher demand for credit with the recovery in economic activity and also demonstrating that credit information is used as an important risk management tool by lending institutions.

The Central Bank of Sri Lanka has reported that the number of advances recorded in the database amounted to 159,500 in 2003, compared with 1349,500 in 2002. Of the number of advances in 2003, 106,000 advances were regular, while 53,500 were irregular advances (advances which are more than six months in default). The value of irregular advances in the database was about Rs. 103 billion compared with about Rs. 99 billion in 2002. Of the total irregular advances, 74 per cent were account for by the corporate sector, while the balance was accounted for by individual borrows. More than 90 per cent of these irregular advances were advances over one million rupees.

#### 4.1.11 **Consumer Protection Regime**

Enactment of the Consumer Affairs Authority Act No. 9 of 2003 and creation of the Consumer Affairs Authority has been of concern to the Banks and the other financial institutions. Because of inclusion of these institutions also to fall within the ambit of the definition of “Trader” certain stringent provisions of the Consumer Affairs Authority Act apply to the Banks and other Financial Institutions. Pursuant to the representations made by the Sri Lanka Bankers’ Association, the then Minister of Commerce and Consumer Affairs agreed to amend that Law to refer all the complaints against them to a Financial Ombudsman, if created. Accordingly Sri Lanka Bankers’ Association took steps to have the office an independent Financial Ombudsman created on the same lines as that exists in the UK. A Guarantee company was formed by the Banks and the other financial institutions for that purpose. However, the promised amendment has not yet been made and the new Minister of Commerce and Consumer Affairs has promised to look into the matter.

#### 4.2 **Security in personal property**

##### 4.2.1 **Mortgage and Pledge**

4.2.1.1 Mortgage is that privilege over the property of another which tends to the security of a debtor or personal claim. ‘Pledge’ strictly so called or ‘Pawn’ is constituted, when the thing which is the subject of the contract is delivered to the creditor, while the transaction is called ‘hypothec’ when the possession does not pass. The word ‘mortgage’ is used in a comprehensive sense as equally applicable to pledges or pawns and hypotheses.

4.2.1.2 The distinction between a pledge and a mortgage is that in a pledge the subject of the contract is delivered to the creditor while in a mortgage the possession does not pass unless it is a usufructory mortgage.

4.2.1.3 Oral pledges of movable property require for their validity an actual delivery to the pledgee. Pledge is constituted by actual delivery of possession. Its essential characteristic is that thereby possession of the thing passes to the creditor.

4.2.1.4 A Banker’s lien is also considered to be a pledge. Lien does not normally confer a right of sale. It is merely a right to retain the goods until the debt is paid. A Banker’s lien however is described as an implied pledge and is generally considered that the remedies of a pledge apply, where appropriate, to securities subject to the lien of a Bank.

4.2.1.5 In practice a letter of pledge setting out the right of a Bank in relation to the goods from time to time pledged is always obtained by a Bank although the actual or constructive possession of the goods which constitute the pledge is given to the Bank.

4.2.1.6 Subject to the statutory modifications the law applicable to pledge as for mortgage in Sri Lanka is the Roman Dutch Law which does not allow a pledgee to sell the property pledged without reference to a Court of Law even if there be an agreement between the parties on parate execution. According to Roman Dutch Law such an agreement is one which the law will not recognise except in the case of movables of small value and of shares held by a Bank in which case the right to do so depends on custom by which the law has been abrogated. This position has since been changed by the provisions of the Mortgage Act in respect of mortgage of shares, corporeal movables etc. in favour of approved credit agencies which have been dealt with elsewhere in this paper.

4.2.1.7 Mortgage of properties which is the most popular and acceptable form of security in most of the countries is in Sri Lanka governed by the Roman Dutch Law which is the common law of this land, subject to changes and modifications made from time to time by statutory law.

#### 4.2.2 **Security in Movables**

4.2.2.1 Various types of business debts such as working capital, overdraft and commercial credit facilities are secured by movable properties such as stock-in-trade, plant and machineries which are not fixtures.

4.2.2.2 Under Sri Lankan law a mortgage of movables can be created only in two ways, namely, (a) by delivery (b) by registered written instrument.

4.2.2.3 The Mortgage Act No.6 of 1949 contains a special provision applicable to mortgage of movables where a mortgagee is an approved credit agency. All licensed commercial Banks in Sri Lanka are approved credit agencies. The State Mortgage and Investment Bank, the Loan Board, the National Savings and the other institutions approved by the Director of Commerce on application made in terms of the Section 114 of the Mortgage Act are also approved credit agencies within the meaning of the Mortgage Act. In terms of Section 85 of the Mortgage Act, where a mortgage of any corporeal movables is created in favour of an approved credit agency it shall be lawful for the agency to sell any of the movables subject to the mortgage which may for the time being be actually in the possession and custody of the agency. The power conferred on the agency to sell could be exercised only if the instrument of mortgage or an agreement between the parties contains provisions in terms to this section empowering the agency to exercise the power of sale conferred thereby and if one of the following conditions is fulfilled :-

(a) Where the mortgage is created as security for the payment of money stated to be payable on demand, if the mortgagor fails to make payment of the monies due and payable under mortgage within one month of the issue to him by the agency of a notice of demand in accordance with the provisions of Section 86; or

(b) Where the mortgage is created as security for the payment of any money stated to be payable on a specified or ascertainable date, if the mortgagor fails to make payment of the monies due and payable under the mortgage within one month of the date of issue to him by the agency, after that date, of a notice of demand in accordance with the provisions of Section 86.

4.2.2.4 When considering the realisability of a mortgage of movables in Sri Lanka, one has to bear in mind the provisions of section 18 of the Prevention of Frauds Ordinance read in conjunction with sections 17 and 18 of the Registration of Documents Ordinance. In terms of section 18 of the Prevention of Frauds Ordinance, no promise, contract, bargain or agreement unless it be in writing and signed by the party making the same or by some person thereto lawfully authorised by him or her shall be of force or no avail in law for the purpose of pledging movable property, unless the same shall have been actually delivered to the person to whom it is pledged. Section 17 of the Registration of Documents Ordinance, provides that no pledge, mortgage or bill of sale of movable property shall be of any force or effect in law or give the pledgee, mortgagee or transferee any lien charge claim right or priority to such property unless

(a) such property is actually delivered into the possession and custody of the pledgee, mortgagee or transferee or some person on his behalf and continues to remain actually, ostensibly and bona fide in such possession and custody; or

(b) such pledge, mortgage or bill of sale is created by an instrument in writing signed by the person effecting the same or by some person authorised by him and duly registered within 21 days in the Office of the Registrar of Lands.

4.2.2.5 It was held in the case of *INDIAN BANK LTD -v- CHARTERED BANK 43 NLR 49* that the phrase “ostensibly and bona fide in such custody” in the section 17 (earlier numbered 18) means the possession of the person possessing should be not only bona fide but should be of such a nature as to make it apparent to others that such person was in possession.

4.2.2.6 Transfers or assignments of pledges, mortgages and bills of sale are also required by Section 18 of the Registration of Documents Ordinance to be in writing and similarly registered.

#### 4.2.3 **Mortgage of Movables – General – Appointment of Receiver**

Where a mortgage is created in respect :-

- (a) of the entirety of the goods which are, or may at any future time, be in any specified premises; or
- (b) of the goods which constitute or may at any time constitute *the entire* stock-in-trade in any specified premises

and an action is instituted by the Mortgagee for the enforcement of the mortgage or the recovery of the moneys due thereunder, the mortgagee may, at or after the time of the institution of the action, make application to the Court by petition (supported by an affidavit) for the appointment of a RECEIVER of the mortgaged property. (vide section 96 of the Mortgage Act).

At any stage before filing by the mortgagor of his answer the application for appointment of a receiver can be dealt with ‘ex parte’ by the Court.

#### 4.2.4 **Seizure by other Creditors of Mortgages Movables**

4.2.4.1 Section 105(1) of the Mortgage Act contains provisions to preserve the rights of a mortgagee of movables even if such mortgaged movables are seized by other creditors. I quote below those provisions :-

“Where any movable property whatsoever which is subject to a mortgage is seized in execution of a decree in favour of any person other than the mortgagee-

- (a) the claim of the mortgagee shall not be investigated or dealt with as provided in sections 241 to 247 of the Civil Procedure Code;
- (b) the mortgagee shall be entitled to make application to be added as a party to the proceedings in which the seizure was effected;
- (c) where the mortgagee is so added before the sale under the seizure, and makes application in that behalf supported by affidavit declaring that the property is subject to a mortgage in his favour, the court shall order that the sale under the seizure be stayed and that the property be sold by public auction by an auctioneer to be appointed under subsection (2).”

4.2.4.2 Notice of an order under subsection (1) (c) the section 105 is required to be given to the parties to the action, and the court will after such inquiry as may be necessary appoint an auctioneer to conduct the sale and give directions as to the time and manner of such sale.

#### 4.2.5 **Decree and Sale of Movebles in Hypothecary Action**

4.2.5.1 Where in a hypothecary action in respect of any movable property the court finds that the mortgage ought to be enforced, the decree shall, in relation to the mortgaged movables, order that the movables shall be sold in default of payment within such period as may be specified by the court not exceeding one month from the date of the decree, of the moneys due under the mortgage:

Provided, however, that the court may, in its discretion and subject to such conditions, including the making of specified payments on specified dates as it thinks fit, on application made in that behalf before the entry of the decree, fix such longer period than one month as the court may consider reasonable. (vide section 107 of the Mortgage Act)

4.2.5.2 Subject as hereinafter provided the mortgaged movables shall be seized and sold by the Fiscal under Chapter XXII of the Civil Procedure Code and all the provisions of that Code relating to the seizure and sale and delivery to the purchaser of movable property seized in execution of a decree for the payment of money shall apply accordingly:

Provided, however, that the court may, in its discretion if it thinks fit so to do, either in the decree or subsequently, direct that the property shall be sold by the Fiscal or by an auctioneer approved by the court, without being previously seized, and shall in such case in the decree or subsequently give directions as to the conduct and conditions of sale to the delivery of possession to the purchaser at such sale, and as respects such other matters as the court may find necessary.

#### 4.2.6 **Variation for special types of collaterals**

Special provisions in respect of mortgage of motor vehicles and shares and insurance policies and assignment of book debts needs be looked at separately.

#### 4.2.7 **Mortgage of Motor vehicles**

4.2.7.1 Special provisions have been made in the Mortgage Act for mortgage of motor vehicles. One advantage in the case of this category of movables is the convenience of identification by reference to the distinctive number given by the Registrar of Motor Vehicles.

4.2.7.2 Where any motor vehicle is mortgaged to any person :-

- (a) the instrument of mortgage will, on presentation to the Registrar of Motor Vehicles, be registered by means of an entry made in the register of motor vehicles kept under the Motor Traffic Act; and
- (b) the certificate of registration issued under that Act to the registered owner of the motor vehicle may be presented to the Registrar of Motor Vehicles, who will, on such presentation, make an endorsement on the certificate to the effect that the motor vehicle has been mortgaged by the instrument of mortgage. (vide section 102(1) of the Mortgage Act).

4.2.7.3 Where the instrument of mortgage of any motor vehicle has been registered under section 102, the following provisions shall apply :-

- (a) Notwithstanding anything in any other law, any sale or other disposition of the motor vehicle by or against the mortgagor shall not, so long as the mortgage continues in force extinguish or be deemed to extinguish the mortgage of the motor vehicle, which shall remain subject to the mortgage in the hands of the transferee or other person in whose favour such disposition is effected;
- (b) Upon the issue by the Registrar under the Motor Traffic Act of any new certificate of registration to any person registered as the new owner or of a duplicate certificate, the Registrar shall make an endorsement on the certificate to the effect that the motor vehicle has been mortgaged by the instrument referred to in paragraph (a) of section 102 (1). (Vide sec.103)

4.2.7.4 The registration by the Registrar of an instrument of mortgage of a motor vehicle and any endorsement made upon the certificate of registration under section 102 or under section 103 to the effect that the motor vehicle is mortgaged, shall be cancelled by the Registrar at the request of the mortgagee or upon an order being made by a District Court directing such cancellation upon application made to it in that behalf by petition and affidavit.

#### 4.2.8 **Mortgage of Shares**

4.2.8.1 Where the holder of any shares -

- (a) creates a mortgage of such shares in favour of an approved credit agency by means of an instrument in the form set out in the Third Schedule to that Act, and
- (b) deposits with such agency the certificate or certificates issued to him in respect of such shares, and
- (c) executes and delivers to such agency an instrument of transfer of such shares in favour of such agency or of any nominee of such agency, or an instrument of transfer in which the name of the transferee is not entered at the time of the execution (referred to as a "transfer in blank"),

the provisions of the section 73 of the Mortgage Act will apply, that is to say:-

- (i) if the shares are mortgaged as security for the payment of any moneys stated to be payable on demand, and the mortgagor fails to make payment of the moneys due and payable under the mortgage within one month of the

issue to him by the agency of a notice of demand in accordance with the provisions of section 74, of the Mortgage Act; or

(ii) if the shares are mortgaged as security for the payment of any moneys stated to be payable on a specified or ascertainable date, and the mortgagor fails to make payment of the moneys due and payable under the mortgage within one month of the issue to him by the agency, after that date, of a notice of demand in accordance with the provisions of the said section 74,

it shall be lawful for the agency to sell, or as the case may be to cause the nominee to sell, the shares, at their current market value, and where a transfer in blank had been executed, to complete the sale by the insertion in the transfer in blank of the name of the purchaser as the transferee of the shares.

4.2.8.2 Such a right of the agency to sell any shares includes the right to purchase the shares at the current market value, or where the transfer had been executed in favour of the agency to retain the shares, credit being in either event given to the mortgagor to the extent of the current market value.

4.2.8.3. The rights of the agency may be exercised in respect of all the shares which are for the time being subject to the mortgage under the instrument referred above or separately in respect of any shares so subject.

4.2.8.4. Upon the exercise of the right of sale or purchase of any shares and the completion of a transfer in blank by the insertion of the name of the purchaser as transferee of the shares, the transfer as so completed shall have the like effect as though it had been executed by the mortgagor at the time of completion.

4.2.8.5. Where a transfer (other than in blank) of any shares has been executed by the mortgagor in favour of an approved credit agency or a nominee of such agency, the fact that the transfer had been executed by way of mortgage shall not affect the right of the agency or the nominee, during the pendency of the mortgage, to apply to be registered as holder of the shares and to be so registered.

4.2.8.6. Upon the sale or purchase of any shares in exercise of the right conferred by section 73 of the Mortgage Act -

(a) the moneys realized upon such sale or credited shall be applied by the agency in satisfaction of the debt due and payable under the mortgage, and the mortgagor shall be entitled to receive the balance, if any, remaining after such debt is satisfied;

(b) if the moneys realized or credited upon the sale or purchase of all the shares mortgaged by the instrument are insufficient to satisfy such debt, the deficiency may be recovered from the mortgagor in the ordinary course of law.

4.2.8.7. Where a mortgage of shares has been created, and the mortgage is discharged by payment of the moneys due and payable thereunder, or by reason that the moneys realized upon a sale or purchase of some only of the shares so mortgaged are sufficient to satisfy the debt, or otherwise-

(a) the mortgagor is entitled, in the case of a transfer in blank, to receive from the agency the certificate or certificates in respect of such shares or of the shares remaining unsold, as the case may be, together with the transfer in blank in respect thereof;

(b) the mortgagor is entitled in the case of a transfer otherwise than in blank, to receive from the agency or its nominee at the instance of the agency, a duly executed instrument of retransfer of the share or of the shares remaining unsold, as the case may be.

4.2.8.8. The Bankers should ensure that the right of sale of mortgaged shares is properly exercised. Section 78(1) of the Mortgage Act provides "Where any shares mortgaged as provided in section 73 are sold or caused to be sold, or are purchased by the agency, otherwise than in the due exercise of the right conferred in that behalf by that section, the mortgagor shall be entitled to recover from the agency the amount of any; loss or damage suffered or incurred by reason of such sale or purchase ....."

4.2.8.9. The operation of any other written law or of any regulations or provisions which apply to the transfer of shares, or to the registration of the transferee of any shares as the holder thereof, or which confer any right to decline to effect such registration will not in any way be affected or modified by reason that a transfer of any such shares is effected in the exercise of the right conferred by section 73 (Vide Section 79)

4.2.8.10. With the coming into operation of the Central Depository System (CDS) the sale and purchase of all shares in Public Quoted Companies have to be processed through the CDS. A shareholder desiring to sell his

shares is required to open an account with the CDS and execute a nominal transfer in its favour and the shares so transferred are registered in the name of the CDS. However, the shareholder continues to be a member of his Company for all other purposes. In taking a mortgage of shares in Public, Quoted Companies, a Bank or other approved Credit Agency has to in addition to the requirements under the Mortgage Act referred to above, obtain from the Mortgagor the following documents :-

- (a) A CDS Account Opening Form duly completed;
- (b) A sold Transfer Form, one for each certificate duly completed;
- (c) A letter of authorization empowering a Broker to act for him in the sale of the shares by the approved Credit Agency and to pay the proceeds to such Agency.

The letter of authorization becomes necessary as only Share Brokers who are members of the Colombo Stock Exchange are allowed to deal with the CDS. The above steps will be required to be followed when obtaining a mortgage of shares in a Public Quoted Company.

4.2.8.11. For the above purposes (covered by sections 73 to 79 of the Mortgage Act) "shares" means any shares, debentures, stock or other securities in the funds of the Government of Sri Lanka or in the capital of any company incorporated or registered in Sri Lanka.

#### 4.2.9 **Mortgage of Life Insurance Policies**

4.2.9.1 In Sri Lanka, where the holder of a policy of life insurance -

- (a) creates a mortgage of the policy in favour of a bank (an approved credit agency) by means of an instrument in the form set out in the Third Schedule to the Mortgage Act of Sri Lanka; and
- (b) assigns the policy to the bank by way of mortgage and deposits it with such agency the provisions of Section 81 of the Mortgage Act applies in the following manner :-
  - (i) if the policy is mortgaged as security for the payment of any moneys stated to be payable on demand, and the mortgagor fails to make payment of the moneys due and payable under the mortgage within six months of the issue of notice of demand of payment in accordance with the provisions of Section 82; or
  - (ii) if the policy mortgaged as security for the payment of any moneys stated to be payable on any specified or ascertainable date, and the mortgagor fails to make payment of the moneys due and payable under the mortgage within six months of the issue, after that date, of notice of demand of payment in accordance with the provisions of Section 82; or
  - (iii) if any premium due on the policy remains unpaid after one month from the issue, in accordance with the provisions of Section 82, by the agency of a notice demanding payment of such premium to be made to the insurer,

such agency may be entitled to surrender the policy to the insurer and to receive payment of the surrender value of the policy or of such amount as would have been payable to the assured if the policy had been surrendered by him. If the moneys so received are insufficient to pay such debt, the agency shall be entitled to recover the balance in the ordinary course of law (Section 83). If the policy is surrendered by the agency otherwise than in the due exercise of the right conferred by Section 81, the mortgagor shall be entitled to recover from the agency the amount of any loss or damage suffered or incurred by him in consequence of such surrender (Section 84).

4.2.9.2. A word of caution to the Bankers who exercise the right conferred by the section 81 is also necessitated because of the provisions of the Section 84 of the Mortgage Act. If the policy is surrendered by the Agency otherwise than in the due exercise of the right (conferred by the section 81) the Mortgagor will be entitled to recover from the Agency any loss or damage suffered or incurred by him in consequence thereof. Therefore the Bankers and the other Agencies should familiarise with the provisions of the Section 81 and 82 and ensure strict compliance when realising a security of an insurance policy.

#### 4.2.10 Assignment of Book Debts

4.2.10.1. If an assignment of any book debt -

- (a) is executed in favour of an approved credit agency; and
- (b) is expressed to be by way of mortgage; and
- (c) is duly registered under the Registration of Documents Ordinance Section 90 of the Mortgage Act confers on the Agency the right to demand accept and recover payment of such debt from the person owing such debt to the assignor. (This right is in addition to the right to enforce such mortgage by action in any competent court).

4.2.10.2. No such right to demand accept and recover payment of such debt conferred by Section 90 can be exercised :-

- (a) unless notice of the assignment is given by the agency, to the person owing such debt, in any manner provided by section 91, and the debt is due and unpaid at the date on which notice is so given;
- (b) if the right to demand, accept or receive such payment is, by the instrument of the mortgage, declared to be conditional upon the happening of any event or the non fulfilment of any obligation by the assignor, unless such event has happened or such obligation has not been fulfilled within the time specified in that behalf in the instrument, as the case may be.

4.2.10.3. The provisions referred to above apply in relation to a book debt notwithstanding:-

- (a) that it may not be specially assigned; or
- (b) that it may not have been due, or that the consideration therefor may not have passed, at the time of the execution of the assignment.

4.2.10.4. "Book debt" means any debt which -

- (a) is due or may become due to any person on account of any loan made in the ordinary course of any business carried on by that person as a money-lender, or on account of goods sold in the ordinary course of any business carried on by that person a seller of such goods, or on account of work or services performed or rendered in the ordinary course of any business carried on for profit by that person, and
- (b) is shown in the books kept by such person in the ordinary course of the business.

4.2.10.5. Section 91 of the Mortgage Act reads :-

"(1) Notice of the assignment of a book debt may be given by the agency to a person owing such debt in any manner set out hereunder, that is to say :-

- (a) by sending or presenting to the person owing such debt a notice addressed to such person and signed by the assignor to the effect that the debt has been assigned to the assignee; or
- (b) by sending or presenting to such person (i) a general notice signed by the assignor to the effect that all book debts which are due or may become due have been assigned to the assignee, or (ii) a copy of such notice certified by a director, manager, partner or secretary of the agency."

"(2) Any notice referred to in paragraph (a) or paragraph (b) of subsection (1) may be signed by the assignor at the time of the execution of the assignment or at any time thereafter, and may be sent or presented to the person owing the debt at any time while the assignment is operative."

4.2.11 Two other forms of security also needs our attention in this report.

4.2.11.1 Trust Receipts

4.2.11.1.1 A trust receipt is another kind of security against which credit is granted by an approved credit agency. Trust Receipts fall into two categories: trust receipts for imported goods and trust receipts for exportation of goods.

4.2.11.1.2. In our country Trust Receipts Ordinance No.12 of 1947 governs the execution of trust receipts and the registration and effect of trust receipts so executed. The operation of the Ordinance is restricted to trust receipts executed in favour of approved credit agencies.

4.2.11.1.3. Our Act No. 14 of 1990 has introduced another type of trust receipt called "The Inland Trust Receipt". The Act provides for the execution of an Inland Trust Receipt in favour of an approved credit agency in

such a case as where a person proposes to purchase goods for the purpose of transportation and sale within Sri Lanka and obtains advances by way of loan, overdraft or otherwise from that agency for the purpose of making payment for the goods and of meeting expenditure in connection with the transportation and sale and preparation for transportation and sale thereof. In the case of this trust receipt the person executing the same undertakes to hold the goods in trust for the agency, to mark the goods or the packages or cases containing them in a specified manner, to keep the goods in specified premises, to hold in trust and to pay the agency from time to time proceeds received from the sale of those goods or a specified proportion thereof etc. This Act also has made provision for the registration of an Inland Trust Receipt with the Registrar of Lands as a bill of sale. It also gives the agency in favour of which the trust receipt is executed the same preferential rights which are available under the Trust Receipts Ordinance and mentioned above.

#### 4.2.11.2 Guarantees

4.2.11.2.1 Guarantee is another form of security often sought by the Bankers for their advances in Sri Lanka. Although it is not a healthy practice Bankers seek the personal guarantees of Directors in advances granted to the companies. Bankers may be doing this for their convenience but such an attitude does not at all contribute to development of banking in any country.

4.2.11.2.2. Nevertheless the Bankers should realise that the real value of a guarantee turns upon value, form and enforceability of the document.

4.2.11.2.3. The form and execution of a guarantee must be in conformity with the applicable law. Although the English Law as amended by statutes is applicable to banking matters in Sri Lanka, the law applicable to a guarantee is Roman Dutch Law.

4.2.11.2.4. As I stated earlier a guarantee granted even in favour of a Bank in Sri Lanka is governed by the Roman Dutch Law. Sureties are entitled to certain benefits under the Roman Dutch Law unless they renounce the same. The situation in India and the other countries are different.

#### 4.2.12 **Finance Leasing**

In 2000 Sri Lankan Parliament enacted the Finance Leasing Act No. 56 of 2000 for the regulation and monitoring of the business of investing money for the provision of equipment under a finance-lease. Under this Act Leasing Institutions that carry on finance leasing business activities need be registered with the Central Bank and their activities are supervised by the Central Bank.

Section 20 of the Act empowers the lessor to, inter alia, recover possession of the leased equipment and recover damages. Police assistance and the Court's intervention can also be obtained by such Lessor under the provisions of sections 27, 28 and 29 of the Act. It will be of interest to note that the Section 26 of the Act provides as follows:-

*“26. (1) The rights of a lessor under this Act may be enforced against a trustee in bankruptcy of the lessee, or against any creditor of a lessee, including any creditor who has obtained an attachment in execution of such equipment.*

*“(2) For the purposes of subsection (1), “a trustee in bankruptcy” includes a liquidator, administrator or other person appointed to administer the estate of a lessee for the benefit of the lessee's creditors.”*

#### 4.2.13 **Commercial Paper**

Commercial Paper was another avenue for short term borrowings by large corporates. At the same time it continued to provide investors with alternative investment opportunity. According to the Central Bank of Sri Lanka the issues of Commercial Paper declined significantly in 2003 (by over 50% to Rs. 11.1 billion) reflecting higher liquidity in the market and the increasing competitiveness in bank lending rates. The majority of Commercial Paper was supported by Commercial Banks.

#### 4.2.14 **Negative Pledge**

Although the negative pledge is not a security the Commercial Banks found comfort in taking the negative pledges from large conglomerates by evaluating their credit rating. In some instances the conglomerates have given the negative pledge to all their banks by one instrument and each Bank has thereby ensured that another bank does not rank in priority in its claims over the other.

#### 4.3 Unsecured Claims

##### 4.3.1 Debt Recovery (Special Provision) act No. 2 of 1990 as amended by he Act No. 9 of 1994

Licensed Commercial Banks, a few named Specialised Licensed Banks (viz: State Mortgage and Investment Bank, National Development Bank, National Savings Bank and Development Finance Corporation of Ceylon) and Finance companies registered under the Finance Companies Act to carry on finance companies, all of whom are collectively defined as Lending Institutions can institute action under the Debt Recovery (Special Provisions) Act which was a law enacted to regulate the procedure relating to Debt Recovery by Lending Institutions. This procedure has been designed to facilitate recovery of debts which fall within the meaning of the definition of that term contained in the Act.

*“debt” means a sum of money which is ascertained or capable of being ascertained at the time of the institution of the action, and which is in default, whether the same be secured or not, or owed by any person or persons, jointly or severally or as principal borrower or guarantor or in any other capacity, and alleged by a lending institution to have arisen from a transaction in the course of banking, lending, financial or other allied business activity of that institution, but does not include a sum of money owned under a promise or agreement which is not in writing.*

The summary procedure laid down in this law is somewhat similar to that applicable to liquid claims as observed by the Court of Appeal in *Ramanayake –v- Sampath Bank* (1993) 1 SLR 145.

After the service on the defendant (as debtor or the guarantor) alienation or disposal of movables or immovable property in any manner by him or his representatives in interest without the approval of the Court is prohibited.

Of course, this law requires strict compliance with the procedure laid down. Unless the documentation is in perfect order the plaintiffs take the risk of the action being dismissed. There is no specific provision to amend the plaint once it is filed and likewise the decree nisi once entered cannot be amended. It is still a moot point as to whether the parties can resort to *causis omissis* provisions contained in the Section 19 of the Law which provides that in the matters not provided for in the Act the provisions of the Civil Procedure Code would apply.

An effort made by the Government to amend this law further by making a few changes which included the enlargement of the scope of the definition of “the debt” and also to extend the application of the law to all the Licensed Specialised Banks failed as the Supreme Court struck down some of the provisions of the amending bill as unconstitutional and declared that the same cannot be passed by a simple majority but only by a special majority.

##### 4.3.2 Non Judicial Collection Techniques

###### 4.3.2.1 Bankers Lien

4.3.2.1.1. A banker's lien has been judicially recognised for a long time. Bankers have a general lien on all securities deposited with them, as bankers, by a customer, unless, there be an express contract, or circumstances that show an implied contract, inconsistent with lien.

4.3.2.1.2 The lien applies only to the securities which came into a banker's hands in the ordinary course of business. If the securities were handed to a bank for a special purpose (i.e. for safe custody), no lien could be exercised. If securities are deposited for a particular loan or an advance never granted the right of lien cannot be exercised in respect of some other loan or advance. The difficulty arises in deciding exactly what securities are subject to the banker's lien. According to the leading authority on Banking, Paget, "the better view would seem to be that the lien only attaches to such securities as a banker ordinarily deals with for his customer, otherwise than for safe custody when there is no question or contemplation of indebtedness on the part of the customer."

###### 4.3.2.2 Set Off

The right of set-off of a bank against its customer arises from their relationship which is that of debtor and creditor. The right of a bank to look upon any credit balance as security is a right of set-off, which is also known as the right of combination of accounts. Monies deposited by a customer becomes the property of the bank subject to the bank's obligation to repay the customer upon demand or within the agreed period of notice in the case of a deposit. Lord Denning M.R. said in the case of *Halesowen Presswork Assemblies Ltd V. Westminster Bank Ltd* (1970) 3 WLR 625:-

"Using this phraseology, the question in this case is: suppose a customer has one account in credit and another in debit. Has the banker a right to combine the two accounts? so that he can set off the debit against the credit and be liable only for the balance ? the answer to this question is: yes, the banker has a right to combine the two accounts whenever he pleases, and to set off one against the other, unless he has made some agreement, express or implied to keep them separate".

## 5.0 **Liquidation**

### 5.1 Principal Laws Governing Liquidation

#### 5.1.1 **Laws which apply to formal or judicial liquidations**

The Companies Act No. 17 of 1982 (as amended) and the Winding-up Rules made in 1939 under the repealed Companies Ordinance, which are still in force, having been adopted under the Companies Act. (Please see paragraph 1.2.1 also).

#### 5.1.2 **Certain BOI Companies exempted from Winding-up**

Section 17 of the Board of Investment of Sri Lanka Law empowers the Board of Investment of Sri Lanka ("BOI") to enter into agreements with any enterprise and to grant exemptions from any law referred to in Schedule B thereto or to modify or vary the application of any such laws, to such enterprise in accordance with such regulations as may be made by the Minister in charge of the subject of the BOI. Every such agreement is reduced to writing and constitutes a valid and binding contract between the BOI and the enterprise upon registration of such agreement with the BOI.

One of the laws referred to in the Schedule B is the Companies Ordinance but the Companies Ordinance has been replaced by the Companies Act No. 17 of 1982. In terms of Section 16(1) of the Interpretation Ordinance, where in a written law or document reference is made to any written law which is subsequently repealed, such references shall be deemed to be made to the written law by which the repeal is effected or to the corresponding portion thereof. Accordingly the reference to the Companies Ordinance in the said Schedule B is deemed to be a reference to the Companies Act No. 17 of 1982.

In terms of the Board of Investment of Sri Lanka Regulation No. 2 of 1984, gazetted on 8<sup>th</sup> April 1994, the BOI may embody or incorporate in any agreement entered in terms of Section 17 of the aforesaid Law, with an enterprise, if such enterprise is a resident company and which in accordance with such agreement has invested or intends to invest in Sri Lanka within the period specified in such agreement, not less than (50) fifty million United States Dollars or its equivalent in any other foreign currency, to meet the cost of any project approved by the BOI (hereinafter referred to as a "flagship company"), the following provisions:-

- (i) that the number of contributories who may present a petition for the winding-up of a flagship company on the ground specified in Sub-section (f) of Section 255 of the Companies Act No. 17 of 1982 shall be not less than five contributories holding not less than ten percentum of its issued share capital; and
- (ii) that only a creditor to whom, a flagship company is indebted and is unable to pay a debt of not less than Rupees one (1) million shall be entitled to present a petition for winding-up of a flagship company by Court on the ground specified in Sub-section (c) of Section 255 of the Companies Act, No. 17 of 1982.

Accordingly the provisions contained in Section 255 of the Companies Act stand varied in respect of the BOI enterprises which are flagship companies.

#### 5.1.3 **State Owned Enterprises, Banks and Financial Institutions**

Please see paragraphs 4.1 and 4.12 in respect of liquidation of State-owned enterprises and banks and financial institutions.

#### 5.1.4 **Types of Winding-up**

A company can seek to have itself wound-up either by compulsory winding up or under supervision of Court or voluntarily

We elaborate on those three types of winding up below:

##### 5.1.4.1 **Compulsory Winding-up by Court**

###### 5.1.4.1.1 **A company may be wound up by court if**

- (a) the company has, by special resolution, resolved that it be wound up by court; or
- (b) default is made in delivering the statutory report to the Registrar or in holding the statutory meeting; or
- (c) the company does not commence its business within a year from its incorporation, or suspends its business for one year; or
- (d) the number of members is reduced, in the case of a private company below two or, in the case of a public company below seven or, in the case of a people's company to below fifty; or
- (e) the company is unable to pay its debts (Please see para 3.3.2 below); or
- (f) the court is of the opinion that it is just and equitable that the company be should be wound up.

###### 5.1.4.1.2 **In terms of the provisions of the Companies Act a company shall be deemed to be unable to pay its debts where**

- (a) a creditor, by assignment or otherwise, to whom the company is indebted in a sum exceeding five hundred rupees then due, has served on the company, by leaving it at the registered office of the company, a demand under his hand requiring the company to pay the sum so due, and the company has for three weeks from the date of so leaving, neglected to pay the sum, or to secure or compound for it to the reasonable satisfaction of the creditor; or
- (b) execution or other process issued on a judgment, decree or order of any court in favour of a creditor of the company is returned unsatisfied in whole or in part; or
- (c) it is proved to the satisfaction of the court that the company is unable to pay its debts, and, in determining whether a company is unable to pay its debts, the court shall take into account the contingent and prospective liabilities of the company.

##### 5.1.4.2. **Voluntary Winding-up**

###### 5.1.4.2.1 **A company may be wound up voluntarily -**

- (a) when the period, if any, fixed by its articles for the duration of the company, expires and the company in general meeting has passed a resolution that it be wound up voluntarily; or
- (b) when any event has occurred, on the occurrence of which the articles provide that the company be dissolved, and the company has passed a resolution in general meeting that it be wound up voluntarily; or
- (c) when the company resolves by *special resolution* that it be wound up voluntarily; or
- (d) when the company resolves by *extraordinary resolution* that it cannot, by reason of liabilities, continue its business and that it is advisable to wind up.

5.1.4.2.2 Within the period of five weeks before the passing of the resolution for the voluntary winding up of a company under section 308, the directors of the company or, if the company has more than two directors, the majority of them should, at a meeting of the board, make a statutory declaration that they have made a full inquiry into the company's affairs and that they are of the opinion that the company will be able to pay its debts in full within such period, not exceeding twelve months from the date of commencement of the winding up. This declaration (on Form 66) has to be delivered to the Registrar before the expiry of the period of five weeks, as mentioned above, prior to the passing of the resolution for the voluntary winding up of the company under section 308. The declaration has also to embody a statement of the company's assets and liabilities as at the latest practicable date before the making of the declaration. A winding up, where this declaration has been made and delivered to the Registrar, is called a 'members' voluntary- winding up'. And a winding up, where no such declaration has been so made and delivered, is called a 'creditors' voluntary winding up'. (Please see para 3.1.4.5 below).

5.1.4.2.3 A voluntary winding up is deemed to commence at the time of the passing of the resolution for the winding-up (Vide Section 310)

5.1.4.2.4 In the case of a voluntary winding up, the company should from the date of commencement of winding up cease to carry on its business except so far as may be required for the beneficial winding up thereof. However, the corporate state and corporate power of the Company will continue until such time as the company is dissolved. Any transfer of shares, not being a transfer made to, or with the sanction of the liquidator, will be permitted after the commencement of the winding up and any alteration in the status of the members of the company will be void. (Vide Sections 311 and 312).

## 5.2 Claims in Winding-up

Proving and recognizing of claims in every mode of winding-up.

Debts of all descriptions should be proved in every winding up as provided for in section 345.

Section 346 extends the application of Insolvency Ordinance in respect of the insolvency of the of the estates of individuals adjudged as insolvent shall be observed with regard to the rights of secured and unsecured creditors and to debts provable etc.. in winding up of companies also.

However, Section 347 provides that in a winding up there shall be paid in priority to all other debts the following:-

- (a) Income tax
- (b) Business Turnover Tax (now Value Added Tax)
- (c) All rates or taxes (other than income tax) payable within the 12 months prior to the relevant date up to a sum of Rs. 2000.00
- (d) All dues to the Government of Sri Lanka for services given or rendered periodically.
- (e) All provident fund dues, gratuity payments and industrial court awards payable to any employee or workman.
- (f) All wages or salaries to employees as specified in that Section the 4 months
- (g) All accrued holiday remuneration as specified in that section.
- (h) Workmen's compensation as specified in that section.

The abovementioned priority debts rank equally among themselves and have priority over the claims of holders of debentures under any floating charge.

Subject to the retention of such sum as may be necessary for the costs and expenses of winding up the said priority debts should be discharged forthwith in so far as the assets are sufficient to meet them.

This section also provides that in the event of a landlord or any other person distraining or having distrained on any goods or effects of the company within three months immediately prior to the date of a winding-up order, the debts to which priority is given the provisions of this section shall be a first charge on the goods or effects so distrained on or the proceeds of the sale thereof. Provided that in respect of any money paid under any such charge, the landlord or other person shall have the same rights of priority as the person to whom the payment is made.

Another matter which may be relevant to be referred to here is the position of the first charges under Statutes vis-à-vis mortgages as secured creditors. This question arose in the Court of Appeal in the *Development Finance Corporation of Ceylon and other v. Deputy Commissioner of Inland Revenue and others* CA (SC) Appeal Nos. 437/75(F) 438/75(F) and 439(F) D.C. Colombo Case No. 77764/M, which has been discussed in paragraph 4.1.3 above.

Whether a charge created is a fixed charge or floating charge also will be relevant when coming to determine priorities in a winding-up of a company. A fixed charge applies to the property it covers from the point of creation. A fixed charge will usually take priority over a subsequent fixed charge and over any floating charge no matter when created. This is however, subject to the provision, that if a floating charge is created prior to a fixed charge and the floating charge prohibits the creation of any subsequent charge with priority over that floating charge and this condition is actually registered with the prescribed particulars at the company's registry, then that floating charge will take ahead of a subsequent fixed charge.

We should also make note of the provisions of section 350 of the Companies Act No. 17 of 1982 on effect of a floating charge created within twelve months of winding-up and the provisions of section 347 of the Act which deals with preferential claims. Similar provisions are generally found in the companies laws of the other countries too.

It is important to have any charge created by a company registered in Sri Lanka in compliance with the provisions of section 91 of the Companies Act. Those provisions apply to charges created on lands, book debts and assets of the company. Even if the property of the company is situated outside Sri Lanka or the charge is created outside Sri Lanka the provisions of the section 91 apply with certain modifications as to the stipulated period of time for registration. In the absence of such registration the charge is so far as any security on the conveyer's property or undertaking is conferred thereby, void against the liquidator and any creditor of the company.

### **5.3 Effect of winding up on antecedent and other transactions:**

Section 348 declares that any conveyance, mortgage, delivery of goods, payment, execution or other act relating to property which would, if made or done by or against an individual, be deemed in his insolvency a fraudulent preference, shall if made or done by or against a company, be deemed, in the event of its being wound up, a fraudulent preference of its creditors, and be invalid accordingly.

It might also be noted that for the purposes of this section, the commencement of the winding up shall be deemed to correspond with the act of insolvency in the case of an individual.

Any conveyance or assignment by a company of all its property to trustees for the benefit of all its creditors shall be void to all intents.

Liabilities and rights of fraudulently preferred persons is covered by section 348 are set out in section 349. It is also relevant to refer to section 350 which provides that where a company is being wound up a floating charge on the undertaking or property of the company created within twelve months of the date of commencement of the winding up, shall, unless it is proved that the company immediately after the creation of the charge was solvent, be invalid except to the amount of any cash paid to the company at the time of, or subsequently to the creation of, and in consideration for, the charge, together with interest per annum on that amount at the legal rate.

Section 351 contains provisions in respect of onerous property and Section 352 contains restrictions of rights of creditors as to extension or attachment in case of a company wound up.

Sections 354 to 360 contain offences by officers antecedent to and in the course of winding up which make the officers of the companies liable to be punished for fraudulent acts referred to therein.

### **5.4 Wishes of creditors and Contributors**

Section 371 provides that court may, as to all matters relating to the winding up of the company, have regard to the wishes of the creditors or contributories of the company and direct meetings of the creditors or contributories be held. In the case of those meetings regard will be had to the value of each creditors debt and in the case of contributories regard will be had to the number of votes conferred on each contributory by this Act or the articles.

## **6.0 REHABILITATION/COMPOSITIONS/SCHEMES**

Although Sri Lanka does not have any general legal framework for rehabilitation/compositions/schemes the following are relevant to be referred to here:-

### **6.1 Power to Compromise with Creditors and Members – Sections 206 and 207 of the Companies Act**

1. The sections 206 and 207 of the Companies Act contains provisions in respect of power to compromise with Creditors and Members.

2. If a compromise or arrangement is proposed between a company and its creditors or between the company and its members, or between the company and both its creditors and members, the court may, on the application of any creditor or a member of the company, or its liquidator, order a meeting of the creditors or of the company's member to be summoned for the purpose of sanctioning such compromise or arrangement.

3. If a majority, representing three-fourths in value of the creditors or members, voting either in person or by proxy, agrees to any compromise or arrangement, such compromise or arrangement will, if sanctioned by court, be binding on the creditors or on the members or on the liquidator. Such a court order will have no effect until a certified copy therefore is delivered to the Registrar of Companies for registration. A copy of such order has to be annexed to every copy of the company's memorandum issued after the making of the order.

4. The expression 'arrangement' includes any reorganization of the share capital of a company by the consolidation of shares of different classes, or by the division of shares into shares of different classes, or by both these methods.

5. If a meeting of creditors or members is summoned as mentioned above, the company is obliged to send to every creditor or member, together with the notice of the meeting, a statement explaining the effect of the compromise or arrangement so far as it influences the material interests of the directors, whether as directors or as member or as creditors of the company, as against the material interests of other persons.

#### 6.2 **Reconstructions and Amalgamations (Mergers)** – *Sections 208 and 209 of the Companies Act*

1. Provision for reconstructions and amalgamations are found in sections 208 and 209 of the Companies Act.

2. Where a compromise or arrangement, as referred to in the preceding paragraph is shown to court as a scheme for the reconstruction of any company or companies or for the amalgamation (merger) of any two or more companies and that, under that scheme, the whole or any part of the undertaking or property of any company involved in the scheme is to be transferred to another company, the court may, by the order sanctioning the compromise or arrangement make provision for all or any of the several matters outlined under paragraphs (a) to (f) of section 08(1).

Where a scheme or contract involving the transfer of shares in a company to another company has been approved by the holders of shares in the transferor company in terms of section 209(1), the shares held by any dissentients to the scheme or contract can be acquired by the transferee company as provided for under the same section.

#### 6.3 **To manage mortgaged properties** – *Section 5 of the Recovery of Loans by Banks (Special Provisions) Act No. 4 of 1990*

The provisions are found in section 5 of the Recovery of Loans by Banks (Special Provisions) Act No. 4 of 1990 (as amended by the Act No. 24 of 1995) for a Board of Directors of a Bank-Mortgagee to take possession of mortgaged property and control and manage the same. If the loan is granted to any agricultural or industrial undertaking on the security of any plant, machinery or other movable property, the Board of the Bank-Mortgagee can authorize any person to take possession thereof and manage and control such undertaking.

#### 6.4 **Tourist Development Act**

Special provisions have been made in the Tourist Development Act No. 14 of 1968 (as amended) in respect of loans by an approved credit agency on the security of land alienated by the Ceylon Tourist Board. The provisions which are similar to those contained in the Recovery of Loans by Banks (Special Provisions) Act No. 4 of 1990, inter alia, authorizes the Lender to authorized a Manager to take possession and manage the mortgaged property.

#### 6.5 **Orders in Applications** *under Sections 210 and 211 of the Companies Act.*

In applications made to court under Sections 210 and 211 of the Companies Act the Court has wide powers to make orders in respect of, inter alia, the regulation and conduct of the affairs of a company. This is in addition to the power to give remedies for oppression or mismanagement under section 210 of 211 of the Companies Act.

#### 6.1.6 **Stepping-in-arrangements for BOI Enterprises.**

In most of the infrastructure projects the BOI agrees to stepping-in arrangements for creditors of a BOI Enterprise. This is included in the BOI Agreements.

## 6.7 Rehabilitation of non-performing or under-performing businesses

### Under the Inland Revenue Act

Exemption is granted from income tax for acquisition of non-performing or under performing business enterprises engaged in specific areas of activity for rehabilitation as provided for in terms of section 21E of the Inland Revenue act No. 38 of 2000 (as amended by the Act No. 19 of 2003).

### Exemption from income tax of any company acquiring non-performing or under performing business enterprises.

The profits and income of any trade or business (other than any profits from the sale of capital assets) of a company which acquires a non-performing or under performing business enterprise engaged in a specific area of activity, to rehabilitate such enterprise (subject to terms approved by the Minister and subject to adequate provision being made to meet the statutory liabilities outstanding at the time of acquisition of such enterprise) shall be exempt from income tax, for a period of three years, where the acquisition has been completed and commercial operations have commenced on or before 31<sup>st</sup> March 2004.

The said period of three years referred to above shall be reckoned from the year of assessment in which the acquired enterprise commences to make profits or any year of assessment, not later than two years reckoned from the date on which each enterprise commences commercial operations whichever is earlier.

## 6.8 Bank Restructuring

Two Licensed Commercial Banks, i.e. Union Bank of Colombo Ltd (UBCL) and the National Mercantile Bank Ltd. (MERC) were successfully recapitalized and restructured with the assistance of two established large banks. This restructuring was carried out under the supervision of BSD and was facilitated by the necessary regulatory approvals of the Monetary Board.,

- i. The UBCL was recapitalized and restructured by a consortium of investors led by the Sampath Bank Ltd. (a LCB) in August 2003. Accordingly, the consortium infused fresh equity capital of Rs. 252 mn subscribing to a different class of ordinary shares. Further, Rs. 100 mn of capital in the form of debenture proceeds was infused, increasing the total new capital fusion to Rs. 625 mn. The resolution of non-performing loans of the UBCL was accomplished through the establishment of a Special Purpose Vehicle Company (SPV) to which the non-performing loans were transferred. This capitalisation and restructuring process successfully transformed the weak financial position of the UBCL by restoring the capital adequacy ratio to over the statutory minimum requirement of 10% and reducing non-performing loans considerably.
- ii. The MERC Bank was recapitalised and restructured by the DFCC Bank (a LSB) by the acquisition of a 94% stake of MERC Bank to make it a subsidiary of the DFCC Bank. Consequent to the recapitalisation, the capital position of the MERRC Bank rose to a level adequate to restore its capital adequacy ratio to over the statutory minimum requirement of 10 per cent. The Board of Directors of MERC Bank was also reconstituted to allow for adequate representation from the DFCC Bank. Later, the corporate name of MERC Bank was changed to DFCC Vardhana Bank Ltd. Its operations which were carried out through 3 branches at the time of restructuring were expanded with 4 more branches established at the premises of 4 branches of the DFCC Bank

## 6.9 Proposed Reforms

The Central Bank of Sri Lanka has constituted a special committee consisting of representatives of stake holders (viz: Banks, Chambers of Commerce, Bar Association of Sri Lanka) to suggest legal reforms to make the recovery process of loans more effective and at the same time to work out a legal scheme for restructuring of sick industries. BRIPASL (Business Recovery and Insolvency Practitioners Association of Sri Lanka) is assisting this committee in formulating a scheme for restructuring the sick industries.

## 7.0 **Insolvency Treatment**

### 7.1 **State-owned Enterprises**

This aspect is governed by the Statutes, if any, separately governing the respective enterprises. If there is no separate statute the general statutes would apply. If the Government ceases to hold more than 20% of the capital of the Corporation, the Corporation's business has to be transferred to a Company and the Corporation should be dissolved as provided for in Part IV of the Government-Sponsored Corporations Act No. 19 of 1995 (as amended). Where the appropriate Minister considers that the activities of a Public Corporation should be terminated, the Minister may, as provided for in Section 19 of the Finance Act No. 38 of 1971 (as amended), under the authority of a resolution passed by the Parliament, dissolve the Corporation and appoint one or more persons to be the liquidator or liquidators of the Corporation. The Liquidator's powers and closure of liquidation are provided for in Sections 20 and 21 of the said Finance Act.

### 7.2 **Licensed Commercial Banks**

Voluntary liquidation of a Licensed Commercial Bank incorporated in Sri Lanka is possible only with the prior authorization granted in writing by the Monetary Board as provided for in section 51 of the Banking Act No. 30 of 1988 (as amended). Provisions for compulsory liquidation of a Licensed Commercial Bank are contained in section 56 of the said Banking Act. The liquidation proceedings are to be carried out in terms of the provisions of the Banking Act. While Section 12(1) of the Banking Act empowers the Monetary Board to give (with the concurrence of the Minister) the approval for a closure of a branch of a Licensed Commercial Bank, Section 70 of the said Act sets out the procedure for closure of business of Licensed Commercial Banks incorporated outside Sri Lanka with the approval of the Monetary Board.

It must be noted that the provisions contained in Part VIII of the Banking Act in respect of liquidation of Licensed Commercial Banks incorporated within Sri Lanka and closure of branches of Licensed Commercial Banks incorporated outside Sri Lanka, prevail over the provisions of the Companies Act and the Monetary Law.

### 7.3 **Finance Companies**

Section 18 of the Finance Companies Act No. 18 of 1998 (as amended) empowers the Director (who is the head of the Department of the Central Bank of Sri Lanka to which the subject of Finance Companies is assigned) to take steps for winding up of a Finance Company. Furthermore Section 20 of the same Act empowers the Monetary Board to take over administration and management of a Finance Company.

## 8. **Accountability and Reporting Process**

### 8.1 **Prudential Regulations And Directions issued by the Central Bank**

The Banking Supervision Division of the Central Bank of Sri Lanka (BSD) continued to monitor compliance by banks with regulatory requirements introduced from time to time under the provisions of the banking act and other prudential directions applicable to capital, liquidity, large exposures, share ownership in banks, investments in shares by banks, asset quality, income recognition, provisioning for bad and doubtful debts, related party transactions, acquisition of immovable property, disclosure of quarterly and annual financial statements and the audit of banks.

Directions and other Prudential Requirements issued during the year 2003

During the year under review, the following directions and determinations of the Monetary Board and prudential requirements were issued by the BSD:

i. Amendment to Schedule II, relating to Valuation of Securities for Provisioning Purposes, in the Directions on Suspension of Interest on Non-Performing Advances and Classification of Bad and Doubtful Advances for Provisioning Purposes. This amendment effected the following:-

(a) At the time of first provisioning for a loan secured against a primary mortgage over property, only 75% of the forced sale value (FSV) of the property based on a current professional valuation report can be considered as the value of security.

(b) When a loan is transferred to the “Loss” category, (i.e. where a loan has been non-performing for 18 months or more) the following progressive discounts will apply to the FSV of immovable property held as collateral, based on a current professional valuation report. A current professional valuation report is a report that is not more than four years old in respect of loans for residential purposes granted against residential property occupied by the borrower and in respect of loans granted for all other purposes, it is a report that is not more than three years old.

No. of years in “Loss” category	% of immovable property that can be counted as the value of security
1-2 years	60%
2-3 years	50%
3-4 years	40%

(c) With regard to loans in the “Loss” category for more than 4 years, all immovable property held as collateral should be reviewed on a regular basis and discounted further at the discretion of the Management.

ii. Directions in the Single Borrower Limit were amended to incorporate the following in respect of licensed commercial banks incorporated in Sri Lanka and licensed specialized banks:

(a) Funds realized from a new share issue or a rights issue may be considered as capital funds for the computation of the Single Borrower Limit effective from the date on which the proceeds of the share issue were received by the bank and accounted for in its books.

(b) A bank’s current year’s profits could be considered in the capital funds for the computation of the Single Borrower Limit to the extent that the External Auditors of the bank have certified such profits as being capitalized profits as at the date of certification

(c) Further if a bank incurs losses during the current year or if there is any reduction in the retained profits due to payment of dividends etc., capital funds considered for the computation of the Single Borrower Limit should be reduced accordingly to reflect the reduction.

(i) Requirements relating to maintenance of statutory Liquid Assets of off-shore banking units (OSBU) of licensed commercial banks were amended to provide for the maintenance of foreign currency liquidity for OSBUs liabilities and rupee liquidity for liabilities of domestic banking units, and for the expansion of the definition of liquid assets to accommodate specified instruments.

(ii) Guidelines on “Know Your Customer Rules (KYC)” relating to certificates of Deposit (CDs) were introduced. Licensed commercial banks and licensed specialized banks were required to satisfy themselves with KYC in respect of customers who invest in CDs with banks, and of persons encashing CVDS, issued on 30<sup>th</sup> June, 2003 and thereafter.

(iii) Public Disclosure by Publication of Financial Statements in the Press. All LCBs and LSBs were informed that their financial statements should be published in the press on a quarterly basis within two months of the end of each quarter.

(iv) Display of Interest Rates and Exchange Rates. All Licensed Commercial Banks (LCBs) and Licensed Specialised Banks (LSBs) were requested to compile a representative list of their interest rates on deposits and advances and in the case of LCBs their buying and selling rates for foreign currencies as well, and to display such information to the general public in all branches and other banking outlets commencing from 1<sup>st</sup> January 2004 the latest.

Under the off-site surveillance system, the BSD continued to monitor the financial condition of LCBs and LSBs on the basis of periodic information provided by the banks on their operations. In terms of the provisions of the Monetary Law Act, all licensed commercial banks are subject to statutory examinations, i.e. on-site examinations, at least once during each examination period as determined by the Monetary Board, which at present is two years, or if the necessity arises, at a lesser interval. On-site examinations on licensed specialized banks are conducted in terms of the provisions of the Banking act.

*Source: Central Bank Annual Report - 2003*

## 8.2 Credit Rating

Deposit taking institutions are required to obtain a credit rating and publish the rating obtained as per the Budget 2003. By end-February 2004, Fitch Ratings Lanka Ltd., had published 10 entity ratings given to financial institutions. It had also published 3 other entity ratings given to corporates. It is also now mandatory to obtain a credit rating for issues of all varieties of debt instruments, except for those issued by the government, where the value exceeds Rs. 100 million. Amongst the issue ratings published up to February 2004 were the five year debentures of Sri Lanka Telecom Ltd. issued in 2000 and listed on the CSE (SL AA+), the issue of 100 million preference shares of Rs. 10 each of Commercial Bank of Ceylon Ltd. issued in 2003 and listed on the CSE (SL AA-), the five year debentures of Commercial Bank of Ceylon Ltd. issued in 2003 and listed on the CSE (SL AA), Rs. 400 million debentures of Aitken Spence & Company Ltd. issued in 2002 and listed on the CSE (SL AA). And the three year debentures of Singer Sri Lanka Ltd. issued in 2002 (SL A). Fitch Ratings Lanka Ltd., is the only rating company operating in Sri Lanka, at present.

## 9.0 CROSS BORDER INSOLVENCY

There is no legal provision or recognition in respect of the matters raised in this paragraph. However, we briefly set out the law applicable in respect of reciprocal enforcement of judgments.

### RECOGNITION OF FOREIGN JUDGMENTS OR ORDERS

Foreign judgments can be enforced in Sri Lanka only if such enforcement is permitted under the Reciprocal Enforcement of Judgments Ordinance.

The Ordinance provides that where a judgment has been obtained in a superior court in the United Kingdom, the judgment creditor may apply to have the judgment registered in Sri Lanka at any time within twelve months after the date of the judgment or such longer period as may be allowed by the court. Upon registration the judgment is of the same force and effect as if it had been a judgment originally obtained in Sri Lanka.

The same ordinance provides that the ordinance may by declaration of the Minister be extended to judgments obtained in a superior court in any other part of the Commonwealth in like manner as it extends to judgments obtained in the United Kingdom. So far the Ordinance has been extended by orders and made under the provisions of Section 6 of the Act only to the following countries:-

<u>Country</u>	<u>Number and date of Gazette</u>	
Hong Kong	7,442	January 23, 1925
Mauritius	7,444	January 30, 1925
New South Wales	7,489	October 2, 1925
Straits Settlements	7,427	October 31, 1924
Tanganyika	7,448	February 27, 1925
Uganda	7,448	February 27, 1925
Victoria	7,587	June 10, 1927

Federation of Malaya	10,127	July 21, 1950
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It is important to note that an insolvency order or winding-up order does not fall within a scope of a “judgment” under this Ordinance because of the definition thereof which we quote below:

*“judgment” means any judgment, decree, or order given or made by a court in any civil proceedings, whether before or after the passing of this Ordinance, **whereby any sum of money is made payable**, and includes an award in proceedings on an arbitration if the award has, in pursuance of the law in force in the place where it was made, become enforceable in the same manner as a judgment given by a court in that place.”* (emphasis is ours)