

# Contract Enforcement

The Practicalities of Dealing with Commercial Disputes  
in Nepal

Anita Krishnan, Kathryn Connelly & Surath Giri



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# Contents

<i>About the Authors</i>	<i>iv</i>
<i>Acknowledgement</i>	<i>v</i>
<i>Preface</i>	<i>vii</i>
<i>Abbreviations &amp; Acronyms</i>	<i>ix</i>
<i>List of Tables &amp; Figures</i>	<i>ix</i>
<b>1. Introduction</b>	<b>1</b>
<b>2. Reasons for Breakdown</b>	<b>5</b>
<b>3. Nepal's Alternatives to The Public-Order State Contract Enforcement</b>	<b>13</b>
<b>4. State Commitment</b>	<b>25</b>
<b>5. Concluding Remarks</b>	<b>29</b>
<i>References</i>	<i>31</i>
<i>Annexes</i>	<i>33</i>
<i>Samriddhi, The Prosperity Foundation: an introduction</i>	

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# Acknowledgement

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# Preface

As a part of its efforts to raise the economic agendas in Nepal, Samriddhi Foundation is committed to an annual analysis of growth constraints of Nepal along with exploring policy options. This process termed as the 'Nepal Economic Growth Agenda (NEGA)' is an annual effort to identify short term as well as long term policy bottlenecks that hinder Nepal's economic growth. This research paper 'Contract Enforcement: the practicalities of dealing with commercial disputes in Nepal' was prepared as a follow up to the NEGA 2012 and is one of the six cross-cutting issues covered under the NEGA 2013.

NEGA 2012 identified and discussed policy constraints in five growth sectors of Nepal viz. Agriculture, Education, Hydropower, Transport Infrastructure and Tourism. Building on this research, NEGA 2013 focuses on identifying and discussing cross-cutting issues that affect the growth of all five sectors and also makes recommendations to address these issues. The goal of these analysis and papers is to facilitate the creation of a competitive and conducive business environment for Nepal thereby leading to economic growth and prosperity.

The six different issues studied under NEGA 2013 are Industrial Relations, Contract Enforcement, Anti-Competitive Practices, Foreign Direct Investment, Public Enterprises and Regulatory environment for businesses. Each research paper has been prepared in consultation with individuals and groups who are experts or are involved in the particular field.

The six issues studied under NEGA 2013 have been presented as individual research papers that will be combined and presented as NEGA 2013 towards the end of 2013. This research paper on Contract Enforcement was prepared by the team of Ms. Kathryn Connelly, Ms. Anita Krishnan and Mr. Surath Giri.

This paper analyzes contract enforcement in Nepal focusing on the settlement of commercial disputes. While indigenous systems of contract enforcement like

trust and social exclusion are important to facilitate trade, economic growth is better achieved when third party neutral institutions can resolve commercial disputes and contract enforcement at a relatively low cost. The question is whether the Nepali judicial system or alternative dispute resolution mechanism has been able to serve this purpose.

As this paper discusses, Nepal primarily faces three problems in contract enforcement. First, Nepal's government is a known contract defector in itself and members of the government accept bribes and promote favoritism. There are numerous high profile examples of criminals being granted impunity. Second, the courts are cumbersome and crowded and so the monitoring of contracts is both costly and time consuming for the parties to the exchange. Third, informal contract enforcement institutions, such as reputation-based deterrence, are limited in scope. That is, they work well when repeated future exchanges are known, but are inefficient in markets that are largely informal and suffer from huge information asymmetries. If an economy cannot develop its organic, informal contract enforcement institutions into formal practices and institutions, then it will not succeed in economic expansion.

While there are alternative dispute resolution mechanisms that also help enforce contracts, they are not in popular use and are not cost-feasible for low volume transactions. Therefore, this paper focuses on low cost measures like mediation.

Finally the paper also discusses some marginal reforms in the existing state based and alternative dispute resolution mechanism that can bring down the cost of legal recourse and help establish trust in these mechanisms for contract enforcement.

## Abbreviations and Acronyms

ADR	Alternative Dispute Resolution
HEP	Hydro Electric Power
LCs	Letter of Credits
NEA	Nepal Electricity Authority
NEGA	Nepal Economic Growth Agenda
NEPCA	Nepal Council of Arbitration
NMS	Nepal Mediator's Society
OECD	Organization for Economic Cooperation and Development
UNCITRAL	United Nations Commission on International Trade Law
UNCTAD	United Nations Conference on Trade and Development
VDCs	Village Development Committees

*The Nepali year is based on the Bikram Sambat Calendar and is approximately 57 years ahead of the Gregogrian calendar (2062/1/1=2005/4/14)*

## List of Tables & Figures

Table 1: Summary of procedures for enforcing a contract in Nepal—the time and cost

Box 1: Common types of Alternative Dispute Resolution (ADR)



# 1. Introduction

The Nepal Economic Growth Agenda 2012 (Samriddhi, 2012) identified five important sectors of growth through nationwide consultations: agriculture, education, hydropower, infrastructure, and tourism. Contract enforcement is important in creating an environment conducive to the growth of these sectors. Traditionally, informal norms and practices are the basis for contract enforcement. Nepali society has its set of informal constraints that ensure contract enforcement during exchanges. Historically, however, informal contract enforcement has had its limitations depending upon the size and vibrancy of the market. Informal contract enforcement mechanisms depend upon self-enforcing behavior from trust, personal relationships, and the promise of future income through repeated exchanges. Informal constraints have proved to be inefficient in modern economies, which require exchanging with strangers, exchanging over distance and time, and dealing in large quantities. Through assessment of the modern legal and contract enforcement systems in place in Nepal, it is apparent that Nepal's economic growth is stunted by its lack of an established, formal, and low cost system of contract enforcement.

Economic development necessitates institutions that mitigate the risk associated with impersonal and inter-temporal exchange. In *The Wealth of Nations*, Adam Smith first identified specialization and division of labor as the keys to productivity and growth<sup>1</sup>. Economic development

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1 “The certainty of being able to exchange all that surplus part of the produce of his own labor ... for such parts of the produce of other men's labor as he may have occasion for, encourages every man to apply himself to a particular occupation, and to . . . bring to perfection what talent or genius he may have for that particular species of business. . . . The greatest improvement in the productive powers of labor . . . seem to have been the effects of the division of labor. [It is this] which occasions, in a well-governed society, that universal opulence which extends to the lowest ranks of the people” (Smith 1776)

is thus the expansion of an economy to include impersonal and inter-temporal transactions, as specialization forces an expanded trading nexus. These include transactions in which reputation from repeated dealings does not constrain the opportunistic behavior to cheat. The most important institution that mitigates risk is the contract; but an unbiased third party, be it the government or a private institution, must uphold it. In many developed nations, courts are state-run institutions that provide services in case of breach of contract and provide enforcement, and such a set up exists in Nepal. However, there are enforcement breakdowns.

In general, contract enforcement fails for three reasons: one, the unbiased third party institution uses its unequal coercive power with bias and does not use its force to unequivocally protect property rights; two, it is costly to measure compliance and violation; three, societal norms do not constrain the choice set at the moment of opportunism (North 1989). Nepal faces all three of these problems. First, Nepal's government is a known contract defector in itself and members of the government accept bribes and promote favoritism. There are numerous high profile examples of criminals being granted impunity. Second, the courts are cumbersome and crowded and so the monitoring of contracts is both costly and time consuming for the parties to the exchange. Third, informal contract enforcement institutions, such as reputation-based deterrence, are limited in scope. That is, they work well when repeated future exchanges are known, but are inefficient in markets that are largely informal and suffer from huge information asymmetries. If an economy cannot develop its organic, informal contract enforcement institutions into formal practices and institutions, the economic will not succeed in expanding either.

Based upon this understanding, the paper analyzes contract enforcement in Nepal focusing on the settlement of commercial disputes. The problems that have been mentioned in the preceding paragraphs are detailed in the following pages. Also, along with assessing the performance of the courts, alternative methods for settling commercial disputes are discussed. Many countries have adopted alternative commercial dispute resolution mechanisms, and comparatively, Nepal falls short of utilizing

them to its optimal benefit. What impedes such a process? Are the alternatives too expensive, procedures too difficult to comply with, or is choosing an arbitrator/mediator not as easy as it looks on paper—these questions still remain. Through this paper, we not only make an attempt to find answers to the questions noted above but also look briefly into the centuries-old indigenous practices of communities across the country<sup>2</sup>.

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2 What are contract enforcement institutions? According to Greif (2005) there are two types of contract enforcement institutions- organic and designed- and this separation breaks down into public-order and private-order. The organic contract enforcement institutions are the result of the economy co-evolving with social and cultural norms. They are referred to in other literature as informal institutions. The organic contract enforcement institutions then influence the establishment of designed contract enforcement institutions, such as credit card companies or governments. Designed contract enforcement institutions are also called formal institutions and are more efficient and effective for large, dynamic economies. One necessity must, however, accompany formal institutions; this necessity is coercion restraining institutions. The idea is that an institution that is strong enough to coerce a party into fulfilling its contractual obligations is also strong enough to abuse property rights, which undermines the economy. Public-order refers to state institutions where the punishment mechanism is enforced by a third-party; while private-order refers to punishments dispatched internal to the contractual parties. Where public-order institutions are mired in corruption or are slow, private-order institutions can provide increased efficiency. With a large, dynamic economy, however, speed of access to information is necessary to support the efficiency of private-order institutions. Even in the presence of private-order institutions, however, public-order institutions are necessary for economic development.





## 2. Reasons for Breakdown

A contract is an enforceable promise, an exchange of value, and a clear understanding of mutual obligations and expectations<sup>3</sup> (Barton 1983). Written contracts remove ambiguity as to what will be considered a breach of contract. Transactions—big or small, rely on contracts. Ideally, large and dynamic economies will have transactions based on written contracts. This formalization will be capable of clearly presenting information in a state or third-party enforcement measure. Contracts, however, can also be unwritten, and premised on social norms based on reputation and repeated dealings, and therefore enforceable through means other than courts and state agencies, such as economic or social sanctions (Kähkönen 1997). Willingness to comply with a contract is assured only if an enforcement mechanism exists that penalizes the breach of contract. Thus, most national and international traders, especially those with large exchanges, look for strong contract enforcement mechanisms that provide security and predictability.

Formal contracts in Nepal are enforced as per the Contract Act 2056. Individuals usually undertake a cost-benefit analysis to assess whether or not they would want to resort to legal mechanisms for the enforcement of a contract. On an average, the legal fee for contract enforcement ranges above NRs. 10,000. For matters that involve small monetary transactions, individuals find it wiser not to spend time and resources enforcing such contracts through the formal legal system.

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3 The notion of contract used here would include certain legally-implied duties not based on explicit agreement, as well as undertakings such as options that are not strict exchanges and hence may not meet common law standards of consideration, but do meet civil law criteria of mutuality and exchange.

In general, the more complex the economy, the more common is inter-temporal exchange and the more important is the role of designed, third-party contract enforcement (Kähkönen 1997). Informal contract-enforcement institutions can undermine the incentives to invest in designed institutions that support a dynamic economy. Further, if they are the main method of enforcement, they are only efficient in thin markets with repeated exchanges (Greif 2005). As per Satu Kähkönen and Patrick Meagher (1997), factors that play a part in informal contract enforcement would include reputation, personal trust, morality, strong group identity (e.g. religion, race), and built-in collective punishment mechanisms. Similar factors also play a role in the Nepalese market, where informal contract enforcement mechanisms are the norm.

## 2.1 Reputation matters and so does mutual trust

For most of the businesses in Nepal, contracts are based on the informal mechanism of oral commitments. Pankaj Bhatta, a cloth businessman says, *“Written contracts would imply a lack of trust in businesses like ours’; asking any party to sign a formal contract would mean exactly that. In the market, reputation matters most—we have been functioning accordingly.”* On the issue of lack of enforcements, he added, *“The thought of businesses suffering deters people from breaching contracts, and also, word-of-mouth might bring them negative publicity in the market.”*

Businesses, in this regard, depend heavily on personal and family contacts. Repeated dealings and mutual trust keeps such businesses from defaulting. For small businesses, such a system of repeated dealings and trust is more efficient than engaging a designed third-party institution. One implication of this culture is that requiring a written contract would mean the parties do not have community or personal reputation to support their exchange. Suggesting a written contract would actually be to the detriment of the exchange. In order to build trust, small quantities may be entrusted to the parties, and the exchanges would increase as trust is built, until the parties can be trusted with large quantities. This culture undermines

the foundations of international trade, where one must transact in large quantities with unknown parties (Greif 2005).

A written contract is a source of information on the behavior of the parties to the exchange. A written contract specifically explains what will be considered a breach of contract. By opting into an informal contract, a breach is easier. Sajjan Bar Singh Thapa, Senior Lawyer, Legal Research Associates shares, *“Most of the contracts in Nepal are rental contracts. When people rent a house, the contracts are mostly based on negotiations—in terms of tax compliances and rent amount and other terms and conditions. Both the parties fall under obligation in case of having entered into a formal written contract; no wonder people choose to shy away from any form of legal implication post the breach. Not to mention the endless procedures that one has to comply with in terms of getting a written contract written and agreed upon by both the parties!”*

## 2.2 Cost is key

As stated earlier, informal contract enforcement mechanisms can undermine designed or formal mechanisms. Similarly, faulty third-party enforcement in designed institutions can cause informal mechanisms to persist. The choice of the contracting and enforcement mechanism also depends on the cost of using it. The focus is not only on the direct cost (say, a court fee) incurred, but also on transaction costs (for example, time spent in court, bribes, social detriment in escalating disputes) of the service. If transaction costs in the state system are high, individuals and firms will tend to rely on non-state enforcement or on vertical integration where appropriate.

According to data collected by Doing Business<sup>4</sup>, enforcing a contract in Nepal takes 910 days, costs 26.8% of the value of the claim and requires 39 procedures. Globally, Nepal stands 137th in a ranking of 185 economies

<sup>4</sup> Doing Business measures the efficiency of the judicial system in resolving a commercial dispute before local courts. Following the step-by-step evolution of a standardized case study, it collects data relating to the time, cost and procedural complexity of resolving a commercial lawsuit.

on the ease of enforcing contracts. In the subcontinent, Nepal has been doing better than Pakistan and India who rank 155 and 184 respectively (World Bank 2013).

Table 1: Summary of procedures for enforcing a contract in Nepal—the time and cost.

Indicators	Nepal	South Asian average	OECD High Income Average
Time (days)	910	1,075	510
Filing and Service	45	45	
Trial and judgment	500	500	
Enforcement of judgment	365	365	
Cost (% of claim)	26.8	27.2	20.1
Attorney cost (% of claim)	20.8	20.8	
Court cost (% of claim)	3.5		
Enforcement cost (% of claim)	2.5		
Procedures	39	43	31

As per the table, contract enforcement in Nepal requires 910 days on an average—almost three years. Osho Rai, who has been running a stationery shop for over a decade says, *“Who would want to run to the courts for breaches of contracts? Courts take a long time to sort things out. Courts are nothing but a hassle and I have a business to run.”*

When the cost of going through state based mechanisms, say the court, is high and takes longer for the resolution of disputes, people choose not to go through formal contract mechanisms and formal courts in instances of breach. Private-order institutions are used. The complexity of the private-order institutions, whether they are designed or organic, depends upon several factors including the ability to obtain verifiable information and their ability to enforce punishments for breach of contract (Greif 2005).

Oral contract enforcement in Nepal has been provided for by Section 11(c) of the Contract Act 2056. This, however, requires evidence that certain

transactions have taken place e.g. money has been paid, goods have been delivered, or that there exist any other direct or indirect evidence. Most oral contracts are for small transactions—resorting to legal mechanisms in these cases would make the choice for enforcement uneconomical. For example, if a shop does not provide quality goods as per the bargain, the customer will simply not go there again, rather than sue the business in court. Nepal has a large informal market. When the market operates outside the sphere of documentation or legality, it is impractical, and usually illegal, for these parties to take their issue to a state institution.

### 2.3 Coercion works

When formal institutions like courts do not meet the needs of the developing economy and its varied dimensions, the people of Nepal turn to other methods, perhaps in the form of services provided by formal, non-state, or informal mechanisms.

In theory, there are many reasons that state-based institutions like the courts in Nepal are preferred—state institutions are considered predictable, transparent, impartial and low-cost. But as mentioned earlier, years of running to the courts, of keeping up with the endless court procedures and paying lawyers can amount to a considerable sum of money. Aavash Pradhan, an aspiring entrepreneur who has also been studying law says, *“There is a reason why I took up legal studies. Ever since I was a kid, I have seen my father take his monthly salary only to give it to the lawyer who has been handling our old family case for almost three decades.”* He is but one among many who hold the same opinion about the delay of court proceedings in Nepal.

Every year when the Supreme Court of Nepal comes up with its annual reports, the fact becomes clear that court dockets are over-crowded with pending, unresolved cases. In such a scenario, there’s hardly a sense of cost efficiency with state mechanisms.

Coercion often provides the punishment mechanism lacking in state courts. It is often used in cases of informal transactions, agreements between informal enterprises, where third party intermediation is either too slow or not forthcoming due to inefficiency or corruption in the court system. In these cases, the enforcers are thugs, mafia, or even the police (Huang 2012). Resonating with the same notion, various coercive mechanisms have been used in Nepal instead of resorting to courts. Mr. Osho Rai adds, *“There aren’t many contract breaches in not-so-large businesses like ours. Where and when there are, people would rather use threat, violence and intimidation; such can recover the losses for a percentage from the recovered amount. It is a speedy way to ensure that promises are delivered.”* While this may be an alternative for small transactions, it has many implications. One immediate impact of this is the proliferation of violence in society. Another impact is on large-scale transactions. These cannot rely on the local mafia as large transactions fall under the scrutiny of the revenue department.

Most economic transactions are prone to the risk of default by contracting partners, even though it is collectively beneficial for all relevant parties to act honestly. Understanding how to optimally manage such risk is thus essential in achieving efficient outcomes from voluntary exchanges. This problem has been going on in society and may become more severe over time as growing specialization in the economy generates more frequent and complex economic exchanges among agents (Kähkönen 1997).

When it becomes more productive to trade with strangers outside one’s community, the legal system is often relied upon to enforce contracts at the society level. The existence of strong social networks, as in the case of Nepal’s traditionally woven society, does not necessarily reduce overall welfare, but it may slow down the legal development process, since relational-based contracts have a comparative advantage in such an environment (Greif 2005).

An individual or a firm chooses the contracting arrangement, whether a legally-enforceable contract or an informal arrangement, including the enforcement mechanism, from various options dependent

upon the information available and the existing institutional environment. The efficiency of state and non-state arrangements, and thus the choice, depends on the characteristics of the transaction, the cost of using the mechanism, and the fairness and predictability of the outcome along with the social setting. One can see this in the context of Nepal, where values like mutual trust and collective community enforcement matter.





### 3. Nepal's Alternatives to The Public-Order State Contract Enforcement

**F**requently, developing countries like Nepal will find that their state institutions share the overarching weaknesses of the public sector, and often do not provide for predictable contract enforcement. Most people understand this and as the market expands, they will develop private, designed (formal) alternatives.

#### **Box 1: Common types of Alternative Dispute Resolution (ADR)**

**Arbitration** involves using a neutral arbitrator to make a decision about the outcome of the dispute. Once the parties have agreed to the process, arbitration is binding (the decision is final and can be appealed only on very narrow grounds).

**Mediation** is a process in which a neutral mediator helps the parties discuss and find a mutually acceptable solution.

**Conciliation** is a variation of mediation in which a conciliator meets with the parties separately (rather than jointly, as in mediation) and seeks concessions from the parties that would help resolve the dispute. Unlike arbitration, conciliation is not legally binding.

**Early neutral evaluation** is a process in which a case is referred to an expert, usually an attorney, who provides a balanced and unbiased evaluation of the dispute and offers an opinion on the likely outcome of a trial.

*Source: Rozdieczer and Alvarez de la Campa 2006.*

Of the many systems that deal with the inadequacies of the state courts, Alternate Dispute Resolution (ADR) is one. ADR is defined as any process or procedure other than adjudication by a presiding judge in court; litigation in which a neutral third party assists in or decides on the resolution of the issues in dispute (Rozdieczer 2006). ADRs offer a solution to the problem of access to justice faced by citizens in many countries due to three factors: the volume of disputes brought before courts is increasing, the proceedings are becoming lengthier, and the costs incurred by such proceedings are increasing.<sup>5</sup> Among the many different types of ADR processes, the most common are mediation, arbitration, and conciliation. Others include early neutral evaluation, summary jury trial, mini trial and settlement conference.

In Nepal, there are two forms of ADR that require mentioning: arbitration and mediation. **Arbitration** is adopted in commercial disputes that would require a longer duration of time to settle in a formal legal system. An arbitration award is final and binding on parties, but there are some exceptions on its finality provided by statutory provisions regarding legal questions, public interest and public policy. As in the state-system, in arbitration the dispute is decided impartially by a third party who is the arbitrator or umpire. The neutral role of an arbitrator is recognized by Nepal's law even if the arbitrator is appointed by one party. The duty of an arbitrator is not only towards the disputing parties but also towards the fairness of the arbitration process and the public at large.

In the context of the Nepalese legal system, an individual or firm involved in breach of contract has to pay "reasonable" damages to the innocent party as per the Contract Act 2056. Damages are the primary punishment for breach of contract. In Nepal, like in many other countries, a breach of contract does not incur criminal sanction unless fraud is involved. In Nepal, most cross border investments are facilitated by Letters of Credit (LCs). Although there are problems, this system is the prevailing method for most international trade. In complex deals and exchanges with larger companies, pre-drafted contracts are the norm. Many businesses prefer

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5 Green Paper on alternative dispute resolution in civil and commercial matters, 2002.

not to go through the cumbersome court procedures and have been largely arbitrating as an alternate mechanism for enforcing contracts.

In commercial disputes, both parties want disputes settled in an effective, amicable, inexpensive, and expeditious manner. In Nepal, the traditional justice mechanism not only lacks resources but also the technical expertise, many a times falling short of meeting the needs of complex commercial disputes. The arbitral process supplements the traditional system, serving as a cost-effective alternative to lengthy delays and high-priced litigation. Arbitration is a more flexible and adaptable process, capable of accommodating the particular needs of the disputants, the business community, and society at large. The most universally accepted reason favoring commercial arbitration is the relative low cost of the arbitral process versus traditional litigation. Compared to long and expensive court proceedings, arbitration offers a timelier and cost-effective process for settling disputes as opposed to the backlogs, delays and tight budgets that characterize the courts.

Nepal legally recognized arbitration in the Arbitration Act of 1981, which was superseded by the Arbitration Act of 1999, the prevailing general law on commercial arbitration. The Act has been drafted in line with the United Nations Commission on International Trade Law (UNCITRAL) Model law. On the basis of this new act, the Supreme Court of Nepal has promulgated the Arbitration (Court Procedure) Rules, 2002 relating to court procedures in order to promote arbitration in Nepal. Also, because of the New York Convention of 1958 during which Nepal and other countries agreed to uphold foreign arbitral awards, arbitrations have become important in cross-border commercial matters.

Although arbitration is becoming the main alternative to the state court system, there are a few questions that need to be considered. First, **is arbitration more effective?** The effectiveness of arbitration depends on the transaction in question. Arbitration is effective when both parties are creditworthy (big companies) and are undertaking complex deals (which most government judges are not trained to understand), and/or in matters that require confidentiality.

Second, **is arbitration cost efficient?** Anjan Neupane from Neupane Law Associates shares, *“The courts being state run institutions are subsidized by the State/Government. However, parties have to bear the cost of arbitrators themselves. In addition to the lawyers, they also have to bear the judges’/arbitrators’ fees. Usually arbitrators have plenty of time (unlike the court which has to hear several cases in a day) to examine the case and they also take time to deliver good quality judgment because it helps maintain their reputation for the next arbitration dispute. But good arbitrators are not that easy to find and most of those who can be found are very expensive as opposed to court lawyers.”* When arbitration is referred through the court, the fee is charged as per the pre-determined cost structure according to the Arbitration Act of 1999. However, when businesses approach independent arbitrators on their own, outside the reach of standardized costs, the clients are charged based on the particulars of the given case.

The ad-hoc nature of arbitration is a major challenge. Chandeshwor Shrestha, Senior Lawyer, Sreejana Law Firm also asserts the same, *“Most arbitrators deal with disputes on an ad-hoc basis and have other engagements. In contractual disputes that have to do with technical issues, engineers with technical expertise are used as arbitrators. Such an ad-hoc arrangement ceases to exist as soon as the arbitral award is granted. In case of Nepal, because the award can be challenged in court, there have been instances whereby the court has asked for the ad-hoc arbitral committee to come together and re-work on the decision. Such does not fit well with the understood arrangement of the arbitrators.”* He further adds, *“The practice of drafting the contract also needs to be re-thought. Mostly, contracts are copied from elsewhere and do not meet the requirements of the particular case. It leaves spaces for ambiguity and many a times falls short of addressing the issues that may arise from the breach of contract terms.”*

Kamala Upreti, Legal Manager at ZTE Nepal Pvt. Ltd and the former Director of Nepal Council of Arbitration (NEPCA) asserts, *“Having a fully functional commercial court would have made situations much better. But*

6 The market for high end arbitration exists for big commercial disputes and arbitrators charge any amount between NRs. 0.1 million to NRs. 0.5 million on average per case for such disputes

*the fact that we don't have a commercial court and the existent commercial benches are not well-equipped with the needed resources—both in terms of well-qualified judges able to handle commercial disputes and also enough resources—have been creating a lot of hassles to the growth of business.” She adds, “The formal process of contract enforcement like courts, on an average takes around 910 days to solve a case, and as per the requirements arbitral awards are to be granted within 120 days—we can see the difference there. Ideally, arbitration does save the conflicting parties a lot of time and money.”*

A major limitation of arbitration as an alternative to the courts is that the award settlement ultimately rests upon the courts. Due to the over-burdened nature of the courts, the timely implementation of awards is similarly delayed. This has provided a major loophole in the system, and undermines the relative competency of private arbitration in Nepal. It is a challenge that needs to be overcome.

While arbitration is a major caterer to the needs of bigger business communities in Nepal, **mediation** is also a major alternative dispute resolution mechanism. A benefit of mediation is its speed. Ishwori Prasad Bhattarai, Secretary General, Nepal Mediator's Society says, *“Though Arbitration these days has been a catch-phrase in Nepal, it is important that we do not undermine the role of mediation. It provides for third party facilitation and because the final output is based on the consent of both the parties, it is a win-win mechanism for the parties involved in the dispute.”* As a neutral third party, the mediator listens carefully to the parties and facilitates communications that will resolve differences and then assists the parties in reaching an agreeable settlement. However, since this process is not binding, Bhattarai emphasizes that consent does have a vital role to play. He also adds that if no agreement is reached, the case may be referred back to the court.

Nepal is a signatory to the World Trade Organization's agreement, which highlights the use of ADR mechanisms for the settlement of disputes, primarily mediation. The Mediation Act of 2069 has already been passed, but because it has not been published in the Gazette, the act cannot be

implemented. Apart from mediation being practiced through formal channels, the indigenous communities of Nepal also practice community mediation. Nepal is ethnically and linguistically diverse, and the different regions have unique and evolved customs for resolving disputes (Lederach 2012). For example, *Thakalis*, *Magars* and *Tharus*, indigenous communities of Nepal, have traditional institutions that continue to function. Heads of villages, or (ethnic) community organizations such as *mukhiya*, *mahato* or *badghar*, have, since ancient times, been community mediators facilitating discussions among disputing parties. Mediation by local notables, known as *bhaladmi* or *pancha bhaladmi* is also prevalent. These institutions combine mediation, arbitration and even more formal adjudication. Even today, communities beyond the access of centralized legal structures resort to community mediation for the resolution of disputes, commercial or otherwise.

Efforts have also been made to integrate mediation into the community level justice system. The Asia Foundation, for example, since 2002 A.D. has been facilitating community mediation, which now operates in 90 Village Development Committees (VDCs) and municipalities in 12 districts across Nepal. By building capacity among the locals and encouraging the use of locally available resources, community mediation has been able to improve law and order in these communities. Prieti Thapa, Senior Program Officer, The Asia Foundation shares, *“Though initially it was difficult to set up community mediation as such in the communities, over the time we have realized that it has helped build the sense of ownership of community members who have been increasingly accessing such services. People trust such mechanisms as opposed to formal courts and our success rate has been around 83%. Such systems work well within the given community and cannot cover large scale disputes.”*

While the Mediation Act is still in pre-implementation limbo, community based mediations in indigenous communities wait to be developed on a large scale. It remains to be understood whether such practices can cover a wider range of disputes, whether these mediation

practices could be successful across all communities, and whether they can penetrate the inter-community disputes where each community may have different dispute resolution mechanisms. Similar questions of efficacy and efficiency need to be answered. Also, to encourage interpersonal transactions, a standard set of universal rules and norms are needed. These are not likely to be fulfilled by indigenous mediation mechanisms.

### 3.1 Other viable alternatives

As per the Doing Business Report 2013, Bhutan is ranked higher in contract enforcement than Nepal. Since 2005 Bhutan has made enormous strides in contract enforcement. In fact, as per the report, among the 10 economies making the greatest progress in this period, 6 are in Sub-Saharan Africa. The reason was cited as being the introduction of specialized commercial courts or divisions that made it easier to enforce contracts.

Increasing the capacity and specialization of judges, divisions or courts in commercial cases has been a common reform to increase court efficiency in recent years. Two economies implemented such reforms in the past year. Liberia launched a specialized commercial court in November 2011 and has already appointed 3 new judges for the court. In Africa, Cameroon created specialized commercial divisions within its courts, and the Republic of Benin appointed more judges and bailiffs in commercial courts, additionally introducing the concept of managing judges as well as enforcement judges.

Georgia, Poland, the Slovak Republic and Turkey amended the procedural rules applying to commercial cases, mainly to simplify and speed up proceedings and to limit obstructive tactics by the parties to a case. For example, courts are now obliged to deliver a complaint to the defendant in less than 60 days (World Bank 2013).

At low levels of economic development, informal contract enforcement mechanisms may be reasonably good substitutes for formal contract enforcement mechanisms, but become increasingly imperfect

substitutes at higher levels of economic development involving large, long-term, highly asset-specific investments or increasingly complex traded goods and services, especially outside repeated exchange relationships (Greif 2005). A well-established system of enforcement that brings in the best of both the state and non-state institutions with complementary roles is ideal. Having said that, the following are recommendations for increasing the efficiency and efficacy of contract enforcement in Nepal:

### 3.2 Reforms in the existent state-run court system

- A designated commercial court would bring about considerable changes in the settlement of commercial disputes. At present, in the absence of a commercial court, parties in dispute have to appeal to scattered legal authorities to deal with the varied nuances of a commercial dispute. For example, a labor dispute party has to attend labor court, tax disputes are addressed at the Inland Revenue Department, and in the situation of an appeal, the case passes from district to appellate to supreme courts. With an efficient, designated commercial court, the process would be streamlined and discourage improper adjudication due to confusion.

Given that, the current state of the court, management, staffing, and resources will need to improve regardless of whether a commercial bench is added or not. Alleviating the current burden of the courts will also help with commercial disputes, at least until an efficient commercial bench is added. If the commercial bench is added without assessing the needs and problems of the current court, it runs the risk of having the same pitfalls.

- For the enforcement of contracts of low cost transactions, a consumer court with low fees can be a solution. This establishment would entail a simple procedure without lawyers, where each party



represents themselves in front of a judge. The complaint procedure would be simple. This consumer court should have jurisdiction of purely consumer transactions between consumers and businesses for transactions (a limit can be set on the amount of such transactions). In this way, enforcement of small transactions can also be improved and consumer rights can be protected.

### 3.3 Reforms in the Arbitration related laws

- For large commercial disputes, high-end clients pay between NRs 0.1 million to NRs 0.5 million for arbitrators. For smaller disputes, arbitrators can charge as much as NRs. 20,000 each. This amount does not include lawyers' fees for both parties, which would be an additional NRs. 40,000. If the parties want to hire more in-demand arbitrators and lawyers then the cost could be higher. The number of skilled arbitrators in Nepal is limited, and they are therefore able to charge a higher price. If more and better skilled arbitrators are enticed to enter the market, arbitration would become a more feasible solution for people of all economic backgrounds.
- At present, the arbitrators, after the arbitral award has been granted, are required to present all their documents to the district court. However, there is no practice of notifying the court pre-arbitration. This means there is no exact data for the number of cases under arbitration. A simple notification system would help track the number of cases. Chandeshwor Shrestha shares, *"For decades we have been pushing for the establishment of a commercial court. The reasoning against it has been that there lacks volume in terms of commercial disputes. If there existed a proper mechanism to tap in to the number of commercial disputes that are either settled in the court or through Alternate Dispute Resolution (ADR) it would be easier to substantiate that there exist enough such cases and that a commercial court would facilitate the settlement of such disputes in a more efficient manner."*

- Arbitration in Nepal can be challenged in the higher courts on points of law. There have been instances where the parties have resorted to courts endless times in order to challenge the arbitral award. Article 30 of the Arbitration Act, 1999 provides for circumstances in which the decision of the arbitrators may be invalidated. Any party dissatisfied with the arbitrator's decision may, if one wishes to invalidate the decision, file a petition to the Appellate Court within 35 days of the date of decision or notice received. The court under the cited circumstances can invalidate the award granted through arbitration. Such a provision has led to parties filing petitions numerous times and not complying with the arbitral award. In the absence of well-defined clauses, this has lengthened the process. The Arbitration Act needs to be amended to include a clause about the finality of the award.

The United Nations Commission on International Trade Law recommends that courts should be permitted to set aside awards only in limited and precisely defined situations. Otherwise, as has happened in India, litigation over the validity of awards can spiral out of control as the losing side seeks to win in court what it lost at the arbitration table.

- Access to arbitration in a neutral country is often important to foreign investors, who fear that the courts in the country of the investment are biased against them, or are too slow or too inexperienced to hand down a timely and accurate decision. International arbitration has emerged as an important way for investors to reduce the risks of submitting disputes to local courts (UNCTAD, 2003). To improve the investment climate, the government needs to remove obstacles to international arbitration.

Nepal has already ratified the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention) which implies that arbitration awards of Nepal can be enforced in around 150 different countries, and 150 different countries' arbitration awards can be enforced in Nepal. This is an important reason behind the use of arbitration clauses in international/cross-border contracts. It is a major cause for the popularity of arbitration in international commercial contracts. To ensure that cross-border transactions add to the economic growth of the country, Nepal must comply with the provisions of such international conventions.

Where the parties to arbitration or other alternative dispute resolution mechanisms contemplate continued dealings, each has an incentive to abide by the arbitrator's award. Each may also comply because of the effect on its reputation if it refuses to do so. If a party refuses to honor an arbitrator's decision, such a decision runs the risk of other firms viewing it as untrustworthy for future business.

### 3.4 Reforms in the mediation related laws

- The Mediation Act 2069 needs to be implemented. In accordance with the act, it is also imperative that needed policies and directives be drafted to facilitate the process of mediation.
- Successful community mediation practices need to be researched with the aim of understanding the impact parallel judicial mechanisms would have on the state's justice system. If such practices fit the needs of communities, such practices can be facilitated through further research and trainings.



## 4. State Commitment

In the modern economy it is necessary, even given alternatives, that a public-order, third-party designed contract enforcing institution i.e. the state, commits to contract enforcement. The role of the state should be twofold. First, it must curtail private-order contract enforcement institutions from using their coercive economic power to disrupt exchange and efficiency. Second, the state must uphold contract enforcement institutions such as brand names, which act as self-enforcing contracts ensuring a certain quality and trustworthiness. To explain this situation, Greif (2005) explains the credit card company. In the example of one entity engaging in one exchange with another entity with no expectation of future exchanges, the risk of breaching a contract is high. Credit card companies as private-order designed contract enforcement institutions prevent breaches of contract. The party agreeing to pay may not be restrained by future exchanges with the other party, however he/she is restrained by future credit issued by the credit card company.

The credit card issuing company is in a unique position that makes it privy to one's finances and wealth, a position that could afford abuse and weaken property rights. The public-order institution (state) is responsible for preventing these abuses. Additionally, it will protect the brand name of the credit card from forgery, protecting its image and fostering more trust in credit. The public-order institution, that is the government, in its position of economic and coercive power, must be restrained in its behavior as well. People must believe it can credibly commit to upholding contracts and the property rights of the people. These functions are essential for the development of an expanded market. In order for a government to be constrained in its use of coercive power, the asset holders must control the government's administration. The rulers must find it more beneficial to

uphold the rights of the asset holders than to abuse them (Greif 2005). In all of these areas, Nepal fails.

Shashi Sagar Rajbhandari was the former Director of Nepal Electricity Authority (NEA) and is currently associated with Upper Solu Hydro Electric Company under which a 23.5 MW project is under construction. As per his experiences of having worked in the hydropower sector for decades, he opines, *“Look at the Gandak hydropower project as an example—where despite the provisions in the contract no compensation was paid to the people whose lands were taken during the initial days of the project. And then take the super six (Khare Khola, Singati Khola, Maya Khola, Solu, Tallo Solu, and Mewa Khola)—aren’t all these based on government contracts? They are! But the truth remains—there is hardly any enforcement. Not many of the hydropower related contract breaches ever reach the court—it takes around 4-5 years and in instances even 8-10 years for the delivery of justice and with that too we can never be sure if such a decision would in any ways be favorable. The contracts usually have clauses on amicable solutions and arbitration for dispute management to be used as a primary tool and courts are approached only when such a processes of amicable solution and arbitration do not work.”*

He explains that because hydropower projects require large investments and bank loans, it is mandatory that contracts be made and that a formal system of contracting be adopted. Contracts are vital to ensuring security and proper filing of taxes and financial reports. He adds, *“NEA mostly has contracts and so do the other companies. The problem is that not even the government sticks to the contracts. Contract terms are vaguely drafted; it is the government that opens the tender, lays out the contracts but they hardly play by the rules. While tendering, the government commits to a lot, but when it comes to implementation they build excuses—lack of budget, time constraints, and the like. Such instances discourage private sectors from investing in the projects. No wonder the development of the super six has been held back and the problem of load shedding is paramount. The Government needs to keep its end of the bargain if it wants to bring about change.”*

Birendra Bahadur Deoja is an infrastructure specialist who has served in the government and other private organizations. Presently, he is also an arbitrator. He shares, *“As a mechanism, use of formal contracts has been institutionalized in the Nepalese system and various legal mechanisms like the Contract Act and Procurement Act have dealt extensively with the varied nuances of contracting. Arbitration, as well, has been brought into practice. As opposed to our court procedures, arbitration takes a much shorter duration of time and businesses these days put a clause for arbitration in their contracts—it saves them time and the cumbersome court procedures. Especially in the contracts drafted for infrastructural (roads) projects such ADR (Alternate Dispute Resolution) clauses are put in. During the course of the project, however, more than one dispute comes up and in many regards setting up an arbitrary committee for arbitration for each of the dispute is not easy. It is faster than the courts though. Such disputes have to go through the Dispute Board and the Board reels under bureaucratic pressure (it being a part of bureaucracy) in terms of undue intervention and high handedness; the government has enough opportunities to not stand by its part of the bargain.”*

The government cannot commit, and it has used its coercive power abusively. When the state is a party to the contract and the state-based institutions like the judiciary have undue influence from the executive like those evinced by the examples above, non-state institutions that are not influenced by the discretionary powers of the bureaucracy can have a role to play. What constrains the behavior of the government administration is if the asset holders, namely players in the economy, are able to exert influence over the government administration. This will make the government, the third-party enforcer, responsible to the economic participants.





## 5. Concluding Remarks

The formal state system of contract enforcement in Nepal is overburdened and has been unable to build trust as a neutral and efficient agency. These shortcomings inhibit dispute resolution on many levels. Commercial arbitration and mediation saves businesses time and money in resolving commercial disputes, with greater control over outcomes and confidentiality. While ADR will never fully replace litigation, it does provide a cost effective, time-effective adjudication method. Properly run, commercial arbitration and mediation can provide parties with at least as effective legal decision-making as the state court system without the hangover resulting from tight court budgets and the resulting reduced legal services (National Arbitration Forum 2005). For the same reasons, reforms as have been outlined above can help increase the efficiency of commercial dispute settlement. The greater truth, however, remains that people do not have confidence in the formal legal structure. Rule of law and order in Nepal is low, meaning that people do not trust the existent legal structure. This lack of trust undermines many structural reforms. The reforms proposed above will be the first of many steps in the direction of an overall reform targeting efficiency and building confidence in the justice mechanism.



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## Annexes

Annex 1: List of people consulted for “Contract Enforcement: The Practicalities of Dealing with Commercial Dispute in Nepal”

Name	Designation	Organization
Sajjan Bar Singh Thapa	Senior Advocate	Legal Research Associates
Anjan Kumar Dahal	Advocate	CeLRRd
Gyanendra Lal Pradhan	Executive Chairman	Hydro Solutions
Kamala Upreti	Legal Manager	ZTE Nepal Pvt. Ltd
Mr. Toya Nath Adhikari	Deputy Registrar	Company Registrars Office
Umesh Chandra Jha	President	Nepal Law Commission
Dr. Ram Krishna Timalsena	Executive Director/ Principal	National Law College
Anjan Neupane	Lawyer	Neupane Law Associates
Ishwori Prasad Bhattarai	Secretary General	Nepal Mediator’s Society
Anjan Bhattarai	Advocate	Legal Research Associate
Pankaj Bhatta	Owner	Alap Traders
Osho Rai	Owner	Osho Books and Stationaries
Avash Pradhan	Student	Nepal Law Campus
Chandeshwor Shrestha	Senior Lawyer	Sreejana Law Firm
Preeti Thapa	Senior Program Officer and Advocate	The Asia Foundation
Sashi Sagar Rajbhandari		Upper Solu Hydro Electric Company
Birendra Bahadur Deoja	Infrastructure expert	



## Samriddhi, The Prosperity Foundation an introduction

Samriddhi, The Prosperity Foundation is an independent policy institute based in Kathmandu, Nepal. It works with a vision of creating a free and prosperous Nepal.

Initiated in 2007, it formally started its operations in 2008. The specific areas on which the organization works are:

- i. Entrepreneurship development
- ii. Improving business environment
- iii. Economic policy reform
- iv. Promoting discourse on democratic values

Centered on these four core areas, Samriddhi works with a three-pronged approach—Research and Publication, Educational and Training, Advocacy and Public Outreach.

Samriddhi conducts several educational programs on public policy and entrepreneurship. It is dedicated to researching Nepal's economic realities and publishing alternative ideas to resolve Nepal's economic problems. Samriddhi is also known for creating a discourse on contemporary political economic issues through discussions, interaction programs, and several advocacy and outreach activities. With successful programs like “Last Thursdays with an entrepreneur” and “Policy Talkies”, it also holds regular interaction programs bringing together entrepreneurs, politicians, business people, bureaucrats, experts, journalists, and other groups and individuals making an impact in the policy discourse. It also hosts the secretariat of the ‘Campaign for a Livable Nepal’, popularly known as Gari Khana Deu.

One of Samriddhi's award winning programs is a five day residential workshop on economics and entrepreneurship named Arthalya, which intends to create a wave of entrepreneurship and greater participation among young people in the current policy regime.

Samriddhi is also committed towards developing a resource center on political economic issues in Nepal called Political Economic Resource Center (PERC) currently housed at Samriddhi office. It also undertakes localization of international publications to enrich the political economy discourse of Nepal. Samriddhi was the recipient of the Dorian & Antony Fisher Venture Grant Award in 2009, the Templeton Freedom Award in 2011 and the CIPE Global Leading Practice Award in 2012.

*(For more information on the organization and its programs, please visit [www.samriddhi.org](http://www.samriddhi.org))*



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'Contract Enforcement: The Practicalities of Dealing with Commercial Disputes in Nepal' is one among six research paper series prepared for the Nepal Economic Growth Agenda (NEGA), 2013. NEGA is an annual constraints analysis performed by Samriddhi Foundation to identify, deliberate and offer policy alternatives to existing policy bottlenecks that hinder Nepal's economic growth.

After NEGA 2012 identified five growth sectors of the Nepalese economy viz. agriculture, education, tourism, hydropower and infrastructure, NEGA 2013 focuses on researching cross-cutting issues that affect growth in all these sectors and hinders Nepal's economic growth process. The cross – cutting issues covered by NEGA 2013 are industrial relations, contract enforcement, anti-competitive practices, foreign direct investment, public enterprises and regulatory environment for businesses.

This study on contract enforcement is particularly focused on the conflict resolution mechanisms in case of breach of contract. This study emphasizes that while alternative dispute resolution mechanisms and indigenous dispute resolution is a common practice in Nepal, for economic growth to become a reality a creditable and low cost neutral third party mechanism for contract enforcement has become a necessity. The study also makes some recommendations on changes in the existing mechanisms in place to help us move in the direction of achieving an efficient mechanism.



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