Insolvency & Restructuring - Nigeria

Insolvency of Capital Market Intermediaries and Adequate Protection for Investors

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This update focuses on the treatment of account holders in the event of insolvency and includes an overview of the General Insolvency Framework and the special protection afforded to account holders in the banking and capital markets industries through special statutes, such as:

- the Banks and Other Financial Institutions Act;
- the Nigeria Deposit Insurance Corporation Act;
- the Investments and Securities Act 2007; and
- the Securities and Exchange Commission (SEC) Rules and Regulations.

This update also analyzes the potential impact of the International Institute for the Unification of Private Law (UNIDROIT) Convention on Nigerian insolvency practices, particularly as it concerns dealings in corporate securities and priority rules in the event of the insolvency of intermediaries.

The meaning of the term 'bankruptcy' in Nigerian law refers only to individual insolvency, as distinct from corporate insolvency, by virtue of the Bankruptcy Act 1992. Indeed, the generic term 'insolvency' is scarcely used, even with reference to corporate insolvency, which, in Nigeria, includes:

- arrangements and compromises;
- receiverships;
- winding-ups and company liquidations; and
- certain aspects of corporate restructuring and mergers and acquisitions, excluding the UK concept of administration.

Two statutes set out the ordinary legal framework for insolvency in Nigeria (ie, general corporate insolvency within the direct holding system of corporate securities). These are the Company and Allied Matters Act Cap C20 Laws of the Federation of Nigeria 2004 (which creates a general framework for dealing with corporate business reorganization and insolvency, particularly Part XIV to XVI thereof) and the Companies Winding-Up Rules 2001.

Within this general framework, dealings in securities are dependent on certificated securities or transactions where an investor deals directly in the securities of the issuer company and is recognized either as a member or as a secured creditor of the debtor company in the relevant registers(1) of the company with the attendant rights attached to its class of securities.

Under normal law, in a best case scenario the administration and management of the undertaking would be subject to one of the following:

- a temporary takeover of control;
- a joint management by the secured creditor for the purpose of liquidation of the secured obligation of the company; or
- a restructuring of the undertaking and the rights of classes of member, debenture holder and creditor (receivership or arrangement/compromises).

To a large extent, these scenarios entail (i) the collaboration of the insolvent company with several other stakeholders, such as institutional creditors or regulators, secured creditors, trade (ie, unsecured) creditors and employees, and (ii) a balancing act with regards to the different interests. In the worst case scenario the general insolvency law requires the compulsory or voluntary winding-up of the insolvent company and the establishment of priority rules to guide the redistribution of proceeds realized from the assets of the failed company.(2)

By virtue of these provisions, preference is given to secured creditors holding either a legal mortgage or debenture on the company's specific assets, followed by the costs, expenses and remuneration of the liquidators arising from the insolvency administration (receivership, winding-up or liquidation), followed by state revenue and labour claims, which rank equally. Trade creditors and holders of floating debentures are at the bottom of the pyramid, followed finally by contributories.

Thus, the implication of the priority rule under the general corporate insolvency law is that general creditors (both direct shareholders and indirect account holders) are greatly at risk, usually when the assets of the insolvent company are insufficient to meet its liabilities. As capital markets investors holding securities through intermediaries would mostly be treated as trade creditors, it follows that no assurance or special protection is given to this special breed of investors which operate in an environment typically characterized by the dematerialization and immobilization of securities.

Regarding insolvency of intermediaries, the relevant technique used under the Investments and Securities Act is the doctrine of segregation of assets of the intermediary, with regards to securities held on behalf of investors or account holders. The intermediary is also obliged to operate a trust account in which investors' funds are held. The relevant provisions are Sections 39 to 43 of the Investments and Securities Act on segregation of accounts by capital market operators(3) and the SEC rules which oblige intermediaries to keep separate accounts. Non-compliance is heavily penalized under Sections 39(4) and (5) of the Investment and Securities Act. Where the intermediary makes a withdrawal of money from a trust account without authority, it is criminally liable under Section 40(5) and Section 41.

Section 42 creates the priority rule that, subject to lawful claim and right of lien, money in a trust account is unavailable for the payment of the intermediary's debt.(4)

However, this rules creates a conflict with the general laws of Section 86 of the Company and Allied Matters Act, which require registration of securities by holders in order for legal rights to be attached to the securities. Several other Investments and Securities Act provisions are also in direct conflict with the general law,(5) in that the inherent features of capital market dealings in securities (premised on a dematerialized environment) are not contemplated by the certificated and direct holding system of the general law.

While the conflict is adequately resolved in the banking scenario due to Section 55(2) of the Banking and Other Financial Institutions Act, the same does not apply to the segregation provisions of the Investments and Securities Act.

Thus, although theoretically Section 42 of the Investments and Securities Act may be interpreted to mean that account holders (to the exclusion of all others, including insolvency administrators in the context of winding-up under Sections 484 and 494 of the Company and Allied Matters Act) are seen as secured creditors for a certain category of assets (securities or cash held in trust accounts) held by the intermediary in practice, there may be a challenge posed by the loophole in the relatively recent and not yet sufficiently tested litigation aspects of the Investments and Securities Act.

In view of the challenges, the existing conflicts between the general law (direct holding system) and the special law (indirect holding system) and the substantial deficiencies observed, the UNIDROIT convention will have no practical effect unless the municipal law is reformed with regards to Article 7, which preserves municipal procedural and substantive law of insolvency, and Article 21, which sets out guiding principles and establishes the rights of the account holder against insolvency administrators and secured creditors and reserves the right of the insolvency administrator to challenge transactions, thereby jeopardizing the overall objective of the priority of protection of the investor.

An urgent amendment of the general law is needed or, ideally, the creation of several statutes, including a parallel statute for uncertificated securities to deal with the issues described and to articulate a legal framework for dealings in an intermediated and dematerialized environment. In particular, on matters of priority of creditors, the general law should be subjugated to the interest of account holders in intermediated securities.

It is commercially imperative that the government fully integrate its securities exchange and economy into the global market and attract the requisite foreign direct investment that would lead to sustainable growth.

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Endnotes

(1) Sections 79(2), 91, 151, 152 and 169 of the Company and Allied Matters Act.

(2) Sections 484, 494 and 495 primarily, but also Sections 393(1), 402 to 404, 413, 414 and 448 of the Company and Allied Matters Act.

(3) Other provisions of the Investments and Securities Act seek adequately to protect

investors, such as:

- the creation of an Investors Protection Fund;
- the expanded management takeover control provisions given to the SEC;
- the creation of statutory civil and criminal liability for professionals dealing in the capital market; and
- the SEC Rules and Regulations on capitalization of the intermediaries.

(4) See Rule 207A (8) on segregation of accounts by custodians and Rule 207B (18) on segregation of accounts by market participants.

(5) Section 55 of the Investments and Securities Act and SEC Rule 98 on the electronic transfer of securities.