

Promoting Multi-Creditor Workouts: A Nigerian Perspective

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Abstract

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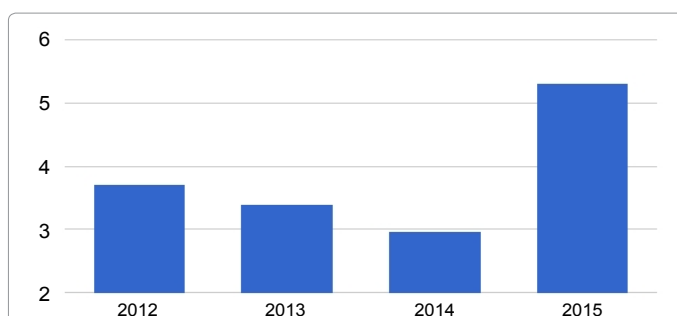
Keywords: Economic challenges; Financial stability; Unemployment; Equity capital; Insolvency; Liquidation

Introduction

The current economic situation in Nigeria like in many other countries makes it almost inevitable that a number of companies will be financially distressed and in need of some form of reorganization to ensure they can continue as a going concern [1]. As at July 2016, over 4 million employees have lost their jobs given challenges faced by their companies (FSB, 2016). By the end of 2015, industry and CBN reports put the total stock of non-performing loans at about N620 billion, which is almost at the CBN regulatory threshold of 5%. This position has deteriorated to 22% as at March 2016, compared to 3.8% in March 2015.

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The exposure of the energy sector to Nigerian banks as at March 2016 is about N3.673 trillion. A significant portion of these loans are non-performing given the current state of the oil prices which has fallen by over 60% in the past 18 months from a peak of about \$109/barrel to as low as \$44/barrel. Since a significant portion of these loans are denominated in dollars, the depreciation in the value of the Naira relative to the dollar from an exchange rate of N165/\$1 in mid-2014 to N320/\$1 in 2016 has further exacerbated the situation.



Source: TheGlobalEconomy.com, The World Bank

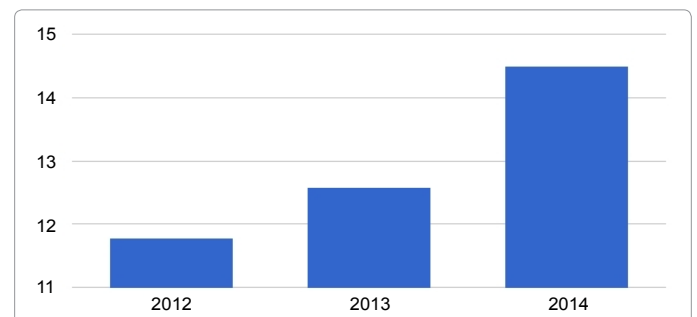
Figure 1: Nigeria non-performing loans.

As a consequence of these and other factors, bank profitability and liquidity has reduced significantly. The profitability of First Bank of Nigeria for example fell from N86 billion by end of fiscal 2014 to N15 billion by 2015. 39% of the bank's loan portfolio is to the oil and gas sector (FBN annual report, 2015).

At a time when bank lending to the private sector has increased significantly, this creates a problem for both the borrowers and the bank lenders and other creditors (Figure 2).

Companies are unable to service their loans because of the current economic situation. Some of these borrowers are exposed to multiple lenders and creditors [2] (Figure 3).

As a consequence of the foregoing, unemployment rates in Nigeria have seen a rapid surge in the past year. The delinquency rate of personal and consumer loans in banks have expectedly been on the rise. One way out of this situation is of course restructuring of loans of these borrowers through multi-creditor workout arrangements.



Source: TheGlobalEconomy.com, The World Bank

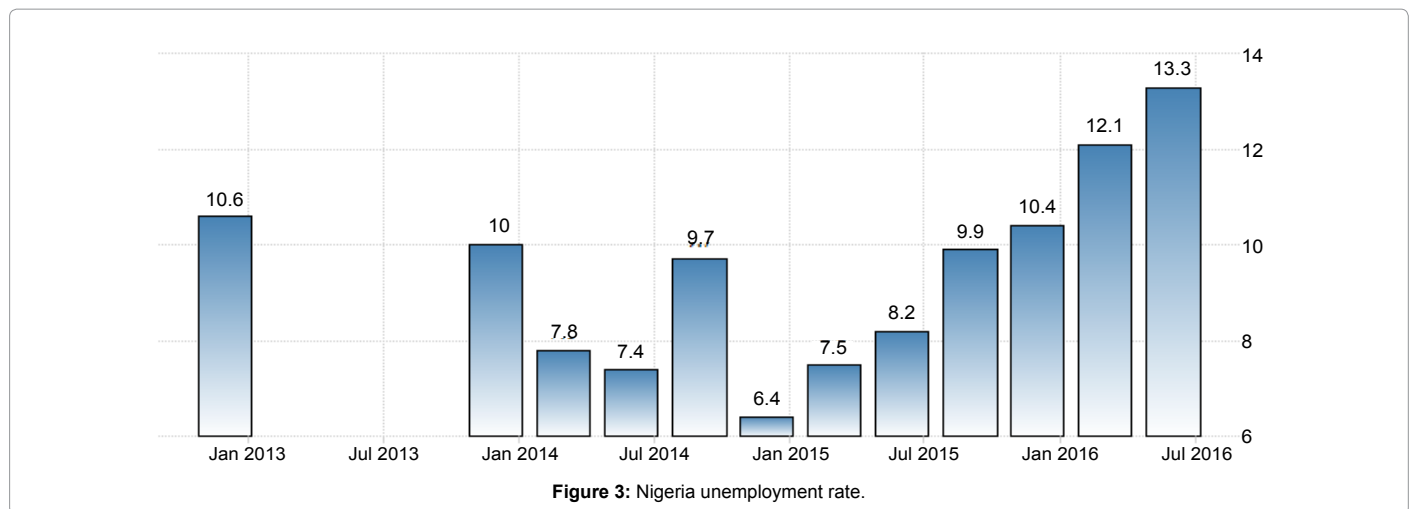
Figure 2: Nigeria bank credit to the private sector.

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Meaning and Nature of Insolvency

Insolvency is a situation where an individual, company or sovereign state is unable to meet its financial obligations to lenders or creditors when they fall due (Bankruptcy and Insolvency Act, 1992). While insolvency may be triggered by a wide range of external and/or internal factors, and may be strategic, operational and financial in nature [3], it presents itself primarily in the shape of a temporary or sustained reduction in cash flow, wherein cash generation is lower and lags cash consumption. In this presentation, we will be focusing on insolvency in corporations.

A leading case in Australia that has been used by many Insolvency Professionals in determining the 'Insolvency' of an entity was *ASIC v Plymin* (2003) 46 ACSR 126. In that case, the Judge referred to a checklist of the indicators of Insolvency:

1. Continuing losses.
2. Liquidity ratio (current assets over current liabilities) below 1.
3. Overdue taxes.
4. Poor relationship with present bank including inability to borrow additional funds (lack of financial flexibility).
5. No access to alternative finance.
6. Inability to raise further equity capital.
7. Supplier placing the person or company on 'Cash on Delivery' terms, other otherwise demanding special payments before resuming supply.
8. Creditors unpaid outside trading terms.
9. Issuing of post-dated cheques.
10. Dishonoured cheques.
11. Special arrangements with selected creditors.
12. Solicitors' letter, summons, judgments or warrants issued against the company.
13. Payments to creditors of rounded figures, which are irreconcilable to specific invoices.
14. Inability to produce timely and accurate financial information

to display the company's trading performance and financial position, and make reliable forecasts.

From a financial perspective and with respect to profit-oriented organizations, and not minding the specific opportunity, market, industry, business model, geography, customer base, product and services, and any altruistic disposition of a business and its owners, all businesses have a common structure and objective, which is to create financial value for the shareholders and capital providers, while being mindful of the implications and impact of their activities on other relevant stakeholders [4].

As we are aware, businesses require capital to execute its strategies and business operations in pursuit of a given opportunity. This capital is provided by shareholders in the form of equity and by lenders in the form of debt securities [5,6]. Other forms of capital are provided by way of working capital by trade creditors, working capital loans, and deferment of statutory obligations like taxes etc. These capitals thus represent claims that may be secured or unsecured, represented by various security instruments, on the assets and specifically on the streams of cash flows generated by the business. Contractual terms and priority in standing determines the levels and timing of the allocations of cash flows accruing to the business. Thus a business is essentially a vehicle for aggregating capital/cash from capital providers and using these cash in the operations of businesses for the creation/generations of higher flows of cash for distribution to these capital providers in accordance with the legal and contractual obligations of the businesses to these capital providers.

An intrinsic measure of financial value is the present value of the distributable or free cash flows that a business can generate and distribute to the providers of capital based on its contractual and fiduciary obligations to these parties over the life of the business. If the business can be maintained into the foreseeable future as a net cash generator, then it is valuable and worth supporting, not minding intermittent variation in cash flows that may occur over this period.

From the foregoing, the capacity of a business to generate incremental free cash flows is the source of its value to those who have claims on these cash flows. The asset configuration of the business and their efficient deployment in operations in accordance with a clear strategy is what generates these cash flows. Assets are tangible or intangible resources owned or controlled as a result of past transactions, which creates future cash flows for the business. The liabilities of the

company (capital and credit provided by lenders/creditors) enables the company put those assets in place and creates claims on the cash flows generated from the assets. Where the assets are adjudged to be terminally impaired, the capital providers and creditors have recourse to the assets to realize their investment. Usually though, the impaired assets in liquidation are usually less valuable than the assets in use. It is thus in the interest of the lenders and creditors to keep the business as a going concern as far as is reasonable and possible in order for them to realize their value.

From the foregoing, a business is “Technically Insolvent” if the book value of its liabilities exceeds its book value of assets. While this may be indicative of problems, it is not enough to conclude that the business is no longer viable. Further investigation is required. Even though the business may be technically insolvent, it may be “Operationally Solvent”. That is it may still be able to meet up its operational obligations from a cash flow perspective. This is possible where the “financial flexibility” of the company enables it raise cash externally to meet its obligations to creditors and lenders without breaching the terms of its existing debt obligations.

However, a company is “insolvent” [(Net Income+Depreciation)/(Total Liabilities)], if in any event it is unable to meet its long-term financial obligations, for example, interest and principal repayment on terms loans, debenture, bonds, and non-cumulative preference dividend. Where it is unable to meet its short-term obligations, for example, trade credit obligations, it is said to be “illiquid”. This may be due to a delay in the timing of cash flows as could happen in the case of extended operation cycles and cash cycles, and an inability to convert its assets into cash on a timely basis.

This study takes the position of some scholars and practitioners [7,8] that insolvency means an inability to meet your long-term or short-term obligations when they fall due.

Research-based and anecdotal evidence suggests that one reason (amongst many) why informal multi-creditor workout arrangements is not common in Nigeria, and where applied it fails to help resolve the situation in an efficient manner is because of the failure of the various lenders/creditors to understand this fundamental construct of a business. Recognizing that a business is meant to generate net positive cash flows and where this is not the case, a situation of insolvency has occurred, then the key issues to resolve are:

- I. Identify the reason and nature of the problem that has precipitated the cash flow slow down/insolvency.
- II. Evaluate whether this problem is systemic and severe enough to precipitate a going concern issue.
- III. Independent assessment of a plan to determine if the business can indeed continue as a going concern, resume generation of cash flow and meet its financial obligations to its lenders and creditors.
- IV. Design a financial/operational restructuring plan/workout plan as required for repositioning the company in line with the findings of step (III) above
- V. Obtain the sign-off of the multi-creditors for the execution of the plan

Business Rescue vs. Liquidation Approach to Resolving Insolvency

A few decades ago, insolvency was very closely associated with litigation, bankruptcy and liquidation of businesses. Conventional

thinking now contemplates insolvency and Insolvency Practice (IP) from a business rescue framework, rather than a litigation/liquidation framework [1]. This shift in emphasis lends itself more to informal arrangements rather than formal or litigation based approaches of resolving insolvency situations.

This move towards business rescue is being promoted for reasons that are backed up by a growing body of evidence; it usually results in creation and preservation of real value for all parties, including the secured lender/creditor, unsecured lenders/creditors, third parties, the borrower and the economy at large [9,10]. It is usually less contentious, more equitable, less expensive to orchestrate and it takes less time. This is especially true in the case of Nigeria.

Business rescue as a process and multi-creditor workout arrangements as a mechanism for resolving insolvency within a business rescue framework is multi-disciplinary by its very nature. In litigation based approach the primary focus is to use the instrument of the law to ensure payment of debt by a borrower usually by the realization of secured or unsecured assets, without taking into account the underlying cause of the insolvency. The primary actors in this situation are usually litigants represented by their lawyers. Except there are well developed bankruptcy laws that can protect the debtor from its creditors while it reorganizes its operations to enable it meet its obligations, the process can be very disruptive and damaging to the company, the unsecured lenders/creditors and other stakeholders (employees, suppliers etc.), and may eventually precipitate the bankruptcy and liquidation of the company. In the final analysis, the secured lenders/creditors who instigate the litigation usually are no better off when the cost, time and effort involved is taken into account.

A business rescue approach on the other hand, starts from the premise that the borrower is a going concern and it is in the best interest of all creditors/lenders, irrespective of the nature of their securities, to work with the borrower in executing an expeditious and structured resolution of the problem, and ensure that the borrower continues as a going concern [11]. It is a cash flow/value creation perspective rather than an assets realization perspective. To this extent, the Insolvency Practitioner (IP) who takes a business rescue approach must deploy expertise that includes, strategy, operations, finance, accounting, taxation, legal, people and negotiation skills, as all these are relevant in resolving the situation. The IP must therefore work within a multi-disciplinary team.

The focus of this paper is for the strategy, finance and performance aspect of insolvency and business rescue and reorganization within the context of multi-creditor workout.

Legal Aspect of Insolvency and Corporate Reorganization in Nigeria

The fundamental legislation that governs the practice of insolvency in Nigeria is the Company and Allied Matters Act (enacted in 1990), which, is based on the UK Companies Act of 1984. While the UK Act has seen several revision of the legislation, especially as it relates to the practice and process of insolvency, bankruptcy and liquidation, these relevant areas of the law in Nigeria has not witnessed any significant revision.

Evidently, the state of practice of insolvency and business rescue has significantly outpaced the development of corresponding and enabling legislation. In recognition of this state of affairs, the Business Recovery and Insolvency Practitioners Association of Nigeria (BRIPAN), has initiated a rigorous reform agenda by producing a Draft Insolvency

Bill whose objective is to bring the legal framework of insolvency, business rescue and bankruptcy in line with current realities and global best practice. With the assistance of the Federal Ministry of Industry, Trade and Investments, the bill was proposed as an executive bill, was reviewed by a technical committee and approved by the Ministry of Justice. By the time of transition of power to the Buhari administration, the bill was awaiting transmission by the Minister to the Federal Executive Council for approval.

Not minding the lack of a well-established legal framework, insolvency practitioners under the auspices of BRIPAN have been working with lenders/creditors and borrowers, especially within the context of informal arrangements, to bring best practice techniques in the resolution of insolvency issues.

It is also pertinent to note that the financial services industry and regulators (NDIC and CBN) have made significant strides in creating legal frameworks and directives for the rescue and restructuring of ailing banks that have enabled banks to manage insolvency challenges through the processes of restructuring, consolidations, mergers and acquisitions, recapitalization and even liquidation where this is the best option in the circumstance.

The AMCON Act No 4 of 2010 (as amended in 2015) was a laudable legal mechanism for managing the rescue of banks in distress, but has been criticized [12], and perhaps rightly so for the perceived excessive powers given to AMCON under the act, which fails to appropriately take into account the rights of creditors, labour rights and property rights in resolution of insolvencies. Once AMCON takes over the eligible asset of a bank and subject to the provisions of the Land Use Act, the eligible bank asset becomes vested in AMCON and can thus exercise all the rights and powers of the bank from which the eligible asset was acquired in relation to the bank asset, the debtor concerned and any guarantor, surety or receiver, liquidator, examiner or other person concerned, and the eligible financial institution will cease to have those rights. In other word, ownership of the underlying asset reverts to AMCOM without any encumbrance or restrictions, except where there is in force and subsisting, a valid order of court, made after due notice to the eligible financial institution from which the eligible bank asset is to be acquired, expressly restraining such acquisition.

There are significant assets on the books of AMCON today that are more of a financial burden given the difficulty in valuation and sale of these assets. The benefit of hindsight would suggest that a workout arrangement involving all creditors to the original borrower and owner of the assets may have been the most optimal approach for all parties and especially AMCON. As at the end of 2014, the loss before tax of AMCON was N275 billion, substantially due to the losses from write-off of its loan portfolio against the relevant underlying assets.

Workout Arrangement

A workout in insolvency practice is usually an informal mutual arrangement between the lender and the obligor, wherein an insolvent or financially troubled company agrees on a scheme designed to enable the troubled company meet its obligations to its creditors and lenders and thus avoid bankruptcy. It is a delinquent borrower's repayment plan worked out and agreed with the creditor/lender.

This arrangement typically involves rescheduling of debt and modification of terms to ensure the company meets its obligations under less onerous terms. It includes for example agreeing on a moratorium on interest and/or principal repayment, extending the repayment period, reducing the level of interest and principal

repayment tranches etc. The objective is to ensure the company can continue as a going concern and the creditor lender is able to get as much payment as it ordinarily would if his company allowed entering into bankruptcy proceedings.

Arrangement of workouts can be fairly straightforward in a single creditor-borrower situation. However, where there are multiple creditors/lenders, the so-called multi-creditor workout arrangement, things can be very complicated. This is so because the difference in the terms of borrowing agreed by the borrower with the individual creditors/lenders and the nature of liens and securities that they hold with respect to their lending, confers different rights, priorities and claims to the lenders. The situation is even more complicated in cross-border lending arrangements.

For example, some lenders are secure lenders and may hold securities that attach to specific assets of the borrower. Where this class of lender decides to exercise his right to realize the asset in repayment of his loan, it may seriously compromise the ability of the borrower to continue as a going concern. Realization of the residual/unsecured assets may not be sufficient to repay the remaining creditors. Realising their weaker positions and risk of financial losses, these unsecured lenders may work with the borrower to impose legal obstacles/multiple law suites in the part of the secure lender, preventing him from realizing his lien in a timely, and cost effective manner, if at all.

A multi-creditor workout arrangement that optimizes the position of all creditors/lenders may therefore be a tidier, less contentious approach, creating a win-win for all parties, especially in Nigeria where the legal process can be very drawn-out and expensive. It is also not unknown in Nigeria for judgments in favour of secured lenders to be difficult to execute.

Before formal insolvency proceedings are commenced, it is likely that a company would have explored informal arrangements with its creditors to seek out alternative means of meeting its obligations to these lenders and creditors. Where these arrangements are not contemplated in a structured and organized manner, it is possible that they may create a situation where a resolution is not optimal and equitable for all lenders and creditor, due largely to the fact that they were not adequately involved and they did not participate/collaborate in the design and execution of the arrangements or schemes designed for the resolution of the problem.

Multi-Creditor Workout Arrangements in Situations of Insolvency

In its nature and conception, if it is determined that the insolvency of a borrower can be remedied given time and other constructive intervention and business rescue and restructuring initiatives, workout arrangements envision a situation where the insolvency of a borrower is resolved informally with the active involvement of the creditor(s)/ lender(s) to ensure the borrower can continue as a going concern [13].

The major challenge of course is how to manage the interest of a secured lender who decides to opt for a litigation-based realization of its security, a situation which may compromise the ability of the other creditors/lenders from being able to collect their debt. A principle that may apply here is the so-called "better-off-test" and "enlightened self-interest". A secured lender within a multi-creditor situation must ask the question, given the cost, time; effort involved, is better off subjecting myself to an informal or court-sanctioned multi-creditor workout arrangement, rather than seek to independently realize my security through the legal process?

INSOL, the International Federation of Insolvency Professionals issued what is described as a Statement of Principles for a Global Approach to Multi-creditor Workouts. The objective of these principles is to provide best practice guideline that would enable all creditors/lenders of a financially troubled company, work together with the company to fashion the most financially optimal and efficient arrangement for resolving the problem. The Bank of England and the British Bankers Association have endorsed this statement of principles.

This so-called “London Approach”

The Principles

1. Where a debtor is found to be in financial difficulties, all relevant creditors should be prepared to co-operate with each other to give sufficient (though limited) time (a “Standstill Period”) to the debtor for information about the debtor to be obtained and evaluated and for proposals for resolving the debtor’s financial difficulties to be formulated and assessed, unless such a course is inappropriate in a particular case.

- Relevant creditors will include all major/material lenders and creditors, including major customers and suppliers of credit. This is the so-called global approach.
- A principle for determining relevance could be based on the Mendelow’s stakeholder analysis (Influence=Economic Interest i.e., materiality/degree of loss × Power i.e., capacity to frustrate the process/nature of and ease of enforce the security held).
- Limiting the overall number of creditors in the pool to the minimum may be necessary for order and efficient/timely negotiations.
- We can organize creditors by classes based on the nature of the security they hold.

2. During the Standstill Period, all relevant creditors should agree to refrain from taking any steps to enforce their claims against or (otherwise than by disposal of their debt to a third party) to reduce their exposure to the debtor but are entitled to expect that during the Standstill Period their position relative to other creditors and each other will not be prejudiced.

- Avoid preferential treatment of each creditor and a tendency towards “each creditor to itself”.
- Establish “stand still commencement date”- generally first date of formal disclosure by the debtor to the creditors as a group of the situation (formal meeting of commercial creditors).
- Debtor should provide timely and comprehensive information to the lender group. This include comprehensive information of exposures to all class of lenders/creditors, business operations, cash flows, capital structure, sufficient to enable the lender/ creditor group evaluate the position and prospect of the debtor.
- Agree of standstill period duration.
- Decide if there is a financial and commercial basis for proceeding with the rescue plan.
- Enter into formal standstill agreements (debtor-creditors and/or inter-creditor) with relevant terms, conditions and warranties by the parties that will not prejudice the position of any of the creditors.

- Complex loss sharing provisions in the event of fluctuating exposures during the standstill period.

3. During the Standstill Period, the debtor should not take any action, which might adversely affect the prospective return to relevant creditors (either collectively or individually) as compared with the position at the Standstill Commencement Date (Or prejudice their position post standstill commencement date).

- Sale/transfer of assets
- Payments other than that to employees and non-relevant creditors
- Incurring additional debt
- Offering security in the form of charges, liens, mortgages, guarantees to non-participating creditors.

4. The interests of relevant creditors are best served by coordinating their response to a debtor in financial difficulty. Such co-ordination will be facilitated by the selection of one or more representative co-ordination committees and by the appointment of professional advisers to advise and assist such committees and, where appropriate, the relevant creditors participating in the process as a whole.

- The coordinator/representative/steering committee is only a representative usually does not have the mandate to commit anyone of the creditors except expressly mandated to do so
- May require special agreement detailing the scope of his responsibility
- Usually paid by the debtor, prefunded by the creditor group or some offsetting arrangement.

5. During the Standstill Period, the debtor should provide, and allow relevant creditors and/or their professional adviser’s reasonable and timely access to, all relevant information relating to its assets, liabilities, business and prospects, in order to enable proper evaluation to be made of its financial position and any proposals to be made to relevant creditors.

- Information gathering, due diligence and evaluation
- Valuation, due diligence, inspections, verifications
- Relevance, reliability, completeness and timeliness
- Recue, rearrangement and reconstruction proposals by debtor
- Need for court sanctions
- Insolvency models for evaluating Better-off-test/comparative analysis (workout versus liquidation action versus sale of debt)
- Validity of claims of relevant creditors, validity of securities, guarantees, right of setoff, etc.

6. Proposals for resolving the financial difficulties of the debtor and, so far as practicable, arrangements between relevant creditors relating to any standstill should reflect applicable law and the relative positions of relevant creditors at the Standstill Commencement Date.

7. Information obtained for the purposes of the process concerning the assets, liabilities and business of the debtor and any proposals for resolving its difficulties should be made available to all relevant creditors and should, unless already publicly available, be treated as confidential.

8. If additional funding is provided during the Standstill Period or under any rescue or restructuring proposals, the repayment of such additional funding should, so far as practicable, be accorded priority status as compared to other indebtedness or claims of relevant creditors.

- Requirement for, level and guarantees for New money provided by the creditor(s)

Conclusion

Corporate insolvency in Nigeria is expected to rise in Nigeria given the economic challenges facing the country today. Current thinking and insolvency best practice recommends informal business rescue approach for the resolution of the financial challenges faced by companies rather than a formal, litigation oriented liquidation and bankruptcy approach.

While there is no robust legislation in place to mandate or facilitate the process of multi-creditor workout arrangements, this mechanism can still be used, following the so call "London Approach". The likely benefits include preservation of value and optimization of returns for the creditors and lenders, expeditious, less expensive and efficient resolution of the insolvency situation, preserving the debtors business as a going concern.

It is hoped that creditors and Insolvency Practitioners will increasingly employ this approach in Nigeria.

Recommendations

1. BRIPAN as a body of Insolvency Practitioners should continue to take the lead in advocating the economic, legal and social logic for borrowers and especially creditors and lenders in adopting the MCW approach to resolving insolvency challenges of debtors, given the potential savings in cost, time and effort.

2. We should continue to advocate for the enactment of robust legal frameworks that support the application of the multi-creditor workout arrangements

3. Debtors should be proactive and forthright about informing creditors and lenders of any financial challenges they might be facing. Early engagement with the MCW arrangement increases the chances of acceptance by creditors and the chances of success.

4. Creditors should recognize the benefit of working as a group and applying the coordinated multi-creditor workout approach rather than the each-one-by-himself approach, which usually triggers a race to the bottom.

5. IP practitioners in Nigeria should continue to develop their skills in applying this approach as well as develop other ancillary skills that would facilitate the successful application of this mechanism. For example, development of liquidation models and comparative/better-off-test evaluations, including the development of realistic workout plans that takes into account the interest of all creditors and lenders given their contractual, tortious claims, and the nature of their security.

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