DECLARATION

I, **EUNICE A. OTIENO – ARWA** do hereby declare that the thesis is my original work and has not been submitted and is not currently being submitted for a degree in any other University.

Signed
EUNICE A. OTIENO – ARWA

This Thesis has been submitted for examination with my approval as the University Supervisor.

Signed
**MR. TIM MWESELI**

Nairobi, October 2005
DEDICATION

To Jotham, Lloyd and Ryan for suffering my many long hours of study and research.
ACKNOWLEDGMENTS

I am grateful to many people for their contributions to this Dissertation. My greatest debt is to my supervisor; Mr. Tim Mweseli for his guidance in terms of criticisms and suggestions. I also wish to thank my husband Mr. Jotham Arwa for his invaluable comments, assistance and encouragement. Finally I am deeply indebted to those who assisted in typing this work especially Anne, Neema and Wambui.

To all of you, I say

"Asante Sana"

EUNICE A. OTIENO – ARWA

OCTOBER 2005
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GENERAL INTRODUCTION

TOPIC:

CORPORATE INSOLVENCY SYSTEMS IN KENYA: A CASE FOR REFORM

1. INTRODUCTION

This study aims at discussing the corporate insolvency systems, its philosophical underpinnings and their role. We shall then study the corporate insolvency regime in Kenya. We shall be asking ourselves whether what we have as a regime or system is adequate, efficient and/or effective.

We shall then compare insolvency regimes of other jurisdictions including England, Germany and the United States of America. In doing this, we shall be asking ourselves what it is that we can learn from the experience of these other countries.

This study also aims at providing tangible solutions to the problems that shall be identified herein. We shall suggest areas of reform that need to be looked into and thereafter make recommendations.

The purpose of this study is also to arouse the interest of other researchers to do further research in this area that has been neglected for quite a while now.

2. BACKGROUND

The period between 1997 and 2004 witnessed the systemic collapse of major companies and corporations in Kenya. These included banks, insurance companies and a host of other companies. Presently a number of companies
are struggling to survive in circumstances where their assets outstrip their liabilities; that is to say, many insolvent companies are struggling to survive.

When these companies collapse a number of employees are rendered jobless and thousands of creditors including banks and other trading companies and corporations lose millions of shillings. These circumstances have far reaching consequences for the economy of our country.

A status report by the Federation of Kenya Employers states that more than 215 companies have collapsed in the past five years. Employees who lost their jobs as a result of these companies collapse are more than 15,000. These figures are broken down as follows in the said report:

<table>
<thead>
<tr>
<th>Year</th>
<th>No. of Companies that closed down</th>
<th>No. of employees who lost their jobs</th>
<th>No. of Companies placed under receivership</th>
<th>No. of employees within Companies put under Receiverships</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>34</td>
<td>1,255</td>
<td>6</td>
<td>697</td>
</tr>
<tr>
<td>2000</td>
<td>41</td>
<td>1,462</td>
<td>9</td>
<td>2,206</td>
</tr>
<tr>
<td>2001</td>
<td>27</td>
<td>863</td>
<td>4</td>
<td>2,042</td>
</tr>
<tr>
<td>2002</td>
<td>19</td>
<td>969</td>
<td>3</td>
<td>173</td>
</tr>
<tr>
<td>2003</td>
<td>46</td>
<td>3,434</td>
<td>2</td>
<td>260</td>
</tr>
<tr>
<td>2004</td>
<td>23</td>
<td>1,079</td>
<td>1</td>
<td>150</td>
</tr>
</tbody>
</table>

The question that we need to ask ourselves is what causes this trend of collapse of so many companies. The report mentioned above attributes the collapse mainly to what the Federation calls poor business environment. This
is scaled down to the following factors:

- **Poor infrastructure**
- **Insecurity**
- **High cost of power**
- **Corruption**
- **False financial statements**
- **Poor management**

Whatever the cause of these systemic failures of business organizations, the primary question concerns the capacity of the Kenyan insolvency system, first, to prevent insolvency. Secondly, to facilitate the rehabilitation of corporate organizations facing severe liquidity problems. Thirdly, where such rehabilitation is not possible, to cushion individuals and corporate creditors and employees of such organizations from the drastic consequences of such failures. The foregoing, therefore, forms the background for this dissertation.

### 3. RESEARCH PROBLEM

As explained above, the collapse of several major companies in Kenya in the recent past and the consequent loss occasioned to thousands of creditors of those companies, has brought into sharp focus the capacity of the Kenyan insolvency system, first, to facilitate the rehabilitation of companies facing financial difficulties, and next, to cushion creditors from the devastating consequences of such collapse. Serious concerns have been raised regarding the efficiency of the Kenya corporate insolvency system.

While many commentators have attributed the systemic collapse of major companies to financial mismanagement by the directors and managers of
those companies, others have blamed it on the inefficiency of the Kenyan corporate insolvency system. This second group of scholars subscribe to the view that the Kenyan insolvency systems encourage rather than discourage insolvency and once insolvency proceedings are commenced, our insolvency system simply facilitates the plunder rather than preservation of the meager resources of the ill-fated company. How true is this allegation and what can be done about it? Is Kenyan corporate insolvency system in need of reforms? And if so, which reforms?

The main research problem for this dissertation will therefore be to examine whether the Kenyan insolvency system has made any contribution to the systemic collapse of major companies in Kenya and whether the Kenyan insolvency system can sufficiently cushion creditors from the devastating impact of the collapse of a major company. This dissertation will also examine the collateral question whether the Kenyan insolvency system is in need of reform to improve its capacity to address the new challenges brought about by globalization, and if so, suggest the appropriate reforms.

4. THEORETICAL/CONCEPTUAL FRAMEWORK

While the main discussion in this study seeks to be focused on the efficiency (or lack of it) of the insolvency systems in Kenya, it is important to understand the general philosophical underpinnings of insolvency law. In addition, one needs to understand what the roles of insolvency systems are.

The words insolvency and bankruptcy are used synonymously with each other in some jurisdictions. Legally the two terms should be distinguished
from one another. Insolvency is a general state of affairs wherein a debtor is unable to pay its or his debts. A person is referred to as “bankrupt” if that status has been actually imposed in consequence of a formal, legal process to which the debtor has been a party. Bankruptcy is also used in some jurisdictions to refer to personal insolvency. Insolvency status does not have to result from a legal process. The concept of corporate insolvency consists in the corporation’s inability to meet its financial commitments. There are at least three ways of determining whether a corporation is insolvent or not.

1. **The Cash Flow Test**
   
   This is a simple method to determine insolvency. The question one needs to ask is; can the business pay its debts when they fall due for payment?

2. **Balance Sheet Test**
   
   This simply answers the question; does the business owe more than it owns or is the business assets exceeded by its liabilities? This test should include contingent or future liabilities.

3. **The Legal Action Test**
   
   If a creditor has obtained judgment against the corporation, this may demonstrate the business’s insolvency and the creditor may petition to wind up the said corporation.
Corporate insolvency law should ideally have the following overriding objectives; -

(a) To prevent insolvency.
(b) To maximize returns to creditors as a whole where the company cannot be saved.
(c) To establish a fair and equitable system for the ranking of claims and the distribution of assets among creditors involving a redistribution of rights and;
(d) To provide a mechanism by which the causes of failure can be identified and those guilty of mismanagement brought to book and where appropriate, deprived of the right to be involved in the management of other companies. It can therefore be said that the underlying philosophy of an insolvency system should be:

(i) Preventive
(ii) Rehabilitative
(iii) Distributive
(iv) Punitive

Firstly, a good insolvency system should be one capable of preventing insolvency. There should be in place laws and independent institutions capable of monitoring the solvency status of corporations and thereafter prevent insolvency where necessary.

Secondly, a corporation, which is insolvent because its assets are not sufficient to cover its liabilities but which may still be rehabilitated through
the institution of some changes in its management, organization, policies, strategies, operations or finances should be rehabilitated by the insolvency system.

Thirdly, an efficient insolvency system should ensure that if there is no hope of saving the corporation from collapse, then there is fair distribution of the assets of the company among its creditors. Generally insolvency systems have three categories of priority; claims with preference, secured creditors and unsecured claims. Payment to these categories of creditors should be balanced so that the distribution is seen to be fair.

Fourthly, a good insolvency system should be punitive. In this regard it should distinguish between a recklessly managed corporation where for example debts are incurred with the aim of later voluntarily petitioning to be wound up and an honestly and diligent managed corporation forced into insolvency due to harsh economic times. The system should be able to punish conduct that leads to insolvency. The target should be mainly directors and other officers so responsible.

**IMPERATIVES OF A GOOD INSOLVENCY SYSTEM.**

It is one thing for an insolvency system to be efficient but another thing for it to be effectively utilized. In this study we shall examine reasons that will enable effective utilization of an insolvency system.

The first one is the adoption of incentives to use the system. Another attraction for the utilization of an insolvency system is dynamism. One
other reason is that an insolvency regime should address political, social and economic concerns. Finally, there should be flexibility of the rehabilitation package.

5. LITERATURE REVIEW

As mentioned earlier our study is focused on corporate insolvency systems in Kenya. These include not just the laws that govern insolvency but the procedures and institutions as well. The focus is on the efficiency of lack of it. With this in mind, we embarked on reviewing literature of other researchers that relate to this area of research. We could not find any researcher who directly wrote on the same area of research as ours. Most of their work is on general insolvency, which means both corporate and personal insolvency, and the work is mainly theoretical. Most of the other researchers have dwelt on bankruptcy laws. The only other researcher who wrote on corporate insolvency wrote on an aspect of it, which is receivership. Our scope of study is on corporate insolvency as a whole including the insolvency status of corporations, Liquidations, receiverships and dissolution of corporations that is the general state of insolvency.

Our area of study does not just capture the situation in Kenya but compares it to other jurisdictions as well. This study also includes innovations with regard to reforms and recommendations, which is lacking in other works, as we shall demonstrate below.

Ian Fletcher, in his book The Law of Insolvency, gives an in depth study on the law of insolvency. He first tackles personal insolvency then proceeds to corporate insolvency. He bases his study on English Law as
currently amended, which is mainly the Insolvency Act of 1986. He later in his writing delves into the issue of insolvencies with an international element. He gives the English Law and practice in this area and goes through the provisions of the Insolvency Act, which touch on this. All in all his work is quite interesting and captivating raising questions in the minds of his readers on issues like unity of both personal and corporate insolvency laws, and if the said unity works (or supposedly works) in England, can it work in other countries as well?

Thomson J. H, in his book *The Law Relating to Bankruptcy, Liquidations and Receiverships*, also writes on insolvency laws in general that is both personal and corporate insolvencies. His work is mainly theoretical and is also based on the English law as it was in 1977.

Kimani J.K in his dissertation titled, *Receivership Costs, Some Legal Aspects of the Remedy of Receiverships*, tackles the issue of receiverships in Kenya. He states that the law on receivership is inadequate in that it omits the serious questions such as the duration of a receivership, fraud by a receiver on the company, remuneration of the receiver, the plight of other stakeholders in the entity under receivership and the qualifications of a receiver manager. These are very pertinent issues he raises. He goes on to describe receiverships giving their legal perspective. He recommends that a profession of receivers be created and that the law be amended to include duration of receiverships. He also suggests that the remuneration method of receivers should be part of our laws. His work only touches on one aspect of insolvency. He only deals with receiverships. We in this study deal with insolvency as a whole.
Nyagesoa J. M. in his dissertation titled The Purpose of Bankruptcy Law[^8] only deals with the bankruptcy aspect of insolvency law. He notes that Bankruptcy Law is credit-centered. The debtor has a weak if no bargaining position. The author equates bankruptcy to an insurance scheme where creditors have a common pool wherefrom they get their proceeds namely the debtor’s property. He suggests that this being the case there should be mutual trust between both parties, which in insurance is effected through utmost good faith. He suggests that debtors should be transparent to all creditors. He suggests that voluntary presentation of bankruptcy petition should be scrapped as it is subject to abuse by crooks. He recommends the establishment of a Bankruptcy Tribunal to handle matters of bankruptcy. He suggests that the law be amended so as not to be pro-creditor only.

Chesang J. in her dissertation titled The Adjudication Process of Bankruptcy Law[^9] states that the bankruptcy law in Kenya is pro-debtor. It emphasizes the distribution of the debtor’s assets to creditors and also punishment of the debtors. There is hardly any proposition in this work. She suggests automatic discharge of a debtor after a certain period of time. There is very little on reforms of the law in this work.

As can be seen above, there is very little written on corporate insolvency. We have not yet come across any literature to review on the work under study. Most of the literature is on bankruptcy, which is personal insolvency.
6. OBJECTIVES OF THE STUDY

The objectives of this research can be summarized as hereunder: -

(a) To illustrate that there is an urgent need to reform our corporate insolvency systems to improve its capacity not just to adequately and effectively address the new challenges brought by globalization, but also to enhance its capacity to rehabilitate companies facing liquidity problems as well as to cushion creditors from the devastating impact of winding ups, liquidations and receiverships.

(b) To demonstrate that the present corporate insolvency system in Kenya was modeled upon the English Insolvency Systems of the nineteenth century and that they have since been rendered not just archaic, but terribly inefficient by the circumstances and conditions of the global economy.

(c) To show that the recent developments in the fields of technology and science coupled with the internationalization of trade and commerce have created new opportunities for very sophisticated cross-border frauds and other corporate crimes thereby making the business environments more risky and exposing companies to an increased risk of insolvency from many quarters.

(d) To give detailed recommendations on the appropriate reforms that will most likely, improve the efficiency of the Kenyan corporate insolvency system thereby making it possible for Kenyan businesses to compete effectively with businesses from other neighbouring countries for the
limited opportunities available in the global market.

7. **JUSTIFICATION FOR THE STUDY**

A lot of academic debate has been raging regarding the efficiency of the Kenyan insolvency system or lack of it. Such discussions have been so intense to the extent that they have caught the attention of policy makers, who through the instrumentality of the Kenya Law Reform Commission, has seen it fit to act on them.

On 31\textsuperscript{st} January 2005, the Kenya Law Reform Commission under the auspices of the Government Justice Law and Order Reform (GJLOS) programme sent out a request for proposals, calling upon consultants to tender for the consultancy on the reform, not just of the Kenya Companies Act, but also, and more importantly, of the entire Kenyan corporate insolvency system. This work is currently ongoing and we are yet to see its results.

This research project therefore seeks to supplement the efforts so far made in this area and intends to make more meaningful contributions to this country in general and to the corporate sector in particular.

8. **HYPOTHESES**

This dissertation will be premised on the following set of hypotheses:

(a) That the Kenyan corporate insolvency system is very inefficient and that this has partly contributed to the collapse of major companies in the recent past.
(b) That the inefficiency of the Kenyan corporate insolvency system stems from the fact that the same is built upon the superstructure of laws borrowed from the Victorian England, which laws have since been rendered obsolete by the vicissitudes of the global economy, for which reason they have been amended substantially in England where they originated from.

(c) That in order to bring the Kenyan corporate insolvency system in line with the circumstances of the contemporary world, there is need to implement far reaching insolvency law reforms that take into account, not just the domestic risks to business organizations but also, and more importantly, of the risks inherent in international trade in general and e-commerce in particular.

(d) That there is need to move away the traditional punitive goals of insolvency to more humane goals focusing principally on the triune goals of preventing the risk of insolvency, rehabilitating companies already insolvent and preventing the drastic consequences of insolvency on the unfortunate creditors.

9. METHODOLOGY TO BE USED

In the nature of the subject under inquiry the study primarily relies on library research and Internet searches. We shall use this methodology to study textbooks and articles especially recent ones that give an up to date perspective on insolvency systems.
ENDNOTES:

1. The report was given by the National Chairman of the Federation of Kenya Employers; Mr. Aram Mbui to the 46th Annual General Meeting of the Federation. It was also analyzed in the Financial Standard of 26th July 2005.


3. info@ksa.companyrescue.com

4. We came up with these objectives after having researched on insolvency regimes in other jurisdictions. Though not mentioned directly, they appear to incorporate them.


9. Chesang Grace Jemutai; The Adjudication Process of Bankruptcy Law; Whom Does It Serve, the Debtors or the Creditors,(LL.B UoN, Nairobi
CHAPTER ONE:

1.0 THE CONCEPT OF INSOLVENCY: ITS MEANING AND PHILOSOPHY

1.1 INTRODUCTION:

It is a pity that in the contemporary world in which the economic survival of any society depends on its capacity to manage business risks associated with bankruptcies and insolvencies of individuals and companies, discussions on the twin concepts of bankruptcy and insolvency have been reduced to mere platitudes. In saying “bankrupt” or “insolvent” most people now mean the opposite of what they want to convey. Accordingly any effort aimed at reforming the insolvency law to bring it in line with the realities of the contemporary world must, perforce, start by exposing the kernel of bankruptcy and insolvency and present them in all their conceptual starkness.

A reformist’s approach to insolvency law must also be preceded by a painstaking appraisal of the insolvency system itself. This involves a thorough examination of what is happening on the ground and comparing the same with the ideal situations based on the philosophical underpinnings of insolvency law.

This chapter therefore seeks to re-conceptualize bankruptcy and insolvency, examine the philosophical underpinnings of insolvency law and thereby expose the imperatives of an efficient insolvency system.

1.2 THE DEFINITION AND DISTINCTION BETWEEN BANKRUPTCY AND INSOLVENCY

Most writers use the words bankruptcy and insolvency synonymously with each other. This however should not be the case. The two terms though closely related have distinct meanings.

Bankruptcy is defined as the commission of a bankruptcy offence followed by adjudication.\(^1\) Bankruptcy therefore is a legal status. This is as opposed to insolvency, which we shall see shortly as being a factual situation.
The status of a bankrupt can only be achieved through a legal process. Furthermore, the term is usually used to refer to an individual. For an individual to be declared bankrupt he or she must have committed any of the following acts of bankruptcy:

1. If in Kenya or elsewhere, he makes a conveyance or assignment of his property to a trustee or trustees for the benefit of his creditors generally,

2. If in Kenya or elsewhere, he makes a fraudulent transfer, conveyance, gift or delivery of his property or part of it,

3. If in Kenya or elsewhere, he makes any conveyance or transfer of his property or of any part thereof, or creates any charge thereon which would under the Bankruptcy Act or any other Act be void as a fraudulent preference if he were adjudged bankrupt,

4. If with the intention to defeat or delay his creditors he departs from Kenya or his dwelling house or otherwise absents himself or begins to keep house,

5. If execution has been levied against him in any civil proceedings and his goods have been sold or kept by the bailiff for 21 days,

6. If he files a declaration of his inability to pay his debts or presents a bankruptcy petition against himself,

7. If a creditor has obtained a final decree or order against him and served a bankruptcy notice which he does not comply with within 7 days,

8. If he gives notice to his creditors that he has suspended or is about to suspend payment of his debts,

Insolvency on the other hand is a general term. It refers to a general state of affairs wherein a debtor (whether a natural person or a legal person) is unable to pay his
debts\textsuperscript{3}. Strouds Judicial Dictionary\textsuperscript{4} describes insolvency not merely to mean "being behind the world if an account was taken, but insolvency to the extent of being unable to pay just debts in the ordinary course of trade or business"\textsuperscript{5}.

As earlier stated therefore insolvency is a factual situation which then can be determined by applying what is normally called the tests of insolvency. They are:

1.2.1 **The cash flow test**
This involves a confirmation that the debtor is unable to meet its current obligations\textsuperscript{6}. That is, the debtor cannot pay his/its debts when they fall due. This test is more commercially useful and easier to determine. Most creditors are unable to access financial records of a debtor and they will just rely on the fact that their debt has not been paid when it fell due to determine the solvency status of the debtor. Though easily accessible this test must be approached with a lot of caution. This is because there should be a clear distinction between a debtor's mere refusal or omission (especially where the debtor has the material means to do so) to pay one or more of his/its debts and the factual circumstances of the debtor's inability to pay debts.

1.2.2 **The balance sheet test**
This is another way of determining the solvency status of the debtor. In this case what one seeks to find out is whether the business owes more than it owns. That is, the liabilities exceed the assets with a result that it is impossible for all the liabilities to be discharged in full. This is a more accurate test save for the fact that it may be difficult to access the financial records required.

Most of the Kenyan laws that regulate the different kinds of companies have requirements for the publication of accounts. For instance under the Companies Act\textsuperscript{7} the directors of all companies are required to provide a profit and loss account within 18 months of incorporation and subsequently once every calendar year during the companies' annual general meeting.
The Banking Act on the other hand requires every banking institution to exhibit throughout the year at a conspicuous place in every office and branch a copy of its last audited balance sheet. The balance sheet should also be submitted to the Central Bank of Kenya not later than 3 months after the end of its financial year. Insurance companies are not exempt from this requirement either. They are to prepare accounts and balance sheets after each financial year.

All these provisions do not require the publication of the accounts to the members of the public. Accounts are left to be managed by the company. This only serves to buttress our earlier position that it is more difficult to prove a company's solvency status using the balance sheet test. The other difficulty may arise because of what is called creative accounting. This has been common especially with financial institutions. Their balance sheets are sometimes made to look “rosy” yet the institution may be facing insolvency. Creative accounting includes tax-dodging methods.

That said and done the above test presents a different kind of challenge. Our legal systems do not differentiate between two situations. That is, between short-term insolvency and absolute insolvency. Short-term insolvency is also known as Practical Insolvency. Here the debtor's total assets are not sufficiently liquid to provide an adequate amount of money to meet the liabilities as they fall due. In the situation of Absolute Insolvency the sum total of all debts present, future and contingent exceeds the total sum of all assets. In this case, the state of insolvency is irretrievable. Our law treats these two situations the same. Our suggestion is that if a company is going through practical insolvency then it should be rehabilitated.

1.2.3 The legal action test
This is the third test of insolvency. If a creditor has obtained judgement against a company and the Company is unable to settle the same then this may serve as an indicator of its solvency status, which the creditor may rely on in the winding up petition.
This test is widely used by creditors who having obtained judgment have made unsuccessful attempts at having the said judgment satisfied by the debtor. A judgment against a debtor is an effective proof that the debt is due and payable. Though a highly recommendable test, one should be careful in using this test as a final determinant of the solvency status of a company. This is because if the judgment relied upon is not a judgment on the merits of the case then questions may be raised on whether the debt is due and payable though legally it is.

1.3 THE UNDERLYING PHILOSOPHICAL FOUNDATIONS OF INSOLVENCY LAW.

The philosophical foundations of insolvency law are based on ordinary commercial realities. To begin with everybody hates insolvency. It is therefore expected that the primary goal of insolvency law should be to prevent insolvency. However, it must also be considered that it is impossible to eliminate insolvency in all its forms, irrespective of the stringent measures put in place. It is therefore realistic that insolvency law should also seek to identify companies and individuals facing liquidity problems and rehabilitate them. This, then is the second most important objective of insolvency law. Where, however, the rehabilitation programme fails and the company in question becomes insolvent then insolvency law acquires a completely new and important role; that of ensuring that the assets of the insolvent company are distributed fairly to all its creditors. This has been referred to as the distributive role of insolvency law. Finally, for insolvency law to be effective, it must instill some discipline on managers and directors of companies. It should therefore punish fraudulent, corrupt, careless or negligent conduct that leads to insolvency. This has been referred to as the punitive role of insolvency law.

In what follows, we shall examine briefly each of the goals.
1.3.1 The Philosophy Of Prevention

There should be institutions and laws in place to prevent insolvency. Prevention of insolvency should be viewed in two ways. Firstly, the general prevention of insolvency of which caters for all companies. We have a good example of this in the Sick Industrial Companies (Special Provisions) Act of 1985 of India\textsuperscript{12} which was enacted to make in the public interest special provisions with a view to securing the timely detection of sick and potentially sick companies owning industrial undertakings, the speedy determination by a board of experts for adopting the preventive, ameliorative, remedial and other measures which need to be taken with respect to such companies.\textsuperscript{13} The functions of the Board do not include to wind up the companies. It conducts inquiries into sick companies and recommends winding up to the High Court if the company cannot be rehabilitated. This Board performs the function of an oversight board and therefore foresees if a company will be falling into the so-called 'sick state'. It then conducts an inquiry into how and why it did so. The Board finally makes recommendations for revival of the said company including its winding up by the High court if the said company cannot, in their opinion be rehabilitated.

Secondly, there is the prevention of insolvency at a time when the company is facing solvency problems. In this case prevention of insolvency should include such measures as suspension of payments. This measure should also be used to rehabilitate an insolvent company, but even a company that is not yet insolvent (properly so-called) can use this measure to prevent insolvency. Under this remedy, when a corporation possesses sufficient property to cover all its debts but foresees the impossibility of meeting them, when they fall due, it may petition the relevant authorities to enable it to engage in a rehabilitative programme.

This remedy allows a corporation to propose to its creditors a moratorium on payment of its claims while still suffering from liquidity problems. The challenge that this system poses is whether it should be left in the hands of creditors entirely to accept or refuse to accept the proposal. If the process is entirely creditor driven as
the case in countries like Philippines\(^{14}\) it may turn out not to have much effect as most creditors would want their debts paid in the shortest time possible. The creditors may opt for the surer and faster way of winding up the company.

1.3.2 **Rehabilitative Philosophy**

The second objective of an insolvency system is that it should restore the debtor company to profitable trading where practicable. That is the system should be rehabilitative.

A corporation which is insolvent because its assets are not sufficient to cover its liabilities but which may still be rehabilitated through the institution of some changes in its management, organization policies, strategies, operations or finances should be given a second chance especially where it shows signs of revival.

This is an important goal of an insolvency system because if the corporation is allowed to be dissolved, it is mainly the creditors who benefit. But it is not only the creditors who are adversely affected by the insolvency. For the creditors their failure to recover that debt means simply that, the failure to recover their debt. But for the shareholders of the corporation, it means total loss of their investment. If the company is rehabilitated the shareholders are given a chance to retain their investment. The challenge is who would determine whether a corporation should be rehabilitated? Should it be the creditors or an institution created for that purpose? Our suggestion would be the latter. This is because as with the issue of suspension of debts, this decision should not be left entirely in the hands of creditors who may be in a hurry to get their debt paid through the winding up of the company.

The Rehabilitation concept in an insolvency system should also cover areas like who will take charge of the implementation of the rehabilitation plan not forgetting to cater for who manages the company during the rehabilitation process.
1.3.3 **Distributive Philosophy**

The third objective of an insolvency system should be to maximize the return to creditors as a whole where the corporation itself cannot be saved. The insolvency system should aim at establishing a fair and equitable system, the ranking of claims and the distribution of assets among creditors involving redistribution of rights and to provide a mechanism by which the causes of failure can be identified. The system should be **fairly distributive.** We shall see how our Kenyan law handles this issue in the next chapter. In the distribution of assets of the debtor most insolvency regimes have three categories of priority;

(i) Claims with preference.
(ii) Secured claims
(iii) Unsecured claims.

Claims with preference include tax and government interests, wages e.t.c. In some countries like Korea, the constitutional court of Korea declared unconstitutional the provision of the Basic Act of Taxation stipulating the priority of tax claims over the security interests established within one year of the creation of the tax claims. The National Assembly of Korea thereafter amended the Act so that tax claims did not rank in priority over the secured claims. This is an issue of balancing public interest vis-à-vis private interest.

1.3.4 **The Philosophy Of Punishment**

The fourth underlying philosophy is that the insolvency regime should be **punitive.** First of all those who are guilty of mismanagement should be brought to book. The Chief Justice of Kenya Justice Evans Gicheru captured this sentiment recently when he said that the judiciary is proposing strict regulations to manage and monitor performance of insurance firms. The regime he said should involve holding the chief executives and top managers of the companies responsible for any mismanagement. He went on to say: -
"They should be held personally and criminally accountable for business fraud leading to the insolvency of the companies as has been done in other jurisdictions in the recent years."

The insolvency regime should also deal with incidences of insolvency offences during the pendency of the insolvency proceedings such as fraudulent preference, disposal of property among other offences. An effective insolvency system should therefore be in a position to punish fraudulent, corrupt, careless or negligent conduct that leads to insolvency.

1.4 THE IMPERATIVES OF AN EFFICIENT INSOLVENCY SYSTEM

Having stated that an efficient insolvency regime should be preventive, rehabilitative, distributive and punitive, the following are some of the issues that need to be addressed to ensure that an efficient insolvency system works.

(i) Firstly, there should be an incentive to utilize the system. Without an incentive, the efficient system may be in place but may not be used by those who are expected to. For instance, in Thailand a rehabilitation law was enacted in 1998. There was no incentive to use this law over the other laws that provided for dissolution of companies. This led to very few rehabilitations.

We should contrast this to Australia where a voluntary administration procedure was introduced in 1993 which installed clear incentives for directors of insolvent companies to have prompt recourse to the voluntary administration system and a new regime imposing criminal and personal liability for directors of companies who continued to trade while insolvent. If the directors promptly appointed a voluntary administrator, then they would avoid personal liability. In addition, the taxation laws in Australia were amended to provide for personal liability of directors for unpaid taxes if they failed to appoint a Voluntary Administrator within a specified period following a receipt of a penalty notice from the taxation authorities. This incentive
has triggered many voluntary administrations in Australia, which has become the most commonly used form of insolvency procedures.

(ii) Secondly, an efficient insolvency system should also be predictable in different ways. In the first instance, it should be predictable in terms of priority given to secured creditor claims and whether their priority is absolute or not. It should also be predictable in the enforcement mechanisms available to creditors. This especially may lead a lender to decide whether to lend or not. The issue of priority is an important issue such that if the system is predictable, in this regard, the absence of absolute priority will not in practice discourage lending.

In an insolvency scenario however, it is important in our opinion that priority be afforded to new money provided in order to preserve a viable business. Although in order to protect creditor interests (i.e. the general body of creditors) and avoid unnecessary dilution of their claims, new priority should be only be afforded to new money if an independent planner, administrator or trustee is in charge of the business. That is if the business is in the process of rehabilitation as mentioned above.

(iii) Thirdly, insolvency systems however efficient need to be dynamic. One of the lessons learnt from the recession in the late 80’s in many countries and Asian crisis in the late 90’s is that deficiencies in insolvency systems materialize in times of crisis. The economic and social purpose of insolvency law changes as the economy moves through its cycles. In times of crisis it is advisable from a macro and micro economic perspective that the goal of insolvency laws should be to focus on saving viable businesses even if rehabilitation over a number of years will be required to achieve this end. However in times of economic prosperity, insolvency regimes should offer more utility in providing quick and direct liquidation of insolvent entities so as to free resources to be allocated to other prosperous businesses.
Furthermore the stigma attached to insolvency affects the suitability of its use at a given time. For instance in times of crisis it is important that directors do not feel that an admission of insolvency is an embarrassing situation and should be avoided at all costs. While in times of economic prosperity the stigma should serve to bring out the positive overall effect on the survival of a business in trouble. These matters are intangible.

(iv) Fourthly, an insolvency law should inherently **address political, social and economic concerns**.

Insolvency law should by its nature be geared towards achieving a political, social or economic objective. It has a role in the efficient operation of the economic market place. If it favors debtors or creditors or secured creditors or provides priority to employees or taxation authorities it is considering political and social interests.

In drafting or designing an insolvency system, due regard must be had to international law and conventions, for example the International Labor Organization (ILO)\textsuperscript{18} concerning the protection of workers’ claims. In the event of insolvency of the employer this convention should be considered especially by countries that have signed and ratified it.

(v) Fifthly, in an efficient insolvency system directors of insolvent companies who continue to trade and incur debts should have a **direct responsibility to creditors**. The concept of corporate veil and corporate limited liability that directors rely on should be done away with in such cases. These duties should include both statutory and fiduciary duties. A director who breaches his duties must be responsible to those to whom he causes damage.

(vi) Sixthly, there should be **flexibility** of the rehabilitation package. The more flexible the procedure, the greater the likelihood of successfully saving a viable business and maximizing the returns to creditors and shareholders. The procedure should involve both business and corporate reorganization.
1.5 **CONCLUSION:**

Having thus examined the meaning of and the distinction between bankruptcy and insolvency, we have demonstrated that while bankruptcy has conventionally been regarded as a legal issue, insolvency has always been treated as a factual issue. One thing that needs to be considered is whether there is any value in perpetuating this distinction.

Secondly, we have illustrated the existence of a fundamental disconnect between the philosophy of insolvency and/or bankruptcy law and the goals of the current insolvency and bankruptcy law.

Finally, we have also discussed the imperatives of efficient insolvency system. In what follows, we will look at how the aforesaid disconnect can be eliminated with a view to improving the efficiency of our insolvency law.

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1. Ex. p. Attwater, S. ChD. 30
2. Section 3 of the Bankruptcy Act Cap 53 of the Laws of Kenya
3. Parke B., Parker V. Gossage, 5 L.J Ex 4
5. Per Willes J in R Vs. Saddles Co. 10 HL Cas 404
6. Per Lord M'Laren in M'Lay V M' Queen, 1 Fraser 804
7. Section 148
8. Section 22 of the Banking Act
9. Section 23 of the Banking Act
10. Section 54 of the Insurance Act
11. Stiglitz Joseph: The Roaring Nineties; Why We are Paying The Price for the Greatest Decade in History, (Penguin Books; London 2003) at Pg 129
12. of 1986
13. Under Section 4 of the Act. The Board for Industrial and Financial Reconstruction was constituted.
14. The Insolvency Act of Philippines provides for this remedy.
15 Sogeun O. H.; Insolvency Systems in Asia: An Efficiency Perspective; Creditor Rights in Insolvency Procedure; (Sydney Australia 1999).

16 The Chief Justice's speech delivered during the admission of new Advocates in Nairobi and reported in the Daily Nation of 29th July 2005.

17 Lampros Vasilio: Insolvency systems in Asia; An efficiency perspective (Sydney Australia 1999)

18 Ibid

19 No. 173
CHAPTER TWO

2.0 Corporate Insolvency Law in Kenya – A Critical Appraisal

2.1 Introduction:

In the previous chapter, we examined the meaning and distinction between insolvency and bankruptcy, the philosophical underpinnings of insolvency law, and the imperatives of an efficient insolvency system. When this debate is considered in the context of Kenya, it automatically becomes essential to consider whether the Kenyan insolvency law conforms to the already-discussed philosophies of insolvency law, and whether the Kenyan insolvency system is efficient or not. In an endeavour to answer these questions, and thereby establish whether there is any need to reform our insolvency law this chapter examines the Kenyan corporate insolvency regime in some detail.

2.2 The Insolvency Regime in Kenya

In Kenya the insolvency regime is generally found in the following Acts:

(a) The Companies Act
(b) The Deeds of Arrangements Act
(c) The Bankruptcy Act
(d) The Banking Act
(e) The Insurance Act

Accordingly, and for a more spectral analysis, we shall examine each of these statutes briefly to see what bearing they have on our insolvency regime. Since our discussion herein focuses on corporate insolvency regime, it therefore follows that we shall dwell more on the Companies Act, the Banking Act, and the Insurance Act. We shall then have a brief discussion of the Deeds of arrangements Act and then carry out a case study of an insolvent company before concluding this chapter.
2.2.1 THE BANKING ACT

(i) An Overview

The Banking Act (hereinafter called "the Act") is the Act that governs banks and financial institutions in Kenya. Indeed banks are companies that begin by incorporation under the Companies Act. They are later licensed to transact business under the Banking Act. But what is a bank? Is it a company? The answer to this question is found in the interpretation section of the Act. It defines a bank as a company that carries on or proposes to carry on the business of banking in Kenya. This definition includes The Co-operative Bank of Kenya but excludes the Central Bank of Kenya. The same section defines a financial institution as a company other than a bank that carries on or proposes to carry on financial business. From the above definitions we observe that banks and financial institutions are companies, which means that the provisions of the Companies Act govern them.

It is therefore also true that the procedures applying to the winding up of companies under the Companies Act should also apply to banks as well as financial institutions. This is as per the preamble to the said Companies Act. This in fact was the position until around the Mid 80’s. Before this time banks and financial institutions were being wound up under the provisions of the Companies Act. Around mid-80’s there was an upsurge of collapsing banks. The winding up procedures proved to be too tedious complex and unduly long. This was a matter of concern especially because of the effect it had to the economy of this country. It was therefore necessary to find a solution to this problem as quickly as possible. This situation led to an amendment to the Banking Act, which made it mandatory for winding up of banks and financial institutions to be undertaken under the Act. Under this amendment the Deposit Protection Fund Board (hereinafter called the "the DPFB") was established as the liquidator of all banks and financial institutions that were placed under liquidation.
So here we have an interesting scenario where there are two parallel legal regimes that govern insolvency of banks. During our research herein we found that this confusing scenario ought to be resolved through legislation. We have discovered as we shall later demonstrate that in countries such as the United States of America, their law specifically exempts banking institutions and insurance companies from being wound up under the Bankruptcy Code since specific legislation has been enacted that govern the winding up of such institutions. In practice though banks and financial institutions have been and are being wound up under the Act and the Central Bank has been at the forefront in implementing the winding up of banks and financial institutions under the Act. This practice has been brought about by the fact that there is simplicity of procedures therein. The other advantage of the procedures under this Act is that the Central Bank to which the DPFB belongs has supervisory powers over banks and financial institutions. It has the necessary information of banks and financial institutions and therefore qualifies to oversee their winding up. The insolvency provisions in the Act are outlined below.

The Act gives the Central Bank powers to intervene in the management of banks in certain situations such as inability to meet their debts or when their auditors gives a report of fraud or breach of the Act.

The intervention by the Central Bank involves appointment of a manager for the bank and removal from office of those responsible for the bank's situation. This intervention we presume is only implemented when in the opinion of the Central Bank the bank can be revived and continue doing profitable business.

So when is a bank deemed to be insolvent and what other measures other than management by the Central Bank mentioned above can be undertaken? The Act specifies when a bank can be deemed insolvent, which includes;

(a) Inability to pay sums due to depositors
(b) The bank is deemed unable to pay its debts under the Companies Act
(c) A winding up order has been made against the bank or a resolution of the creditors to wind it up has been passed

(d) The Central Bank has determined that the value of the banks assets is less than its liabilities.

It therefore follows that the Act provides for both the cash flow and balance sheet test of insolvency. This in our opinion makes this Act much better than the others that govern insolvency, as we shall see later.

Now when the bank has been confirmed to be insolvent to a point of no return then two procedures for winding up are provided. The first one is very simplified. The Act provides for voluntary liquidation.

Thus the bank may if it is insolvent seek for the permission of the Minister\textsuperscript{12} to voluntarily liquidate itself. All that is needed is an application for the Ministerial approval in the prescribed form.

Other than voluntary winding up the Act also provides for winding up by Central Bank through the DPFB as earlier stated. This may be termed as involuntary liquidation. In this case the liquidator is the said DPFB. The High Court is only allowed by the Act to appoint a liquidator unless the Central Bank waives its rights to do so. The liquidation procedures by the Central Bank are clearly provided here.\textsuperscript{13}

The Act also provides for the ranking of creditors. Under the Act the depositors rank first in the list of priority of creditors. The other creditors are ranked according to the provisions of the Companies Act\textsuperscript{14}

The Act further goes on to provide that the provisions of the Companies Act apply to winding up of banks only if the latter is not inconsistent with the former. This does not in our view solve the problem mentioned earlier of the conflict of the two Acts as
they both still apply. In our view one Act should apply to the exclusion of the other completely.

We also suggest that this information that is so readily available to the Central Bank should also be availed to the members of the public as a check to the powers of the Central Bank. We also agree with the issue raised by the King’arui Report when it posed the question whether the DPFB should be the only liquidator of banks. What if it is not acting at all or acts when it is too late or acts in a rash manner? The Act should be amended to allow depositors and creditors to take their plight to court in such cases and the court to appoint a liquidator for the bank.

(ii) **An Appraisal of the Insolvency provisions of the Banking Act**

Having stated the above we shall not be fulfilling our mandate if we do not examine the Act against the backdrop of the general philosophical underpinnings of insolvency law.

Firstly on the issue of prevention of insolvency, we believe that in a way the role of Central Bank as a supervisor of banks and financial institutions cannot be underplayed. Section 17 of the Act provides that the Central Bank may from time to time prescribe the minimum ratios to be maintained by the institutions as between their core capital and total capital on one hand. Furthermore, the auditors of these financial institutions are approved by the Central Bank and their audit reports are submitted to the same bank. This kind of supervision has been said to be a mirage as most of the time auditors give a “rosy” picture of the financial institution while the reality is different. It is sometimes called creative accounting and it is what led to the collapse of major companies like Enron in the U.S.A and Parmalat in Italy. In Kenya we have seen so many cases of companies like Access Insurance Company Limited and United Insurance Company Limited, which have gone under due to this kind of reporting. It is now that the Auditors in Kenya are trying to adopt the new International Standards Of Accounting which place more responsibilities on Auditors.
to look out for fraud when examining financial statements. Also under Section 27, the Central Bank may require an institution to furnish it with information that will enable it maintain its supervisory and surveillance role. Under section 32 the Central Bank if directed by the Minister inspects any institution. So much is said for the supervisory role of the Central Bank, but what of after having foreseen insolvency coming does it prevent it? Under section 33, the central bank ha powers to advise and direct the institutions on how to improve the bank and even appoint a manager. These provisions may be a good start in preventing insolvency in theory but in practice we hardly see them implemented. All in all we can say that this Act at least makes an attempt in providing measures though minimal, which in the end may prevent insolvency.

Secondly there are very few provisions in this Act that enables insolvent institutions to be rehabilitated. The Act provides that the Central Bank appoints a liquidator when the institutions become insolvent, but section 34 may be credited for attempting to adhere to this principle. It allows the Central Bank to appoint a manager, remove incompetent officers or employees. This is yet to be seen in practice as most banks have been liquidated without these options being adopted by the Central Bank.

Thirdly, on the question of Distribution of the assets of insolvent banks, section 34A(b) Provides that depositors rank first then all the other creditors are ranked as per the ranking under the Companies Act. As earlier stated we find this a fair distribution of assets.

Fourthly, on the Punishment of responsible officers of an insolvent bank, there is very little of this provided by the Act. The Act does not meet out punishment for officers and employees responsible for the insolvency of their institutions or those who continue to trade while insolvent. S49-metes out punishment for officers who do not comply with the Act. They should be held personally liable for debts incurred by the insolvent banks.
2.2.2 **THE INSURANCE ACT**

(i) **An Overview**

The Insurance Act (hereinafter called “the Act) has provisions that deal with insolvency of insurance companies. This therefore poses the same problem witnessed when discussing insolvency of banks. Insurance companies are first and foremost companies registered under the Companies Act, which means that the provisions of the said Act that govern insolvency of companies should apply to them as well.

Under Section 23 of the insurance Act no person shall be registered as an insurer unless the person is a body **corporate incorporated** under the Companies Act and at least one of the controlling interests are held by Kenyans. This again brings forth the problem of duality of regimes governing these companies.

The Act\(^9\) spells out solvency margins for companies carrying out general insurance business and those that don’t. The prescribed minimum shillings Ten Million or 15% of net premium income and 1 million for both kinds of companies respectively. In both cases the admitted assets should not be less than the aggregate value of admitted liabilities. The solvency margin is mainly determined by the balance sheet test. The Act\(^20\) also provides for preparation of accounts and balance sheets every financial year, which should be deposited with the commissioner of insurance. The fine for non-compliance is Kshs.100/= and Kshs.1000/= for everyday the breach continues. Part XII deals with insolvency and winding up.

The Act allows two types of winding up procedures, which are **voluntary winding up** and **winding up by the Court**. But the said Act clearly prohibits voluntary winding up of an insurer carrying out long-term insurance business not withstanding
anything to the contrary in the Companies Act.\textsuperscript{21} This provision we believe is for the protection of long-term policyholders like life policy insurance but we find it in direct conflict with the Companies Act. Under winding up by the Court, either the Commissioner of Insurance or a creditor can present the petition for winding up to court. A petition can be presented on grounds that it is just and equitable in the interest of the policyholder thus giving the Commissioner the discretion of deciding what is just and equitable in the interest of the policyholder.

The Act does not have any provisions on priority of claims. It does not even refer to the Companies Act in this respect which is a shortcoming of the Act. The Act only provides for the appointment of a Statutory Manager by the Commissioner of Insurance under section 67(c) (2) (1) to conduct the affairs of the company where the company does not meet the solvency margins. The aim of this provision is to rescue insurance companies but none of insurance companies put under statutory management in Kenya has ever been revived and come out of its insolvency status. They all end up being wound up.

(ii) **Insurance Act from an Insolvency Efficiency Perspective**

We now briefly consider whether this Act adheres to the philosophical underpinnings of insolvency laws.

Firstly on the issue of prevention of insolvency there is very little that one can attribute to that objective in the Act. It vests some supervisory powers on the Commissioner of Insurance an example of which is found in section 7. This provision gives the said Commissioner the power to call for information and production of books of accounts. The fine for breach of this provision is a fine of Ten Thousand Shillings (Shs.10,000/=). In practice The Commissioner has not been seen to exercise this power much. It is only recently that he has come up to demand for these reports when so many insurance companies have gone under, especially after
the case of United Insurance Company Limited had been highlighted. So we can rightfully say that the insurance insolvency regime ranks poorly in this principle both with regard to written down law and in practice.

The second principle is that of rehabilitation of insolvent insurance companies. This Act has some provisions in dealing with this issue. Especially the ones on statutory managers stated above. In practice the rehabilitation of these companies is rarely realized through this option.

On the third principle of fair distribution of assets of insurance companies we find that this is not provided for at all in this Act.

Fourthly, there is no punitive measure with regard to directors who continue to trade while insolvent.

In our assessment this Act is a poor source of insolvency law for Insurance Companies.

2.2.3 INSOLVENCY AND THE COMPANIES ACT

Insolvency provisions of the Companies Act can be grouped into 3 main categories

a) Winding up of insolvent companies
b) Receiverships
c) Reconstructions

A) WINDING UP OF INSOLVENT COMPANIES

The Companies Act Cap 486 (hereinafter called “the Act”) was enacted in 1962. It is a Replica of the Companies Act of England of 1948. Since then it has been amended nominally in 1978.
Sections 212 to 344 are devoted to winding up procedures. We found these sections to be quite repetitive, complex, bulky and tedious. We shall now attempt to highlight some of the sections we found to be relevant to this discussion as below:

Section 212 spells out the modes of winding up as: -
(a) Voluntary
(b) By the Court
(c) Or subject to supervision by the Court.
In what follows, we shall examine briefly these modes of winding up.

(a) **Voluntary winding up**
The Act gives instances when accompany can be voluntarily wound up as: -
(i) When the period fixed for the duration of the company by the articles expires.
(ii) When an event occurs which the articles provide that at the occurrence of the same the company is dissolved.
(iii) When the company in general meeting has passed a resolution requiring it to wound up.
(iv) When the company resolves by a special resolution to wind up.

It is interesting to note that inability to pay debts is not one of the grounds to wind up a company voluntarily thus a company may be insolvent but since no resolution had been passed to wind it up it will continue to trade.

Once the resolution is advertised the company stands wound up from the date of resolution. This mode of winding up has been subjected to abuse as companies have been registered for corrupt purposes and dissolved soon thereafter using method. These so-called “shell” companies thrive for lack of proper laws to pin liability of their directors. England has tried to circumvent this problem by enacting the Company Directors Disqualification Act of 1986, which seeks to disqualify directors who are
unfit to manage a company. Under section 214 of the Insolvency Act of England a
director is to bear civil liabilities for debts incurred by the company that continues
trading while insolvent. Section 216 of the English Insolvency Act prohibits directors
of a company wound up to be involved in another company without the court's leave.
This is to avoid the registration and dissolution of one company only to register
another by the same directors. Our law is silent on such salient issues.
The second mode of winding up is winding up by the court.

(b) **Winding up by the court**

This kind of winding up is also called compulsory winding up. Section 219 spells out
the grounds for which the court can wind up a company. They are: -

- The company has by special resolution resolved that it be wound up by the
court.
- The company defaulted in delivering the statutory report to the registrar or in
holding a statutory meeting.\(^{23}\)
- The company does not commence business within a year from its
incorporation or it has suspended business for a whole year.
- The company is unable to pay its debts.
- It is just and equitable in the opinion of the court that it be wound up.
- Winding up proceedings have been commenced in the country of
incorporation of a foreign company carrying on business in Kenya.

From the above we can deduce that the solvency status of a company has very little
bearing on whether it may be wound up or not as these grounds hardly lead one
such a conclusion. It therefore follows that a company may be solvent but still end
up being wound up by the court. The most common ground used to petition for a
winding up order is that the company is unable to pay its debts.

The Act\(^ {24}\) specifies three criteria or methods for determining that the company is
unable to pay its debts hence insolvent. Interestingly the Act only provides for the
cash flow test of insolvency in these three criteria. They are; -
(a) A debt exceeding shillings one thousand (shs.1,000/=) must be owed by the debtor to a creditor or creditors collectively. Furthermore the creditor must have served on the company a demand, which has remained unpaid for three weeks.

(b) Execution or any process has been issued on the company by any court and the company has not wholly or partially satisfied it.

(c) If it is proved to the satisfaction of the court that it is unable to pay its debts. In coming to this conclusion the court shall take into account the contingent and prospective liabilities of the company.

We can already see one shortcoming of our Act among the many others. It does not provide for the balance sheet test as a determinant of insolvency. The English Insolvency Act provides for the balance sheet test of insolvency as well. It states that where it is proved to the satisfaction of the court that the value of a company’s assets is less than the amount of its liabilities then the company is deemed to be unable to pay its debts. Having earlier said that the balance sheet test is the more accurate of the two it is quite important that it be given prominence in our Act.

The Act also limits the number of persons allowed to present a petition. They are: -

- The Company
- The Company’s creditors
- Contributories

We find this list too narrow. There should be a wider range of persons allowed by the law to present petitions such as the Registrar of Companies and others. The other issue that is worth considering when reviewing the provisions of the Act is whether the jurisdiction in insolvency matters should only be vested in the High Court. Though the English Act more or less does the same thing we should ask ourselves whether this is appropriate for our situation. Our aim is to have a simplified
accessible and affordable insolvency regime. Shouldn’t we then give jurisdiction to Magistrates Courts to exercise the same on behalf of the High Court. The Tanzanian Companies Act\textsuperscript{26} of 2002 gives jurisdiction in winding up matters to both the High Court and the Magistrates Court.

The Act gives very lengthy and needless to say complicated procedure for winding up, which we shall not go into suffice to say that, the same needs to be simplified and reduced.

(c) **Winding up under the court’s supervision.**

This mode of winding up is not found in English Insolvency Act or the Tanzanian Act. Under the Kenyan Act it is found in section 304. The court is empowered under this provision to supervise a voluntary winding up wherein there is liberty for the parties to seek the court’s direction on issues they cannot agree on\textsuperscript{27}.

The King’arui report\textsuperscript{28} noted that this mode of winding up had never been utilized but still suggested that it be retained. Should this be case? Do we need to retain a provision that is not been utilized just for the sake of having it there? Maybe we should investigate why this mode of winding up is not popular and either improve it or remove it all together.

b) **RECEIVERSHIPS**

This is found in Part VII under the Companies Act\textsuperscript{37}. There has been growing criticism of receiverships in Kenya in that they do not achieve what they were meant to achieve. Instead of resuscitating business in order to improve their profitability and hence debt repayment ability, they more or less have been seen as a kiss of death to the company\textsuperscript{38}. The appointment of a receiver is one of the remedies available to debenture holders or mortgagee when the company defaults in repayment of the loan. A receiver can be appointed by the court or under the power contained in an
Having looked at the provisions in our Act that deal with receiverships, we agree with the King'arui Report that the Act does not spell out the qualifications of those to be appointed as receiver managers. In fact this is one of the main reasons why receiverships "kill companies" because the receivers are not trained or well equipped for the jobs. The report went ahead to recommend an amendment to the Act, that only the following categories of persons should be appointed as receivers/managers:

(a) A practicing certified public accountant  
(b) A practicing certified public secretary  
(c) A practicing advocate

In addition to being appropriately qualified, we recommend that before adopting the appointment as a receiver, the appointee should have adequate professional indemnity insurance cover. Furthermore, the receivers should upon appointment execute a bond for the good performance of their work. In the English system, the Institute of Insolvency Practitioners trains, examines and prepares persons who would take up these roles. We should look for ways of establishing this kind of system into our insolvency regime.

Also the fact that the Act does not make receivers accountable to anybody is a major problem in our system. The Act only makes it mandatory for the directors of companies to be accountable to them. We also suggest that the issue of remuneration of receivers should also be part of the reforms to be carried out. The current situation is that they fix their own remuneration unless fixed by the court. They therefore end up overcharging and make their remuneration a priority over repayment of any other debt. In the end, the company collapses.

The receiver managers are also not held liable for acts committed during their tenure. The law as it is allows them to deny personal liability in contracts entered
into by them. The law on receiverships currently has so many loopholes and is conduit for the collapse of so many insolvent companies. This problem has to be taken care of in our law reform agenda.

(c) **RECONSTRUCTIONS**

According Blacks Law Dictionary reconstruction is the process of re-building, recreating or reorganizing something in the context of insolvency, re-construction is the process of re-creating an already insolvent company. There are several provisions in the Companies Act dealing with reconstructions. The following are some of them.

a) Section 210 of the Companies Act dealing with acquisition and transfer of shares.

b) Section 209 of the Companies Act dealing with Takeovers and Amalgamations

c) Section 207 dealing with compromise arrangements with creditors.

i) **Acquisition and Transfer of Shares**

Public offers of shares have assumed great prominence in recent times. It has come to be universally accepted as the most efficient method that an insolvent company can use to raise funds as part of its reconstruction process. The idea of swapping a debt for equity in the company has also received wide acceptance in contemporary world. Instead of winding up the company and distributing its meager resources to the creditors who eventually end up getting only a small fraction of their debts paid, its far for more useful to transfer the company shares to the creditors in payment of their debts.

From the foregoing, it is clear that the public offers of shares can be used to reconstruct an insolvent company in two ways.

   a) To raise funds which can be used to pay the creditors as well as build the liquidity status of the company
b) Convert the company’s debts into equity and therefore climb above the insolvency threshold.

In Kenya, section 210 of the company deals with the acquisition of shares. It is however restrictive to the extent that it is limited only to the acquisition of shares of shareholders dissenting from a scheme of arrangement. This section should be amended to formally allow for the public offers of shares of an insolvent company in line with the provisions of the Capital Markets Act.

ii) **Takeovers and Amalgamations**

Take-overs and Amalgamations provide yet another scheme of dealing with the problem of corporate insolvency. Instead of winding up an insolvent company and distributing its meager assets, it is even more useful to amalgamate that company with another company and thereafter use the joint assets of the two companies to pay creditors. This is an aspect of pooling up of resources to create a joint venture. The other method of achieving the same end is the take-over of the insolvent company by some other company which is otherwise solvent.

Section 209 of the Companies Act which deals with amalgamation however does not cover take-overs, further it is limited basically to amalgamation in the context of implementation of a proposed scheme of arrangement.

We therefore recommend an amendment to section 210 of the Companies Act to liberalise the process of take-overs and amalgamation as a useful tool for dealing with the problem of insolvency.

iii) **Company Voluntary Arrangement**

Section 207(1) of the companies Act allows a company which is facing liquidity problems to enter into voluntary arrangements or compromise with its creditors or any class of them. Such an arrangement can be made between a company and its
members or any class of them and where the company is being wound up, the application can be made by the liquidator or the general meeting of creditors. If the compromise is consented by more that three-fourths in valued of the creditors, present and voting either in person or by proxy at the meeting.

Section 207 is therefore very significant as far as insolvency is concerned. It makes it possible for a company to avoid the risk of insolvency by entering into some form of arrangement or compromise with creditors.

**How efficient are the Winding-Up provisions of the Companies Act?**

Having discussed briefly the insolvency procedure under the companies Act, we now try to focus on the underlying philosophical foundations that had been the subject of our discussion in chapter one. We shall try to find out if our law incorporates those principles and to what extent.

The first one is the **prevention** of insolvency. The companies Act as a whole has a very minimal role if not negligible in terms of prevention of insolvency. The Act requires all companies that have a share capital to make annual returns. Among the documents to be included in the annual returns should be the balance sheet tabled in the last general meeting. These returns are made to the registrar of companies who the Act does not bestow any powers to act on companies whose balance sheets do not reflect a promising solvency status. In any event as earlier said many companies are involved in creative accounting when preparing financial documents for their own survival thus painting a rosy picture of their financial situation. The Act also details how every company should keep proper books of accounts. Keeping books of accounts does not prevent insolvency unless the law provides for what steps are to be taken on the examination of the books of accounts. There being no oversight body it can be said that prevention of insolvency of companies is mainly left by the law in the hands of shareholders. Most of the time
minority shareholders have no say in the companies and the majority shareholders have an interest in the balance sheets of the company looking promising.

In most cases even shareholders cannot do anything to prevent insolvency. The companies are therefore left to the directors who continue trading even after the company becomes insolvent. The directors manage other people’s investments and they are not expected to manage the companies with all due diligence. Adam Smith the father of Economics\textsuperscript{31} once said

“...... the directors (managers) of such companies, however being managers of other peoples money than their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private co-partnership frequently watch over their own Negligence and profusion therefore must always prevail more or less in the management of the affairs of such a company...”

The Act\textsuperscript{32} also provides for matters that need to be disclosed in a prospectus by companies that need to raise their share capital through the Nairobi Stock Exchange. But we need to ask ourselves how many people get to read prospectuses of companies.

Generally the provisions of the Act do not prevent insolvency. The requirement for financial information without further requirement for publication to the general public and also measures to be taken depending on the nature of such information is a major shortcoming of this Act.

The second question we need to look at is whether the provisions of the Act can lead to rehabilitation of insolvent companies. The Act only provides for winding up in dealing with the state of insolvency. Even in the winding up, there is no room for the insolvent company to make proposals for payment of debts as allowed by the Bankruptcy Act\textsuperscript{33} for an individual debtor. The Insolvency Act of England\textsuperscript{34} introduced a new procedure where a company that is nearly or actually insolvent can resort to resolve its financial difficulties to the satisfaction of its creditor. These are
called Voluntary Arrangements. The said Act also introduced Administration Orders. It is an order of the court directing that during the period that the order is in force an administrator appointed by the court shall manage the affairs of business and property of the company. We do not have such provisions in our Act.

The third principle is the fair distribution of assets of the insolvent company. The Act generally provides in section 311 that the following preferential claims rank in priority to secured claims which are then followed by non-secured claims. They are: -

(a) All taxes and local rates due from the company due and payable within twelve months
(b) All government rents not more than a year in arrears.
(c) All salaries of employees of the Company (not directors) due within 4 months before the winding and all wages due for any period of time.
(d) All amounts due in compensation under the Workmen’s Compensation Act.
(e) Contribution due under the National Social Security Fund Act.

Is it fair to rank government taxes, rates and rent before the creditors? Our system is not fairly distributive in our opinion.

The last principle is that the law should provide punitive measures for Directors of companies who continue trading while insolvent. This is totally missing in our Act though the law provides for offences antecedent to or in the course of winding up and provides punishment for such offences. The Act does not punish those who are responsible for the insolvency whether negligently or not. In this regard we should refer to the King’arui Report which recommended as follows: -

“Other measures called for included the setting up by the Registrar of Companies a Management Monitoring Unit to keep data of qualified, convicted etc directors. That receivers and managers should be obligated to report to a governmental body
(preferably Attorney General’s office) every director of every solvent company so that he can be blacklisted for future reference. The Registrar was called upon to vigorously apply his powers of investigation and inspection (Cap 486, Section 164 through to 176) and immediately take action against rogue or incompetent directors with a view to disqualifying them in future, and that his disqualification should also apply to the Company Secretary and the executive Managers...”

Such good recommendations have not been implemented to date.

2.4 **THE DEEDS OF ARRANGEMENTS ACT.**

The Deeds of Arrangements Act (hereinafter called “the Act”) provides an avenue for the registration of deeds of arrangement. The said registration should be effected within seven days of execution of the deed. The Registration is done with the Registrar of Deeds of Arrangements.

This Act gives a chance to debtors and creditors who have come to an arrangement to register the same otherwise it is deemed void. This Act seems to govern arrangements arrived at under the Bankruptcy Act but not winding up arrangements. We suggest that our Kenyan law should be reformed to allow for such arrangements even for companies and to have the provisions of this Act made part of the new Act that will be enacted to govern insolvencies generally.

2.3 **CASE STUDY OF LAKESTAR INSURANCE COMPANY LIMITED.**

The discussion in this chapter cannot be complete without an in depth look at a company that has been wound up in Kenya. This will make us see the extent to which our laws are either adequate or inadequate and identify problem areas for a discussion on reforms on the next chapter. Lakestar Insurance Company Limited (hereinafter called “the company”) was incorporated under the Company’s Act. The company was subsequently registered as an insurer in accordance with the provisions of section 19 of the Insurance Act.
The objects for which the company was established were interalia to carry on the business of as insurers for all classes of insurance relating to general insurance (save aviation) and the operation of pension fund schemes and other objects

The commissioner of insurance ordered an investigation after numerous complaints about the company had reached him. The investigation of the company’s financial and management affairs of as at 31st June 2002 disclosed that

a) The company was insolvent to the tune of Ksh 545,767,495/=  
b) The company had a deficit in shareholder funds amounting to Kshs 227,188,318/=  
c) The company had incurred management expenses running to ksh 87,922,766/= for the half year (Jan-June 31st 2002) and Kshs 234,974,487/= for the year 2001.  
d) The company directors had taken unsecured insider loans amounting to Kshs 176,167,896.40  
e) The company was indebted as follows to various service providers  
   i. Advocates Kshs 51,082,524/=.
   ii. To investors, Assessors et al Kshs 823,509/=  
   iii. To various other creditors Kshs 106,446,228/=  
   iv. Bank overdraft Kshs 7,553,053/=  
f) The Company had failed to meet tax obligations of the state.

g) The company had failed to meet its outstanding claims by policy holders amounting to Kshs 461,992,106/=.

Among other provisions of the Insurance Act breached by this company were the following.

- Section 23(1) – failing to meet the prescribed minimum capital requirements.
- Section 29 (1) – failing to maintain the required reinsurance.
• Part V of the Insurance Act relating to solvency margins as required by section 41 thereof and compulsory investment as required by section 50(3) and 50(2) thereof.
• Section 70(1) prescribing limitations on management expenses.
• Section 71 prescribing limitations on the provision of unsecured loans to the directors of an insurer.

The root cause of the problems of the company seemed to have been the disunity amongst the Directors, which was said to have spread to other members of staff. There were staff alignments to Directors with each group working to achieve their own interests at the company’s expense and also policyholders. There was total mismanagement and dishonesty in the running of the company.

Under section 62(c)(1) of the insurance Act, the company was placed under statutory management. Before being placed under statutory management, the commissioner had annually renewed the company’s registration every year up to including 2001 when these issues came to light.

A statutory manager was appointed on 12th July 2002 whose terms of reference are enumerated under section 67(c)(5) of the said Act. The period of appointment is also spelt out therein as twelve months.

The statutory manager then declared a moratorium on all payments of the company of its policyholders and all creditors for a period of six months and later had it extended for a further period of six months. The actions thereafter taxes by the statutory manager included;

Freezing the accounts of the company and only operating the necessary accounts to continue running the business.

Security of assets – The manager moved to court under section 348 of the Companies Act and section 67(c) of the Insurance Act and obtained an order that during the pendency of the moratorium declared by the statutory manager there be
no execution attachment and or garnishee proceedings against the property of the monies of the company. It was discovered that the directors of the company had reflected in the balance sheet that an amount of 23 million had been reflected in the balance sheet as having been expended to buy a property in Karen which property was fond to be in possession of the Chairman and Directors for personal use. The statutory manager managed to repossess some of them. There was generally very poor record keeping of books of accounts. The Directors had also taken huge amounts of money from the company as unsecured loans. The company had been doing well in the first three years of operation i.e. between 1997 and 1999 but the above- name factors affected the liquidity and performance of this company. The statutory manager just managed to collect the assets pay salaries and utility expenses and then recommended to the Commissioner of Insurance to wind up the company. There was nothing in the report of the manager to lead us to conclude that there was a serious efforts to revive the company.

Lessons Learnt from the case study of Lakestar Insurance Company Limited

A number of lessons can be learnt from the case study of the insolvency of Lakestar Insurance Company Limited. The main one is that our insolvency laws are totally inefficient and were responsible for the misfortune that befell this company. Other lessons learnt that stem from this main one include the following:-

i) That a company that is otherwise solvent can be pushed to insolvency through mismanagement by the directors.

ii) That the legal provisions intended to solve the problem of mismanagement by directors in the Insurance Act are very weak and cannot therefore effectively deal with that problem.
iii) That the regulatory framework for Insurance companies in Kenya is very weak and the office of the commissioner of insurance lacks the powers to effectively regulate the industry.

iv) That it is risky to peg the insolvency threshold of insurance companies on their asset base while giving the same companies the liberty of determining that asset base themselves.

v) That there is an urgent need for substantial reforms of the Insurance Act to beef up its insolvency provisions.

2.4 CONCLUSION
Thus far, we have examined the Kenyan insolvency regime. We have seen that it does not strictly conform to the aforementioned philosophies of insolvency law except for the banking insolvency law. To a large extend, the philosophies discussed above are not clearly articulated. It is for these reason that we have witnessed numerous insolvencies of major companies. Insurance industry for example has been hard hit in the very recent past, a number of insurance companies have collapsed. The following insurance companies collapsed almost in circumstances that revealed a serious failure on the part of our insolvency law, that is to say Access Insurance Company Ltd, Kenya National Assurance Company Lt, Stallion Insurance Company Ltd, Lakestar Insurance Company Ltd and United Insurance Company Ltd.

There is therefore an urgent need to reform our corporate insolvency regime to bring it in line with the prevailing commercial realities. However, before we can deal with the questions of reform, it is instructive to see how other jurisdictions have dealt with these issues. The next chapter will therefore deal with the insolvency law in other jurisdictions.

1 Chapter 486 of the Laws of Kenya.
2 Chapter 54 " " " "
3 Chapter 53 " " " "
4 Chapter 488 " " " "
5 Chapter 487 " " " "
Section 2 of the Act
Section 3 of the Act
The Report Of The Task Force Appointed To Review The Law Relating To Companies Investments Partnerships And Insolvency 2nd December 1999 also known as the Kang'arui Report.
Section 36
Section 34
Section 35 (4)
In this case the Minister for Finance
The Banking (Deposit protection fund) Regulations, 2003
Section 34A (5) (b)
Supra note 8
Section 23
See the Daily Nation of 11th October 2005
Section 35
Section 41
Sections 54-67
Section 120
The jurisdiction to wind up is given only to the High Court under 218 of the Act.
Section 220
Section 123 (2)
This mode of winding up has not been utilized in Kenya
Supra note 8
From Section 345 to 355
See the views expressed by Justice Aaron Ringera in the case of Jambo Biscuits Limited Vs Barclays Bank 2(2003) East Africa Law Reports at 443
See section 348 of the Companies Act
The Report of the Task force which was formed by the Attorney General to look into issues relating to the reform of the corporate and insolvency laws in Kenya
The necessity for the creation of a special provision of accountant cum lawyers to manage insolvency of companies was espoused by the efficiency of receiverships in England
The precise limits of the director’s accountability is however not defined
See section 348
section 125
Section 147
Smith Adam; the Wealth of Nations Book IV-V (Penguim Books) Published London 1999) at page 117
Section 39
Section 18
Sections 1-7
Sections 8-27
Supra note 8
Section 4
Vide certificate of Incorporation No. C.71096.
The Company’s Memorandum and Articles of Association
The Statutory managers’ Report to the commissioner of insurance; February 2003.
Ibid
Vide a letter dated 1st July 2002.
Under section 67 (c) (2) (1) of the Insurance Act from 1st July 2002.
CHAPTER 3

3.0  CORPORATE INSOLVENCY SYSTEMS IN OTHER JURISDICTIONS: AN OVERVIEW

3.1  INTRODUCTION

In determining whether it is attainable or even desirable to reform our insolvency regime and the content of reform to be undertaken reference to other jurisdictions will be a useful benchmark in our estimation.

We shall look at only three jurisdictions which are:

1) England
2) The Unites States of America (hereinafter the “USA” )
3) Germany

The reason for the choice of these countries is because their current insolvency regime somewhat contrasts with what we have in our country today.

This chapter does not intend to give a detailed exposition of the insolvency regime in the three countries but rather, seeks to expose the historical development of their insolvency laws, the reform process undertaken therein and the philosophy underlying their respective systems as briefly as possible without losing the point.

3.2  THE ENGLISH INSOLVENCY REGIME

3.2.1  History And Development Of English Insolvency Regime

The early history of insolvency law in England only dealt with individual insolvency
although individual insolvency is not in the ambit of this dissertation. In discussing the history of insolvency Law in England we have to refer to the earlier Acts that dealt with individual insolvency.

The earliest statutes dealing with individual insolvency were enacted from mid Sixteen Century onwards, of which the first statute was the Statute of 1542. These statutes did not originally deal with insolvency, as this was a matter already regulated by the Law Merchants. The Law Merchant governed transactions of Merchants and drew extensively from the customs and practices established among Merchants. However, its principal source of law was Italian Mercantile law which was itself derived form Roman Law. These procedures happened to be practiced only among the ranks of the merchants themselves. As time went by however, the centralized jurisdiction of the ordinary Common Law Courts began to supersede the jurisdiction of the Merchant and Maritime courts from the Fourteenth Century onwards. Eventually English Common Law Courts took judicial notice of mercantile custom by the Seventeenth Century.

The First Bankruptcy Act was the 1542 English Bankruptcy Act. It was enacted to deal with absconding debtors. In 1571 two other statutes were passed – The Fraudulent Conveyances Act of 1571 and The Bankrupts Act, which had detailed provisions for dealing with insolvent debtors. These two Acts only applied to insolvent traders. The 1861 Bankruptcy Act made its provisions applicable to all debtors.

The development of the individual and corporate insolvency in England took place at the same time as development of the concept of corporate legal personality. The case of Salomon and Salomon & Co. was the turning point in this regard. It was held by the House of Lords in this case that upon formation of a company it becomes a distinct legal person separate from its shareholders. This therefore meant that the debts of a company are different from those of its shareholders. From 1844 onwards when the first Companies Act was enacted there has been a separation between corporate and individual insolvency. These provisions of corporate insolvency within the Companies
Act have been amended in the various versions of the Companies Act but was finally removed from the Companies Act in 1985 and 1986 into the English insolvency Act of 1985 and 1989. This Act also consolidated provisions on the insolvency of individuals.

Though the 1986 Insolvency Act unifies both corporate and individual insolvency the same cannot be said to be unified in the true sense of the word. Reference is still made to corporate and personal insolvency as observed by Fletcher:

"Thus... the consolidation of all the statutory provisions governing the insolvency of individuals and that of companies within a single Act... was finally brought about. However, although a high degree of harmonization has been achieved between many parallel provisions belonging to the different branches of insolvency law, the traditional distinction survives between corporate and personal insolvency".

3.2.2 The Insolvency Law Reforms in England.

Before the Insolvency Acts 1985 and 1986 we have already seen that there were separate pieces of legislation dealing with personal and corporate insolvency- Personal Insolvency was governed by the Bankruptcy Act of 1883 and there were specific Provisions of the Companies Act that dealt corporate insolvency. The English Authorities then in a bid to reform the Law of insolvency appointed several committees to handle this task.

The first comprehensive review of the insolvency regime as a whole took place was when the Cork Committee was appointed in 1977 under the Chairmanship of Sir Kenneth Cork. Its brief was as follows:

(a) to undertake a total review of the Law of insolvency, bankruptcy,
liquidation and receivership and to consider desirable or necessary reforms,

(b) to examine the possibility of formulating a comprehensive insolvency system including the possibility of harmonizing and integrating procedures;

(c) to investigate the possibility of formulating less formal procedures as alternatives to bankruptcy and winding up and

(d) to make recommendations.”

The Cork Committee Report was published in 1982. It had made many important recommendations of which a few are highlighted below:\(^4\):

- That a unified insolvency code be enacted to govern both personal and corporate insolvency
- A unified system of insolvency courts be established to administer the law
- The powers and responsibilities of the Official Receiver be sharpened.
- All insolvency practitioners belonging to the private sector should be the subject of professional regulation to ensure appropriate standards of competence and integrity.

The Cork Committee report was handed over to a government that had not commissioned it. Furthermore there was a spate of financial scandals during this time which led to public disquiet especially over the handling of those responsible for the mismanagement of companies. This made the government draft a bill hurriedly in 1984. The resultant Act the Insolvency Act of 1985 did not constitute the unity of insolvency law as envisaged by the Cork Committee. Even though this was the case Fletcher argues\(^5\) that this Act was far much better than what was there before. He says

“The Act which received Royal Assent on October 30\(^{th}\) 1985 could fairly be described as of revolutionary stature, in that it had effected a necessary
modernization and streamlining of the entire law of bankruptcy and had similarly implemented the hurriedly needed reforms in the law of corporate insolvency."

The 1985 Act was repealed by the Insolvency Act of 1986. It consolidated all the statutory provisions of corporate and personal insolvency as envisaged in the Cork Report. However, the traditional distinction of corporate and personal insolvency law and their pre-existing procedures still exist in this Act.

Can we then say that the English Insolvency Act of 1986 is a unification of both corporate and individual insolvency? In our opinion there is a difference between consolidation harmonization and unification. The former is what was brought about by the 1986 Act and not the latter. We shall later see other forms of unification in the USA Bankruptcy Code and the Insolvenzordnung of Germany of 1994.

3.2.3 The Underlying Philosophical Features Of The English Insolvency Regime

The Insolvency Act of 1986 gives first priority to alternatives to winding up. This is a clear distinction from our Act, which begins with the various modes of winding up. The English Act therefore de-emphasizes the necessity of winding up and especially when the other alternatives mentioned at the beginning of the Act have not been resorted to.

Parts 1, II and III provides for these alternatives to winding up they are:-

(a) Voluntary Arrangement

Part I makes provisions for company voluntary Arrangements. Here the directors of a company other than one for which an administrative order is in force or which is being wound up may propose to the company and its creditors for a composition in satisfaction of its debts or a scheme of arrangements of its affairs. Under this voluntary arrangements a nominee is appointed in the said proposal to manage the affairs of the
company and to summon meetings of the company members and its creditors to consider, approve and implement the proposal\(^\text{16}\)

When the voluntary arrangement has been approved all creditors (so long as they are entitled to vote at the meeting) are bound by it. The Nominee must be a person qualified to act as an insolvency practitioner. This is a desirable provision as it gives room for the company to be rehabilitated before an administration order or a winding up order is made. In other words before the company becomes absolutely insolvent and irretrievable from the state of dissolution it is given a second chance to manage its affairs this time through a nominee. Many “sick” companies are therefore given a chance to recover through this arrangement.

The Act gives room to the directors of companies to determine whether they need to use this option. The Act does not spell out at what stage a company experiencing solvency problems should use this process. It would be encouraging to learn that there are incentives to the use of this option such as the immunity from personal liability of directors who take timely steps to use it to avoid absolute insolvency. The Company Directors Disqualification Act we believe acts as an incentive though in a negative way. It gives courts powers to disqualifying directors who continue to trade while insolvent and makes them personally liable for debts incurred then\(^\text{17}\). The second alternative to winding up provided by the Act is found in Part II of the hereof

(b) **Administration Orders**

The company or its directors or a creditor or creditors may petition the court to make an administration order\(^\text{18}\). The Court will make the order if among other reasons:

(a) It is satisfied that a company is or is likely to become unable to pay its debts

(b) It considers that the making of an order would be likely to achieve any of
An administration Order is an order directing that during the period for which the order is in force the affairs, business and property of the company shall be managed by a person ("the administrator") appointed by the court.

The following are inter alia the objectives sought to be achieved by an administration order:

- The survival of the company as a whole or in part as a going concern.
- The approval of a voluntary arrangement under part I
- A more advantageous realization of the companies assets than would be effected on a winding up.

The Administrator is empowered to make proposals for advancing the goals of the order which shall be approved by the Creditors and later implemented. The administrator is required by Section 230 to be a qualified insolvency practitioner.

(c) **Receiverships**

This is the third alternative to winding up and is found in Part III of the Act. The provisions herein do not specify the qualifications of a receiver which is also a shortcoming that our Act has. A receiver can be appointed by Court or by an in instrument. The Act makes a distinction between a receiver appointed under a floating charge whereby such a receiver is called an "administrative receiver".

The purpose of this distinction is to specify in the said Act the powers of an administrative receiver since the powers of a receiver appointed to take charge of a property secured by a debenture are spelt out in that instrument. The Act also makes the administrative receiver more accountable to the unsecured creditors without
affecting the position of a receiver appointed under a fixed charge. This is why it is important to distinguish between the two receiverships. The Kenyan Companies Act does not draw this kind of distinction. The powers of an administrative receiver are also spelt out in the Act.22

**Winding Up**

This is covered under Part IV of the Act. Unlike our Act that provides for three modes of winding up, this Act only provides for winding up by the Court and voluntary winding up. Section 76 makes directors and shareholders of a company being wound up personally liable if the company makes a payment out of its capital in respect of the redemption or purchase of any of its own shares. The person for whom the shares were redeemed or purchased and the directors who signed the statutory declaration for that redemption or purchase are also liable.

This is provided for under Chapter 11. Section 89 provides for the making of a Statutory declaration of solvency by the directors. Where this declaration is made the winding up is referred to as a “members voluntary winding up”. If there is no declaration of solvency then it is a “creditors” winding up. The distribution of the companies property is subject to the provisions on preferential payments be applied to the satisfaction to the company’s liability pari passu and then to the members according to their rights.

The grounds for winding up by the court are the same as those of our Act. The debt for which a company may be wound up for should not be less than £750 as compared to ours which is One Thousand Shillings (Shs.1,000/=)

As earlier on mentioned the definition of inability to pay debts constitutes both the cash flow and balance sheet test of solvency. The act also allows for winding up on grounds
of public interest whereby the petition is to be presented by the Secretary of State. This is one provision that is lacking in our Act. There are those companies incorporated for illegal purposes or against the public interest which can only be wound up if we had this provision in our law. Preferential debts are to be paid in priority of all other debts General Creditors claims also have priority over debenture holders, or holders of floating charges.

Section 212 provides that if directors or officers of a company who misapply, retain, or become accountable for any money or property of the company the court may compel them to repay the money or property or contribute to the company’s assets. The Act gives the court powers to prosecute any officer or member of a company who is guilty of any offence in relation to the company. This is a deterrent feature of the Act and may reduce the number of criminal acts. The second part of the Act then deals with individual insolvency.

Having gone through the English Insolvency Act we have seen an Act far much better than what we have. It has provisions that are rehabilitate fairly distributive and punitive.

3.3 INSOLVENCY LAW IN GERMANY

The current insolvency code in Germany Insolvenzordnung of 1994 is a law that can be said to be unified in every sense. This is an admirable feature. But the Insolvency regime in Germany is not just admirable because it is unified but because of its innovativeness and its incorporation of liberal policies in such a sensible way.

3.3.1 Historical development of Germany Insolvency Law

Dalhuisen says that no uniform system of insolvency law existed in Germany during its early history. Only individual remedies were available for creditors even up to as late as the Sixteenth Century. Bankruptcy laws developed under the influence of Italian Laws.
Germany was not unified at the beginning of the Nineteenth Century and state law prevailed then. These laws were mainly Roman Law amended into German Law. In States like Bavaria and Prussia codification occurred in the Eighteenth and Nineteenth Centuries. By 1855 Prussia had a codified bankruptcy law while other states did not. After the unification of Germany codification occurred gradually. This led to the All-German codes of 1900. The 1877 Bankruptcy Act was passed and enacted in 1898 to conform to the All-German Civil Code of 1900. This Act was passed during what commentators call the “Promoters Age” which was a period of escalating industrialization in Germany. It was said to have been tailored to meet demands of big business and based on the idea of debtor’s fault. The Reorganization Code was also introduced in 1935 to meet the need to provide relief to honest debtors without using the bankruptcy procedure. There was therefore need for reform and in 1978 the Ministry of Justice appointed a committee to recommend an effective modern business oriented and socially relevant insolvency law.

The proposals of this committee were presented in 1985. By 1989 the final draft of the law on insolvency called the Experts Draft of a statute of Reforming Insolvency Law was ready. The challenge the unification of Germany brought was the integration East Germany’s insolvency law into the West Germany’s legal framework.

To this end the Aggregate Execution Code that applied in East Germany was amended and adopted for execution in the former German Democratic Republic.

The Insolvenzordnung (Insolvency code) of 5th October, 1994 was enacted in 1999. The act is unified in two senses. Firstly it unified the Insolvency laws in East and West Germany. Secondly it unified both corporate and personal insolvency into one code. The following are the features that make the German insolvency system admirable.
3.3.2 **Features of the German Insolvency Code**

i) **Unified Insolvency proceedings.**

The code has introduced a unified insolvency system that streamlines and consolidates all the previous legislation on insolvency that existed before in the East and Western Germany. Furthermore both personal and corporate insolvencies are completely unified in the code with no distinction between the two branches of law.

ii) **Reorganizations**

There is a revised approach towards reorganization which are aimed to rescue “sick” businesses before such rescue becomes impossible. Thus there has been removal of requirement of insolvency before reorganization can be entered into and replacing it with a more attainable and practical requirement of “threatened illiquidity”\(^{35}\) This feature is also present in the English Insolvency Act. The latter leaves open the time when a company resolves to enter into a voluntary arrangement.

iii) **Debtor in Control**

The code allows the debtor to manage the bankruptcy on its own but subject to the supervision of an administrator. This is similar to what we shall discuss below of the debtor in possession concept of the USA Bankruptcy Code.

iv) **Increased Independence**

Stewart\(^{36}\) argues that this code attempts to strike a balance between creditors running their own affairs in insolvency proceedings and subordinating their creditors rights for the common good. With independence of the creditors comes the supervision of the court in certain matters when required especially when they overstep their mark.

v) **Secured Creditors**
Unlike previously when secured creditors could not participate in insolvency proceedings. They are now allowed to do so by the code.

vi) **Labour issues**

This makes the German Code stand out. It has Sixteen (16) provisions that directly address labour issues. Although it does not try to preserve jobs at the expense of everything else. It anchors labour law principles firmly into insolvency. This it does for example by providing for the right of employees to be represented in a Creditors committee\(^{37}\)

vii) **Release from remaining liabilities**

The code provides for some relief for bonafide debtors who co-operate with the administrator, the court and all creditors\(^{38}\)

viii) **Consumer bankruptcy and simplified proceedings**

Though the ambit of this dissertation is not personal insolvency it is good to note what is desirable. The code tries to discourage the adjudication of consumer bankruptcy cases in formal courts. Part Nine of the code contains simplified alternatives to bankruptcy.

ix) **Insolvency courts.**

A unified insolvency law can in our opinion only work in a streamlined court system which are specialized. Thus the specialized bankruptcy courts in Germany are an added advantage and one of the main reasons why the unified system works.

It is noticed that in Germany and the USA the word "bankruptcy" is used to refer to "Insolvency".
The Germany insolvency system is a bold, modern piece of insolvency law that strikes a balance between simplified insolvency procedure and the protection of debtor and creditor rights.

3.4 **INSOLVENCY IN THE UNITED STATES OF AMERICA**

The USA Insolvency jurisdiction is totally unified. It is also very liberalized. In fact Germany borrowed a leaf from the USA. The USA insolvency could even serve as a template for insolvency law reform worldwide. But countries should be wary of adopting this system as a whole. They should only use what is workable for them depending on their state of development. The USA law is fascinating because its liberalization and reform did not come with a bang as we have seen in the two previous countries. It was progressive hence the insolvency regime has been hailed by many observers for its “progressive liberalization” quality. We shall now discuss the history of American bankruptcy law.

3.4.1 **The History of the American Bankruptcy Laws prior to 1978 and its Development**

The American bankruptcy laws have their conceptual roots in the English bankruptcy laws that existed prior to 1800. When studying the history of American Bankruptcy law, reference is made to the first bankruptcy law in England the 1542 Act and later the 1570 Act. The Laws in the USA then were pro-creditor in nature. These laws were in force up to the time of the American Revolution.

In the next two Centuries there were quite a number of amendments. The statute of Anne of 1705 did away the English bankruptcy law. It introduced a discharge of debts for co-operative debtors. Although the statute still remained semi-criminal, the Act provided a foundation for a more humane approach for honest debtors who suffered
misfortune. In the Eighteenth Century a more liberal approach to bankruptcy was established due to changing attitudes regarding credit and commerce that were brought about by commerce and industrial revolution.

The first real American bankruptcy law was passed in 1800 at the time of promulgation of the American Constitution. This was the first federal bankruptcy law the 1800 Bankruptcy Act. Before this different states had passed different laws on bankruptcy. The statute could still only be used by creditors and it only applied to merchants. It was repealed after three years and the different states began to regulate relations between debtors and creditors again. It was then that two cases led to the abandonment of this system. The first case Sturges V. Crowns in Shield\(^41\) held that states could not constitutionally discharge pre-existing debts. The second case of Ogden V Saunders\(^42\) held that states could discharge future debts against citizens of the same state but not of another state.

This led to the passing of the 1841 Bankruptcy Act. It provided for both voluntary and involuntary bankruptcy. This Act did not apply to corporations\(^43\). This Act entrenched important principles such as the use of voluntary proceedings by debtors and the marriage of the concepts of insolvency and bankruptcy\(^44\). This Act has been termed by scholars as the first modern bankruptcy law.

Later in 1867 A Bankruptcy Act was passed that now applied to corporations. The Act of 1874 introduced a new innovation in the form of a composition arrangement which was a forerunner of modern compositions. Next was the Bankruptcy Act of 1898. It remained in force with various amendments for eighty years and was repealed by the Bankruptcy Reform Act of 1978. This Act signaled the era of permanent federal bankruptcy legislation. It ushered in the modern era of liberal debtor treatment in the USA\(^45\). It would also ensure equitable distribution of the debtors assets among the creditors, Creditors were now allowed to elect a trustee (hence exercising more control). In later amendment federal courts were made bankruptcy courts and bankruptcy judges
were appointed. Compositions were introduced as an alternative to liquidation. There were various amendments to the 1978 Act that led to the enactment of the Bankruptcy Reform Act of 1994.\textsuperscript{46}

3.4.2 \textbf{The Underlying Philosophical Principles In The Bankruptcy Code}

a) The code provides\textsuperscript{47} that the dollar amounts therein shall be adjusted by a similar percentage every six years. In doing so due regard is taken to the changes in the cost of living – This is a good provision that needs to be emulated as we in Kenya still adhere to very low figures in our law. The procedure is that the Director of the Administrative office of the US courts reports to the Congress on May 1 every 6 years and recommends the changes. The changes do not have to be effected. The dollar amounts are found primarily in the Exemption Section\textsuperscript{48} The Wage priority\textsuperscript{49} and the eligibility for chapter 13\textsuperscript{50}

b) Section 109 defines who may be a debtor. This definition encompasses both individual and corporate persons such that in the whole code there is no distinction between individual and corporate insolvency. This is what makes this piece of legislation so unique and admirable. The procedures are uniform for both branches of law. Interestingly, this provision defines a debtor as follows:-

"...................a person that resides or has domicile; a place of business or property in the United States or a Municipality........."

A person is defined in the definition section as "................an individual, partnership, and corporation but does not include governmental unit........"

There is uniformity of procedure for the different kinds of persons:
Excluded from this definition of a debtor are the following institutions.
- domestic insurance company
- bank
creditors is found in Section 366. Here the debtor is given protection from a cut off service by a utility because of the filing of bankruptcy case. The utilities covered are electricity, gas, telephone. The utility company may not alter refuse or discontinue service because of the non-payment of a bill that would be discharged in the bankruptcy case.

This is quite a fair provision in our opinion. It actually removes the discrimination given to a debtor by everyone else around him or it. Debtors should not be criminalized.

f) The code provides\(^{53}\) for distribution of the assets which is quite fair in our view. The list is as follows:-

- Administrative expenses allowed under the Code
- Unsecured claims allowed claims or interests already proved
- Wages salaries, or commissions including vacation, severance and sick leave pay earned by an individual.
- Sales commissioned earned by a person acting as an independent contractor for the sale of goods or services for the debtor
- Unsecured claims for contributions to the employees benefit plan
- Unsecured claims to the extent of $1,800 of an individual who deposited money with the debtor for purchase, lease or rental of a property of the debtor.
- Claims for debts to a spouse or child of debtor for alimony, maintenance or any form of or supports in accordance with a separation agreement or a divorce decree or other order of the court.
- Unsecured claims of governmental units

The tax is measured by income on gross receipts and for a taxable year ending on or before the date of the filing of the petition for which a return is due. Also included here are customs duties.
This is quite a fair system as creditors are almost given first priority over government taxes as opposed to many other systems including ours.

\[58\]

\[This\ is\ quite\ a\ fair\ system\ as\ creditors\ are\ almost\ given\ first\ priority\ over\ government\ taxes\ as\ opposed\ to\ many\ other\ systems\ including\ ours.\]

\(\text{g) There is further protection for the debtor under Section 525 where any governmental unit is prohibited from denying, revoking, suspending or refusing to renew a licence, permit, transfer employment to the debtor.}\)

\(\text{h) The law also provides for the liquidation of municipalities separately}\ .\)

\(\text{i) Chapter 11 is dedicated to reorganizations. It contains no special procedure for companies with debt. Factors such as the Standard to be applied to solicitation of acceptance of a plan of reorganization are left to be determined by courts on a case by case basis.}\)

Here the debtor is permitted to file a plan in court detailing how he or it intends to settle its claims if accepted then it is binding.

In this arrangement a debtor may be left in possession of the Estate and has powers of a trustee (Debtor in possession). A debtor is left in possession of its or his property during bankruptcy. This is a very liberal approach to bankruptcy which in the end benefits debtors and creditors alike.

3.5 \textbf{CONCLUSION}

We have only managed to highlight some important and mainly desirable aspects of the insolvency regimes of these three jurisdictions. We have seen how conservative the English system has been throughout the years even the current insolvency regime can be said to be conservative though quite a number of reforms have been undertaken. We have also seen some quite admirable aspects of the German Law and lastly the USA bankruptcy regime. What remains quite distinct is how the USA bankruptcy regime
31 Supra Note 4
32 Ibid
33 Ibid
34 Supra Note 28 at page 9-10
36 Ibid
37 Ibid 14-15
38 Sections 286 - 303
40 Supra note 37
41 17 US (4 wheat) 122 (1819)
42 25 US (12 Wheat) 213 (1827)
43 Ibid
44 Ibid
47 Section 104
48 11US.C 522)
49 1 U.S. 6 507
50 II U.S 109
51 Section 301
52 Sections 321 and 322
53 Section 507
54 Section 401
CHAPTER FOUR

4.0 CORPORATE INSOLVENCY LAW – WHITHER REFORMS?

4.1 INTRODUCTION.
This chapter makes recommendations for the much needed reforms of our insolvency regime. The proposals are not intended to be an exhaustive list of all possible reforms of the Kenyan insolvency law. Instead they respond to the issues which should be given priority in carrying out such reform.

There have been various recommendations on reform of insolvency law made by different persons. Among them was the Task Force Appointed To Review The Law Relating To Companies, Investments, Partnerships and Insolvency headed by Mr. Joseph King’arui (hereinafter called the Task Force)\(^1\)

The mandate of the task force included the following\(^2\)

a) To review laws governing companies, partnerships and their operations and to make recommendations thereon.

b) To review the laws relating to insolvency, liquidations and receiverships

c) To make such further recommendations incidental to the foregoing.

Although these terms of reference were wide, it was felt that they left out some crucial aspects related to the reform of the Company Law. It was during the launching ceremony of this same task force that the Attorney General expanded these terms and included the modernization of these law with a view to making them conform to many changes that had taken place since 1963. He emphasized the need to remove unethical business practices such as the use of commercial entities as vehicles of exploitation and fraud on unsuspecting public\(^3\)
4.2 **IS THERE NEED TO REFORM KENYA’S CORPORATE INSOLVENCY LAW REGIME?**

It is rather pathetic that 18\textsuperscript{th} century Laws are governing business practice in Kenya today. In other words there is a huge gap between the law and the practice. In modern world almost everything is pegged on efficiency, expediency and cost management. Our Companies Act is a replica of the English Companies Act of 1948. It does not match up to these principles. With globalization there have come new challenges posed by being a single market, increased commercial activity, new channels of communication like the internet and cross border dealings through e-commerce. Our law lags behind in coping with the challenges above stated. We have also examined the status of air insolvency regime currently vis a vis the philosophical underpinnings of insolvency law generally and also made comparison with the insolvency regimes in other jurisdictions. What has emerged is that we have a strong case for urgent reforms of our insolvency regime.

4.3 **LEGAL REFORM RECOMMENDATIONS**

Thus far, we have established that there is an urgent need to undertake corporate insolvency law reforms in Kenya. These reforms should ensure that our corporate insolvency law subscribes to the fundamental philosophies of insolvency law. The ultimate goal of these reforms should however be to improve the efficiency of our insolvency system. These reforms should encompass formal as well as substantive reforms.

4.3.1 **FORMAL AND JUDICIAL REFORMS**

Apart from the substantive reforms to be discussed later, there is need for far reaching formal and judicial reforms these include:
In our view, the scope of review of this Task Force was too wide. This in turn did not give them room to recommend major reforms, which our insolvency law is in urgent need of. For instance since their mandate covered the review of the whole of the Companies Act. There were just a few significant recommendations on the reform of insolvency laws, but still within the ambit of the Company Law. Our recommendations will want to see the removal of the insolvency law regime from the company law altogether. The King'arui Report was never published it was just shelved like many other such reports. But the Government of Kenya did not stop there in its endeavor to review the Companies Act.

Sometime in 2003 the Attorney General mandated the Kenya Law Reform Commission⁴ to review the recommendations of this task force with a view to drafting the legislations required.

Recently the Government of Kenya through the Ministry of Justice and Constitutional Affairs and with support from international development partners has been in the process of conducting a program for the reform of the Governance, Justice, Law and Order Sector (GJLOS Reform Program). As part of the GJLOS Reform Program, the Kenya Law Reform Commission is now in the process of reviewing the Company Law of Kenya⁵. We hope that the results of this painstaking exercise will be an overhauled insolvency system. We have already seen the status of our insolvency law in Kenya in Chapter Two and drew a comparison with other jurisdiction in Chapter Three.

Before we embark on recommendations for reforms we need to understand why we need the reforms, in other words the importance of an effective insolvency system.
(a) **The enactment of a single statute with a single procedure**

The biggest impediment to the efficiency of our insolvency system is the multiplicity of contradictions and inconsistencies between the provisions of the Bankruptcy Act dealing with personal insolvency and the provisions of the companies Act dealing with corporate insolvency. They apply different standards in evaluating the behaviour of insolvent persons, and prescribe different methods of dealings with essentially the same problem.

Moreover, the insolvency regimes prescribe the different statutes dealing with the same problem to wit, insolvency of companies - are not just different but confusing. For example, the provisions of the Banking Act dealing with aspects of insolvency law are sharply different from those of the Insurance Act dealing with the same problem of insolvency. The fact that one company is carrying on banking business while the other carries on Insurance business does not justify a different treatment since the problem sought to be addressed is essentially the same. Moreover, where the same company carries on both banking and insurance business, it is not easy to tell which provisions should govern its insolvency, as the provisions of the Banking Act as well as the insurance Act will apply and so will the winding up provisions of the Companies Act.

It is for this reason that we think that there is an urgent need to review the formal structure of our insolvency regime. Insolvency regimes can only take any one of the following forms:

a) Multiple statutes with multiple procedures
b) A single statute with multiple procedures
c) A single statute with a single procedure.
Kenya as we have noted above has multiple insolvency statues prescribing multiple procedures. It therefore belong to the first category. Britain belongs to the second category to the extent that it has a single statute with multiple procedures. United States of America on the other hand belong to the last category to the extent that it has a single statute prescribing a single procedure for all legal persons, they human persons or corporate persons.

Since in all other areas of law, both corporate and human persons are treated equally, and in view of the fact that the Kenyan constitution prohibits discrimination in all its forms, we see no reason why the distinction between corporate and personal insolvency should be perpetuated. In the context of insolvency, human and corporate persons are being given different treatment. This results in a situation where the corporate persons are accorded certain benefits which are denied to human persons. It is for this reason that we are recommending the abolition of this duality in the context of insolvency followed by the adoption of the American system whereby both juristic and human persons are given the same treatment. In a nutshell, we recommend the enactment of a single insolvency statute prescribing the same procedure for both corporate and human persons.

We also recommend the enactment of a Kenyan equivalent to the English Company Directors Disqualification Act for reasons already stated above.

(b) **The Establishment of Insolvency Courts**

Insolvency proceedings are not just legal proceedings. Though they raise legal issues, they also raise issues of accounting, management and administration. To this extent therefore, insolvency court judge need to be armed not just with the benefits of legal training, but should also possess vast knowledge, experience and skill in matters of corporate management, business accounting and general administration. It is for this reason that in other places, notably Germany, special courts have been established to deal with insolvency matters. Such courts
are presided over by specially trained insolvency judges who are experts not just on law but also on corporate governance, financial accounting and business administration. This is also the case in the U.S.A.

The establishment of such courts in Kenya will assist in the development of sound jurisprudence in insolvency matters. This will go a long way towards preventing and/or managing insolvency such courts will also adopt flexible rules of procedures which ensures expediency of matters to avoid the debilitating delay in normal courts as well as eliminating the injustice that normally result from the strict application of the ordinary rules of procedure and evidence.

4.3.2 **SUBSTANTIVE REFORMS**

Apart from the formal reforms discussed above, Kenya’s corporate insolvency regime is in need of far reaching substantive reforms. The major objective of the substantive insolvency reforms would be to bring our corporate insolvency regime in line with the philosophical foundations of insolvency law as discussed above. But in more practical terms, these substantive reforms are intended to achieve the following purposes:

a) Prevention of insolvency
b) Equity and fairness in insolvency proceedings
c) Rehabilitation of companies facing liquidity problems
d) Distribution of assets of insolvent companies
e) Punishments of those whose conduct result in insolvency.

In what follows, we will examine the set of reforms that need to be put in place to achieve the aforestated goals.

i) **Prevention of Insolvency**

A desired insolvency regime is one which puts in place an effective, efficient and predictable systems for dealing with all cases of insolvency. To put in
place an efficient, effective and predictable insolvency regime in Kenya, the following reforms need to be effected

Ordinary businessmen know that business has a life of its own. There are good times and bad times. Businessmen however make decisions based on their own predictions based on the prevailing business situations. Sometimes however, these predictions fail and business suffers greatly. This is the time when the business moves to the threshold of insolvency, once a businessman realizes that he has reached the threshold of insolvency - that is to say, when he is legally insolvent – he is able to retreat by reversing his earlier decision and making other requisite managerial and administrative changes. This means that a company that is insolvent has the capacity to reorganize itself to escape the wrath of insolvency.

This structural re-organization is however impossible at the moment. Our insolvency law simply state that immediately a company reaches the threshold of insolvency, that should ipso facto trigger the insolvency process. This means that companies that have the capacity to re-organize themselves to avoid insolvency ends up being wound up.

We therefore recommend the introduction of provisions which would enable companies facing financial difficulties to reorganize themselves. These would include the supervision of payment to creditors, the pronouncement of a moratorium etc. Companies threatened with insolvency should also be allowed voluntarily hand over management to professional managers without going through the insolvency procedures. This would have a lot of benefits to its creditors, and the general public, since, in the long run, it reduces the transaction costs and minimize the resources devoted to the insolvency system itself as well as minimizing the distortive efforts on companies operating for long extended periods of time with the benefit of court
protection. As already stated above, re-organization should address not just the obtaining of financial concessions but also operational re-structuring of the company itself. Specific provisions should be put in place to facilitate allow such re-organization.

ii) Mainstreaming Equity Labour and Human Rights Issues in Insolvency Proceedings

Owing to its historical origins, and specifically the criminal ancestry of insolvency, the law relating to bankruptcy and insolvency has always been titled as against the debtor and in favour of the creditor. This raises serious equity concerns.

The law should be changed to ensure that management powers are only ceded to the general body of creditors in situations where it is proved, on credible evidence, that the debtor is unable to manage its affairs profitably. Moreover, the general body of creditors should only be given the powers to manage the debtor's business if they can show that they will manage the business. Professionally, and in any event, better than the debtor would himself do. The law should protect the debtor from undue harassment by creditors.

But if fairness and equity is necessary as between the debtor and his creditors, then it is indispensable as between the creditors themselves. There is no reason why one creditor should be given undue advantage over all the other creditors. In this regard, the protection traditionally given to secured creditors is brought in sharp focus. In recent past, many jurisdictions have abolished the concept of secured creditors. We recommend that Kenya should follow that example. This is because in Kenya, more than anywhere else, insolvency proceedings end up benefiting only banks, and financial institutions because they are the only ones empowered to take securities. If for example a debtor has 100 creditors whom
he owes a total of Kshs.800,000,000 and if one of them, a bank which is owed Kshs.6,000,000, has a floating charge over the business undertakings and goodwill of the debtor, then the bank will seize all the assets and business of the debtor, and sell the entire business worth Kshs.400,000,000 at the cost of Kshs.5,000,000 and thereafter sue the debtor for the balance of Kshs.1,000,000. This is preposterous. The whole concept of secured creditors needs to be abolished.

Finally, there is the issue of labour rights which have never been considered by our insolvency regime. Whenever a company collapses, it is not just the directors and shareholders whose interests are affected. Our insolvency law however proceeds on the assumption that only directors and shareholders of insolvent companies have interests worth considering. It therefore completely ignores the interests of employees who, in most cases usually suffer more than the directors and the shareholders.

Employees interests should therefore be protected. Employees should for example be given an option to purchase shares in a collapsing company or in any other way protect their interests in cases of insolvency. They should therefore be given an opportunity, if it is in their power, to do anything that can save the company from eventual collapse. If on the contrary they lack the capacity, power or wherewithal to save the company from imminent collapse then their salaries and other benefits should be secured in priority to the claims by creditors. Creditors should not be allowed to plunder the meager resources of the debtor much to the detriment of the employees of the debtor and their families.

iii) Rehabilitation Of Financially Distressed Companies
The fact that a company is insolvent does not mean, as is usually assumed that it cannot be run profitably. Insolvency may be the result of one single managerial mistake made by the directors as was the case with Uchumi Supermarkets
Limited. Uchumi supermarkets limited was brought down on its knees by the decision made by the directors to expand its chain of supermarkets beyond what its resources could sustain. It therefore found itself on the brink of insolvency. Sometimes insolvency results from mismanagement. This has been the case mainly in Banks and insurance companies. Lakestar Insurance Company Limited and Stallion Insurance Company Limited were both pushed into insolvency through mismanagement by the directors.

In each of these cases, the company can be returned to profitability simply be either reversing the expensive decision which triggered insolvency or removing the directors responsible for the mismanagement and replacing them with more qualified and responsible managers. This can only be made possible however if the insolvency regime has inbuilt systems for early detection of liquidity problems and thereafter facilitating the taking of a remedial action.

The remedial action may take one of three forms. Under the Philippine Insolvency Act of 1956, a financially ailing corporation has four major remedies.

a) Suspension of payment
b) Rehabilitation
c) Dissolution
d) Debtor in possession

Under the first of three remedies a corporation which possesses sufficient property to cover all its debts but which foresees the impossibility of meeting them when they respectively fall due may petition the court that it be declared in a state of suspension of payments. This remedy allows the corporation to propose to its creditors a moratorium on payments of their claims while the corporation is suffering some liquidity problems. The creditor’s view on the proposed suspension on payments should be considered before the court approves the proposal.
The second remedy available to an ailing corporation is rehabilitation. Under our insolvency law as it is presently an insolvent company has no option but to be wound up. This means that even those cases where the business of the company is still profitable and the insolvency was caused by a fleeting episode of mismanagement or a temporary nationwide economic crisis not of its own making, the company will still have no option but to face insolvency. The company must therefore close down its business and all its assets surrendered to the liquidator in winding up for distribution of the proceeds to all its creditors many of whom end up receiving only a small fraction of their credit. The remedy of rehabilitation obviates the injustice caused by this state of the law.

The remedy of rehabilitation makes it possible for a company which is insolvent because its assets are insufficient to cover its liabilities but which may still be rehabilitated through the institution of some changes in its management, policies; organization, strategies, operations or finances to petition for rehabilitation. In this regard, a commission to be known as the Insolvency Commission should be established to consider such petitions. If the commission approves the petition for rehabilitation, then it recommends the appointment of a rehabilitation receiver. This is a professional insolvency practitioner skilled in rehabilitation of distressed companies.

The third remedy available is one of dissolution. If despite the suspension of payments ordered by the court or the rehabilitation allowed by the insolvency commission, the financial condition of the company does not improve, the Insolvency Commission may, on the basis of the findings and recommendations of the management committee, or rehabilitation receiver, or its own findings, determine that the continuance in business of such company would not be feasible or profitable, nor work in the best interests of shareholders, creditors or the general public order the dissolution of such corporation and its remaining assets liquidated accordingly.
The final remedy is one whereby the commission having examined the honesty of the debtor, his industry and business acumen and the circumstances that led to the insolvency, comes to the conclusion that in the interests of the debtor himself, his/her creditors and the general public would be better served if the debtor was allowed to continue running the business then the commission may order that the debtor do continue managing the business but that his management be closely monitored by officials appointed by the commission itself. This fourth remedy has been referred to as the **Debtor-in-possession system**. It is well entrenched in America. Under this system the debtor remains in possession of the assets of his own estate but continues so to do as a trustee for and on behalf of his creditors. His management is however closely monitored and supervised by the insolvency commission.

iv) **Distribution Of Assets of Distressed Companies in Insolvency**

That an efficient, effective and predictable insolvency regime should ensure a fair and equitable distribution of the assets of the debtor is beyond question. Equity is therefore the essence of distribution in insolvency proceedings. Accordingly a substantial part of this paper dissertation relating to distribution of assets has already been discussed above.

These are however three major issues that merit special consideration at this point. These include:

a) The qualification and competence of the persons charged with the responsibility of distributing the assets of the debtor to its creditors

b) The rules of priority applied in the distribution exercise.

c) Sufficiency of the protection given by the insolvency regime to the interests of international creditors.

I) **Qualification and Competence of Receivers, Liquidators or Trustees in Bankruptcy**
In the case of **Jambo Biscuits Ltd Vs Barclays Bank of Kenya**\(^7\), justice A.G Ringera (as he then was) stated that courts in Kenya can now take judicial notice of the fact that the only thing that receivers can do perfectly well is to plunder the resources of the ailing company and expedite its eventual collapse. Though the object of receivership is to resuscitate an ailing company and bring it back to profitability through the removal of its directors and their replacement with an experienced and qualified receiver, this noble goal has never been achieved in Kenya where all receivership end up expediting the collapse of the insolvent company. This fact is of sufficient notoriety to have compelled the honourable justice Ringera to take judicial notice of the same. But why is this so? And what needs be done?

The main reason behind this unfortunate state of affairs is the existence of a major disconnect between the theoretical expectation and the practical reality, a disconnect which has been caused by a major hiatus in the law relating to receiverships.

Theoretically speaking, a receiver liquidator or trustee in bankruptcy is supposed to be more qualified, more competent, more prudent, more circumspect and more honest than the directors of the ailing company. He is also supposed to possess superior skills in corporate governance, business administration, and financial accounting than the directors of the ailing company. Moreover he is also supposed to be well trained in the law as to be able to understand the law perfectly well and ensure that all his activities and decisions are taken in accordance with the law. Our insolvency law however does not impose any conditions or requirements that would ensure the convergence of all these theoretical pre-requisites on the persons of the receiver, liquidator or trustee in bankruptcy. On the contrary, our law does not impose any condition regarding the qualifications that a person must possess before he/she can be appointed a receiver liquidator or trustee in bankruptcy. Hence anybody can be appointed a
receiver, liquidator or trustee in bankruptcy. This has led to a gross abuse of the land relating to receiverships.

There are many cases of unqualified persons being appointed as receivers, liquidators or trustees in bankruptcy. Such individuals only use their position to plunder the company and expedite its collapse. This is why virtually all receiverships in Kenya end up in dismal failures.

Our law should therefore be reformed to prescribe in detail the qualifications that a person must possess before he or she can be appointed as a receiver, liquidator or trustee in bankruptcy. We should consider the possibility of creating a completely new and distinct profession of "Insolvency Practitioner" which should comprise of persons specially trained on Law, Accounting, Corporate Governance and Business Administration. Only insolvency practitioners should be eligible for appointment as receivers, liquidators or trustees in bankruptcy. This is what has been done in the United Kingdom and we can borrow this practice.

(ii) Rules of Priority between Creditors

Earlier in this Chapter, we examined the rules of priority as between the Debtor and Creditor, Creditors and employees of the Company and Creditors and fellow Creditors. We saw how these rules require substantial amendment to ensure equity and fairness in the administration of the debtor's estate. In what follows, we shall continue with discussions on the issue of priority as between Creditors.

Priority is determined by statutes and is strictly observed in individual debt collection process. Generally speaking, there are three categories according to their priorities. Claims with preference, secured claims and unsecured claims. According to our insolvency laws at present, the interests of shareholders of the
company are placed under those of unsecured creditors. What is the justification for this? Is it fair?

Moreover, according to our insolvency laws, tax claims rank in priority to those of secured creditors. Is there any justification for this? Is it lawful? In Korea, the Constitutional Court declared the provision of the Basic Act of Taxation stipulating priority of tax claims over those of secured creditors unconstitutional.

As was explained above with reference to secured Creditors, we recommend that in the interests of fairness, the rule stipulating the absolute priority of taxation claims should be abolished.

(ii) Concerns with the protection of the interests of foreign creditors

Our current insolvency laws were designed to operate in a closed society, in which all business activities are carried on within the borders of the country where all creditors know and understand the local insolvency procedures and are free to participate and vote in all meetings called to deliberate on the affairs of the debtor. This is however not possible anymore.

The deepening globalization has completely changed the business environment on the global economy. Most commercial activities are now carried out across the borders of the state sometimes by electronic means. This raises two major concerns. First, increased international trade increases the risk of cross-border fraud. Secondly, it increases the risk of loss to foreign creditors whose interests may not be sufficiently protected by the current insolvency regime. To address there issues, the OECD has proposed a model law on cross-border insolvency which has been referred to as UNCITRAL MODEL LAW ON CROSS BORDER INSOLVENCY. Kenya should domesticate the provisions of this model law.
v) **Reviewing The Rules Relating To Prevention Of Deliberate Frauds Perpetrated On Creditors**

Since the insolvency law must balance the interests of debtors with those of creditors, it must not lean too heavily on the side of debtors. It must also recognize that there are many debtors who have the propensity to commit deliberate acts of frauds as against the creditors and thereafter seeking protection under the provisions of the insolvency law. Insolvency law must devise new and more effective ways of punishing such debtors. The more effective way to deal with such cases is through the invalidation of antecedent transactions. This is presently dealt with in part 6 of the companies act which identifies certain transactions for invalidation and thereafter punishes the persons found guilty of the same.

The most material provisions in Kenya is section 312 dealing with fraudulent preference which invalidates any transfer, conveyance, charge, mortgage, delivery of goods, payment, execution or other act relating to the property done by or against the company within six months before the commencement of the winding up. Such transaction however, can only be invalidated if at the instance of the liquidator.

Section 312 of the Companies Act cannot however deal with the new and complicated forms of frauds that can not be perpetrated on creditors. It therefore needs to be reviewed substantially.

First it is not enough to invalidate the transaction. If is preferable that such fraudulent preference be made both a criminal and civil wrong as was done in England through the instrumentality of legislative reforms of 1985-1986.
Secondly the scope of possible frauds as against the creditors should be expanded to include fraudulent trading. This has also been done in England. Section 214 of the English insolvency Act 1986 for example provides that if a company continues to carry on business at a time when its directors or any of them know that it has no prospects of repaying its debts, then all the directors are personally responsible. Such a clause would protect many creditors who suffer at the hands of directors who continue to trade knowing that the company is already insolvent but in the hope of taking cover under laws relating to limitation of liability for companies.
ENDNOTES

1 The task force was appointed by the Attorney General on August 13, 1993. It presented its recommendations to Attorney General on December 22, 1999.

2 The Report of the Task Force Appointed to Review the Law Relating to Companies, Investments,

3 Partnerships and Insolvency (hereinafter called the King’aru Report)

4 Ibid.

4 Established by The Kenya Law Reform Commission Act chapter 3 of the laws of Kenya on May 21, 1982 to contribute to the systematic reform.

5 See the Daily Nation Advertisement March 1, 2005.

6 See Daily Nation Newspaper 15th October 2005

7 See the East Africa Law Reports 2(2003) at page 443.