

# CORPORATE RESTRUCTURING: TOWARDS MORE INFORMAL AND FLEXIBLE MODELS

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## Abstract

A corporate entity which is in financial distress can resolve its predicament in two broad approaches. The first is by engaging in a formal bankruptcy procedure, which commonly involves a court, and enables the debtor to deal with creditors collectively. Alternatively, it can engage in an out of court restructuring based around negotiations with individual creditors. This article focuses on the engagements of corporate restructuring outside the formal statutory insolvency procedure and in particular pre-negotiated deals, private workouts and pre-packs. The first section of the article provides a background to the out of court restructuring and underscores the many advantages it holds as compared to the formal insolvency proceedings. It then explores the development and usage of selected informal approaches to corporate restructuring. It concludes with an analysis of the place of informal strategies in Kenya. It is argues for the need to develop a functional equivalent of a workout which allows for the possibility of having mechanisms tailored on realities of a developing economy. However, having an effective workout is hugely dependent on the existence of reliable formal mechanisms to at least act as a threat of enforceable legal approach, and the weaknesses inherent in the Kenya formal mechanisms may be an impediment.

**Keywords:** Bankruptcy, Corporate Restructuring, Insolvency, Economy

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## 1.0 Introduction

A corporate entity which is in financial distress can resolve its predicament in two broad approaches. The first is by engaging in a formal bankruptcy procedure, which commonly involves a court, and enables the debtor to deal with creditors collectively. Alternatively, it can engage in an out of court restructuring (in this article also referred to as informal strategies), based around negotiations with individual creditors. This article focuses on the engagements of corporate restructuring outside the formal statutory insolvency procedure and in particular pre-negotiated deals, private workouts and pre-packs. In essence, the chapter will concentrate on activities such as changing the composition of assets and liabilities of debtors in financial difficulty without resorting to a full judicial intervention. This is done with the objective of promoting efficiency, restoring growth and minimising the cost associated with the debtor's financial difficulty.

The first part explores how such procedures evolve by using game theory. It then discusses the relationship between informal mechanisms and formal insolvency processes. As it will be observed, informal rescues commonly involve negotiation with creditors on an individual basis although there are known models of collective informal procedures, such as the London Approach, which has been widely recognised as having enabled notable informal workouts. The famous London Approach will be discussed because of its wide recognition globally with an intention to understand the tenets underpinning such workouts. Besides, informal workouts, as proposed by international players such as the International Monetary Fund (IMF), World Bank and INSOL will also be explored.

However, given the similarities in the principles underpinning the workout processes, as championed by the international players, it will arguably not serve any merit to focus on the proposals of each; rather the discussion will consider workouts generally. The term 'workout' will be used to refer to the collective negotiations between the debtor and its creditors and entails some contractual agreement. In addition, 'enhanced restructuring' will also be explored. The term 'enhanced restructuring' refers to mechanisms that combine the benefits of both formal mechanisms and informal insolvency procedures and a good example of this type of restructuring is the London Approach. The last part explores how the Kenyan jurisdiction, with its lack of

any notable informal approach to business restructuring, can apply the widely recognised informal principles.

## 2.0 Background to the Out-of-Court Restructuring

Informal restructuring has been around for a long time, although many jurisdictions have not given it as much attention as the formal options. The significance of achieving business survival without recourse to courts has been linked to the broader social and governmental trends keen on adopting proactive risk management strategies.<sup>1</sup> In US, for instance, a significant number of chapter 11 cases start off as private workouts, with companies attempting to reorganise informally and whenever such efforts fail to achieve consensus, the debtor enters chapter 11.<sup>2</sup> The UK's informal rescue practices can be traced back to the 1970s.<sup>3</sup>

The World Bank's Financial Crisis Survey done in 2009 in the EU, on the use of bankruptcy procedures revealed that the formal approaches were less frequent than the state aid and debt restructuring.<sup>4</sup> On average, 8.3 percent of European firms applied for state aid in the previous 12 months (as of June – July 2009), whereas, only 2 percent of all surveyed companies filed for bankruptcy.<sup>5</sup> Besides, there is substantial evidence that changes in business and finance in recent years have put strain on the legal mechanisms, prompting the development of alternative approaches to financial distress. For instance, the Asian crisis in 1997 prompted the Asian nations, with the assistance of the IMF, to develop workout rules targeted at enhancing business recovery. Besides, the extensive impact of corporate failure on the community and economy has necessitated an active and deliberate incorporation of the role played by social norms in business restructuring. The informal mechanisms

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<sup>1</sup> John Armour, and Simon Deakin, 'Norms in Private Bankruptcy: The 'London Approach' to the Resolution of Financial Distress' (2000) University of Cambridge ESRC Working Paper No 173, available at <http://ssrn.com/abstract=258615> or <http://dx.doi.org/10.2139/ssrn.258615>.

<sup>2</sup> Gerard McCormack, *Corporate Rescue Law-An Anglo-American Perspective* (Edward Elgar Publishing Ltd, 2008) 13.

<sup>3</sup> John Flood, 'The Vultures Fly East: the Creation and Globalization of the Distressed Debt Market' in *Adapting Legal Cultures*, D. Nelken, ed, (Hart Publishing, 2001) 257-278, available at <http://ssrn.com/abstract=949581>.

<sup>4</sup> Elena Cirmizi, Leora Klapper, Mahesh Uttamchandani 'The Challenges of Bankruptcy Reform', available at <http://econ.worldbank.org>.

<sup>5</sup> Ibid.

in different jurisdictions have been acknowledged as being pivotal in contributing to solving financial distress for business entities. In essence, corporate insolvency is best addressed by a comprehensive and integrated system that has both formal and informal mechanisms. Admittedly, solving a firm's financial distress either through the formal or informal approaches, typically burdens a firm with direct costs, such as administrative expenses, or indirect costs, such as incentive distortion. Thus, the efficient choice is one that minimises the costs in addition to ensuring that the firm's value is not eroded. Pursuant to this reality, evidence shows that a debtor and its creditors should generally use approaches that enable an agreement to be reached out-of-court; as such approaches enable a faster resolution, and minimise costs.

On an international level, there has been significant recognition of out-of-court workouts (a widely recognised informal strategy) as useful tools to expedite corporate insolvency challenges. Such workouts are regarded as an integral part of an efficient creditor-debtor regulatory system. This view of their importance was echoed by the IMF in its study of insolvency and debtor protection regimes that concluded that informal restructuring mechanisms play an important role in a holistic approach towards corporate insolvency.<sup>6</sup> As a result, the IMF recommended using pre-packages and pre-negotiated plans in its 'Orderly and Effective Insolvency Procedures' in 1999.<sup>7</sup> The importance of informal workouts was also recognised in 2000 by the publication of the INSOL Principles.<sup>8</sup> In addition, the World Bank in 2001 developed 'Principles and Guidelines for Effective Insolvency and Creditor Rights Systems',<sup>9</sup> later revised in 2005. These principles acknowledge the vital contribution of informal workouts and assert that a country's financial sector should promote the development of a code of conduct on an informal out-of-court process for dealing with cases of corporate financial difficulty in which banks and other financial institutions have a significant exposure, especially in markets where enterprise insolvency has reached systemic levels.<sup>10</sup>

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<sup>6</sup> IMF, *Orderly & Effective Insolvency Procedure: Key Issues* (IMF, Washington, 1999) pg.13 [www.imf.org/external/pubs/ft/orderly/index.htm](http://www.imf.org/external/pubs/ft/orderly/index.htm).

<sup>7</sup> Ibid.

<sup>8</sup> INSOL, *A statement of principles for a Global Approach to Multi-Creditor Workouts*, (INSOL International, London, 2000), available at [www.insol.org/page/57/statementof-principles](http://www.insol.org/page/57/statementof-principles).

<sup>9</sup> World Bank Principles, available at [www.worldbank.org/ifa/ipg\\_eng.pdf](http://www.worldbank.org/ifa/ipg_eng.pdf).

<sup>10</sup> Ibid.

Further, the United Nations Commission on International Trade Law (UNCITRAL) through the ‘Legislative Guide on Insolvency Law’ of 2005<sup>11</sup> equally promotes informal mechanisms by encouraging voluntary restructuring negotiations and agreements. Much of these international initiatives consist of guidelines that do not give exact details and instead allow room in their recommendations to adjust to jurisdictional circumstances. Remarkably, they reflect the broad thrust that informal mechanisms are vital. In practice, informal approaches in many jurisdictions tend to be initiated by the company directors or a creditor, such as bank, who, because of its relation with the business can see overdraft limits being exceeded which is a typical red flag.<sup>12</sup> Generally, informal restructuring arrangements are purely contractual in nature and they are therefore not subject to any specific set of legal requirements but require affected creditors to agree to the proposed restructuring solution for it to be binding.<sup>13</sup>

### 3.0 Development of Informal Strategies

It is an undisputed fact that legislated rules are generated and drafted through the country’s legislature under its democratic mandate, and such rules are often intended to be used to solve disputes, commonly, through the courts. However, the informal practices will come into existence in a rather unique way. For instance, INSOL International produced a ‘Statement of Principles for a Global Approach to Multi-Creditor Workouts’, which was published in October 2000.<sup>14</sup> In essence, it is resorting to expertise to develop ‘soft’ norms which are possible solutions or approaches to existing challenges. It was acknowledged by Terry Bond, Vice-Chairman of the INSOL Lenders’ Group, that the London Approach was a source of considerable inspiration to the INSOL Lenders’ Group.<sup>15</sup>

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<sup>11</sup> UNCITRAL, UNCITRAL Legislative Guide on Insolvency (United Nations, 2005).

<sup>12</sup> Vanessa Finch, *Corporate Insolvency Law, Perspectives and Principles*, (Cambridge University Press 2002) 213.

<sup>13</sup> USAID, *Insolvency Systems in South Africa: Strengthening the Regulatory Framework* (December 2010) available at [www.fsp.org.za/blog/wp-content/uploads/south-africa-insolvency-systems1.pdf](http://www.fsp.org.za/blog/wp-content/uploads/south-africa-insolvency-systems1.pdf).

<sup>14</sup> See Chief Editor, ‘International approach to workouts’ (2001) 17, IL&P 59.

<sup>15</sup> Ibid.

In essence, one of the most obvious sources of informal strategies is as a result of the work of the several international financial standard-setting agencies who are actively engaged in coordinating aspects of regulatory standards on a global basis.<sup>16</sup> One of the primary objectives of many of these agencies is to co-ordinate action to ensure international financial stability through both crisis prevention and crisis management.<sup>17</sup> It must be observed that informal strategies developed by the agencies are majorly guiding principles i.e. broad statements that apply to a range of acts and, in Common Law systems, tend to develop through a series of cases and experiences rather than being established in a single incident.<sup>18</sup> It must be appreciated that much as the informal strategies are championed by experts who have no direct democratic mandate to legislate, some of the international financial institutions are intergovernmental organisations, others have been created as a result of intergovernmental initiatives while others are sector-specific groupings of supervisors or regulators and hence are very influential stakeholders.<sup>19</sup>

Internally, jurisdictions can also develop solutions to the challenges they face. Sunstein points out that in a typical society, challenges occur and connectedness among neighbours will necessitate discussion on how to resolve issues.<sup>20</sup> As such, information will be shared among neighbours who share common values when making decisions; the rules they use generate norms, a clear example being that of a 'norm entrepreneur'.<sup>21</sup> Sugden argues that societies exhibit strong self-organisations in the presence of shared values about norms without necessarily engaging in formal rules.<sup>22</sup> Hence, human action can evolve into norms without conscious human effort and the norms may maintain themselves without any formal machinery for their enforcement.<sup>23</sup>

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<sup>16</sup> See Pollack, 'International Harmonization of Regulation and Supervision Frameworks' in Marion Giovanoli *International Monetary Law: Issues for the New Millennium*, (Oxford University Press, 2000).

<sup>17</sup> Anu Arora, 'The Global Financial Crisis: A New Global Regulatory Order?' (2010) 8 *Journal of Business Law*, 670-699.

<sup>18</sup> Iain MacNeil, 'Uncertainty in Commercial Law,' (2009) 13 *Edinburgh Law Review* 1, 68-99.

<sup>19</sup> For a detailed discussion of the origins, roles and work of the various international standard settings agencies see Mario Giovanoli, 'A New Architecture for the Global Financial Market: Legal Aspects of International Financial Standards' in *International Monetary Law Issues for the New Millennium*, (Oxford University Press, 2000).

<sup>20</sup> Cass R Sunstein, 'Social Norms and Social Roles' (1996) 96 *Columbia Law Review* 903.

<sup>21</sup> Randal Picker 'Simple Games in a Complex World: A Generative Approach to the Adoption of Norms' (1997) 64 *University of Chicago Law Review* 4.

<sup>22</sup> Robert Sugden, 'Spontaneous Order' (1989) 3 *Journal of Economic Perspectives* 4.

<sup>23</sup> *Ibid.*

Besides, these mechanisms have been consciously borrowed by other jurisdiction such as Hong Kong<sup>24</sup> and Thailand<sup>25</sup> among others who are keen on developing their informal corporate rescue mechanisms. Moreover, workouts inevitably require guidelines on how these arrangements are negotiated. Consequently, in conducting informal workouts, many jurisdictions adopt methods similar to the London Approach or that of the INSOL Multi-Bank Workout Principles.<sup>26</sup> Such, informal insolvency strategies, and in particular, workouts, are much more than natural self- evolving norms, although this does not fully negate the possibility that norms can genuinely be spawned naturally. In Kenya, for example, the use of elders and traditional processes of resolving disputes or conflicts are common, especially in the rural areas. Neither the government nor any external pressure plays a role in shaping how such a pattern emerges. Such a traditional process is a typical modern day informal mechanism for addressing and resolving conflicts. In fact, the relevance of these norms depends on the legal set up such that decisions that are made in these systems can be overturned by courts if they are deemed to be repugnant to justice, morality or any written law.<sup>27</sup>

#### 4.0 Dynamics of Corporate Restructuring

A firm is in distress at any given time when there is a mismatch between its liquid assets and current liabilities. This can be rectified through debt restructuring.<sup>28</sup> Corporate restructuring can take a variety of forms such as debt rescheduling, interest rate reductions, debt-for-equity swaps and debt

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<sup>24</sup> Hong Kong Association of Banks (HKAB) and the Hong Kong Monetary Authority 'Hong Kong Approach to Corporate Difficulties', available at [www.hkma.gov.hk/media/eng/publication-and-research/reference-materials/banking/fa03.pdf](http://www.hkma.gov.hk/media/eng/publication-and-research/reference-materials/banking/fa03.pdf).

<sup>25</sup> Tumnon Dasri 'Out-of-Court Corporate Debt Restructuring in Thailand', available at <http://unpan1.un.org/intradoc/groups/public/documents/APCITY/UNPAN005376.pdf>.

<sup>26</sup> The famous London Approach was developed by the Bank of England as an unofficial set of guidelines to assist banks and their borrowers in reaching an agreement to restructure their bank debt. The basic tenets of the London Approach have bred many variant models used in the context of financial crises (e.g. Indonesia, Malaysia, South Korea, Thailand, Turkey, and more recently Iceland and Latvia) or in use informally in other countries.

<sup>27</sup> The Bench Bulletin (2010) 1 Kenya Law Reports 12.

<sup>28</sup> Robert Mooradian, Kose John, Edith Hotchkiss, and Karin S Thornbun, 'Bankruptcy and the Resolution of Financial Distress', in Eckbo, B E (Ed), *Handbook of Corporate Finance: Empirical Corporate Finance* (Elsevier, 2008), 235-287.

forgiveness.<sup>29</sup> In essence, restructuring involves an adjustment of the assets side of a company's balance sheet in order to generate cash to meet current liabilities or an agreement of a compromise with creditors. However, to enhance the long term viability of a company, debt restructuring is often accompanied by operational restructuring geared to addressing the structure and efficiency of the firm's business through closures and reorganisation of productive capacity.<sup>30</sup>

There are several informal strategies that can be used, although the literature on firms in distress focuses on a few main types of response to distress. For example, firms can raise new capital through an assets sale, negotiate terms with creditors or they can address their difficulties by merging with another company or engaging in a workout, amongst others.<sup>31</sup> A debt for equity swap can be employed as part of an informal approach which is where a creditor agrees to exchange a debt for an equity share in the company with the hope that it will produce a greater return in future.<sup>32</sup> It is an approach that can enable a suitable compromise to be reached with creditors and can be useful especially where the defaulted debt is a loan which was offered without security. Such a conversion is advantageous to the company as it takes away the burden of interest repayment; it also eases cash flow and working capital difficulties.<sup>33</sup> However, such a swap can be time consuming and expensive to negotiate because the consent of the company shareholders, as well as the main creditors is usually required.<sup>34</sup> Generally, leading lenders may be able to use their influence to force distressed companies to restructure by means of downsizing, management replacement or otherwise.<sup>35</sup>

In some instances, more than one strategy can be used concurrently. Since restructuring does not take place in a vacuum and entails dealing with conflicting interests, there are many factors that influence the choice of

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<sup>29</sup> Ibid.

<sup>30</sup> Thomas Laryea, 'Approaches to Corporate Debt Restructuring in the Wake of Financial Crisis' (2010) IMF Staff Position Note 10/02, Washington: International Monetary Fund, available at [www.imf.org/external/pubs/ft/spn/2010/spn1002.pdf](http://www.imf.org/external/pubs/ft/spn/2010/spn1002.pdf).

<sup>31</sup> Rajdeep Sengupta and Mara Faccio, 'Corporate Response to Distress: Evidence From Asian Financial Crisis' (2011) 93 Federal Reserve Bank of St Louis Review 2.

<sup>32</sup> Cagman Palmer, 'Debt-for-Equity Swap and Reorganization Law in the People's Republic of China' (2010), available at <http://ssrn.com/abstract=1671909>.

<sup>33</sup> Ibid.

<sup>34</sup> Finch (n 12) 230.

<sup>35</sup> McCormack (n 2) 16.



restructuring strategy employed by a company. The main one is the structure of a firm's liabilities.<sup>36</sup> A secured debt can easily be restructured through direct negotiation because their support during a corporate reorganisation could be a request not to enforce their legal rights immediately or to modify the debt contract.<sup>37</sup> Secured creditors may also be invited to inject new funds into the distressed company. It is worth noting that lending new funds to a business in financial distress is regarded by creditors as a very risky activity, as they can be repaid in full only if the rescue attempt is successful.<sup>38</sup> Accordingly, the injection of new funds into the traumatised business may not prove to be an easy task,<sup>39</sup> as reluctant creditors may seek to receive additional reassurances and incentives prior to granting their support.<sup>40</sup> Unsecured debt tends to need to be dealt with using exchange offers such that a firm offers cash securities in exchange for an outstanding debt.<sup>41</sup> Besides, the more the number of creditors with multiplicity of interests, the more difficult it becomes to engage in negotiations. In essence, corporate businesses which typically have multiple creditors need to carefully consider and choose an appropriate strategy. Generally, the approach that creditors take towards corporate rescue depends heavily on their philosophy and culture and also on 'market forces' and, key lenders would not wish to link their reputations with a corporate collapse.<sup>42</sup> Therefore, it could be said that banks are cautious and seek to protect their reputation by offering their support to ailing businesses.<sup>43</sup>

<sup>36</sup> Paul Asquith, Robert Gertner and David Scharfstein, 'Anatomy of Financial Distress: An Examination of Junk of Bond Issuers' (1994) 109 *The Quarterly Journal of Economics* 3.

<sup>37</sup> Michael Pomerleano, and William Shaw, *Corporate Restructuring: Lessons from Experience* (World Bank Publications, 2005) 345; Also see Stuart C. Gilson 'Troubled debt restructurings: An Empirical Study of Private Reorganization of Firms in Default' (1990) 27 *Journal of Financial Economics*, 315-353.

<sup>38</sup> Vanessa Finch, *Corporate Insolvency Law- Perspectives and Principles* (Cambridge, 2009) 40.

<sup>39</sup> Gerard McCormack, 'Super-Priority Financing and Corporate Rescue' [2007] *JBL* 701-732.

<sup>40</sup> Principle 8 of the INSOL International Statement of Principles For A Global Approach To Multi-Creditor Workouts, (2000) 33, available at [www.insol.org/pdf/Lenders.pdf](http://www.insol.org/pdf/Lenders.pdf).

<sup>41</sup> Gertner Schafstein, 'A Theory of Workouts and the Effects of Reorganization Law' (1991) 46 *Journal of Finance*.

<sup>42</sup> Alexandra Kastrinou, 'European Corporate Insolvency Law: An Analysis of the Corporate Rescue Laws of France, Greece and the United Kingdom' (A PhD Thesis Submitted to University of Leicester, 2009) pg. 247.

<sup>43</sup> *Ibid.*

A good example is the London Approach, as used in companies with liabilities to multiple banks.<sup>44</sup> Besides, a combination of secured private debts and numerous public debts tend to limit the usage out-of-court restructuring. This is because secured creditors such as banks are well protected in bankruptcy, hence have no incentive to offer relief such that those with many public creditors each can easily free ride even in the midst of problems.<sup>45</sup> It is argued that if a restructuring strategy is to be successful it has to be tailored to the individual circumstance of a firm. A firm has to consider the number and size of debts, its internal policies, institutional framework, and its potential to facilitate a voluntary standstill, as well as coordination with its financiers. Such factors are essential as they are necessary in determining the feasible timing of restructuring and decisions on the firm's viability.

The choice of the strategy used to solve distress also depends on the relative costs and benefits of each mechanism.<sup>46</sup> Informal procedures are often more attractive than formal steps and participants hope that informality will avoid the negative repercussions associated with formal insolvency procedures.<sup>47</sup> For example, if the cost of restructuring involves a sale of assets through efficient mechanisms such as an auction, the overall cost of resolving financial distress may be lower, encouraging the use of such an approach.<sup>48</sup>

Further, the choice of restructuring options depends largely on the degree of investor protection and labour laws of a jurisdiction.<sup>49</sup> Labour enjoying a strong legal protection is shown to acquire enough power relative to other stakeholders such as investors and managers to be able to impact corporate decisions and outcomes.<sup>50</sup> Positively, the likelihood of value-reducing asset sales increases as collective bargaining and labour relations' laws grant more power to labour unions, suggesting that these asset sales are countenanced

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<sup>44</sup> Nicholas Frome, 'Multi-creditor Restructurings in Transition Countries: Lessons from Developed Jurisdictions', available at [www.ebrd.com/downloads/legal/insolvency/multicr.pdf](http://www.ebrd.com/downloads/legal/insolvency/multicr.pdf).

<sup>45</sup> Ibid.

<sup>46</sup> Hottchkiss, Mooradian, and Thornbun (n 28) 248.

<sup>47</sup> Finch (n 12) 294.

<sup>48</sup> Ibid.

<sup>49</sup> Julian Atanassov, and Han E Kim, 'Labour and Corporate Governance: International Evidence from Restructuring Decisions' *Journal of Finance*, Forthcoming; Ross School of Business Paper No. 1044, available at <http://ssrn.com/abstract=898702>.

<sup>50</sup> Mohamed Belkhir, 'Labor Protection and Corporate Debt Maturity: International Evidence' A paper Presented in Financial Management Association International (FMA) 2014 Annual Meeting, held in October 15-17, 2014 at Nashville, Tennessee, USA).

by workers.<sup>51</sup> Negatively, strong protection of labour also protects underperforming managers, thereby, resulting in the weakening of a firm's value-enhancing objectives.<sup>52</sup> For instance, restructuring measures such as large scale employee layoffs, top management turnover, and major asset sales which could be the necessary remedies to a troubled business and can improve stock price and subsequent operating performance could be frustrated.<sup>53</sup> The sacrificing stakeholders may seek to block these restructuring measures if labour laws grant sufficient power to workers to block such actions.<sup>54</sup>

In practice, the incumbent management may form an alliance with workers to maintain the status quo by foregoing value-enhancing restructuring measures resisted by workers. In a recent Kenyan case involving Kenya Airways, an attempt to downsize the number of employees, which was one of the intended restructuring strategies, triggered numerous court battles, frustrating restructuring efforts because the labour laws are arguably strong. The employees, through their union, filed a case and the issues arising included complaints that the redundancies were done unfairly, that there had been discrimination on grounds of gender, there had been infringement of employees' rights to employment, amongst others.<sup>55</sup> The respondent adduced evidence of its firm experiencing financial distress. However, the court issued an order of reinstatement of the employees, hence, quashing the redundancy one-off pay offered by the company to the employees in favour of the employee's salaries, allowances and damages. It is argued that such legal battles would inevitably delay restructuring and, unless the case is decided faster, the firm's viability will deteriorate.

In addition, the insolvency law determines the allocation of control over distressed firms and the extent to which market mechanisms are used to resolve financial distress.<sup>56</sup> The law can have incentives that can facilitate the out-of-court strategy.<sup>57</sup> For instance, the existence of a rule that is reliably binding on hold-out creditors is critical to the success of restructuring. Further, the existence of efficient bankruptcy laws discourages strategic behaviour by

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<sup>51</sup> Atanassov and Kim (n 49).

<sup>52</sup> Ibid.

<sup>53</sup> Ibid.

<sup>54</sup> Ibid.

<sup>55</sup> *Aviation and Allied Workers Union v Kenya Airways Limited & 3 Others* [2012] eKLR.

<sup>56</sup> Hotchkiss, (n 21) Pg. 237.

<sup>57</sup> Laryea (n23).

the creditors and debtors, causing those engaging in out-of-court restructuring mechanisms to take their engagement seriously. The presence of an efficient legal framework provides a credible means of credit enforcement by directly impacting on the willingness of debtors to come to the negotiating table. In practice, the existence of an effective legal framework gives the creditors an avenue of filing an insolvency suit against the debtor, which comes with cost as well as the likelihood to taint the company image and its creditworthiness depending on the outcome of the case.

A further important aspect was noted by Mooradian and Ryan in their examination of out-of-court restructuring, namely, that, banks can play a very important role in facilitating debt restructuring.<sup>58</sup> This view is supported by the findings of Gilson, Kose and Lang that the likelihood of out-of-court restructuring is positively related to the firms' reliance on bank debt.<sup>59</sup> The explanation for this is that action by large creditors, such as banks, allows small creditors to coordinate more efficiently. This is linked to the fact that banks have superior information, as a result of which their decision to participate in restructuring injects a degree of 'strategic solidity' in credit markets. In addition, such asymmetric information enhances banks' confidence to avail rescue funds necessary for restructuring. Besides, bank participation in restructuring helps to mitigate hold out problems among the public debts holders.

## 5.0 Significance of Informal/ Out-of-Court Restructuring

Informal and formal corporate insolvency mechanisms have similar underpinning in that they all address many and, at times, conflicting creditors' interests in a situation of financial difficulty. For this reason, it is difficult to draw a clear dividing line between formal and informal operations. In reality, numerous insolvency procedures tend to overlap and in some instances one procedure will be a continuation of another. In France, for example, safeguard

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<sup>58</sup> Robert M Mooradian, Harley E Ryan, 'Out-of court Restructuring and the Resolution of Financial Distress: Section 3(a)9 Compared to Investment Bank Managed Exchange Offers' (2005) 78 Journal of Business 4.

<sup>59</sup> Stuart Gilson, John Kose, Larry H P Lang, 'Troubled Debt Restructuring: An Empirical Study of Private Reorganization of Firms in Default' [1990] Journal of Financial Economics 27, 315-353.

and conciliation proceedings are commenced by the commercial court but the negotiations for a restructuring via a compromise between the creditors and debtors are done out-of-court, with the agreed plan then being approved by the court.<sup>60</sup> In the US, a company will often have pre-arranged a chapter 11 planning advance of filing for chapter 11 and here the negotiations between the debtor company and the main creditors are done prior to filing for formal chapter 11 proceedings. In the UK, much as their pre-pack is considered an informal procedure and is dependent on administration for implementation.<sup>61</sup>

It is evident that informal workouts are negotiated in the ‘shadow of the law’ and, therefore, depend on the enabling legal environment having clear laws and procedures to facilitate disclosure or access to timely and accurate financial information regarding the distressed enterprise.<sup>62</sup> In addition, formal proceedings complement the informal mechanisms, as they address issues such as investigating directors’ actions, and the enforcement of contractual agreements that can only be done using the formal frameworks.<sup>63</sup> Further, even in a scenario where there are effective informal restructuring arrangements, formal insolvency procedures are important as a last option largely resorted to when the informal strategies have been exhausted.<sup>64</sup> This positions the informal approaches as crucial immediate mechanisms that enterprises commonly employ in their attempts to circumvent looming failure. It is argued, therefore, that in a scenario where informal approaches to insolvency are successful in restructuring, there will be no need for the formal mechanism. It has also been appreciated that the existence of shortcomings in informal workouts and the inflexibilities of formal insolvency proceedings have generated efforts to combine the advantages of informal workouts with some of the effects of formal proceedings, resulting in the development of

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<sup>60</sup> Shinjiro Takagi, ‘A Need to Establish an International Rule for Out of Court Workout Agreed By the Central Banks, the Bankers’ Association and Other Organizations Worldwide’ A Paper Presented at Twelfth Annual International Insolvency Conference in International Insolvency Institute Paris, France on June 21-22,201.

<sup>61</sup> Chrispas Nyombi, ‘An Examination of the Evolving Approach to UK Corporate Rescue and the Impact of Subsequent Legal Reforms’ (February 28, 2011), available at <http://ssrn.com/abstract=2012190>.

<sup>62</sup> World Bank, *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems* (World Bank, Washington DC, 2001) pg.5, available at [http://www.worldbank.org/ifa/ipg\\_eng.pdf](http://www.worldbank.org/ifa/ipg_eng.pdf).

<sup>63</sup> Finch (n 12) 211.

<sup>64</sup> Ibid.

enhanced restructurings, or hybrid procedures, such as pre-packaging.<sup>65</sup> Therefore, informal mechanisms can generally reflect a variety of ‘calculated technologies’, disciplinary perspectives and even sets of negotiations.<sup>66</sup>

In many jurisdictions, the evidence indicates that a legal system influences informal procedures and to a certain extent determines the possibilities for out-of-court debt restructuring in any given jurisdiction.<sup>67</sup> In essence, effective formal insolvency becomes a warning to those who will not willingly participate in out-of-court arrangements. In jurisdictions such as the UK, where corporate failure is perceived negatively, and as a result creditors tend to desert a business once it has entered formal proceedings and debtors may suffer a rapid loss of goodwill, informal alternatives is a welcome alternative.<sup>68</sup> In addition, informal proceedings are known to provide cost-effective, efficient, flexible and contractually sustainable solutions when resolving a debtor’s financial affairs. Much as the negotiation will not be costless, the expected cost of negotiation is lower than the cost of insolvency proceedings, even more so when done in secrecy, as indirect costs such as a loss of good will are curtailed.<sup>69</sup>

In addition, workouts are frequently used because creditors retain a measure of control over negotiation, something that they would not enjoy when a company is put into formal insolvency proceedings.<sup>70</sup> Directors also remain in control during the workouts and this has merits over alternative formal procedures in which directors are deprived of control.<sup>71</sup> Contractual workouts in contrast to formal procedures are considered flexible because the negotiations can be initiated by the debtor or the creditors and does not require evidence of financial difficulties.

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<sup>65</sup> Jose M Garrido, ‘Out-of- Court Debt Restructuring’ (Washington, World Bank, 2012).

<sup>66</sup> Ibid.

<sup>67</sup> Garrido (n 65).

<sup>68</sup> John Armour, ‘The Rise of the Pre-Pack: Corporate Restructuring in the UK and the Proposal for Reform (2012), available in <http://ssrn.com/abstract=20931334>.

<sup>69</sup> Robert A Haugen and Lemma W Senbet, ‘The Significance of Bankruptcy Costs to the Theory of Optimal Capital Structure’ (1978) 33 *Journal of Finance* 383-394.

<sup>70</sup> Lijie Qi, ‘The Rise of Pre-packaged Corporate Rescue on Both Sides of the Atlantic’ (2007) 20 *Insolvency Intelligence*.

<sup>71</sup> Ibid.

## 6.0 Selected Informal Approaches

There are many informal approaches that can be used by a distressed company although only a few are popular and others are strategies that are used as part of other informal approaches. The forms of restructuring featured in the literature are debt for equity swaps, workouts, pre-packaging and debt restructuring.

### 6.1.0 Informal Workout

According to Stewart, ‘there is no formal definition or even a typical restructuring as all deals are different and when assessing the respective rights, remedies and options of the parties, the devil is always in the detail’.<sup>72</sup> In essence, workouts is a ‘loose’ term used to include a variety of approaches implemented differently in different jurisdictions. Nonetheless, in literature, an informal workout, also referred to as consensual out-of-court restructuring, is a non-judicial process through which a financially distressed business and its significant creditors reach an agreement for adjusting the obligations of the business enterprise.<sup>73</sup> Despite being termed as non-judicial, other literature explains the informal workout as a mechanism to reorganise troubled companies outside the bankruptcy court with minimal court intervention.<sup>74</sup> Fundamentally, the creditors agree on a ‘coordinated approach’ by seeking to work with each other to devise a collective response which is in their mutual self-interest. Notable divergences exist in so far as the implementation of the workout in different jurisdictions is concerned but not without similar main characteristics.

In the UK, for example, popular informal workouts include the famous London Approach and other informal rescue arrangements such as pre-packs and debt-for-equity swaps. In the US, private workouts tend to be less expensive or less time consuming and because of this a significant number of

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<sup>72</sup> Gordon Stewart, ‘The Business Case for Using Out-of-Court Workouts: The Creditors’ and Debtors’ Perspectives’ (Vienna, 14 February 2012), available at [www.wbginvestmentclimate.org/advisory-services/regulatory-simplification/debt-resolution-and-business-exit/upload/The-Business-Case-for-Using-OCW.pdf](http://www.wbginvestmentclimate.org/advisory-services/regulatory-simplification/debt-resolution-and-business-exit/upload/The-Business-Case-for-Using-OCW.pdf).

<sup>73</sup> Frome (n 44).

<sup>74</sup> Qi (n 70).

companies attempt to reorganise through private workouts.<sup>75</sup> The empirical evidence indicates that the shareholders and creditors are better off when debt is restructured privately than through chapter 11.<sup>76</sup> In addition, private restructurings are more likely to accomplish something when a higher proportion of the company's debts are owed to commercial banks and complex investors such as insurance companies.<sup>77</sup>

Informal workouts have gained international recognition and regional groups such as the INSOL Lenders groups and international financial powers such as the World Bank have developed principles which they assert are non-binding guides and informal workouts generated from commentary of best practice.<sup>78</sup> The INSOL principles trace their roots to England and in many ways can best be described as a London Approach in a modern context. In fact, the ever changing business dynamics generate complexity of the capital structures of corporations. Besides, the advancements of businesses to a global scale and their exposure to a diverse range of financial creditors have necessitated deliberation on possible solution in an international context.

By comparison, the workout principles championed by all the international players are very similar. For instance, co-operation by the creditors is a notable requirement since restructuring involves collective actions of many groups. Similarly, the financial institutions are expected to keep the funds flowing as the firms are still dependent on them. INSOL, in its eight principles, has a requirement for additional funding to be provided during restructuring and be accorded priority status as compared to other indebtedness or claims of relevant creditors.<sup>79</sup> In the same spirit, the World Bank, in principle 26, proposes that a country's financial sector should promote a code of conduct on an informal out-of-court process, essential in dealing with corporate financial difficulty.<sup>80</sup> In addition, it proposes eight conditions that must be present for a workout to be attempted.<sup>81</sup> It is evidently emphasised in these provisions that

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<sup>75</sup> Ibid.

<sup>76</sup> Julian Franks, and Walter Torous, 'A Comparison on Financial in Distressed Exchanges and the Chapter 11 Reorganizations' (1994) 35 Journal of Financial Economics 349.

<sup>77</sup> Ibid.

<sup>78</sup> Terence Halliday, Bruce Carruthers, *Bankrupt: Global Lawmaking and Systemic Financial Crisis* (Stanford University Press, 2009) 84.

<sup>79</sup> INSOL (n8) see the eighth principle.

<sup>80</sup> World Bank 2005 (n 9).

<sup>81</sup> Ibid.



the presence of an effective formal insolvency is crucial for the workouts to work.

### 6.2.0 London Approach

The London Approach is a brilliant example of how informal strategies can be developed and effectively used in helping corporations in distress.<sup>82</sup> This approach to corporate financial distress emerged through the efforts of the Bank of England to refine existing long-standing traditions to address corporate financial difficulties in the UK. It is by design that it has no formal code and relies on consensus, persuasion and banking collegiality to resolve the financial distress.<sup>83</sup> There are four notable phases in this informal procedure. The creditors adopt a 'standstill', a consensual moratorium, where none is to enforce individual rights and existing lines of credit are maintained. Meanwhile, a team of accountants appointed by the banks will investigate the company's financial condition and develop an independent review of its long-term economic viability. If rescue is feasible, one bank will lead the restructuring negotiations.<sup>84</sup> Negotiations would traditionally be led by the bank which was the debtor firm's principal lender, although, over time, some banks developed expertise at mediating workouts, enabling them to offer their services for an appropriate fee. During the restructuring period, new finance is accorded priority and the losses and gains are shared pro-rotta according to creditors' seniority and exposures at the time of standstill. A unanimity rule applies to voting.

The London Approach benefits from a special form of consensual 'moratorium' in the form of the standstill. However, creditors are not obliged to engage in any part of the processes leading up to the restructuring agreements and these agreements only become legally binding once done. While, a corporation (debtor) negotiates with some creditors, the debtor remains open to attack from other creditors.<sup>85</sup> Of particular importance, the trust and

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<sup>82</sup> For details on how London Approach works see John Armour and Simon Deakin, 'Norms in Private Insolvency Procedures: The 'London Approach' to the Resolution of Financial Distress' (2000) University of Cambridge ESRC Working Paper No. 173, available at <http://ssrn.com/abstract=258615>.

<sup>83</sup> Colin Bird, 'The London Approach' (1996) 12 *Insolvency Law & Practice* 87.

<sup>84</sup> Anrew Keay and Peter Walton, *Insolvency Law: Corporate and Personal* (Jordan Publishing Ltd, 2008) 196.

<sup>85</sup> Keay ( n 69) 195.

cooperation from the banks involved are vital components for a rescue under the London Approach.<sup>86</sup>

The ability of the London Approach to become a normative force was founded on two aspects. First, there was a perceived threat of regulatory sanctions from the Bank of England as the financial institution that played a supervisory role as a banking regulator. In view of this role, parties strived to maintain a good working relationship with the Bank of England giving it a degree of authority. Second, the Bank of England had the reputation of being an honest, impartial broker. The other banks, too, contributed to the ability of the London Approach to impact through decentralised enforcement mechanisms, such that there was the threat of exclusion from future business by other banks. The influence of the London Approach in multi-creditor workouts has however diminished because of a number of realities. First, is the rise of debt trading, and the rise of hedge funds or the influx of the US-based ‘Vulture Fund’ investors, which are relatively recent phenomenon in the UK.<sup>87</sup> Second, globalisation of financial markets has enabled borrowing from a variety of lenders such as insurance companies, bond holders and other specialist investors. This variety makes the positions of unanimity and standstill more difficult to reach. Third, market practices and regulatory requirements which govern all those involved make the use of London Approach strategy harder.

The principles that are core to the London Approach, as already mentioned, have gained popularity and have influenced the modern workouts. In fact, the INSOL Principles<sup>88</sup> replicate some of the details of the London Approach-type workout. However, principle six, which requires that arrangements between relevant creditors relating to any standstill should reflect the applicable law and the relative positions of relevant creditors at the Standstill Commencement Date, was not well-articulated in the London Approach. Generally, the coordinated response has been applauded for giving the parties time to help manage the impact of debtor defaults and for creating an opportunity to explore and evaluate the options for consensual agreement

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<sup>86</sup> John Flood, ‘The Vultures Fly East: The Creation and Globalisation of the Distressed Debt Market’, available at <http://ssrn.com/abstract=949581>.

<sup>87</sup> On the future of London Approach, see generally P Kent, ‘Corporate Workouts- A UK Perspective’ *Int. Insolv. Rev.*, 6: 165–182, Also see Peter Brierley and Gertjan Vlieghe ‘Corporate Workouts, the London Approach and Financial Stability’ (1999) 7 *Financial Stability Review* 168.

<sup>88</sup> INSOL International website, available at [www.ifecom.cjf.gob.mx/PDF%5Carticolo%5C4.pdf](http://www.ifecom.cjf.gob.mx/PDF%5Carticolo%5C4.pdf).

outside a formal insolvency process.<sup>89</sup> However, like the many other informal strategies, workouts will only be most successful in facilitating rescues if an appropriate legal, regulatory and governmental policy framework supports them.<sup>90</sup>

### 6.3.0 Pre-Packaging

A 'pre-pack' is a process in which a troubled company and its creditors reach an agreement before a statutory rescue procedure starts and then implement the agreement during the procedure.<sup>91</sup> This definition typically fits the US pre-pack where it is a rescue process: primarily a pre-negotiated plan. However, in UK, it is essentially a strategy for business sale.<sup>92</sup> Generally, a pre-pack may be regarded as a 'hybrid' procedure as it combines the features of informal mechanisms, such as negotiation, and formal mechanisms, such as involving the use of insolvency practitioners, as well as court involvement which varies in many jurisdictions. For instance, in the UK, pre-packs now commonly take place within out-of-court administrations. Under this process, a pre-packaged sale of the company's business is agreed prior to the opening of proceedings and an administrator is then appointed who will execute the sale on behalf of the company.<sup>93</sup> In the US, the process is always court-driven.<sup>94</sup> Much as pre-packaging may involve the selling of a business to new owners, this is not always the case because, in certain circumstances, it may be commercially justifiable to sell it back to the management if, for example, they seem to be the only potential buyer.<sup>95</sup> Therefore, pre-pack takes the form of a management buyout of the company's business.<sup>96</sup>

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<sup>89</sup> INSOL International (2000) (n 5) pg. 4.

<sup>90</sup> Ibid.

<sup>91</sup> Vanessa Finch, 'Pre-packaged administrations: Bargaining in the Shadow of Insolvency or Shadow Bargains?' (2006) *Journal of Business Law*, 568-588.

<sup>92</sup> Sandra Frisby, 'Report to the Association of Business Recovery Professional: A Preliminary Analysis of Pre-packaged Administration' (2007), available at [wwwr3.org.uk](http://wwwr3.org.uk).

<sup>93</sup> Finch, (n 91).

<sup>94</sup> David Brown, *Unpacking the Pre-Pack Insolvency Law Bulletin* July 2009, pp.164-167, available at <http://ssrn.com/abstract=2133067>.

<sup>95</sup> Sandra Frisby, 'Report on Insolvency Outcomes' (2006), available at [www.insolvency.gov.uk/insolvencyprofessionandlegislation/research/returntocreditors.pdf](http://www.insolvency.gov.uk/insolvencyprofessionandlegislation/research/returntocreditors.pdf).

<sup>96</sup> Ibid.

Pre-pack has a number of advantages. It embraces negotiations which, often, can start early. It also offers speedy routes to recovery and keeps legal and other professional costs low.<sup>97</sup> In addition, it offers the prospects of a faultless transition to turnaround that limits disruption and reduces the risks of market falling, and losses of reputations, assets or business partner relationships.<sup>98</sup> It can be an appropriate action in a business with a strong brand and intellectual property whose value would drastically reduce in the event of formal insolvency proceedings.<sup>99</sup> It has also been argued that pre-packs are a useful device in countering hold out problems with the growth of ‘vulture funds’ which, in many ways, have been a main impediment to informal reorganisations.<sup>100</sup> The pre-pack is also flexible because negotiation takes place outside the formal statutory framework and this gives room to a company to have a unique plan to suit its particular situation. As a hybrid, it is considered cheaper.<sup>101</sup> The pre-pack has been heralded as a freshly effective procedure to further rescue objectives, although others see it as a means by which powerful creditors bypass carefully constructed protections.<sup>102</sup>

Despite the long list of advantages, English pre-packs are not without fault. In practice, pre-packaged negotiations are done in secret and this gives room for the debtor to hand-pick the potential buyers to negotiate the sale of business to. This makes it susceptible to manipulation.<sup>103</sup> Being a predetermined sale of an ailing business, the pre-pack has raised concerns relating to the morality and effectiveness of insolvency practitioners in the pre-pack process and has become, for many, the subject of fierce criticism.<sup>104</sup> Since the pre-pack entails a quick business sale, often to an insider, practitioners are often criticised as failing to consult the wider market and it is contended that, as a result, they may not achieve the best possible price for the assets of a company in administration.<sup>105</sup> The criticism was validated by the findings in 2011 which

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<sup>97</sup> Ibid.

<sup>98</sup> Finch, (n 91).

<sup>99</sup> Martin Ellies, ‘The Thin Line in the Sand: Pre-packs and Phoenixes’ [2006] *Recovery* (Spring) 19.

<sup>100</sup> Ibid.

<sup>101</sup> Qi (n 70).

<sup>102</sup> S Harries, ‘The Decision to Pre-pack’ [2004] *Recovery* 26.

<sup>103</sup> Ibid.

<sup>104</sup> Peter Walton, ‘Pre-packaged administration Trick or Treat’ (2006) 19 *Insolvency Intelligence* 8.

<sup>105</sup> Kerry Scott, ‘A Fair Deal?’ (2009) 159 *New Law Journal* 421.

concluded that 25 per cent of the 2,808 companies that entered administration used the pre-pack procedure and that nearly 80 per cent of pre-pack sales were to connected parties.<sup>106</sup> In addition, the BIS Select Committee report of 2013 asserts similar sentiments and acknowledges the lack of transparency, resultant abuse of pre-pack administrations and their link to ‘phoenix companies’.<sup>107</sup>

Importantly, in the summer of 2013, Vince Cable MP, Secretary of State for Business, Innovation and Skills, announced an independent review into pre-pack administration aimed at rectifying as many of the problems and criticisms of the existing pre-pack procedure as possible. This culminated into Graham Review Report<sup>108</sup> which was published together with a report on pre-pack empirical research.<sup>109</sup> The finding on the aforementioned Graham’s report summarised the weaknesses on pre-packs in the following points: <sup>110</sup>Pre-packs lack transparency; Marketing of pre-pack companies for sale is insufficient; More could be done to explain the valuation methodology; Insufficient attention is given to the potential viability of the new company; and the regulation - and monitoring of that regulation – of pre-pack administration could be strengthened.

The same report made a number of recommendations, namely: Pre-pack Pool such that connected parties approach a ‘pre-pack pool’ before the sale and disclose details of the deal, for the pool member to opine on; Viability Review such that on a voluntary basis, the connected party complete a ‘viability review’ on the new company; Compliance with six principles of good marketing and that any deviation from these principles be brought to creditors’ attention; Valuations must be carried out by a valuer who holds professional indemnity insurance amongst others.<sup>111</sup>

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<sup>106</sup> The Insolvency Service, ‘Annual Report on the Operation of Statement of Insolvency Practice 16’, January/ December 2011.

<sup>107</sup> House of Commons Business, Innovation and Skills Committee, ‘The Insolvency Service’, Sixth Report of Session 2012-13’.

<sup>108</sup> Graham Review into Pre-pack Administration Report to the Rt Hon Vince Cable MP June 2014.

<sup>109</sup> Pre-pack Empirical Research: Characteristic and Outcome Analysis of Pre-Pack Administration – Final Report to the Graham Review, Prepared by Professor Peter Walton and Chris Umfreville with the assistance of Dr Paul Wilson, University of Wolverhampton, April 2014.

<sup>110</sup> Ibid.

<sup>111</sup> See Section 9 Grahams Review Report.

Generally, the findings corroborated criticisms previously echoed in pre-packs. In fact, the independent review endorsed pre-pack and admitted that as an insolvency procedure, it had a place in the insolvency field as it preserved jobs, was cheaper than alternative upstream restructuring procedures and contributed to the economy. Noteworthy, the recommendations have found their way into law with the enactment Small Business, Enterprise and Employment Act 2015. Remarkably, clause 126 is concerned with pre-packs to ‘connected persons’ and will hopefully enhance vitality of pre-packs as an efficient insolvency procedure.

## 7.0 Challenges of Informal Restructuring

Informal mechanisms, just like formal mechanisms, do not guarantee the survival of a business but they lay down a framework under which the stakeholders may engage to consider rescue potentials. However, much as an informal strategy of corporate restructuring plays a crucial role in contributing to enhancing economic efficiency, there are notable impediments that may be faced by those intending to use the informal strategies. To start with, informal rescue, generally, is not a perfect solution for every economic challenge in respect of all companies.<sup>112</sup> Besides, informal mechanisms cannot operate exclusively on their own as they rely on an enabling legal framework to facilitate investigation of corporate misbehaviour whenever necessary. Further, a workout requires the unanimous consent of affected creditors, especially in a situation where a company has limited funds, hence, unable to pay hold-out in full, a task which may often be too difficult to obtain.<sup>113</sup> This is because corporations entail the involvements of many individuals and the presence of many creditors may lead to the forming of coalitions and to conflicts of interests.<sup>114</sup> The different classes of creditors have different preferences as to the outcome of negotiations and as a result, these creditors may engage in opportunistic hold up behaviour so as to demand a larger share

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<sup>112</sup> Alice Belcher, *Corporate Rescue: A Conceptual Approach to Insolvency Law* (Sweet & Maxwell, 1997) 127.

<sup>113</sup> Pen Kent, ‘Corporate Workout- A UK Perspective’ (1997) 6 Intl Insolvency Rev 165-182.

<sup>114</sup> Regis Blazy, Jocelyn Martel and Nirjhar Nigam, ‘The Choice between Informal and Formal Restructuring: The Case of French Banks Facing Distressed SMEs’, available at <http://ssrn.com/abstract=1836895>.

of overall returns as the price for their agreements.<sup>115</sup> This is majorly done by lower rank creditors who may feel that their hold out has little impact on the restructuring process but actually this behaviour may cause the negotiations to fail. Additionally, creditors often have heterogeneous priorities and this could trigger differences of opinion about the appropriate course of action, making it difficult to resolve.<sup>116</sup> The US data shows that out-of-court negotiations are more likely to be effective where businesses have relatively homogeneous capital structures.<sup>117</sup>

Another impediment is the presence of asymmetric information.<sup>118</sup> Individuals involved in the restructuring have varying levels of information concerning the firm's value. For example, managers will have better information about the firm's assets and future cash flow than any other creditor. Armour and Deakin argue that creditors' willingness to negotiate a compromise, rather than insisting on payment in full, is based on the convictions that prospective gains are greater under an informal strategy than formal and they have to see the likely surplus gains from negotiations.<sup>119</sup> As a result, poorly informed creditors may prefer a formal court –supervised restructuring and may be reluctant to negotiate.<sup>120</sup> Furthermore, the lack of a moratorium on creditor demands while problems are being resolved is a challenge to workouts. The company lenders have to voluntarily agree to negotiate. However, in incidences where the lenders agree, trust is a delicate aspect, such that there is also the risk that the suppliers and other trade creditors could initiate legal proceeding should the confidentiality of the negotiations be lost.

Despite the existence of impediments to out-of-court restructuring, there are means by which they can be mitigated. Negotiation tends to succeed where the firms have closer relationships with their banks and deal with a smaller pool of creditors.<sup>121</sup> Therefore, enhancing dissemination of information helps,

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<sup>115</sup> Robert Gertner, and David Scharfstein 'Theory of Workouts and the Effects of Reorganization Law' (1991) 46 *Journal of Finance* 4.

<sup>116</sup> Ibid.

<sup>117</sup> Stuart C Gilson, 'Management Turnover and Financial Distress' (1989) 25 *Journal of Financial Economics* 241-265.

<sup>118</sup> Blazy, Martel and Nigam (n 114).

<sup>119</sup> Armour (n 68).

<sup>120</sup> Maria Carpareto, 'Bankruptcy Bargaining with Outside Options and Strategic Delay' (2005) 11 *Journal of Corporate Finance* 736-746.

<sup>121</sup> Stuart Gilson, John Kose, Larry Lang 'Troubled Debt Restructuring: An Empirical Study Private Reorganization of Firms in Default' (1990) 27 *Journal of Financial Economics* 315-353.

since informed creditors are positive in their involvement and this impact on the outcome of negotiations.

## 8.0 The Place of Informal Restructuring in Kenya

As already discussed, informal restructuring mechanisms are common and of numerous varieties and include all efforts, ranging from crisis management and turnaround to the use of consultancy services to improve management. Kenya cannot be said to be devoid of informal mechanisms of corporate restructuring but, from the surface, the methods of resolving disputes out-of-court are less developed. Nonetheless, consistent with practices in many countries, companies employ a wide range of approaches in their attempts to restructure their companies' informally. Debt-for-equity swaps is common and the newspapers regularly have stories which are good evidence that this practice happens. For example, one institutional investor with Kenya's infrastructure investment firm called Trans Century opted to switch its holding of the firm's convertible bonds into equity.<sup>122</sup> The managers of the companies involved were confident that this conversion was going to improve the profitability of the company.<sup>123</sup> Besides such compromises, the usual managerial techniques that even solvent companies might engage in may be included in the category of informal rescues, such as cost-cutting measures and downsizing the workforce, disposing of non-core assets or units of the business, and the taking of additional collateral to secure repayment.

The practices are common and useful to large businesses, but may leave small debtors under the threat of inevitable insolvency, owing to inadequate resources. For instance, carrying out employee lay-offs will require some degree of financial strength to pay for the redundancies. In all of these practices, there is a glaring lack of any documented evidence on how they are undertaken. However, the media report efforts to solve many disputes out-of-court which are not necessarily business related. The use of informal approaches as a way of solving business financial distress has not been explored fully. Nonetheless, there is tangible evidence that shows how, in the context of resource-based conflicts, such as in respect of land, forests, water and even political conflicts,

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<sup>122</sup> Beatrice Gachenge, 'Kenya Trans Century Investor in Bond –Equity Swap' *Reuters* (Nairobi, 22 Monday August 2012).

<sup>123</sup> *Ibid.*



there are examples of informal approaches having played a central role in the lives of the Kenyan people. A most notable example was the post-election crisis that engulfed Kenya during the 1997 elections.<sup>124</sup>

Besides, there is a general recognition in Kenya of the reality that taking every dispute to court burdens the judicial system and strains beneficial relations. The legal environment is conducive in nurturing out-of-court settlements of disputes. For instance, the Constitution of Kenya, 2010, recognises alternative dispute resolution mechanisms and raises their status to a judicial principle.<sup>125</sup> In addition, arbitration is probably the best-known out-of-court mechanism in Kenya and the rules of the game are laid out in the Arbitration Act. In addition, the existence of institutions such as Kenya's Dispute Resolution Centre (DRC),<sup>126</sup> which are independent, non-profit organisations that promote effective and economic resolutions of disputes through arbitration and predominantly mediation and expert determination are evidence that Kenya's multi-cultural business community can conduct business restructuring without the complexity and expense of court proceedings, or even arbitration.

## 9.0 Conclusion

Informal restructuring, just like its formal counterpart, is the product of deliberate efforts to avert or at least minimise the impact of market dynamics upon a struggling business. The lack of a modern insolvency law in Kenya makes informal mechanisms a good alternative. In addition, the fact that Kenya is used to informal approaches to dispute resolution is a good justification for advocating workouts. The test is whether the principles or approaches championed by international institutions suit Kenya. The external supply of best practices can facilitate radical changes but the danger is that they might not be feasible in the circumstances of a developing economy.

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<sup>124</sup> John Ouch, 'Undercurrents of Post-Election Violence in Kenya: Issues in the Long-term Agenda', available at [www2.warwick.ac.uk/fac/soc/crer/afrobrain/oucho/publications/john\\_oucho.pdf](http://www2.warwick.ac.uk/fac/soc/crer/afrobrain/oucho/publications/john_oucho.pdf).

<sup>125</sup> The Constitution of Kenya, Article 159 (2) (c) is clear that alternative forms of dispute resolution including reconciliation, mediation, arbitration and traditional dispute resolution mechanisms shall be promoted.

<sup>126</sup> Brenda Brainch, 'The Climate of Arbitration and ADR in Kenya' (Paper given to the Colloquium on Arbitration and ADR in African States, King's College London, June 2003).

It is argued that developing a functional equivalent of a workout is a realistic approach as this allows for the possibility of having mechanisms tailored on realities of a developing economy. These sentiments were echoed by Thomas, who proposed that tailoring a corporate debt restructuring strategy to individual country circumstances requires attention to a number of key factors, such as policy coordination, consideration of the reform of the legal and institutional framework for enforcement of credit, government support to facilitate out-of-court restructurings and potential innovations to facilitate voluntary standstills amongst others.<sup>127</sup> Therefore legal reforms, such as those introduced by the Insolvency Act 2015, are only one requirement for an effective insolvency system and reforms to the wider infrastructure would be equally important.

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<sup>127</sup> Laryea, (n 30).