

SURETY BONDS AND COMPANIES RENDERING BONDING
SERVICES IN ETHIOPIA: THE LAW
AND
THE PRACTICE

BY
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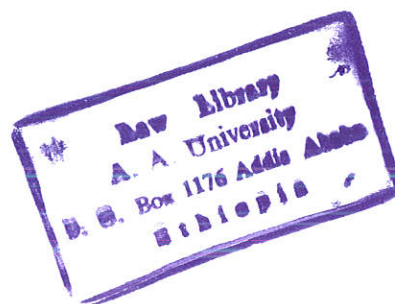
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ABSTRACT

A bond is a written acknowledgment of debt or an instrument of indebtedness. Bonds are of different types. The bond that is issued by a surety is called surety bond to distinguish it from the other types of bonds. A surety bond is a document in which a surety (an individual or a company) undertakes an obligation towards a creditor to discharge the obligation of the principal debtor should the latter fail to do so. In other words a surety bond is a document in which the contract of suretyship is contained.

Companies, which are engaged in the business of surety bonds, are called surety or bonding companies. In other countries, in addition to surety companies, which are specialized in rendering bonding services, banks and insurance companies also render such services. Here, in Ethiopia, we never had specialized companies, which have been formed purely for rendering bonding services. Until recently, only banks and insurance companies have been engaged in bonding businesses. Since the last two years, however, the National Bank of Ethiopia has prohibited insurance companies from issuing certain types of bonds.

Therefore, the main purpose of this study is to investigate the root causes for the imposition of such prohibition and at the same time find out whether there is a disparity between the law and the practice of rendering bonding services, whether there is the required skill, knowledge and experience of the bonding business in Ethiopia and finally, find out whether the prohibition imposed by the National Bank of Ethiopia is justified or not.

For this purpose, a survey of literatures on contractual security devices both from the common law and the civil law countries has been made. A study tour to some of the head offices of banks and insurance companies has been undertaken. Some bond forms have been scrutinized to find out whether such forms are compatible with the law of suretyship or not.

Finally, in this study, an attempt has been made to show the disparity between the law and the practice of bonding business and a conclusion has been reached that, in general, there is lack of the required skill, knowledge and experience for running the bonding business in Ethiopia, and that the prohibition imposed on insurance companies not to issue certain types of bonds is unfounded and unjustifiable.

CHAPTER ONE

INTRODUCTION

A. INTRODUCTION

It is very difficult to think of development without movements of goods and services from places where they are in abundance to places where they are scarce and most needed. Such movements of goods and services are usually facilitated by commercial activities.

The concept “commerce” is wider than trade. Trade is simply selling and buying, and nothing more. Commerce, on the other hand,, includes what are known as aids to trade, such as banking, insurance, agency and transportation.¹

The origin and development of Commerce is coextensive with the origin and development of civilization. Both commerce and civilization emerged, grew and further developed in the same area that is today known as the Middle East.² From there they spread out in all directions to the rest of the world.

¹M.J. Mathew, Business Organization (1999), pp. 9-14, and N. Vinayakam, et al, A Text Book of Business Organization (1986), pp. 9-12.

²J.C. Bahl, et al, Elements of Commerce And Business Methods (5th ed. 1946, Revised), pp. 1-9.

It is said that, originally, man mainly depended on whatever mother earth could offer. He never tried production of any sort to satisfy his material needs.

With the passage of time, however, when he began settling down along riverbanks, on the sides of lakes and seashores, he learned fishing and agriculture.³ It was through these and similar other specialized occupations that men were able to produce surplus products. Surplus products in turn brought about an exchange of commodities directly against commodities, what was then known as bartering.

No sooner had the barter system begun than it became a bottleneck for the smooth flow of goods and services from one area to the other. It had many shortcomings. Among other things, lack of double coincidence of wants was the major one. The system of bartering required that a person who wished to trade his goods or services should have found another person who was not only willing to exchange these goods or services but also possessing goods or services, which the former was looking for.

Due to this, and some other shortcomings of the bartering system, money was introduced into commercial activities. Money simplified the exchange system by overcoming the drawbacks of the bartering system. The varieties

³ Ibid., p.2

and quantities of goods also went increasing than ever before. Greater specialization of production was also achieved.⁴

However, every step in the development of commerce has been linked to specific problems. Although the use of money simplified the exchange system when compared with the bartering system, it has never, however, provided all solutions to all the problems connected with the movements of goods and services from places where they are in abundance to places where they are most needed. Sometimes, buyer and seller may be at two different geographical locations. In this case, the seller may hesitate to forward the goods before he is sure that he will be paid. The buyer also shows the same hesitation to pay the price before he receives the goods and services. Not only that, even if the two are within the same geographical location, the buyer may not be in a position to pay the price immediately due to the scarcity of money.⁵ It is said that scarcity; among other things is what makes money good money. There are central bodies in every country, which artificially manipulate the supply of money to create scarcity.⁶ It is beyond the scope of this paper to go deep into that.

⁴ M.L. Jhingan, Money, Banking, International Trade & Public Finance (4th ed. 1992), p. 20, and L.W.T. Stafford, Modern Commercial Knowledge (4th ed., 1977) pp. 1-3 and 134.

⁵ Ibid.

⁶ Ibid.

To overcome such inconvenience, credit system was developed and began to be widely used side by side with money in commercial activities. To make things simpler and convenient, and also to instill confidence in the minds of creditors, credit instruments such as cheques, bills of exchange and promissory devices such as real security (movable or immovable and tangible or intangible) and personal security (a physical person or corporate body) were set in place. Countries who know how to utilize the credit system with all its credit instruments and security devices properly are the richest in the whole world today.⁷

This study is concerned with one of the above-mentioned securities, which in Anglo-American legal system is known as corporate surety. The corporate surety, in Anglo-American law, is an incorporated body, which has specialized in rendering surety-ship services and engaged in such activity as a business. Of course, banks and insurance companies are also rendering similar services there. Here, in Ethiopia, we have never had specialized companies in this field. Such services have been rendered both by banks and insurance companies. Recently, however, the National Bank of Ethiopia with regard to such services has imposed certain restrictions on insurance companies.

⁷ Kevin Patrick McGuinness, The Law of Guarantee: A Treatise On Guarantee, Indemnity and the Standby Letter of Credit (1985), p.5.

Therefore, this study mainly concentrates on examining the law and the practice of rendering bonding services in Ethiopia, and the root causes that prompted the National Bank of Ethiopia to prohibit insurance companies from rendering these services.

B. THE STUDY

1. STUDY SAMPLES

As it has already been said earlier in the introduction of this paper, there are no specialized surety companies (bonding companies) in Ethiopia, which have been formed purely to deal with businesses of rendering bonding services. Surety bonds have been and are still being issued by banks and insurance companies in the country.

Banks and insurance companies have been experiencing many ups and downs during the last forty- four years since the promulgation of the Commercial Code of Ethiopia in 1960. On the eve of the 1974 Ethiopian Revolution, there were three private banks, three financial institutions and about fourteen insurance companies in this country. All of them were nationalized during the early period of the revolution. During the whole period of the revolution and until the time when EPRDF came to power in 1991, there had been only one commercial bank (the Commercial Bank of Ethiopia) and one insurance company (the Ethiopian Insurance

Corporation). Only these two financial institutions had carried everything out.

After EPRDF came to power in 1991, however, banks, insurance companies and other financial institutions had sprung up like mushrooms. At present, there are about eight commercial banks, nine insurance companies and twenty-two micro-financing institutions in the country.

Almost all these banks and insurance companies have their head offices in Addis Ababa. A number of them have also branches here in the city. Few of them have branches in various Regional States throughout the country. This study, however, is intended to cover and concentrate on those branches of banks and insurance companies that are found within the Addis Ababa City Administration.

Originally, when the proposal for this study was submitted, there was an intention to divide the period after the promulgation of the first Commercial Code of Ethiopia into three for the purpose of this study. However, with such scant information about the times of Emperor Haile Selassie and Dergue with respect to banking and insurance activities, it is really impossible to give sufficient highlight of the practice of bonding services at that time. Due to this fact, this study is limited in time and space, that is it

covers only the post-Dergue period and the study samples are only those banks and insurance companies that are located here in Addis Ababa.

2. BACKGROUND TO THE PROBLEM

Surety-ship is one of the oldest institutions. In fact it is as old as humanity himself. It is said that it antedates the Christian era by many centuries. Its recorded history is traced back to the Babylonians times somewhere around 2750 B.C., or even earlier. Tablets containing records of the making of surety- ship contracts were found in the Library of Sargon I, king of Accad and Sumer. The Code of Hammurabi, the oldest Code in recorded history, also contained rules relating to the making of contracts of surety-ship.

There are also evidences showing that surety-ship had been widely in use among the Hebrews⁸ (Genesis 43:9, 44:32, Job 17:3 Proverbs 6:1-5, 11:15, 17:18, 20:16) and also among the Persians of the time of Cyrus and Darius.

At the time when the Roman jurist Gaius wrote his Commentaries (around 150 A.D), the Romans had already had a highly developed surety-ship law.

The English translation of the Fetha Nagast (By A. Paulo's Tzadua) also contains provisions relating to Surety-ship contracts.

⁸ Willis D. Morgan, "The History And Economics of Suretyship," The Cornell Law Quarterly, Vol. 12 No. 2 (1927), notes 8 and 11-14, pp. 156-157.

Therefore, *"It is hardly an exaggeration to say that the need which suretyship was conceived to meet is common to humanity, as old as humanity"*⁹ [

All those that have been mentioned hereinabove show that the universality and also the antiquity of suretyship. However, despite its universality in usage and also its antiquity in time, it had taken quite a long time until it finally emerged in corporate form.

The first corporate surety in history emerged in England following an announcement that had been made in the London Daily Post published on June 10, 1720. That company was formed to insure fidelity of employees. However, it had not operated for a long time. It collapsed soon after its formation. It had taken many years then after until another surety company engaged in the business of writing fidelity insurance on a commercial basis was formed in England again. Therefore, no further progress had been made in this area since the collapse of the first surety company until finally another surety company came in to existence in 1840 to insure fidelity of employees.

In the United States, the first such surety company appeared in 1883 when the legislature of New York authorized the incorporation of fidelity Companies. Following that, until the year 1900 alone quite a number of

⁹ T. Hewitson, Suretyship: Its Origin and History In Outline (1927), p.1.

surety companies had been established in different parts of the United States.

A Survey made in 1927 confirmed that there were 70 surety companies in Great Britain, 35 in the United States, 2 in Canada, 2 or 3 in Switzerland, 1 or 2 in Germany, 1 in Denmark, 1 in Sweden, 1 in Spain (Barcelona), 1 in Johannesburg (South Africa), 2 in Japan, 1 in Mexico and 1 in Argentina.¹⁰

That was how corporate Sureties sprung up like mushrooms one after another in those countries pursuing free-market economy. It was not without reason that all those countries resorted to the formation of such companies. Corporate sureties have got many advantages when compared with other securities. The advantages of corporate sureties will be discussed later in this.

The paramount importance of surety-ship as a security device in modern business transaction is very obvious.

Indeed, the economy of the entire Western World has for many years been dependent upon the extensive availability of credit. Because credit is so central to the economic health of the nation, the various laws that impart upon creditors have a significant influence upon

¹⁰ Morgan, cited above at note 8, pp. 487-499.

economic health. In general, those laws that promote the extension of credit will tend to promote economic expansion, or at least the continuance of a state of economic good health.

Consideration of inflation aside, those laws that tend to impair the availability of credit will tend to stymie further economic growth, and will perhaps even undermine pre-existing economic conditions. The law relating to guarantees and other engagements of similar nature is one branch of the law that clearly has significance upon the rights of creditors and thus the flow of credit. Accordingly the study of the law relating to guarantee transaction is interesting from both a legal and economic perspective¹¹.

The above statement makes it clear why countries pursuing capitalist path of development make sure that all possible security devices including bonding companies are available for use by the business community.

When it comes to Ethiopia, as it has already been said earlier, there has never been and still, there is no even a single company, which has

¹¹ McGuinness, cited above at note 7.

specialized in rendering bonding services. The reasons may be that during the emperor's time, the county was mainly agrarian. Modern type of business had been at its infancy at that time. And during the Dergue era, the country was following socialist path of development. The major economic activities in the country were totally controlled by the state. The use of bonding companies was unthinkable under such circumstances.

After the county started embarking on free-market economic system, during the past thirteen years, the newly emerged business enterprises started relying mainly on insurance companies for bonding services. Nowadays, even insurance companies have been prohibited not to issue surety bonds first by Directive No. SIB/23/2002 and then, again, by Directive No. SIB/24/2004 issued by the National Bank of Ethiopia. Banks are not directly prohibited from issuing surety bonds. Nonetheless, the bonding services rendered by banks are not adequate enough to satisfy the ever-growing demands for such services. The above-mentioned directives and the anti-corruption campaign have already traumatized the business community.

It is obvious that without surety bonds banks and other creditors may become hesitant to provide credit facilities. Lack of credit facilities certainly has an adverse effect on the movements of goods and services

from places where they are in abundance to places where they are scarce and needed most. As it has already been said earlier, without movements of goods and services, that is, in the absence of exchange of goods and services, development is totally unthinkable.

Credit and surety-ship are the two driving engines of the free-market economic system. Specially, in a country such as ours, that is poverty-stricken, least developed and where land belongs to the state, real and personal securities are not reliable for extending credit facilities. The existence of surety companies or the issuance of surety bonds by insurance companies is indispensable. Many people in Ethiopia believe that the prohibition imposed on insurance companies has already crippled the credit system. The economic situation of the country is very alarming. Instead of taking such drastic measures, it would have been much better to investigate the root causes of the problem that prompted the National Bank of Ethiopia to impose such restriction first. The root causes for the whole problem may be mismanagement, lack of properly functioning legal framework or it may also be lack of knowledge, inexperience or incompetence.

The problem is a nation-wide problem and it is also a serious one. It needs to be studied.

3.OBJECTIVES OF THE STUDY

a. General Objective

The business of modern surety company embraces over five hundred varieties of bonds, of which three hundred are in common use. These, however, may be divided into six great classes: namely, (1) the fidelity bond, (2) bonds for executors, administrators and other fiduciaries, (3) bonds used in court proceedings, as appeal, replevin and attachment bonds, (4) contract bonds, (5) license and permit bonds, and (6) public official bonds¹²

The above statement was written back in 1927. Nowadays, there must be numerous types of surety bonds. Because, there is no theoretical limit to the types of surety bonds which, might be devised. It is the need that determines the type. Be that as it may, however, whatever its type, every type of surety bond plays an important role in the economy of a country.

For instance;

Contract bonds furnish a good example of the valuable services rendered by the surety bond business. Without such bonds being available, many contractors would or

¹² Morgan, cited above at note 8.

could not perform their work. Contract bonds are really credit guarantees and . . . one of the major keystones to his operations . . . they prompt suppliers to extend liberal credit . . . encourage banks to lend money for needed working funds . . . and permit the owner to make partial payment to the contractor with safety while the job is in progress . The value of contract bonds appear in the gigantic size of the more than hundred billion dollar construction industry. Public construction invariably requires a contract bond before bids and contracts are awarded. Such tremendous structures as Houston's Astrodome, Canada's Expo'67 civic centers, highways, bridges, and tunnels could not be attempted without adequate bonds. Private construction needs for such bonds extend far beyond the small residential homebuilder. Apartments, business buildings and other construction works also require millions of dollars of protection to guarantee that work will be successfully completed on schedule, in spite of whether delays, strikes, labor or material shortages, financial dishonesty, equipment failure,

erroneous cost estimates, Subcontract defaults, and many other uncertainties.¹³

The narration deals with only one type of surety bond. One can imagine what role several types of surety bonds can play in the multi aspects of the economy of a county. Directive No SIB/23/2002 and Directive NO. SIB/24/2004 have crippled such an essential vital and indispensable transaction mechanism. Both were issued by the National Bank of Ethiopia one after another.

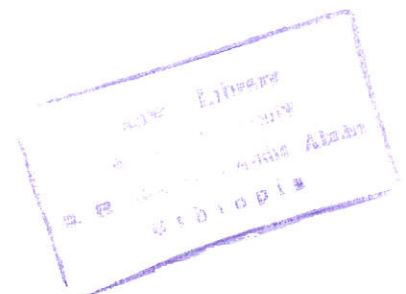
There are official and unofficial reasons given for prohibiting the insurance companies from issuing surety bonds. The general objective of this study, therefore, will be to investigate the root causes for the prohibition of the issuance of surety bonds by insurance companies and find out whether the measures taken by the National Bank of Ethiopia in this regard are justified or not.

b .Specific Objective

The general objective of this study being the above, in the course of the study, an attempt will also be made to achieve the following specific objectives.

1. Give explanation of certain key terms;

¹³ David L. Bickelhaupt, et al, General Insurance (8th ed., 1970), p, 530.



2. Classify the concepts “bond” and “surety bonds”;
3. Make a survey of the historical background of surety bonds and bonding companies;
4. Find out the proper business procedures relevant to bonding applied in other countries;
5. Find out the mechanisms used by surety companies in other countries to protect themselves from financial losses;
6. Make a survey of surety-ship laws of other countries including that of Ethiopia;
7. Compare surety- ship with insurance;
8. Find out how Ethiopian banks and insurance companies provide bonding services,
9. Examine directives issued by the National Bank of Ethiopia in this respect,
10. Find out whether there is disparity between the Ethiopian surety-ship law and the practice of bonding by banks and insurance companies;
11. Examine decided court cases relating to bonding services.

4. METHODOLOGY

A combination of historical, comparative and critical analyses methods of research have been used to arrive at the final conclusion reached. The sources from which information analyzed in the course of the research were

drawn from codes, proclamations, regulations, directives, circulars, books, journals, newspapers, magazines, foreign legislations, cases, opinions of experts and information gathered through personal observation. An extensive library work has been undertaken to collect background information on the subject under consideration. A study tour to banks and insurance companies here in Addis Ababa was also undertaken to consult expert, to make personal observations and to collect directives and circulars.

a. Historical Method

In this study, an attempt was made, as far as possible, to trace back the geneses and further development of suretyship and bonding companies. Such an approach would certainly help the reader appreciate the importance of the role being played by suretyship and bonding companies in the economic development of a country.

b. Comparative Method

As the drafter of the Ethiopian Civil Code indicated in his commentary on the general contract provisions of the said code, he had used the laws of various countries as a reference during the drafting process. Not only that he had even taken certain provisions word by word from other laws. Due to this

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fact, in order to make things more clear, an attempt has been made to comparatively analyze the different laws of suretyship including that of Ethiopia.

c. Critical Method

For the purpose finalizing the research with proper conclusion and recommendation, directives and circulars issued, expert opinions and the existing practice in field of bonding business have been critically analyzed.

5. SIGNIFICANCE OF THE STUDY

There is no need to repeat here what has already been said earlier about the role surety bonds usually play within the world of commerce. Banks, insurance companies, and the business community at large are direct beneficiaries of bonding services. Bonding services facilitate the smooth flow of credits, which in turn facilitate the smooth flow of the movement of goods and services. Such movement of goods and services always brings with it economic development to a country which in turn helps to raise the living standards of its population. The smooth flow of credits also encourages investment. More investment means more job opportunities. Therefore, this means that all citizens of a country also indirectly derive benefit from the availability of a variety of surety bonds.

The prohibition of the issuance of surety bonds by insurance companies has already disrupted the credit system without which the proper functioning of the free-market economic system is unthinkable. That is what western experiences also confirm. As it has already been said earlier, the problem is nation wide. That is why it needs to be studied. This study attempts to address the real and the root causes of the whole problem. The study may help to point out the lessons to be drawn from the experiences of especially western countries. The study will also provide recommendations of proper procedures to be followed in order to minimize loss, whether the legal framework relevant to bonding services is sufficient and effective or not or whether it needs some kind of amendment or not, and how to distinguish surety-ship from insurance.

Therefore, it is possible to say that banks, insurance companies, the business community in general, lawyers who may be called upon to give advice and opinions on the matter and judges who may encounter cases related to bonding services may benefit from the result of this study. In general, this study would have the following contributions.

- a) It may arouse the interest of lawyers and law students who may want to make further studies on the subject.
- b) It may serve as a stepping-stone for further studies.

- c) It may, to a certain extent, contribute to the development of Ethiopian Law of surety -ship.
- d) It may clear up the enigma of the relationship between surety-ship and insurance.
- e) It may serve as reference material for law instructors and students.
- f) It may reveal the weaknesses and shortcomings of companies that had been rendering bonding services in Ethiopia.
- g) It may introduce the experiences of western countries in this regard.
- h) It may reveal the disparity between the law and the actual practice in the area of bonding businesses.

C. EXPLANATION OF KEY TERMS

1. GUARANTEE, GUARANTY, SURETY, AND SURETY- SHIP

*"The study of law may be described as the science of words, for the rights, liabilities and obligations of persons under the law are defined by words, the words used in drafting an agreement which they have entered; the words used in statute that relates to their situation; the words used by the courts in applying the law to particular fact situation. It follows that a key step in the study of any area of the law is to gain a precise understanding of the terminology employed in that area."*¹⁴.

¹⁴ McGuinness, cited above at note 7, p. 21.

Therefore, an attempt shall be made herein to clear up confusions that might crop up while reading American literatures. Unlike the other common law countries, the Americans draw a distinction between the concepts guarantee and surety-ship. In the American legal system, the term guarantee is used to describe a collateral undertaking, which creates a secondary liability, while the term surety-ship is used to describe a direct and independent or original undertaking under which the promisor is primarily and jointly liable with the principal debtor. However, such distinctions are not drawn in all American jurisdictions. There are some states, which do not make such distinctions at all.

The terms guarantee and guaranty are mostly synonymous. The term guarantee is commonly used in England and in most of the commonwealth, while the term guaranty is commonly used in the United States. The term guarantee again may be used either as a verb or as a noun depending on the context in which it is employed. When it is used as a noun, it may be used in different senses. It may describe an undertaking assumed by a promisor, or it may also describe both the promisor and the promisee¹⁵.

 The 1960 Civil Code of Ethiopia uses the term guarantee both as a noun and as a verb (Article 1920 - 1925 C.C). The code does not make any distinction between guarantee and surety ship. The terminology used by the

¹⁵ Ibid., pp. 21-25.

Civil Code is similar to that used in England and most of the commonwealth and also to that in the civil law system.

Therefore, to avoid any confusion, the terminology used by the Ethiopian Civil Code will be used in this study, except that the terms guarantor and surety, and also guarantee and surety -ship may be used interchangeably.

2. CLASSIFICATION OF BONDS

*"A bond is an obligation in writing usually under seal, binding the obligor to pay a sum of money to the obligee, sometimes with a clause to the effect that on performance of a certain condition the obligation shall be void"*¹⁶.

Other sources also give almost similar definition. For instance, M.Steer, Dictionary of Business Studies, 2nd ed. (Singapore: Pitman, 1989) defines the term bond as *"An agreement or engagement binding on him who makes it"* Similarly, N.M Dani editor, *Danis Legal Dictionary* (Bombay: Neelam Agencies) defines bond as *"An instrument by which a debtor and or his surety binds himself to pay money to another."* Finally, Black's Law Dictionary provides a definition of bond as *"A deed whereby the obligor obliges himself, his heirs, executors and administrators, to pay a certain sum of money to another at a day appointed."* In general, therefore, a bond is an instrument or a document evidencing the undertaking assumed by or

¹⁶ Corpus Juris Secundum (1928, Vo. 11, Section, Bills & Notes).

These are some of the major types of bonds. These may again be categorized into several types of bonds. However, these are enough for our present purpose. They may give, at least, a general picture of what we mean by the term bonds.

CHAPTER TWO

CONTRACTUAL SECURITY DEVICES

A. CONTRACTUAL SECURITY DEVICES IN GENERAL

The term security is used in various senses. For instance, the Black's Law Dictionary defines this term as "Protection, assurance, and indemnification." According to the same dictionary, "The term is usually applied to an obligation, pledge, mortgage, deposit, lien, etc given by a debtor in order to make sure the payment or performance of his debt, by furnishing the creditor with a resource to be used in case of failure in the principal obligation. The name is also sometimes given to one who becomes surety or guarantor for another." Another law dictionary entitled "*Cochran's Law Lexicon*," defines the term security as "*that which renders certain the performance of contract, as the personal obligation of another, or the pledge, or mortgage of property belonging to the obligor, (2) A surety, or guarantor.*"

Other sources, such as Sheldon and Fidler's Practice and Law of Banking, which is available in our Law Library, classify security as follows. "A banker in the course of his business has many different kinds of security submitted to him as cover for advances to his customers. Some borrowers

tender stocks and shares, others guarantee, land, life policies, bills of exchange, promissory notes or documents of title to goods."³

According to this source the term "security" refers to the property (movable or immovable)², which is made available to the creditor to secure debts, or it refers also to guarantor (an individual or company).³

Such use of this term in such different senses creates confusion. To avoid this confusion in this study, the term "security" is used to refer to the property (movable or immovable) that is usually made available to a creditor to secure debt and also to the guarantor (surety).

The different types of securities that are made available to guarantee the performance of an obligation may be categorized into two major groups of securities, real securities, and personal securities. Under real security⁴ come all types of property, which in the common law are classified, into real and personal (immovable and movable) property. Whereas, the personal security⁵ is classified into an individual person and a company (personal surety and corporate surety). The legal mechanisms by which a creditor acquires a right over a security that is made available to him to secure a

³ P.J.M. Fidler, Sheldon and fidler's Practice and Law of Banking (12th ed. 1982), p. 292.

² Ibid., pp. 292-302 and pp. 342-506.

³ Ibid., pp. 303-341.

⁴ George Whitecross Paton, A Text-Book Of Jurisprudence (3rd ed. 196), pp. 476-479 and p. 477, note 1.

Please see also F.H. Lawson, Introduction To The Law of Property (1958), pp. 153-155.

⁵ Ralph Slovenko, "Suretyship," Tulane Law Review, Vol. 39 (1965), pp. 427-490.

interchangeably with the term "*pawn*."¹³ The term *pawn*¹⁴ refers to only the pledging of movable property and nothing more.

The pledge or the thing pledged might be actually owned by the debtor or a third party who has consented that such thing be held, as security on behalf of the debtor may own it.¹⁵ However, the third party who gives his property as a pledge on behalf of the debtor "*does not oblige himself personally*."¹⁶ "*One who pledges a thing for the obligation of another resembles a surety, with the difference that the surety answers with all his property, because he is held personally, whereas a person who gives a thing in pledge for a debt not his own does not engage himself personally but only the thing he gives to the creditor: res non persona debet. From this point of view, the pledge by a third person is less onerous than surety.*"¹⁷

In cases where a third party pledges his property on behalf of the debtor, two legal relationships are created, one is the relationship between the third-person pledgor and the creditor which is governed by the law of pledge and the other is the relationship between the third-person pledgor and the debtor which is governed by the law of surety- ship.¹⁸

¹³ Ibid.

¹⁴ Ibid.

¹⁵ Ibid.

¹⁶ Ibid.

¹⁷ Ibid.

¹⁸ Ibid.

In order for a contract of pledge to be effective, there are certain requirements that must be satisfied. These are:

(1) the thing pledged must be delivered to the pledgee or custodian.

Delivery, either actual or constructive, of the articles pledged in consideration of the debt or advance is essential for pledge. Constructive delivery is sufficient where it is practically impossible to give physical possession (as in the case of bulky goods) or where the pledge remains in the possession of the pledgor for a special purpose; the pledge may be legally delivered though it does not actually pass from the hands of the pledgor to those of the pledgee. Delivery of a key of a warehouse in which goods are stored, or the handing of a delivery order directing a warehouseman to deliver goods to the pledgee (followed by the warehouseman's acknowledgment of the delivery order) may be sufficient in law to form constructive delivery. But where the goods are in the possession of a third person, such as warehouseman, the latter must attorn to the pledgee.¹⁹

¹⁹ A.G. Guest (Gen. ed.), Chitty On Contracts (25th ed 1983), p. 147.

(2) the act of pledge must be in writing. *"The writing is required only with reference to third persons. An oral contract of pledge is valid between the pledgor and the pledgee, although the reduction of the contract to writing is advisable to facilitate proof. The general rule in law of contracts is that contracts affecting movable property as between the parties need not be reduced to writing."*²⁰ (3) the contract must state the amount of the debt secured, and (4) the contract must describe the property pledged.²¹

During the pledge, the pledgee has got an exclusive right of *"possession of the property until the debt is discharged."*²² He has the responsibility to take reasonable care for the thing pledged. *"The pledgee is liable for decay or loss of the thing due to his fault."*²³ A pledgee from whom the pledged thing is stolen *"will be discharged from liability if he can show that he took ordinary care of it. Similarly he is excused where the thing was perishable, and did in fact perish. If several things are pledged for the same debt, and one of them is lost without default in the pledgee the residue is liable to be retained for the whole debt."*²⁴

²⁰ Slovenko, cited above at note 6.

²¹ *Ibid.*

²² Fidler, cited above at note 1, p. 293.

²³ Slovenko, cited above at note 6.

²⁴ Guest, cited above at note 19, p. 150.

The contract of pledge does not pass ownership to the pledgee. The debtor remains owner of the pledged property until he pays the debt. If the debt is paid, the pledgee has an obligation to return the thing he has been holding as a pledge to the pledgor. In case of failure of the payment of debt at maturity, the pledgee may apply to the court to authorize a sale²⁵ or he may sale the thing himself, provided that there is such express agreement to that effect.²⁶ "If the proceeds of the sale exceed the debt, the surplus shall be restored to the owner, if, on the contrary, they are not sufficient to satisfy it, the creditor is entitled to claim the balance out of the debtor's other property."²⁷

2. THE CHARGE

*"A charge is often treated as a particular type of mortgage. There is, however, the following important distinction between the two: a mortgage is a conveyance of an interest in property subject to a right of redemption (that is, a right to have the interest reconveyed when the debt is repaid), whereas a charge conveys nothing, but simply confers upon the chargee certain rights over the property."*²⁸ This type of security device is common

²⁵ Slovenko, cited above at note 6.

²⁶ Ibid.

²⁷ Ibid.

²⁸ Chorley cited, cited above at note 7, p. 201.

in stock²⁹ financing (wholesale financing) receivables³⁰ financing and company³¹ financing.

There are two types of charges, fixed charge and floating charge.³² Fixed charge confers rights on some or on all fixed assets (land and buildings) while floating charge confers rights on such assets as the stock in trade and book debts.³³

"Once a fixed charge has been given,"³⁴ the debtor "cannot dispose of the specified assets covered by the charge except subject to the charge."³⁵ In case of floating charge, however, the debtor is free to dispose the stock in trade as if the charge did not exist.³⁶

In English law,³⁷ when a company borrows money from a bank or the investing public by issuing debentures, most of the charges created as a result, whether fixed or floating, must be registered with the registrar of companies. "Where a charge created by a company does have to be registered, the prescribed particulars of the charge, together with the instrument (if any) which created the charge, must be delivered to the

²⁹ Roy Goode, Commercial Law (2nd ed. 1995), pp. 794-800.

³⁰ *Ibid.*, pp. 800-819.

³¹ Chorley, cited above at note 7, pp. 221-224.

³² *Ibid.*, p. 222.

³³ Fidler, cited above at note 1, p. 435, and Chorley, cited above at note 7, p. 222.

³⁴ Fidler, cited above at note 1, p. 435.

³⁵ *Ibid.*

³⁶ *Ibid.*

³⁷ Fidler, cited above at note 1, p. 445.

Registrar of Companies within 21 days after the creation of the charge. If these formalities are not observed, the charge will become void against the liquidator or a creditor unless a court order is obtained authorizing an extension of the 21 days period."³⁸

When any company acquires property subject to "a registrable charge, it and its officers are subject to statutory penalties if it fails to do so."³⁹

According to English law, the charges that must be registered are:⁴⁰

- (a) a charge created to secure any issue of debentures;
- (b) a charge on the uncalled share capital of the company
- (c) a charge created (or evidenced) by a document which would have had to be registered as a bill of sale if it had been executed by an individual;
- (d) a charge on land wherever situate, or any interest in land, but not including any charge to secure rent or other periodical sums issuing out of land;
- (e) a charge on book debts of the company;
- (f) a floating charge on the undertaking or property of the company;

³⁸ *Ibid.*, p. 446.

³⁹ *Ibid.*, p. 447.

⁴⁰ Chorley cited above at note 7, p. 222.

- (g) a charge on calls made but not paid;
- (h) a charge on a ship or on an interest in a ship;
- (i) a charge on the goodwill or a trademark of a company or on a patent or copyright (or on a license under a patent or copyright).

In cases where land belonging to a borrowing company becomes subject to a charge, such charge must be registered both on the registers of companies and land (at land registry).⁴¹

After registerable charges are registered properly, the registrar normally issues a certificate of registration a copy of which "*must be indorsed on every debenture or on every certificate of debenture stock issued by the company. After payment of a debt, which is secured by a registered charge the company should file the appropriate form at the Companies Registry. The Registrar will then enter a memorandum of satisfaction on the register.*"⁴²

⁴¹ Fidler, cited above at note 1, p. 447.

⁴² Ibid.

3. HYPOTHECATION

Hypothecation is a civil law institution.⁴³ It was introduced into English law through international trade.⁴⁴ In English law, *"Hypothecation is a legal transaction as a result of which goods are made available as security for a debt without transferring either the property in them or the possession to the lender."*⁴⁵ The arrangement is made *"by a means of a letter of hypothecation, also called a letter of lien."*⁴⁶ In continental countries, *"the hypothec of personal property (chattel mortgage) was introduced under the influence of the Roman Law in the last centuries of the Middle Ages, but the nineteenth century civil codes know nothing of the mortgage of chattels, but only of the mortgage of immovable property."*⁴⁷

In French law, hypothec applies only to immovable⁴⁸ with certain exceptions, which will be discussed hereinunder. The French law classifies⁴⁹ hypothec into contractual hypothecs, judicial hypothecs and legal hypothecs. All types of hypothecs must be registered.⁵⁰ A duly registered hypothec *"gives the droit de preference and the droit de suite - the right to be paid out of the proceeds of the realization of the property in preference to other creditors and the right to follow the property into the*

⁴³ Chorley, cited above at note 7, p. 202, note 3.

⁴⁴ Ibid.

⁴⁵ Ibid., p. 202.

⁴⁶ Ibid., p. 238.

⁴⁷ Ibid.

⁴⁸ Slovenko, cited above at note 6.

⁴⁹ F.H. Lawson, et al (ed.), Amos and Walton's Introduction to French Law (2nd ed. 1963), p. 123.

⁵⁰ Ibid., p. 126.



hands of third parties."⁵¹ Such registration remains valid only for ten years.⁵² It must be renewed for another term.

As it has already been said earlier,⁵³ in French law, hypothec applies only to an immovable. There are, however, certain exceptions to this rule.

Originally no real security could be established over a movable unless the creditor took physical control of it. However, during the past century steps have been gradually taken to create such securities, under the various names of hypothec, nantissement and warrant, without transfer of control, thus enabling the debtor to use the thing charged and thereby earn money with which to pay the debt. The oldest of such securities attach to ships. The title to ships is absolutely governed by registration at the port of registry; hence it was easy to arrange for a ship to be hypothecated and for the hypothec to be registered. Analogous provisions have been made for river craft or aircraft.

The other main starting point was the negotiable warrant, or warehouse receipt, known to commercial law. By analogy with it a law of 1898 created the warrant agricole, which enables farmers to pledge, without relinquishing physical control, particular objects among their stock and equipment; and another law of 1913 created the warrant hotelier, on similar lines, as a pledge of the furniture and equipment of hotels. Meanwhile a law of 1909 had allowed the nantissement of fonds de commerce.

A third line of development was that of financing the purchase of automobiles by means of what we should call a non-possessory lien, and, likewise, of industrial plant and equipment; and as a special variety, financing the building up of stocks, of petrol by the warrant petrolier, and of other industrial stocks by warrants industriels.⁵⁴

⁵¹ *Ibid.*, p. 126.

⁵² *Ibid.*

⁵³ *Ibid.*

⁵⁴ *Ibid.*

4. MORTGAGE

Mortgage is a common law term. The equivalent term used in the civil law is hypothec or hypothecation. The device hypothec has already been discussed earlier.⁵⁵ In this part of the study, the device mortgage as it is understood in the common law countries shall be discussed.

*"A mortgage is a conveyance of an interest in property as security for the payment of debt or for the discharge of some other obligation. The borrower is called the mortgagor and the lender the mortgagee."*⁵⁶

Property, such as land and buildings, stocks and shares, and life policies are usually made available as securities by means of the mortgage device.⁵⁷

There are two types of mortgages, legal and equitable.⁵⁸

This distinction can be explained only by a brief reference to the history of our law. In former times the law was administered by the courts of common law on the one hand, and, by the court of chancery on the other. The latter court administered a system of justice called equity, and the rights which it recognized became known as equitable rights, whereas those recognized by the common law courts were

⁵⁵ Ibid., pp. 127-128.

⁵⁶ Ibid., and Chorley cited above at note 7, pp. 200-202.

⁵⁷ Chorley cited above a note 7, p. 200.

⁵⁸ Ibid., p. 201.

*known as legal rights. So far as mortgages are concerned, a legal mortgage was one in a form which the common law courts would recognize, whilst an equitable mortgage would be recognized only by the court of chancery. The important practical distinction at the present day between these two kinds of mortgage is that a legal mortgagee usually enjoys wider and more effective remedies than an equitable mortgagee.*⁵⁹

A legal mortgage is usually created by a sealed deed, while an equitable mortgage is created simply by deposit of the document of title with the lender with or without written memorandum or by the execution of a memorandum without any deposit of title deed.⁶⁰

The legal mortgage must be registered. To complete the registration, the mortgagee is required to produce the mortgage deed, a copy thereof, the search certificate, and the land certificate.⁶¹ The registrar makes the appropriate entry in the changes register and retains the copy of the mortgage deed, the search certificate and the land certificate.⁶² Upon completion of such registration “A document known as a charge certificate is issued to the bank within which is stitched the original of the

⁵⁹ *Ibid.*

⁶⁰ *Ibid.*

⁶¹ Fidler, cited above at note 1, pp. 364-366.

⁶² Chorley, cited above at note 7, p. 214.

mortgage deed. It will be seen that the system is simple in its operation, the only drawback being the fairly heavy registration fee which is payable to the registry and is based upon the amount of the mortgage"⁶³

A mortgagee who has taken a legal mortgage has got various remedies⁶⁴ to enforce the security in case of default by the debtor.

The first available remedy is to sell the mortgaged property. Unless otherwise stipulated in the mortgage deed, a mortgagee whose mortgage is by deed has the power to sell such property or any part thereof either by public auction or by private contract.⁶⁵

The second remedy open to a legal mortgagee is the appointment of receiver. *"This remedy may often be necessary because the existence of some interest in the property which cannot be got rid of may prevent an advantageous sale from being made. A good example of this occurs when the mortgaged property is let to a tenant on a long lease. Here a receiver will probably have to be appointed. He will collect the rents, and out of these the current interest will be paid, and the surplus, if any, will be used in reduction of the capital amount of the debt."*⁶⁶

⁶³ *Ibid.*,

⁶⁴ *Ibid.*,

⁶⁵ *Ibid.*, p. 211.

⁶⁶ *Ibid.*,

A third remedy is to apply to the court for a foreclosure order. A mortgagee who obtains a foreclosure order becomes the owner of the property-mortgaged subject of course to any prior encumbrances.⁶⁷

Still, another remedy available to the mortgagee is to take possession of the mortgaged property peaceably or "by means of an action for recovery of the land against the mortgagor."⁶⁸

The last remedy is to sue the debtor himself personally. However, "*this remedy is not likely to be as fruitful as those exercised against the security itself.*"⁶⁹

5. SURETY SHIP / GUARANTEE

Surety ship is the simplest⁷⁰ and also the commonest⁷¹ form of security device. It is "*a promise by one person, who is called the guarantor or surety, to answer for the present or future debt of another person who is called the principal debtor, such promise being made to the party to whom the principal debtor is, or will *become liable*.*"⁷²

⁶⁷ Ibid., p. 212.

⁶⁸ Ibid.,

⁶⁹ Ibid.,

⁷⁰ Ibid.,

⁷¹ Fidler, cited above at note 1, p. 303.

⁷² Ibid.,

Minors, mentally disordered persons or undischarged bankrupts may not give guarantees.⁷³ However, minors or undischarged bankrupts may give guarantees when acting as an agent for someone else.⁷⁴ A partner may give a guarantee *"if the guarantee is in the ordinary course of the business of the partnership"*⁷⁵ Otherwise, he must get the authorization from the other partners. However, *"it is more safer . . . to obtain the signatures of all the partners either on the guarantee itself (if there is sufficient space on it for all the partners to sign) or on an authority expressly referring to the guarantee. If the guarantee is under seal and is not signed by all the partners, it is essential that those partners who do sign the guarantee should have been authorized to do so under seal, since authority to execute a contract under seal can only be conferred under seal."*⁷⁶

A company may also give a guarantee, provided *"it is expressly permitted to do so by its memorandum."*⁷⁷ Though *"A trading company has an implied power to do certain things necessary for the conduct of its business even if it is not expressly permitted to do so by its memorandum, but a trading company would probably never be considered to have an implied power to give a guarantee."*⁷⁸ Therefore,

⁷³ Chorley, cited above at note 7, p. 242.

⁷⁴ Fidler, cited above at note 1, p. 307.

⁷⁵ *Ibid.*,

⁷⁶ *Ibid.*,

⁷⁷ *Ibid.*,

⁷⁸ *Ibid.*,

*If, after examining the memorandum, the banker discovers that the company which is proposed as guarantor does have capacity to give the guarantee, he should see that a board resolution is passed, conferring authority on one or more of the directors to give the guarantee, and should obtain a certified copy of the resolution. Sometimes, however, a banker will accept a guarantee signed by one or more of the directors on behalf of the company without obtaining a certified copy of the board resolution.*⁷⁹

Normally, a guarantee is given "to meet the money liability of the principal debtor arising from his default, whether the default itself relates to the payment of money or the performance of some other obligation, for example, to execute building works. But there is nothing to prevent a guarantor from assuming a secondary liability for performance of the principal debtor's non-money obligations, and it is not uncommon for surety-ship bonds given in connection with construction contracts to empower the issues of the bond to take over the contract upon default by the contractor, as an alternative to payment of damages."⁸⁰

⁷⁹ *Ibid*

⁸⁰ *Ibid.*, pp. 307-308.

back to the classification of property. Property is classified⁸⁴ into movable and immovable property. Movable⁸⁵ property is again divided into tangible and intangible property.

Movable or the personal property, which may be subject to a pledge is called collateral.⁸⁶ The tangible property which may be used as collateral are goods such as *"(a) consumer goods - used primarily for personal, family, or household purposes, (b) farm products - crops, livestock, unmanufactured products of the farm and farm supplies, (c) inventory business goods that are intended for sale or lease, or (d) equipment - goods used by a business in performing its function, such as a computer used by a secretary for word processing."*⁸⁷

The intangible property, on the other hand, *"represents real value in rights to money, goods, or contractual performance. Intangible property generally is evidenced by documents or writings. It includes the accounts receivable of a business, the rights to performance under a contract, bills of lading, or air bills, warehouse receipts, commercial papers, and bonds or stocks."*⁸⁸

⁸⁴ Civ. C., Art. 1126.

⁸⁵ Civ. C., Arts. 1127, 1647, and Com. C., Art. 124.

⁸⁶ Norbert J. Mietus, et al Abridged Version Applied Business Law (13th ed. 1988), p. 363.

⁸⁷ Ibid., pp. 366-367.

⁸⁸ Ibid., pp. 368-369.

When we go back to the provision of Article 2829(1) of the Ethiopian Civil Code and compare it with the above explanation, the term "chattel" refers to farm products, inventory and equipment. The term "*a totality of effects*" refers to consumer goods. And while the term "*a claim or another right relating to movable property*" refers to the intangible property. The intangible property "*includes claims and debts, which are called chose in action.*"⁸⁹ Chose in action are "*forms of personal property which have no physical existence, although they may be evidenced by some physical thing such as a share certificate or a mortgage deed. The essential characteristic of a chose in action is that it is a property right which can, if necessary, be asserted by taking legal action in the courts.*"⁹⁰ Some of the examples of choses⁹¹ in action, inter alia, include debts owed to a business, shares held in a business, business goodwill, intellectual property, such as patents, copyright and trademarks and negotiable instruments such as cheques and bills of exchange.

a. FORMAL REQUIREMENTS

The contract of pledge may be made orally or in writing depending on the amount of debt. If the amount of the debt is more than five hundred Birr, it

⁸⁹ John D. Ashcroft, et al, College Law For Business (7th ed. 1975), p. 400.

⁹⁰ John Ellison, et al, Business Law (1991), p. 501.

⁹¹ Ibid.

representing the thing and enabling him to dispose thereof."⁹⁵ A person to whom such documents have been transferred acquires constructive possession. The third method is delivery of the thing to a third person⁹⁶ that may hold the thing on behalf of another whereby the latter acquires indirect possession. An indirect possession is tantamount to actual possession of the thing.

In a contract of pledge, possession must be transferred in one of the three ways mentioned hereinabove. Accordingly, it is provided in Article 2825 of the Ethiopian Civil Code that the debtor has an obligation to deliver the pledged thing to the creditor. It is further provided⁹⁷ that even if the pledged thing has not been actually delivered to him, *"the creditor shall be deemed to be in possession of the pledge where the document of title without which the pledge cannot be disposed of has been delivered to him."*⁹⁸ Such is the case, for example, when *"a voucher for goods warehoused, or the bill of lading or way bill in the case of goods in transport, has been endorsed in his favor."*⁹⁹ Debtor and creditor may also *"agree that the pledge be delivered to a third party acceptable to them both."*¹⁰⁰

⁹⁵ Civ. C. Art. 1143.

⁹⁶ Civ. C. Art. 1144.

⁹⁷ Civ. C. Art. 1141.

⁹⁸ Civ. C. Art. 2830 (1).

⁹⁹ *Ibid.*

¹⁰⁰ Civ. C. Art. 2830 (2).

further provided that in cases where the pledge has been given by a third party, any contract whatsoever that may be concluded between the creditor and the debtor following the contract of pledge does not in any way adversely affect the third party pledger.¹⁰⁸ The third party pledger is given the right to raise all possible defenses¹⁰⁹ that are available to the debtor against the creditor even when the debtor himself has waived such defenses.

The only duty, which the law imposes on the pledger is the reimbursement of the "*pledgee for expenses incurred in maintaining and preserving the pledge.*"¹¹⁰

d. RIGHTS AND DUTIES OF PLEDGEE

It is provided that, in addition to what has been provided under Articles 2825 - 2874 of the Ethiopian Civil Code, the pledgee¹¹¹ also has on the debtor's property the rights, which a creditor normally has. That means that, if the proceeds of the sale of the pledged thing cannot be sufficient to cover the debt, the creditor can still go against other property belonging (owned) by the debtor. In cases where the pledged thing produces fruits, such fruits shall be appropriated to the expenses incurred for the custody and preservation of the pledge, to the interest and to the principal debt

¹⁰⁸ Civ. C. Art. 2847.

¹⁰⁹ Civ. C. Art. 2838.

¹¹⁰ Ibid.

¹¹¹ Civ. C. Art. 2835.

become the absolute property of the creditor."¹¹⁹ Law of Constantine abolished this law. Commissoria lex is also prohibited under Ethiopia Law. It is provided under Article 2851 Eth. C.C. that "*Any agreement, even subsequent to the furnishing of the pledge, authorizing the creditor, in the event of non-payment on the due date, to take possession of the pledge or to sell it without complying with the formalities required by law shall be of no effect.*" It seems that the intention is to discourage unconscionable pledge contracts. However, after the debt is due, the debtor may, by his own free will, transfer the ownership to the creditor in satisfaction of the debt.¹²⁰ Proclamation No. 96/1998, however, has modified this legal principle.

Therefore, before causing the pledge to be sold, the pledgee is required to put the pledger in default by giving the latter due notice and reminding him the consequences of his failure. The same notice shall also be given to the third party who has provided the pledged thing on behalf of the debtor.¹²¹ If, within eight days as of the date of such notice, no objection has been raised either by the debtor or the third party who has furnished the pledged thing or if such objection is dismissed by the pledgee, the latter may cause the pledged thing to be sold by public auction or "*where the pledge is quoted on the market or has a current price, the pledgee may cause it to be*

¹¹⁹ Civ. C. Art. 1850.

¹²⁰ ¹²⁰ Black's Law Dictionary (4th ed. 1957), and Cochran's Law Lexicon (4th ed. 1969), Commission Lex.

¹²¹ Civ. C. Art. 2851(2).

*sold by private contract through the intermediary of a person authorized to make such sale.”*¹²² Things that are quoted on the markets are shares and bonds that are usually sold on the stock exchange market. And things that may have current prices may be farm products or minerals.

The term “*cause the pledge to be sold*” used in Articles 2853 and 2854 of the Ethiopian Civil Code requires interpretation. It is not clear whether the sale of the pledged thing is carried out with or without the intervention of court. In order to solve this problem, the term “*cause the pledge to be sold*” in Articles 2853 and 2854 must be read in conjunction with the term “*the formalities required by law*” in Article 2851(1). Such reading makes it clear that, what is required from the pledgee is to comply with the rules laid down for the sale of property by public auction. The formalities to be followed in case of sale of property by public auction are provided in the Civil Procedure Code, beginning from Articles 422 to 438. The problem is however, there is no private auctioneer conducting public sales. Only an officer of the court conducts public auctions here. An officer of the court, on the other hand, does not accept private requests. He must, by all means, get a court order to conduct public auction. Therefore, whether one likes it or not, one should file a petition to obtain an order for the sale of the pledged thing by public auction through an officer of the court.

¹²² Civ. C. Art. 2853.

The pledgee has also another alternative. Instead of causing the pledged thing to be sold, he may also apply to the court demanding that such thing be given to him in satisfaction of the debt based on an evaluation of an expert or the current or the quoted price in the market.¹²³

In both cases, the priority right of the pledgee is protected as against other creditors only if the thing pledged has been in his possession or in the possession of a third party¹²⁴ designated for the purpose by both the pledgor and the pledgee during the sale or when he applies to the court demanding expropriation.¹²⁵ Otherwise, third parties rights will never, in any way, be affected if the pledged thing has still been returned to the pledgor or if it has been in the possession of another person from whom the creditor cannot demand its return.¹²⁶

The proceeds of the sale are appropriated to the principal debt, to the contractual and legal interest and to the expenses incurred for the custody, preservation or sale of the pledged thing.¹²⁷ Here, we see that in cases where the pledgee is paid through the sale of the pledged thing, he is entitled to get not only the contractual interest fixed in the loan agreement

¹²³ Civ. C. Art. 2854 (2).

¹²⁴ Civ. C. Art. 2856.

¹²⁵ Civ. C. Art. 2852.

¹²⁶ Civ. C. Art. 2856.

¹²⁷ Civ. C. Art. 2852.

negotiable instruments are in the possession of a guaranteed creditor or a third party who places “*the said securities in a special account*”¹⁴² which he shall open on first call”¹⁴³ in whatever manner such instruments may come into the hands of the guaranteed creditor or the said third party.

When a claim that yields interest or produces periodical income, such as dividend, is pledged, such pledge applies only to the future benefits that may become due and not to those that have already become due at the time of the conclusion of the contract unless agreed otherwise.¹⁴⁴ In case such benefits are represented by separate titles such as coupons, such benefits are not included in the pledge, unless the law somewhere requires to the contrary.¹⁴⁵ The pledgee collects such periodical income and appropriates¹⁴⁶ it to the expenses incurred by him, to the interest and then to the principal debt successively.

A pledgee has an obligation to take all preservatory measures¹⁴⁷ to prevent the extinguishment of the claim or the right pledged and also collects¹⁴⁸ the debt pledged when it is due. When the intangible pledged is a negotiable

¹⁴¹ Slovenko, cited above at note 6.

¹⁴² Com C. Arts 952 (2) and 912-918.

¹⁴³ *Ibid.*

¹⁴⁴ Civ. C. Art. 2867.

¹⁴⁵ *Ibid.*

¹⁴⁶ Civ. C. Art. 2868.

¹⁴⁷ Civ. C. Art. 2869.

¹⁴⁸ Civ. C. Art. 2872.

instrument the pledgee has got the rights and duties of a bank that are specified under Articles 897 to 900 of the Commercial Code.

Finally, when the debtor fails to discharge his obligation in accordance with the agreement, the pledgee may apply the provisions of Article 2854 of the Civil Code or may expropriate the residuary from the debt or the periodical income collected or exercise the right embodied in the commercial paper.

2. MORTGAGE

Mortgage is another security device under Ethiopian Law whereby an existing, future, conditional or contingent claims¹⁴⁹ are secured. Mortgage may result¹⁵⁰ from the law (legal mortgage) or judgment (judicial mortgage) or can be established by a contract or other private agreement (contractual mortgage).

It is required that the contractual agreement must be made in¹⁵¹ writing, that means that with all the requirements of written contracts¹⁵² fulfilled. Under Ethiopian Law, property liable to mortgage includes immovable,¹⁵³ business¹⁵⁴ and ships.¹⁵⁵

¹⁴⁹ Civ. C. Art. 3046.

¹⁵⁰ Civ. C. Art. 3041.

¹⁵¹ Civ. C. Art. 3045.

¹⁵² Civ. C. Arts 1723 and 1727-1730.

¹⁵³ Civ. C. Art. 3047.

¹⁵⁴ Civ. C. Arts 171-193.

¹⁵⁵ Maritime C. Arts. 30-42.

a) CONDITIONS FOR CREATING A MORTGAGE

*“ A mortgage may be created by the debtor or by some other person in favor of the debtor.”*¹⁵⁶ The third party who provides or allows his immovable to secure the debt of another person is usually presumed not to have personally¹⁵⁷ guaranteed the debt, unless proved otherwise. That means that nothing goes to his other property. In the case of a guarantor who at the same time mortgages his immovable to secure the debt which he personally guarantees, such guarantor is *“assimilated to the person who acquires an immovable mortgaged”*¹⁵⁸ and his rights and duties are determined under Articles 3090 to 3104 in addition to the provisions of Articles 1920 to 1951 of the Civil Code.

For a contract of mortgage to be valid, binding and enforceable, certain conditions¹⁵⁹ must be¹⁵⁸ satisfied. These are: -

- a) the debtor who secures his debt by his immovable must be a person who can dispose of the immovable for consideration.

¹⁵⁶ Civ. C. Art. 3049 (1).

¹⁵⁷ Civ. C. Art. 3105.

¹⁵⁸ Civ. C. Art. 3106.

¹⁵⁹ Civ. C. Arts 3048-3053.

- b) in case where the debt is secured by a third party, such third party must be one who can dispose the immovable mortgaged gratuitously;
- c) a mortgage relating to an immovable that may be acquired in the future is not valid;
- d) the mortgage must be registered at the place where the immovable mortgaged is situate;
- e) the registration must take place before a third party who is not liable for the payment of the debt secured acquires the immovable and registers his rights;
- f) the registration must take place before an action for the attachment of the immovable mortgaged is brought and entered in the register;
- g) the registration must take place before the mortgagor is declared bankrupt; and
- h) the registration must be renewed at the end of every ten-years period for another term.

b) Effects of Mortgage

The right created by mortgage extends to the intrinsic elements and accessories of the immovable mortgaged including the improvements, the buildings and crops made on such immovable.¹⁶⁰ It also extends to insurance and expropriation compensations including the compensation due

¹⁶⁰ Civ. C. Arts. 3064 and 3066.

in case of loss or deterioration of such immovable.¹⁶¹ When a leased immovable is mortgaged, the right extends to the rent as of the date when such immovable is attached.

The mortgagor is free to transfer¹⁶² the ownership of the immovable mortgaged and to charge¹⁶³ such immovable with an usufruct, servitudes, mortgages or other rights in rem irrespective of whether there is a contrary agreement or not. In such cases, the right created by mortgage follows¹⁶⁴ the immovable. *"The mortgagee may cause the immovable to be sold as though such rights had not been created"*.¹⁶⁵ The person who acquires the mortgaged immovable can enjoy the fruits¹⁶⁶ he collected until the time when such immovable is attached in his hands. He will not be liable to the mortgagee for any loss or deterioration of the immovable, unless *"such loss or deterioration is due to his fault or negligence and occurs after he has been informed that proceedings have been instituted for the attachment of the immovable"*¹⁶⁷ Such person may demand payment from the proceeds of the sale for any improvements, buildings, plantations or crops he made on the immovable mortgaged which have increased its value.¹⁶⁸ The law of

¹⁶¹ Civ. C. Art. 3069.

¹⁶² Civ. C. Art. 3084.

¹⁶³ Civ. C. Art. 3088.

¹⁶⁴ Civ. C. Art. 3085.

¹⁶⁵ Civ. C. Art. 3089 (2)

¹⁶⁶ Civ. C. Art. 3093.

¹⁶⁷ Civ. C. Art. 3092 (2)

¹⁶⁸ Civ. C. Art. 3090.

suretyship governs his relationship with the mortgage. He can “*avail himself of the rights vested in the guarantor.*”¹⁶⁹

An immovable mortgaged may be attached and caused to be sold during the term of the contract at the instance of the creditors of the mortgagor or at the instance of the mortgagee when the debtor fails to discharge his obligation. For whatever reasons the immovable is sold, the mortgagee shall be paid in priority¹⁷⁰ to any other creditor. In addition, he has got also all the rights of an ordinary¹⁷¹ creditor as far as his other claims, if any, are concerned.

The preferential rights of payment of the creditor extends to the registered amount of claim,¹⁷² to the interest¹⁷³ (to an amount not exceeding two years interest), to the necessary expenses incurred by him for the preservation of the mortgaged property, to the insurance premiums “*due by the owner and have been paid by the mortgagee,*”¹⁷⁴ costs¹⁷⁵ of attachment proceedings and legal interest¹⁷⁶ run on the sums of all the above mentioned amounts.

When the number of creditors who have a registered claim on the same immovable is more than one, they shall rank according to the date on which they have registered their claim. Those whose claims have been registered

¹⁶⁹ Civ. C. Art. 3090.

¹⁷⁰ Civ. C. Art. 3059 (1)

¹⁷¹ Civ. C. Art. 3059 (3).

¹⁷² Civ. C. Art. 3076.

¹⁷³ Civ. C. Art. 3077.

¹⁷⁴ Civ. C. Art. 3078.

¹⁷⁵ Civ. C. Art. 3079.

¹⁷⁶ Civ. C. Art. 3080.

on the same¹⁷⁷ day are treated equally and shall be paid in proportion to the amount of their claims from the proceeds of the sale of the mortgaged immovable. And those with an earlier¹⁷⁸ date of registration are paid in priority to those with a later date of registration.

When a mortgaged immovable is attached and is caused to be sold, the attachment and the sale of such property must be executed in accordance with the provisions of Articles 404 to 431 and Articles 439 to 449 of the Civil Procedure Code. Any agreement which purports to give a right to the creditor to appropriate or to sell the immovable without observing the provisions of the law made at the time of the conclusion of the contract or even after that, but before the debt has become due, shall not have any effect. However, the creditor and the mortgager may reach an agreement for the transfer of the ownership of the immovable to the former after the debt has become due.¹⁷⁹

The mortgage attached to an immovable property may be extinguished when the registration is cancelled from the registers of immovable property. The grounds for and the manner how such registration may be cancelled are provided under Articles 1630 to 1636 and Articles 3109 to 3116 of the Civil Code.

¹⁷⁷ Civ. C. Art. 3082.

¹⁷⁸ Civ. C. Art. 3081.

¹⁷⁹ Civ. C. Art. 3060 (2).

3. ANTICHRESIS

In French and Louisiana law the term “Antichresis” is defined as a contract whereby a debtor transfers the possession of his immovable to a creditor with the purpose of allowing the latter to enjoy the fruits and revenues deriving therefrom on condition that such fruits and revenues be deducted from what is due.¹⁸⁰

Antichresis is also provided under the Ethiopian Civil Code (Articles 3117 to 3130). Antichresis is defined as “ *a contract whereby the debtor undertakes to deliver an immovable to his creditor as a security for the performance of his obligation*”.¹⁸¹

A bare owner of an immovable cannot create antichresis. An antichresis can be created only by a contract. It cannot be created to guarantee a claim embodied in an instrument to order or to bearer.¹⁸²

In addition to the provisions of Articles 3121 to 3130 of Civil Code, the provisions of the Code governing the relations between lessor and lessee or

¹⁸⁰ Slovenko, cited above at note 6.

¹⁸¹ Civ. C. Art. 3117.

¹⁸² Civ. C. Art. 3119 (2).

farmer-tenant shall also apply¹⁸³ to the relations between the parties to the contract of antichresis Not only that, Articles 3041 to 3063 and Articles 3109 to 3116 also, mutatis mutandis, apply to the contract of antichresis

The person who charges his immovable with an antichresis has a duty to hand over¹⁸⁴ such immovable with its accessories to the creditor or to another person designated for this purpose. After the conclusion of the contract and until the completion of delivery or if the immovable is returned to the person who has charged it with antichresis, such “*antichresis shall have the same effect as a mortgage*”¹⁸⁵ The immovable shall be delivered in the condition in which it was on the day of the conclusion of the contract.¹⁸⁶ The person who created the antichresis may be held liable only for such defects¹⁸⁷ which seriously endanger the life or health of the possessor of such immovable including that of persons living with him or of his employees and which he failed to mention at the time of the making of the contract. Such person cannot be compelled¹⁸⁸ to make repairs to the immovable charged.

The creditor is not entitled to demand interest on his claim. The use he makes of such immovable, the fruits and profit he derives from are in

¹⁸³ Civ. C. Art. 3120.

¹⁸⁴ Civ. C. Art. 3117 and 3121 (1)

¹⁸⁵ Civ. C. Art. 3121 (2).

¹⁸⁶ Civ. C. Art. 3122 (1).

¹⁸⁷ Civ. C. Art. 3122 (3).

¹⁸⁸ Civ. C. Art. 3123.



replacement of the interest he might have otherwise derived.¹⁸⁹ Any clause in the contract of antichresis, which entitles the creditor to collect interest in addition to the use he makes of such immovable, to the fruits and profits he enjoys, has no legal validity.¹⁹⁰

4. SURETYSHIP

Surety-ship is the commonest type of security device, which is available in almost all legal systems. The Ethiopian Civil Code also provides rules governing surety-ship contract under Articles 1920 to 1951. As this device is the main theme of this study, a separate chapter is devoted to the Ethiopian surety-ship law.

Everything relating to the basic principles of this law shall be discussed under the said chapter. Therefore, there is no need to deal with this device here. It will cause repetitiveness.

5. CONCLUSION

An attempt has been made in this chapter to point out the available security devices and indicate that surety-ship is also one among those available security devices. Each of those security devices has got its own advantages and disadvantages. Certainly, it will be outside the scope of this study to go into the details of such advantages and disadvantages of each of those

¹⁸⁹ Civ. C. Art. 3124 (2).

¹⁹⁰ Civ. C. Art. 3124 (3).

security devices. However, it is appropriate to say a few things on the matter en passant.

As it has already been said earlier, *"Security falls into two broad groups, personal and real security. In the former the creditor insists on having the debt guaranteed by another person; that is to say, he insists on the debtor providing him with another person who agrees to pay if the debtor does not"*.¹⁹¹ Such guarantor is either an individual or a company depending on circumstances. The disadvantages of having an individual or a company as a guarantor are the individual may die, go bankrupt, impoverish himself, transfer all what he has to another and a company may also be dissolved, it may go bankrupt, impoverish itself or transfer all what it has to another.

The second type of security, which is known as real security, may be divided into¹⁹² possessory security, proprietary security, charges and non-possessory liens. Possessory security may require instituting possessory action and taking preservatory measures. Proprietary security requires registration, consistent follow-up and renewal of the registration every now and then whenever the term of the registration expires. It is also possible that the creditor may be compelled to take legal actions or other measures for the preservation of the property involved in this case. Property security

¹⁹¹ Paton, cited above at note 4.

¹⁹² Lawson, cited above at note 49.

goes on deprecating. Its market value may decrease substantially. It may be destroyed, damaged or lost.

Therefore, when the advantages of each of the security devices are compared with each other based on the explanation given above, the advantages of the device surety-ship far outweigh the advantages of the other devices.

CHAPTER THREE

THE ORIGIN AND DEVELOPMENT OF SURETYSHIP

A. The Antiquity of Suretyship

It is said that "*The oldest contracts recorded are those made by the surety*"¹

Almost all authorities agree that "*The contract of suretyship antedates the Christian era by more than 2500 years*"² The first recorded contract of surety-ship was found in the Library of Sargon I,³ king of Accad and Summer, then parts of Babylon. In that contract, when a farmer who had been drafted into a military service rented his farm to another until he came back a merchant of the city of Accad stood surety to the farmer who took the farm on lease.⁴

The Code of Hammurabi, the earliest⁵ known Code, enacted about 500 years after the time of Sargon I, imposed guarantee obligation upon a city and its governor to ensure the fidelity of those who came within the jurisdiction of the city and at the same time to protect those persons who

¹ Earl C. Arnold, "The Compensated Surety," Columbia L. Rev., Vol. 26(1926), pp. 171-189.

² Willis D. Morgan, "The History and Economics of Suretyship," The Cornell L. Rev., Vol. 12, No. (1927) pp. 153-171.

³ Ibid.

⁴ Ibid.

⁵ Ibid.

came within the jurisdiction of such city from the dishonesty of others⁶. That placed both the city and the governor in the positions of sureties.⁷

They say also that surety-ship used to play an essential role in Babylonian marriage. According to the story told by the Greek historian Herodotus,⁸ Babylonian girls who reached marriageable age were assembled every year in the market to be sold into marriage by a crier. The sale of such girls usually began with the most beautiful and ended up with the most ugly. However, whether a girl was the most beautiful or the most ugly, "*no man could take away the woman he purchased without first producing a surety that he would make her his wife*"⁹

There are evidences confirming the wide practice of both verbal and written contracts of surety-ship among the Hebrews,¹⁰ Assyrians¹¹ and Persians¹² also.

Therefore, "*it is hardly an exaggeration to say that the need which suretyship was conceived to meet is common to humanity, and as old as humanity*"¹³

⁶ Ibid.

⁷ Ibid.

⁸ Ibid.

⁹ Ibid.

¹⁰ Ibid.

¹¹ Ibid.

¹² Ibid.

¹³ T. Hewitson, Suretyship, Its Origin And History In Outline (1927), p.1.

B. Suretyship Under Roman Law

*“When Gaius wrote his Commentaries (Circa 150 A.D.), the Romans had developed a highly technical law of surety -ship. The adpromissor, or surety, was of three varieties; the sponsor, the fidepromissr, and the fidejussor. Sponsors and fidepromissress could act as such only on verbal contracts, whereas the fidejussor could be a surety on any undertaking whether re verbis, litteris or consensu. A sponsor had also to be a Roman citizen.”*¹⁴ Sponsor¹⁵ was a surety who had to be a Roman Citizen and bound himself by the word spondeo. The obligation undertaken by this type of surety never transferred to his heirs. Fidepromissor was not a Roman citizen and did not bind himself by the word spondeo. The heirs of the fidepromissor¹⁶ were not also bound by his undertaking. The fidejussor,¹⁷ on the other hand, was a surety whose heirs were bound by his undertaking. Therefore, the liabilities of sponsor and finderpromissor terminated ¹⁸ at death, while the liability of the fidejussor descended¹⁹ to his heirs.

The Romans developed certain principle in the area of suretyship, which are applicable even today. For instance, in Lex Appuleia²⁰, the sponsor or the fidepromissor was entitled to demand contribution from his co-sponsors

¹⁴ Morgan, cited above at note 2.

¹⁵ Ibid.

¹⁶ Ibid.

¹⁷ Ibid.

¹⁸ Ibid.

¹⁹ Ibid.

²⁰ Ibid.

or the co-fidepromissores after paying the debt. However, the fidejussores were also not entitled to benefit from this principle. The surety, whether sponsor, fidepromissor or fidejussor had also the right to demand reimbursement²¹ from the principal debtor through an action known as mandate.

*“Creditors naturally preferred the more complete liability of the fidejussor. For this reason, by the time of Justinian, the contract of the sponsor and of the fidepromissor had practically passed out of use-so much so, in fact, that in his Institutes he speaks only of the fidejussor”*²²

C. Suretyship in English Law

English law is the source for the laws of many of the common law countries. A brief survey of the English surety-ship law may give, at least, a bird's-eye view of the laws of such countries in this regard.

In English law,²³ the origin and development of surety-ship had been closely connected with the origin and development of the judicial system. *“It may be safely postulated that in its beginning as in its development, surety-ship will be everywhere found interwoven as it were into the very fabric of procedure. We have glimpsed it as a prominent judicial institution*

²¹ *Ibid.*

²² *Ibid.*

²³ Hewitson, cited above at note 13, p. 76.

in Grecian, Roman and Frankish legal history. It loses little, if any, of its importance in Anglo-Saxon, Celtic and later English law."²⁴

The surety was used to enforce criminal laws.²⁵ For this purpose, they used group sureties. Originally, the clan had been held responsible for any injury any of its members caused upon any of the members of another clan, and then came what were known as the gild brethren into the scene. The gild brethren were required to stand surety for each other. When the law further developed, instead of group sureties, it was required that every man should have a surety who was subject to the punishment which would have been imposed upon such man, had he committed a crime and escaped. *"In this manner did the Anglo -Saxons insure compliance with their criminal laws."*²⁶

The practice of using surety-ship was not limited only to criminal laws. It was also further extended to Civil Procedure²⁷ in order to force the appearance of defendants and the execution of judgments given. In this way, step by step, in addition to the judicial surety-ship, extra-judicial²⁸ surety-ship also began to take root and spread out further. They say that once there was a law, which required a surety and witnesses in every

²⁴ *Ibid.*

²⁵ *Ibid.* pp. 76-82.

²⁶ Morgan, cited above at note 2.

²⁷ Hewitson, cited above at note 13, pp. 83-92.

²⁸ *Ibid.* pp. 100-105.

business transaction²⁹ “ *Shakespeare’s Merchant of Venice is evidence of the wide use of the contract in Elizabethan England*”³⁰

1. THE SCOPE OF ENGLISH SURETYSHIP LAW

In English law, a surety is defined as “*one who contracts with an actual or possible creditor of another to be responsible to him by way of security, additional to that other, for the whole or part of the debt.*”³¹ A surety promises to “*answer for the debt, default or miscarriage of another person*”³² Hence, the obligation of a surety is a collateral obligation and the contract of surety-ship is also an accessory to the main contract between the creditor and the principal debtor.

However, that does not mean that any person who promises to pay another’s debt is a surety.³³ A person may promise to procure an advantage to another person. Unless the basis upon which such a person binds himself is not the same as that upon which that other person is bound or will also become bound, such person cannot be regarded as surety. The same is true also with a person who substitutes another who is already bound.

²⁹ Morgan, cited above at note 2.

³⁰ *Ibid.*

³¹ David G M. Marks, et al, *Rowlat On The Law of Principal and Surety* (4th ed. 1982), p.1.

³² P.J.M. Fidler, *Sheldon and fidler’s Practice and Law of Banking* (11th ed. 1982), p.304.

³³ Marks, cited above at note 31, pp. 5-6, and Fidler, cited above at note 32, p. 304.

In English law, minors, insane persons (mentally disordered person) and undischarged bankrupts are not allowed to stand surety.³⁴ Minors or bankrupts may conclude surety-ship contracts as agents³⁵ only. “*In view of the necessity of a principal debtor a difficulty arises where a person purports to become surety for one who is under disability. It seems clear that this does not prevent the so-called surety from being liable to the creditor where there is no fraud or misrepresentation*”³⁶ A surety is also normally held liable for the money borrowed by a company ultra vires, as long as the debt is incurred in good faith.³⁷ However, a guarantor of a loan made to a minor³⁸ in excess of his powers cannot be held liable, if all the parties concerned knew the fact of the minority of the debtor.

2. FORMAL REQUIREMENTS

According to Section 4 of the Statute of Frauds,³⁹ an action cannot be brought on a guarantee, unless such guarantee has been made in writing or in some kind of note or memorandum and has been signed by the guarantor or by his lawfully authorized agent. The note or memorandum may consist

³⁴ Fidler, cited above at note 32, p. 307.

³⁵ *Ibid.*

³⁶ Marks, cited above at note 31, p.2.

³⁷ *Ibid.*

³⁸ *Ibid.*

³⁹ Fidler, cited above at note 32, p. 305.

of several pieces of documents⁴⁰ as long as the document, which was signed by the guarantor or his agent makes reference to such pieces of documents.

The signature may be by a printing of the name, if done with authority, or by initials, or in the case of an illiterate (who, if he so executes, must be taken to be such), by a mark. It need no be at the foot or end of the memorandum, provided it governs and authorities the whole.

A memorandum may be signed by an agent, and its well settled that such agent need be authorized in writing; verbal authority or subsequent verbal ratification; is sufficient. Two parties may be represented by a common agent who signs for both, as, in the case of sales within the Statute, an auctioneer.

But one party cannot be agent to sign for the other. The agent of one party may also be agent of the other to sign the memorandum, if in fact authorized by him to put his name to it as a binding memorandum. But a mere note, by way of record of the promise, written by

⁴⁰ Marks, cited above at note 31, p. 38.



*the clerk of the promise in the presence of the guarantor, is not sufficient.*⁴¹

It is not required to use special form of words even the word guarantee⁴² in the written note or memorandum. It suffices to name the parties and include the essential terms of the contract only. That means that a guarantee need not be expressed, it can be presumed from what is written in the note or memorandum. *"The person to whom the guarantee is given must appear from the written document or documents evidencing the guarantee, or from a written answer accepting a guarantee offered."*⁴³

As written contracts are divided into contracts of dead (contracts under seal) and simple contracts (contracts under hand), a guarantee contract under seal is subject to stamp duty,⁴⁴ while the other type of written contract does not require payment of such duty.

The other important element in the English law of contract is consideration. A guarantee given in simple contracts (contracts under hand) is required to be supported by sufficient consideration for its validity. *"There must be fresh consideration; if there is not sufficient consideration, or if there is a total failure of consideration, the guarantor has no liability under the*

⁴¹ Ibid., p.39.

⁴² Ibid., p. 37.

⁴³ Ibid.

⁴⁴ Ibid., p.238 and Fidler, cited above at note 32, p. 306.

guarantee."⁴⁵ The consideration is always moving from the creditor (promisee) and it is not required to be given to the guarantor (promissor). *"in accordance with well-known principle that an executed consideration will not support a promise, a guarantee note under seal for a debt already incurred will not be valid unless there be some further consideration moving from the creditor."*⁴⁶ Consideration may be entire as in the case of guaranteeing the performance of an employee or the duties of a lessee or fragmentary and divisible as in the case of advance or supply of goods.⁴⁷ A consideration for guaranteeing *"an existing debt is commonly either a forbearance on the part of the creditor to press for the debt, or the allowance of a further credit or advance. But it may also be a payment by or on behalf of the creditor to the guarantor or any other legal consideration moving from the creditor to the principal or the guarantor. A consideration moving merely from the principal to the surety will not suffice."*⁴⁸ The consideration may not appear in writing. It is sufficient if it can be proved by oral evidence.⁴⁹

⁴⁵ Fidler, cited above at note 32, p. 305.

⁴⁶ Marks, cited above at note 31, p.9.

⁴⁷ *Ibid.*

⁴⁸ *Ibid.*, p.10.

⁴⁹ Fidler, cited above at note 32, p.305.

3. EFFECTS OF DEFECTIVE CONSENT AND ILLEGALITY

A contract of a guarantee is not a contract of utmost good faith (*uberrimae fidei*).⁵⁰ None of the parties to such contract has "*an obligation to disclose to the other all material facts known to him which might influence the decision of the other.*" However, if the creditor misrepresents any fact known to him and material to be known to the surety, whether such misrepresentation is made fraudulently or not, the surety will not be bound by the contract.⁵¹ In *Davies v. London & Provisional Marine Insurance Company*, it was commented that "*the avoidance of a contract of guarantee by the non-disclosure of a material fact depends in each case upon whether, having regard to the nature of the transaction, and the relations of the parties, the fact not disclosed is impliedly represented not to exist, and very little omitted which ought to have been said will suffice to avoid the contract*"⁵³

A contract of guarantee may also be avoided if the guarantor can prove that he entered into the contract by reason of undue influence. "*There is a presumption of undue influence where the guarantor was persuaded to*

⁵⁰ *Ibid.*, p. 335.

⁵¹ *Ibid.*

⁵³ Fidler, cited above at note 32, p. 336.

*enter into the guarantee by someone in whom he placed his trust and confidence and where"*⁵⁴ the creditor " *knew that this was so"*⁵⁵

Finally, illegality of either the principal contract or the guarantee or both makes the contract void.⁵⁶

4. RIGHTS OF THE GUARANTOR

A guarantor may be called upon to discharge the obligation he has undertaken only when the principal debt becomes due.⁵⁷ When the principal debt becomes due, the creditor can directly demand payment or performance from the guarantor, even sue him before requesting the principal debtor to pay or suing him.⁵⁸

As it was said earlier, a guarantee is a secondary or accessory contract. In order for a guarantor to be held liable, there should be another person who may become primarily liable. " *If for any reason the principal debtor is not liable or if in fact there is no principal debtor, the guarantor will not be liable under the guarantee*"⁵⁹

A guarantor who is liable has such rights as the rights to require the creditor to call upon the principal debtor to pay his debt, to raise against the creditor

⁵⁴ *Ibid.*

⁵⁵ *Ibid.*

⁵⁶ Marks, cited above at note 31, p. 127.

⁵⁷ *Ibid.*, pp.108-109, and Fidler, cited above at note 32, p. 309.

⁵⁸ *Ibid.*

⁵⁹ Fidler, cited above at note 32, p.313.

any defenses which is open to the principal debtor to be subrogated to all the rights of the creditor, to any security given to the creditor by the principal debtor and to get contribution from the co-sureties.⁶⁰

A guarantor may be released from his liability if the principal debtor pays the debt, when the principal debtor is expressly released from all further liability, when more time is given to the principal debtor to pay the debt, if material variations are made in the principal contract, any deviation is made from the terms of the contract or where the legal position of the parties changes.⁶¹

A contract of guarantee made for an indefinite period can be terminated by notice.⁶² It may also be terminated when the guarantor is declared incapable or bankrupt⁶³

D. SURETYSHIP UNDER FRENCH LAW

It is well-known that the French law is the source for the codified laws of Ethiopia. Therefore, it is worth discussing the principles of French suretyship law. It may help to understand the principles of the Ethiopian suretyship law.

⁶⁰ *Ibid.*, pp.315-320.

⁶¹ *Ibid.*, pp. 320-330.

⁶² *Ibid.*, p. 330.

⁶³ *Ibid.*, pp. 333-334.

"The French law of suretyship at the time of the compilation of the Code Napoleon was substantially as outlined in Pothier⁶⁴. According to Pothier,⁶⁵

The engagement of a surety is a contract, by which a person obliges himself on behalf of a debtor to a creditor, for the payment of the whole, or part of what is due from such debtor, and by way of accession (c) to his obligation. The person who contracts such obligation, is called a surety, (caution or fidejusseur)

*The engagement, besides the contract, which intervenes between the surety and the creditor, in whose favor the surety obliges himself, includes sometimes another contract, which is supposed to intervene, at least tacitly, between the surety and the debtor for whom he is engaged, and this is the contract of Mandate, which is always supposed to intervene, when the surety engages with the knowledge and consent of the principal debtor, according to this rule of law, *semper qui non prohibet pro se intervenire mandare creditur* . . . When the engagement is made with the knowledge of the debtor, it cannot be supposed to include any contract between the surety and the debtor; but there is supposed to intervene between*

⁶⁴ Hewitson, cited above at note 13, p. 131.

⁶⁵ M.Pothier, A Treatise On The Law of Obligations, William David Evans (trans), (2000), pp.228-229.

them in this case, that kind of quasi-contract which is called negotiorum gestorum. We shall treat of the obligation which arise from this contract of mandate, or from the quasi-contract negotiorum gestorum . . .

The contract, which intervenes between the surety and the creditor, in whose favor the surety is obliged, is not of the class of contracts of beneficence, for the creditor by this contract receives nothing more than is due to him; he only procurers a security for what is due to him, without which he would not have contracted with the principal debtor, or would not have allowed him time; but the engagement includes a benefit with regard to the debtor, for whom the surety is engaged.

He deduced from the above definition several corollaries.⁶⁶ Some of them are the following:

1. As the obligation of the surety is an accessory to that of a principal debtor, in order for the obligation of the surety to be valid, there should be a valid obligation of a principal debtor. There can be no accessory without a principal obligation.

⁶⁶ Ibid., 229-247.

the obligation if the debtor does not."⁶⁸ The essential elements of this definition are:

1. a contract of surety-ship pre-supposes the existence of contractual relationship between the debtor and the creditor;
2. the contract of surety-ship is concluded between the surety and the creditor, and;
3. the surety is called upon only if the debtor fails to discharge his obligation. Contract of surety-ship may be concluded without the knowledge or in certain cases, even against the will of the debtor⁶⁹.

The consent of the latter is not at all a requirement for the formation of a contract of surety-ship. A Contract of surety-ship creates a tripartite⁷⁰ relationship between the creditor, the debtor and the surety.

The French law recognizes three types of surety.⁷¹ These are: conventional, legal and judicial sureties. *"From the viewpoint of the surety, surety-ship is always voluntary and conventional. When the debtor is required by law to furnish a surety, the surety is called a*

⁶⁸ Ralph Slovenko, "Suretyship," Tulane L. Rev., Vol. 39(1965), pp. 427-490.

⁶⁹ Ibid.

⁷⁰ Ibid.

⁷¹ Ibid.

*legal surety; when required by the judgment of court, the surety is called a judicial surety."*⁷²

2. REQUIREMENTS OF SURETY-SHIP CONTRACT

*"In surety-ship there are two distinct obligations: the principal obligation, between the creditor and the principal debtor, and the surety-ship obligation, between the creditor and the surety. Although the two contracts are distinct, they are linked in the sense that suretyship, being an accessory contract, presupposes a principal obligation. There may also be a third contract between the debtor and surety. This contract is distinct from the other two, and it need necessarily exist."*⁷³

As any other consensual obligation, suretyship is governed by the general law of contract.⁷⁴ Lack of capacity or illegality of object may render the contract of surety-ship invalid or infective.

The French law⁷⁵ does not require any particular form for the conclusion of a contract of surety-ship. It may be made orally or in writing. The intention to undertake the act of suretyship must be clearly expressed. It cannot be presumed. Unlike the French law, Article 2278(3) of the Louisiana Civil

⁷² Ibid.

⁷³ Ibid.

⁷⁴ Ibid.

⁷⁵ Ibid.

Code⁷⁶ requires written form for the conclusion of the contract of suretyship. They say that this requirement of writing was taken from the English Statute of Frauds of 1677. In addition to the above article, the Louisiana Civil Code also contains another article, Article 3039 which is similar to Article 2015 of the French Civil Code which provides that "surety-ship cannot be presumed; it ought to be expressed"⁷⁷ The article requires only the clear expression of the intention of the surety. " *When the intension is clear, the form in which it is manifested is immaterial under the specific surety-ship article. Perhaps because the tacit or oral intention is often obscure and uncertain, the Louisiana Legislature, for practical reasons, adopted article 2278(3), which requires a written act*"⁷⁸

Another requirement of suretyship contract in French law is the extent of suretyship obligation.

Suretyship cannot exceed that which is due by the debtor or be contracted on more onerous conditions.

The surety may undertake an obligation equal to or less, but not greater, than that of the principal debtor.

Thus, the principal debtor might be bound absolutely and the surety conditionally, but not conversely.

⁷⁶ Ibid.

⁷⁷ Ibid.

⁷⁸ Ibid

However, although the obligation of the surety cannot be more onerous than that of the principal debtor, the remedy for enforcing it may be more extensive than that which the creditor could have adopted against the debtor.

Thus, the performance by the surety of his obligation may be secured by a pledge or mortgage, while the principal debtor is only personally liable.

Suretyship which exceeds the debt or which is contracted under more onerous conditions is not null, but it is reduced to the principal obligation. For example, the engagement of a surety of 3000 dollars for a debt of 2000 dollars is reduced to 2000 dollars. Similarly, a surety can not be made to pay a greater rate of interest or to have his obligation mature within a shorter time than that of the principal debtor's obligation.

The suretyship can, however, be limited to a part of the obligation or it can be contracted on less onerous conditions. The right of a surety to restrict his obligation to

only a part of the principal obligation applies only to the conventional surety

. It does not apply to the statutory or judicial surety, whose obligation must satisfy certain requirements. The obligation of the conventional surety who does not limit the extent of his obligation is co-extensive with that of the debtor. A general and indefinite suretyship extends to all the accessories of the principal debt, and even to the costs.⁷⁹

3. EFFECTS OF SURETYSHIP

Suretyship creates legal relationships between different parties. These are: the relations between the creditor and the surety, the relations between the surety and the debtor, and the relations among co-sureties, if any. Therefore, in this part, an attempt shall be made to examine the consequences of each of these relationships may have on the parties involved.

⁷⁹ Ibid.

a. BETWEEN CREDITOR AND SURETY

i. BENEFIT OF DISCUSSION

There are two types of sureties, the ordinary surety and the solidary surety (a surety bound in solido with the debtor). The solidary surety may sign the contract of suretyship using such terms⁸⁰ as "*co-debtor*", "*surety and principal debtor*" or "*surety and co-principal debtor*" and the like. In such cases, since he is deemed to be a co-debtor, "*the creditor can look to him for satisfaction of the whole debt.*"⁸¹ That means that the creditor has several options. He may proceed either against the debtor or the solidary surety or against both jointly until the debt is fully satisfied. In the civil law, this type of surety ship has been termed as "*solidary surety ship*" or "*quasi-surety ship*."⁸² It is called "*quasi - surety ship*", because "it produces certain effects of an accessory obligation and certain effects of a principal obligation."⁸³ The relations between the creditor and the solidary surety are governed by those rules of law that apply to joint debtors (debtors in solido). While the relations between the solidary surety and the debtor are regulated by suretyship law, "and these cannot be prejudiced by the

⁸⁰ Ralph Slovenko, "Effects of Suretyship," The American Journal of Comparative Law, Vol. 6(1960), pp.48-77 and Slovenko, cited above at note 68.

⁸¹ Slovenko, cited above at notes 68 and 80.

⁸² Ibid.

⁸³ Ibid.

creditor. The subrogation effect of suretyship subsists in the case of a solidary surety."⁸⁴

The other type of surety, the ordinary surety, "engages himself to pay only if the principal debtor does not."⁸⁵ Thus, his obligation is subsidiary and conditional. As a result of this, "*the debtor and surety are obligors in different classes, the former being primarily and principally liable and the latter secondarily.*"⁸⁶

The civil law confers a special right known as the "*benefit of discussion*" on ordinary surety. This right is not available to solidary surety (surety bound in solido). According to the principle of the benefit of discussion, "*the creditor is obliged first to proceed to execution against the property of the principal debtor.*"⁸⁷ However, it is not required that the creditor must sue the debtor first. The surety invokes the benefit of discussion only when he is sued⁸⁸ "*It is a dilatory plea that must be raised in limine litis, before issue is joined. The creditor, instead of suing the surety alone, may join the debtor and surety in the same suit, and in this case, when judgment is*

⁸⁴ Ibid.

⁸⁵ Ibid.

⁸⁶ Ibid.

⁸⁷ Ibid.

⁸⁸ Ibid.

*obtained against both, the surety (unless he is a solidary surety) may urge that the judgment be first executed against the principal debtor."*⁸⁹

The benefit of discussion has two advantages when seen from the point of view of the ordinary surety. The first is that the "*judgment against him is deferred pending the security and execution of judgment against the principal debtor. The property pointed out may be sufficient to satisfy the creditor.*"⁹⁰ And the other is that "*if there was property that could have satisfied the creditor, and the creditor is remiss, the resulting loss falls on the creditor and not in the surety. It will be the creditor's loss.*"⁹¹

In employing the exception of discussion, the surety must point out property of the principal debtor available for seizure within the jurisdiction, and he must pay the expenses of the seizure. The surety's right to discussion depends upon an adequate description of the property, and the property must not be encumbered with other debts or involved in litigation. When under a plea of discussion, the surety has pointed out property subject to seizure in the jurisdiction and has furnished funds to have the discussion effected, the creditor must

⁸⁹ Ibid.

⁹⁰ Ibid.

⁹¹ Ibid.

*suffer the loss for the insolvency of the principal debtor, to the amount of the property pointed, provided the loss has occurred through the creditor's remissness in commencing proceedings.*⁹²

ii. BENEFIT OF DIVISION

It was the Roman Emperor Hadrian (117-138 AD) who introduced the *beneficium divisionis*.⁹³ This principle "*is preserved in the civil codes of Louisiana, France, and Italy, but not of Germany.*"⁹⁴ The principle of benefit of division applies when there are several sureties guaranteeing the same principal obligation. The plea of division is usually raised when one of the sureties is sued for the whole or more than a pro rata⁹⁵ share of the principal obligation. "*The benefit of division is available even though the sureties were engaged in separate acts.*"⁹⁶ By the plea of division any one of the sureties may demand that the creditor divide his action by reducing his demand to the share and portion of each surety. The creditor, in this case, shall be compelled to divide and apportion his claim among the sureties who are solvent at the time of the institution of the action. "*The risk of insolvency of a surety, prior to the demand of the benefit of division, falls*

⁹² *Ibid.*

⁹³ *Ibid.*

⁹⁴ *Ibid.*

⁹⁵ *Ibid.*

⁹⁶ *Ibid.*

*upon the other sureties, and not upon the creditor. The pleas of division raises an issue of fact, namely, the solvency of the other sureties. This is tested at the time the division is demanded. When the plea of division is urged, the burden is upon the creditor to show the insolvency of a surety"*⁹⁷.

However, the risk of insolvency of any of the sureties shifts from the co-sureties to the creditor, if it happens after the plea of division has been raised.

The benefit of division may be waived if it is not claimed by a surety when sued or it may also be waived by an express renunciation in the contract at the instance of the creditor, "*or impliedly by the sureties binding themselves in solido with the principal debtor.*"⁹⁸

iii. OTHER PLEAS

In addition to the benefits of discussion and division the surety may also raise other defenses against the creditor. "*The surety can raise any defense which renders the principal contract invalid, and apparently he may plead a relative nullity of the principal obligation, even though the debtor has not disaffirmed the contract. The surety may have the defense that the principal contract has been extinguished, and consequently his own. The surety can of course, plead a vice of consent in his own suretyship contract. Briefly*

⁹⁷ Ibid.

⁹⁸ Ibid.

*put, the causes of extinction of suretyship can be divided into two groups: first, causes extinguishing the principal obligation, and at the same time by way of consequence that of the surety; and second, causes extinguishing the obligation of the surety but not the principal obligation."*⁹⁹

b. BETWEEN DEBTOR AND SURETY

The fact that a debt is guaranteed by a single surety or co-sureties does not make any difference as far as the effects of suretyship between the debtor and the surety or sureties are concerned,

i. SUBROGATION

A surety or sureties who pay the creditor in satisfaction of the debt are subrogated to the rights of the creditor against the debtor. Subrogation is substitution of the creditor by the surety whereby the latter is put in the shoes of the former for all practical purposes. Subrogation may be conventional when it is achieved by the agreement of the parties or legal when it is achieved by the operation of the law. A surety is subrogated to the rights of the creditor by the operation of the law.

ii. INDEMNIFICATION

The surety, who has paid the debt, has the right to demand indemnification from the principal debtor. Such indemnification may consist of the

⁹⁹ Ibid.

principal and interest including *"those costs of suit charged against him after he has notified the debtor of the action against him."*¹⁰⁰ A debtor who has not been informed about the legal action brought against the surety has no obligation to reimburse the costs of the suit to the surety who has failed to inform him of such suit.

A surety who is released from his obligation by making a discounted payment, is entitled to claim *"from the debtor only the discounted amount and not the full nominal debt."*¹⁰¹ It is said, *"the actual amount of surety's payment to the creditor is the measure of his rights against the debtor."*¹⁰²

There are two situations whereby a surety may lose his right against the debtor. The first one is when the debtor pays the creditor without being informed of the payment made by the surety. *"The surety in this case cannot recover indemnification from the debtor. The risk of a second payment is placed upon the surety, because of his negligence. However, the surety has a right to reimbursement from the creditor, as the creditor is not entitled to two payments."*¹⁰³ Therefore, a surety who makes payment to a creditor in relation with his suretyship obligation must inform the principal debtor the making of such payment immediately.

¹⁰⁰ Ibid.

¹⁰¹ Ibid.

¹⁰² Ibid.

¹⁰³ Ibid.

The other situation whereby the surety may lose his right of recourse against the principal debtor is where he "*voluntarily pays without notice to the debtor and the debtor has a valid defense. The surety is limited to an action against the creditor for restitution. In this situation, the surety has only the rights that any assignee of the creditor would have.*"¹⁰⁴

c. BETWEEN SURETIES

Those who guarantee the same debtor and the same debt are called co-sureties. Co-sureties, whether they sign the agreement of suretyship each of them separately or together at the same time, are entitled to claim the right of contribution. "Privity of contract among the sureties is not required. There need be no arrangements between the sureties themselves nor is it necessary that the obligations be assumed simultaneously. The same debt and debtor constitute the essentials for the right of contribution."¹⁰⁵

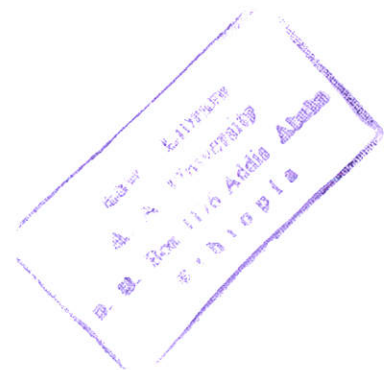
A surety who has paid the whole debt or more than his ratable share of the debt may proceed against the other co-sureties for contribution. "*There are several reasons that one of several sureties may have paid more than his share, namely, a waiver of the benefit of division, a failure to plead timely the benefit of division, or perhaps the insolvency of one of the other co-sureties. From the principal debtor, the surety is entitled to complete*

¹⁰⁴ Ibid.

¹⁰⁵ Ibid.

*subrogation or complete indemnity; but from the co-sureties he is entitled only to contributive subrogation or contributive indemnity. The paying surety is obliged to divide his recourse, just as the solidary debtor who has paid the entire debt."*¹⁰⁶

¹⁰⁶ Ibid.



CHAPTER FOUR

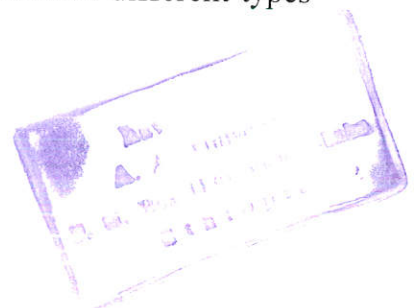
BASIC PRINCIPLES OF THE ETHIOPIAN SURETYSHIP

LAW

A. Introduction

Ethiopia is a nation of nations and nationalities. It is said that there are about eighty nations and nationalities. Each nation and nationality has got its own rich culture. The problem is, however, the cultural heritage and the traditional institutions of the majority of these different nations and nationalities have not been adequately studied. Those that have been studied relate only to a small community inhabiting a limited area of the country. Due to this fact, it may be very difficult to trace back the origin and development of the institution of suretyship, which could be a representative institution of the whole nations and nationalities of Ethiopia. Therefore, there is no alternative other than being content with that what already exists.

Similar to other countries, the origin and development of the instantiation of suretyship in Ethiopia has also been interwoven with the origin and development of the judicial system. The most typical feature of the traditional court proceedings in Ethiopia, for a long time, had been the practice of guarantee (Waas). They say that there had been different types



of sureties, such as Yegebeqabe or Yemegazia waas, Yesne-serat waas, Yegefi waas, Yedagnet waas, Yebesella waas, Ythelefa waas and Yjje-tebik waas [Abera Jembere, " *Tatayyaq Muget: The Traditional Ethiopian Mode of Litigation*"¹

Although it had no wide coverage of the whole geographical span of the county, the Fetha Nagast (The Law of Kings), as translated by Abba Paulos Tzadua, also contains provisions on guaranty.

The Present Civil Code of Ethiopia contains 32 articles specially dealing with suretyship. These articles are part of the law on general contract. Therefore, the purpose of this chapter is to give a bird's-eye view of those basic principles of suretyship law provided under the said articles.

B. NATURE OF CONTRACT OF SURETYSHIP

Suretyship is the guarantee of an obligation whereby a person undertakes towards the creditor to discharge such obligation in case the debtor fails to discharge it.² The guaranteed obligation may be a future or a conditional one.³ The condition attached to such obligation may be a condition precedent⁴ or a condition subsequent.⁵

¹ Abera Jembere "Tatayyaq Muget: The Traditional Ethiopian Mode of Litigation," *J. Eth. L.*, Vol. 15 (1992), pp. 82-93.

² Civ. C. Art. 1920.

³ Civ. C. Art. 1925.

⁴ Civ. C. Art. 1871.

⁵ Civ. C. Art. 1872.

A contract of suretyship may be concluded for a definite or an indefinite period of time. If it is concluded for an indefinite period of time, the surety may terminate such suretyship contract any time as long as the guaranteed obligation is not yet due .⁶

In a contract of suretyship, there are always two obligations.⁷ The obligation undertaken by the guaranteed debtor is called principal obligation and that which is undertaken by the guarantor is called an accessory or a secondary obligation. The secondary obligation undertaken by the guarantor is binding upon him only if the principal obligation in respect of which such guarantee has been given is valid. However, if the guarantor was aware of the fact that the debtor was incapable or his consent was obtained by mistake, he will remain bound by his obligation even if the principal obligation has been rendered ineffective as a result⁸ (ECC 1923).

As a contract of guarantee is a contract between the guarantor and the creditor, the consent of the debtor is not required. The guarantee may be given without the knowledge of the debtor and without any request from

⁶ Civ. C. Art. 1925.

⁷ Civ. C. Arts 1920 and 1923.

⁸ Civ. C. Art. 1923.

him,⁹ and even against his will. A surety may guarantee the obligation of customers who purchase goods on time payment without them knowing it.

The maximum amount for which the guarantee is given must be specified in the contract of suretyship.¹⁰ A guarantee may be given in respect of part of the debt and on less burdensome terms. But, a guarantee, which exceeds the amount, owed by the debtor or which has been given on more burdensome terms may be reduced to the primary debt.¹¹ In no case, can a guarantee be extended beyond the contractual limits.¹² However, the guarantor may be held liable beyond the limits of the maximum amount stated in the contract of surety ship for the costs of any court action against the principal debtor, provided that he has been given due notice before the institution of such action¹³ including the payment of interest, if any, within the limits of the specified maximum amount¹⁴

C. *FORMAL REQUIREMENTS*

The Ethiopian Law prohibits the presumption of the existence of contract of suretyship between two parties. Inferences of circumstances to find out whether there exists suretyship contract between parties are not allowed. It

⁹ Civ. C. Art. 1921.

¹⁰ Civ. C. Art. 1922.

¹¹ Civ. C. Art. 1924.

¹² Civ. C. Art. 1922.

¹³ Civ. C. Art. 1931.

¹⁴ Civ. C. Art. 1930.

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The maximum amount for which the guarantee is given must be specified in the contract of suretyship.¹⁰ A guarantee may be given in respect of part of the debt and on less burdensome terms. But, a guarantee, which exceeds the amount, owed by the debtor or which has been given on more burdensome terms may be reduced to the primary debt.¹¹ In no case, can a guarantee be extended beyond the contractual limits.¹² However, the guarantor may be held liable beyond the limits of the maximum amount stated in the contract of surety ship for the costs of any court action against the principal debtor, provided that he has been given due notice before the institution of such action¹³ including the payment of interest, if any, within the limits of the specified maximum amount¹⁴

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¹¹ Civ. C. Art. 1924.

¹² Civ. C. Art. 1922.

¹³ Civ. C. Art. 1931.

¹⁴ Civ. C. Art. 1930.

is required that suretyship must be expressed.¹⁵ The term "*express*" does not in any way imply only a written form. A verbal agreement is also an express agreement. Whether the contract is made in writing or verbally, the only thing that is required by Civ. C. Art.1922 is the fact that a party has undertaken to guarantee the obligation of another person must be stated in the contract of suretyship in a clear and an unequivocal manner. But, that does not mean that a suretyship contract can be concluded verbally under Ethiopian Law. The Ethiopian Law requires a written form for the conclusion of a contract of suretyship.¹⁶ This is one point where the Ethiopian Law deviates from the French Law, which does not require written form for the conclusion of suretyship contracts. The Ethiopia Law is similar to that of Louisiana in this regard.

Under Ethiopian Law, a written contract is required to be signed by all the parties bound by such contract and should be attested by two witnesses.¹⁷ 1727). The question, then, is whether the contract of suretyship should also be signed by both the surety and the creditor, and attested by two witnesses. "*In French Law, surety ship (the creditor - surety contract) is considered to be a unilateral contract and requires nothing more than the clear and convincing intention of the party to act as a surety.*"¹⁸ From the reading of

¹⁵ Civ. C. Art. 1922.

¹⁶ Civ. C. Art. 1725.

¹⁷ Civ. C. Art. 1727.

¹⁸ Ralph Slovenko, "Suretyship," Tulane Law Review, Vol. 39 (1965), pp. 427-490.

Civ. C. Art.1920, one can deduce that under Ethiopian Law suretyship is also a unilateral contract. This is because that in the said article it is only the guarantor who is expected to undertake towards the creditor to discharge an obligation. The undertaking of the creditor towards the guarantor has not been foreseen by the said article. Therefore, as a unilateral contract, the person bound by suretyship contract is only the guarantor. Since the requirement is that a written contract to be signed by those parties bound by it¹⁹ it is sufficient if it is signed by the surety (guarantor) only. The signing of suretyship contract by the creditor is not required and is unnecessary.

Another problem that needs solution is whether the written contract of suretyship should be attested by two witnesses or not. From the reading of Civ.C.Art. 1727(2), it seems that the attestation of written contracts by two witnesses is mandatory. However, the phrase "*where witnesses are required by agreement*" in Civ. C. Art. 1729(1) clearly indicates that the attestation by two witnesses is required only when the special law dealing with that particular contract so prescribes or when the parties provide in their agreement for such attestation. Such is the case, for example, when an immovable property is donated.²⁰ Therefore, attestation by two witnesses is not required in the case of suretyship contracts. This is because that there is

¹⁹ Civ. C. Art. 1772.

²⁰ Civ. C. Arts. 2443 and 881.

no specific provision of the law requiring such formality with regard to suretyship contracts.

D. TYPES OF GUARANTEES AND GUARANTORS

The Ethiopian Law of suretyship classifies guarantee as simple guarantee²¹ joint guarantee²² counter-guarantee²³ and secondary guarantee.²⁴ Similarly, the guarantors are also classified as simple guarantor, joint guarantor, and counter-guarantor, secondary guarantor and co-guarantor.

The simple guarantor is what in the Civil Law is called ordinary surety or guarantor. Whereas, the joint guarantor in the Civil Law is called a solidary guarantor (surety bound in solido with the principal debtor). A counter guarantor, on the other hand, is a guarantor who guarantees towards the simple or joint guarantor the effectiveness of his or their indemnity claims against the principal debtor.²⁵ And, the secondary guarantor is a person who stands surety for the guarantor who guarantees the principal debt. The relationship between the guarantor and the secondary guarantor is similar to that which exists between a simple guarantor and the principal debtor.²⁶ Finally, co-guarantors (co-sureties) are several persons who guarantee the

²¹ Civ. C. Art. 1934.

²² Civ. C. Art. 1933.

²³ Civ. C. Art. 1950.

²⁴ Civ. C. Art. 1951.

²⁵ Civ. C. Art. 1949.

²⁶ Civ. C. Art. 1950.

same debtor in respect of the same debt. Such guarantors may undertake the obligation at the same time in the same instrument or by different instruments or one after another by successive instruments. When the undertaking is made at the same time, each of them is held liable as a simple guarantor for his pro rata share and as secondary guarantor for the shares of his co-guarantors. But, when their undertakings have been executed by successive instruments, *"he who bound himself in the second place shall be held liable as secondary guarantor of the guarantor who bound himself before him"*.²⁷ In cases where such co-guarantors bind themselves expressly as joint guarantors either with the principal debtor or as between themselves, each of such co-guarantors shall be held liable for the whole debt.²⁸

E. RIGHTS OF THE SURETIES

The contract of surety ship creates relations between the surety and the creditor, the surety and the principal debtor, the co-sureties, the counter-guarantor and the guarantor, the counter-guarantor and the debtor, the secondary guarantor and the creditor, the secondary guarantor and the guarantor and the secondary guarantor and the debtor. Therefore, the effect of such relationships on each of the parties will be analyzed in the following manner.

²⁷ Civ. C. Art. 1951.

²⁸ Ibid.

1. Rights of Surety Against the Creditor

A contract of surety-ship establishes relationship between the creditor on the one hand and the simple guarantor or joint guarantor or secondary guarantor or co-guarantors on the other.

Any of such guarantors may challenge the validity of both the principal contract and the suretyship contract on the ground of non-fulfillment of the requirements set forth under ECC art 1678²⁹ (ECC art. 1923). The only exception to this basic rule is that he cannot invoke mistake of or incapacity of the principal debtor if we were aware of such mistakes or incapacity at the time of the conclusion of the contract of suretyship. Otherwise, unless the main contract fulfils the requirements of a valid contract provided under Civ. C. Art. 1678, the suretyship contract shall not be binding upon the surety. Of course it should not be forgotten here that, in order to be binding, the suretyship contract must also satisfy those requirements laid down under Civ. C. Art.1678.

A simple guarantor, a secondary guarantor or co-sureties who have not bound themselves in solido, may invoke what is known as the benefit of discussion when sued by the creditor.³⁰ According to Cochran's Law Lexicon and Black's Law Dictionary, the term "*Benefit of discussion*"

²⁹ Civ. C. Art. 1923.

³⁰ Civ. C. Art. 1935.

comes from the Latin term "*beneficium ordinis excussionis or discussionis*" or "*beneficium ordinis*" which means a privilege by which a surety could call on a creditor to sue the principal debtor first, and only after that sue the surety for that what he could not recover from the principal debtor. The two dictionaries further provide that in Roman law the term "*discuss*" or "*excuss*" means to seize and detain by law. Therefore, the term "*discussion*" in Civ.C. Art.1935 means to cause the property of the principal debtor to be sized by court order for the purpose of execution. An action must be brought first in order to give an order for the seizure of the property of another. Therefore, when it is said discussion, it means that the creditor must go all the way through proper court proceedings and get judgment against the principal before he starts the process of execution.

The guarantor can raise the plea of the benefit of discussion "*as soon as he is first proceeded against*"³¹ and not before that. The statement "*as soon as he is first proceeded against*" means during the preliminary objection and not after that. If it is not raised during the preliminary objection, it is regarded as waived. The guarantor is not allowed to raise it after that. The guarantor can successfully claim the benefit of discussion if only the insolvency of the debtor has not been judicially established.³²

³¹ Ibid.

³² Ibid.

In order to obtain an order of discussion, the guarantor who claims the benefit of discussion has an obligation to indicate the assets of the debtor to be discussed and also advance sufficient money necessary for the discussion of such assets. However, property of the debtor which is subject to litigation or which is outside the jurisdiction of the court entertaining the case between the creditor and such guarantor or property mortgaged as security for the debt guaranteed or which is no more in the possession of the debtor cannot be indicated by the guarantor claiming the benefit of discussion.³³

Another right that may be claimed by a surety is what is known as the benefit of division. This is also of a Roman origin. According to Cochran's Law Lexicon, the term " *benefit of division* " comes from the Latin " *beneficium divisionis* " which means the right of a surety to contribute only ratably with his solvent co-sureties. Solvency of the co-sureties is a precondition for claiming this right. The question of the benefit of division arises when several guarantors guarantee the same debtor in respect of the same debt without being bound jointly either, with the principal debtor or as between themselves.

Under Ethiopian Law, each co-surety is regarded as a simple guarantor as far as his pro rata share is concerned and also as a secondary guarantor as

³³ Civ. C. Art. 1936.

far as the shares of his co-sureties are concerned.³⁴ This means that a co-surety who has been sued as a simple guarantor may claim the benefit of discussion and he who has been sued as a secondary guarantor may claim the benefit of division, that is, the discussion of the assets of the other co-sureties who are solvent. Therefore a co-surety against whom an action has been brought separately for the whole debt may claim both the benefit of discussion and also the benefit of division at the same time.

Both the benefit of division and also the benefit of discussion are not available to the joint guarantor.

2. RIGHTS OF SURETY AGAINST THE DEBTOR

A guarantor may not be compelled to pay before the time fixed even if the principal debtor goes bankrupt before such fixed time.³⁵ Upon maturity of the debt, if the guarantor is forced to pay such debt, he acquires the right of indemnification whether the guarantee has been given with or without the knowledge of the debtor.³⁶ Such indemnity claim against the debtor extends to the principal, interest, costs incurred³⁷ and damages suffered, if any, due to the fault of the debtor.³⁸ The guarantor may lose such right of indemnification if he fails to raise all the defenses available to the principal

³⁴ Civ. C. Art. 1951.

³⁵ Civ. C. Art. 1932.

³⁶ Civ. C. Art. 1940.

³⁷ *Ibid.*

³⁸ Civ. C. Art. 1941.

debtor unless the defenses are such which are excluded by the nature of the guarantee.³⁹ For example, a guarantor who stood surety for an incapacitated person may not avail himself of the incapacity of the principal debtor. His right of indemnification shall, however, be maintained if he is able to prove that he failed to raise such defenses due to ignorance of the existence of such facts.⁴⁰

The other right of the guarantor is the right of subrogation. Subrogation is of two types, legal subrogation or conventional subrogation. The conventional subrogation arises from the agreement of the parties⁴¹, whereas the legal subrogation arises from the operation of the law.⁴² The right of subrogation of a surety arises from the operation of the law.⁴³

A guarantor who pays the debt shall automatically be subrogated to the rights of the creditor to the extent of such payment. The right of subrogation cannot be waived in advance before it is acquired.⁴⁴ The creditor who has been paid by the guarantor has an obligation to hand over the documents of title to the guarantor and perform all the necessary formalities that will enable the latter to exercise his remedy and realize the

³⁹ Civ. C. Art. 1942.

⁴⁰ Ibid.

⁴¹ Civ. C. Art. 1968 and 1969.

⁴² Civ. C. Art. 1971.

⁴³ Civ. C. Arts. 1944 and 1971.

⁴⁴ Civ. C. Art. 1944.

securities available.⁴⁵ Failure to discharge such obligation due to an act or omission may result in the release of the guarantor.⁴⁶

3. RIGHTS OF SURETY AGAINST COSURETIES

The question of co-sureties arises when several persons guarantee the same debtor in respect of the same debt.⁴⁷ The guarantee given by the co-sureties may be ordinary guarantee (simple guarantee) or solidary guarantee or joint guarantee (to be bound in solido with the debtor or as between themselves.

When the guarantee given is an ordinary guarantee, the obligation of each co-surety is similar to that of a simple guarantor as far as his pro rata share of the debt is concerned and that of a secondary guarantor as far as the shares of other co-sureties are concerned.⁴⁸ In this case, a co-surety may be compelled to pay the shares of his co-sureties only if such co-sureties are insolvent and they have no any assets to be discussed. Otherwise, there is no other way by which a co-surety may be compelled to pay the shares of his co-sureties. If it so happens, then, unfortunately, such co-surety who has been compelled to pay the shares of his co-sureties acquires a right of contribution against such co-sureties.

⁴⁵ Civ. C. Art. 1945.

⁴⁶ Civ. C. Art. 1946.

⁴⁷ Civ. C. Art. 1951.

⁴⁸ Ibid.

In the case of joint guarantee (solidary guarantee), when the several guarantors agree to be bound in solido with the principal debtor or as between themselves, the creditor may demand the payment of the whole debt from each of such co-sureties. A co-surety who has been compelled to discharge the whole debt acquires a right of contribution against his co-sureties.⁴⁹

4. EXONERATION

The Ethiopian Law of suretyship provides several situations the occurrence of which may help the surety to free himself from liability. For example, *"the guarantor shall be released when the primary debt is discharged for any reason whatsoever"*,⁵⁰ including the invalidation of the principal obligation due to lack of any of those requirements of a valid contract. A voluntary acceptance by the creditor of an immovable or any other asset in satisfaction of the primary debt⁵¹ and any extension of the time of payment granted to the debtor without getting the consent of the guarantor⁵² are also circumstances which may help the guarantor to free himself from liability.

The guarantor shall also be released if the creditor fails to proceed against the principal debtor within six weeks for enforcement of his rights after

⁴⁹ *Ibid.*

⁵⁰ Civ. C. Art. 1926.

⁵¹ Civ. C. Art. 1927.

⁵² Civ. C. Art. 1928.

being notified to do by such guarantor when the debt has fallen due.⁵³ He will also be released from liability if the creditor fails to discuss the assets of the principal debtor indicated to him by such guarantor and being supplied with sufficient money for their discussion.⁵⁴ The failure of the creditor to notify the surety the bankruptcy of the principal debtor immediately as it happens releases such surety. Therefore, the creditor has a duty to make follow up of the position of the principal debtor.⁵⁵

⁵³ Civ. C. Art. 1938.

⁵⁴ Civ. C. Art. 1937.

⁵⁵ Civ. C. Art. 1947.

CHAPTER FIVE

SURETY BONDS AND BONDING COMPANIES

A. SURETY BONDS

A surety is a person (an individual or a corporation) who " *engages himself to a creditor to satisfy an obligation undertaken by the debtor if the latter does not satisfy it. This person, called the surety, obliges himself personally and is, in effect, a second debtor for the creditor.*"¹ And a bond " *is a written obligation that binds the surety to pay a certain sum upon the happening of some specified event.*"² In short, a bond is an instrument by which the surety promises to the creditor to satisfy the obligation undertaken by the principal debtor should the latter fail to do so. It is " *a written promise under seal which commits its issuer (the surety) to pay a named beneficiary, called the obligee, a sum up to a stipulated amount, but subject to the provision that the obligation of the issuer will cease if certain specified conditions are met.*"³

A surety bond may be issued by a bank⁴ bonding or insurance company⁵ or by other financial institutions⁶. One can issue as many different types of

¹ Ralph Slovenko, "Suretyship," *Tulane L. Rev.*, Vol. 39 (1965), pp. 427-490.

² John F. Dobbyn, *Insurance Law In A Nutshell* (3rd ed. 1996), p. 346.

³ Kevin Patrick McGuinness, *The Law of Guarantee: A Treatise On guarantee, Indemnity and the Standby Letter of Credit* (1986), p. 358.

⁴ David G. M. Marks, et al, *Rowlat On The Law of Principal And Surety* (4th ed. 1982), p. 233.

⁵ *Ibid.*, and Raoul Colinvaux, *The Law of Insurance* (3rd ed. 1970), p. 343.

bonds as possible. There is no theoretical limit to the type of bonds to be issued. It is the need that determines the types of bonds to be devised. In a journal article that was written back in 1927, it was confirmed that the business of surety company at that time embraced over five hundred varieties of bonds, of which three hundred of them were in common use.⁷

*"These, however, may be divided into six great classes: namely, (1) the fidelity bond, (2) bonds for executors, administrative and other fiduciaries, (3) bonds used in court proceedings, as appeal, replevin and attachment bonds, (4) contract bonds, (5) licence and permit bonds, and (6) public official bonds"*⁸. One can imagine therefore, how many more varieties of such bonds have so far been included to the list through all these years since 1927.

1. PARTS OF A BOND

It has already been said that a bond is a written instrument. This written instrument consists of three parts. The first part, which is called the obligation, or the operative part defines the obligation of the surety. The second part called the recitals explains the transaction and the factual context. And the third part deals with "*the condition set forth the occurrences that will trigger the obligations.*"⁹ Such condition may be a condition precedent or a condition subsequent. "*A condition precedent is a condition that must be satisfied in order for an obligation to arise. A condition subsequent is a*

⁶ Marks, cited above at note 4.

⁷ Willis D. Morgan, "History And economics of Suretyship," The Cornell Law Quarterly, Vol. 12 (1927), pp. 487-499.

⁸ Ibid.

⁹ Dobbyn, cited above at note 2.

condition *upon* which the continuation of a liability previously assumed is dependent¹⁰

2. **UNCONDITIONAL BONDS**

"*These* are four forms of documentary security in common usage in modern commercial practice. These are: (1) the surety bond, (2) the standby letter of credit; (3) the performance guarantee; and (4) the letter of comfort or letter of intent"¹¹ The use of such different forms has created confusion of terminology, particularly in the business of bonding services. It seems that there are difficulties in distinguishing surety bonds from the other documentary securities.

It is that "letters of credit and performance guarantee are quite similar in nature to each other. On the other hand, with respect to the nature of the protection afforded under surety bonds and letters of comfort, they are dissimilar to each other, and both differ greatly from letters of credit in the type of protection which they afford".¹²

It is said "the stand by letter of credit originated in the United States."¹³ When the national banking associations in the United States were

¹⁰ McGuinness, cited above at note 3, pp. 152-153.

¹¹ *Ibid.*, 358

¹² *Ibid.*

¹³ Clive M. Schmitthoff, *Schmitthoff's Export Trade: The Law And Practice of International Trade* (8th ed. 1986), p. 364.

prohibited not to issue guarantees, they began to make use of letter of credit in domestic banking. These days, standby letters of credit are also widely used in International Trade. Not only that “ *among the most common alternative uses of the letter of credit*”¹⁴ are the uses made by “ *banks and other lending institutions around the world.*”¹⁵ For instance, they use the standby letters of credit “*as vehicles for entering broad range of transactions in the role of quasi-guarantors*”¹⁶ It “ *may be deposited in court to secure the payment of a possible adverse judgment, or to secure the performance of contract or some other duty.*”¹⁷

The other type of documentary security is what is known as performance guarantee.

Performance guarantees are more common in Europe and the Third World than they are in North America. A performance guarantee (also known as an on demand guarantee) is documentary form of security under which the issuer undertakes to guarantee the payment of a stipulated amount to a named or designated beneficiary, upon compliance with terms set out in the performance guarantee. As in the case of a letter of

¹⁴ McGuiness, cited above at note 3, p. 383.

¹⁵ Ibid.

¹⁶ Ibid.

¹⁷ Ibid.

*credit, payment under a performance guarantee generally must be made upon demand. It is not usually necessary for the beneficiary to prove actual default by the principal. Thus despite the name, it is clear that a performance guarantee is not a guarantee in the legal sense. A bank or similar financial institution, as opposed to bonding company or insurer, usually issues performance guarantees. Thus, in terms of both the nature of the obligation assumed and the type of institution likely to enter into such an undertaking, performance guarantees are very similar in nature to letters of credit, and indeed (although the law on this point is not yet firmly established) it would seem that the two terms are Synonymous - the term performance guarantee being used to describe this type of obligation in Europe, while the term standby letter of credit is more common in American practice.*¹⁸

Still, another concept, which has created confusion in bonding business, is the term "guarantee" This term "is often used in other than its legal

¹⁸ Ibid., pp. 396-397.

sense"¹⁹ . For instance, " *in international trade, a bank guarantee or another contract guarantee has often - though not always - a different meaning. It means a primary and independent undertaking by the guarantor to pay if the conditions of the guarantee are satisfied.*"²⁰ While in its legal sense, a guarantee is an accessory or a secondary obligation to another contractual obligation.

David G.M.Marks and Gabriel S. Moss, authors of " *Rowlatt on The Law of Principal And Surety*", say that " *a distinction is in practice drawn between performance bonds issued by surety companies and those issued by banks or other financial institutions. In the case of the former, there is a guarantee in the event of the contractor's failure causing loss; in the case of the latter there is often an undertaking to pay money, in the event of breach or in certain cases upon presentation of certain documents or even upon a mere formal demand*"²¹

From the legal point of view, these instruments that are known as " *standard letter of credit*" " *first demand guarantee*", " *performance guarantee*", " *on demand bonds*", " *demand performance guarantee*" and " *financial guarantee bond*" including many other similar instruments, which may be called by different names, have one thing in common. They are all

¹⁹ Schmitthoff, cited above at note 13, p. 379.

²⁰ Ibid.

²¹ Ibid.

instruments by which the obligor undertakes a primary and an independent obligation towards the obligee (the creditor) to discharge the specified obligation irrespective of whether the debtor has failed to carry on his obligation or not. The obligation undertaken by any of these instruments does not depend in any way on the contractual relationship, between the creditor and the principal debtor, though such relationship had been the cause for the issuance of such instrument. That is why such instruments, in general, are known as unconditional bonds.²²

When it comes to surety bonds, however, they are conditional bonds. In this instrument called surety bonds, the surety undertakes an obligation towards the creditor to discharge the obligation of the principal debtor only if the latter fails to discharge it. That is why a suretyship obligation is called an accessory or a secondary obligation to that of the principal debtor's obligation. It cannot stand by itself without the primary obligation.

Therefore, in conclusion, it is possible to say that it is not the term used or the mere fact that an instrument has been issued by a certain institution (a bank or a bonding company) that makes an instrument conditional or unconditional, but what is written in the instrument is the determining factor. The undertaking may be conditional or unconditional, that is, it may

²² Ibid.

be accessory or secondary, or, it may be primary and independent. In the former case, it is a surety bond, and in the latter, it is not.

B. BONDING COMPANIES

Bonding companies are known by different names. They are also called corporate sureties or surety companies. These type of companies are specialized companies which are purely engaged in suretyship business or bonding business.

The lead in the formation of corporate surety was taken by England. " *The first company to insure the fidelity of employees held its preliminary meeting in 1720, pursuant to announcement in the London Daily Post.*"²³ It had taken sometimes, however, until finally in 1840 an English surety company was established to engage in the business of writing fidelity insurance on a commercial basis.²⁴

In the United States, the first step towards corporate suretyship was taken in 1853, when the legislature of New York authorized the incorporation of fidelity companies; but none was incorporated until 1875. Many of the present-day surety companies became established during the two decades between 1880-

²³ Earl C. Asnold, "The Compensated Surety," Columbia L. Rev., Vol. 26 (1926) pp. 171-189.

²⁴ Ibid.

1900. Approximately twenty- five such organizations now compete for fidelity and surety business on a national scale, and local corporation will about double this number. Two hundred and seventy-five different kinds of so-called bounds given by various companies are now recognized.

The first sanction accorded corporate surety companies by the federal government is found in the brief act of congress of August 13, 1894. Except for the amendment of March 23, 1910 transferring supervision from the Attorney General to the Secretary of the Treasury, the Act of 1894 remains in force as originally adopted.²⁵

This was written back in 1926. A survey carried out in 1927²⁶ showed that there were seventy companies in Great Britain, thirty-five in the United States, two in Canada, two or three in Switzerland, one or two in Germany, one in Denmark, at least one in Sweden, one at Barcelona (Spain), one at Johannesburg in Africa, two in Japan, one in Mexico and two in Argentina.

²⁵ *Ibid.*

²⁶ Morgan, cited above at note 7.

That was how the business of corporate bonding had begun and went on spreading to the rest of the world.

Different reasons were given for the emergence and development of corporate sureties. One of the reasons given was the dissatisfaction created by the practice of private individuals acting as guarantors. "*The obligee, the surety, and the principal found the practice undesirable.*"²⁷

Another reason, which stimulated the further development of corporate surety, was "*the permanence and stability of the surety corporation. They are subject to the regulation provided by the statutes, they have a lasting and permanent organization.*"²⁸ Such organization which conducts bonding business usually has "*large amounts of capital and surplus and is subject to the supervision of the state.*"²⁹

Lasting, permanent and stabilized with large amounts of capital and surplus and which is subject to the supervision of a government can only be what we call share company in Ethiopia, public limited company in England and India and Corporation in the United States of America. No private limited company or partnership possesses such characteristics. Particularly, in the case of a partnership, a guarantee given by a partnership is a guarantee given by the partners jointly, since the liability of the partnership is a joint liability of its partners. In other words, it is going to be

²⁷ S.B. Ackerman, *Insurance: A Practical Guide* (3rd ed. 1948), p. 320.

²⁸ David L. Bickehaupt, et al, *General Insurance* (8th ed. 1970), pp. 517-518.

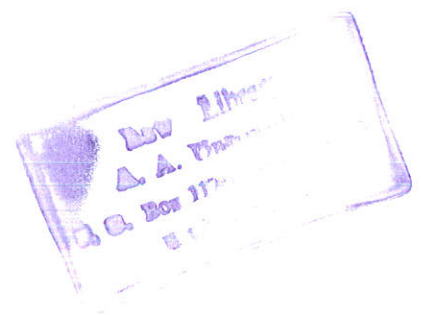
²⁹ Ackerman, cited above at note 27, p. 321.

individual suretyship rather than corporate suretyship. That is not desired in bonding business. Therefore, the desired form of business organization for bonding services is the corporation. "*Corporate surety-ship assumes risks that most individuals cannot afford to assume, and its performance is generally dependable.*"³⁰

Since the primary purpose of surety bonds is to serve in the extension of credit, surety companies seek to secure themselves against loss wherever possible. To accomplish this, in some cases the companies demand that the principal give them collateral as security. If a misfeasance occurs, the surety companies can then sell the collateral that has been deposited. Generally the following types of collateral are acceptable: (1) cash or certified check; (2) Savings bankbooks properly assigned to the bonding company; (3) bonds listed on a stock exchange and made payable to the bearer; (4) stocks listed on a stock exchange.

The principal may desire to offer mortgages and real estate as security. These are not desirable forms of collateral. The reason is that the bonding companies can be certain only after a title search has been made that the principal has the interest he claims in the mortgage or real estate. The cost of

³⁰ Slovenko, cited above at note 1.



*the search is expensive and the time required may be long. Also, there is the problem of liquidation and marketability of the property in case the surety company acquires the property.*³¹

C. THE DISTINCTION BETWEEN SURETYSHIP AND INSURANCE

The surety business is run as an ancillary business by banks and insurance companies and as a main business by surety or bonding companies. Particularly insurance companies and bonding companies practically apply the same basic principles in dealing with risks that may involve in the course of their respective businesses. As a result *"a few writers consider these companies to be insurers, while others view them as something unique, a hybrid as it were, devoted neither to insurance nor banking but related perhaps to both."*³² As it has been said earlier, in practice, the way both insurance and bonding businesses are run is strikingly similar.

As a further indication of the true nature of these companies, it is significant that their main function is precisely that of pure insurance. Risks of any nature may be met in three distinct ways: by avoidance, by prevention or by combination. This last method, commonly known as insurance involves the assumption of risks in return for a fixed price and its

³¹ Ackerman, cited above at note 27, p. 321.

³² Morgan, cited above at note 7.

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³¹ Ackerman, cited above at note 27, p. 321.

³² Morgan, cited above at note 7.

final analysis represents an exchange of a un- certain future loss for a present fixed sum. Thus, the main functions of insurance is said to be to replace the uncertainty of the future with the certainty of the present. And surety company in taking risks involving the dishonesty or irresponsibility of human beings in return for a fixed sum of money, is performing this very function.

The corporate surety, like every other type of insurance occasions an economic loss. The gross premiums charged by surety companies may be divided in three parts: (1) provision for the payment of losses, known as the pure premium, (2) provision for the costs of management and (3) residual amount which contributes to the surplus of the company.³³

Though the businesses of insurance and bonding services are run in the same manner and using the same principles of risk management as shown above, there is a clear distinction between the two. " A contract of surety creates a tripartite relation between the party secured, the principal obligor, and the party secondarily liable, and the rights, remedies, and

³³ Ibid.

defenses of a surety cannot be disassociated from this relationship even though you call the contract one of insurance"³⁴. The contract of insurance, on the other hand, does not create a tripartite relationship. There are only two parties in a contract of insurance, the insurer and the insured. Besides, a contract of insurance is a primary and an independent contract. Thus, *"Suretyship is a collateral undertaking while insurance is an original undertaking."*³⁵ Not only that *"in surety-ship the liability of the principal, debtor is said to contractual, whereas in insurance the liability of the one against whom subrogation is available is usually delictual"*³⁶

Sometimes, confusion may be created when a fidelity bond is issued. Depending on who has concluded the contract with the insurance company or the bonding company the contract may be either fidelity insurance or a fidelity suretyship. In case where an employer concludes a contract with an insurance company or a bonding company to protect himself from the dishonesty of his employees, the contract shall be fidelity insurance. On the other hand, when an employee concludes a contract with an insurance company or a bonding company so that such company guarantees towards the employer his honesty, such contract shall be fidelity surety-ship.

In general, *"the conclusion is drawn that the distinctions between suretyship and insurance are of some value but should not be thought of as*

³⁴ Slovenko, cited above at note 1.

³⁵ Ibid.

³⁶ Ibid.

always true in comparing all types of insurance with all types of bond. The differences are much more meaningful when contrasting specific types of insurance with specific types bonds."³⁷

D. THE ROLE PLAYED BY SURETYSHIP IN CREDIT BASED ECONOMY

It is said " the economy of the entire Western world has for many years been dependent upon the extensive availability of credit. Because credit is so central to the economic health of the nation, the various laws that impact upon creditors have a significant influence upon economic health."³⁸ All laws " that promote the extension of credit will tend to promote economic expansion, or at least the continuance of a state of economic good health."³⁹ Therefore, the laws governing security devices have a significant impact on the flow of credit and as a result on the maintenance of economic good health.

The various security devices have already been discussed earlier in a separate chapter in this study. Such security devices may be classified into two major groups, the real security devices and the personal security devices. The real security devices deal with movable and immovable, tangible and intangible property. While the personal security may be an

³⁷ Bickelhaupt, Cited above at note 28.

³⁸ McGuinness, cited above at note 3, p.5.

³⁹ Ibid.

individual or a company. And the security device, which involves such personal security, is called suretyship.

In the case of real security, the creditor may need to make title search and go through the process of registering his rights. Besides, he may need to take preservatory measures. For that, he needs additional manpower and organizational set-up whereby he incurs additional costs. If such things are normally done by a specialized company such as bonding or a surety company, things may become easier and less expensive. But, if banks involve in such activities outside their normal business purposes, things may become more complicated and also more expensive.

Therefore, the existence of bonding companies is very beneficial to institutions organized for credit extending purposes. They can provide credit facilities without any worry. They can easily get back their money without difficulty. The experiences of other countries have already confirmed that, the *"corporate suretyship assumes risks that most individuals cannot afford to assume, and its performance is generally dependable."*⁴⁰

⁴⁰ Slovenko, cited above at note 1.

CHAPTER SIX

COMPANIES RENDERING BONDING SERVICES IN ETHIOPIA

A. Introduction

Bonding services have been provided by banks and insurance companies in Ethiopia. There has never been even a single specialized company in Ethiopia engaged in bonding businesses. Banks and insurance companies have been rendering such services as ancillary services.

As banks and insurance companies in Ethiopia have had a short span of life, compared with those of the developed countries, the bonding business has not yet developed to the extent where it can fulfill the requirements of the business community in that respect. Banking, in its modern sense, was first introduced to Ethiopia in 1905.¹ The first bank was established here in Addis Ababa under a 50-years' franchise agreement with the then British owned National Bank of Egypt.² The bank had branches in Dire Dawa, Gore and Dessie, agency office in Gambella and transit office in Djibouti.³ However, the bank did not remain operating for long.⁴ It was liquidated being accused of inefficiency.⁵ Following that, an indigenous bank called Bank of Ethiopia was established by an official decree on August 29, 1931.⁶

This bank also opened branches in Dire Dawa, Gore, Dessie, Debre Tabor and Harrar,

¹ Belai Giday, Currency & Banking: Ethiopia (1987), p. 68.

² Ibid.

³ Ibid., p. 70.

⁴ Ibid.

⁵ Ibid.

⁶ Ibid., p. 71.

an agency in Gambella and a transit office in Djibouti.⁷ Although not indigenous, there were also other banks during that time operating in the country.⁸ The Bank of Ethiopia operated until 1935 when it finally ceased its function due to the fascist invasion. During the occupation of the country about six Italian⁹ banks had opened branches in different regions of the country.

After the liberation of the country from fascists' occupation, a new bank called the State Bank of Ethiopia¹⁰ was established by General Notice No. 18 of 1943. The same bank also acted as a Central Bank of Ethiopia. Between 1943 and 1963, this bank opened about 21 branches in different parts of the country as well as in Khartoum, the Sudan, and a transit office in Djibouti. In 1963, when a monetary and banking law was issued, the State Bank of Ethiopia was split into two, the National Bank of Ethiopia and the Commercial Bank of Ethiopia.¹¹ Between 1941 to 1974, Banco di Roma, Bankco di Ethiopia, Banqu del Indochine, Agricultural Bank, Development Bank of Ethiopia, Imperial Savings and Home Ownership Public Association, Investment Bank of Ethiopia, National Bank of Ethiopia, Commercial Bank of Ethiopia, Addis Ababa Bank, Savings and Mortgage Corporation of Ethiopia, Ethiopian Investment Corporation, and Agricultural and Industrial Development Bank had appeared, operated and some of them disappeared during the same period.

⁷ *Ibid.*

⁸ *Ibid.*

⁹ *Ibid.*, p. 72.

¹⁰ *Ibid.*, p. 73.

¹¹ *Ibid.*, p. 75.

During the 1974 Ethiopian revolution, all private banks had been nationalized and only four had been operating under state ownership. These were: (1) the National Bank of Ethiopia, (2) the Commercial Bank of Ethiopia, (3) Agricultural and Industrial Development Bank, and (4) Housing and Savings Bank.

After EPRDF seized power in 1991, a number of private banks have been established. Today¹², one central bank, eight commercial banks and one development bank with numerous branches throughout are operating in the country.

Insurance business is also a recent phenomenon in this country. Who would believe if he were told that a bank here began insurance activity in Ethiopia? It was the Bank of Abyssinia, which began Insurance activity in the 1920s.¹³ An Austrian national established the first insurance Company, in 1923¹⁴ as an agent of foreign fire insurance company. During the period of the fascist occupation, no insurance company other than the Italian companies was allowed to operate in the country.

After the liberation, the first insurance company with its head office here in Addis Ababa was established in 1951. That company was called the Imperial Insurance Company of Ethiopia. Following that a number of insurance companies were formed expanded the business by opening branches in different parts of the country. On the eve of the 1974 Ethiopian revolution there were thirteen¹⁵ insurance companies,

¹² Birritu, August-October 2003, on the inside of the last cover.

¹³ Belai Giday, cited above at note 1, p. 100.

¹⁴ *Ibid.*

¹⁵ *Ibid.*, p. 101.

namely: (1) Imperial Insurance Company of Ethiopia, (2) Ethiopian -American Life Insurance Company, (3) National Ethiopian Insurance Company, (4) Afro-Continental Insurance company, (5) Blue Nile Insurance Co. (6) African Solidarity Insurance Co., (7) Lion Insurance Co. (8) Ethiopian Life Insurance Co., (9) General Insurance Co., (10) Pan- African Insurance Co., (11) International Insurance Co., (12) Rasai-Ethiopia Insurance Co., and (13) Union Insurance Co. In 1975, after the eruption of the revolution, all the thirteen insurance companies were nationalized and the Ethiopian Insurance Corporation, a government owned corporation, was established to run the insurance business in their stead.

After EPRDF came to power in 1991, again, a number of insurance companies have been established. Today, there are eight private insurance companies and a Government Insurance Corporation.

It may be worth-mentioning here that the backbone of these newly established private banks and insurance companies are former employees of the Ethiopian National Bank, the Commercial Bank of Ethiopia and the Ethiopia Insurance Corporation. Some of them left their former place of work on pension and some of them left seeking better working conditions, better salary and joined the newly established banks and insurance companies. They took with them the same theoretical background, the same working habit, the same way of doing things and the same psychological make-up. One should not expect new ideas, new way of handling

business, a better theoretical background and a different psychological make-up in the newly established banks and insurance companies.

B.BANKS

In addition to the proper banking business, banks in Ethiopia also render bonding services as ancillary services. The type of bond they issue depends on the wish of their clients who require such services. Some require conditional bonds and some unconditional bonds. Sometimes, a client may come with his own draft bond instrument and request the bank only to sign such draft instrument. There are still other clients who request a guarantee bond, which incorporates the ICC Uniform Rules for Demand Guarantees. Therefore, some banks, especially the Commercial Bank of Ethiopia, have admitted using the ICC Uniform Rules for Demand Guarantees.

These Uniform Rules for Demand Guarantees (ICC Publication No. 458) result from the work of ICC joint working party of members representing the Commission on International Commercial Practice and the Commission on Banking Technique and Practice, and also from the work of the Drafting Group set up to finalize the text. The Rules are intended to apply world wide to the use of demand guarantees, that is, guarantees, bonds and other payment undertakings under which the duty of the guarantor or issuer to

make payment arises on the presentation of a written demand and any other documents specified in the guarantee and is not conditional on actual default by the principal in the underlying transaction.

Demand guarantees differ from documentary credits in that they are properly invoked only if the principal has made default. However, the guarantor, like the issuer of a documentary credit, is concerned not with the fact of default, but only with documents. Standby credits are already governed by the Uniform Customs and Practice for Documentary Credits (UCP) (1983 Revision No. 400). They have developed into all-purpose financial support instruments, which are used in a wide range of financial and commercial activity that demand guarantees, and regularly involve practices and procedures (e.g confirmation, issue for a bank's own account, presentation of documents to a party other than the issuer) that are infrequently encountered in relation to demand guarantees and that ally standby credits more closely with documentary credits. Accordingly, while standby credits are

technically within the definition of demand guarantee, it is expected that issuers of standby credits will continue to use the UCP, which are both more detailed and more appropriate to the particular requirements of standby credits.

These Rules do not apply to surety-ship or conditional bonds or guarantees or other accessory undertakings under which the guarantor's duty to pay arises only on actual default by the principal. Such instruments are widely used but are different in character from demand guarantees and are outside the scope and purpose of these Rules.^{9 16}

Therefore, banks may issue either a surety bond or a demand guarantee bond at the request of their customers without any restrictions whatsoever. When they issue a bond (a surety bond or a demand bond), they demand collaterals from their customers who require such bonding services. The collateral may be movable or immovable property, such as vehicles, houses and buildings, merchandise, business or cash.

¹⁶ International Chamber of Commerce, ICC Uniform Rules for Demand Guarantees, publication No. 458 (1992), pp. 4-5.

There were situations where banks were called upon to discharge their obligations undertaken in the instruments of surety bonds or demand bonds. However, these days, banks can easily get back the money they have paid to the beneficiary of the bond by selling the collaterals they are holding in accordance with the foreclosure laws (*Proclamation No 97& 98 of 1998*). The problem is, however, they say that banks have difficulties in finding interested buyers of the collaterals.

C. INSURANCE COMPANIES

The other institutions that have been providing bonding services in Ethiopia are insurance companies. It is not new for Ethiopian insurance companies to provide such services. Insurance companies in other countries¹⁷ also provide such services side by side with their main services.

Ethiopian insurance companies use standard forms prepared in the English language for the issuance of the said bonds. Some insurance companies use a format prepared for issuance of performance bonds in relation with construction contracts for all types of contracts; for example, for purchase contracts too. The bonds, whatever their nature, are signed in practice by both the principal debtor and the surety or guarantor. The language used in these standard bond forms makes one think that these forms have been copied from another country, particularly from the United Kingdom.

¹⁷ Raoul Colinvaux, *The Law of Insurance* (3rd ed. 1970), p. 343.

The financial guarantee bond has got three parts. The first part is the obligation part wherein it is stated that the principal and the surety "*are held and firmly bound unto . . . in the full and just sum of Birr . . . for the payment of which sum well and truly to be made the principal binds itself its successors and assigns and the surety binds itself its successors and assigns jointly and severally firmly by these presents.*"

The second part contains the recitation in which it is stated that the primary " *contract with all its covenants and conditions is hereby made a part of this Bond to all intents and purpose as though that contract had been incorporated herein including and duly authorized modifications of the said contract that may be made hereafter*"

And the third part contains the conditions wherein ,in some bonds, it is stated that "*if the principal shall well and truly and faithfully comply with all terms, covenants and conditions of said contract on its part to be kept and performed according to the tenor of the said contract or if on default by the principal the guarantor unconditionally and irrevocably without going into the merits of the case shall satisfy and discharge the damage sustained by the obligee thereby upon the first written demand of the obligee stating that principal has defaulted up to the sum of Birr . . . then this obligation shall be null and void otherwise it shall remain in force and virtue*".

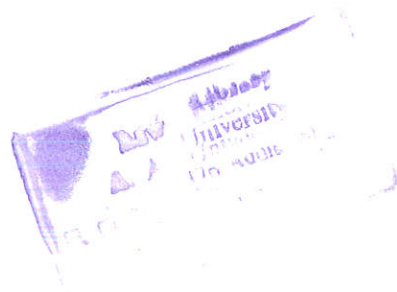
In other financial guarantee bonds, in the conditions part, they simply state that " *if the principal shall well and truly and faithfully comply with all terms, convents and*

conditions of the said contract on its part to be kept and performed according to the tenor of the said contract or if on default by the principal the surety shall satisfy and discharge the damage sustained by the obligee thereby up to the sum of Birr . . . then this obligation shall be null and void otherwise it shall remain in force virtue " In the bond in which the guarantor binds himself unconditionally and irrevocably, they usually incorporate the ICC Uniform Rules for Demand Guarantees which has already been discussed earlier in this study. The topic of both types of forms used for financial guarantee bonds is "*Financial Guarantee Bonds*" But the difference between the two financial guarantee bonds is that one is unconditional and irrevocable and the other is conditional otherwise in both bonds the guarantor undertakes monetary obligation.

Insurance companies demand collaterals in return from their customers whenever they are asked to issue bonds by such customers. Usually they demand such collaterals as vehicles, merchandise, houses and buildings or businesses. When they hold vehicles as collaterals, they tell the pledgor to go to the Road Transport Authority or other government body empowered to discharge the functions of Road Transport Authority and get the seal of such authority put on the title documents of the vehicles indicating that the said vehicles are pledged and finally hand over such documents to the insurance company concerned. Outside this, no contract of pledge is signed between the pledgor and the insurance company concerned. Although the actual practice is that insurance companies usually demand collaterals from their customers in consideration of the issuance of bonds, there are, however, cases where

they allow some of their customers whom they call highly valued and selected clients to obtain surety bonds without having provided collaterals. However, they do not define what they mean by " *highly valued and selected clients* " Therefore, the definition of this term depends on how each branch manager comprehends it. It means that insurance companies use subjective standard in this case. Certain insurance companies' internal rules which prescribe the manner how bonds should be issued and what requirements to be fulfilled before the issuing bonds. However, there are evidences indicating violations of such rules.

That was how insurance companies have been providing bonding service until recently. Recently, however, the National Bank of Ethiopia issued two directives one after another prohibiting insurance companies from issuing certain types of bonds. The first directive issued by the National Bank of Ethiopia in this regard was Directive No. SIB/23/2002, which was to come into force as of the 23rd day of December, 2002. In that Directive, the prohibited bonds were financial guarantee bonds and unconditional bonds. In the said directive a financial guarantee bond was defined as " *an obligation undertaken by an insurance company to pay to a lending bank or another creditor or supplier all outstanding claims arising from non-payment by principal debtor or debtors* ". And an unconditional bond is defined as " *a bond other than a Financial Guarantee Bond issued by an insurance company that is payable to the beneficiary upon demand, without any pre-conditions attached to such payment.* "



The said directive was followed by another directive known as Directive No. SIB/24/2004 which came into force as of the 1st day of March 2004 and which repealed Directive No. SIB/23/2002 as a whole. This Directive also prohibits the issuance of certain types of bonds by insurance companies. Both Directives are basically the same, except that in the latest one the definition of a Financial Guarantee Bond has been modified and phase-out periods for outstanding financial guarantee bonds and unconditional guarantee bonds have been set forth. In this latest directive, financial guarantee bond has been defined as *"a bond payable on demand issued by an insurance company obliging such insurance company to pay to a lending bank or another creditor or supplier all outstanding claims arising from non-payment by principal debtor or debtors."* In the former definition the phrase *"an obligation undertaken by an insurance company"* was used. While, in this latest definition instead of such phrase, the phrase *"a bond payable on demand issued by an insurance company obliging such insurance company"* is used. Therefore, the basic difference between the two definitions or the change that has been made in issuing the latest or the repealing directive is the inclusion of the term *"payable on demand"* in this latest definition. The term *"payable on demand"* indicates that the bond is an unconditional bond and nothing else. Whether this is a change of policy or not is subject to question.

They give different reasons for taking such measure. In both directives, the repealed one and the one in force, it is stated that the prohibition is imposed *"in order to prevent possible losses that insurers may suffer as a result of issuing Financial Guarantee Bonds and other Unconditional Bond."* On the other hand, the experts in

the Insurance Supervision Department of the National Bank of Ethiopia, on their part, say that due to the fierce competition in which insurance companies had engaged themselves, they had been almost on the verge of collapse. According to these experts, insurance companies had endangered not only their own existence but also that of banks. They further say that it was to protect the public interest that such measure was taken by the National Bank of Ethiopia.

Another expert working in the National Bank of Ethiopia who wrote an article entitled "*Emerging risks and Underwriting Practice of Financial Guarantee Bond: The case of Ethiopia*"¹⁸ is of the opinion that the problem created in connection with the bonding services rendered by insurance companies was caused among other things, due to lack of expertise and experiences in collateral management.

There are also others who have hailed the measure taken by the National Bank of Ethiopia stating that "*it is now gratifying to note that such bonds are banned by the supervisory authority which measure is evidently long overdue but probably not too late.*"¹⁹ However, the majority in the business is not happy with the measure taken by the National Bank of Ethiopia. But none of them would like to speak out on the matter. They prefer to express their disapproval by gestures only.

¹⁸ Temesgen Zeleke, "Emerging Risks and underwriting Practice of Financial Guarantee Bond: The Case of Ethiopia," *Birritu*, No. 79 (Nov. 2001- Jan. 2002), pp. 19-25.

¹⁹ Teffera Demissie, "How to Enhance Competition in the Insurance Industry," *BIRRITU*, No. 86 (August-October 2003), pp. 37-42.

D. THE LICENSING AND SUPERVISORY AUTHORITY

The licensing and supervisory authority both for banks and insurance companies in Ethiopia is the National Bank of Ethiopia. Proclamations No. 83, 84 and 86 of 1994 confers this power on the said bank.

According to the information gathered during the study tour, banks have no problem connected with the issuance of bonds by whatever names they are called. As it was said earlier, it is the insurance companies, which was prohibited from issuing certain types of bonds, such as financial guarantee bonds and unconditional bonds.

Therefore, this part of the study shall be confined to the licensing and supervision activities of the National Bank of Ethiopia in relation with insurance business in general and bonding business in particular.

With regard to insurance companies, until March 1, 2004, the National Bank of Ethiopia has issued twenty-six directives out of which only six have direct relevance to supervision activity of the bank. The rest are on licensing activities.

The National Bank of Ethiopia has got two departments, the Department for Licensing and Supervision of Banking, and Insurance Licensing and Supervision Department, through which it exercises its licensing and supervisory authority.

As it has already been said earlier, the experts working in the Insurance Licensing and Supervision Department alleged that insurance companies had been on the verge of

collapse endangering not only their own existence but also that of banks. However, what we read in some newspapers and what we hear from individuals engaged in the business is quite the opposite. For example, the weekly English newspaper, "*CAPITAL*," Vol.6 No.281, published on Sunday, April 26,2004 on page 9, reported that Awash Insurance Sc., had achieved a net profit of 4.6 million Birr in the year ending December 31,2003, which is 16% improvement over the previous year, 2002. Similarly, the managing director of the Ethiopia Insurance Corporation, in an interview he gave to the Amharic weekly newspaper called "*REPORTER*" Vol. 9 No. 82/455, Sunday, Ginbot 15, 1996 E.C., on page 14, has confirmed that the corporation's income from premiums had grown from 280 million Birr to 500 million Birr. The improvement is more than 78%.

Coming back to the allegations made by the experts of the National Bank of Ethiopia, the said experts did not support their allegations by facts and figures. Also the other experts who wrote articles²⁰ on the matter did not support their assertions by facts and figures.

E. PERSISTENT PROBLEM AND ITS ROOT CAUSE

It has already been said earlier that the backbones of the newly formed private insurance companies are former employees of the National Bank of Ethiopia and the Ethiopian Insurance Corporation who had left these institutions either on pension or in search of better working conditions and better salaries.

²⁰ please see notes 18 & 19 above

These employees took with them the knowledge they had gained through practice. They continued to do things in the same manner they had seen people before them doing those things.

The interviews made to some of these employees including to those at the Ethiopian Insurance Corporation and the personal observations made during the study have disclosed that the business of bonding services is not managed on the basis of risk distribution. If an insurance company is not managing his business based on the principle of distribution of risk, it is very difficult for it to determine whether it has really gained or suffered losses simply by taking into account individual cases only.

Another problem that has been observed during the study tour is that insurance companies issue bonds to a customer without properly examining the credit worthiness of such customer by simply holding a movable or immovable property belonging to a third party as a collateral. When they hold property belonging to the customer or a third party as a collateral, they do not usually observe the proper procedures prescribed by law and make actual valuation of the property concerned. For example, in one case, an insurance company claimed that it was holding two vehicles belonging to two persons as collateral in consideration for a surety bond issued to a customer who afterwards disappeared. The owners of the vehicles, on their part, absolutely denied the allegations made by the insurance company and demanded a written contract to be produced, if any, to prove the allegation. The said insurance

company was unable to produce any written contract and lost the case as a result.

Over valuation of collaterals and lack of proper title search are also recurring problems connected with bonding business. These observations and findings concur with the opinion of experts of the National Bank of Ethiopia who stated that "*however, because of imprudent underwriting, unqualified collateral management practices, the absence of foreclosure rights, the high moral hazard associated to the transaction etc., insurance companies are exposed to above average risks associated to financial guarantee bond transaction*"²¹

There is also an insurance company which has issued a series of internal circulars repeatedly reminding its branches not to issue bonds without examining the credit worthiness of a customer, without holding collaterals, without fulfilling requirements relating to the holding of collaterals and so on and so forth.

²¹ Temesgen Zeleke, cited above at note 18, p.24.

CHAPTER SEVEN

DISCUSSIONS, CONCLUSIONS AND SUGGESTIONS

A. DISCUSSIONS

In this study, an attempt has been made to show how essential suretyship is to a credit based economy. Suretyship is a contract whereby an individual or a company undertakes an obligation towards a creditor promising to discharge the obligations of a debtor in case the latter fails to do so.

In the highly developed countries, the most popular, the most dependable and which have got also a large amount of capital are the surety companies (corporate sureties or bonding companies). These are large companies, which were established in the form of share companies and are engaged in suretyship businesses only. They are specialized companies in risk management connected with bonding business. Of course, insurance companies and banks also provide bonding services in those countries.

In our country, we never had such bonding or surety companies particularly established for rendering bonding services. The business community has depended only on banks and insurance companies for such services..

Except the Ethiopian Insurance Corporation, the rest are all newly established companies. All of them have been formed within the last thirteen years. Thirteen years' period is a very short time span in the life of a company. One cannot expect these companies to run the bonding businesses perfectly within such short period.

It is clear from the very outset that these companies entered into the bonding business without having sufficient knowledge and experience. The fact that they are still utilizing foreign forms prepared in the English language, in fact copied forms, is an ample evidence for that. The knowledge and experiences of the employees of these companies are limited to clerical works (paper works) only. Their theoretical background of the bonding business is, therefore, limited. If they had the required knowledge and experience they would have known how to draft a bond in each case and drafted their own forms instead of copying foreign forms. A speech delivered by the managing director of the Ethiopian Insurance Corporation at a meeting organized by the Addis Ababa Chamber of Commerce confirms the existence of lack of knowledge and experience in the area of bonding services (The weekly Amharic newspaper REPORTER, VOL.10, NO.4/475, pp.8&19, SUNDAY, MESKEREM 30, 1997 E.C.). In almost all these copied forms, there is a clause, which binds the surety jointly and severally with the principal debtor. This shows that they do not comprehend the implications of the term "*joint and several liability*" If they knew its implications, they would not have included such term in the form they are utilizing. They would have given simple guarantee, unless the customer himself insists otherwise. In some of the forms, they bind themselves "*jointly and severally*"

with the principal debtor where they at the same time bind themselves " *unconditionally and irrevocably without going into the merits of the case*". These two types of liability do not go together. Once a person has bound himself " *unconditionally and irrevocably*", he has to discharge the obligation he had undertaken upon first demand without any further condition. Therefore, the term "*jointly and severally liable*" in this case, does not serve any purpose at all.

All the above facts can prove that those companies, which are involved in the business, had entered into such business without having the required knowledge and experience of bonding business even from the very outset.

Earlier, in this study, an attempt has been made to show the experiences of other countries in running the bonding business. Among other things, it was shown how the risk connected with the bonding service is managed. Further it was said that in other countries, such risk is also managed in the same manner as an insurance risk. Bonding companies apply the principle of distribution of risk. They break down the premium charged into its components, such as (1) provision for the payment of losses, (2) provision for the costs of management and (3) a residual amount which contributes to the surplus of the company.

During the study tour, a discussion was held with some of the experts of some of the insurance companies on how they manage the risk and how they determine the amount of premium and what its components are. But, no one was able to give an adequate answer or explanation.

Another problem observed during the study tour and corroborated by written documents is the problem connected with collateral management. In practice, *"when an insurance company issues a guarantee bond, it requires collateral from the party to whom the guarantee is issued."*¹¹ However, the internal circulars of one of the insurance companies visited during the study tour makes it clear that, in the first place, the employees of such companies involved in the issuance of surety bonds have been issuing it without even asking or demanding collaterals. Even if they demand collaterals, they have not been making proper valuation of such collaterals and without having fulfilled the requirements prescribed by law. For instance, it has already been mentioned earlier, a company, which had been claiming to hold two vehicles belonging to two third parties as collaterals, lost a case instituted against such third parties due to lack of formal requirements. This is not only lack of sufficient knowledge or experience of the business but there is also lack of devotion and good faith on the part of the employees of such company.

There is so manifest lack of knowledge of surety ship law resulting from lack of knowledge of the business of bonding itself. This is mostly reflected in the usage of bonding business terms and the position of experts in one way or another involved in such business. For example, according to an expert of the National Bank of Ethiopia, *"Once an insurance company bestows its surety ship, it cannot withdraw unless the consent of the contracting party is prearranged"*¹² This is completely contrary to the

¹ Temesgen Zeleke "Emerging Risks and underwriting Practices of Financial Guarantee Bond: The Case of Ethiopia", BIRRITU, NO. 79 (November 2001-january 2002): pp 19-25.

² Ibid

Ethiopian Law of surety-ship that provides under Article 1925(2) of the Civil Code
"where the time during which the guarantor is to be bound has not been stipulated in the instrument creating the guarantee, the guarantor may put and end to his undertaking so long as the primary debt is not yet due".

Not only that, "*financial guarantee bond*" is a term used in bonding business. This type of bond is issued guaranteeing monetary obligation.³ monetary obligation may be undertaken either by a bank, an insurance company or a bonding company. There is no legal ground for saying that financial guarantee bonds are always issued by banks. But, usually, in practice, banks issue unconditional bonds not to be dragged into the dispute arising between the principal debtor and the creditor. However, unconditional bonds are not surety bonds and they are not subject to surety-ship law. They are rather governed by the general contract provisions. Therefore, there is no difference between "*financial guarantee bond payable on demand*" and "*unconditional bond*" as far as liability is concerned. The difference may be in the act to be performed. An unconditional bond may be issued undertaking monetary obligation or an obligation to perform a certain act that the principal debtor has promised to do it.

Finally, the action taken by the National Bank of Ethiopia has been hailed by insignificant number of individuals, and on the other hand, the overwhelming majority of the business community has accepted it with a shock. A weekly English newspaper. "*FORTUNE*", Vol.4 No. 199 Sunday, February 22, 2004, under the topic.

³ David L.Bickelhaupt and John H.Magee, General Insurance 8th ed (USA: Richard D.Irwin Inc., 1970) p.876 And, Kevin Patrick Mc.Guinness, The Law of Guarantee: A treatise on Guarantee, Indemnity and the Standby Letter of credit (Toronto: Carswell, 1989), note 18 on page 362.

"NBE's New Directives Terrify Insurance Firms" explained the situation in the following manner.

The National Bank of Ethiopia (NBE) has got tough with insurance firms whose managers and shareholders are terrified following a series of directives it has issued which include prohibitions from being involved in certain activities and further prescriptions about their conduct. The Bank has introduced two new directives, while amending one that was originally issued two years ago. All the directives will be enforced as of March 1, 2004, according to NBE.

The directives have not considered the international procedures of the insurance industry, a veteran insurance manager said, It has focused on hastening the demise of the few emerging companies instead of protecting and helping them to grow. According to this manager the wording of the directives shows that the National Bank has made its business to scare the insurance industry."

obligation he has undertaken in the bond without any further condition whatsoever, on demand. Surety ship law does not govern such bonds.

The reasons for imposing restrictions on the issuance of bonds are not at all convincing. The experts of the supervising authority alleged that insurance companies had been on the verge of collapse due to the bonding business. But, they did not support their allegation with facts and figures to convince the public. The allegation is also contrary to what one observes on the ground. Insurance companies have been declaring higher profits. They are still opening branches here and there thereby expanding the sphere of their activities. All these show the growth of the business. The reasons for the prohibition of the issuance of bonds, therefore, are not well founded.

The prohibition has been understood by the business community as prohibition of the issuance of any kind of bond whatsoever to guarantee any kind of loan or advance taken from a bank. This feeling still persists. Bank means where the money is stored. Without money, there is no investment. Without investment, there is no employment and also development.

In this country, land belongs to the State. Building and houses are no more reliable securities. They can be removed any time at the instance of the Government. There is no stock exchange market. Share companies have not yet started issuing debentures (bonds). Vehicles may overturn, collide, burn or stolen. Merchandises may be easily

transferred to another, may be stolen or destroyed. There is no even a single company, which has specialized in rendering bonding services in this country. The only suitable security that has been rendering bonding services is an insurance company. That has already been rendered impotent by the action taken. The measure taken, whatever its motive, coupled with the anti-corruption campaign traumatized the business community in general .A recent report indicated that about 17 billion Birr intended for lending purposes has been lying idle accumulated both in government and private banks due to lack of reliable s security (THE WEEKLY AMHARIC NEWSPAPER REPORTER, VOL.10, NO.5/ 476,front page SUNDAY, TIKIMT 7,1997) Finally the Constitution of the Federal Democratic Republic of Ethiopia provides in Article 41(1) that "*Every Ethiopian has the right to engage freely in economic activity and to pursue a livelihood of his choice anywhere within the national territory.*" Nowhere in the Constitution, it is allowed to the Ethiopian Lawmakers or to the Government to pass a law, regulations or directives, which may curtail or in any way impose restrictions or limitations on this right. Therefore, the measure taken by the National Bank of Ethiopia is not only undesirable, it is also unconstitutional.

C. RECOMMENDATION

Bonding service should not be seen as any other ordinary business. Special attention must be given to it. Because, bonding service serves as a pillar to the credit system. That is why economically developed countries utilize companies particularly those

ones specializing in rendering bonding services and in managing risks relating to such services, in addition to insurance companies and banks.

Therefore, to rehabilitate the deteriorating and ailing economy of the country, it is advisable that the said prohibitions are lifted as soon as possible and an attempt be made to help the business community recover from the shock caused by the said prohibitions.

Insurance companies alone may not be enough to render adequate bonding services. Therefore, it would be advisable if even the Government encourages by the supervising authority or the establishment of bonding companies.

The legal and economic aspects of the bonding business need to be properly studied in depth. The final outcome will definitely help to enhance the legal and theoretical knowledge of those who directly or indirectly are involved in this type of business. Therefore, for this purpose, insurance companies themselves may form two independent committees of experts, one consisting of legal experts only and the other economic experts who may study the legal and the economic aspects of bonding business and finally come out with training manuals to be used in the training of experts who are in one way or another involved in the businesses of bonding.

Finally, periodical training must be arranged for those who are engaged in activities connected with bonding services. If after all these efforts have been made, improvements cannot be shown in the conduct of the business and in the supervision

of the bonding service, strict disciplinary measures must be taken against those who either intentionally or negligently commit the same mistakes that have already been discussed earlier. All the board members of an insurance company, the employees of which cause damage to the financial interests of such company due to intentional or negligent performance must be held personally liable for such damage.

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DECLARATION

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

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