CM ADVOCATES LLP

CAN A COMPANY AVOID INSOLVENCY THROUGH RECAPITALIZATION OR SHAREHOLDER SUPPORT?

Introduction

In Kenya's dynamic business environment, companies may experience financial distress arising from operational inefficiencies, market volatility, regulatory changes or broader economic shocks. When a company becomes unable to meet its financial obligations as they fall due, it risks insolvency.

The law however does not treat insolvency as an automatic death sentence. The Insolvency Act, No. 18 of 2015 **("the Insolvency Act")** provides several mechanisms through which financially distressed companies may restructure, stabilize and continue operating as going concerns. Among these mechanisms include recapitalization and shareholder support, which if properly structured and lawfully implemented, can play a decisive role in averting insolvency.

Insolvency under Kenyan law

Insolvency in Kenya is governed primarily by the Insolvency Act and the Insolvency Regulations, 2016. The law sets out specific circumstances under which a company may be deemed insolvent, providing both creditors and the courts with clear benchmarks.

Under section 384 of the Insolvency Act, a company is deemed unable to pay its debts where:

- A creditor owed Kshs. 100,000 or more issues a written demand and the company fails to pay or compound the debt to the creditor's reasonable satisfaction within 21 days;

- Execution on a judgment, decree or court order against the company is returned wholly or partly unsatisfied;

- It is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due; and/or

- It is proved that the value of the company's assets is less than the amount of its liabilities, including its contingent and prospective liabilities.

Further, under section 424 of the Insolvency Act, a company may be wound up if it is unable to pay its debts or if it is just and equitable to do so.
However, Kenyan courts have consistently held that temporary financial difficulties alone do not justify liquidation.

The inability to pay must be real, substantial and continuing. This position was reaffirmed in ***Mulwa & 59 Others v Invesco Assurance Company Limited & another [2023] KEHC 21411 (KLR)***, where the High Court emphasized that even when insolvency is established, liquidation is not the automatic outcome. The Court highlighted that one of the Insolvency Act's core objectives, under Section 3(1), is to give companies with redeemable financial positions the opportunity to continue operating as going concerns.

This decision reflects the courts' preference for corporate rescue over premature liquidation when recovery is realistic. This can include recapitalization or shareholder support, allowing the company to continue as a going concern.

Recapitalization as a tool to avoid insolvency

Recapitalization is a strategic financial restructuring process through which a company reorganizes its capital structure by altering the balance between debt and equity. Unlike liquidation, which results in the cessation of business and the realization of assets, recapitalization serves as a corporate rescue tool. It allows a company to continue its operations under a revised financial architecture designed to align its debt obligations with its actual cash-flow capacity.

While the Insolvency Act does not provide a singular definition for the word "recapitalization", the concept is embedded in the law through provisions for schemes of arrangement (section 922 of the Companies Act) and Company Voluntary Arrangements ("CVAs"). These frameworks allow for debt-for-equity swaps, the issuance of new share capital or the reduction of existing capital to absorb losses.

Core mechanisms of recapitalization

1.Equity recapitalization: This involves issuing new shares or increasing equity capital through contributions by existing or new shareholders. By strengthening the equity base, the company reduces reliance on debt financing, improves its balance sheet and enhances solvency ratios.

While effective, equity recapitalization may result in dilution of existing shareholdings, making shareholder approval and transparent valuation essential.

2.Debt recapitalization and debt-to-equity conversion: Debt recapitalization focuses on restructuring existing liabilities. This may include:

- Converting short-term debt into long-term facilities;
- Renegotiating interest rates or repayment schedules; or
- Converting debt into equity through debt-to-equity swaps.

These measures reduce immediate cash-flow pressure and align creditor interests with the long-term success of the company.

3.Hybrid recapitalization structures: In practice, recapitalization often combines both debt and equity adjustments. For example, a company may simultaneously raise new equity while restructuring or partially converting existing debt. This blended approach allows for greater flexibility and may produce a more sustainable outcome.

4.Asset-backed recapitalization: Recapitalization is frequently supported by the disposal of non-core or underperforming assets to generate liquidity, reduce liabilities and refocus the business on its core operations.

Shareholder support in financially distressed companies

Beyond formal recapitalization, shareholders play a pivotal role in averting insolvency through various support mechanisms. This support takes the following forms:

1.Capital injections and subordinated loans: Direct financial assistance through the subscription of new shares or the provision of shareholder loans. In distress scenarios, these loans are often "subordinated", meaning shareholders agree to be paid only after third-party creditors are satisfied, thereby improving the company's balance sheet.

2.Credit enhancement: Providing personal or corporate guarantees and pledging private assets as security to back the company's credit facilities, which can prevent lenders from calling in distressed debts.

3.Strategic governance: Offering specialized management expertise or restructuring oversight to address the operational inefficiencies causing the financial distress.

While shareholder support is vital, it must be accurately structured to survive judicial and regulatory scrutiny under the Companies Act, 2015 and the Insolvency Act. Informal or undocumented support is risky as transactions between a company and its shareholders are subject to strict disclosure requirements and fiduciary duties, meaning any perceived exploitation can be set aside by the court.

Limitations and risks

While recapitalization and shareholder support are powerful rescue tools, they carry legal risks that can undermine their effectiveness:

1.Financial insufficiency: Capital injections often fail if they are deployed too late. If a company's situation is so dire that new funds only cover immediate arrears without addressing the underlying cash-flow insolvency, the injection may be insufficient to restore long-term viability, leading to eventual liquidation.

2.Claw back of preferential transactions: Any shareholder support provided before formal insolvency is at risk of being "undone". Under sections 682 and 683 of the Insolvency Act, the court can void transactions at an undervalue or preferences (e.g. repaying a shareholder loan while other creditors remain unpaid) within the relevant time.

3.Director liability for wrongful and fraudulent trading: Under section 506 of the Insolvency Act, directors may be held personally liable for wrongful trading if they continue to incur debts when they knew (or ought to have known) there was no reasonable prospect of avoiding insolvent liquidation.

Conclusion

In Kenya, insolvency is a legal status that can be actively averted through the decisive application of recapitalization and shareholder support. By leveraging the Companies Act, 2015 and the Insolvency Act, distressed entities can transition from financial instability back to going concern status. Kenyan courts, backed by precedents increasingly prioritize corporate rescue over terminal liquidation, provided that restructuring is bona fide, transparent and legally structured.

How We Can Help You

Navigating financial distress while avoiding insolvency requires timely, strategic, and legally compliant action. At our Corporate Restructuring and Special Situations Practice (CRSS Practice), we provide comprehensive support to companies facing such challenges, helping directors and management make informed decisions to protect the business and their personal interests.

Our services include:

a) **Financial & Legal Assessment:** Review of cash flow, debts and obligations to guide decision-making.
b) **Debt Negotiation & Restructuring:** Negotiating with creditors for extended terms, reduced interest, or partial settlements.
c) **Pre-Insolvency Moratorium:** Assisting with applications to secure temporary protection from enforcement actions.
d) **Company Voluntary Arrangements (CVA):** Preparing and supervising binding debt compromise proposals.
e) **Administration & Schemes of Arrangement:** Guiding complex restructurings to preserve business value and continuity.
f) **Ongoing Advisory Support:** Ensuring compliance, operational improvements, and proactive risk management.

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CONTRIBUTOR

Mercy Chore
Associate Advocate
Email: mchore@cmadvocates.com
CM Advocates LLP