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TOUGH TIMES AHEAD – ARE WE LOOKING AT A RECESSION, AND CAN WE ESCAPE IT?

2022, the Year of the Tiger, is settling into an interesting rhythm. In the Chinese Zodiac, tigers are associated with ambition, justice, courage, and assertiveness. The year has definitely asserted its will on our lives, what with the direction the global economy is taking and new waves of Covid-19 forcing reintroduction of public health measures. The year has definitely taken a menacing direction, much like the Tiger it's named after – I have never come across one but rely heavily on pop culture.

The Kenyan economy is known to face election year headwinds, but these are not solely to blame for its current performance. The only people benefitting from the election antics seem to be graduation photographers, as the importance of documenting such events has never been more apparent.

US inflation as of May 2022 had accelerated to 8.6%, forcing the US Federal Reserve to make the biggest increase to its benchmark interest rate in 28 years. In the UK, the Consumer Price Index in the 12 months to April rose by 9.1%. Here at home, the Kenya National Bureau of Statistics indicates that as of May 2022 inflation stood at 7.1% and food inflation at 12.4%. The Kenyan Shilling has lost about 9% in value to the greenback from a similar time last year, and prices of essential commodities have joined billionaires in the space race.

Performance of securities listed at the Nairobi Securities Exchange deteriorated to a 19-year low which saw over KES 700 Billion in investor wealth wiped out since 2022 started. I expect seasoned investors will follow the nyayo of the famous Rothschild who said, "the time to buy is when there's blood in the streets". There is blood in the streets, and I expect to see seasoned investors and those with big appetites capitalize on it. I am sure crypto investors, who watched crypto assets lose an estimated USD 2 Trillion in market capitalization value this year alone, would have some choice words on this.

Separately, the current fuel prices (expected to rise further as the fuel subsidy is progressively eliminated) have turned telecommuting into a budgeting tool from a pandemic containment strategy. Else, while the current global economic performance is not a recession, it does however point to tough times ahead.

Cognizant of the interesting times we live in, we decided to focus on insolvency matters in this edition of our Newsletter. We hope it'll provide you with useful insights on the options law provides to distressed businesses, and prepare you for any storms ahead.

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Concerns for Directors of Financially Distressed Companies

The 2015 Companies Act brought many gains including listing duties and responsibilities of directors. These duties and responsibilities were not previously written down and Kenyan courts would rely on the decisions of English Courts. The responsibilities and duties boil down into one cardinal rule – directors should act in good faith to promote the company's success for its members' benefit. This duty changes if it becomes uncertain whether the company can stay afloat, because in performing their roles directors must now also consider creditors interests.

Indicators of financial distress include inability to pay debts when due, lack of operating capital, or assets significantly less than total liabilities. In such instances, the duty to creditors is so critical that failing to properly perform it could lead to criminal sanction under Kenyan insolvency law. The penalty for such an offence, includes being held personally responsible for debts incurred by the company when it was in financial distress.
While this may seem harsh, a director holds a position of trust and is expected to act in the best interests of the company, its shareholders, employees, and creditors. The penalty seeks to ensure that directors are incentivized to avoid breaking this trust.

When can a director be personally responsible for company debts?

If the director gave a personal guarantee, or continued business knowing staying afloat was impossible, or ran the company dishonestly or illegally. Aside from being sued for payment under a guarantee, a director can be sued for fraudulently or wrongfully doing business. Therefore, a director must be careful to watch out for fraudulent trading, wrongful trading, and voidable transactions.

Fraudulent trading

This occurs where the company's business is intentionally ran to defraud creditors, for example borrowing well beyond ability to repay. Directors must ensure the company only takes debt it intends to pay and can pay. Accepting debt the company has no reasonable prospects of paying, not only harms the company but also exposes its directors. If a liquidator can show a director's actions considerably contributed to the company's collapse, the liquidator can sue the director for fraudulent trading.
Boards should therefore keep a keen eye on the company's debt capacity, financial forecasts, and the fine print. Having accounting and legal experts clarify the obligations and possible consequences you are accepting prevents unpleasant surprises down the line.

Wrongful trading

This is where a company continues operating after it becomes apparent to its directors insolvency is inevitable. The line here is not as clear as businesses have ups and downs – and directors should not be punished for not being fortune-tellers or for being optimistic. Additionally, establishing when a director should have known insolvency was unavoidable is not practically easy. Kenyan courts appreciate the dilemma directors face trying to keep a company going while reasonably hoping things will get better—however misplaced their hope.

The key is not a snapshot of the company's financial position at any given time, but rather what one might rationally expect the future may hold. When trading through a particularly bad spot, directors should clearly document the basis of their decisions, including discussions and dissents.

Voidable transactions

The 2015 Insolvency Act allows courts to undo certain transactions done by insolvent companies within a specific period. Courts can undo transactions done in the two years immediately before insolvency or while appointment of an administrator was underway. Within such periods, the court can restore the company's position by undoing undervalue asset sales, gifts, and deals done to favour a creditor. The court will only interfere if the transaction resulted in inability to pay debts or was done at a time the company was unable to pay its debts.
An undervalue sale is safe if done in good faith to ensure business continuity under reasonable belief it would benefit the company. Directors of financially distressed companies must be careful to document the reasoning behind any transactions which appear vulnerable.

Conclusion

Directors should exercise skill and diligence in performing their roles and seek independent advice where they are uncertain. This duty is even more pronounced in financial distress. Directors must monitor the ability to pay debts and ensure total debts do not far exceed assets. Where directors cannot reasonably foresee bringing in additional capital, increasing revenue, or reducing debt, they must consider insolvency options. Ultimately directors have to find the right balance and discern when to work harder and when to let go.

Principles for Successfully Restructuring Insolvent Entities

What is restructuring?

Restructuring occurs when an entity significantly modifies its debt, operations, ownership, or structure to either improve or protect its business. This may be done through a host of tools including mergers and acquisitions, debt conversions and reorganization, company voluntary arrangements and schemes of arrangement.

Restructuring is often but not always a response to financial pressures – it can also be an effective way of improving business performance e.g. sale of a cost centre. In this article, we focus on insolvent and near-insolvent restructuring.

When does insolvency occur?

Kenyan law recognizes balance sheet insolvency (technical) and cash flow insolvency (commercial). Commercial insolvency is easier to establish as it focuses on the ability of a company to pay its debts. Technical insolvency assesses whether a company's assets are sufficient to meet its liabilities, including contingent and prospective ones.

Establishing the nature and current value of contingent and prospective liabilities is a difficult exercise. Contingent liabilities, think insurance or guarantees, are debts which may become due if some future event like a fire or loan default occurs. Prospective liabilities, think rents or bullet loans, are debts which will fall due at a future point.

Why should you want to restructure?

Valuation is an art not a science. The value of a company's present assets depends on who is buying, under what circumstances, and what assets they are buying. As a going concern a business is worth more than its parts, but not in a clearance sale. Valuable assets to an operational company such as goodwill, intellectual property and custom software, can lose all of their value in liquidation. This is why, almost as a rule, liquidation rarely results in all creditors being paid in full.

An entity can have assets covering all of its liabilities while also lacking cash to pay its due debts. In such cases, allowing an entity to convert its assets

and investments into cash in the normal course of business preserves value for both the company and its creditors. An open market sale under normal conditions will always secure better value than an insolvency driven auction. If for no other reason because open market buyers have a lot fewer contingencies to price into their bids.

An entity can have cash to pay its due debts while lacking the assets to cover all of its liabilities. Remembering contingent debts may never fall due and future debts are affected by time, it makes sense to play the long game. Dismantling an operational entity today because it may be unable to pay debts five years from now is not a sensible recovery strategy.

Lastly, closure costs more. Liquidation turns an unrealized loss into an actual loss which need not always be the case. Enough of the factors underlying most insolvencies can be addressed through better planning and management, and time to warrant serious consideration of restructuring.

How can we ensure a successful restructuring?

First, goodwill and cooperation. Creditors must appreciate they are in a prisoner's dilemma. This is because individual creditors are incentivised to act in ways that create subpar outcomes for the creditors as a collective. Creditors are always better off when they cooperate and coordinate with each other and the company in making decisions.

At a minimum, the company and its insolvency advisors require time to formulate and assess recovery proposals. All creditors should agree to provide this time and to refrain from taking adverse action against the company to avoid jeopardizing the recovery process. The company should similarly agree that during this period it will not to take any action that may adversely affect the position of creditors.

This goodwill and cooperation must continue into the implementation of any restructuring plan. It defeats logic to approve a restructuring plan and then withhold the cooperation needed to ensure successful implementation and recovery.

Second, transparency and information. The insolvent entity should provide to its creditors timely access to information regarding its financial position and prospects. This information enables creditors to proper-

ly evaluate and make informed decisions on the restructuring proposal. The creditors must equally be willing to agree to keep such information confidential, unless it is already public knowledge. By protecting confidentiality, creditors protect the viability of any proposed restructuring while simultaneously ensuring a higher likelihood of success which are key to recovery of a distressed business.
Creditors must also be aware and accept that any funding provided to aid the restructuring will be first in line to be paid. The only way an insolvent entity is able to obtain any additional funding necessary to implement a turnaround is if such debt gets first priority on payment.

Third, equity and equality. Restructuring proposals are often bitter pills to swallow, but if fairly structured and implemented can stimulate great recovery for everyone's benefit. Different creditors have varying rights under insolvency laws. Under Kenyan insolvency law, creditors fall into three broad categories – those secured by assets (secured), those secured by law (preferential), and those without security (unsecured).
Secured creditors recover their debts directly against an entity's assets provided as security. Preferential creditors, the tax man and employees, are paid first out of the proceeds of the remaining assets. Whatever is left after secured and preferential creditors are paid, is what pays unsecured creditors.
A good proposal treats all creditors fairly notwithstanding their category, and each creditor fairly in comparison to other creditors in its category. A creditor should not be more adversely affected than other creditors on account of categorization or voting against the proposal. Recognizing these basic tenets in the structuring and implementation of a restructuring proposal increases the likelihood of a successful outcome.

Last, patience and time. The problem with restructuring financially distressed entities, is that it is a long play which takes time before it pays off. Marvel went from bankruptcy in 1996, to running the most successful movie franchise in history with revenues in excess of USD 25 billion generated so far. Similarly, Apple recovered from near bankruptcy in 1997 to becoming the first company in the world to achieve a trillion-dollar value. Restructuring a business takes time and requires time before it pays off – understanding the value of delayed gratification can allow recovery and success.

The way forward

Restructuring if done right prevents the untimely death of otherwise viable businesses. When properly planned, prudently implemented, and generally supported, restructuring can provide respite to reorder affairs and ensure recovery.

Kenya's insolvency regime while relatively new only seeks to implement universal accepted and proven principles. With the Business Registration Service reporting an increase in the number of legal entities registered annually, it is not shocking that we would see a rise in entities facing financial distress. The Official Receiver indicates that 2021 saw a 100% increase in administrations from 2020.

Financial distress need not be the death of businesses – Apple and Marvel Entertainment went from insolvency to global powerhouses dominating their industries. With the right expertise, goodwill, and patience, businesses can come back from deathbeds to be global industry leaders. Recovery of a financially distressed business is a win-win for all parties involved, and that is why restructuring continues gaining traction globally.

Case Law Review on Insolvency

Does termination or non-renewal of franchising agreements during administration require administrator consent or court approval?

Case 1 Hoggers Limited (In Administration)

An administration moratorium only protects an insolvent entity from security enforcement, lease forfeiture, asset repossession, and legal proceedings. This temporary prohibition only applies to legal proceedings of a judicial or similar nature. It does not affect other contractual rights such as account set-off or combination, termination or rescission, debt acceleration, and giving notices. This is an important reminder that insolvency moratoriums suspend but do not destroy, some but not all rights of creditors.

Brief

The Administrator moved to court to challenge the terminations and non-renewal of various franchise agreements. The Administrator argued these actions were done during an administration moratorium without his consent or the court's approval. Additionally, allowing the franchise to end would defeat administration as the company's revenue generation was entirely reliant on franchising. Losing the franchise would force the company to de-brand, losing all goodwill to the detriment of creditors.

The Decision

Termination or non-renewal of franchise agreements were not legal proceedings requiring the administrator's consent or the court's approval. This was a contractual right that was not affected by an administration. The 2015 Insolvency Act is clear which methods of enforcing contracts were prohibited while there was a moratorium. The provision prohibiting legal proceedings could not apply to events such as giving notice under a contract.

Does a security that does not contemplate administration prevent appointment and does an appointee require training specific to the insolvent entity?

Case 2 Thika Nursing Homes & Thika School of Medical and Health Sciences

A creditor holding a pre-2015 Insolvency Act security can still ask a court to appoint an administrator. An administrator does not need training specific to the entity to be appointed. The administrator only needs to be qualified to assist the insolvent entity achieve the objectives of administration.

Brief

The Nursing Homes and School challenged appointments of administrators as the bank lacked authority and the proposed administrators lacked medical training necessary to run them. The bank's securities were prepared before administration was introduced by the 2015 Insolvency Act. The institutions also felt it would defeat the objectives of administration if the administrators appointed lacked training relevant to ensuring business continuity.

The Decision

The court commended the bank on choosing administration which keeps the company a going concern rather than appointing a receiver manager. The bank's securities allowed appointment of a

receiver manager, who runs businesses and deals with their assets solely to ensure the bank is paid. Lack of express authority in the bank's securities did not prevent public interest appointments. Additionally, the court found lack of institution specific training does not defeat administration objectives. An administrator can continue operations under current staff for a better outcome for all stakeholders. Administration was the best outcome where the other option was selling the land on which the institutions stood which would force them to close.

What duty does a receiver manager owe the company or its creditors?

Case 3 Mumias Sugar Company Limited

A receiver manager is a remedy available to a secured creditor to appoint someone to recover its debt by running the business and dealing with assets. Rights of secured creditors are protected and neither subject to insolvency proceedings nor interference by an administrator or liquidator.
However, where there are ongoing insolvency proceedings the court must consider public interest. This goes beyond contract matters and also looks at the socioeconomic impact to employees, suppliers, customers, and the community. A court may therefore allow receivership and administration (or liquidation) to co-exist. It is not only good but also accepted practice in such cases to use the same person as administrator and receiver.

Brief

This was a challenge to the decision of joint receivers to lease the insolvent company's property. The challenge claimed the receivers were in contempt of court orders banning disposal or transfer of the insolvent company's assets. The challenge also claimed that the receivers had a duty to consider interests of other creditors.

The Decision

The court found that leasing of assets does not amount to either a disposal or transfer of property. Consequently, such protective orders cannot prevent a receiver from leasing the protected property. A receiver's sole duty is to protect a security holder's interests; a receiver has no duty to consider interests of the company or its creditors. A secured creditor is entitled to exercise its rights outside the insolvency regime if default occurs. These rights were not subject to any insolvency proceedings and neither could they be interfered with by either an administrator or liquidator. Accordingly, the proposed leasing could proceed subject to ensuring compliance with the provisions of the 2010 Competition Act.
However, public interest takes centre stage in determining the rescue or reorganization of financially distressed entities. This public interest looks beyond debtor versus creditors to those socioeconomically affected including employees and the local community. It was possible for receivership and administration or liquidation to run concurrently.
Therefore, to ensure transparency and accountability of the receivership process to other creditors, a receiver was also appointed administrator. The receivers were added to the insolvency proceedings and made to regularly report on receivership progress to the court.

Case Law Review on Insolvency

What conditions are necessary for recognition of foreign insolvency proceedings?

Case 4 Zarara Oil & Gas Company Limited

A Kenyan court must be shown that an administrator or liquidator or representative has been appointed pursuant to valid foreign insolvency proceedings. When recognizing foreign proceedings, the court may impose conditions necessary to protecting Kenyan creditors. Neither the tax man nor employees must be paid before foreign insolvency proceedings are locally recognized.

Brief

A foreign representative applied for the Kenyan courts to recognize insolvency proceedings occurring in Mauritius. Kenyan creditors opposed this as the foreign representative had not provided a list of creditors or financial statements to show the company was in financial distress. Kenya Revenue Authority (KRA) also opposed the recognition claiming it had priority on tax before the company paid creditors.

The Decision

A foreign representative is an entity appointed by a foreign court as administrator, liquidator, or as representative. Proof of appointment of a foreign representative is sufficient evidence of financial distress.

Accordingly, the Kenyan court could recognize the foreign insolvency proceedings, stay ongoing legal proceedings and make its approval necessary to starting any new legal proceedings. The recognition came with conditions for monthly progress reports and prohibited dealings with Kenyan-located assets without approval of a Kenyan court. The court also asked its Mauritian counterpart to adopt a process that would give Kenyan creditors meaningful and affordable access and participation.

The court could only decline to recognize foreign insolvency proceedings regarding a bank in respect of which the Central Bank of Kenya was intervening or if the proceedings are against Kenyan public policy. Ordering KRA must be paid before foreign proceedings are recognized would violate insolvency's basic principle of treating all creditors of the same class fairly and equally. Additionally, it would also amount to the court taking over foreign proceedings.

About Us

KN Law LLP is a boutique corporate and commercial law firm operating from Nairobi, Kenya, with a regional reach across multiple jurisdictions and with a Liaison office in London. Our proven experience and proficiency in providing legal advisory to local and multi-national corporations and high-net-worth individuals is the core of our practice. We offer innovative, efficient and practical legal solutions through our team of highly trained, skilled and expert lawyers.)

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