

# An appraisal of the Ethiopian bankruptcy regime

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## OPSOMMING

### 'n Beoordeling van Ethiopië se bankrotskapregime

Boek V van die 1960 *Commercial Code* van Ethiopië maak voorsiening vir Ethiopië se bankrotskapregime en handel oor die bankrotskap van handelaars en kommersiële besigheidsorganisasies wanneer betalings opgeskort word. Die bankrotskapregime wat vir meer as 'n halfeeu van krag was, maar selde gebruik is, het verouderd geraak in sowel die filosofiese grondslag as aanwending daarvan. Behalwe vir die wysiging wat kragtens proklamasie 592/2008 aangebring is, en net op banke van toepassing is, was daar geen hersiening ten einde die insolvensieregime op datum te bring nie. Laasgenoemde regime word baseer op die veronderstelling dat die skuldenaar te blameer is en hy of sy staar ernstige gevolge in die gesig in geval van bankrotskap. Tensy die skuldenaar om 'n reëlinskema ("scheme of arrangement") aansoek doen, maak die regime geen voorsiening vir besigheidsredding nie. Bankrotskap betrek verskeie belange, insluitend dié van werknemers, verskaffers, verbruikers, die regering en die publiek – en veral die belange van skuldeisers wat die onmiddellike slagoffers van insolvensieverrigtinge is. Die insolvensiereg fokus op die verdeling van die opbrengs van likwidasie tussen skuldeisers. Dit slaan egter nie voldoende ag op ander belange nie. Die artikel ondersoek die bestaande reg in die lig van internasionaal-aanvaarde standaarde en beste praktyke en beveel veranderinge aan die stelsel aan. Die feitlik nie-bestaande insolvensiepraktyk word ook ondersoek ten einde die faktore te identifiseer wat die beoefening daarvan verhinder het.

## 1 Introduction

The Commercial Code of Ethiopia, which came into effect in 1960,<sup>1</sup> is the main source of the Ethiopian bankruptcy regime. Although the regime has been in force for over half a century, its underlying theories have remained intact, despite the makeover they have undergone due to the dynamism of commerce. It has, accordingly, remained static, contrary to observations by scholars that the law of insolvency has been in a state of

1 Commercial Code of Ethiopia Proclamation No 166 of 1960, *Negarit Gazeta*, *Gazette Extraordinary*, 19th Year, No 3, Addis Ababa, 5 May 1960 (hereafter the Code, Commercial Code or Com Code).

flux.<sup>2</sup> A close look at its provisions reveals that its precepts come from a by-gone era where a trader was blamed for any failure and bankruptcy was a form of punishment. The interests of creditors were the regime's only concern. The regime has reached this juncture with little application of transcending kaleidoscopic economic models. It is, therefore, essential to closely examine the law to assess whether it has served the nation and whether it has been kept abreast of the times.

This article is a modest contribution to the scant literature on the bankruptcy law of Ethiopia and aims at shedding some light on its contents and application. It does not set out discuss all the parts or provisions of the law because of time and space constraints. It is, rather, an attempt to evaluate the law by examining certain core elements, selected to illustrate the theme of the article. In particular, the policy underpinnings of Ethiopian bankruptcy law, which determined the contents of the provisions, are scrutinised to ascertain their timeliness and suitability to modern times. It attempts to question both the law and practice regarding their comprehensiveness, clarity and consistency regarding the requirements to subject one to the full force of the bankruptcy regime.

In what follows, the law, as it currently stands, is explored to understand its fundamental tenets. It is also tested against the standards of modern bankruptcy law in order to identify its shortcomings and drawbacks, to analyse the underlying policy of the law, and to test the theories that gave content to the bankruptcy provisions. As Tadesse pointed out, 'Ethiopian basic codes in general were drafted in a vacuum, overarching public policies'<sup>3</sup> – said codes obviously including the Commercial Code. The drafters chose the policy considerations of the Code from the options available at the time. Now, it may be asked whether a law, which emanated from a mental exercise of the drafters (who were not in a position to fully comprehend the prevailing socio-economic reality on the ground) can fit in the system. It cannot be expected to respond to the reality on the ground if the policy was based on 'assumptions'<sup>4</sup> made by the drafters. With the above in mind, the discussion below deals with the legal framework for insolvency, policy choices made, the proceedings recognised, the participants (and their roles), and the insolvency practice itself. However, it is first necessary to find clarity on the concepts and terminology employed in the legal system.

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2 Bridge 'Insolvency – a Second Chance? Why Modern Insolvency Laws Seek to Promote Business Rescue' 39, available at <http://www.ebrd.com/download/research/law>. See also UNCITRAL Legislative Guide on Insolvency Law (2005)16

3 Tadesse 'Ethiopian Bankruptcy Law: A Commentary (Part II)' 2008 *Journal of Ethiopian Law* 86.

4 Tadesse insists that the public policies to be served by the enactment of the codes were, if anything, afterthoughts and often came from the drafters themselves as being what suited Ethiopia's needed at the time. See *supra* n 3.

## 2 Concepts and Terminology

Terminology is not a problem if one limits oneself to the last book of the Commercial Code. However, if reference is made to other parts of the Code or other laws, the use of the two terms 'insolvency' and 'bankruptcy' can be confusing in the absence of a proper definition. Generally, the terms may have the same or a different meaning, depending on the legal system on which one is focusing. In legal systems where the two terms have different meanings, insolvency denotes either the factual situation regarding the financial position of the debtor, or it refers to the bankruptcy of a non-trader.<sup>5</sup> Against this background, it is pertinent to inquire whether the terms have the same or different meanings under Ethiopian law.

The Commercial Code consistently uses the term 'bankruptcy' in all but one provision, while almost all the other codes<sup>6</sup> employ both terms. Article 542(3) the Commercial Code uses both terms in the alternative, which may mean that they denote the same concept. The terms seem to be used interchangeably in the Civil Procedure Code<sup>7</sup>; while, in the Civil Code, the two terms appear to connote indebtedness and status.<sup>8</sup> For instance, the insolvency of an association or an endowment can be a ground for the dissolution of an association<sup>9</sup> or the termination of an endowment<sup>10</sup>; issues beyond the scope of the bankruptcy regime of Ethiopia. Thus, the law refers to the factual situation due to which the association or the endowment could not pay debts when they became due. There are also provisions indicative that insolvency does not presuppose a decision by a court of law.<sup>11</sup> These and other provisions<sup>12</sup> demonstrate that the Civil Code simply refers to a situation

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5 See Bhardwaj *Towards Establishing Modern Insolvency and Bankruptcy Codes for Small Enterprises in India*, Federation of Indian Micro and Small & Medium Enterprises (FISME) 2009 4.

6 Maritime Code of the Empire of Ethiopia Proclamation No 164 of 1960, Negarit Gazeta, Gazette Extraordinary, 19th Year, No 1, Addis Ababa, 5 May 1960. Art 299/1 uses the term 'bankruptcy' in only one of its provisions.

7 Cf art 15(2)(b), 28, 42(d), 54 and 55 of the Civil Procedure Code of the Empire of Ethiopia, Decree No 52 of 1965, Negarit Gazeta, Gazette Extraordinary, 25th Year, No 3, Addis Ababa, 8 October 1965.

8 The latter requires a judgment as incorporated in the Commercial Code whose usage is replicated in art 1145, 1932, 2000, 1947 and 2697/3 of Civil Code of the Empire of Ethiopia Proclamation No 165 of 1960, Negarit Gazeta, Gazette Extraordinary, 19th Year, No 2, Addis Ababa, 5 May 1960 (hereafter the Civil Code).

9 Civil Code art 461/d.

10 Civil Code art 504/d.

11 From art 1981 of the Civil Code one can gather that insolvency can exist without judicial pronouncement while article 298/2 mentions notoriously insolvent. Art 1986 mentions an act done to become insolvent or to increase insolvency, which is fraudulent.

12 See Civil Code art 2109/c/, 2400/1 and 2475/1. Further, art 2582 uses the two terms, which shows that they refer to different ideas.

without a judgment by a court to ascertain the factual situation. The Criminal Code makes the same distinction between the two terms.<sup>13</sup>

Even though there is no conceptual clarity, it can be said that Ethiopian law by and large uses the term 'insolvency' to signify the inability of a debtor to pay debts which are due, whether or not the debtor is a trader and whether or not the debt is commercial. On the other hand, the term 'bankruptcy' is a legal term that describes the status of a person with the concomitant legal consequences.<sup>14</sup> Bankruptcy cannot exist in fact unless there is a judicial pronouncement that recognises the fact of the financial distress of an enterprise.<sup>15</sup> Insolvency of a person does not give rise to bankruptcy, unless the debtor is a trader or a commercial business organisation and a court of law hands down a judgment that confirms the factual situation.

It is interesting to note that the Banking Business Proclamation No 592/2008 introduced 'receivership' instead of the word 'bankruptcy'. It defines 'insolvent' as the financial condition of a bank when its liabilities exceed its assets as determined by the National Bank.<sup>16</sup> Two important deviations can be pinpointed. First, the date of commencement to be used to determine whether a bank is insolvent differs from the test for insolvency adopted in the Commercial Code. Second, the central bank will determine whether insolvency exists, which differs from the judicial pronouncement required by the Code. Apparently only the National Bank can invoke insolvency and trigger receivership. The proclamation uses the term 'insolvency' to signify the financial situation of a bank, although it is more than a mere fact, as a decision is required by the regulatory organ. It is not liquidation *per se*, as it is one of the grounds for the appointment of a receiver. The proclamation uses the term 'receivership' instead of 'bankruptcy' to denote corrective measures to be taken, which include liquidation.<sup>17</sup> Hence, the proclamation exacerbates the disparity in the use of the terms.

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13 Criminal Code of Federal Democratic Republic of Ethiopia, Proc No. 414/2004, art 725 and 727.

14 The Code distinguishes between bankruptcy and scheme of arrangement as separate proceedings. It is suggested that this term should be used to refer to all proceedings under Book V of the Commercial Code rather than limiting it to liquidation. See Position of the Business Community on the Revision of the Commercial Code of Ethiopia, Private Sector Development Hub/Addis Ababa Chamber of Commerce and Sectoral Associations, (2009) 81; See also Taddese 'Ethiopian Bankruptcy Law: A Commentary (Part I)' Vol XXII No 2 2008 *Journal of Ethiopian Law* 66-67

15 Com Code art 970.

16 Banking Business Proclamation No 592/2008, Federal Negarit Gazeta 14th Year No 57, Addis Ababa, 25 August 2008 (hereafter 'Banking Business Proc') art 2/12.

17 Banking Business Proc art 49, 58/6/c and 33 ff.

### 3 The Legal Framework for Bankruptcy

An economy or a society in general cannot exist without an efficient mechanism and a sound insolvency system, which must be designed to work in harmony in order to enable creditors to enforce their claims.<sup>18</sup> Certainty brought about by these systems is vital for the smooth functioning of commercial transactions and for maintaining confidence in business. Uncertainty about the enforceability of contractual rights increases the cost of credit to compensate for the increased risk of non-performance or, in severe cases, leads to the tightening of the granting of credit.<sup>19</sup> The insolvency process is an extension of the enforcement options available to creditors which must be triggered when a credit impact encompasses more than a dispute between two parties. Hence, the risk of insolvency is one of the risks of non-performance.<sup>20</sup>

Although questions may be raised as to their efficiency, predictability and effectiveness, Ethiopian law provides for systems for the enforcement of claims. A creditor has two options available at the same time even though they cannot be seen as alternatives. In fact, bankruptcy has a narrower application as it can be used as an enforcement mechanism against traders, commercial business organisations and public enterprises. However, it is maintained that bankruptcy is more than debt collection<sup>21</sup> and should reconcile and balance diverse interests affected by the insolvency process. Unlike the ordinary enforcement procedures, in bankruptcy a creditor's interest is balanced against a wider range of interests. The importance of debt collection in insolvency is not overlooked. However, it is not a mere debt collection process as it attempts to respond to other interests affected by the proceedings.<sup>22</sup>

The bankruptcy regime of Ethiopia comprises the overarching provisions of the Commercial Code (Book V) and the provisions of Proclamation 592/2008 which specifically apply to banks. The Code has been in force for more than sixty years without amendment or revision save for the changes introduced by the banking proclamation. During this period the bankruptcy regime moved from 'debtor repression to debtor protection' and a 'redefinition of bankruptcy from sin to risk, from moral failure to economic failure'.<sup>23</sup> For the Code has been immune from these transformations, it still clings to the philosophy that underpinned its provisions six decades ago.

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18 The World Bank *Principles and Guidelines for Effective Insolvency and Creditor Rights System* (April 2001) 3. It is also available at [http://www.worldbank.org/ifa/ipg\\_eng.pdf](http://www.worldbank.org/ifa/ipg_eng.pdf).

19 *Idem* 4.

20 *Idem* 17.

21 For a detailed exposition of the debate on whether bankruptcy is mere debt collection see Teo 'Bankruptcy Law: Is it Really Only about Debt-collection?' Vol. V 2009 *Cross-sections*, available at <https://view.anu.edu.au/cross-sections/vol5/pdf/10.pdf>, accessed on 2014-08-12.

22 *Idem* 116.

23 *Supra* fn 2 32.

It is submitted that the law should be reappraised at regular intervals to ensure that it meets current social needs, taking into account the realities of the country and international best practices.<sup>24</sup> Against this backdrop, one important question which must be posed is whether the bankruptcy regime/system of Ethiopia which is rarely utilised has taken into account the realities existing in the country. It is obvious that an effective insolvency system responds to national needs and problems based on the country's broader cultural, economic, legal and social context.<sup>25</sup> The drafter of the Code gave the assurance that the law would respond to the realities prevailing at the time and in the immediate future.<sup>26</sup> However, the application of the law hardly testifies in favour of such assertion.<sup>27</sup> This raises the question whether the policy decisions made respond to the factors relevant to such a law. The primary policy issues are raised below to determine their responsiveness to current realities.

### 3 1 Policies and Goals of the Law

It is obvious that the promulgation of a bankruptcy law is a product of policy decisions and has some objectives in mind which the law aims to achieve. Bankruptcy law is heavily influenced by public policy as several competing interests converge. This calls for a choice to be made when determining the contents of the law. For instance, an advisory report submitted to the Ministry of Economic Development of New Zealand identified the reduction of the cost of credit and the promotion of entrepreneurship as public policy factors which the law should address.<sup>28</sup> Once a decision is made on the preference and emphasis of the law, the next step is to articulate the 'appropriate incentives and sanctions to encourage behaviour which will promote those underlying values'.<sup>29</sup>

The purposes and goals of a bankruptcy law depend on the theory that the law adopts.<sup>30</sup> It is, therefore, pertinent to explore the preferences and theory that underpin Ethiopian bankruptcy law. However, it was mainly the choice made by the drafters that determined its contents. The Code was necessitated by the fact that the development of commerce had outgrown the provisions of the laws relating to business organisations and bankruptcy which were promulgated earlier.<sup>31</sup> The person tasked with drafting a code for Ethiopia borrowed from the bankruptcy law of

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24 *Supra* fn 18 27.

25 *Idem* 1.

26 Winship *Background Documents of the Ethiopian Commercial Code of 1960* (1974) 1.

27 It is described as the least known and least practiced part of the Code. See *supra* fn 14 81

28 *Insolvency Law Reform: Promoting Trust and Confidence. An Advisory Report to the Ministry of Economic Development* (2001) 14.

29 *Ibid.*

30 Keay and Walton *Insolvency Law, Personal and Corporate* (2003) 21.

31 Com Code preface.

the Continental system, mainly from France and Italy.<sup>32</sup> The law was transplanted in the context that the country had not made policy choices in advance, taking into account the socio-economic setting prevailing at the time or expected to be attained in the immediate future.

In fact, transplantation of a law cannot be carried out without borrowing the theory of the source. If one accepts that transplanting laws is a mechanism of improving legal systems, it should be noted that in this instance the law was transplanted from a country that had different cultural, economic and political conditions prevailing at the time. It is necessary to ask whether in such a case the transplant fits the situation or whether the necessary adaptations were made to make it fit. New insolvency systems must reflect how individual nations have experienced the growth of market economies, and how, philosophically, countries have viewed debt. Bankruptcy systems are social tools. As such, they are value-laden and must be drafted with care to reflect the particular values of a culture.<sup>33</sup>

It has been said that the design of an insolvency legal system is influenced by several policy objectives pertaining to a variety of goals, rights and interests. The choices to be made include promoting discipline or to encourage entrepreneurial activity; being pro-debtor ('debtor friendly') or pro-creditor ('creditor friendly'); having a wider social or collective purpose, or the resolution of individual competing interests; protecting investment or to protect employment; and rehabilitation or liquidation.<sup>34</sup> The discourse on bankruptcy law cannot overlook these and other policy issues. If one examines the provisions of the Code in search of answers to these questions, one will meet with some success. The problem is whether it is a conscious decision on the pertinent policy matters taking into account the realities prevailing at the time. Likewise, the background documents give some idea as to why a particular approach was selected even though one may question whether that is a systematic explanation based on a single theory or priorities of goals set based on domestic needs.

The question whether a bankruptcy law has an organising principle has been raised and some have insisted that it aims at creating the bankruptcy estate.<sup>35</sup> Others maintain that the key objective of bankruptcy law is supposed to be the maximisation of the proceeds of the estate.<sup>36</sup> It is further insisted that the first task of any insolvency system is to establish a framework of principles that determine how the

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32 *Supra* fn 26 100.

33 Martin 'The Role of History and Culture in Developing Bankruptcy and Insolvency Systems: The Perils of Legal Transplantation' 2005 28(1) *Boston College International & Comparative LR* 5, available at <http://lawdigitalcommons.bc.edu/iclr/vol28/iss1/2>.

34 *Supra* fn 18 27.

35 Carlson 'Bankruptcy's Organizing Principle' *Florida State University LR* Vol 26 550.

36 Cabrillo and Depoorter *Bankruptcy Proceedings* (1990) 264, available at <http://encyclo.findlaw.com/7800book.pdf>.

estate of the insolvent debtor is to be administered for the benefit of all affected parties.<sup>37</sup> It can, therefore, be said that substantial disparities can be identified among national insolvency regimes with regard to their underlying policy considerations, structure and content even though they focus on liquidation.<sup>38</sup>

The absence of policy choices leaves one with no option but to rely on the theories on which the sources are based. However, the sources have undergone several amendments and significantly shifted from their earlier stance and it is now necessary to develop an indigenous justification to maintain the existing bankruptcy regime. Currently, despite the fact that there is a difference in approach, the allocation of risk among participants in a market economy in a predictable, equitable and transparent manner and protection and maximising value for the benefit of all interested parties and the economy in general are the two objectives that are shared by most systems.<sup>39</sup> Even in such case, there is a need to balance these objectives and choices also need to be made as to the beneficiaries of the value that is maximised.<sup>40</sup>

Bankruptcy law represents a balancing of several objectives which necessitates making policy decisions to strike a balance between competing interests. A series of choices must be made in designing this distribution system in order to ensure that the law embodies goals and priorities consistent with the values of the society.<sup>41</sup> It aims at protecting creditors' rights while safeguarding the interests of shareholders and customers on the one hand and at avoiding liquidation of potentially viable businesses on the other hand. Within this context insolvency law fosters discipline and honesty in financial management and facilitates the rehabilitation or orderly market exit of business enterprises that are inefficient.<sup>42</sup> On the other hand, the focus of modern insolvency regimes has moved steadily from the liquidation of enterprises to their rescue and, increasingly, to financial restructuring rather than a realisation of the assets of the business.<sup>43</sup> Hence, although the underlying fundamental consideration of the Code is the protection of creditors, other interests are not given due consideration and the law opens the door for more questions in its attempt to strike a balance among those competing interests. In the following sections a close examination of the objectives of the existing Ethiopian law, their compatibility with modern bankruptcy laws and the dilemma encountered in drafting or reforming a bankruptcy law are illustrated.

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37 *Supra* fn 18 27.

38 European Parliament *Harmonization of Insolvency Laws at the EU Level* (2010) 5.

39 *Supra* fn 28 15-16.

40 *Ibid.*

41 *Supra* fn 18 27.

42 *Supra* fn 36 5.

43 Kornberg *Insolvency Law in the UK and the US* 4 available at <http://fds.oup.com/www.oup.com/pdf/13/9780199579693.pdf> accessed on 2012-12-31.

### 3 1 1 *Blameworthiness of the Bankrupt*

The prosperity or collapse of a business may be seen as a natural phenomenon although the reasons for any of these outcomes may be diverse. It is in the nature of business that a commercial decision or a series of decisions are made regarding the risk it takes which may result in making or losing money. The decision could be so vital that it may bring about the downfall of the business enterprise which may raise the question as to whom is to blame for the collapse. Of course responsibility should be ascribed based on the decision maker's contribution to the failure. The consequent loss may stem from a lack of foresight, aptitude or business inexperience on the part of the owner or the decision making organ. At times, the cause for failure could be extraneous and may therefore not be foreseeable or controllable. With this in mind, it may be asked whether the trader or a business organisation should be held responsible and face the severe consequences whenever a financial debacle occurs.

Following the Latin approach, the drafter of the Code deliberately made the choice that the debtor is blameworthy.<sup>44</sup> Escara<sup>45</sup> identified the choices available, namely, to consider bankruptcy as blameworthy and a punishable offence or a simple accident of commercial life which needs correction. He chose the former, more severe attitude towards the debtor, which was made law with the approval of the Codification Commission<sup>46</sup> and parliament. The rationale for this approach has been summarised as 'Ethiopian commerce must be oriented towards severity which, although it will inhibit some persons, nevertheless will assure the prosperity of the greatest number'.<sup>47</sup> Hence, the law maintains the position that when a business goes bankrupt the trader is to blame. The presumption in this regard recurs in different parts of the law which mainly shaped the provisions of the Code that provide for the effects of a declaration of bankruptcy.<sup>48</sup>

An examination of the experience in other jurisdictions in this regard reveals that while some countries have clearly banished the traditional anti-debtor sentiments from their bankruptcy law, it seems equally clear that many countries still retain a bankruptcy regime that either does not recognise any of the debtors' interests or is largely intolerant and punitive towards them.<sup>49</sup> Ethiopia belongs to the latter group. This necessitates the question whether the law should be revised to take into

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44 *Supra* fn 25 103.

45 Professor of comparative law of the University of Paris who was tasked to draft a commercial code for Ethiopia but died before completing the work which was taken over by Prof Jauffret. See *supra* fn 25 iv.

46 *Supra* fn 25 199, 202. See documents 32 and 34 of the Background Document.

47 *Ibid* 106.

48 See section 5 below.

49 Efrat 'The Fresh-Start Policy in Bankruptcy in Modern Day Israel' *ABI LR* Vol 7P 577.

account the reality by which debt-forgiveness could be granted to those bankrupts who were fair towards creditors, cooperated in the proceedings and were not responsible for the failure. This approach is out of date as legal systems have long recognised that taking business risks should not *per se* entail punishment or condemnation. During the deliberations of the Codification Commission, Graven argued that debtors who become bankrupt often found themselves in this position without fraudulent intent.<sup>50</sup> Rather, if the wrong is done by the debtor or when the bankruptcy is fraudulent, the debtor should be held responsible. Otherwise there is no point in placing responsibility and restrictions on someone who had the courage to try new avenues or take risks. In this regard, the law has become too outdated to fit into the contemporary commercial realm with the increasing awareness to recognize business failure of an economy as a natural trait of an economy.<sup>51</sup>

It is argued that the severe treatment of the debtor is justifiable as there are no reasons for treating him or her otherwise, taking into account the economic development of the country.<sup>52</sup> It is submitted that making bankruptcy law applicable to non-traders creates the situation by which the relative position of the non-trader becomes weaker.<sup>53</sup> However, the choice to be made here is determined by the policy stance that the country takes and the principle it subscribes to rather than by mere practical considerations such as the economic development of the county or the scope of the law. Practical considerations may be one component rather than the key determinant which in any case cannot be overlooked. The law as a tool should also reflect the values of the society.<sup>54</sup> Considering all the social and economic factors, it can be said that Ethiopia ought to embrace this policy as it will thereby reap great benefits both socially and economically.

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50 *Supra* fn 26 109.

51 UNCITRAL *Legislative Guide on Insolvency Law* (2005) 280

52 Berhe *Composition and Scheme of Arrangement under Ethiopian Bankruptcy Law* (unpublished 1963) 58.

53 *Ibid.* Martin *supra* fn 33 43 associates the need for discharge with extensive growth in consumers.

54 In the absence of a study and given cultural diversity, it may be difficult to determine the value of the society in this respect. However, it can be seen in light of the two major religions in the country. Bridge *supra* fn 2 37 has the following to say: 'Major religions have viewed default on debt payment as seriously wrong but have enjoined creditors to treat the debtor with mercy. Psalm 37:21 of the Old Testament reads, 'The wicked borroweth, and payeth not again; but the righteous showeth mercy, and giveth'. In Chapter 5 of the Qur'an, debtors are enjoined to respect their promises in the verse 'Oh, ye who believe! Fulfil obligations', and creditors are asked to be patient and generous with creditors: 'if the debtor is in difficulty, grant him time 'til it is easy for him to repay. But if ye remit in by way of charity, that is best for you if ye only knew' (verse 2.280). Common to both Christianity and Judaism is the Jubilee year, a special year of remission of sins and pardons, where every 50th year 'ye shall return every man unto his possession, and ye shall return every man unto his family' (Leviticus 25:10).'

### 3 1 2 *Rehabilitation Policy*

A legal system has to make a choice whether priority should be given to rehabilitate a failing business. If we consider bankruptcy as a simple debt collection process, it is not worthwhile to dwell on this issue. However, it has become clear that declaring a debtor bankrupt will have far reaching consequences that affect the interests of many people other than the debtor and creditors. Therefore, a bankruptcy law should provide for both efficient liquidation of non-viable businesses and those where liquidation is likely to produce a greater return to creditors, and for rehabilitation of viable businesses. Nearly all jurisdictions have a liquidation law and an alternative procedure designed to save a business rather than terminate it. Although a variety of rescue models have been developed, efforts are constantly being made to make the rescue process more efficient and find ways to best accommodate it.<sup>55</sup> In fact, the composition and scheme of arrangement recognised in the Code are meant to ensure that a business continues after going through financial distress. However, it has been contended that the bankruptcy law must provide more than a choice between a strict traditional liquidation and rehabilitation which is more difficult to obtain.<sup>56</sup> Further, it may be questioned why these are options available to the debtor who is only allowed to initiate the proceedings for continuation of the business.<sup>57</sup> In both cases, the concern of the law is the interest of creditors who do have a say in the decision to give the enterprise another chance.

Regarding the question whether the choice of a proceeding which decides the fate of an enterprise in financial difficulty should be left to debtors or creditors, it can be said that a panacea acceptable to all is not offered for countries with diversified needs and economic and social ambiance in addition to their laws on security interests, property and contractual rights, remedies and enforcement procedures. In this regard it should be noted that some jurisdictions give priority to the recognition and enforcement of creditor rights whereas others prefer rehabilitation of the debtor in view of its benefits for workers and other constituencies.<sup>58</sup> As a corollary to this, some countries adopt a unitary approach that establishes an interim period for review of the business prospects before deciding whether to liquidate or rehabilitate the business.<sup>59</sup>

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55 *Idem* 27.

56 *Idem* 28.

57 Some legal systems allow creditors to propose competing plans. See Gagnier 'France's New Legislation Attempts to Narrow Shareholders' Powers in a Restructuring Scenario: A First Step in Rebalancing Creditors' and Shareholders' Rights' *Insolvency and Restructuring International, The Journal of the IBA Insolvency Section* Vol 8(2) 10.

58 *Supra* fn 17 27.

59 *Idem* 28.

Rehabilitation holds several economic, social and political advantages. To begin with, it encourages entrepreneurs to take risks.<sup>60</sup> Rehabilitating the enterprise relies on 'the basic economic theory that greater value may be obtained from keeping the essential components of a business together, rather than breaking them up and disposing of them in fragments'.<sup>61</sup> Hence, the modern trend that supports rehabilitation or rescue is an extension of the goal to maximise value based on the idea that the value of the whole is greater than the value of the parts. In other words, an enterprise is more valuable as a going concern than when it is dismembered or liquidated. Further, this approach considers other interests such as preserving jobs with the ensuing social and political advantages.<sup>62</sup>

Advocates of rehabilitation present it as an efficient procedure that avoids many preventable liquidations and reduces the social costs of bankruptcy, while opponents consider it to be an inefficient procedure that deprives bankruptcy from its main objective, namely, the reallocation of the debtor's assets to more productive application through creditors' collective action.<sup>63</sup> It boils down to the goal set by the law which will determine whether the law should give priority to administer medication to the ailment or to amputate the enterprise so that the market can be relieved of it. The law as it stands now is creditor-centred and no or little attention is given to other interests. However, this approach can be challenged not only by alternative theories<sup>64</sup> but by the reality on the ground. As an instrument of reconciling competing and conflicting interests upon occurrence of such an incident, the law should give due attention to all interests affected and attempt to strike a balance.

It is also worth asking whether it is always in the interest of creditors to liquidate an enterprise. It is argued that it is often not worthwhile for creditors to take legal action without giving debtors some indulgence and an opportunity to pay.<sup>65</sup> It should be sufficient for the rescue regime to allow a result that would achieve more than if the enterprise was liquidated. Indeed, in some cases the rehabilitation may contemplate an eventual liquidation or sale of the business.<sup>66</sup> Hence, the law should strike a balance between short-term debt recovery through liquidation and preserving the business by rehabilitation for the benefit of all stakeholders.<sup>67</sup>

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60 If secured parties are given too much power over debtors, entrepreneurs may be reluctant to start new businesses and the disincentives imposed by risk-adverse secured creditors may hamper economic success. See *supra* fn 17 15.

61 *Supra* fn 12.

62 *Supra* fn 17 24.

63 *Supra* fn 34 275.

64 For instance, as an alternative to the creditors bargain theory, there are other approaches such as the communitarian theory and the multiple values approach.

65 *Supra* fn 58 12.

66 *Supra* fn 17 28.

67 *Supra* fn 58 12.

### 3 1 3 Discharge

A trader is not relieved from responsibility unless all the debts are paid because the concept of discharge is virtually absent in the law of insolvency. A bankruptcy proceeding is closed and the debtor is restored to his full rights when he proves that all the creditors who have proved claims have been paid or that he has deposited with the trustees a sufficient amount to pay all creditors who have proved and costs.<sup>68</sup> Because of the presumption that the debtor is to blame, Ethiopian law does not give priority to a fresh start. In fact, it can be said that the debtor has an opportunity to avoid the consequences of bankruptcy by invoking a composition or scheme of arrangement. However, the requirements are so burdensome that it is difficult to imagine how a business entity can pass all those hurdles to survive in the market. It is therefore more important to rely on the outcome of a liquidation process which is the more likely outcome than the more difficult to achieve an arrangement with creditors either through a composition or a scheme of arrangement. So, too, it is seldom possible for an enterprise to raise the funds required to make the payment in order to take advantage of the proceedings for its survival given the fact that it is already immersed in financial distress. Under the circumstances, it is imperative to consider the fate of a trader who could not repay all his creditors' claims or strike a deal with them.

By endorsing discharge, a bankruptcy regime attempts to provide the financially troubled individual with opportunities to re-join society as a productive member of the economy, free from some or all of his burdening pre-existing debts. Although increasing numbers of countries have adopted some form of a fresh-start policy, many have not yet incorporated any such policy into their bankruptcy systems.<sup>69</sup> A survey of the laws of different countries reveals that there are three types of approaches. While the liberal countries are characterised by some form of automatic statutory discharge, the conservative approach is distinguished by the conspicuous absence of a debt-forgiveness provision in its bankruptcy law. We have also the middle ground which provides for debt-forgiveness pursuant to judicial discretion.<sup>70</sup>

It is argued that every modern society should provide an opportunity for a meaningful freshstart to financially troubled individuals who have acted responsibly and fairly towards their creditors.<sup>71</sup> The main concerns regarding the fresh-start policy can be categorised as economic or social although the focus of the law may be divergent in different jurisdictions.<sup>72</sup> Some have suggested that a central justification for the

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68 Com Code art 1117.

69 *Supra* fn 47 555.

70 *Ibid* 775-776.

71 *Ibid* 556.

72 *Ibid* 558.

fresh-start policy is the promotion of moral values in society which stresses that human dignity<sup>73</sup> is of a higher value than the economic benefits or costs associated with achieving a desired economic result. Economic considerations of the fresh-start policy, on the other hand, focus on the efficient allocation and use of resources.<sup>74</sup>

The law does not appear to use the word ‘discharge’ as a technical term since it is used in different books of the Code.<sup>75</sup> By discharge a bankrupt is ‘released from the obligation of all his debts which were or might be proved in the proceedings, so that they are no longer a charge upon him, and so that he may thereafter engage in business and acquire property without its being liable for the satisfaction of such former debts’.<sup>76</sup> The discharge of a bankrupt after liquidation is recognised in article 1107 of the Code which provides for the release of the debtor upon approval of a lump sale of assets. It can be inferred from article 987/1/b of the Code that an application for discharge may be made to the court although the Code is silent on the conditions to be fulfilled and procedures to be followed. Obviously, insufficiency of assets results in the closure of the bankruptcy proceeding which enables each creditor to exercise his rights.<sup>77</sup> The debtor is restored to his full rights if the court establishes that there is no claim against the estate.<sup>78</sup> The privilege that a debtor enjoys is that he is not subject to any restriction after all creditors have been paid despite the fact that he is blameworthy.

It can be said that a debtor is released in case of the approval of a lump sale of assets and the absence of a claim against the estate. The latter is not discharge because of payment in full which leaves no outstanding claim against the debtor. Settlement of claims of creditors when a lump sale of assets is approved, is no guarantee that all the claims of creditors will be satisfied. The debtor is released from liability to pay the balance which could not be paid from the proceeds of the assets realised. This is, therefore, closer to a discharge. Otherwise, the law does not allow a fresh start once an individual finds himself in financial trouble. It is essential for the law to provide for the discharge for natural persons and set forth the conditions to be fulfilled before one can enjoy a fresh start.<sup>79</sup>

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73 Dignity-related objectives consider society’s commitment to the individual and the debtor’s commitment to society; see *supra* fn 47 569-570.

74 Economic objectives of discharge include providing an incentive to remain economically productive, minimising reliance on public support, monitoring the volitional and cognitive deficiencies of the individual, preserving the sanctity of contracts, encouraging efficient entrepreneurship and minimising the cost of credit and maximising its availability. See *supra* fn 47 567-568.

75 See art 162(3), 318(1)(d), 775(4), 776, 1093(a) and 1165(3) of the Code.

76 Black *Black’s Law Dictionary* (4 ed) 626.

77 Com Code art 1114.

78 Com Code art 1117.

79 This is also recommended by the team of fourteen experts. See *Position of the Business Community on the Revision of the Commercial Code of Ethiopia*, Private Sector Development Hub/Addis Ababa Chamber of Commerce and Sectoral Associations, (2009) 107

### 3 1 4 Protection and Treatment of Creditors

Traditionally bankruptcy is a creditor-centred proceeding which attempts to provide for an orderly settlement of claims of creditors against a debtor who is unable to pay his debts. Being a fundamental concern of bankruptcy law, creditor rights are the driving force behind the contents of a number of provisions of the Code. Both liquidation and rehabilitation of the enterprise involve creditors who take part in the proceeding through their committee in addition to their right to initiate the process and to prove their claims. Unlike the ordinary enforcement system, in bankruptcy creditors cannot act individually and enforce their claims separately. Rather, the adjudication brings all the claims of the creditors together to form the universality of creditors.<sup>80</sup> All unsecured creditors bring together their claims under the universality which will be a legal entity.<sup>81</sup> The mandatory collective nature of the proceeding is usually identified as one of its most important attributes.<sup>82</sup> A declaration of bankruptcy brings about the suspension of individual suits and the formation of the universality of creditors.

Even if it is said that the proceeding focuses on the protection of the interests of creditors, these interests may be competing. To avoid competition among creditors, the law impedes individual action and the judgment in bankruptcy heralds the beginning of a collective execution. One of the principles of a bankruptcy proceeding is to treat similarly situated creditors equally. The creditors who will be affected by the judicial process will be determined based on the policy stance taken by a legal system. Generally, creditors may be classified as ordinary, preferred and secured. the bankruptcy regime of a legal system usually affects unsecured creditors while those creditors who managed to secure their claims with some kind of guarantee over the property of the debtor are not affected.

There are significant disparities regarding the way in which secured rights are treated in bankruptcy proceedings. In some countries, bankruptcy has no effect on secured creditors while in others secured creditors are prevented from enforcing their rights in bankruptcy, either through compulsory grace periods or in some cases by moratoria placed on enforcement in the event of reorganisation proceedings.<sup>83</sup> In countries that favour the rescue of businesses in financial difficulty, the proceeding may affect secured creditors even though the bankruptcy law recognises the priority that secured creditors enjoy as regards their collaterals. Yet, the protection of security interests and the rehabilitation

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80 Com Code art 1026.

81 Com Code art 1025/2.

82 Blum *Bankruptcy and Debtor/Creditor* (2004) 98.

83 Even in such a case, it is maintained that it should be of limited specified duration, strike a proper balance between creditor protection and insolvency objectives, and provide for the possibility of orders being made on the application of affected creditors or other persons for relief from the stay. See *supra* fn 17 41-42.

of the business in distress are competing goals that are delicate to reconcile. Where the rights of secured creditors are impaired to promote a bankruptcy policy, the interests of these creditors in their collateral must be protected to avoid a loss or deterioration in the economic value of their interest.<sup>84</sup>

As the law now stands, bankruptcy exists mainly, if not exclusively, for the benefit of creditors as can be gathered from its various provisions. Being the main focus of the law, other policy decisions are made with a view to achieving this goal. A bankruptcy proceeding aims at collecting, preserving and conserving,<sup>85</sup> managing,<sup>86</sup> and realising<sup>87</sup> assets and distributing the proceeds<sup>88</sup> among creditors. Hence, the proceeding involves liquidation to repay creditors. Considering the above classification, it can be said that secured creditors are exempted from the effects as they are at liberty to exercise their security interests. The general trend is to keep them outside of the realm of bankruptcy except for the stay to which they may be subject during rehabilitation. Rehabilitation requires a balance to be struck between effective enforcement for secured creditors and effective protection for a rescue effort.<sup>89</sup> But, as can be gathered from article 1140 of the Code, scheme of arrangement, the only chance for rehabilitation before bankruptcy, does not involve secured creditors.

Secured creditors may, however, be directly affected if the law allows an automatic stay upon commencement of bankruptcy proceedings by which the enterprise will be in operation while the creditors and managers negotiate. An automatic stay allows time for the debtor to communicate with creditors before deciding whether the firm should be liquidated so as to avoid premature liquidation. Some countries may opt not to allow automatic stay even if they recognise reorganisation, thereby practically denying such enterprises the opportunity to file for reorganisation.<sup>90</sup> In Ethiopia we may consider the scheme of arrangement as the only possibility to rescue a going concern<sup>91</sup> which in

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84 *Supra* fn 17 41. See also UNCITRAL Legislative Guide on Insolvency law, (2005) P. 94

85 Com Code art 1004 ff.

86 Com Code art 1035 ff.

87 Com Code art 1103 ff.

88 Com Code art 1109-1110.

89 *Supra* fn 17 15.

90 Lee, Peng and Barney 'Bankruptcy Law and Entrepreneurship Development: A Real Option Perspective' *Academy of Management Review* 262 263-264.

91 Composition is a means of avoiding the effect of bankruptcy, as until the confirmation of the proposal by the court the enterprise ceases operation. See art 1081(3) which makes it clear that the proposal for composition suspends the winding-up of the enterprise.

any case does not hinder secured creditors from realising their collaterals.<sup>92</sup> Hence, secured creditors cannot be prevented from realising the assets temporarily although it is absolutely essential to rescue the business and keep the security interests intact.

The conclusion that Ethiopian law excludes secured creditors from the purview of the bankruptcy regime is now impugned. Recently, the Cassation Division of the Supreme Court ruled that secured creditors are not outside of the bankruptcy proceeding. In this case, the bank pleaded to the court to lift the injunction order it gave over a mortgage, so that it could foreclose it. The court of first instance rejected the application, while the appellate court reversed this ruling. Finally, it was settled by the Cassation Division of the Federal Supreme court, casting doubt whether secured creditors are not affected by a bankruptcy proceeding. This is a binding decision, leading to confusion as to whether the law, or this decision, should be used to come to this conclusion. As we have seen above, the law is vivid in this regard: secured creditors are outside of the purview of a bankruptcy proceeding. On the other hand, a binding decision establishes that they cannot foreclose or realize a collateral, and what they can benefit from is priority from the proceeds, making the exercise of the right contingent upon the insolvency proceeding.<sup>93</sup>

It may further be inquired whether a distinction can be made among those creditors whose claims are not secured by collateral. The bankruptcy laws of many countries recognise, in varying degrees, the priority of certain categories of unsecured debts, such as taxes and unpaid wages.<sup>94</sup> The position that the law takes in this regard is a reflection of the policy decision by which the priority of the state is manifested. Countries opt to prioritise some claims over others in the distribution scheme because their policies recognise important public interests, such as preserving the state's revenue base or ensuring employee security.<sup>95</sup>

The proceeds of a winding-up will be distributed, after the deduction of costs and expenses, sums applied for the support of the debtor or his family, and sums paid to preferred creditors. Thereafter the net proceeds of the winding-up is distributed amongst all the creditors.<sup>96</sup> This distribution scheme is criticised for failing to provide a concise list of the priority framework and a lack of clarity of what 'special privileges' are, and how they affect the claims of other secured and unsecured

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92 It can be inferred from art 1131(3), 1121, and 1140 of the Code that the proceeding involves only unsecured creditors. Cf art 1189 which provides that secured creditors are not affected by the process and outcome of a composition. It is submitted that encumbered assets should be included in bankrupt estate, thus limiting the enforceability of security interests by application of stay.

93 *Holland Car Pvt. Ltd. Co. V Zemen Bank S.Co.*, Cassation Division of the Federal Supreme Court, File No. 102061 decided on 13/02/2015.

94 *Supra* fn 18 44.

95 *Ibid.*

96 Com Code art 1110.

creditors.<sup>97</sup> Priority is one area of controversy, which causes a delay in the distribution of proceeds and is in some cases raised against secured creditors.<sup>98</sup> The lack of clarity in this regard causes disputes and delays which characterise the provisions of the Commercial Code. The Banking Business Proclamation<sup>99</sup> sets a good example and ameliorates some of the doubts by providing for an extended list of order of priorities. Accordingly, secured claims are paid first, followed by preferred creditors in the following order: receivers, new creditors (creditors who extended new credit to the bank after the appointment of the receiver), employees, depositors and tax authorities. All other creditors are paid from the residue.

### 3 2 Scope of Application of the Law

The law should clearly delimit its scope and identify the subjects to which it applies, which is 'a threshold policy decision that can have enormous economic implications because entities left outside the process will not be entitled to the benefits or exposed to the discipline of the system.'<sup>100</sup> This is one area of incongruence across jurisdictions, as some bankruptcy laws apply to all debtors, with certain specified exceptions, while other laws draw a distinction between, and provide different legal regimes for, natural and juristic persons. Factors that are grounds for diversity in laws and approaches include the activities that the debtor is engaged in, the level of indebtedness and the type of economic sector.<sup>101</sup> The laws of various countries follow a certain pattern in identifying or treating separately the subjects based on the classification adopted. For instance, English insolvency law contains two separate regimes of bankruptcy for natural persons and insolvency for juristic persons or corporate entities whereas other insolvency laws are divided along 'merchant' and 'non-merchant' lines.<sup>102</sup>

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97 USAID *Ethiopia Commercial Law & Institutional Reform and Trade Diagnostic* (2007) 53. The priority to be established as regards preferred creditors has become debatable. See Huaiyu 'An International Comparison of Insolvency Laws' (OECD 2006) 2, available at <http://www.oecd.org/daf/corporate-affairs/> accessed on 2014-08-12.

98 Banking Business Proc No 592/2008 art 45.

99 See, eg, *Abyssinia Bank SC v Abdu Ahmed et al* file no 40921, decided on 5 March 2009, regarding the issue whether employees' claims should be paid before the secured creditors' claims. Decisions of the Cassation Division of the Supreme Court Vol 8 (2010) 173.

100 *Supra* fn 18 28; see *supra* fn 51 42.

101 Some of these laws address the insolvency of 'merchants', which are defined with reference to engagement in economic activities as an ordinary occupation, or companies incorporated in accordance with commercial laws and other entities that regularly undertake economic activities. Some laws also include different procedures based on levels of indebtedness and a number of states have developed special insolvency regimes for different sectors of the economy, in particular the agricultural sector. See *supra* fn 58 42.

102 Merchants, including corporate entities and individual entrepreneurs, fall under one 'business law' insolvency regime, while non-merchants, such as consumers, fall under a separate regime. In any event, the focus on

The Code, which is still the main source of bankruptcy law, applies to natural and juristic persons alike. However, its application is limited to traders, commercial business organisations<sup>103</sup> and public enterprises.<sup>104</sup> A trader is a person who professionally, and for gain, carries on any of the activities listed in article 5 of the Code. Business organisations become commercial where their objects under the memorandum of association, or in fact, are to take part in any of the activities specified in article 5.<sup>105</sup> However, companies,<sup>106</sup> irrespective of the activities they may be engaged in, are deemed to be commercial by virtue of their form.

Since only traders and commercial business enterprises can be declared bankrupt under the Commercial Code of Ethiopia, the fulfilment of the conditions for bankruptcy is not sufficient, as the law only applies if the subject is a trader, a commercial business organisation or a public enterprise. They are singled out because they are engaged in business activities designated as such under article 5 of the Code. Hence, a business organisation or a business person is beyond the purview of the bankruptcy regime if the activity it/he/she is engaged in is not a trade activity as characterised by the law – even if the activity is commercial *par excellence*. With an exhaustive list, which entertains no exception, it might be imagined that some businesspersons are excluded – not to mention those engaged in economic activities.<sup>107</sup>

The borderline is permeable and sometimes it is stretched to those who are not traders by the strict application of the law. For instance, the law recognises that a deceased or a retired trader can be declared bankrupt.<sup>108</sup> Similarly, the application of the law is extended to a business organisation in liquidation and *de facto* business organisations.<sup>109</sup> Bankruptcy of the firm entails bankruptcy of partners who are jointly and severally liable, and any person who has carried out

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corporate' insolvency law varies according to the relevant economy. *Supra* fn 2 32.

103 Com Code art 979 and 1155.

104 Public Enterprise Proclamation No 25/1992 art 40. With the advent of the federal state structure, regional states may establish public enterprises that are not governed by this proclamation. It appears that state enterprises are outside of the bankruptcy system unless the governing law enacted by states contains a similar provision. Currently they appear to be excluded.

105 Com Code art 10/1.

106 Private limited companies and share companies are the two types of companies recognised in Ethiopia and they are deemed to be commercial because of their form. See Com Code art 10(2).

107 *Ibid.* In fact, in the case of public enterprises, no such classification exists, as they are made subject to the bankruptcy law incorporated in the commercial code as per article 40 of Public Enterprise Proclamation No. 25/1992.

108 Under art 979 and 980 of the Commercial Code, a trader may be declared bankrupt within one year from his death if suspension occurred before his death (art 980) while a retired trader may be declared bankrupt if the retirement occurred before his name was struck from the commercial register.

109 Com Code art 1155(3).

commercial operations on his own behalf, disposed of company funds as though they were his own, and concealed his activities under the cover of such company,<sup>110</sup> without expecting them to be traders.

With the goal stated above, the current arrangement leaves some enterprises outside the latitude of the bankruptcy regime. Subsequent pieces of legislation regulating commerce attempted to broaden the definition to cover those excluded by the Code. However, such an effort does not fundamentally tackle the problem as presented here because of the piecemeal approach followed. For instance, commercial registration and business licensing proclamation no 686/2010 defines a business person 'as any person who professionally and for gain carries on any of the activities specified under article 5 of the Commercial Code, or who dispenses services, or who carries on those commercial activities designated as such by law'.<sup>111</sup> It is obvious that this definition admits that there are commercial activities beyond the list that we have under article 5. It is, therefore, an attempt to catch those excluded. The question that follows is whether it is tenable to expose those operating in the same field to different disciplinary mechanisms.

It is not necessarily correct to assume that the scope of a bankruptcy regime is limited to those who are engaged in commercial activities. During the drafting of the Code it was suggested that the rules governing petty bankruptcy can be extended to non-traders. This was rejected by the drafter on the ground that it 'presented more difficulties than advantages'.<sup>112</sup> It may be asked whether a paradigm shift is called for from the current business bankruptcy to include consumer bankruptcy. It is maintained that society could adopt a largely procedural bankruptcy system that provides the posited advantages of liquidation and still offers consumers the same debt relief that they would receive under non-bankruptcy law.<sup>113</sup> However, such expansion is justified by the availability of credit to consumers which is literally non-existent in Ethiopia. Bankruptcy would not be possible without the existence of credit since insolvency is, by definition, the inability to pay one's debts.<sup>114</sup>

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110 Com Code art 1163.

111 Commercial Registration and Business Licensing Proc No 686/2010, Federal Negarit Gazeta, 16th year, no 42 (2010) art 2/2.

112 *Supra* fn 26 109. Mr Roberts inquired whether the simplified procedures can be extended to non-traders.

113 Hynes 'Why (Consumer) Bankruptcy?' 2004 *College of William & Mary Law School* 123, available at <http://scholarship.law.wm.edu/facpubs>, accessed on 2014-08-12.

114 *Supra* fn 2 30. It is proposed that the application of the Commercial Code be restricted to traders and include in the Civil procedure Code provisions for insolvency of non-traders. See Position of the Business Community on the Revision of the Commercial Code of Ethiopia, Private Sector Development Hub/Addis Ababa Chamber of Commerce and Sectoral Associations, (2009) 81.

## 4 Proceedings and their Commencement

### 4.1 Types of Proceedings

A legal system designs a system of addressing the situation of entities which are in financial difficulty. This includes the recognition of different alternatives to deal with the problem. The proceeding to be initiated and the options available are not the same in all jurisdictions.<sup>115</sup> Ethiopian law limits itself to liquidation and the scheme of arrangement as ways out when there is, or will be, a suspension of payment. Other legal systems have additional alternatives, such as reorganisation and negotiations with creditors entered into by the debtor on a voluntary basis and conducted essentially outside the insolvency law.<sup>116</sup>

A bankruptcy proceeding can be unitary or multiple, depending on the approach adopted by a country. Ethiopian law subscribes to the dual proceedings approach and the action to preserve or liquidate is initiated separately and independently. The term 'bankruptcy' does not refer to the entire situation or status arising from the inability to pay debts when they become due. Basically, two proceedings can be identified, namely bankruptcy (with its variant of petty bankruptcy) and a scheme of arrangement. The former merely refers to the liquidation process. In the case of a unitary proceeding, a single action determines whether the business should be preserved or liquidated, while in a multiple proceeding the law allows separate proceedings, which may lead to liquidation or reorganisation depending on the relief sought by the applicant. Ethiopian law does not provide for a proceeding which can have different outcomes based on the findings of the investigation by the court. Hence, there can be an application for liquidation by the debtor or creditors or an application for a scheme of arrangement lodged by the debtor.

Countries which opt for the unitary approach do so because of the difficulties in determining from the very outset whether the debtor should be liquidated rather than reorganised.<sup>117</sup> It is maintained that the determination of whether the business of the debtor is viable should determine, at least in theory, which proceedings will be sought<sup>118</sup> rather than leaving the choice to the applicant. This approach does not allow a position to be taken on the financial situation of the entity, which will be

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115 A comparative overview of the proceedings of member states of the European Commission aimed at rescuing entities which are in financial difficulties revealed that different types of proceedings are adopted, including pre-insolvency proceedings (confidential and public), debtor in possession proceedings and full insolvency proceedings: Bariatti and Van Galen 'Study on a New Approach to Business Failure and Insolvency – Comparative Legal Analysis of the Member States' Relevant Provisions and Practices' (European Commission 2014) 20.

116 *Supra* fn 51 21.

117 *Ibid.*

118 *Ibid.*

determined after the observation period and the choice whether to liquidate or reorganise will be made based on the findings of the assessment made during the observation period.<sup>119</sup> This approach has advantages and disadvantages. Its advantages include procedural simplicity, flexibility, cost efficiency and encouraging debtors to have early recourse to the proceedings. Delay is the main disadvantage because of the additional observation period.<sup>120</sup>

A bankruptcy proceeding under Ethiopian law is one by which the debtor, a creditor, the court or the public prosecutor initiates the liquidation of the assets of the debtor, with a view to paying out creditors. However, after declaration of bankruptcy the debtor has one more opportunity to obtain rehabilitation through a composition. In other words, a proceeding initiated to liquidate the business may be reversed by a proposal by the bankrupt to settle it by an agreement with creditors,<sup>121</sup> subject to confirmation by the court.<sup>122</sup> Any person who has been declared bankrupt may submit a proposal of composition to the commissioner.<sup>123</sup> Confirmation of a composition suspends the bankruptcy proceeding.<sup>124</sup> In the absence of a composition, compulsory winding up<sup>125</sup> ensues, which is a situation where the property of the debtor is sold and the proceeds used to satisfy the claims of creditors.

The summary procedure is a liquidation proceeding, which reduces the steps to be followed to realise the bankrupt estate. It becomes operative when the assets in the bankruptcy do not exceed one thousand Ethiopian Birr,<sup>126</sup> or where the dividend to be distributed cannot exceed ten per cent.<sup>127</sup> In this procedure, seals shall not be fixed, the appointment of a creditors' committee is optional, the commissioner decides on debts in dispute unless an application is made to the court, the commissioner may authorise any negotiations, there shall be one distribution only, and differences relating to the trustee's accounts and his remuneration shall be decided by the commissioner.<sup>128</sup>

A scheme of arrangement is similar to a composition by which a debtor petitions to the court in order to reach a settlement with the creditors. However, there are three fundamental differences, namely, the time of the application, the amount to be offered and the majority required for approval. The debtor has to initiate the process to save the business from the ordeal of bankruptcy if he has or is about to suspend payment. A scheme of arrangement, together with a composition, are viewed as ways by which a debtor's situation may be alleviated and the

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119 *Ibid.*

120 *Supra* fn 51 21.

121 Com Code art 1084.

122 Com Code art 1086.

123 Com Code art 1081.

124 Com Code art 1090.

125 Com Code art 1101.

126 This is less than 50 USD.

127 Com Code art 1166.

128 Com Code art 1167.

enterprise refloated.<sup>129</sup> It may be asked whether rescuing the enterprise is the main concern of these mechanisms of dealing with the affairs of a bankrupt enterprise. It is admitted that here also the importance attached to the satisfaction of creditors is paramount.<sup>130</sup> Apart from questioning the focus of the law on liquidation, it is imperative to inquire whether the law should broaden the options available to stakeholders to resolve the financial strain of an enterprise.

## 4 2 Commencement Standard

One of the most important elements of a bankruptcy proceeding is the commencement of the process. Of the two widely employed commencement standards, the liquidity and balance sheet tests, Ethiopian law subscribes to the former standard. It still is the preferred<sup>131</sup> test for insolvency because the fact that the assets of the debtor exceed his liabilities is irrelevant as there is no reason why creditors should be expected to wait while the debtor realises assets. The legal ground for bankruptcy adjudication is that the debtor has ceased to pay his debts when they became due.<sup>132</sup> Accordingly, under the Code, which subscribes to the liquidity test, any trader who suspends payment<sup>133</sup> may be declared bankrupt by a court of law. In other words, the factual situation that must exist for declaration of bankruptcy is the suspension of payment, which stems from ‘any fact, act or document showing that the debtor is no longer able to meet the commitments related to his commercial activities’.<sup>134</sup> The drafter of the Code believed that listing acts which constitute acts of bankruptcy does not have practical significance because of the broadness of the term ‘suspension of payment’ which incorporates acts of bankruptcy.<sup>135</sup> It may be asked whether the standard used by the Code can help to determine whether the factual situation is present so as to declare a debtor bankrupt.

The clarification in this regard is essential in order to provide guidelines to a court regarding predictability. Further, in order to ensure that the proceeding is not abused by a creditor, it is necessary to ascertain that it is more than a two-party dispute.<sup>136</sup> For instance, does

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129 *Supra* fn 52 59.

130 *Ibid.*

131 It is submitted that the balance sheet approach can be an inaccurate measure of insolvency because domestic accounting standards and valuation techniques may give rise to distorted values that do not reflect fair market values. If domestic practices and rules do not follow international accounting principles and are not applied uniformly by qualified valuation experts, the balance sheet test as the sole measure of insolvency may invite arbitrariness, uncertainty and even corruption. See *supra* fn 18 29.

132 Kornberg *supra* fn 43 6.

133 Com Code art 969.

134 Com Code art 971.

135 *Supra* fn 26 107.

136 *Supra* fn 18 29.

it suffice if one creditor can show that he demanded payment?<sup>137</sup> Should action be instituted, judgment be secured and execution be initiated? Is it enough to adduce a protest issued by a bank to evidence the dishonouring of a cheque because of the insufficiency of funds? Judges are left to decide which facts, acts or documents prove that one has suspended payment and should therefore be declared bankrupt. No legislative guideline or direction is given, at least by way of illustration. The application of the law is therefore in the hands of the court, which has the latitude to determine whether one act or a series of acts is necessary for a declaration of bankruptcy.<sup>138</sup>

Once it is established that the term ‘suspension of payment’ is broad enough to include all acts of bankruptcy, the next issue is how the facts which constitute suspension of payment can be proven. When the application is filed by the debtor, his task can be easier as the law provides that it must be accompanied by the balance sheet of the firm, the profit and loss account and a list of commercial credits and debts, with the names and addresses of the creditors and debtors.<sup>139</sup> Creditors may not have access to these documents and even not all debtors do have the legal obligation to keep account or they may fail to keep financial records and it is proper to inquire as to what evidence they can produce to initiate the process.

The Code requires that a fact, act or document showing that the debtor is no longer able to meet the commitments related to his commercial activities be invoked to establish the suspension of payment.<sup>140</sup> The evidence to be produced can relate to an act, a fact or a document augmenting the option to prove suspension of payment. However, it is not a mere default or a dispute between a debtor and a creditor. The failure to pay one claim does not suffice, for the law extends the requirement to other commitments, so that it becomes clear that the debtor is indebted to such an extent that it does not have the liquidity required to perform its obligations. Further, the default must be related to the commercial activity, since it is the suspension of commercial debts that may give rise to bankruptcy. The cumulative requirements are that debtor must be a trader and that the default must be in respect of a commercial debt. If the debt is not commercial, even if it is not paid, it cannot initiate the proceeding. But what if the debt is commercial but the debtor is not a trader? This situation has arisen with the introduction of

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137 A debtor’s failure to pay a debt within a specified period after a written demand for payment has been made is a reasonably convenient and objective test. See *supra* fn 18 30.

138 *Supra* fn 26 107.

139 Com Code art 973(1). In fact, the law anticipated that these documents may not be present and in such case the applicant has to state the reason why they cannot be produced. See art 973(2).

140 Com Code art 971. It is argued that the standard in this provision is too broad calling for limiting its reach. See *Position of the Business Community on the Revision of the Commercial Code of Ethiopia*, Private Sector Development Hub/Addis Ababa Chamber of Commerce and Sectoral Associations, (2009) 84

income-generating activities for charities and societies.<sup>141</sup> The two requirements are cumulative and must be present to establish suspension of payment as required by the law.

An attempt to provide some insight regarding the commencement standard clashes with the new standard introduced by the banking proclamation. The insolvency of banks does not merely stem from the suspension of payment, but from an insufficiency of assets. As discussed below, the law deviated from the commencement standard adopted in the Commercial Code which is still applicable to non-bank enterprises including other financial institutions. The question is whether it is a departure with a view to catering for the idiosyncrasies of banks. The answer is that banks are distinctive in that the insolvency concept under general law proves somewhat dysfunctional for them. First, a bank's failure to effect payments when they fall due is not necessarily proof of bankruptcy and may be due to a temporary liquidity problem. Second, unlike other enterprises, banks can pay creditors even when experiencing financial hitches because of the continuous cash flow from depositors. Third, close monitoring is imperative for early intervention by the regulatory organ, which should be prompted by other grounds such as growing financial losses, management failures and shortcomings in internal systems and controls.<sup>142</sup> For the above reasons, prudential regulation demands that the standard of commencement for banks should be different from the general standard that is subscribed to by the Banking Business Proclamation.

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141 Charities and Societies Proclamation No 621/2009, Federal Negarit Gazeta 15th Year, No 25, Addis Ababa, 13 February 2009, art 103.

142 Hüpkes 'Insolvency – Why a Special Regime for Banks?' 2003(3) *Current Developments in Monetary and Financial Law* 9-10, available at <http://www.imf.org/external/np/leg/sem/2002/cdmfl/eng/hupkes.pdf> accessed on 2013-03-28.