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THE NEED FOR MODERNIZING THE ETHIOPIAN BANKRUPTCY LAW *[A CRITICAL ANALYSIS]*

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INTRODUCTION

The 1960 Commercial Code of Ethiopia introduced Book Five Bankruptcy and Schemes of Arrangement Provisions.¹ The purpose of bankruptcy law is said to benefit both the debtor and creditors. Bankruptcy proceedings relive an honest debtor from all dischargeable debts by either an orderly liquidation of a debtor's estate or a judicially confirmed plan for full or partial repayment of creditors. The bankruptcy proceedings also protect providing an opportunity for a fresh start. The system also benefits creditors by providing a forum for unsecured creditors from preferential or fraudulent transfers of the debtor's estate. The proceedings also provide adequate protection to secured creditor's interest on their collateral under conditions determined by law.²

However the Ethiopian Bankruptcy and Schemes of Arrangement provisions are formulated primarily as debt collection mechanisms. Though the provisions have existed for more than forty years they are rarely and poorly applied. The research of Tilahun Teshome and Seyoun Yohannes to the Commercial Code Revision Committee shows that the bankruptcy provisions are poorly implemented³. Their research shows that the principal impediment to the application of bankruptcy law is ignorance of the law among lawyers and the business community at large coupled with the weakness of the court system contrary to the assumption of the Code i.e. a strong court system to implement bankruptcy laws.⁴ Even though these impediments are of vital importance for having an effective and efficient and transparent bankruptcy law; this thesis does not contest their findings nor deal with these issues rather deals with the additional issue: whether the existing bankruptcy provisions are adequate enough for a modern market

¹ Commercial Code of Ethiopia, Negarit Gazeta Extraordinary No. 166, 1960

² Wax man, W. Ned gilbert Law Summaries, Bankruptcy, Law Distributors, Chicago, 1992 p.1

³ Tilahun Teshome, Problems On The Implementation of The Ethiopian Law of Bankruptcy

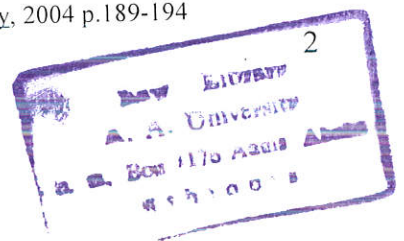
⁴ Ibid. P.35-36

economy which is based on free competition and continuous structural adjustment? Modernizing the insolvency legislation is recognized to be an important part of the legal framework of the modern market economy.⁵ Ethiopia has opted to pursue a market economy based on free competition.⁶ Therefore there is a need to ascertain whether the existing law is adequate enough for a modern market economy.

The thesis employs critical analysis and comparative approach as a methodology in its research on current development in bankruptcy theory and practice vis a vis existing bankruptcy laws of Ethiopia. However, the thesis does not attempt to discuss all major issues in the field but is rather limited to the general aspects of the law, the purposes and goals of bankruptcy laws in general and some major issues in modern bankruptcy proceedings and shortcomings witnessed in the existing Ethiopian bankruptcy provisions. Therefore this paper investigates whether the existing Ethiopia bankruptcy laws can serve an effective and efficient market economy, and the measures to be adapted to make it more effective and efficient. Chapter one of the paper deals with the need for an effective and efficient bankruptcy law, background of bankruptcy law in general and the bankruptcy provisions of the Commercial Code of 1960. The chapter makes a short overview of the historical legacies of the Roman bankruptcy law to that of Europe and Ethiopia. It also investigates the relationship between the Ethiopian bankruptcy laws and that of the 1914 U.K. Bankruptcy Act. It deals on the different modifications and exclusions made during adopting the bankruptcy provisions of the Commercial Code of Ethiopia.

⁵ Wssles Bob, Business and Bankruptcy Laws in the Netherlands, Kluwer Law International, The Hague, 1999 p.205

⁶ Federal Democratic Republic of Ethiopia Industrial Development Strategy, 2004 p.189-194



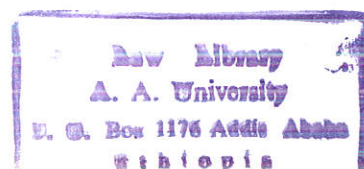
The second chapter deals with the general objectives and basic issues of the modern bankruptcy laws. The chapter deals with the development and transformations seen in the goals of modern bankruptcy laws in the rest of the world. Ethiopia as a part of the globalized world should transform the goals of its bankruptcy law to meet the changing economic, social and political goals of bankruptcy of the world and Ethiopia itself. The chapter also investigates the basic issues of bankruptcy law in general. Hence the chapter serves as a theoretical framework for the discussions in chapter three and four of this paper.

The third chapter deals with the problems of the Ethiopian insolvency proceedings. The chapter investigates the problems seen in the existing bankruptcy provisions beginning from the definition of insolvency, through the interim protective measures necessary, the application of stay, distribution of proceeds up to discharge of the debtor. The fourth chapter deals with the existing composition and schemes of arrangement provisions of the bankruptcy law of Ethiopia and considers the available alternatives to carry out modern rehabilitation proceedings. The fifth and last chapter is a summery and conclusion of the four preceding chapters, it also contains research recommendations.

OBJECTIVES, MATERIAL AND METHODS

The bankruptcy provisions of the Ethiopian Commercial Code are one of the least applied provisions of the Code. The fact that the provisions are not applied in practice indicates that the provisions are a dying body of law, which is harmful to the economy. The Ethiopian Commercial Code of 1960 Book 5, Bankruptcy and Schemes of Arrangement provisions are drafted on the traditional goals of bankruptcy i.e. to save the enterprise by composition with creditors or to liquidate the enterprise as stated by Winship. Hence the main purpose of the bankruptcy provisions of the Ethiopian Commercial Code is to protect creditors without the proper due regard to the innocent debtor.

It has been a recognized fact that modern bankruptcy provisions are an important part of the legal framework of the market economy. Bankruptcy provisions serves as a litmus test for the proper functioning of the Civil Code, the Commercial Code and company laws and even more broadly the whole economic structure of a country. This recognition led to the development of an independent or autonomous bankruptcy code (insolvency laws) with its own mature legal infrastructure in the developed western world. The acknowledgement also led to a systematization of bankruptcy laws in many transition economies. Hence insolvency legislation is part of the legal framework of a market economy. Each market economy or economies in transition should create a legal framework for a quick, fair, transparent and effective resolution indebtedness, which has a major influence on the national economy. The quick resolution bankruptcy cases will be of great assistance to overcome the problems of the business sector. Experience and research in the field demonstrate that the absence of an orderly and effective bankruptcy procedures can exacerbate economic and financial crises. Without an



effective procedures that are applied in a predictable manner creditors may be unable to collect their claims, which will adversely affect the future availability of credit. Without orderly procedures the rights of debtors may not be adequately protected and different creditors may not be treated equitably. The research project investigates whether there is a need for a modern bankruptcy law for Ethiopia? If there is the need what type of systematization or modernization would be appropriate for Ethiopia?

1. General objectives

Bankruptcy legislations of each country has its own specific objectives which are peculiar to each state. However there are general objectives shared almost by all modern bankruptcy legislations. The two over all objectives generally shared by all modern bankruptcy legislations are firstly the allocation of risk among participants in a market economy in a predictable, equitable and transparent manner; secondly, to protect and maximize value for the benefit of all interested parties and the economy in general.

The thesis investigates the different policy choices to allocate the risks of bankruptcy among the participants in a business venture. And how clearly the risks are allocated in the laws and could be consistently applied by individuals and institutions that are charged with implementing them. The other common feature of all bankruptcy proceedings are designed to address a situation in which a debtor is no longer able to pay the debt to its creditor generally hence it provides a mechanism that will provide for equitable treatment of creditors. Closely related with the policy objectives of predictability and equity is that of transparency. During bankruptcy proceedings, interested participants must be given sufficient information for them to exercise their rights under the law. The proceedings be open and the rationale underlying the court's decision be made publicly available.

The second general objective of bankruptcy proceedings is to protect and maximize value for the benefit of all interested parties and the economy in general. This objective is most obviously pursued during rehabilitation, where value is maximize by continuing a viable enterprise and liquidate enterprises that cannot be rehabilitated. To achieve the value maximization, there should be equitable risk allocation mechanisms. Through appropriate policy decisions, bankruptcy laws can clearly play a critical role in a number of areas such as in managing the bankrupted enterprise and above all it impose discipline on the debtor which increases the competitiveness of enterprise and facilitates the provision of credit and reduce the deterioration of the value of their asset and enhance the accumulation of capital.

2. Specific Objectives

The bankruptcy law must also make specific policy choices with respect to a number of substantive issues in its legal flame work. The thesis investigates the policy choices made by Book Five: Bankruptcy and Schemes of Arrangement Provisions of the Commercial Code and their rational and effects. It also investigates policy alternatives adopted by developed Bankruptcy Codes and bankruptcy laws in the transition economies. The most important issues are what type of bankruptcy laws would:

1. Support modern economic process based on competition and continuous structural change in accordance with the life cycle of enterprises?
2. Foster discipline and honesty in financial management of enterprises?
3. Facilitate the rehabilitation or the orderly market exists of enterprises that are inefficient?
4. Protect the rights of third parties such as creditors and employees?

5. Resolve conflict of interest and harmonize the conflicting interest in the global context and among the sector?
6. Protect all the creditors against the actions of the debtor that would diminish the assets to which they are entitled and the discharge of honest debtor?
7. Provide honest debtors with a measure of protection against the demand for payment by the creditors?
8. Maximize the value of the insolvent undertaking in the interest of the creditors, the debtor, employees and the public at large?

3. METHODS

The first method of research to achieve these objectives would be library research on developments in bankruptcy laws and proceedings. The main source of materials in this regard would be libraries and their materials and reports in the field. Recent developments in this regard will be compared with the policies adopted by the Civil Code of Ethiopia. The second research method would be carried by conducting interviews the existing bankruptcy laws and procedures. Judges and other professional empowered to implement the laws would be enquired to identify the practical problems encountered in the application of the laws. To this effect the researcher has interviewed the vice president of the Federal Supreme Court Ato Mmbere Tsehay Tadesse, Supreme Court Justice Hagose Woldu and Dagne Melaku. Practicing High court judges Yosef and the Wolde Tsadik Somonoe of the Ministry of Trade and Industry have also contributed valuable insight to the research.

The third method of research is case study. The research will investigate insolvency cases and how the substantive and procedural laws of bankruptcy laws are interpreted and applied in practice. However there are only a few cases that were seen during the Derge era. One of the cases is still pending and no new cases has opened in recent years. Hence lack of cases forced the research to resort to foreign cases.

CHAPTER ONE

BACKGROUND TO THE PROBLEM

1.1.General

Enterprises finance their operation either by equity capital or credit or both⁷. It is usually for an enterprise to finance its operation through credit. Credit means a *transaction in which money is loaned, goods are sold or services are rendered in exchange for a promise to pay for them at some future date*⁸. The equity investors are the owners and ultimate decision makers of the enterprise and hence the enterprise benefit its owners by paying them dividends that comes from its operational net profit.⁹ On the other hand the creditors do not normally participate in the management of the enterprise and are rather compensated by a fixed amount whether there is profit or not. In the event where the firm failed on its obligations, the un-paid creditor could initiate collection proceeding.¹⁰

There are two major types of debt collection mechanisms i.e. judicial and extra-judicial. Creditors commonly employ extra-judicial mechanism to obtain payment, in order to avoid the additional delay and expenses involved in litigation. Extra-judicial collection mechanism usually involves request of payment either orally or in writing¹¹. Creditors who try to collect a claim through judicial process must sue the debtor at a court of law. However, court litigation is not a speedy process. While collection lawsuits are pending, the debtor may dispose of his assets or other creditors may seize the debtor's property to satisfy their claims. In order to

⁷ Commercial Code of Ethiopia, Negarit Gazeta Extraordinary No. 166, 1960

⁸ Barnes. A. James, Law for Business, Irwin McGraw. Hill, Boston, 2000 p.777

⁹ Commercial Code of Ethiopia, Negarit Gazeta Extraordinary No. 166, 1960 Art.458

¹⁰ Civil Code of Ethiopia, Negarit Gazeta Extraordinary No. 165, 1960 Art.1771

¹¹ Epstein, David, Debtor-Creditor Laws, West Publishing Co. St. Paul, 1998 p.8

overcome this problem, creditors attach the property of the debtor to be released only upon judgement or collection of the claim.¹²

However the drive to get security on the one hand will reduce the availability of credit and even where security is provided the same asset could be attached by multiple creditors, the collateral may not be sufficient to cover the debt, and there will always be a competition to be the first to sue and attain a judgement and be paid in full. Because the rule of the non-bankruptcy regime satisfaction of liabilities rests on the rule "*first come first served*". The competition among the creditors to be the first and be paid upon perceived or actual insolvency of the debtor would create for multiple lawsuits, which increases the collective legal cost to get paid among the creditors.

However bankruptcy as a collective debt collection mechanism stays at least temporarily the race to improve the status of a creditor among other creditors by seizing the assets of the debtor or by concluding a contract or taking collateral as security from the debtor.¹³ Similarly the debtor's ability to make preferential transfers is considerably limited. The opening of bankruptcy also increases a chance for the discharge of honest debtor and makes a fresh start.¹⁴

Bankruptcy proceedings, would also resolve the problem of creditor coordination especially where there are multiple creditors. This does not only avoid excessive resource wastage to win the race on an insolvent enterprise asset. The bankruptcy proceeding by temporally halting the dismantling of the assets of the debtor would increase the aggregate value of the enterprise. The proceeding, by halting individual enforcement of claims and an early dismemberment of the enterprise could open the

¹² Civil Procedure Code, Negarit Gazeta Extraordinary No 3 1965 Art. 151-153

¹³ Commercial Code of Ethiopia, Negarit Gazeta Extraordinary No. 166, 1960 Art.1026

¹⁴ Wax man, W. Ned gilbert Law Summaries, Bankruptcy, Law Distributors, Chicago, 1992 p.183

possible re-structuring of the enterprise as a viable enterprise. Even where the enterprise could not be made profitable it could be sold as a going on concern hence, reducing the creditors cost and maximizing the value of the debtor's estate.¹⁶ The bankruptcy system inhibits individual action of claimant's, creates a common pool in the interest of claimants as a group. In order, to resolve the problem created by the fact that the enterprise assets are not sufficient to cover its liabilities, the bankruptcy procedure serves the unique functions as far as possible, by adopting the fundamental principles of non-bankruptcy legal provisions.¹⁷

Despite its great advantaged modern bankruptcy laws are not without problems. Some of the major shortcomings are the determination as who participates in the division of assets of the debtor. The bankruptcy law should also provide as who is entitled to participate in the proceeding and the proceeds of the liquidated asset. To ascertain the right of the claimant the non-bankruptcy law should be used to identify whether a particular claimant has the right to reach the debtor asset. The other difficulties pertain to a claim whose cause of action cannot be ascertained at the time of the commencement rather in the future.¹⁸

Still a more difficult problem is when bankruptcy is used for selfish goals such as a long term lender accelerates its claim to collect its loan in an accelerated manner. Another important problem arises concerning the question of valuation, where the values of claims are not already fixed in the non-bankruptcy forum. Setting the value of these un-liquidated claims may be both costly and time consuming. Finally the amount each claimant receives ultimately depends on the normal size of his claim versus the

¹⁶ Posner, Richard, Corporate Bankruptcy Economic and Legal Perspective Cambridge University Press, Cambridge, 1996 p. 26

¹⁷ Ibid. P59

¹⁸ Commercial Code of Ethiopia, Negarit Gazeta Extraordinary No. 166, 1960 Art.1050-1054

claims of others in the pool and the relative priority of those shares vis a vis other claimants.¹⁹

Where the absolute priority rule is adopted as in the US Bankruptcy Code it provides senior owners to be paid in full before junior owners are paid any thing.²⁰ Absolute priority rule is also essential to the understanding of corporate re-organization. Those who contribute to the capital of the firm must agree as how the firm assets should be divided if bankruptcy happened.²¹ The common priority order is secured creditors come first, followed by general creditors, subordinated debenture holders, preferred stock holder; common stock holders. Hence even if the modern bankruptcy laws are not without their own problems a market economy that is based on credit facilities and competition cannot function properly without a modern effective and efficient bankruptcy system. However bankruptcy law has taken a long time and many challenges to depart from the traditional debt collection scheme to evolve to the modern separate and systematized modern code of its own, without which a modern market economy cannot function properly.

1.2. General History

Insolvency potentially must have existed as far back the first creditor debtor relationship of the ancient world. Insolvency as a concept has a history that goes only to the Roman times. The Roman law was said to be severe towards debtors since execution under Roman law was carried out on the person of the debtor himself. In this form of execution the creditor has a right to arrest, sell, kill or maltreat his debtor where the debtor was found to be insolvent. In the later period of the Republic private

¹⁹ Posner, Richard, Corporate Bankruptcy Economic and Legal Perspective Cambridge University Press, Cambridge, 1996 p.61-63

²⁰ Barnes. A. James, Law for Business, Irwin McGraw. Hill, Boston, 2000 p.830

²¹ Commercial Code of Ethiopia, Negarit Gazeta Extraordinary No. 166, 1960 Art.505

imprisonment of the debtor was changed to public prison. Sale into slavery as a punishment for a debtor's inability to pay his debts was also abolished around 300 B.C. However, the power of the creditor to arrest his debtor survived in the form of state police power of "*imprisonment for debt*" until the modern times.²²

Roman law at the time of Gaius, saw a new method of execution against the property of the debtor in what was known as *venditio bonorum*. The creditors, in this system could petition the official *Praetor* to grant them an order authorising them to take possession of all the debtor's estate. After an interval of thirty days from seizure of the debtor estate the creditors meet and elect a manager (*magister*) who controls the estate and sell the debtor estate by public auction. The buyer who is the highest bidder would pay the dividend to the creditors and becomes the universal beneficiary. The law allowed the whole of the debtor's estate or *universitas* to be sold in block and transferred to the person who offered the creditors the largest dividend on their claims. The buyer by paying dividend to creditors becomes the *universitas juris* of the debtor, hence could sue on behalf of the debtor to collect the assets of the debtor while on the other hand he could be sued by creditors for failure to discharge his obligation.²³

Roman law at a latter period improved the concept of insolvency nearer to what is now the modern conception of execution on the debtor's estate with the concept known as *venditio bonorum*. The *venditio bonorum* involve the sale of the debtors' whole estate, making the insolvent debtor infamous and releasing the debtor after the proceeding was over. However

²² Hockly, Harold, *The Law of Insolvency in South Africa*, Juta and Co. Ltd. Cape Town, 1980 p.1

²³ Leage R, *Roman Private Law*, 1930, P.445-446

the release does not extinguish the debtor's obligations, rather the creditors could subsequently sue him at any time where he has acquired property.²⁴

A more merciful method of execution during the latter period of Roman times was the *cessio bonorum* of Julian law. This law enabled a debtor to make a voluntary *cessio* of his goods to his creditors, who sold it and divide it in *pro tanto* to satisfy their claims. A debtor adopting this method debt discharge avoided infamy and was allowed *beneficium competentiae* at the time though the creditors might proceed against him after he acquired property. In any case the creditors could not deprive him of the bare necessities of life.

The *bonorum cessio* form of sale was to some extent modified in the case of debtors of high rank, in which megastar or *the creditors, subject to the sanction of the praetor, appoint curator*. This official who is in charge of the debtor's estate is allowed to sell the estate in block or in piecemeal, as was convenient or advantageous and sufficient enough to satisfy the claims of creditors. This procedure known as *venditio bonorum* would not deprive the debtor of his subsistence at any time. This system is beneficial to a person of rank because it protects him from being infamous because of bankruptcy.²⁵

Roman law reached the idea that execution of debt should not necessarily include selling the whole property of the debtor, at a latter period, only as a generalization of the rights given to a person of rank. Hence the execution of un-satisfied judgement was enforced by seizure and delivery as much as the debtor's property as was sufficient to satisfy the judgment. The sale under the direction of the magistrate became also the

²⁴ Hockly, Harold, *The Law of Insolvency in South Africa*, Juta and Co. Ltd. Cape Town, 1980 p.2

²⁵ Leage R, *Roman Private Law*, 1930, P.447

accepted norm and it was conducted within two months the seizure of the property became the practice of the period.²⁶

The Roman law concept of *cessio bonorum* was introduced into Holland towards the end of the 15th century. However there was a remarkable feature in the Dutch practice, in that subsistence maintenance was not a right, which a debtor could claim, rather was regarded as a privilege which the court might at its discretion extend to the debtor and only if his insolvency were due to misfortune alone. Gratus described it as an act of grace, which was granted by the court only after the debtor, had supplied the fullest information concerning the position of his estate and after the creditors had had notice of the proceedings. When the court granted a *cessio*, a commissioner under the supervision of the local magistrate should administer the estate. In the 18th C. Holland chambers were established and entrusted with the administration of insolvent estates. In addition to the *cessio*, the Roman concept of *missio possessionem* was also practiced in the form of an appointed curator who distributes the proceeds of the debtor's estate *pro rata* among his creditors after sale of the assets by public auction.²⁷

The U.K. Bankruptcy statutes dates back to the time of Henry VIII and Elizabeth and James I. The bankruptcy provisions of early UK Acts were only applicable to those who came under the category of traders. However the 1861 Bankruptcy Act allowed non-traders to be beneficiaries of bankruptcy.²⁸ The only condition to benefit from the Act was a petition of bankruptcy should be presented either by the debtor or by a creditor and in accordance with this petition a receiving order should be made by the

²⁶ Ibid. p. 447

²⁷ Hockly, Harold, *The Law of Insolvency in South Africa*, Juta and Co. Ltd. Cape Town, 1980 p.2-3

²⁸ Montgomerie, John, *Steven's Elements of Mercantile Law*, Butterworth and Company Ltd. London 1950 p.539

court. The only exception to this general rule is that an act of bankruptcy committed by the debtor, in which case the court could make a receiving order against the debtor himself.²⁹

1.3. History of Ethiopian Bankruptcy Provisions

Ethiopia does not develop its own systematic indigenous bankruptcy provisions, rather the bankruptcy Provisions of the Commercial Code were drafted on the basis of common law and civil law traditions.³⁰ Prior to the introduction of Commercial Code Bankruptcy provisions problems of creditors in debt collection like any other dispute was settled in accordance ~~with~~ ^{with} customer law. Since Ethiopia is the home of many cultural groups the customary law differs from one cultural group to the other, the diversity ranges from debt slavery to debt based forced labor and that of granting additional time to pay the debt.³¹ Ethiopia by adopting the Administration of Justice Proclamation no.1 of 1942 allowed all civil cases in the country to be brought before a court of law. Any contracting party who has a right or a claim to collect debts due is allowed to institute contractual civil proceedings.³² Hence even after the 1942 Justice Proclamation there was no separate proceeding for an insolvent debtor, until the coming of the 1960 Commercial Code. The Bankruptcy provisions of the Ethiopian Commercial Code of 1960 could be traced to common European historical sources, among which the practice of the mercantile cities of northern Italy is the most important ones.³³ However European tradition itself has considerable diversity. The Latin countries have the tradition to associate bankruptcy with blame-worthiness, which is reflected

²⁹ Ibid. 539

³⁰ Win ship Peter, Background Documents of the Ethiopian Commercial Code of 1960, Artistic Printers, Addis Abeba, 1974 p. 111

³¹ Gilkes Patrick, The Dying Lion, Feudalism and Modernization in Ethiopia 1975 P.46

³² Consolidated Laws Ethiopia. The Faculty of Law Haile Sellassie I University V. IP. 394

³³ Win ship Peter, Background Documents of the Ethiopian Commercial Code of 1960, Artistic Printers, Addis Abeba, 1974 p.100

in the survival of debt and loss of right after the liquidation procedure. Hence the debtor should pass through special rehabilitation procedure. The German and Anglo-Saxon tradition on the other hand is based on the practical needs of creditors' hence the bankruptcy laws reflect the interest of creditors rather than the bankrupt.³⁴

The drafter of the Code made choice among variant concepts on issues such as should bankruptcy be necessarily be considered as blame worthy act or only as a simple accident of commercial life. The Code though tried to incorporate pro debtor measures such as schemes of arrangement in order to save enterprises it also put restrictive measures even on the movement of the debtor.³⁵ This position of the Ethiopian Bankruptcy Commercial Code is largely emanate from that of the British Bankruptcy Act of 1914, from which it is adopted.³⁶ Hence a brief investigation of the relationship between the common features of the two laws and the differences and deviations is essential to understand the background to the current problem of the law. Therefore this paper investigates major aspects of the two laws in respect of insolvency proceedings, composition and schemes of arrangement.

1.3.1. Insolvency Proceedings

Bankruptcy law in England began as a debt-collecting device for creditors and the early English statutes were all directed at strengthening the hand of creditor and increasing their chance of being paid, but not providing relief for debtors.³⁷ The 1914 Bankruptcy Act aimed at strengthening the chance of creditors being paid. The Act enables either the

³⁴ Ibid. p. 100

³⁵ Commercial Code of Ethiopia, Negarit Gazeta Extraordinary No. 166, 1960 Art.1019

³⁶ Win ship Peter, Background Documents of the Ethiopian Commercial Code of 1960, Artistic Printers, Addis Abeba, 1974 p.201

³⁷ Posner, Richard, Corporate Bankruptcy Economic and Legal Perspective Cambridge University Press, Cambridge, 1996 p.29

debtor or the creditor or several creditors to jointly petition the court to declare the debtor bankrupt. Where the debtor files petition, the court will at any time give a receiving order. Where a creditor files petition there will be a hearing to ascertain the continued existence of debt, the inability of the debtor to pay the debt or the existence of the act of bankruptcy.³⁸

A) Appointment of Receiver or Commissioner

The court makes a receiving order at any time after the presentation of the petition in case of voluntary application while in the case of involuntary petition after the hearing of the case. Where a receiver is appointed by the court, the official constitutes a receiver of the property of the debtor and takes away from the creditors all remedies against the property or person of the debtor except from secured creditors, creditors whose debt are not provable in bankruptcy and to certain extent the land lord.³⁹ The court has a general discretion to rescind its orders where the order is obtained by the presentation of a petition under circumstance which amount to an abuse of the process.⁴⁰

The official receiver is appointed by the Board of Trade to receive all the bankrupt's property until the appointment of a trustee. It is not usual to nominate a separate receiver for each estate, the practice being to appoint a receiver within a given district.⁴¹ The receiver manages the property and the affairs of the debtor, acts as a trustee until the official is appointed. The official receiver must send notice to every creditor as soon as possible, to call and preside the first meeting no later than the fourteen days after the date of receiving the order. Where the creditors are many, three creditors form quorum to choose a chairman, admit proof and adjourn. The chief

³⁸ Montgomerie, John, Steven's Elements of Mercantile Law, Butter worth and Company Ltd. London 1950 p.544-546

³⁹ Ibid p.547

⁴⁰ Ibid. p. 547 - 548

⁴¹ Ibid. P. 570

business of the first meeting is to determine whether it is desirable to consider the proposal for composition or scheme of arrangement on the one hand or to adjudicate him bankrupt and appoint a tutee and a committee of inspection on the other.⁴²

The provisions of Book Five of the Commercial Code of Ethiopia apply only to traders, hence in this regard the Ethiopian Bankruptcy Provisions lag one step even to that of the 1914 UK Bankruptcy Act and non traders are not allowed to benefit from the bankruptcy system like that of the 1861 UK Bankruptcy Act.⁴³ The petition of the debtor, one or more creditors, the public prosecutor, or the court itself can institute bankruptcy proceedings.⁴⁴ The court after hearing the petition may appoint a judge for the purpose of investigating into the affairs and activities of the debtor. Any judge so appointed may require the assistance of a trustee in its task to investigate the affairs of the debtor's business. However all information collected shall be reported to the court.⁴⁵ At the first hearing or where appropriate, on receiving the report under Art. 976 of the Commercial Code the court shall fix the date of suspension of payments; and subject to the provisions relating to schemes of arrangement, declare the debtor bankrupt.

Where the court adjudicates the debtor bankrupt, a court replaces the investigating judge appointed commissioner and one or more trustees. The commissioner in Ethiopian bankruptcy serves the role of the receiver in UK Bankruptcy Act of 1914. Art. 991 of the Commercial Code entrusts the commissioner with the following powers:

⁴² Ibid.

⁴³ Commercial Code of Ethiopia, Negarit Gazeta Extra-Ordinary Issue No 166 of 1960, Addis Abeba, 1960, Art. 968

⁴⁴ Civil Code of Ethiopia, Negarit Gazeta Extraordinary No 165 of 1960, Addis Abeba Art 975(1)

⁴⁵ Commercial Code of Ethiopia, Negarit Gazeta Extra-Ordinary Issue No 166 of 1960, Addis Abeba, 1960, Art.976

- (1) The commissioner shall have power to supervise and deal with all matters concerning the bankrupt estate.
- (2) He shall refer to the court any claims which fall within the jurisdiction of the court and the court in its decisions shall mention such reference.
- (3) He shall take or cause to be taken by the competent authorities all steps and measures necessary to preserve the assets.
- (4) He shall call the creditors' committee as required by law or where he considers it to be necessary.
- (5) Where it is in the interests of the estate, he shall authorise the trustee to appoint assistants, unless such an appointment is reserved to him by law.
- (6) He shall authorise the trustee in writing to enter appearance in legal proceedings.

The commissioner is appointed by the court to administer the debtor's estate with the duty to preserve the assets and call the meeting of creditors. Where the interest of the estate requires the establishment of creditors committee the commissioner shall call creditors meeting to establish a creditors committee. As a supervisor of the debtor's estate he authorises the trustee to appoint assistants and enter into legal proceedings to maximize the assets of the estate. Unlike the UK receiver the Ethiopian commissioner does not conduct an investigation into the affairs of the debtor's business, since the investigating judge already had conducted the investigation prior to the adjudication of the debtor bankrupt, as is the case in the French bankruptcy law.⁴⁶

B) The Debtor

The UK Bankruptcy Act of 1914 obliges the debtor to submit a statement of the affairs of the business as soon as possible. The UK Debtors Act of 1869 has abolished imprisonment for debt, except in certain cases specified by the Act. The court may order arrest of the debtor and

⁴⁶ French Civil Code, 1982 as amended Article 1621-11,

seizure of his books and papers where there is reason to believe that the debtor has absconded or about to abscond to avoid payment, to force him or appear in person or co-operate in the examination of his affairs and the underling bankruptcy proceedings.⁴⁷ It is the duty of the official receiver to examine the affairs of the debtor's business. Hence he gives notice to the creditor and the debtor in the Gazette in a local paper for the debtor to undergo an examination in open court about his conduct, dealings and property by the court, the official receiver, and the trustee and by any creditor who has tendered a proof of his claim.⁴⁸

The debtor under Ethiopian bankruptcy law is not subject to arrest, similarly to that of the 1914 UK Bankruptcy Act, unless he fails to obey a lawful decision of a competent authority being duly notified in accordance Article 433 of the 1957 Ethiopian Penal Code. However, the debtor is not allowed to leave the area in which he resides without the permission of the commissioner.⁴⁹ Where the debtor breaks any such prohibition he is made liable in accordance with the provisions of Article 433 of the 1957 Penal Code. The restriction imposed by the bankruptcy law on the right of free movement of the debtor runs counter to the right of free movement enshrined in Article 32 of the Constitution of the Federal Democratic Republic of Ethiopia.

The debtor and his family may also get subsistence maintenance where the commissioner approves the request of the trustee. Hence the right to subsistence is not yet a right of the debtor under current Ethiopian bankruptcy law rather it is still a favour that may be granted similar to that of the 15th C. Dutch law. Where the commissioner grants the request of the

⁴⁷ Montgomerie, John, Steven's Elements of Mercantile Law, Butter worth and Company Ltd. London 1950 p. 569

⁴⁸ Ibid. p. 550

⁴⁹ Civil Code of Ethiopia, Negarit Gazeta Extraordinary No. 165 of 1960, Addis Abeba Art. 1019

trustee part of the bankrupt estate could be applied to support the debtor and his family.⁵⁰ The support extended to the debtor is dependent on such terms and conditions, as the commissioner shall fix in order to facilitate the winding-up of the enterprise.⁵¹ A bankrupt shall not administer or dispose of his property, however acquired, from the day he is declared bankrupt until he is discharged. After adjudication, all legal proceedings shall be instituted and all applications for execution be made by or against the trustees. The bankrupt may be authorised by the court or the commissioner to intervene in any proceedings to protect his interest.⁵²

C) The Trustee

Under the 1914 UK Bankruptcy Act the trustee is appointed by the ordinary resolution of creditors meeting upon the debtor being adjudicated bankrupt. The creditors may also pass a resolution for the debtor to be adjudicated bankrupt by the creditors or the committee of inspector (where the committee are authorized by the creditors). The trustee could also be appointed by the Board of Trade, where the creditors fail to appoint within four weeks of the adjudicator or within seven days of the failure of proceedings in relation to composition or within three weeks of a vacancy.⁵³ The appointment of the trustee is not complete until the Board of Trade has given the certificate of appointment. Certificates of appointment are not issued until the trustee has given security for the due performance of his duties. The security must be given to the person appointed by the Board of Trade, which fixes the amount and the nature of such security and may from time to time increase or decrease the amount.

⁵⁰ Commercial Code of Ethiopia, Negarit Gazeta Extra-Ordinary Issue No 166 of 1960, Addis Abeba, 1960, Art. 1020

⁵¹ Ibid. 1021

⁵² Ibid. 1023

⁵³ Montgomerie, John, Steven's Elements of Mercantile Law, Butter worth and Company Ltd. London 1950 p.571

The Board could also refuse to authorize such person where he was not elected bonfires, for previous misconduct or impartiality.⁵⁴

The main duty of the trustee is to realise the estate to the best advantage and to distribute as quickly as possible, to act with regard to the resolution of the creditors and the orders of the Board of Trade. The trustee in every case must require the wishes of the general body of creditors, regularly and expressly. He must also keep proper books of accounts and all transactions should be made through the Bankruptcy Estate Account. All moneys received should at once be paid into this account and all payments be made by a cheque in the name of the estate signed by the trustee.

The Ethiopian bankruptcy Provisions of the Commercial Code allows the trustee to be selected from a list of qualified persons of good repute resident in Ethiopia. The law provides for such list to be prepared at the beginning of each year by the Ministry of Commerce and Industry. However, the Ministry of Commerce and Industry until now has not prepared such a list.⁵⁵ The number of trustees shall not exceed three, where more than one trustees are appointed they shall act jointly and severally and are liable for their acts collectively. The trustee shall be responsible for the administration of the bankrupt estate under the supervision of the commissioner.⁵⁶ He shall represent the universality of creditors in relation to third parties. However he may not assign his functions but may, with the approval of the commissioner, delegate them in respect of isolated transactions.⁵⁷

⁵⁴ Ibid. p. 572

⁵⁵ Tilahun Teshome, Problems On The Implementation of The Ethiopian Law of Bankruptcy p.24

⁵⁶ Commercial Code of Ethiopia, Negarit Gazeta Extra-Ordinary Issue No 166 of 1960, Addis Abeba, 1960, Art.994 (1) (2) (3)

⁵⁷ Ibid. Art. 995

The trustee in order to maximize the estate of the debtor shall, with the permission of the commissioner sell all depreciable or perishable goods or property the preservation of which is costly. He also collects debts where he is authorised by the court to continue operations of the business. The trustee may sell movable property or goods in accordance with the conditions of sale authorized by the commissioner. Where the business continues to operate, creditors whose claim has arisen out of such operation shall be creditors of the universality. They shall not be subject to the provisions regarding bankruptcy and shall be paid from the assets of the bankruptcy before the creditors whose claims are included in the universality. Instead of operating the business he, the trustee may be authorised by the commissioner to appoint a receiver to carry on the business. Unlike the UK Bankruptcy Act from which the law was adopted there is no requirement for the board of trade to give a certificate of appointment nor a need for the trustee to provide security for his good performance. Lack of security for good performance has been found by the courts a hindrance to appoint a trustee and ensure the proper performance of the system.⁵⁸ The present arrangement does not guarantee trustee's proper discharge of his obligations, hence the law is open to misuse or even enables irresponsible trustee to abscond with the debtor's assets. Although the trustee under Ethiopian law is required to keep proper books of accounts there is no legal requirement similar to the UK Bankruptcy Act to conduct all transactions through the bank or payments to be made by a cheque in the name of the estate hence creditors could not be confident in such a system. This lack of transparency and credible accountability seems to be one of the reasons why creditors make the bankruptcy law of little use.

⁵⁸ Yosef, Federal High Court Judge (Interview)

D) Committee of Inspection

The Committee of inspection under the 1914 UK Bankruptcy Act is appointed by the creditors at the first or subsequent meeting, from among the creditors qualified to vote. A member of the committee is in a fiduciary capacity, hence like any other trustee must not purchase or drive profit from any transaction arising out of the bankruptcy, except by leave of the court. The duty of the committee is to supervise and to superintend the general administration of the estate. Where the committee is not appointed the trustee may obtain sanction from the Board of Trade for the exercise of the powers in respect of which he is required to get permission of the committee. The accounts of the trustee are inspected by two separate bodies i.e. the committee of inspection and by the Board of Trade. The committee must see all books and vouchers at least once in every three months or at any time earlier. The committee must sign and certify the cashbook upon each audit.⁵⁹

The Ethiopian bankruptcy law provides for the appointment of a committee of creditors who may serve as inspectors by the commissioner. The creditors' committee shall be appointed not later than ten days after the deposit of the order showing the list of creditors provided in the registrar of the court. However, the committee is only appointed where the commissioner thinks it is desirable to have such a committee. The commissioner chooses from three or five creditors from among the creditors and appoints the chairman. The commissioner may on their request replace the members of the committee or the court on the proposal of the commissioner may remove them. No relative by consanguinity or

⁵⁹ Montgomerie, John, Steven's Elements of Mercantile Law, Butter worth and Company Ltd. London 1950 p.579

affinity of the debtor, up to the fourth degree inclusive, may be a member of the creditors' committee.⁶⁰

The main function of the committee is to give its advice where such is required by law or requested by the court or the commissioner. The committee shall have special regard to the verification of the accounts and the statement of affairs prepared by the debtor and to the supervision of the acts of the trustees. To discharge this obligation the committee may at any time require information on the state of the bankruptcy proceedings and on the position of receipts and payments. The committee shall however be consulted by the trustees with regard to all legal proceedings but their liability is limited to acts or omissions that amount to gross negligence.

1.3.2. COMPOSITION AND ARRANGEMENTS

The 1914 UK Bankruptcy Act allows a debtor to obtain realises from his debt through the acceptance of a composition agreement or a scheme of arrangement by his creditors. A composition is a contract between debtors or two or more creditors, in which the creditors agree to take a specified partial payment in full satisfaction of their claims. On the other hand an extension is a contract between the debtors or two or more creditors in which the creditors agree to extend the time for the payment of their claims against the debtor. Where an agreement is reached in which the creditors agree some portion of their claim over a longer period of time, the agreement can be both a composition and an extension.⁶¹

In order to conclude a composition or scheme of arrangement the debtor must submit his proposal to the official receiver. The official receiver or trustee must submit the proposal to the creditors and call a

⁶⁰ Commercial Code of Ethiopia, Negarit Gazeta Extra-Ordinary Issue No 166 of 1960, Addis Abeba, 1960, Art.1002

⁶¹ Epstein, David, Debtor-Creditor Laws, West Publishing Co. St. Paul, 1998 p.136

meeting. If the creditors meeting approve by a majority in number and three fourth in value the proposal is submitted to the court.⁶²

The court approves the composition agreement or the schemes of arrangement only where the proposal is reasonable and is in the interest of the general body of creditors. The court cannot approve a scheme, which does not provide for the prior payment of preferential creditors and priority debt. All debts, which the creditors have agreed to be realised, shall be discharged under a scheme of arrangement. Where creditors did not agree with the schemes of arrangement he could receive a security from a third party on behalf of the debtor with full knowledge of the other creditors and hence the scheme becomes binding on the rest of the creditors.⁶³

✓ The Ethiopian bankruptcy law allows a trader who has entered insolvency propose a composition with creditors. The proposal should be submitted after the expiry of the period of time provided for creditors who appear in the balance sheet or who has proved his right to lodge their claim. Proposal for composition with the creditors should be submitted to the commissioner. The proposed composition shall specify the percentage offered to unsecured creditors and the period of time required for payment. It shall also show the guarantees to cover the payment of debts, legal costs and the remuneration of the trustees.⁶⁴

Upon receiving the proposal for composition the winding-up is suspended the commissioner shall consult the trustees and the creditors' committee. Where the commissioner considers the proposal and the recommendations of the trustees and the creditors committee to have merit he notifies the creditors for a period, not less than twenty days nor more

⁶² Montgomery John, Steven's Elements of Mercantile Law, Butter worth & Co. 196, P.589

⁶³ Ibid. p. 590

⁶⁴ Commercial Code of Ethiopia, Negarit Gazeta Extra-Ordinary Issue No 166 of 1960, Addis Abeba, 1960, Art.1081

than thirty days, within which the dissenting creditors may file with the court their refusal to accept the proposed composition.⁶⁵ All duly admitted creditors have the right to vote, including those admitted provisionally or subject to a reservation. However, votes of creditors enjoying special securities shall not be counted in respect of their debts in the transactions relating to the composition unless they forego their guarantees. The results of such renunciation shall cease to have effect where the composition is not finalised, or is not ratified, or is revoked or withdrawn.

The composition shall be of no effect unless it is approved by two-thirds of the creditors representing two-thirds of the debts. The claims of creditors who do not take part in the voting shall not be taken into account in calculating the majority. Creditors who have not notified their dissent from the proposals of the bankrupt within the period of time provided in Article 1082 (5) shall be deemed to be in agreement. The court shall only refuse to confirm the composition where there are irregularities either substantial or procedural or confirmation of the composition is contrary to the public interest or the interests of the creditors.⁶⁶ The commissioner, the trustees and the creditors committee shall ensure the carrying out of the composition, in accordance with the detailed instructions contained in the judgment confirming composition.

On the other hand a debtor who has suspended or is about to suspend payment without entering the insolvency proceedings could apply to the court for the opening of a scheme of arrangement.⁶⁷ The application in accordance with Art .1121 of Commercial Code shall contain the following minimum requirements:

⁶⁵ Ibid. Art. 1082

⁶⁶ Ibid. Art. 1087

⁶⁷ Ibid. Art. 1119

- (a) An undertaking to pay not less than 50% of the capital value of unsecured debts within one year from the date of confirmation of the scheme, or 75% within a period of eighteen months or 100% within a period of three years;
- (b) A promise to furnish material or personal guarantees to secure the undertakings made under paragraph (a) and giving details of the guarantees.

The debtor may propose to assign to his creditors all assets held by him at the date of the application for a scheme of arrangement where the assets are sufficient to meet payments as provided in sub-article 1(a) of Article 1121 Commercial Code. The scheme of arrangement shall be approved by a majority of creditors representing not less than two-thirds of all non-preferred of unsecured debts. Again secured creditors may not vote, unless they give up their security. Such surrender may be partial but shall not be less than one third of the full value of the debt.⁶⁸ The court, when confirming the scheme arrangement shall bind all creditors prior to the opening of the proceedings for the scheme, but their rights against persons jointly and severally liable with the debtor, sureties and assignees shall not be affected.⁶⁹ The commissioner shall supervise the carrying out of a scheme in accordance with the procedure laid down in the judgment.⁷⁰

1.3.3. ARRANGEMENT OUT SIDE THE BANKRUPTCY ACT

The 1914 UK Bankruptcy Act allows creditors to make arrangements with the debtor outside the provisions of the Bankruptcy Act. In such cases the rules of ordinary contract would apply. Hence the arrangement is a contract that could be enforced by a court of law subject to the general rules of contract.⁷¹ However the Ethiopian bankruptcy law does not provide for arrangement outside the court system even if there are

⁶⁸ Ibid. Art. 1140

⁶⁹ Ibid. Art. 1150

⁷⁰ Ibid. Art. 1151

⁷¹ Montgomery John, Steven's Elements of Mercantile Law, Butter worth & Co. 196, P.591

a number of advantages for a debtor to prefer a composition rather than bankruptcy. Arrangements outside the court system enable the debtor to avoid the stigma of bankruptcy. The discharge in composition is determined by the agreement to the composition, hence with a possibility that a substantial or all of the debt being discharged. Hence providing such an arrangement would be beneficial to the Ethiopian bankruptcy system.⁷²

1.4. Effects of the Bankruptcy System

The Ethiopian bankruptcy provisions, though adopted in 1960, was based on the 1914 UK Bankruptcy Act rather than that of the 1948 UK Company Insolvency Laws which was a recent one at the time. The decision to model the laws on earlier UK laws seems with the intention to benefit from the simplicity of the system. However, the Ethiopian bankruptcy laws started at a lower level of development from the jurisprudence of bankruptcy law of the period.

A critical analysis of the two laws also shows the Ethiopian bankruptcy provisions even have omitted some of the beneficial aspects of the 1914 UK Bankruptcy Act. The first serious limitation starts from the decision that bankruptcy system is only open to traders. The decision to exclude individuals from the system though rational from the fact that the bankruptcy provisions are part of the Commercial Code, it has deprived its citizen to benefit from the system. It also seems to have contributed to the restricted awareness of the public to the beneficial aspect of the system. Restrictions on the liberty of debtor free movement and provisions for maintenance makes the law too much creditor centred. Hence the debtor is left without any incentive to petition for bankruptcy and make use of the system.

⁷² Epstein, David, Debtor-Creditor Laws, West Publishing Co. St. Paul, 1998 p.136

The second major limitation of the Ethiopian bankruptcy law arise from the introduction of the French investigating judge rather than a receiver or commissioner of the UK and to conduct the early investigation. Even if the investigating judge could possibly require the assistance of a trustee the system lacks continuity and possibly loose the benefit that may be gained from the expertise of the commissioner in business and financial difficulties. The trustee though required by law to be appointed from the list prepared by the Ministry of Trade and Industry, the Ministry has not prepared such a list and the courts appoints the trustee directly. The UK Bankruptcy Act requirement for the trustee to be approved by the Ministry upon presentation of a security for proper discharge of his duties is also missing. This serious shortcoming makes the system less transparent and makes the trustee without any mechanism to force proper discharge except that of civil and criminal prosecution after the fact. Similar shortcomings are seen with regard to the establishment of creditors committee, which is made optional under Ethiopian bankruptcy law. Apart, from making their existence dependent on permission of the court the committee is also given only an advisory role, which makes it weak to supervise the activities of the commissioner and the trustee to protect the interest of creditors.

The provisions with regard to composition agreement and schemes of arrangements though proper to the time, the provisions are drafted only as debt collection mechanisms. The law even though did not prohibit debt collection agreement outside the bankruptcy system it did not provide for it despite its great advantage to the debtor. This made the Ethiopian bankruptcy law creditor centred and without reorganization and pre bankruptcy workout mechanisms, hence making it inadequate for a modern bankruptcy law with the goal of ensuring the survival of the enterprise and maximization of its assets, in the interest of the economy at large.

Recent experience in East Asia has shown that the absence of an orderly and effective insolvency proceeding can exacerbate economic and financial crisis. Where the proceedings are not applied in a predictable manner creditors may be unable to collect their claims, which have an adverse effect on future availability of credit.⁷³ The bankruptcy provisions of the Commercial Code were not even sufficient to meet the requirements of the 1960's rather than a modern market economy, hence there is a need to modernize it.

⁷³ International Monetary fund, Orderly and Effective Procedures, 1999

CHAPTRE TWO

GENERAL OBJECTIVES AND BASIC ISSUES IN BANKRUPCY

2.1. General

Traditional bankruptcy laws were formulated on a number of fairly simple policy propositions such as.⁷⁴

1. Bankruptcy law has a special role to play in determining how losses from a business failure should be borne;
2. Creditors as well as others may some times be required to give up some of their ultimate rights to the assets of the firm so that the firm will have a better chance of surviving;
3. Entrusting a bankruptcy judge with equitable discretion as a useful and un-objectionable way to balance the conflicting and competing interests of the parties; and
4. Creditors in bankruptcy have no cause to complain when they loose some right they had outside of bankruptcy; because bankruptcy is an entirely new game that deals which the different kinds of problems.⁷⁵

Modern bankruptcy or insolvency laws are given broad social and economic objectives than traditional bankruptcy laws. Insolvency legislations are needed to support a modern economic process based on competition and continuous structural change according to the life-cycles companies. An efficient and effective bankruptcy law also foster discipline and honesty in financial and legal management of enterprises. The bankruptcy system should also facilitate the rehabilitation or the orderly market exit of enterprises that are inefficient and it should also protect the rights of creditors and employees. In a nutshell modern insolvency legislations aim at a solid and transparent domestic insolvency law that gives both local and foreign investors confidence in those rules that govern

⁷⁴ Wesseles Bob, Business and Bankruptcy Laws in the Netherlands, Kluwer Law International, The Hague, 1999 p.205

⁷⁵ Posner, Richard, Corporate Bankruptcy Economic and Legal Perspective Cambridge University Press, Cambridge, 1996 p.96

economic competition that stimulate investment, strengthen economic performance.⁷⁶

In the conception of an economist competition is the market device that drives the markets toward a state of long run equilibrium in which those firms remaining in existence produce at a minimum average costs. In the transition to long-run equilibrium, inefficient firms with absolute technologies and those producing products that are in excess supply are eliminated by the competition. Hence, consumers benefit because in the long run goods and services produced are sold at the lowest possible prices. To achieve these goals bankruptcy law plays a special role, in the words of an economist:

The legal mechanism through which insufficient firms most often are eliminated is that of bankruptcy. [Bankruptcy] ... serves as a screening process designed to eliminate those firms, which economically are inefficient, and whose resources could be better used in some other activity.⁷⁷

Recently Thailand modernized its bankruptcy legislations with the aim of addressing the needs of a market economy in the new global world. The central conception of the bankruptcy legislations were that of economics:

- (1) To support modern economic processes based on competition and continuous structural change;
- (2) To foster discipline and honesty in financial management; and
- (3) To facilitate the rehabilitation or the orderly market exit of enterprises that is inefficient.⁷⁸

⁷⁶ Wesseles Bob, Business and Bankruptcy Laws in the Netherlands, Kluwer Law International, The Hague, 1999 p.205

⁷⁷ Posner, Richard, Corporate Bankruptcy Economic and Legal Perspective Cambridge University Press, Cambridge, 1996 p.207

⁷⁸ Wesseles Bob, Business and Bankruptcy Laws in the Netherlands, Kluwer Law International, The Hague, 1999 p.226-227

Modernizing the insolvency legislation is recognized to be an important part of the legal framework of a market economy and economics in transition by many Eastern Europe and East Asian Countries.⁷⁹ An other East Asian country, Indonesia, which is also a country in transition into a market economy, made amendments to its bankruptcy act. The main goals of the amendments were to overcome the financial crisis of the country with the goals to accelerate the creation of legal remedies and ensure quick, fair, transparent and effective resolution of company indebtedness. The amendment main goal was the resolution of company indebtedness, which was considered to have a major influence on national economic life. The quick resolution to the debt problems in the national business sector was considered to be of great assistance in overcoming the uncertainties in the economic sector and the financial crisis of the country.⁸⁰ Hence apart from the broad goals of insolvency the bankruptcy laws could also be designed to meet the specific requirements of each country.

Despite the differences in the goals of insolvency laws in different countries two general overall objectives are found to be common to most laws. The first overall objective refers to the allocation of risk among participants in a market economy in a predictable, equitable and transparent manner.⁸¹ The second objective of insolvency law is to protect and maximize the value of the debtor's estate to the benefit of all interested parties and the overall economy in general.⁸²

⁷⁹ Ibid. p. 227

⁸⁰ Ibid. p. 227

⁸¹ International Monetary fund, *Orderly and Effective Procedures*, 1999 p.6

⁸² Ibid. p. 7

2.1.1. Allocation of Risk

The bankruptcy law should allocate risk among the various participants in a market economy.⁸³ The law should formulate this allocation in a predictable, equitable and transparent manner. Predictability refers to risk allocation among the participants between an enterprise and its creditors and customers. Where the risk is clearly formulated by the insolvency legislations participants often are able to take measures to manage the risk including price adjustment.⁸⁴

Clearly formulated insolvency law provides a mechanism that facilitates investment decision-making. Investment is primarily risk assessment. In extending credit facilities to an enterprise the risk refers to the fact that the debtor might fail to meet the terms of the agreement in which credit facilities were extended. The risk is not dependant only on the business environment but also on the legal and institutional mechanisms that enable creditors to enforce their right against a debtor. Hence a clear law and an efficient insolvency mechanism will assist investors in making their investment decisions.

The facilitation of investment and risk assessment also takes into account on whether there is a clear criterion for the distribution of liquidated asset of the debtor. The liquidation procedure should recognize the seniority established by the pre insolvency contractual agreements. Creditors will feel confident when they are able to manage the risk they incur when making investment decisions. The allocation of risk should not be only predictable it should also be equitable. Equitable treatment refers to the treatment of the various classes of creditors in the bankruptcy proceedings. Since different classes of creditors have struck fundamentally

⁸³ Samuelson A. Paul, Economics An Introductory Analyses, Mc Graw-Hill Book Company, 1967 p.406-409

⁸⁴ International Monetary fund, Orderly and Effective Procedures, 1999 p. 6-7

different commercial bargain with the debtor prior to insolvency, the insolvency law should recognize the obligations created in accordance with the law. Hence the different classes of creditors should be treated differently while at the same time members of the same class of creditors should be treated in the same manner.⁸⁵

On the other hand insolvency law must address the problem of fraud and favouritism that arise during financial distress so as to up-hold the principle of equal treatment among members of the same class of creditors.⁸⁶ The second objective of equitable treatment of similarly situated creditors should be treated in the same manner because insolvency is a collective procedure of all creditors against all the assets of the debtor. Bankruptcy as a collective procedure of all creditors must enforce a stay on all creditors, at least temporarily, from the enforcement of legal remedies that would enable individuals to deprive the enterprise from its valuable assets. Equitable treatment of creditors also requires the avoidance or annulment of preferential or fraudulent transfers made by the debtors prior to the commencement of the proceedings. The main conflict of interest in insolvency proceedings is not between the debtor and the creditors themselves but also among creditors.

This conflict of interest among creditors in general and the various classes of creditors i.e. between the secured creditors and un-secured creditors in particular should be tackled. Among the un-secured creditors there is a conflict of interest between short-term creditors and long-term creditors. The principle of equitable treatment is based on the notion that bankruptcy as a collective proceeding, creditors with similar legal rights should be treated in the same manner. The equity principle uses

⁸⁵ Waxman, W. Ned gilbert Law Summaries, Bankruptcy, Law Distributors, Chicago, 1992 p.1

⁸⁶ International Monetary fund, Orderly and Effective Procedures, 1999 p. 7

mechanism such as stay, provisions to set aside preferential and fraudulent claims and recapture property of value, classification and voting procedures in rehabilitation and distribution mechanisms to achieve the goal of equitable treatment.⁸⁷ Bankruptcy laws apart from being predictable and equitable it should also make the system transparent. This principle enables interested participants to receive sufficient information to exercise their right under the law. The law also should provide adequate guidance for the participants to make decisions.⁸⁸

2.1.2. Maximization of Value

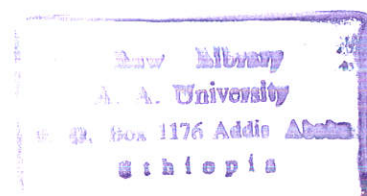
The second general objectives of insolvency law aims at protecting the estate of the debtor and maximize the value of the estate in the interest of all parties and the economy in general. The objective of value maximization could only be further upon the fulfilment of equitable risk allocation. However, the general objectives of insolvency law and its specific policies are not a unified and coherent whole. Therefore, there is a need to balance the various objectives with one another. In addition there is a need to determine as who should be the beneficiary of the value maximization of the debtor estate and determine whether the law should be based on a pro-debtor or pro-creditor bankruptcy law.⁸⁹

The second mechanism that is used to maximize the value of the assets of the estate is the appointment of an independent liquidator. The liquidator is not only a professional in the business but also a professional with the necessary skill in the management of enterprises in difficulties. A liquidator with broad powers and the necessary skill in business management enables the temporary continuation of the enterprise and

⁸⁷ World Bank, Principles and Guidelines for Effective Insolvency and Creditor Rights System, Apr.2001.p. 25

⁸⁸ International Monetary fund, Orderly and Effective Procedures, 1999 p.7

⁸⁹ IMF, 1999, P. 7-8 and World Bank, 2001, P.4



creates the necessary condition for the rehabilitation of the enterprise. Confidence in the integrity and professional efficiency of the liquidator creates an incentive for creditors to provide financing through priority for post petition financing of enterprises under proceedings.⁹⁰ The power of the liquidator not only to continue the enterprise with aim of maximization of the value of the estate but also with broad powers such as nullification of transactions and transfers that are fraudulent or preferential would interfere with the terms of the contract entered into by the debtor before the proceedings started. Hence there is a need to balance the goal of value maximization with that of the principle of predictability and the equitable and transparent risk allocation.

The Federal Democratic Republic of Ethiopia has based its economic policy on market economy and free competition. The government has opted to support enterprises that could strongly compete in a market economy. In order to foster free competition and a market economy the government has opted to forbid subsidise that distort free market and curtail competition.⁹¹ The policy decision to uphold market economy and free competition is also supported by legislations that promote free competition and curtail anti-free competition activities such as Proclamation No. 329/ 2003. The policy decision of the government and the Proclamation that support free competition needs an insolvency legislation based on competition and continuous structural change according to the life-cycles companies.

Such legislation should also be efficient and effective bankruptcy law so as to foster discipline and honesty in financial and legal management of enterprises. The bankruptcy system should also facilitate

⁹⁰ Wesseles Bob, Business and Bankruptcy Laws in the Netherlands, Kluwer law international, The Hague, 1999 p. 196-197

⁹¹ Federal Democratic Republic of Ethiopia Industrial Development Strategy, 2004 p. 189-194

the rehabilitation or the orderly market exit of enterprises that are inefficient and it should also protect the rights of third parties such as creditors and employees. A modern insolvency legislations that aim at a transparent domestic insolvency law that gives both local and foreign investors confidence in the rules that govern economic competition that stimulate investment, strengthen economic performance is a necessity for the success of a market economy based on free competition. Hence the paper investigates how much the general goals of risk allocation and protection of the value of the estate are incorporated in the existing bankruptcy law of Ethiopia and what should be done in this regard?⁹²

2.2. General Objectives and Ethiopian Bankruptcy Laws

The main objective of the existing bankruptcy law in Ethiopia to serve as a debt collecting device for creditors similar to that of the 1914 UK bankruptcy law. The insolvency proceedings, composition and schemes of arrangement are all directed at strengthening the hand of the creditor and increasing their chance of being paid, without providing relief for debtors.⁹³ The Ethiopian bankruptcy law by strengthening the chance of creditors to be paid left the debtor without any incentive from the bankruptcy system. Such a system is very weak to rehabilitate enterprises that are in difficulties and ensure an orderly market exit of enterprises, which are not viable. This limitation in terms of its objectives seems to reflect in its scope of application and the discipline it imposes on the subjects of bankruptcy and the economy in general.

⁹² Wesseles Bob, Business and Bankruptcy Laws in the Netherlands, Kluwer law international, The Hague, 1999 p.205

⁹³ Posner, Richard, Corporate Bankruptcy Economic and Legal Perspective Cambridge University Press, Cambridge, 1996 p.29

2.2.1. Scope of Application

The determination, which entities should be, the subject of general insolvency law is an important issue to be determined by each country's bankruptcy legislations.⁹⁴ Some countries apply the laws of insolvency only to traders while others extend the law to all debtors. The decision as to the scope of applicability of the insolvency law has an important implication for a country's economy. Since entities that are excluded from the scope of insolvency will neither be subject to the discipline imposed by an effective insolvency regime nor the debtors would benefit from the advantages offered by the bankruptcy regime to honest debtor.⁹⁵

The traditional goal of bankruptcy proceedings is realizing assets for the benefit of creditors. Hence most insolvency laws are applicable to traders and commercial entities. Where an insolvency law only applies to traders and commercial entities, other debtors facing financial difficulties remain out side the scope of the system. Even where a global scope is adopted like in the U.S. Bankruptcy Code, particular issues are raised whether certain entities such as banks and insurance companies, and consumers should be covered by bankruptcy proceedings?⁹⁶ The Commercial Code of Ethiopia in Article 968 determine the scope of application of the bankruptcy provisions:

- (1) The provisions of this Book shall apply to any trader within the meaning of Art. 5 of this Code and to any commercial business organisation within the meaning of Art. 10 of this Code with the exception of joint ventures.
- (2) Without prejudice to such provisions as are applicable to physical persons only or to the provisions of Title IV

⁹⁴ Winshiship Peter, Background Documents of the Ethiopian commercial Code of 1960, Artistic Printers, Addis Abeba 1974 p. 100

⁹⁵ International Monetary fund, Orderly and Effective Procedures, 1999 p. 16

⁹⁶ Vallens Jean - luc Comparative Insolvency Law, French Ministry of Foreign Affairs p. 2

applicable to business organisations only, the provisions of Titles I, II, III and V of this Book shall apply to traders and commercial business organisations.

A trader is defined by the Commercial Code of Ethiopia as a person who professionally and for gain carries any of the activities enumerated in Article 5 of Code. The article is enumerative and any activity under the article and similar activities are deemed to be acts of trade. The Code further lays that share companies and private limited companies are presumed to be of commercial nature and other business organizations except joint venture are deemed to be of commercial nature where their objective in the memorandum of association or in fact is an act of trade enumerated under Article 5 of the Code.⁹⁷ Joint ventures do not have legal personality under Ethiopian law hence are excluded from the definition of trader. This definition of the Code also excludes bodies corporate under public law such as the federal state and local government entities and administrative and religious institutions and any public undertaking from the scope of the Commercial Code and bankruptcy proceedings.⁹⁸ The only exception to the exclusion from the scope of the Commercial Code and bankruptcy are undertakings in which bodies corporate under public law are only participate in shareholding capacity.⁹⁹

The position of the Commercial Code is not clear in its risk allocation on whether public enterprises are covered under bankruptcy proceedings or not? Secondly though financial institutions such as banks and insurance are publicly regulated entities the Code seems to have allowed them to directly enter into the normal bankruptcy proceeding. Lastly the individual debtor and consumer's debtor are totally excluded

⁹⁷ Commercial code of Ethiopia, Nigarit Gazeta Extra-ordinary Issue No 3 of 1960, Addis Abeba, 1960

Art. 10

⁹⁸ Ibid. Art .4(1)

⁹⁹ Ibid. Art. 4(2)

from the scope of bankruptcy proceedings though the individual has become the beneficiary of the credit facilities of the modern world. Therefore the paper investigates on whether the Ethiopian Commercial Code has followed the proper risk allocation in some detail.

A) Commercial Entities

Traditional insolvency proceedings cover only traders. This is because merchants and companies debt should be paid in due time in order to carry on their business and keep their creditors confidence. The Ethiopian bankruptcy law in line with the traditional concept allows traders to be covered by bankruptcy proceedings. However modern bankruptcy laws have come to the distinction that the bankruptcy of individual debtor's and companies is not the same both in terms of size and impact on economic and social aspect. It is clear that corporate bankruptcies are of great significance than individual ones. Hence modern bankruptcy laws distinguish between bankruptcy proceedings applicable to corporation and individual debtors. In many jurisdictions individual debtors and small traders are legally treated as if they are consumers while corporate insolvency is treated separately.¹⁰⁰ Hence there is a need to have a distinct and separate corporate insolvency law or to have a distinct section for corporate insolvency in the bankruptcy laws of Ethiopia.

B) Banks and Insurance Companies

Financial institutions such as banks and insurance companies are creditors for other enterprises. Financial institutions are also depositories of the saving and other valuables of each society. Hence the bankruptcy of banks and insurance does affect the entire credit system, the monetary system and the economy in general. For this reason insolvency among

¹⁰⁰ Vallens Jean - Luc Comparative Insolvency Law, French Ministry of Foreign Affairs p. 2

such institutions is governed by special rules to ensure public control upon their activities.¹⁰¹

Financial institutions in Ethiopia are regulated sectors of the economy. The National Bank of Ethiopia conducts the licensing and supervision of banking and insurance business.¹⁰² Even if both proclamations allow the National Bank of Ethiopia to control and the proper functioning of banks and insurance to the extent of cancelling the licence of an insurance company.¹⁰³ In case of banks the National Bank has the power to temporary takeover the management where the licensed bank is in difficulty.¹⁰⁴ However the dissolution or winding up of banks is left to be conducted under the Commercial Code bankruptcy proceedings, the only restriction is that the power and function assigned to the liquidator and commissioner are to be exercised by the National Bank of Ethiopia.¹⁰⁵ However the liquidation of a bank does not only affects the savings and customers of the bank but also the economy in general. Hence there is a need to have a separate insolvency procedure to mitigate its effects.

The National Bank is also empowered to apply to the court for the dissolution of the insurance company. The court is allowed to apply the provisions of the Commercial Code like any other commercial business organization.¹⁰⁶ Making the liquidation of insurance like any other enterprise seems to have disregarded the special roll insurance is playing in the distribution of risk, serving as a general guarantor of the credit system in the society at large. Hence there is a need to provide for a special bankruptcy proceeding in respect of these institutions.

¹⁰¹ World Bank, Principles and Guidelines for Effective Insolvency and Creditor Rights System, Apr.2001.p. 28

¹⁰² Proc. No. 84/1994 Art.5 and Proc. 86/1994 Art.4

¹⁰³ Ibid.Art. 7 Proc. 86/1994

¹⁰⁴ Ibid. Art. 22 Proc.84/86

¹⁰⁵ Ibid. Art. 26 Proc. 84/86

¹⁰⁶ Ibid. Art. 39 Proc. 86/86

C) State Owned Enterprises

The state by definition is said to be not insolvent. The state where it is the owner of enterprises it is theoretically assumed to guarantee its debts and support the capital of companies and enterprises in financial difficulties.¹⁰⁷ The decline of socialism and the liberalization of the economics of many countries led to the modification of old laws that govern state owned enterprises to give legal certainty to investors and new shareholders.¹⁰⁸ State owned enterprises in Ethiopia are either the result of the decision of the state to establish an enterprise by a regulations issued by the Council of Ministers or the nationalization that were undertaken in the 1970's socialism. At present these enterprises are administered by a government agency empowered to administer and privatise public owned enterprises in accordance with Proc. No. 25/1992. The establishing regulation determines the purpose and capital of the enterprise. Almost all enterprises are established for an indefinite period with the capital subscribed by the government and in exceptional circumstances with some other shareholders.

The status of public enterprises under the Commercial Code is not settled, some are registered as traders hence are subject to the Code even those not registered could fall under the definition of Code because they carry out activities enumerated by Article 5 of the Code. The issue of bankruptcy of public enterprise is far more unsettled. If one starts from the premise that the state is the owner of these enterprises hence a guarantor of their debt, then the enterprises should not be allowed to petition bankruptcy. On the other hand if one starts from the premise that public enterprises are trades then they should be allowed to benefit from the

¹⁰⁷ International Monetary fund, Orderly and Effective Procedures, 1999 p.17

¹⁰⁸ Vallens Jean - Luc Comparative Insolvency Law, French Ministry of Foreign Affairs p. 3

bankruptcy system. The practice until now is not also settled, in most instances the government underwrites the liability of public owned enterprises while at other times insolvency proceedings are initiated against them and adjudicated bankrupt.¹⁰⁹

Among the new market oriented countries there is no uniformity in the solution adapted to public enterprises. Some of the countries provide specific rules applicable to big companies acting under public control such as financial companies, co-operatives, joint-stock companies under state participation, while others allow the normal bankruptcy to be applied. The World Bank is of the opinion that insolvency proceedings should apply to all enterprises or corporate entities except financial institutions and insurance companies.¹¹⁰ UNICITRAL also suggests that state owned enterprises should not be excluded from the scope of insolvency law in order to create a level plain field for market forces and attain full competition and economic efficiency.¹¹¹ The inclusion of public enterprises in bankruptcy proceeding creates a level plain field in the economy. An investigation as to the condition of public enterprises in Ethiopia shows that they are not in good shape. Among more than 140 public enterprises not more than 40 are profitable.¹¹² Hence imposing the bankruptcy regime at this time would be an economic and social disaster; therefore it would be advisable to have a separate bankruptcy regime under the supervision of the court. However one could argue that allowing free competition and an orderly exit of inefficient enterprise should be enforced which would be of great advantage to the economy and the country in the long run. Even if this latter argument is correct and should be adopted in the light of the

¹⁰⁹ Report of the Public Enterprise Authority, 2004

¹¹⁰ World Bank, Principles and Guidelines for Effective Insolvency and Creditor Rights System, the Apr.2001.p. 28

¹¹¹ Vallens Jean - Luc Comparative Insolvency Law, French Ministry of Foreign Affairs p. 4

¹¹² Report of Public Enterprise Authority, 2004

economic policy of the country, in the opinion of this paper it should not be implemented at the present to avoid economic and social consequences of such a policy.

D) Consumers

The last quarter of the 20th century has seen a growth in credit facilities not only to enterprises but also to individual consumers. The increase in the availability of credit facility led to an increase in the number of individual and family insolvency. Hence there is the need to solve the financial difficulties of the individual by taking the specific situation of these debtors. The individual and at times the family possess few assets and could be with no economic activity and even without a regular income. The traditional insolvency law in such a situation is not only suitable but also has negative impact towards the individual and the family; hence a new treatment is granted in modern bankruptcy laws to the individual consumer who becomes insolvent. The Commercial Code of Ethiopia does not provide for individual who is not a trader to enter into bankruptcy proceedings.

Bankruptcy legislations such as the US and Germany use different mechanisms to address the problem of consumer insolvency. One mechanism adopted by the US Bankruptcy Act is to allow the debtor to have an opportunity to pay his debt in instalments from future income, under the supervision and the protection of the court.¹¹³ Germany empowered the courts to regulate consumer insolvency.¹¹⁴ The issue of consumer insolvency is not yet a serious issue in Ethiopia, however with the expansion of small credit facilities it would be an issue that should be

¹¹³ Barnes A. James, Law of Business, Irwin McGraw. Hill, Boston, 2000 p. 840

¹¹⁴ Vallens Jean - luc Comparative Insolvency Law, French Ministry of Foreign Affairs p. 3

addressed in the near future. Hence the modernization of the Ethiopian bankruptcy law should resolve the insolvency of consumers.

2.2.2. Maximization of the Value of the Estate

Maximization of the value of the estate has become one of the main goals of modern bankruptcy legislations. Maximization of the value of the estate starts from the interim measures taken to protect the assets of the debtor. The interim measures should start from the time the debtor or creditors petitioned the court to open liquidation proceedings.¹¹⁵ The granting of proceedings increases the risk to the debtor's asset of being dissipated before the estate has been created. The first party to fall to the temptation of transferring some of the assets of the enterprise out of the business is the debtor himself. Creditors may also be tempted to grab some of the assets or improve their position in the hierarchy of creditors. Therefore an insolvency law should consider providing for the imposition of interim measures to preserve the estate before the opening of insolvency proceeding. The interim measures should be imposed by the court either at its discretion or the request of one of the parties. Among the interim protective measures that could be taken includes, prohibiting the debtor from disposing of assets, sequestration of some or all of the debtor's asset, suspending the enforcement of security interest against the debtor, suspension of transactions concluded during this period etc.¹¹⁶ Hence the second issue in the administration of the debtor's estate is what measures should be taken to protect the assets from the actions of the debtor, creditors and the liquidator himself?

¹¹⁵ Hockly Harold, *The Law of insolvency in south Africa*, Juta and Co Ltd, cape Town, 1980 p. 129-130

¹¹⁶ International Monetary fund, *Orderly and Effective Procedures*, 1999 p. 22

A) Protection Against the Debtor

The opening of the liquidation proceedings requires the imposition of a comprehensive measure to protect the estate from the debtor. The first protective measure is taken by removing the debtor from the right to manage and operate the business and entrust these powers to that of the liquidator.¹¹⁷ Debtor's facing bankruptcy may be inclined to strip assets or remove books and records in the effort to conceal inappropriate transitions. Hence, the liquidator should control books and records to understand the business, to identify the creditors and the contractual relationship and continue the business to protect the estate.¹¹⁸ The liquidator may resort to affirmative action to recover property that was improperly transferred at the time of insolvency. The justification for recovering such assets is to protect creditors and to up-hold the principle of maximization of the estate. Apart from the recovery of assets most insolvency laws provide a means to set aside prior transactions, which are fraudulent, or the result of preferential treatment.

The Ethiopian bankruptcy law provide that the court upon hearing that the preliminary investigation, confirming the debtor has actually become insolvent and is unable to pay its debt as they become due, determines the date of suspension of payment. The date for suspension of payments is determined in accordance with Article 977 and 978 of the Commercial Code, which is determined:

Art. 977. Determination of the date of suspension of payments.

- (1) At the first hearing or, where appropriate, on receiving the report under Art. 976, the court shall:
 - (a) fix the date of suspension of payments; and

¹¹⁷ International Monetary fund, *Orderly and Effective Procedures*, 1999 p. 26

¹¹⁸ World Bank, *Principles and Guidelines for Effective Insolvency and Creditor Rights System*, the World Bank Apr.2001.p. 35

- (b) subject to the provisions relating to schemes of arrangement, declare the debtor bankrupt.
- (2) Where the date of suspension of payments is not fixed, such date, subject to the provisions of Art. 978 shall be deemed to be that of the judgment declaring the debtor bankrupt

The date of suspension of payment is determined where the court determines the date at which the debtor became insolvent. The date of suspension of payment can be extended by court judgement however it can be extended beyond the balance sheet or the date of a claim proved by a court of law in accordance with Art. 1046 of the Commercial Code. The earlier period that date of suspension of payment is extended cannot go beyond two years before the judgment.¹¹⁹ A judgment in bankruptcy shall appoint a commissioner in bankruptcy and one or more trustees. Administering the estate would be the duty of these officials. Hence a bankrupt shall not administer or dispose of his property, however acquired, from the day he is declared bankrupt until he is discharged.¹²⁰ The protection provided by the court are enough to ensure the protection of the estate upon the debtor being declared bankrupt. However the law is silent on the protection of the debtor's estate during the period of application for bankruptcy and the adjudication of bankruptcy by the court except applying the general stay Art.377 of the Civil Procedure Code. Hence unless the court or one of the parties petition the court for protection during this period the goal of maximization of the assets would be jeopardized. Hence there is a legal vacuum under Ethiopian bankruptcy law, which the modernization should provide provisions that could extend the suspension

¹¹⁹ Commercial code of Ethiopia, Nigarit Gazeta Extra-ordinary Issue No 3 of 1960, Addis Abeba, 1960 Art 987

¹²⁰ Commercial code of Ethiopia, Nigarit Gazeta Extra-ordinary Issue No 3 of 1960, Addis Abeba, 1960 Art 1023

of payment and other protective measures during the interim period. Such measures would protect the assets and other documents from being stripped by the debtor during the suspect period.

B) Protection Against Creditors

Liquidation is a procedure to maximize the assets of the debtor in the interest of creditors. However, insolvency is a collective procedure and could not be compatible with the interest of the individual creditor. Therefore there is a need to reconcile the interest of the collective and the individual creditor. This requires to suspend the action of individual creditor from seizing the assets of the debtor and to avoid forced "*fire sale*". In almost all jurisdictions "stay" is enforced against un-secured creditors. However, the scopes of stay vary from country to country with regard secured creditors. Most jurisdictions apply stay to secured creditors for a limited period. Extending stay to secured creditors give rise to a number of difficulties including the decline in the value of their security. The other problem with regard to creditors arises where creditors with special right of set-off and other privileges such as assignment enforce their legal or contractual rights. Insolvency laws, in many modern jurisdictions give the liquidator the power to interfere with such rights with the goal of maximizing the asset by selling the estate as a going on concern.¹²¹

Upon the debtor being adjudicated bankrupt and the commissioner and the trustee are appointed by the court, all action are instituted not upon the debtor but upon the trustee. One of the consequences of adjudication of bankruptcy is that as from the day of the judgment in bankruptcy, all creditors whose claims are not secured by a special privilege, a pledge or a mortgage, shall bring their claims together in the universality of creditors in

¹²¹ International Monetary fund, Orderly and Effective Procedures, 1999 p. 23

bankruptcy.¹²² Hence the trustee of the estate acquires the universality as a legal entity and could acquire rights or incur liabilities on behalf of the estate. Therefore the judgement in bankruptcy results in:

Art. 1026. Suspension of individual suits.

The judgment in bankruptcy shall prevent any creditor whose claim is included in the universality from bringing an individual suit. As from the day of the judgment, such creditor may not attach the debtor's property, whether movable or immovable.

Since the adjudication of bankruptcy makes all debts due there is no need to lodge a claim to a debt that is in the balance sheet or has been proved and accepted by the trustee or has acquired a court decision. However, stay under Ethiopian bankruptcy law is limited to unsecured creditors. Secured creditors on the other hand are not covered since the order of stay in Article 1025 does not cover creditors whose claims are secured by a special privilege, a pledge or a mortgage. Hence these secured creditors have a direct claim to the security provided by the debtor unless they renounce their right and become part of the collective body of creditors. Where the trustee find such secured property necessary for the estate he must redeem the property upon payment of the amount of the secured claim. In case where the trustee fails to redeem the asset the security holder has the right to sell the asset and collect the amount of his secured claim.¹²³ Interest on debts, with the exception of debts guaranteed by security in rem, shall cease to run against the bankrupt estate as from the day of the judgment. Only sums arising from property given as security may be used to pay interest on secured debts. Ethiopian bankruptcy law by allowing the

¹²² Commercial code of Ethiopia, Nigarit Gazeta Extra-ordinary Issue No 3 of 1960, Addis Abeba, 1960 Art 1025

¹²³ Commercial code of Ethiopia, Nigarit Gazeta Extra-ordinary Issue No 3 of 1960, Addis Abeba, 1960 Art 1058

realization of security claim without any stay upholds pre-bankruptcy contractual bargains, hence upholding the principle of predictability. However such a position has an adverse effect on the maximization of the value of the debtor estate. This position of the law is particularly prejudicial in case of reorganization proceedings. Therefore there is a need to provide at least for temporary stay upon providing adequate protection to secured creditors.

C) Protection Against the Liquidator

The liquidator is the trustee of the debtor's asset. He stands in a fiduciary capacity vis-à-vis the creditors in administering the estate. He has also the duty to liquidate the estate and distribute it in accordance with the law. The liquidator normally works under the supervision of the creditors committee and the approval of the court. However, where the liquidators mismanage the estate, fails to properly discharge his duties or engage in fraudulent activity he should be made liable. Almost all insolvency legislations provide laws that entail civil and criminal liability in such situations. The Ethiopian bankruptcy law provides for civil and criminal liability for any mismanagement or fraudulent activity. However this is not sufficient to create the necessary confidence on creditors, hence there is a need for the modernization to provide provisions that would require the liquidator and other officials to give good performance guarantees.

2.2.3. Stay and Claims of Secured Creditors

The principle of predictability requires bankruptcy law to recognize the priority of secured creditors in their collateral.¹²⁴ Security is acquired by the creditor, for value, in the bi-lateral exchange agreement with the debtor. The creditor needs the security to ensure the return of the extended credit.

¹²⁴ Barnes A. James, Law of Business, Irwin McGraw. Hill, Boston, 2000 p. 830

If security is to achieve its objective the creditor should be allowed to foreclose upon its collateral. However permitting secured creditors to freely separate their collateral from the other assets in the estate can frustrate the basic objective of insolvency proceeding.¹²⁵ Hence the issue to what extent secured creditors should be allowed to assert their priority and enforce their security should be dealt with.¹²⁶ The exclusion of general stay on creditors actions may frustrate liquidator's ability to maximize the value of the estate prior to distribution. In particular, if important assets serve as collateral, the liquidator will be un-able to maximize the value of the estate as a going on concern.

Where the debtor's assets cannot be sold as a going concern, a temporary stay will give the liquidator time to arrange a sale that will give the highest return for the benefit of all secured creditors. Allowing stay on the collateral provided to the creditor will result in the decline of the value of the security interest. Such erosion will ultimately undermine the availability affordable credit. Hence in order to offset the decline in security interest there is a need to increase the price of the credit.¹²⁷ The international practice in this regard is not uniform; there are two basic trends with regard to the granting of secured rights and the treatment of such rights in insolvency proceedings.¹²⁸

The first option is to make bankruptcy with no effect on secured creditors. This group of countries have the universal fixed and floating charges or universal corporate security, which allows the creditor to have a universal security over all of the debtor's assets including future assets.

¹²⁵ International Monetary fund, Orderly and Effective Procedures, 1999 p. 25

¹²⁶ World Bank, Principles and Guidelines for Effective Insolvency and Creditor Rights System, Apr.2001.p. 41

¹²⁷ International Monetary fund, Orderly and Effective Procedures, 1999 p. 24

¹²⁸ World Bank, Principles and Guidelines for Effective Insolvency and Creditor Rights System, Apr.2001.p. 41

Laws that allow universal security allows the secured creditor to sell the collateral without court intervention and permits secured creditor to privately appoint a possessor manager or receiver to run the business without selling. Creditors in countries with universal corporate security do not enjoy the power to appoint a possessor manager or receiver outside the court.¹²⁹ Universal fixed floating charge or universal corporate security would make debtors to be more financially responsible at least with respect to secured creditors. This approach also promotes the highest assurance to lenders and the market that their interest is protected to the maximum extent possible. However the system fails to protect the un-secured creditor without any say or control on the assets attached on the basis of universal fixed floating charge.¹³⁰

The second option is where secured creditors are stayed from the enforcement of their rights in insolvency proceedings through mechanisms such as compulsory grace periods, in some cases freezes on enforcement in the event of re-organization.¹³¹ These mechanisms are commonly referred as stay or temporary stay, which is commonly provided upon providing adequate protection to secured creditors. To balance the interest of secured creditors with those of un-secured creditors in a liquidation proceeding the first mechanism that seems reasonable is to apply stay on secured creditors for a period of not more than 30 or 60 days to give the liquidator the opportunity to assume its duties and take possession of the assets and liabilities of the estate. Courts could be given the power of ordering the stay on the ground that such an extension provides a necessary means of maximizing the value of the estate such as the sale of the whole enterprise

¹²⁹ World Bank, Principles and Guidelines for Effective Insolvency and Creditor Rights System, Apr.2001.p. 41

¹³⁰ Ibid. P. 42

¹³¹ Ibid. P. 42

or part of the enterprise as a going on concern would maximize the estate in the interest of all.¹³² Ethiopian bankruptcy law by allowing the realization of a claim on a collateral without any stay upholds pre-bankruptcy contractual bargains, hence upholding the principle of predictability. However such a position has an adverse effect on the maximization of the value of the debtor estate. This position of the law is particularly prejudicial in case of reorganization proceedings and where disposing of the asset as a going on concern is more beneficial to all secured creditors. Therefore this paper is of the opinion that modernization of Ethiopian bankruptcy law should allow stay on the claims of secured creditors at least temporary with adequate protection to the interest of creditors.¹³³

2.2.4. Protecting the Value of the Collateral

The Second mechanisms that could be used to protect the interest of secured creditors are mechanisms to maintain the economic value the collateral. The various mechanisms that could be utilized to achieve the goal of protecting either the value of the secured claim or the value of the assets claimed. Protecting the economic value of the collateral itself could protect the value of the secured claim. Where the value of collateral is protected the proceeds of the sale of the collateral could be distributed directly to the creditor to the extent of the amount provided as a guarantee for a debt. The different mechanisms that could be employed to achieve such a goal include:

A) Compensation for Depreciation

The value of the creditor's collateral could depreciate during the period of the stay. However, the extent to which the collateral encumbered is limited to the value of the security to which it is attached. To offset the

¹³² International Monetary fund, *Orderly and Effective Procedures*, 1999 p. 25

¹³³ Weil H. Peter, *Asset Based Lending, A Practical Guide to Secured Financing* Practising Law Institute, New York 1992 p.677

prejudice caused by depreciation the liquidator should be required to compensate the secured creditor for the amount of depreciation. This could be achieved either by providing substitute collateral or by making periodic cash payments that correspond to the amount of depreciation.¹³⁴

B) Payment of Interest

The payment of interest, during the period of the stay could also be employed as a mechanism to protect the security interest of the creditor. However, the interest should be limited to the extent the value of the collateral that exceeds the value of the secured claim. Permitting interest payment only in these circumstances, the law could provide a strong incentive to encourage creditors to seek collateral that exceeds the value of their claim.¹³⁵

C) Protection and Compensation for Use

The liquidator may find it necessary to use an encumbered asset to increase the value of the estate as a going on concern or to sell the encumbered asset as part of the enterprise. This happens because the value of estate could be maximized by the continued operation of the business rather than closing it and dismantling the assets or selling them by price meal. However to protect the interest of secured creditors during the continued temporary use the encumbered asset or where the encumbered asset is sold as a going on concern it seems appropriate for the law to give the liquidator the choice of providing the creditor with a substitute equivalent to the collateral or to pay the full amount of the secured claim.¹³⁶

In all the above three situations the stay on secured creditors should be in place only during the liquidation proceedings. Even where the stay is

¹³⁴ International Monetary fund, *Orderly and Effective Procedures*, 1999 p. 25

¹³⁵ Ibid.

¹³⁶ Ibid.

restricted to the period of liquidation, the stay should only be allowed to exist for a brief period and the stay should be lifted where the security does not receive adequate protection. Stay is said to lack adequate protection, where adequate protection is not feasible or would be overly burdensome on the estate resulting in depleting the debtor's estate rather than maximizing its value or the stay becomes meaningless.

2.2.5. Treatment of Pending Contracts

During the Commencement of the liquidation proceeding, the debtor will be a party to certain on going and un-performed contracts. Almost all modern insolvency laws provide for the liquidator to interfere with the terms of the contract with the broad objectives such as value maximization to achieve broad social, economic and political interests. However, the right of the liquidator to interfere with the terms of the un-performed contracts would undermine the predictability of contract performance. Hence such a power needs to balance the economic, social and political interests on the one hand with that of predictability in commercial and financial transactions. However the power to interfere is not without limit. The power to terminate contracts is mostly limited to contracts that are fraudulent, preferential or which are not fully performed.¹³⁷

A) Preferential Payments

One of the major purposes of the bankruptcy law is to assure equal treatment of all the creditors. The law should also prevent an insolvent debtor from distributing his assets to a few favored creditors to the detriment of the other creditors. The trustee has the right to recover preferential payments made by the bankrupt person.¹³⁸

¹³⁷ Barnes A. James, Law of Business, Irwin McGraw. Hill, Boston, 2000 p. 828

¹³⁸ Ibid.

B) Preferential Lines

A creditor might try to obtain an advantage over other creditors by obtaining a lien on the debtor's property to secure the payment of his debt. The creditor might seek to get the debtors consent to a lien or to obtaining the lien by legal process. A preferential lien is invalid if it was obtained within two years of the suspension of payment.¹³⁹ The preference enables the creditor to receive a greater percentage of his claim against a debtor than he would have received in liquidation.

C) Fraudulent Transfers

Where the debtor transfers property or incurs an obligation with the intent to hinder, delay or defraud creditors, the transfer should be voidable by the trustee.¹⁴⁰ The law should also empower the liquidator to determine whether to terminate or continue contracts within specific period following the initiation of liquidation proceedings. The exception to the power of the liquidator could be made to specific contracts such as financial contracts, contracts of employment, lease agreement.¹⁴¹

The Ethiopian bankruptcy law provides provisions to avoid fraudulent and preferential contracts Art. 1029 Commercial Code. The Commercial Code bankruptcy Provisions, with regard to contracts not fully performed, allow the trustee to cancel or continue the lease agreements entered by the debtor. The decision of the trustee should be known within fifteen days from the deposit of the inventory¹⁴². As to other contracts entered by the debtor especially with regard to preferential agreements the law is silent. Hence the law in this regard is very un-clear and inadequate hence the provisions should be updated and systematized.

¹³⁹ Ibid.

¹⁴⁰ Ibid. p. 829

¹⁴¹ International Monetary fund, Orderly and Effective Procedures, 1999 p.31

¹⁴² Commercial code of Ethiopia, Nigarit Gazeta Extra-ordinary Issue No 3 of 1960, Addis Abeba, 1960 Art 1040 (2)

2.3. Effects of the Shortcomings of the Law

The Ethiopian bankruptcy law is still based on the traditional debt collection goal of bankruptcy. This traditional goal of bankruptcy does not meet the modern objective of preservation of potentially viable enterprise, with the goal to maximize the value of the enterprise in the interest of all stakeholders. The laws are also defective in the proper allocation of risk among the participants, by allowing creditors and credit grantors such as banks and insurance to enter into the normal bankruptcy system while on the other hand being ambiguous both in theory in practice with regard to public enterprises. The law has also excluded the individual debtor totally from insolvency unless he is a trader. Hence there is a need to reformulate the law so as to cover all stakeholders so as investors and creditors could fully assess the risk and make the necessary financial adjustments.

The objective of maximization of the value of the enterprise is also dependent on the preservation of the value of the estate, though the existing law provides for conservatory measures there are no proper provisions to extend this protection to make an early application of the conservatory measure beginning the start of the bankruptcy petition. The application of stay as provided under Ethiopian bankruptcy law only covers unsecured creditors, however such an application of stay would frustrate the objective of maximization of the estate and allows for an early dismantling of the enterprise. The total exclusion of secured creditors from the application of stay would particularly defeat any attempt to reorganize a potentially viable enterprise. Therefore the modernization should extend stay at least temporarily and provide adequate protection to protect security interest. The power of the trustee and the court to terminate contracts that are fraudulent, preferential should be broad enough to meet the objective of value maximization. Therefore there is a need to modernize the objectives

of the bankruptcy provisions so as to meet the requirements of a modern market economy with the goal of preserving potentially viable enterprises while at the same time allowing the proper exit of inefficient enterprises.

C H A P T E R T H R E E

L I Q U I D A T I O N P R O C E E D I N G S

3.1. General

The bankruptcy provisions of the Commercial Code of Ethiopia are based on the conception that insolvency is both a collective and universal mode of execution. It is said to be collective in the sense that it puts secured and un-secured creditors more or less in equal footing. It is said to be universal because it applies to the total estate of the bankrupt person. Even if bankruptcy proceedings applies to the total estate of the bankrupt person the assumption that it is collective in the sense that it applies to secured and un-secured creditors is not fully true. Stay under Ethiopian law does not apply to secured creditors; hence secured creditors could take their security at any time after the declaration of bankruptcy by the court.¹⁴³

Apart from the problem of the conception of collectivism, the provisions of bankruptcy law are drafted with the objective either to save the enterprise through composition with creditors or to liquidate it and distribute the proceeds to the creditors.¹⁴⁴ Traditionally insolvency proceedings aim at liquidating the debtor's asset and granting payment to the unpaid creditors. This aim of liquidation dates back to Roman times and is still available in all current insolvency laws. However, modern insolvency laws are assigned with new insolvency objectives in order to meet the new economic and social aspect of insolvency.¹⁴⁵ World Bank Principles and guidelines for effective insolvency system recommend the following key objectives and policies for insolvency laws:

¹⁴³ Commercial code of Ethiopia, Nigarit Gazeta Extra-ordinary Issue No 3 of 1960, Addis Abeba, 1960 Art.

¹⁴⁴ Winshiship Peter, Background Document of the Ethiopian commercial Code of 1960, Artistic Printers, Addis Abeba 1974

¹⁴⁵ Vallens Jean - Iuc Comparative Insolvency Law, French Ministry of Foreign Affairs p.6

- Integrate with a country's broader legal and commercial systems;
- Maximize the value of a firm's asset, including by providing an option to re-organize;
- Strike a careful balance between liquidation and re-organization;
- Provide for equitable treatment of similarly situated creditors, including similarly situated foreign and domestic creditors;
- Prevent the premature dismemberment of a debtor's assets by individual creditors seeking quick judgments;
- Provide for timely, efficient and important resolution or insolvencies;
- Provide a transparent procedure that contain incentives for gathering and dispensing information;
- Recognize existing creditor rights and respect the priority of claims with a predictable and established process;
- Establish a framework for cross border insolvencies, with recognition of foreign proceedings.¹⁴⁶

bankruptcy proceeding
(1) liquidation proceeding
(2) insolvency proceeding

Liquidation procedure is opted where there is no possibility for the rehabilitation of a business. The availability of liquidation proceeding should not dismantle viable and potentially viable enterprises. Therefore the law should balance between liquidation and rehabilitation proceedings.

Insolvency proceeding is a second or alternative component of the general bankruptcy proceedings, which should also prevent the premature dismemberment of a debtor's asset by individual creditors.¹⁴⁷ However, insolvency proceedings still should be considered to be the core proceeding upon which rehabilitation proceedings are constructed.

liquidation procedure is opted where there is no possibility for the rehabilitation of business.

¹⁴⁶ World Bank, Principles and Guidelines for Effective Insolvency and Creditor Rights System, Apr. 2001. P.24

¹⁴⁷ Novikoff Harold, Chapter 11 Business Reorganizations Practising Law Institute, 1991 p.143

Some countries such as Germany use a unitary approach to determine whether the enterprise should enter rehabilitation or liquidation procedure. Others countries such as the US has adopted a two truck approach, however the law should be equipped with provisions to determine the appropriate proceedings to be followed. It should also provide the procedure to convert from one proceeding to the other depending on whether a successful rehabilitation is possible or not.¹⁴⁸ The existing Ethiopian insolvency proceeding allows a trader who suspends payment of his commercial debt to apply to either insolvency or scheme of arrangement.¹⁴⁹ Where a debtor's scheme of arrangement is not approved the court shall adjudicate the debtor bankrupt and is converted back to insolvency proceeding. Hence Ethiopia could build on the existing system and build a unitary approach on the German or French model of bankruptcy proceedings.¹⁵⁰

Where insolvency proceeding is opted as a last option the insolvency laws should provide for a speedy, efficient and transparent proceeding to resolve problems of insolvency by protecting the debtor's estate, protect the right of secured creditors, maximize the value of the estate, liquidate the assets and distribute the proceeds in accordance with established priorities. Hence the most important objectives of an orderly and effective liquidation procedure as identified by the International Monetary Fund are maximizing the assets of the estate, equitable treatment of similarly situated creditors, and facilitate the making of investment decisions.¹⁵¹ The facilitation of investment and risk assessment also takes into account on whether there is a clear criterion for the distribution of liquidated asset of

¹⁴⁸ International Monetary fund, Orderly and Effective Procedures, 1999 p.14

¹⁴⁹ Commercial code of Ethiopia, Nigarit Gazeta Extra-ordinary Issue No 3 of 1960, Addis Abeba, 1960 Art. 972

¹⁵⁰ Ibid. Art.1142&977

¹⁵¹ International Monetary fund, Orderly and Effective Procedures, 1999 p.16

the debtor. The liquidation procedure should recognize the seniority established by the contractual terms. Creditors will feel confident when they are able to manage, the risk they incur while making investment decisions. Hence this chapter investigates whether the insolvency provisions of the Commercial Code of Ethiopia are adequate for an effective, efficient and transparent insolvency proceedings. The first issue to be addressed in this regard would be, the existing insolvency commencement criteria.

3.2. Commencement Requirements

Insolvency laws are designed to deal with business failures in a normal economic environment. Insolvency literally means that the debtor's assets are not sufficient to cover all his liabilities.¹⁵² However the general meaning of the word in many jurisdictions is nearer to the French concept i.e. *the inability of the debtor to meet his receivable debts from his available assets*.¹⁵³ The German law has modified this traditional conception of insolvency by introducing the new criteria of "*imminent insolvency*" which offers a manager of a company about to become insolvent with the possibility to file application for bankruptcy. Such a possibility would enable to make an early detection of financial difficulties hence opening a successful reorganization preceding.

On the other hand the U.S. insolvency law does not set specific criteria for opening bankruptcy proceeding by the debtor. The debtor has only to file an application upon which he/it would be granted the protection of the American bankruptcy law. The court has the duty to investigate the financial situation of the entity, while the debtor enjoys the automatic stay

¹⁵² Vallens Jean - Luc, Comparative Insolvency Law, French Ministry of Foreign Affairs p.5

¹⁵³ Ibid

provided by U.S. Bankruptcy Code.¹⁵⁴ Stay freezes all creditors from taking advantages over other creditors. In the case between Jennings Enterprise Inc. v Carte (GaApp) 481,SE2d 541 1997 the facts of the case were Charles Carte obtained a judgment against Sultan. Mr. Carte's lawyer levied judgment against two Mercedes vehicles owned by Shabazz Jennings Enterprise Inc. A towing and storage yard JEI took possession of the two cars in March 1992. Carte's lawyer informed JEI to take caution since it was responsible for the case until the sheriff's sale could be held. After Mr. Smith took the cars Mr. Shabazz has declared bankruptcy. Up on the entry of the stay Mr. Smith postponed the sheriff's sales of the vehicles but he did not contact JEI. In December 1992, Rebbie Jennings sold the vehicles to Elizabeth Ramey for the amount of JEI lien on the car i.e. storage fees. In April 1994 Mr. Smith asked for the return of the vehicle against JEI, however Robert Jennings claimed that he has a line on the vehicle which has priority, hence free to sell the car to satisfy lien.

The court held that the sale of the vehicle for JEI's storage fee lien violated bankruptcy stay of relief. JEI could not circumvent the bankruptcy declaration by conducting a sale to satisfy its lien. Since all efforts of all creditors must stop when a debtor declares bankruptcy, therefore Mr. Carte is entitled the fair market value from EJI.¹⁵⁵ This decision of the court shows that stay is the corner stone of bankruptcy proceedings, which has priority even on the right of lien to which the holder has priority even to that of the owner. However it is important to note the US Bankruptcy Act has raised the importance of stay one step higher by making "stay" to have an automatic status.

¹⁵⁴ Waxman W. Ned, Gilbert Law Summaries, Bankruptcy, Law Distributors, Chicago, 1992 p.26-31
¹⁵⁵ Anderson A. Ronald, Business Law, South-Western Publishing Co Ohio, 1968 p.693

Among the different criteria used to determine the issue what should be the yardstick to allow the commencement of insolvency? The one criterion, which is common to all modern bankruptcy legislations is that, the law should encourage a financially distressed or insolvent corporation to voluntarily submit to the process. Hence access to the law should be made convenient, inexpensive and quick. Delay can cause a financially distressed entity to become insolvent while an insolvent enterprise being left un-controlled would likely dissipate or waste its assets.¹⁵⁶ However a good bankruptcy law, should not only enable debtors and creditors to commence the proceedings but also should deter potential abuse by creditors who may turn a dispute a little more than a two party into collective ones. Hence when a creditor files a petition to commence a liquidation proceedings it should be required to demonstrate that *the debtor has generally ceased to make payment of his debts as it becomes due.*¹⁵⁷

The Ethiopian Commercial Code Article 970 (1) states that bankruptcy does not result from mere suspension of payment. The two cumulative conditions for the existence of bankruptcy are suspension of payment and adjudication of being bankrupt by the court. However the court has the power to adjudicate the debtor in connection with an offence connected with bankruptcy even where the debtor has not suspended payment.¹⁵⁸ Where suspension of payment is the basis for the application of bankruptcy the suspension should be proved in accordance with Article 971 of the Commercial Code:

¹⁵⁶ World Bank, Principles and Guidelines for Effective Insolvency and Creditor Rights System, Apr. 2001, p. 29

¹⁵⁷ International Monetary fund, Orderly and Effective Procedures, 1999 p. 19

¹⁵⁸ Commercial code of Ethiopia, Nigarit Gazeta Extra-ordinary Issue No 3 of 1960, Addis Abeba, 1960 Art. 970



Suspension of payments shall result from any fact, act or document showing that the debtor is no longer able to meet the commitments related to his commercial activities.

The first criteria for initiation of bankruptcy proceeding, is the existence of suspension of payment. The suspension should be proved either as a fact, an act or by producing document showing the debtor is unable to meet its financial commitments. Secondly the inability to meet its financial commitments must be the result of the commercial activity and not a personal or other liability. However, inability to meet financial obligation can be the result of personal debt or personal liability. Hence the distinction between personal liability and trade liability creates difficulty in proving bankruptcy where the trader is an individual or partnerships. The other difficulty arise from the principle that suspension of payment does not amount to bankruptcy is the requirement that suspension should be the result of commercial transactions of the trader.

However in order to prove the link between suspension of payment and commercial transaction documents such as balance sheet, profit and loss statement, a list of commercial credits and debts with the names and addresses could be presented. This leads us to the problem what facts or acts amount to bankruptcy. A large number of acts and defaults on the part of the debtor have been defined as an act of insolvency in a number of early 20th century insolvency laws. The 1914 UK Bankruptcy Act enumerates the following nine facts and acts as an act of bankruptcy. The first one is where the debtor makes a conveyance or assignment of his property to a trustee for the benefit of his creditors generally, hence admitting bankruptcy.¹⁵⁹ The second one is where the debtor makes a

¹⁵⁹ Montgomerie John, Steven's Elements of Mercantile Law, Butter worth and Co. Ltd, London 1950 p. 542

fraudulent conveyance, gift, delivery or transfer of his property or any part thereof.¹⁶⁰ Thirdly where the debtor makes any conveyance or transfer of his property or any part thereof or creates any claim, which should be void or fraudulent preference.¹⁶¹ Fourthly the debtor with intent to defeat or delay his creditors departs out of the country or being in the country is absent from his dwelling- house without paying his creditors or notifying the change of address.¹⁶² Fifthly where judicial execution against the debtor has been pronounced by seizure of his goods in any civil proceeding. The sixth act is where a debtor files to the court a declaration of his inability to pay his debt or present a bankruptcy petition against himself.¹⁶³ The seventh act is where the debtor is required by judgment to pay and in accordance with the terms of judgment felled to satisfy the court and to discharge the debt.¹⁶⁴ The eighth act is where the debtor gives notice to any of his creditor that he has suspended or is about to suspended payment of his debts.¹⁶⁵ Similar acts and facts are described under the South African Insolvency Act of 24 of 1936 as amended; which is based by on the Anglo-Dutch system.¹⁶⁶ And the 1920 Insolvency Act of Indian.¹⁶⁷ In all the facts and acts enumerated the creditor must establish the debtor's intention to evade or delay payment of his debt. This may be done by showing that the debtor has taken a large some of money, realizing money with which he got away, inability to pay, fraudulent transfer or any other similar fact or act the cumulative effect of the diverse factors taken together must be sufficient to convince the court that the act of departure or absence, the

¹⁶⁰ Ibid. P. 543

¹⁶¹ Ibid.

¹⁶² Ibid .P. 543

¹⁶³ Ibid p. 544

¹⁶⁴ Ibid.

¹⁶⁵ Ibid. p. 545

¹⁶⁶ Hockly Harold, The Law of Insolvency in South Africa, Juta & Co Ltd, Cape Town, 1980 p. 61-75

¹⁶⁷ Chawla C.R, Mercantile Law, Kalyani Publishers, New Delhi 1981p.433-434

default or commission is done with the intention to delay or avoid payment of debts.

However using traditional insolvency law including the 1914 UK Bankruptcy Act, proving such acts as bankruptcy in the modern business culture where there is a great deal of movement would be difficult. In the case between Ato Legesse Kerenessa v the Commercial Bank of Ethiopia,¹⁶⁸ the debtor who runs a pub petitioned the court to declare the business bankrupt. In support of his claim the debtor alleged that he has defaulted on the loan extended by the bank and the bank had secured a judgment against him. Due to the difficulty the business is facing he is forced to lay off its employees. The petitioner debtor requested to prove his case by producing witnesses and pleaded that the business does not keep books of accounts hence could not produce books of accounts in support of his claim. However the Court order the debtor to produce the value of its assets and liabilities, the amount of disputed claim, the date of suspension of payment, the name and number of employees and their salaries, and determine whether the business is a going on concern or not with the reasons that led to the bankruptcy of the business. The decision of the court seems with the intent to establish whether the suspension of payment is the result of the business operation or of a personal nature. Even if this measure could be taken as a mechanism to establish nexuses the law also allows establishing bankruptcy through either as an act or a fact. However the court failed to consider the claims of the debtor in this regard. The petitioner could not produce the documents required by the court hence the petition was dismissed for lack of supporting evidence.¹⁶⁹ This case clearly demonstrates not only the difficulty faced by the court to implement the

¹⁶⁸ High Court Civil case No. 1415/74

¹⁶⁹ Tilahun Teshome, Problems on The Implementation of the Ethiopian Law of Bankruptcy p. 27-28

present insolvency criteria but also the difficulty in determining that suspension of payment is the result of business difficulties or an abuse of the bankruptcy system. Therefore proving insolvency with such criteria like intent to delay or avoid payment, preferential or fraudulent transfer would create a lot of difficulty for creditors and in the above case even for a debtor hence create confusion rather than efficiency or transparency. In order to overcome the difficulty it would be rational to investigate the different criteria used to overcome such a difficulty by modern insolvency laws. There are two general criteria used in many jurisdictions to determine insolvency i.e. illiquidity of the company and the balance sheet test which are dealt hereunder.

3.2.1. Balance Sheet-test

The balance sheet test for insolvency is based on the concept that an enterprise is insolvent if its liabilities exceed the fair market value of its assets. Hence, based on these criteria, where the value of the assets of an entity is less than its liabilities, the debtor could be declared insolvent even where the debtor is still able to meet his liabilities by mechanisms such as credit facilities from a credit institution.⁽⁷⁰⁾ However the effectiveness of the criteria is dependent on whether the balance sheet can accurately measures the assets and liabilities of the enterprise with the standard of valuation of the fair market value of the international accounting principle. Where domestic accounting does not follow international accounting principles or are not applied uniformly it may invite arbitrariness, uncertainty and even corruption.¹⁷¹

¹⁷⁰ Vallens Jean-luc Comparative Insolvency Law, French Ministry of Foreign Affairs p. 4

¹⁷¹ World Bank, Principles and Guideline for Effective Insolvency and Creditors Rights System, Apr. 2001 p. 29

3.2.2. Liquidity test

Liquidity test is based on the cash flow criteria and it depends on the ability of the debtor to service its debt as they become due. The time when debts become due is determined by the contract governing the relationship between the creditor and the debtor. Therefore, where insolvency is decided on the basis of this criteria, consideration should be given whether the business failure is caused within normal economic environment or a systematic financial crisis within the system. Since insolvency laws are designed to deal with normal economic environment it should not be enforced without restraint where there is systematic financial crisis. The system should also protect debtors' from using the proceeding to force business with minor liquidity problem to get out of the market.¹⁷²

3.2.3. Mixed Criteria

The third criteria, is the mixed one i.e. to make use of both the balance sheet test and the liquidity criteria like that of Germany. In this approach the petitioner could use either the balance sheet and liquidity test to ascertain the insolvency of the enterprise. However, such criteria would be vague and hence makes the application of insolvency difficult to ensure transparency, effectiveness and efficiency.

The success of the balance sheet test to determine insolvency is dependent on the country's accounting system. Where the accounts of enterprises are reliable and show the true affairs of the company, the criteria serve as reliable criteria to determine insolvency. However the development of the accounting system in Ethiopia is at a lower level of development hence it is not yet reliable. Apart from its unreliability many enterprises do not keep proper books of accounts.¹⁷³ Therefore this option

¹⁷² Ibid. p. 30

¹⁷³ Lissane Ghibir, Federal Inland Revenue Authority V. 1 no. 2 (Amharic)

could not be the basis of insolvency in Ethiopia. The second alternative is the liquidity test criteria, which is based on suspension of payment. This system only needs determining the amount of “payable debt” and “available debt”. Hence the suspension of payment criteria is more appropriate to prove and easy to implement by the courts. Hence this paper is of the opinion that the existing suspension of payment, in its modified form, should be adopted as the criteria for the determination of commencement of insolvency in Ethiopia.

3.3. Initiation of Commencement

Almost all bankruptcy laws allow the initiation of insolvency proceeding either by the debtor or by the creditor. In some legislation beside the debtor and the creditor or creditor's, government agencies are allowed to initiate bankruptcy proceedings. The Commercial Code of Ethiopia allows insolvency legislation to be instituted either by:

- (a) the debtor; or
- (b) one or more creditors; or
- (c) the public prosecutor; or
- (d) the court itself.¹⁷⁴

This makes Ethiopia among the countries that allow government agencies apart from the debtor or the creditor to initiate insolvency proceedings. Such a system has its own advantages and disadvantages that should be investigated in some detail hereunder:

3.3.1. Creditor Petitions

Insolvency laws are designed to be utilized by creditors, where a debtor is unable to make payments generally. However, a creditor whose small claim is not met should rely on the normal debt collection

¹⁷⁴ Commercial code of Ethiopia, Nigarit Gazeta Extra-ordinary Issue No 3 of 1960, Addis Abeba, 1960 Art. 975

mechanism, unless it is in a position to demonstrate the debtor's non-payment is in fact of a general nature. There is no uniformity approach in tackling this problem among the various jurisdictions. Some jurisdiction try to ensure the requirement of cessation of payment be of a general nature, by requiring a certain number of creditors to file the petition for the opening of proceeding. In other jurisdiction the petitioner or petitioners are required by the court to furnish information that the non-payment is part of a general pattern of non-payment or due to lack of liquid asset.¹⁷⁵ In the US the creditors of Zaddock filed on June 29, 1984 an involuntary bankruptcy petition. The court appointed an interim trustee who conducted an investigation, pursuant to which it was concluded that Reid controlled Zaddock and was improperly mixing Zaddock's assets with his personal assets. As a result the court appointed the interim trustee to manage Reid's personal estate. Reid appealed against the appointment of the interim trustee and the involuntary petition should be dismissed because he is not the subject of a bona fide dispute.

The appeal court found that the creditors failed to satisfy their burden under the law, which requires for three or more creditors to file the petition. The evidence that Reid was commingling assets of the company with his personal estate were also found on insufficient evidence, hence the appointment of the interim trustee was repealed and the case was remanded to the district court for further proceedings.¹⁷⁶ Therefore in this case the creditors failed to satisfy the requirement of the American Bankruptcy Act that the suspension of payment is of a general nature. The Ethiopian bankruptcy law does not make any additional requirement to protect enterprises from possible abuse of the system by creditors. Even though,

¹⁷⁵ International Monetary fund, *Orderly and Effective Procedures*, 1999 p. 19

¹⁷⁶ King Lawrence, *Creditors Rights Debtors' Protection and Bankruptcy*, Matthew & Bender 1997 p. 669-670

there is a need to make insolvency proceedings accessible to creditors. This need should be balanced with the equally important need of protecting enterprises by making requirements, such as a certain number of creditors to file the insolvency petition or liability for wrong full initiation of insolvency proceedings. Hence there is a need to upgrade the law in this regard.

The issue of suspension of payment was raised in the case between the Commercial Bank of Ethiopia and the Ethiopian Building and Road Construction P.L.C.¹⁷⁷ The bank petitioned the court to adjudicate the debtor bankrupt. The petitioner alleged that the debtor had defaulted on at least on twenty loans. The debtor contested some of the debts and alleging that some of the debts are even overdraft not yet drawn by the debtor. The court ordered an investigation on the affairs of the respondent since proper books of accounts are not presented and some of the debts are contested. However, the court also authorized the Ministry of Construction to take over the management of the respondent company and complete works on progress. The attorney of the debtor and a person to be appointed by the creditor were empowered to carry out an investigation in to the affairs of the debtor.¹⁷⁸ The court in this case failed to appoint an investigating judge or investigate the case itself. Rather it went out of what is provided by Ethiopian bankruptcy law to authorize the debtor and the creditor to jointly investigate the contested debt. Hence the court failed to investigate and determine the issue of suspension of payment, the contested debt and whether the debtor is bankrupt or not rather made the debtor under the supervision of the Ministry of Construction. However, the court did not appoint the Ministry of Construction as a commissioner in accordance with

¹⁷⁷ High Court Civil case no. 1158/74

¹⁷⁸ Tilahun Teshome, Problems on The Implementation of the Ethiopian Law Bankruptcy p. 31-32

the law, hence the appointment is outside what is provided in the bankruptcy law, since this case is not a reorganization proceeding.

In the case between the Commercial Bank of Ethiopia v Mir papa Plc¹⁷⁹ the creditor petitioned the court to adjudicate the debtor bankrupt. In support of the claim the petitioner produced profit and loss account and balance sheet showing that the company sustained loss for two consecutive years. It also submitted an additional external auditors report showing that the company has lost the whole of its capital and its liabilities exceeded its total asset. The High Court dismissed the case on the ground that the debtor has not petitioned the court to be adjudicated bankrupt. Rather the manager and the shareholders have absconded from the country by borrowing in the name of the company and personally from individuals and the creditor bank. Therefore the court reasoned adjudicating the debtor bankrupt would tantamount to legitimizing the acts of the debtor and his absconding. Hence, the court dismissed the bankruptcy proceeding and ordered the creditors to initiate an ordinary contract claim and execute the judgment.¹⁸⁰ The decision of the court is based on the assumption that a debtor who absconded should not benefit from bankruptcy proceedings. However bankruptcy proceeding does not benefit those who abuse the system nor discharge their obligations. The court by disallowing bankruptcy proceedings forced the creditors to file individual claims and hence created an unnecessary competition among creditors to be the first to get judgement and enter execution.

3.3.2. Debtor Petition

In almost all jurisdictions the criterion for the commencement of bankruptcy petition is the same whether the petition is initiated by the

¹⁷⁹ High Court Civil case No: 470/74

¹⁸⁰ Tilahun Teshome, Problems on The Implementation of the Ethiopian Law of Bankruptcy p. 27-28

debtor or by the creditor. However courts do not regard creditor and debtor petition alike. The petition of the debtor presumed to be made as a last resort where the debtor is un-able to pay its debt. However, creditors are given the opportunity to contest the claims of the debtor and where necessary to change liquidation proceeding to that of re-organization in the best interest of all creditors. In the case of John and Christine, who were non-commissioned officers of the US Air Force, who each earned \$1,408 net a month. In 1986, they filed a voluntary petition in bankruptcy under chapter 7. At the time of petitioning they had three secured debt and unsecured debt from credit loans. The petitioners proposed to surrender the collateral leaving out only 10,000 of their secured debt and the total of unsecured debt. The court after receiving their income and expense schedule found that there is a surplus of \$276 per month; hence dismissed the case pursuant to the substantial abuse provision of the Bankruptcy Code.¹⁸¹ The US court in this decision has made a ruling that the debtor is allowed to benefit from bankruptcy proceedings only where the debt exceeds the assets of the debtor. In the case between Ato Legesse Kerenessa v the Commercial Bank of Ethiopia the debtor who runs a pub petitioned the court to declare the business bankrupt. In support of his claim the debtor alleged that he has defaulted on bank loan and the bank had secured a judgment against him. Due to its financial difficulties the business is forced to lay off its employees. The petitioner debtor requested to prove his case by producing witnesses on the ground that the business does not keep books of accounts hence could not produce books of accounts. The court dismissed the case on the ground that it failed to produce the necessary books of accounts. Unlike the US court which

¹⁸¹ Metzger B. Michael and Others, Business Law and the Regulation Environment, Concepts and Cases, Irwin, Boston p.664-665

dismissed the case on the ground that the debtor is solvent the Ethiopian court failed to establish whether the debtor was bankrupt or solvent, hence failed to apply the law properly.

The other issue that should be addressed by bankruptcy laws is whether the insolvency law should actually impose a duty upon a debtor to initiate proceedings at a certain stage of its financial difficulties. One approach to this problem is to impose liability upon officers and directors where they continue to trade despite being insolvent. The objective of such an approach is to force company officials to initiate re-organization or liquidation procedure at the earliest possible date; hence increasing the chance of re-organization and decreasing the loss of asset that would be available to the creditors. European Countries provide in their bankruptcy law, sanctions against managers and officers for any delay past a certain point of insolvency. In France, managers are obliged to file for bankruptcy within 15 days from the date the firm become unable to pay its debts as they become due. Managers who failed to observe this duty would possibly be held personally liable and be barred from managing any other enterprise in the future.¹⁸² In Germany managers are required to file for bankruptcy within three weeks of the firms insolvency. The manager faces liability where he fails to discharge this duty.¹⁸³ In Britain directors could be held personally liable for the extra losses sustained due to the continued operation of the firm despite its being insolvent.¹⁸⁴

However such an approach has the disadvantage of discouraging management in making out-of court restructuring agreement on the one hand, and at times an early commencement hence reducing the power of

¹⁸² Posner Richard, *Corporate Bankruptcy Economic legal Perspective* Cambridge university press, Cambridge, 1996 p. 469

¹⁸³ Ibid. p. 470

¹⁸⁴ Ibid.

management to make use of innovative mechanisms to overcome financial difficulties. Hence many jurisdictions prefer to incorporate incentives in re-organization proceedings rather than using penalties to encourage an early insolvency petition by the debtor.¹⁸⁵ The US bankruptcy law encourages saving of enterprises by maximizing the assets. It also encourages early bankruptcy by having a lenient treatment on managers.¹⁸⁶ The Ethiopian bankruptcy law could possibly opt for the US approach in order to encourage the management for an early proceeding, allow management to use innovative mechanisms to overcome financial difficulties, assist the development of an entrepreneur elite and overcome the difficulties of the courts in law enforcement. On the other hand the European approach though creates discipline on the management of enterprises, in a country like Ethiopia where there are no qualified men to run enterprises, having such a strict discipline provision would hinder the development of qualified managerial and entrepreneur elite.

3.3.3. Initiating by Government Authority

In all modern bankruptcy legislations some institutions such as financial institutions are excluded from the normal bankruptcy proceedings. Hence specialized regulatory authorities should manage the insolvency of such institutions. Apart from regulated industries, some jurisdictions allow governments agencies such as the public prosecutor or courts to initiate insolvency proceedings in "the public interest" as a matter of public policy.

Where insolvency is initiated by special government agencies, illiquidity may not be the only cause, though it could be one of the bases for their initiations. Such authorities may also initiate against enterprises

¹⁸⁵ International Monetary Fund, *Orderly and Effective Producers*, 1999 p. 19

¹⁸⁶ Posner Richard, *Corporate Bankruptcy Economic legal Perspective* Cambridge university press, Cambridge, 1996 p.470

that engage in criminal or fraudulent activities. Hence, where government authorities are allowed to initiate insolvency proceedings other than technical insolvency there is a possibility for abuse. Therefore, there is a need either to abolish the power of the court and the public prosecutor to initiate insolvency as in the U.S. or to make sure that the authorities entrusted with such power exercise their authority in accordance with clear guidelines to curtail abuse as in France.¹⁸⁶ This paper is of the opinion that the French model would be more appropriate since it would be a continuation of the present system; however there should be clear guideline for the initiation of insolvency by the public prosecutor and the courts.

3.4. Consequences of commencement

Liquidation is a procedure to maximize the assets of the debtor in the interest of all interested parties. Insolvency as a collective procedure could not be necessarily compatible with the interest of the individual creditor. Therefore in order to stop the action of individual creditor from seizing the assets of the debtor and avoid forced "*fire sale*" stay is enforced. In almost all jurisdictions "stay" is enforced against un-secured creditors while the scopes of stay vary from country to country with regard secured creditors. Most jurisdictions as discussed earlier apply stay to secured creditors for a limited period. However extending stay to secured creditors give rise to a number of difficulties including the decline in the value of their security. The other problem with regard to creditors arises where creditors with special right of set-off and other privileges such as assignment enforce their legal or contractual rights. Insolvency laws, as discussed earlier in chapter two of this paper gives the liquidator or the court, the power to interfere with such matter: such as stay, the right of secured creditor, continued contracts, with the objective of maximizing the

¹⁸⁶ International Monetary Fund, Orderly and Effective Producers, 1999 p. 20

assets of the estate.¹⁸⁷ Hence this chapter investigates this general issue of bankruptcy with regard to insolvency and the laws of Ethiopia in particular.

3.4.1. Stay of individual action

All laws relating to insolvency consider stay against the debtor estate in order to prevent creditors from dismembering the business prior to other creditors of the same rank and preventing the debtor from concealing or selling his assets by fraudulent transfers. The scope of the stay extends to enforcement of judgments, pending lawsuits, foreclosure of security interest, perfection of mortgages and demand of payments. The Commercial Code of Ethiopia Article 1025 accepts the universality of creditors in bankruptcy. The judgment in bankruptcy shall prevent any creditor whose claim is included in the universality from bringing individual suit. Such creditor may not attach the debtor's property whether movable or immovable. Therefore the Code adopts a stay that is enforced upon the declaration of the court rather than the automatic filing of an application.

However, secured creditors are only partly involved in the collective proceedings. The reason for the special consideration of secured creditors is the special right granted to them by law or contracts. The Commercial Code of Ethiopia in Article 1026 applies stay only to creditors whose claim is included in the universality. However, the concept of universality in Article 1025 does not cover secured creditors whose claims are secured by special privilege or mortgage. The Ethiopian bankruptcy law stay provision Article 1025 does not apply to all creditors whose claims are not secured by a special privilege, a pledge or a mortgage. This exclusion of secured creditors will result in forced sell of the enterprise without maximization would defeat the goals of insolvency. This pro- secured creditor position of

¹⁸⁷ Ibid. p. 23

the Code would frustrate reorganization proceedings and attempt to sell the enterprise as a going on concern in solvency proceedings. Therefore, the stay under Ethiopian bankruptcy law should be broadened to include secured creditors, at least temporarily so as to achieve the goal of maximization of the value of the estate.

3.4.2. Secured Creditors

Security for credit is granted to the creditor in the bi-lateral exchange agreement with the debtor. The creditor needs the security to ensure the return of the extended credit to the debtor. If security is to achieve its objective the creditor should be allowed to foreclose upon its collateral. However permitting secured creditors to freely separate their collateral from the other assets of the estate can frustrate the basic objective of maximizing the assets of the debtor in the interest of all.¹⁸⁸ Hence the issue the extent to which secured creditors should be allowed to assert their right on the collateral and enforce their security should be dealt with.¹⁸⁹ In particular, if important assets serve as collateral, the liquidator will be unable to maximize the value of the estate as a going on concern.

Where the debtor's assets cannot be sold as a going concern, a temporary stay as discussed above will give the liquidator time to arrange a sale that will give the highest return for the benefit of all secured creditors. On the other hand allowing stay on the collateral would result in the decline of the value of the security interest and such erosion will ultimately undermine the availability affordable credit. Hence in order to offset the decline in security interest there is a need to increase the price of the credit.¹⁹⁰ The method of protection of the rights of secured creditors

¹⁸⁸ Ibid. p. 25

¹⁸⁹ World Bank, Principles and guidelines for Effective Insolvency and creditors Rights System, the World Bank Apr.2001.p. 41

¹⁹⁰ International Monetary Fund, Orderly and Effective Producers, 1999 p. 24

depends on the method used to protect the security interest. Where the interest of the secured creditors are protected by preserving the value of the collateral, the secured creditor would have a first priority claim on the proceeds, to the extent of the value of the secured claim. On the other hand where the interests of the secured creditors is protected by fixing the value of the secured portion of the collateral, the creditor has first priority claim to the general proceeds with respect to that value.¹⁹¹

The security interest of secured creditors should be protected in order to ensure the reliability of contracts and protect security interest of creditors. However the protection of security interest should be balanced with the rights of un-secured creditors on one hand and that of the goal of maximization of the estate by providing adequate protection of the security interest. Therefore the Ethiopian bankruptcy law should opt for the temporary application of stay with the necessary protection of secured creditors' right either by applying stay on secured creditors for a period of not more than 30 or 60 days to give the liquidator the opportunity to assume its duties and take the assets and liabilities of the estate or the court could be given the power of the stay, on the ground that such an extension provides a necessary means of maximizing the value of the estate and provide mechanisms necessary to protect the interest of secured creditors.¹⁹²

3.4.3. Treatment of Pending Contracts

At the Commencement of the liquidation proceeding, the debtor's enterprise, as a going on concern, would be a party to some un-performed contracts. Almost all modern insolvency laws as discussed in chapter two of this paper provide for the liquidator to interfere with the terms of the

¹⁹¹ Ibid. p. 36

¹⁹² Ibid .p. 25

contract with the broad objectives such as value maximization, social and political interests of the liquidation proceedings. However, the right of the liquidator to interfere with the terms of the un-performed contracts would undermine the predictability of contract performance. Hence such a power needs to balance the economic, social and political interests on the one hand with that of predictability of commercial and financial transactions on the other.

This power is either to avoid pre-bankruptcy transaction or power to avoid wrongful transactions. Ethiopian bankruptcy Provision Article 1029 of the Commercial Code allows the invalidation of gratuitous assignments. In case of payments of debts not due, where the payment is carried in cash by assignment, sale, set-off or otherwise invalidation is permitted. In respect of payments of debts due, made otherwise than in cash such as negotiable instrument or by transfer to a bank could be invalidated. With regard to securities set up on the property of the debtor in respect of debts contracted before the setting up of such securities could be invalidated where such security is acquired between fifteen days before the date of suspension of payments and the date of adjudication.

The power to invalidate preferential and fraudulent contracts is accepted under current Ethiopian bankruptcy provisions; though the provisions lack clarity and systematisation. All contracts after the suspension may be invalidated on the request of the trustees where the parties have received payment or have dealt with the debtor knowing that the suspension of payments had taken place.¹⁹³ The trustee has the power to terminate or continue lease agreements in the interest of the estate. The trustee is also empowered to continue or assign a lease for the un-expired

¹⁹³ Commercial Code of Ethiopia, Negarit Gezeta Extra-ordinary Issue No 3 of 1960 Addis Abeba, 1960 Art 1030

period. Goods the sale of which has been cancelled prior to adjudication either by a decision of the court or by operation of the terms of the contract, may, if they exist in kind, be recovered from the debtor. Where the cancellation of sale has been ordered or confirmed by a court after adjudication, goods may be recovered notwithstanding that proceedings for recovery or for cancellation were brought prior to adjudication.

Hence Ethiopian bankruptcy law though not adequate provide the trustee and the court to intervene in the performance of contracts in the interest of the estate. The exception to the power of the trustee should be that of public interest requirement, which exclude specific contracts such as financial contracts, contracts of employment whose strict performance is required.¹⁹⁴ However the Ethiopian bankruptcy law does not contain such an exception hence financial contracts or contract of employment could be invalidated and therefore there is a need to determine which of the pre insolvency contracts should be allowed to be intervened and the type and nature of specific contracts that should be excluded from the preview of the power of the liquidator's to prohibit avoidance of contracts in the interest of the public.

3.5. Liquidation and Priority Payments

Insolvency as a collective debt collection mechanism requires creditors who wish to participate in the estate of a bankrupt debtor to file proof of their claim within a certain period. Every creditor whose claim is allowed by the trustee or proved by a court of law can participate in the distribution of the assets of the bankrupt estate.¹⁹⁵ Only un-secured creditors are required to file proof of claim. A secured creditor need not file proof of claim unless the value of the collateral is less than the debt and proof is required for the

¹⁹⁴ International Monetary Fund, Orderly and Effective Producers, 1999 p. 31

¹⁹⁵ Barnes A. James, Law for Business, Irwin McGraw. Hill, Boston 2000 p. 830

recovery of the deficiency.¹⁹⁶ The Ethiopian bankruptcy law requires creditors to produce proof of their debts to the trustee after the adjudication of the debtor¹⁹⁷. The debts shall be verified in the presence of creditors committee and finalized by the signature of the commissioner.¹⁹⁸ Secured creditors shall be entered in the inventory only for the purpose of information.¹⁹⁹ Where the security cannot cover the debt, such secured creditor may join unsecured creditors for the remaining amounts.²⁰⁰

Secured creditors have property right (security interest) over the collateral and hence are paid in full if the collateral is sufficient to cover the debt extended. When the amount of the secured claim exceeds the value of the collateral, the claimant is a general creditor as to the deficiency and could share from the remaining available fund with other general creditors of the same class.²⁰¹ Payment is made to the rest of the creditors in accordance with the priority set by law and to the extent of the funds available. Each class must be paid in full before the next class is entitled to receive anything.²⁰² The Ethiopian bankruptcy laws allows secured creditors to have the first right of priority and hence are paid in full if the collateral is sufficient to cover the debt extended.²⁰³ Payment to the rest of the creditor should be made in accordance with the priority set by law and the extent of the funds available.

Following distribution of proceeds to secured creditors and payment of claims relating to costs and expenses of administration, the remaining

¹⁹⁶ Hoeber C. Ralph, Contemporary Business Law, Principle and Case, McGraw-Hill Book Co. New York 1982, p. 1122

¹⁹⁷ Commercial Code of Ethiopia, Negarit Gezeta Extra-ordinary Issue No 3 of 1960 Addis Abeba, 1960 Art 1041

¹⁹⁸ Ibid. Art. 1043

¹⁹⁹ Ibid. Art. 1058

²⁰⁰ Ibid. Arts. 1052-1062

²⁰¹ Hoeber C. Ralph, Contemporary Business Law, Principle and case, McGraw -Hill Book Co. New York 1982 p. 1122

²⁰² Barners A. James, Law for Business, Irwin McGraw. Hill, Boston 2000 p. 832

²⁰³ Ibid

proceeds should be distributed on a *pari passu* bases to the remaining creditor. The only exception should be based on compelling reason to justify the giving of preferential status to a particular debt be it whether public or private should be justified by public interest such as priority given to taxes and un-paid wages.²⁰⁴ The Ethiopian Commercial Code Article 1110 determines the distribution of proceeds to be made after the deduction of:

- (a) costs and expenses;
- (b) sums applied for the support of the debtor or his family, and
- (c) sums paid to preferred creditors;
- (d) the net proceeds of winding up shall be distributed to all creditors subject to the provisions of Arts. 1065, 1066, 1068.

Most laws also provide several types priority to make payment from the proceeds of the debtor's asset. The differences in the order of priority set by different legislations are the result of local rules about credit, securities and privileges. A researcher in the field suggested that creditors could rationally be classified in the following five classes:

- 1st class - Creditors supporting the company during the proceedings.
- 2nd class - debts of the estate of the bankruptcy such as court costs, of administrators, tax claims.
- 3rd class - of the work - force such as salaries, social funds;
- 4th class - claims of secured creditors such as liens floating changes, mortgages, privileged claims.
- 5th class - claims of un - secured creditors. In case of liquidation payment on the value of the estate and secured claims of better rank, and in case of re - organization plan the payment depend on the

²⁰⁴ World Bank, Principles and guidelines for Effective Insolvency and creditors Rights System, Apr.2001.p. 44

postponement defined by the plain and on the agreement about reduced claims.²⁰⁵

The first priorities in the distribution of proceeds referred in Article 1110(a) are costs and expenses cost and expenses defer to the cost of bankruptcy proceedings. Among which come cost of attorney, court fees and charges. Next to these cost expenses that are essential to run the estate and liquidate which consists salary of the trustee and the commissioner and any other operation cost including salaries of employees. Second in the priority under the bankruptcy provision of the Commercial Code cost paid to the debtor and his family. However such sum could only be paid where the debtor is employed in the insolvent enterprise, which is optional at present. Even if such a provision has some purpose with regard individual traders and partnerships it seems un-necessary with regard to companies. Hence its scope application should be restricted.

The third priority right is that of preferred creditors. Preferred creditors are those creditors who have a priority right over other creditors by virtue of the law or contractual agreement. Preference right is given by laws such as labor law to the salaries of employees, banking proclamation to the claims of the bank, tax law with regard to government claims of tax liability. Contractual preference arises from security right given by the debtor to the secured creditor. Such preferred creditor right is created by contracts such as mortgage, pledge agreements and right of lien. Hence the third priority group includes a number of creditors who either by the operation of the law or prior contractual agreement is included in one box, which creates conflict of interest and a lot of friction among themselves, which would make it difficult to administer. The fourth group only exceeding the equity holders is the general creditors. General creditors are

²⁰⁵ Vallens Jean-Luc, Comparative Insolvency Law, French Ministry of Foreign Affairs p. 17

all creditors whose claim is not secured. In some cases creditors whose collateral is not enough to cover their claims such secured creditors join the rank of general creditors to the amount their security is deficient. The owners of the business are not entitled to the distribution of proceeds of assets until all prior creditors are fully paid. Where there is reminder balance, the remainder will be distributed to equity owners in accordance with the ranking of shares specified in the memorandum and articles of association of the enterprise.²⁰⁶

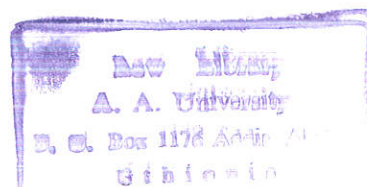
The priority set by the Ethiopian bankruptcy law did not take into account the goal of maximization of the debtor's estate.²⁰⁷ Where an enterprise under insolvency is allowed to operate under insolvency creditors whose claim arises out of such operation are only made part of the preferred creditors.²⁰⁸ Hence prejudicing the financing of enterprises under insolvency. In addition to the priority set by the Commercial Code bankruptcy law other legislations such as the labor law, the banking law and the tax law have set their respective claim of priority. Hence to avoid this conflicting priority claim modernization of the Ethiopian bankruptcy law should set a clear priority to be followed in insolvency proceedings hence make the law predictable transparent and efficient. In order to carry out an efficient, fair and equitable distribution of the liquidated assets of the bankrupt estate the following order seems more appropriate in the opinion of this paper:

1st class creditors supporting the enterprise during the proceeding, without which an undertaking could not receive the funding of creditors during the proceedings;

²⁰⁶ International Monetary Fund, *Orderly and Effective Producers*, 1999 p.37

²⁰⁷ Weil H. Peter, *Asset Based Lending, A Practical Guide to Secured Financing*, Practising Law Institute, New York 1992 p.684

²⁰⁸ *Commercial Code of Ethiopia*, Negarit Gezeta Extra-ordinary Issue No 3 of 1960 Addis Abeba, 1960 Art.1039 (2)



- 2nd class costs and expenses of administration, without which insolvent undertakings could not be sold as a going on concern;
- 3rd class claim of secured creditors such as charges, mortgages and other privileged claim;
- 4th class wages and salaries of employees, without which maximization and protection of the highly vulnerable is not possible;
- 5th class sum paid for the support of the debtor and his family in order to ensure the survival of the debtor and encourage him in the proceeding
- 6th class government claims and taxes
- 7th class all general creditors of the debtor.

3.6. Discharge of the Debtor

One of the main goals of bankruptcy is discharge of honest debtor. A bankrupt person who has not been guilty of certain dishonest acts and who has fulfilled his duties should be entitled to a discharge. Discharge relieves the bankrupt person from further responsibility from those debts that are dischargeable. This gives the debtor a fresh start.²⁰⁹

The issue of discharge was dealt in the US court in the case of Toni and Joseph. In 1991 Joseph and Toni bought a house in Las Vegas, Nevada. Subsequently, Joseph borrowed \$20,000 of his wife savings to invest in business ventures. On November 15, 1993, the Trujillo's defaulted in payment of a promissory note. In May of 1994 the Cadillac automobile, which was given as security to borrow his wife savings of \$20,000 was transferred to his son. Joseph instructed his son to hold the title to the Cadillac in trust until the loan was repaid. Latter the Trujillo transferred to Gilbert two more vehicles without any consideration. In August 1994, the Trujillo's transferred their house to their daughter Valerie Aquino. The

²⁰⁹ Barner A. James, Law for Business, Irwin McGraw. Hill, Boston 2000 p. 831

transfer was made to obtain loan in the name of their daughter and this transfer was also made without consideration. A year after the transfer the Trujillo's filed petition for relief under Chapter 7 of the US Bankruptcy Code. The issue was whether the transfer of the vehicles and the house are fraudulent transfers that could be recovered by the trustee? The Court held that since the credit was obtained on false financial statement and the transfers were made without consideration with the intent to make the assets outside the reach of creditors by fraudulent means, the trustee is entitled to recover the assets.²¹⁰ The Court argued that the debtor has shown reckless indifference as to the accuracy of the financial statement and has the requisite intent to deceive and therefore the debt is declared to be non-dischargeable.²¹¹

In an other case between Byrd v Bank of Mississippi the debtor took a loan of \$20,000 on the basis of the debtor's income tax return and his financial condition as prepared by his accountant. The financial statement dated June 30,1989 shows Dr. Byrd has a net worth of approximately \$649,000 with assets consisting of 60 acres of real property with a value of \$30,000. In fact Dr. Byrd did not own the property nor did pay the property tax on it. The statement also lists as an asset a residence in Covington Country, Mississippi, with an appraised value of \$49,800. At the time financial statement was submitted the property has been sold to his brother on a conditional sale contract with a purchase price of \$39,000 it also encumbered with a deed of trust securing a \$39,000 note to the Bank of Simpson Country. However, neither the conditional sale nor the note and deed of trust were mentioned in the financial statement. Dr. Byrd explained all these as oversight. The issue in this case should the court

²¹⁰ Ibid. P. 829-830

²¹¹ Ibid. p. 833-834

declare the debt by Dr. Byrd to the Bank of Mississippi to be non dischargeable on the ground of fraud. In both cases the US courts declared the debt to be non dischargeable because one cannot be allowed to benefit from his wrongful acts.

An effective insolvency system ensures that the assets of the estate are sold and distributed in a timely, predictable and equitable manner. The liquidator has also a duty to ensure that the sales price is maximized and the administrative costs of insolvency are consistent with the objective of maximizing the value of the debtor's estate.²¹² Once the assets of the debtor's estate are turned into cash, the next stage is the resolution of claims in accordance with the priorities set by law.

The liquidated estate of the debtor may not be sufficient enough to cover the claims of creditors. In such a situation the issue whether creditors whose claim is not fully satisfied still have an outstanding claim against the debtor. The outstanding debt could be claimed from the shareholders to the extent only of the un-paid portion of contribution un-paid to the company. Where all subscribed shares are fully paid then since the liability of each shareholder is restricted to the amount of shares subscribed, the claim cannot exceed the capital of the company unless there is fraud.²¹³ However, where the insolvent is a partnership or an individual owners have un-limited liability. The issue whether the individual or individuals still be personally liable for the un-satisfied claim following distribution of the proceeds should be addressed by insolvency legislation.²¹⁴

²¹² Posner Richard, Corporate Bankruptcy Economic and Legal Perspective Cambridge, University Press, Cambridge, 1996 p. 263-265

²¹³ Commercial Code of Ethiopia, Negarit Gezeta Extra-ordinary Issue No 3 of 1960 Addis Abeba, 1960 Art. 304

²¹⁴ International Monetary Fund, Orderly and Effective Producers, 1999 p. 38

Insolvency laws have taken two opposing views with respect to the issue of discharge. In some jurisdictions the debtor is still liable for the unsatisfied claim subject to statute of limitations. On the other hand some jurisdictions.²¹⁵ Provide for complete discharge of an honest debtor. The Ethiopian bankruptcy law does not contain provisions for the discharge of the debtor. This makes the Ethiopian bankruptcy law without any incentive for debtor's to apply for insolvency proceedings. Hence in order to balance the right of honest debtor with that of the claims of creditors discharge provisions should be introduced in the bankruptcy law of Ethiopia. The introduction of discharge will benefit the debtor to have a "fresh start" which would enable the development of an entrepreneurial class. The introduction of discharge under Ethiopian bankruptcy law could start from a compromise approach in which discharge is granted for the good faith effort to satisfy its obligation to creditors.

²¹⁵ Ibid.

CHAPTER FOUR

REHABILITATION PROCEDURES

4.1. General

Modern insolvency legislations, by departing from the traditional goals of insolvency i.e. liquidation of the debtor's estate in favour of creditors, has enacted new goals aiming at favouring reorganization plan which allows the continuation of the business.²¹⁶ The objective of reorganization as defined by Article 2 of OHADA (Organization for the Harmonization of business law for Africa) is a proceeding designed to save the company and to clear debts by means of a composition with creditors (*concordat de redressement*) .²¹⁷ This rehabilitation procedure aims to enable a financially distressed enterprise to become competitive and productive. Hence the objective of re-organization is not only to benefit owners, creditors and employees but also the economy at large.²¹⁸

Rehabilitation laws encourage the re-organization of troubled enterprises. These proceedings have replaced the former composition "*concordant*" plans and schemes of arrangement, which aimed at the re-organization of debts. The former plan aims at the reorganization of debt; hence the debtor may either propose a composition or an extension plan. In a composition plan the debtor pays creditors less than 100 percent of their claims on a *pro rata* basis for each class of claims. In an extension plan the debtor pays the full amount over a large period than was agreed originally.²¹⁹ The Ethiopian bankruptcy laws provide for the debtor who is under bankruptcy to propose for composition agreement. Article 1081 of the Commercial Code:

²¹⁶ International Monetary Fund, *Orderly and Effective Producers*, 1999 p. 8

²¹⁷ Martor Boris, *Business Law in Africa OHADA and the Harmonization Process*, 2002, p. 167

²¹⁸ International Monetary Fund, *Orderly and Effective Producers*, 1999 p.39

²¹⁹ Hoerber C.Ralph, *Contemporary Business Law, Principle and Cases*, McGraw -Hill Book Co. New York 1982 p. 1130

- (1) At any time after the expiry of the period of time provided in Art. 1046, the bankrupt may propose a composition with the creditors and submit the proposed composition to the commissioner.
- (2) The proposed composition shall specify the percentage offered to unsecured creditors and the period of time required for payment. It shall show the guarantees to cover the payment of debts, legal costs and the remuneration of the trustees.
- (3) The winding-up is suspended by a proposal for a composition.

This Article permits the debtor to propose a composition agreement. Unlike modern reorganization plan, the right to propose is expressly given only to the debtor. The law is silent as to the right of creditors to submit alternative composition proposal. The proposal is required to specify the percentage of the debt to be paid to secured creditors. The law expects secured creditors to take the collateral or be paid the security in full, hence the proposal say nothing about secured creditors, which is not the case in modern reorganization proceedings. The proposal is also expected to show guarantees that ensure the payment of debts, legal costs and the remuneration of the trustee.

Ethiopian bankruptcy law also provide for any trader who is not under bankruptcy proceeding to apply scheme of arrangement to resolve the problem encountered by the enterprise in Art. 1119 of the Commercial Code:

Any trader who has or is about to suspend payments and has not been declared bankrupt may apply to the court for the opening of a scheme of arrangement, in accordance with the provisions of this Title.

The debtor must submit the application for scheme of arrangement to the court. The only requirement of the law is that the debtor is about to suspend payment because the enterprise could not meet its liabilities as they become due. Hence the petition should be annexed with supporting documents such

as balance sheet, profit and loss statements, a list of debtors and creditors. Hence the Ethiopian Commercial Code bankruptcy composition and schemes of arrangement provide only the traditional debt collection mechanisms.

On the other hand the modern re-organization plan could contain provisions relating to a postponement of payments, like traditional composition but also arrangements for the transfer of the business to new managers or shareholders, including modification of employment and other contracts.²²⁰ The reorganization plan is essentially a contract between the debtor and its creditors on matters such as debt payment, and mechanisms such as re-capitalization by giving equity to creditors, change of management, reorganization of the enterprise, sale of branches etc. In all cases the plan is expected to divide the creditors in to classes, set forth how each class of creditors would be satisfied and state which claims are adversely affected by the plan and lastly treat creditors in the same class similarly. The plan must be submitted to the approval of creditors. Up on approval by the creditors the plan goes before the court for confirmation, which shall be implemented up on approval.²²¹ In a US case involving Royal Composing Room Inc. the company was under considerable stress from the competition of the computer industry. The main product of the company linotype machine market share was facing stiff competition from *other* computer. While Royal was a profitable company the company bargained a collective agreement with Typographical Union No.6. However in the years following 1982 the linotype machine was replaced by computer machine hence the sales of the company declined and the company sustained an operating loss.

²²⁰ Vallens, p.8 and World Bank, 2001. p.36

²²¹ Barners A. Jemes, Law for Business, Irwin McGraw. Hill, Boston 2000 p. 837-838

Confronting with these difficulties, in 1983 Royal began to cut expenses by cutting compensation of executives, freezing the salaries of salesmen and middle management, eliminating company automobiles, moving to a smaller location to save rent. During this adjustment period [in 1986] Royal lost its largest customer, thence the company requested the labor union to agree to sacrifice its 3 percent wage increases, agreed earlier. When the union refused Royal filed a petition for reorganization under chapter 11 to reject its collective agreement with the union. After a trial before the bankruptcy judge Royals motion to reject the existing collective agreement was granted. The union then appealed to the district court. The appellate court established that the company tried to enter in to a bargain with the union, but the union failed to negotiate in good faith. When the union refused to bargain the company proposed reorganization plan, which cut the union labor cost. The appellate court found the reorganization proposal to be equitable and fair to all creditors, the debtor and all affected parties including the labor union. The debtor has also fulfilled the burden of proving that its proposal is made in good faith and that it contains necessary changes that will enable the debtor to complete the reorganization process successfully. The decision of the lower court was sustained.²²² This US reorganization case shows that the main objective of the reorganization plan is to bring the enterprise out of current difficulties. The company in order to relieve from its problem must propose a sound reorganization plan. The reorganization plan must be acceptable to all stakeholders. However in this case the labor union the last to make sacrifice refused to agree to the proposal on the ground that the plan could not modify an acquired right of its employees. The court applied the test

²²² Metzger B. Michael, and Others, Business Law and the Regulation Environment, Concepts and Cases, Irwin, Boston p. 668-669

that the plan should treat all stakeholders fairly and equitably and found that the labor union is only refusing its share of sacrifice to save the company from insolvency; hence both the lower and appellate courts dismissed the arguments of the labor union.

In order to avoid unnecessary litigation and additional cost and to make the rehabilitation procedure successful it must create incentives for all stakeholders from undermining it. To ensure the participation of all stakeholders, including secured creditors, the plan should enable to enhance the value of the enterprise.²²³ In line with this objective, the law should provide an adequate opportunity for the creditor to vote on it, and provide guarantee for secured creditors to ensure that their claim or property right is not impaired.²²⁴

In some countries in addition to re-organization proceedings bankruptcy laws have provided an additional pre-insolvency work out procedure. This rehabilitation procedure enables an enterprise in financial difficulties to enter into an informal out of court negotiation with the aim of restructuring debts. Providing out of court amicable settlement procedure without any applicable regulation or legal framework enable the continuation of the enterprise as an on going concern.²²⁵ The case of Planet Holly Wood restaurant can be taken as an out of court amicable settlement. Planet Holly Wood restaurant was established by entrepreneurs of Hollywood, a Saudi Arabian Prince and Singapore billionaire. Planet Holly wood made an early success as a leader in the entertainment industry. The number of restaurants grew in the US by 48 new company owned enterprises and additional 32 restaurants were opened worldwide. The stocks of the company that opened at \$18 per share in 1996 climbed to \$32

²²³ International Monetary Fund, *Orderly and Effective Liquidations*, 1999 p. 39

²²⁴ Ibid.

²²⁵ Vallens, p.8 and World Bank, 2001, p. 8-9

per share at the first day of trading. However the price of shares fell in August 18, 1999 to that of \$0.75 per share. On that date the company announced it would seek protection under chapter 11 of the Bankruptcy Code. After negotiating with its creditors Planet Hollywood agreed on the terms of re-organization:

- the number of restaurants were reduced by 75 percent.
- the company agreed to operate only its most successful outlets.
- debt holders of \$250 million in subordinate agreed to cancel their debt and the back interest in exchange for \$47.5 million in cash and \$60 million new notes, and new common stock representing 30 percent of the new planet Hollywood equity.
- equity holders and shareholders were wiped in the reorganization they only received warrants purchasing shares upon the re-organization being successful.
- an investor group led by prince Alwaleed Bin Talal, Ong Beng Seng and Robert Earl's trust invested \$30 million in exchange for 70 percent of equity ownership in the new reorganized Planet Hollywood.
- the new Planet Holly Wood also revised its menu and added new merchandise in which 25 percent of its revenue to come from the sale of T-shirts.²²⁶

This reorganization agreement between equity holders and creditors provide the enterprise with a second chance for the enterprise and the development of an entrepreneurial class. It also encourages the participation of private creditors in the resolution of financial crisis of enterprises, hence generating a more stable financial system for the country

²²⁶ Cheesema R. Henry, Business Law, Ethical, International & E. Commerce Environment, Upper Saddle River, New Jersey p. 579

at large.²²⁷ Therefore this paper is of the opinion that a legally recognized out of court settlement should be provided under Ethiopian bankruptcy law.

4.2. Commencement Requirements

Rehabilitation proceedings could be initiated either by the debtor or by the creditor. In most bankruptcy legislations rehabilitation proceeding could be initiated not only by the debtor but also by the creditor. Initiation power is given to the creditor with the objective to provide the opportunity for creditors to enhance the value of their claim through the rehabilitation of the enterprise. The U.S. bankruptcy law encourages saving of enterprises by maximizing the assets of creditors.²²⁸ The Ethiopian bankruptcy law on the other hand has adopted the same criteria for both insolvency and composition agreement proceedings. This is because the composition agreement could propose after the debtor is adjudicated bankrupt and the creditors have filed their claims.²²⁹ Initiation of schemes of arrangements could be made where a trader is about to make suspension of payment or has suspended payment. The application to the court should be accompanied by the documents that should be annexed for the application of insolvency proceedings and a report as to the state of the enterprise. The report should give the reasons for the suspension or impending suspension of payments and the schemes of arrangements to pay the debt.²³⁰

Un like the criteria adopted by the Ethiopian bankruptcy law modern rehabilitation commencement criteria of rehabilitation proceeding should establish a framework that will encourage enterprises with financial difficulty to enter into the proceeding at the earliest possible time, in order

²²⁷ International Monetary Fund, *Orderly and Effective Producers*, 1999 p. 39

²²⁸ Posner Richard, *Corporate Bankruptcy Economic and Legal Perspective*, Cambridge, University Press, Cambridge, 1996 p.470

²²⁹ *Commercial Code of Ethiopia*, Negarit Gezeta Extra-ordinary Issue No 3 of 1960 Addis Abeba, 1960 Art. 1081

²³⁰ *Civil Code of Ethiopia*, Negarit Gazeta Extra Ordinary No.165 of 1960 Addis Abeba Art. 1120

to address their financial difficulties. An early rehabilitation proceeding can be encouraged by providing incentives such as giving the power of control to the debtor and imposing penalties for late filing or not filing on the management. The criteria, in jurisdiction such as US does not require any substantive criteria, the debtor can apply at any time whenever it wishes.²³¹ In other jurisdiction such as Germany, the criteria imminent insolvency is used.²³² In any case the criteria used are less than illiquidity to encourage initiation at the earliest financial difficulty and increase the chance of rehabilitation.

However, such a relaxed commencement criteria may encourage debtor's to use the procedure to shelter the enterprise from its legal or contractual obligations. The criteria of prospective financial difficulty could be difficult to assess by creditors for lack of adequate information. To overcome the difficulty of setting appropriate criteria for the commencement rehabilitation procedure, some jurisdictions have opted for a unitary approach by adopting the criteria of general cessation of payment for both insolvency and rehabilitation procedure. On the other hand others countries have adopted a separate commencement criteria for liquidation and rehabilitation procedures. The existing Commercial Code bankruptcy provisions have adopted a unitary approach for bankruptcy and composition arrangement and a similar approach could be used to open an early rehabilitation proceeding. The criteria for opening reorganization proceeding could be made on the basis of imminent insolvency rather than making like that of the US approach open to the management without any criteria.

²³¹ King Lawrence, *Creditors' Rights Debtors' Protection and Bankruptcy*, Matthew & Bender 1997 p.

665

²³² Vallens, p.8 and World Bank, 2001, p. 8

4.3. Consequences of Commencement

The purpose of re-organization proceeding is to rehabilitate enterprises in financial difficulties and turn them into viable entities. To make an enterprise viable it is necessary to avoid a pre-mature dismemberment of the enterprise. The commencement of rehabilitation proceedings unlike that of insolvency does not transfer the control of the debtor's asset to an independent liquidator. In case of re-organization proceedings the debtor under the supervision of the liquidator could be allowed to remain in control of the enterprise.

The Ethiopian bankruptcy provisions on composition and schemes of arrangement enables, in case of bankruptcy for the suspension of on going winding up proceedings and in case of schemes of arrangement for the enforcement of stay of execution of individual proceedings. However the approval of composition and schemes of arrangement is not binding on all creditors as formulated in Arts. 1089 and 1131 of the Commercial Code. The effect of confirmation of composition agreement results in accordance with Article 1089:

- (1) Confirmation of the composition shall be binding on all creditors other than those holding security in rem, which they have not relinquished and unsecured creditors whose claims have arisen during the bankruptcy proceedings.
- (2) Confirmation shall not affect the creditors' mortgage on the debtor's immovable property registered in the name of the estate under art. 1006 and the mortgage registered on the business in the name of the estate under Art. 1007, unless the composition otherwise provides. To this effect the trustees shall register the judgment confirming the composition with the competent authority.

- (3) The composition shall not affect the creditors' rights in respect of persons jointly and severally liable with the debtor.

The stay provided for composition of agreement is not binding on all creditors. Firstly the stay does not affect secured creditors who are holding security in rem unless such a creditors have relinquished their right. Secondly un-secured creditors whose claims have arisen during the proceeding are not included in the stay of claims. Thirdly stay does not apply to mortgage creditors. Lastly, jointly and severally liable people are not covered by the application of stay in a composition agreement. Hence the composition provisions are good as debt collection mechanisms and could not serve the purpose of transforming enterprises in financial difficulties to be viable ones. Allowing all these claims to continue being enforced would allow the dismemberment of the enterprise under the proceeding before it is being rehabilitated. The confirmation of schemes of arrangement in accordance with Art. 1131, similarly does not result in complete application of stay to the enterprise under rehabilitation. Article 1131 of the Commercial Code allows:

- (1) After the application has been made and until final confirmation of the scheme no creditor holding a claim arising prior to judgment may detract, acquire a preferred right over the debtor's property or register a mortgage.
- (2) Prescriptions, preemptions and forfeitures shall be suspended.
- (3) Unsecured debts enjoying no preferred rights shall be deemed to be due but interest shall be suspended as regards the creditors.
- (4) Amounts due in respect of taxes are not subject to the provisions of this Article.

Secured creditors are not allowed to participate and vote in the schemes of arrangements unless they surrender at least one third of their full value of

debt.²³³ Stay of enforcement of claims is applicable to all prior judgment, claims to acquire preferred right, except tax. Again proceeding of schemes of arrangement could not serve the modern purpose of rehabilitation of enterprises in financial difficulties without being dismembered. Hence the Ethiopian bankruptcy laws should balance the goal of rehabilitating an enterprise and the right of secured creditors. Secured creditors have a right to the assets in which they have a security interest whenever the firm defaults. However, in order for the firm to re-organize it must retain its assets, which are essential to its operation. Hence, there is a conflict between the interest of secured creditors and the goal of re-organization. In order to facilitate re-organization it is necessary to allow managers to have the power to override the rights of secured creditors at least temporarily.²³⁴

In the United States, the automatic stay is applied to secured creditors where the reorganization proceeding is carried out. The only restriction to overriding the rights of secured creditors is that the administrator must provide them with adequate protection.²³⁵ France also applies the automatic stay to secured creditors in re-organization. Germany does not, while Britain stays secured creditors under administration order but not under receivership.²³⁶ The application of stay during reorganization proceedings helps to encourage the management to file early in the financial difficulties of enterprises in order to get the benefit of stay from the proceedings. Even if stay post-phones the credit collection power of creditors, the rehabilitation is designed to maximize the value of creditor's

²³³ Commercial Code of Ethiopia, Negarit Gezeta Extra-ordinary Issue No 3 of 1960 Addis Abeba, 1960 Art. 1140(2)

²³⁴ Posner Richard, Corporate Bankruptcy Economic and Legal Perspective, Cambridge, University Press, Cambridge, 1996 p.474

²³⁵ King Lawrence, Creditors' Rights Debtors' Protection and Bankruptcy, Matthew & Bender 1997 p. 873-875

²³⁶ Posner Richard, Corporate Bankruptcy Economic and Legal Perspective, Cambridge, University Press, Cambridge, 1996 p.474

claims by maximization of the value of the assets and turning the enterprise viable. Therefore this paper is of the opinion that stay should be introduced in the rehabilitation proceeding of Ethiopian bankruptcy law at least on the condition that the rehabilitation is carried out in accordance with the reorganization plan and the possibility of successful rehabilitation could be undertaken.

4.4. Control of the Enterprise and Re-organization Plan

The commencement of liquidation proceeding, the debtor is normally removed from the operation of the business. However, there is considerable debate whether the removal of the debtor is appropriate in rehabilitation procedure. The displacement of the debtor from the management of the enterprise would undermine any incentive for the debtor to voluntarily make use of the procedure. In some cases, the incumbent management have the best understanding of the business; hence removal of such a management could undermine the possibility of rehabilitation.

There are two basic approaches with regard to the issue of debtor's participation in the rehabilitation procedure. The first approach is the concept of "*debtor in possession*" in which the debtor remains in full control during the rehabilitation procedure. The second alternative approach is the "*power sharing*" arrangement between the debtor and the administrator. This approach aims to control any abuse by the debtor, to use the system solely to delay the inevitable or undermine the rehabilitation process by fraudulent transfers. The alternative approach is to allow the debtor to continue the operation of the enterprise on a day-by-day basis under the supervision of the court appointed administrator. This approach overcomes possible abuses that may come from the debtor and protects creditors by providing substantial information through the administrator.

The debtor, in some cases, is in the best position to understand the causes of the financial difficulties and possibly how to overcome them. Apart from the informational advantages the debtor is the person who can initiate the proceeding at the earliest possible date. In order to give incentives to the debtor to make use of the rehabilitation procedure it would be prudent to give the debtor the first chance to prepare the rehabilitation plan. Providing second chance to the debtor also foster the development of an entrepreneurial class for the country. The U.S. bankruptcy law provides an exclusive right for the first 120 days to propose the plan and an additional sixty days to adopt it. In addition the law provides for the judge to extend this period indefinitely.²³⁷

In France the bankruptcy law is intended to explicitly save failing firms. Its primary objectives are designed to safeguard the business and maintain the firms operation and discharging liabilities. In France upon the filing for bankruptcy, the judge appoints an outside official who represents the interest of the state rather than creditors. The period of observation, which extends from six to eighteen months the court may order the manager to remain under outside supervision or replaced by another management. In Britain the re-organization plan which is called administration order, aims at encouraging the reorganization of failing firms.²³⁸ Under Ethiopian bankruptcy law the confirmation of composition is followed by the appointment of the commissioner and a trustee who carry out the agreements in accordance with the detailed instruction contained in the judgment confirming composition.²³⁹ In case of schemes

²³⁷ Posner Richard, Corporate Bankruptcy Economic and Legal Perspective, Cambridge, University Press, Cambridge, 1996 p.475

²³⁸ Ibid. p. 475-476

²³⁹ Commercial Code of Ethiopia, Negarit Gezeta Extra-ordinary Issue No 3 of 1960 Addia Abeba, 1960 Art. 1088 (1)

of arrangement the debtor implement under the supervision of the commissioner.²⁴⁰ This paper is of the opinion that in the rehabilitation proceedings the debtor should remain in possession to encourage the use of the proceedings and produce an entrepreneur class.

The second issue in the rehabilitation proceedings pertains to the preparation of rehabilitation plan. There are difference approaches with regard the issue: the preparation of the plan be left to debtor only or should others also be allowed to participate in the process? There are two different approaches in this regard, the first one is the debtor should be given the exclusive opportunity to propose a plan while the second approach is to provide the debtor with an initial period in which it has the exclusive privilege to propose a plan and at the expiration of this period, the creditors may also propose a plan. Between the two approaches the latter alternative is beneficial to increase creditor's confidence, and especially assist the court in countries where the judiciary is weak. In practice the mere possibility of a creditor plan will encourage the debtor to quickly propose a plan that has a reasonable chance of getting creditor support.²⁴¹ In light of the advantages of allowing creditors to participate in making a second alternative reorganization plan this paper is of the opinion that Ethiopian bankruptcy law should follow the second approach and provide the creditor with the right to propose the reorganization plan.

Apart from the approval of the plan and the application of stay, to ensure the successful rehabilitation the enterprise the assets of secured claims would in many instances be vital. The exclusion of these assets or the exercise of the right of collateral attachment may be prejudicial to the success of the plan. Hence the stay must also include secured creditors

²⁴⁰ Ibid. Art. 1151

²⁴¹ International Monetary Fund, Orderly and Effective Producers, 1999 p. 45

with the appropriate protective measures.²⁴² Therefore, the law must provide for all classes of creditors to vote on the plan. In order to allow secured creditors to vote on the plan the rights of secured creditors in Art. 1140 (b) and 1083 (3) of the Ethiopian Commercial Code should be removed. The voting power of creditors could be determined by the amount of credit each party has extended to the debtor. The main purpose of classifying the claims into classes is to provide fair and equal treatment to creditors. Classifying also enables to ensure creditors holding priority or preference claims by treating them in accordance with the established priority under the law. The voting right must be based on the amount of debt rather than the number of creditors. However in order to protect creditors with small claims a hybrid test of class and qualified majority of the total debt could be employed.

There are two stages in the approval of a rehabilitation plan. The first is the approval by a majority of creditors at a creditors' meeting. The second one is approval by the court. A court order approving the plan has the binding effect in the rights and remedies established by the plan including those creditors who did not vote for the plan.²⁴³ The law and the plan should provide a means for monitoring the implementation of the plan. The debtor should make periodic report to the court on the status of implementation and progress during the period to the court. The law must also provide for a discharge or for the amendment and alteration or the plan.

4.5. Pre-Insolvency Workout

The most conducive environment for informal workouts is to have an effective insolvency and enforcement regimes in the bankruptcy law. The

²⁴² International Monetary Fund, *Orderly and Effective Producers*, 1999 p. 48

²⁴³ World Bank, *Principles and guidelines for Effective Insolvency and creditors Rights System*, Apr.2001.p.51

OHADA Uniform Act define the pre insolvency workout procedure as a preventive settlement, *a procedure designed to avert insolvency or a cessation of activity, and to permit the clearing of debts by means of a composition agreement (concordat preventif)*.²⁴⁴ Informal workouts that take place in the "*shadow of the law*" are considered as a consensual individual debt collection mechanism. Such workouts could be effective, where there is a legal framework that can accommodate the restructuring plan such as allowing debt-equity swaps, forgiveness of bank debt, the taking of collateral, restricting the business, which can be enforced if necessary by court order.²⁴⁵

The informal workout process essentially involves bringing together the debtor and at least the main creditors. Though the process is voluntary ones, the law could encourage such a dialogue, when requested by a creditor or a debtor; and the refusal can be made a ground for a formal insolvency proceeding to be perused.²⁴⁶ In practice informal workouts are popular because the process is flexible and less rigid less prone to unwanted publicity and speculation. In particular, corporate financial difficulties could be averted by an early and active involvement of key creditors like banks and financial institutions.²⁴⁷ In light of the multi faceted beneficial effects of this mechanism this paper is of the opinion that the Ethiopian bankruptcy law should provide for pre-insolvency workout proceedings.

²⁴⁴ Bores Mortal, *Business Law In Africa OHADA and the Harmonization Process*, Korgan page London, 2002

²⁴⁵ World Bank, *Principles and guidelines for Effective Insolvency and creditors Rights System*, Apr.2001.p. 53

²⁴⁶ Ibid. p. 54

²⁴⁷ Ibid.

CHAPRER FIVE

CONCLUSION

The Ethiopian bankruptcy law, though adopted in 1960, was based on the 1914 UK Bankruptcy Act rather than that of the 1948 UK Company Insolvency Law, which was a recent one at the time. The decision to model the laws on earlier UK laws seems with the intention to benefit from the simplicity of the system. However, the Ethiopian bankruptcy laws started at a lower level of development from the jurisprudence of bankruptcy law of the period. Recent experience in East Asia has shown that the absence of an orderly and effective insolvency proceeding can exacerbate economic and financial crisis. When we consider the Ethiopian bankruptcy provisions of the Commercial Code it does not even meet the requirements of the 1960's rather than a modern market economy of the 21st Century.

The Federal Democratic Republic of Ethiopia has based its economic policy on market economy and free competition. The government has opted to support enterprises that could strongly compete in a market economy. In order to foster free competition and a market economy the government has forbidden subsidize that could distort free market and curtail competition. The policy decision to uphold market economy and free competition is also supported by legislations that promote free competition and curtail anti-free competition activities such as Proclamation No. 329/ 2003. The policy decision of the government and the Proclamation that support free competition needs an insolvency legislation based on competition and continuous structural change according to the life-cycles of companies. Hence there is a need to modernize the bankruptcy laws of Ethiopia.

The objective of traditional insolvency law was primarily a debt collection mechanism for creditors. Modern bankruptcy or insolvency laws are given broader social and economic objectives than traditional bankruptcy laws. Insolvency legislations in the modern era are needed to support a modern economic process based on competition and continuous structural change according to the life-cycles companies. An efficient and effective bankruptcy law also fosters discipline and honesty in financial and legal management of enterprises. Bankruptcy system could also facilitate the rehabilitation or the orderly market exit of enterprises that are inefficient and it also protect the rights of creditors and employees. In a nutshell modern insolvency legislations aim at a solid and transparent domestic insolvency law that gives both local and foreign investors confidence in those rules that govern economic competition that stimulate investment, strengthen economic performance.

The bankruptcy system should also facilitate the rehabilitation or the orderly market exit of enterprises that are inefficient. It also protects the rights of third parties such as employees. A modern insolvency legislations should aim at a transparent domestic insolvency law that gives both local and foreign investors confidence in the rules that govern economic competition that stimulate investment, strengthen economic performance is a necessity for the success of a market economy based on free competition. The bankruptcy law serves the additional objectives by making the risk allocation predictable and certain and making the proceedings maximizes the assets rather than dismantle the estate prematurely.

The current bankruptcy law of Ethiopia is only applicable to traders. Traders under Ethiopian law are those who carry out acts of trade enumerated under Article 5 of the Commercial Code. A trader should carry the act of trade professionally and for gain. The only business that is

excluded from the definition of trader is joint ventures, which does not have legal personality under Ethiopian law. The definition of the Code also excludes bodies corporate under public law such as the federal state and local government entities and administrative and religious institutions and any public undertaking from the scope of the Commercial Code and bankruptcy proceedings. Therefore acts of trade carried under such entities are excluded from the scope of bankruptcy proceedings.

The position of the Commercial Code, also lack clarity on whether public enterprises are covered under bankruptcy proceedings or not? Since public undertakings are not covered by the commercial code it could be argued that bankruptcy laws of Ethiopia should not govern public enterprises. On the other hand some public enterprises are registered, as traders with the ministry of trade and industry hence are traders. Therefore it could be argued that public enterprises are subject of bankruptcy law. Secondly financial institutions such as banks and insurance are companies governed by the commercial code. Although financial institutions are publicly regulated entities the Code have allowed them to directly enter into the normal bankruptcy proceeding. However insolvency of financial institutions such as bank affects the saving of its customers and the economy at large. The insolvency of insurance companies affects the credit system at large. Due to the special nature of financial institutions and public interest such institutions are excluded from the normal bankruptcy and are governed by special law. The Ethiopian bankruptcy law failed to make public interest considerations in this regard. Lastly the individual debtor and the consumer debtor are totally excluded from the scope of bankruptcy proceedings, though the individual has become the beneficiary of the credit facilities of the modern world.



The Ethiopian bankruptcy law on the one hand excluded some of the participants in the economy from the definition of trade. By so doing it failed to create a level play field for the economy. The exclusion of the individual from the scope of bankruptcy would also create difficulty to tackle the insolvency of the individual consumer. On the other hand allowing financial institution to enter the normal bankruptcy proceedings would create would create instability rather than stability. Therefore there is a need to modernize the scope of application of the Ethiopian bankruptcy laws in order to make them predictable and serve the goal of value maximization.

The Ethiopian Commercial Code Article 970 (1) states that bankruptcy does not result from mere suspension of payment.” The two cumulative conditions for the existence of bankruptcy are suspension of payment and adjudication of being bankrupt by the court. Secondly the suspension must be the result of business activity and not of a personal nature. After establishing such a relationship the existence of suspension of payment could be proved either by documents or a fact or as an act. The law is clear as what documents could be produced to prove bankruptcy, however it is not clear as to the alternative facts or acts that could be used to prove bankruptcy. Apart from technical insolvency the court has also the power in accordance with Article 970 of the Commercial Code to adjudicate the debtor in connection with an offence connected with bankruptcy even where the debtor has not suspended payment. Therefore the existing suspension of payment criteria lack clarity and predictability to make the proceedings effective, efficient and transparent.

Modern insolvency law in order to overcome the difficulty seen in the present Ethiopian bankruptcy law has employed criteria such as liquidity of the company and the balance sheet test. The success of the

balance sheet test to determine insolvency is dependent on the country's accounting system. Where the accounts of enterprises are reliable and show the true affairs of the company, the criteria serve as reliable criteria to determine insolvency. However the development of the accounting system in Ethiopia is at a lower level of development hence it is not yet reliable. Apart from its unreliability many enterprises do not keep proper books of accounts. Therefore this option could not be the basis of insolvency in Ethiopia. The second alternative is the liquidity test criteria, which is based on suspension of payment. This system only needs determining the amount of "payable debt" and "available asset". Hence the suspension of payment criteria is more appropriate to prove and easy to implement by the courts. Hence this paper is of the opinion that the existing suspension of payment should be replaced with the liquidity criteria.

Insolvency is initiated either by the debtor or creditor. Apart from the debtor and creditors insolvency could be initiated by special government agencies such as the court, public prosecutor or an other agency. Where insolvency is initiated by government agencies liquidity may not be the only cause, though it could be one of the bases for their initiations. Such authorities may also initiate against enterprises that engage in criminal or fraudulent activities. Hence, where government authorities like the Ethiopian bankruptcy law court or public prosecutor are allowed to initiate insolvency proceedings other than technical insolvency there is a possibility for abuse. Therefore, there is a need either to abolish the power of the court and the public prosecutor to initiate insolvency or to make sure that the authorities entrusted with such power exercise their authority in accordance with clear guidelines. This paper is of the opinion that government agencies such as the court, the public prosecutor or the National Bank be allowed in the interest of the public to initiate

bankruptcy, however there should be clear guideline for the initiation of insolvency by government agencies.

Rehabilitation proceedings could be initiated either by the debtor or by the creditor. In most bankruptcy legislations rehabilitation proceeding could be initiated not only by the debtor but also by the creditor. Initiation power is given to the creditor with the objective to provide the opportunity for creditors to enhance the value of their claim through the rehabilitation of the enterprise. In contrast the Ethiopian bankruptcy law in Article 1081 of the Commercial Code has adopted the same criteria for both of insolvency and composition agreement proceedings. This is because the composition agreement could propose after the debtor is adjudicated bankrupt and the creditors have filed their claims. Initiation of schemes of arrangements in accordance with Article 1120 of the Commercial Code could be made where a trader is about to make suspension of payment or has suspended payment. Therefore in order to give creditors the opportunity to initiate rehabilitation procedure to modernization of the bankruptcy law should allow not only initiation of the debtor but also the creditor too.

Liquidation is a procedure to maximize the assets of the debtor in the interest of all interested parties. Insolvency as a collective procedure could not be necessarily compatible with the interest of the individual creditor. Therefore in order to stop the action of individual creditor from seizing the assets of the debtor and avoid forced "fire sale" stay is enforced. In almost all jurisdictions "stay" is enforced against un-secured creditors. Stay is also applied to secured creditors for a limited period. However extending stay to secured creditors give rise to a number of difficulties including the decline in the value of their security in order to prevent secured creditors from dismembering prematurely and to maximize the estate.

The scope of the stay extends to enforcement of judgments, pending lawsuits, foreclosure of security interest, perfection of mortgages and demand of payments. The Commercial Code of Ethiopian Article 1025 accepts the universality of creditors in bankruptcy. The judgment in bankruptcy shall prevent any creditor whose claim is included in the universality from bringing individual suit. Such creditor may not attach the debtor's property whether movable or immovable. However the Ethiopian bankruptcy law stay provision Article 1025 does apply to all creditors whose claims are not secured by a special privilege, a pledge or a mortgage. Ethiopian bankruptcy law by allowing the realization of a claim on a collateral without any stay upholds pre-bankruptcy contractual bargains, hence upholding the principle of predictability. However such a position has an adverse effect on the maximization of the value of the debtor estate. This position of the law is particularly prejudicial in case of reorganization proceedings and where disposing of the asset as a going on concern is more beneficial to all secured creditors. Therefore the exclusion of secured creditors will result in forced sell of the enterprise without maximization would defeat the goals of insolvency.

This pro- secured creditor position of the Code would frustrate reorganization proceedings and attempt to sell the enterprise as a going on concern in solvency proceedings. Therefore, the stay under Ethiopian bankruptcy law should be broadened to include secured creditors, at least temporarily so as to achieve the goal of maximization of the value of the estate. Therefore, the law must provide for all classes of creditors to vote on the plan. In order to allow secured creditors to vote on the plan the rights of secured creditors in Art. 1140 (b) and 1083 (3) of the Ethiopian Commercial Code should be removed.

The voting power of creditors could be determined by the amount of credit each party has extended to the debtor. The main purpose of classifying the claims into classes is to provide fair and equal treatment to creditors. Classifying also enables to ensure creditors holding priority or preference claims by treating them in accordance with the established priority under the law. The voting right must be based on the amount of debt rather than the number of creditors. However in order to protect creditors with small claims the Ethiopian bankruptcy law could adopt a hybrid test of class and qualified majority of the total debt.

The power to avoid pre-bankruptcy transaction and wrongful transactions is common in almost all insolvency laws. Some transactions, which were rightfully concluded by the parties but due to the insolvency of the debtor continuation of such contracts, become a burden rather than a benefit. Hence such contracts are made voidable. There are also wrongful contracts, which are either preferential or fraudulent. Such contracts distort the principle of equal treatment of all creditors of the same class. Therefore there is a need to make them voidable. The Ethiopian bankruptcy law in Article 1029 of the Commercial Code allows the invalidation of gratuitous assignments, where payments of debts not due, where carried in cash by assignment, sale, set-off or otherwise. In respect of payments of debts due, made otherwise than in cash such as negotiable instrument or by transfer to a bank could be invalidated. With regard to securities set up on the property of the debtor in respect of debts contracted before the setting up of such securities could be invalidated. Even though the power to invalidate preferential and fraudulent contracts is accepted under current Ethiopian bankruptcy provisions, the provisions lack clarity and systematization and it is not clear whether the right to invalidate continuing pre- bankruptcy contracts is allowed in the interest of maximization of the value of the

estate. The only exceptions are those expressly provided such as where the parties have received payment or have dealt with the debtor knowing that the suspension of payments had taken place or the power to terminate or continue lease agreements in the interest of the estate and goods the sale of which has been cancelled prior to adjudication either by a decision of the court or by operation of the terms of the contract, may, if they exist in kind, be recovered from the debtor. Therefore there is a need to clearly define what types of contracts should be made voidable under Ethiopian bankruptcy law.

The Ethiopian bankruptcy proceedings starts by appointing an investigating judge and where necessary a trustee. The introduction of the French investigating judge rather than UK receiver or commissioner is a deviation from the model law. The French system allows the judge to appoint an outside official who represents the interest of the state rather than creditors. Ethiopian bankruptcy law by allowing ~~by allowing~~ an investigating judge rather than a trustee to carry out the investigation takes public interest seriously. However judges usually lack professional qualification to investigate business difficulties and insolvencies. The law by providing the assistance of a trustee in the investigation carried by the judge makes the system costly and inefficient. Apart from the unnecessary load the system has created the investigating judge is expected to transfer his duties to the commissioner. Hence this arrangement makes the system to lack continuity and possibly lose the benefit that may be gained from the expertise of the commissioner in business and financial difficulties. Therefore there is a need to make the system more efficient by directly appointing an outside official the interest of creditors rather than the state i.e. the commissioner.

The appointment of an independent liquidator, the commissioner in accordance with Ethiopian law is used to maximize the value of the assets of the estate. The liquidator is not only a bankruptcy professional but also a professional with the necessary skill in the management of enterprises in difficulties. A liquidator with broad powers and the necessary skill in business management enables the temporary continuation of the enterprise and creates the necessary condition for the rehabilitation of the enterprise. Confidence in the integrity and professional efficiency of the liquidator creates an incentive for creditors to provide financing through priority for post petition financing of enterprises under proceedings.

The power of the liquidator should always be checked and monitored by the creditors and the court. Ethiopian bankruptcy law provides for the appointment of a committee of creditors who may serve as inspectors to the commissioner. The creditors' committee shall be appointed not later than ten days after the deposit of the order showing the list of creditors to the court. However, the committee is only appointed where the commissioner thinks it is desirable to have such a committee whose chairman is nominated by the commissioner. The court replaces the members of the committee, on their request or the proposal of the commissioner. The main function of the committee is to give its advice where such is required by law or requested by the court or the commissioner. Therefore, Ethiopian bankruptcy law reduced the status of the committee without any substantial power that may function only upon the whims of the commissioner and the court. Hence the creditor under Ethiopian bankruptcy has almost no direct say or control on the process, which should be corrected.

The trustee under Ethiopian law is required by law to be appointed from the list prepared by the Ministry of Trade and Industry, the Ministry has not prepared such a list and the courts appoints the trustee directly. The

U.K. Bankruptcy Act requirement for the trustee to be approved by the Ministry upon presentation of a security for proper discharge of his duties is also missing. This serious shortcoming makes the system less transparent and makes the trustee without any mechanism to force proper discharge except that of civil and criminal prosecution after the fact. Therefore the law did not provide adequate protection for the estate and the proper discharge of the duties of the trustee, hence it should require the trustee to provide adequate guarantee for proper performance and discharge of his duties.

The goal of insolvency proceeding is to maximize the value of the estate and liquidate the assets and distribute it to creditors. To achieve this goal it requires creditors who wish to participate in the estate of a bankrupt debtor to file proof of their claim within a certain period. Every creditor whose claim is allowed by the trustee or proved by a court of law can participate in the distribution of the assets of the bankrupt estate. Only unsecured creditors are required to file proof of claim. A secured creditor need not file proof of claim unless the value of the collateral is less than the debt and proof is required for the recovery of the deficiency.

However the priority set by the Ethiopian bankruptcy law did not take into account the goal of maximization of the debtor's estate. Where an enterprise under insolvency is allowed to operate under insolvency creditors whose claim arises out of such operation are only made by Article 1039 (2) of the Commercial Code to be part of the preferred creditors. Hence prejudicing the financing of enterprises under insolvency. In addition to the priority set by the Commercial Code other legislations such as the labor law, the banking law and the tax law have set their respective claim of priority. Hence to avoid this conflicting priority claim, the modernization of the Ethiopian bankruptcy law should set a clear priority

to be followed in insolvency proceedings hence make the law predictable transparent and efficient.

The debtor under Ethiopian bankruptcy law is not subject to arrest unless he fails to obey a lawful decision of a competent authority being duly notified in accordance Article 433 of the Ethiopian Penal Code. However, the debtor is not allowed to leave the area in which he resides without the permission of the commissioner. Where the debtor breaks any such prohibition he is made liable in accordance with the provisions of Article 433 of the 1957 Penal Code. The restriction imposed by the bankruptcy law on the right of free movement of the debtor runs counter to the right of free movement enshrined in Article 32 of the Constitution of the Federal Democratic Republic of Ethiopia and modern business culture, hence should be removed. The right of the individual debtor and his family to get subsistence maintenance is also dependent on the whims of the trustee and the commissioner. Hence the right to subsistence is not yet a right of the debtor under current Ethiopian bankruptcy law rather it is still a favor that may be granted.

One of the main goals of bankruptcy is to provide discharge for an honest debtor. A bankrupt person who has not been guilty of certain dishonest acts and who has fulfilled his duties should be entitled to a discharge. Discharge relieves the bankrupt person from further responsibility from those debts that are dischargeable. This gives the debtor a fresh start. The Ethiopian bankruptcy laws by failing to provide discharge provisions have failed to meet the requirements of one of the goals of modern insolvency laws. Therefore there is a need to provide the appropriate discharge provisions.

In addition to re-organization proceedings bankruptcy laws also provide for an additional pre-insolvency work out procedure. This rehabilitation procedure enables an enterprise in financial difficulties to enter into an informal out of court negotiation with the aim of restructuring debts. Providing out of court amicable settlement procedure without any applicable regulation or legal framework would enable the continuation of the enterprise as an on going concern. Hence the modernization of Ethiopian bankruptcy law should provide for pre insolvency work out mechanism. By so doing it allows an early initiation of the proceeding in an informal way, hence makes the system more efficient and reduce the burden on courts.

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Abstract

Bankruptcy is a Common risk in any business enterprise. It may happen due to normal business failure and the economy in general or due to fraud or mismanagement. Almost all enterprises in the modern world finance their operation through credit. The failure of a business enterprise raises not only the traditional debt collection problem but also the right of third parties such as employees, other business partners and the economy in general.

To tackle the diverse claims of many interest groups modern bankruptcy laws have departed from the traditional purpose of debt collection mechanism to include additional purposes such as giving a fresh start for an honest debtor and rescuing enterprises that could be made viable through reorganization and maximizing the assets of an enterprise in the interest of all stake holders.

The Commercial Code Bankruptcy Provisions were formulated in the 1960's where the main proceedings in bankruptcy were insolvency, composition and schemes of arrangement; the thesis investigated whether these traditional bankruptcy proceedings are compatible with the modern globalized world and a market economy adopted by the country.

The findings of the comparative analysis, case studies and interviews shows that not only the lawyers and the business community are not adequately aware of the benefits of bankruptcy proceedings but also the existing provisions are harsh to the debtor, not suitable to make a court

supervised agreement. Creditors are also with out any power to check the trustee and the commissioner and the application of stay is not adequate enough to maximize the value of the estate. In a nut-shell the existing bankruptcy laws are dying because of not only non-use but also are inadequate to conduct an effective, efficient and transparent bankruptcy proceeding which is essential for a market economy.

thanks

Declaration

This thesis is my original work and has not presented for a degree in any other University and that all sources of material used for the thesis have been duly acknowledged.

This thesis is written under my supervision.

Supervisor

